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Occupational Pension Plans in Germany

Background to Pension Provision in Germany

By Norman Dreger

Germany's pension system is quite different as compared with the pension systems seen in much of the rest of the world. The expectation held by some outsiders that "all things will work basically the same way they do at home" will often cause people to reach false conclusions regarding the system. A basic understanding of some of the key similarities and differences between Germany's pension system and those seen in other countries is a must for those who are working in the German system for the first time. While Germany is facing the same challenges as the rest of the developed world with regards to providing pensions to an ageing population, it is interesting to observe how in some cases quite different approaches have been found with regards to pension provision.

Germany has a long and proud history of both occupational pension systems and social security programs. The concept of a broad-based state-provided retirement program was established by the first chancellor of unified Germany, Otto von Bismarck, in 1889. The retirement age established by Bismarck—age 65—became a standard retirement age all over the world for over a century.

In addition to the long history of pension provision, it is important to understand that Germany today still offers comprehensive social security pension benefits to virtually all residents. Benefits after a full career are typically on the order of 40 percent to 45 percent of final earnings up to a ceiling (€66,000 in 2011). Thus, while the average German will receive a substantial pension from social security, this will in all likelihood be insufficient for someone to be able to maintain his standard of living in retirement. As a result, both company pension plans and personal savings play a key role in an individual's retirement planning.

Like many similar programs in the developed world, German social security is coming under increased pressure due to the ageing population. The government has introduced a number of measures to curb costs, including raising the retirement age, tighter restrictions for certain benefits, and the introduction of a demographic factor that serves to dampen pension increases as the ratio of pensioners to active workers increases. As such, the need for both occupational pension plans and personal savings is becoming increasingly important, as the German social security system comes under further pressure. The focus of this article is on occupational pension arrangements, in particular on the design and financing options typically found in Germany.

FINANCING VEHICLES FOR THE PROVISION OF OCCUPATIONAL PENSION BENEFITS

In Germany, there are five different vehicles that can be used to provide company pension benefits. These can be broadly divided up into one "internal" approach and four "external" approaches, under which payments are made to some type of external vehicle, such as an insurance company, in order to pre-fund the pension benefits.

Each of these five financing vehicles is subject to different regulations and tax treatments, and each one has different restrictions on pension plan design.

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The five German financing vehicles for the provision of occupational pension benefits are as follows:

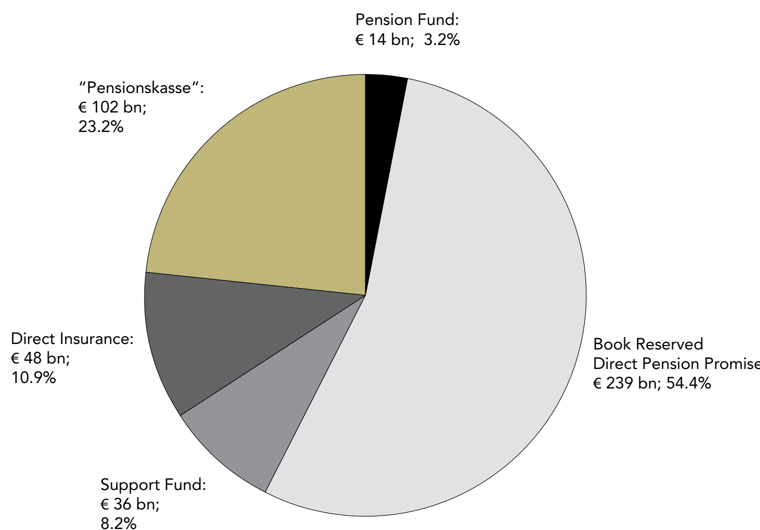
Internal approach:

- *Direktzusage* (direct benefit promises).

External approaches:

- *Direktversicherung* (direct insurance)
- *Pensionskassen* (a type of external "pension fund" that is regulated like an insurance company)
- *Pensionsfonds* (an asset-backed financing vehicle, subject to regulation by the German financial services authority BaFin)
- *Unterstützungskasse* (Support Fund—a traditional external vehicle for providing pension benefits).

Year 2007: € 439 Billion



Source: aba 2009

Internal financing using book reserves is by volume the most common approach for providing occupational pension benefits in Germany, as highlighted in the chart below:

DEFINED BENEFIT (DB) VERSUS DEFINED CONTRIBUTION (DC)

The concept of DB versus DC pension plans is well-defined in the Anglo-Saxon world. DB pension plans have a benefit formula that defines what benefits are payable at retirement. DC plans, on the other hand, simply set out contributions that the company is required to make at regular intervals into a "pensions savings vehicle." For DC plans, a company's main responsibility is, broadly speaking, restricted to making the contributions as required by the terms of the plan documents. For DB plans, accrual accounting is used; for DC plans, contributions are expensed when paid, and no liabilities are recorded for these arrangements.

Unfortunately, the classification of a pension plan as being "DB" or "DC" is not straightforward in Germany.

Under German pension law, all pensions granted have to be expressed (at least implicitly) as a benefit, and all benefits are subject to minimum guarantees. Even when the risks associated with benefits granted have been transferred to an insurer, the sponsoring company still has the ultimate legal responsibility to ensure that benefits promised by the company are provided as a last resort should the provider fail to meet the obligation. The fact that these residual risks to the company will always be present means that from a theoretical standpoint, every pension plan in Germany is technically a DB plan.

> Germany's pension system is quite different as compared with the pension systems seen in much of the rest of the world.

