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Pension Reform in Germany: Reform Discussions and Areas for Improvement

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It is widely acknowledged that structural reforms to the German pension systems are urgently required. Given demographic developments and the aging society, it is clear that current approaches will not be sustainable in the long term. Creative solutions must be found in order to increase coverage in the general population and to prevent old-age poverty from becoming a widespread phenomenon. Various stakeholders have joined the discussion; possible solutions including the German "social-partner model" and the "Germany Pension" *(Deutschlandrente)* are under review. Unfortunately, it appears that the insurance industry, employer representatives, employee representatives and the tax authorities all have different views on how pensions in Germany should be reformed. As a result, Germany risks facing an ineffective compromise as a solution. This article presents a number of approaches used in other countries to deal with the retirement challenges of tomorrow—in particular the use of defined contribution pension plans—and examines their applicability to the German market.

BACKGROUND/STATUS QUO

Germany is aging: a German woman today has on average only 1.4 children in her lifetime, roughly half as many as were born to each woman in the 1960s. The large wave of post-war baby-boomers is marching towards retirement and they are being replaced by too few children and immigrants to close the gap.

The German social security system, as it currently stands, cannot support the impending demographic shifts that will occur in Germany in the coming years. It is financed using a pay-as-you-go approach; contributions made by the working population are used to pay benefits for current pensioners. While a pay-as-you-go system can work well if the population is growing, in a society where the population in retirement is rapidly increasing, and the population that is still working is decreasing, the system is bound to come under strain. At the very least, such an approach could be considered a breach of the intergenerational contract as the younger working population will be required to pay for a benefit level that they are unlikely to receive themselves.

The current working population not only has to worry about their benefits under social security, benefits under the second retirement pillar, company pensions, are also under pressure. Many companies that have historically offered generous pension plans to their employees have since cut benefit levels dramatically or closed the plans altogether. This leads to a perfect storm for today's workers: they have to pay for social security benefits for current pensioners without the guarantee of receiving comparable benefits themselves and they also expect to receive significantly lower company pension benefits as compared to the previous generation.

PROPERTIES OF AN "IDEAL RETIREMENT SYSTEM" AND A COMPARISON OF THE GERMAN RETIREMENT SYSTEMS WITH THESE CHARACTERISTICS

All developed western nations are struggling with the same issues: low economic growth, low birth rates, societies that are growing older and pension systems that are in many cases not robust enough to deal with the upcoming economic and demographic challenges. So, how should modern retirement systems be structured to best deal with these challenges?

Mercer, together with the CFA-Institute, prepared the 2015 study, "Ideal Retirement Systems." The key purpose of this study was to analyse the characteristics of effective retirement systems and to identify best practices.

Characteristics of an ideal retirement system were identified and included the following:

1. High coverage within the private pension system