This being said, there are certainly plan designs in Germany that could be considered DC plans from both an economic and an international accounting standards (IAS 19, U.S. GAAP) perspective. In particular, for pension promises that transfer all economic risks and opportunities to an external provider (e.g., an insurance company), DC accounting under IAS 19 and U.S. GAAP is usually appropriate. Risk-reduced "DC-oriented" plan designs are also increasingly popular in Germany. These plans have many characteristics of a DC plan, while still requiring DB treatment under IAS 19 and U.S. GAAP.

UNFUNDED PLANS AND BOOK RESERVE FINANCING

As highlighted earlier, the most common approach for providing occupational retirement benefits is internally by means of direct benefit promises. For pensions provided in this manner, a company establishes tax-deductible book reserves in its accounts for the benefits that have accrued to date. In the case of internal financing in Germany, there is no requirement to set aside assets to pre-fund benefits.

Direct benefit promises are protected against company insolvency through mandatory pension insolvency insurance, provided by an organization known as the PSVaG, up to a high annual benefit amount (around €90,000 per year). All companies in Germany and Luxembourg that offer occupational pension benefits in this manner are required to pay premiums to the PSVaG. The same premium rate is required of all companies that have granted pension benefits to their employees, and will depend on the actual number of insolvencies in a given year and their severity (e.g., the level of pensions that have to be assumed by the PSVaG in a given year).

This system, consisting of unfunded pension plans combined with compulsory mandatory pension insolvency insurance to provide benefit security, is clearly a radically different approach to pension provision as compared with the pre-funding approach that is typically seen in the Anglo-Saxon world.

BENEFIT SECURITY FOR BOOK-RESERVED PENSION PLANS

Some people have difficulty understanding the concept of the book-reserved plan. People accustomed to determining the relative health of a pension plan by looking at the plan's funded ratio suffer a bit of a shock when they hear that many German pension plans are completely unfunded.

Although often unfunded, benefits for German plan members are arguably as secure as benefits provided under a pre-funding system using segregated plan assets. Rather than investing in the stocks and bonds of other companies in order to secure the pension entitlements granted to employees, companies can use the funds to invest in their own business, allowing them to grow. The PSVaG provides extensive benefit security to plan participants, likely to a higher degree than the security provided by segregated pension assets alone. As long as there is not a total collapse of the German economy, there will likely be sufficient companies around to cover the benefits provided by insolvent companies through the PSVaG. In a true economic collapse scenario, it is unlikely that a funded

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system would fare much better; the assets that the pension funds would be holding to secure benefits would after all be invested in financial instruments, which may well lose much or all of their value in such a crisis situation.

FUNDING OF BOOK-RESERVED PENSION OBLIGATIONS

While there is no requirement for companies in Germany to pre-fund pension obligations granted by means of a direct benefits promise, some companies in Germany choose to do so on a voluntary basis.

The arguments for and against funding of pension benefits are somewhat different in Germany than those seen in the rest of the world. In most cases, key drivers for funding pension obligations are:

1. Benefit security reasons
2. Tax reasons
3. Liquidity and cash flow reasons
4. Accounting reasons.

Some of these reasons for funding apply to Germany, while others do not:

- Given that German pension benefits are protected in the event of company insolvency up to very high limits by the PSVaG, providing benefit security is not a strong reason for funding for the vast majority of pension benefits granted in Germany. An exception to this is very high pension amounts, which are not covered by the PSVaG.

- In many countries, companies receive a tax deduction for contributions made into a pension plan. Generally there are no additional tax benefits when pension benefits of this nature are pre-funded in Germany.

- A company in Germany may consider external funding for cash flow reasons. Take for instance a company that currently has a high active payroll combined with a low pensioner population. As the workforce ages and the company matures, the ratio between active employees and retirees may change dramatically, and if money has not been put aside to pre-fund the pension benefits, the company may find itself in a position where it has to make monthly pension payments out of general funds that are higher than they feel they are able to afford.

- If a company has segregated plan assets backing its pension obligations, this would allow it to show a reduced pension liability in its company accounts, as a liability net of plan assets would be disclosed. As things currently stand, the pension expense will also typically be positively impacted through pension funding, as the expected return on assets assumption will reduce the pension expense.

Thus, of the four funding rationales discussed above, only the latter two, namely cash flow and accounting implications, will apply for most benefits in Germany.

Companies who are interested in pre-funding their direct benefit promises have a number of different options open to them, including the use of insurance or ring-fenced trust structures referred to as “Contractual Trust Agreements” or CTAs.

TRENDS IN GERMAN PLAN DESIGN

Historically, “traditional” DB plan designs were the most common in Germany. It was common to offer a percentage of salary or a fixed amount for each year of service. As in

much of the rest of the developed world, such plan designs have now fallen out of favor. Much more common now are plan designs that use a risk-reduced approach. The following are some of the approaches being considered by companies in Germany today:

1. Using an insured arrangement, where defined contributions are paid to an insurance company each year. DC plan accounting is often possible for such arrangements under international accounting standards and U.S. GAAP.

2. Establishing a book-reserved pension plan with a "cash balance" plan design. The company promises notional contribution amounts to its employees each year, which are then either converted into pension slices at retirement, based on an age-based conversion table, or are collected with interest until retirement, and then converted into a lump-sum or pension amount. While such an arrangement would certainly be risk-reduced from an employer's perspective when compared with a classic final average DB plan design, such an arrangement would still require defined benefit accounting be used under international accounting standards or U.S. GAAP.

3. Granting an asset-backed benefit promise, which provides benefits equal to the contributions made plus the actual return on contributions, subject to a minimum guarantee.

SUMMARY

Although the issues associated with occupational pension provision are the same in Germany as in other developed Western nations, the solutions and vehicles used to provide pension income in retirement are somewhat different. A basic understanding of the similarities and differences in the German approach allows people new to German pension issues to navigate the system more confidently. □

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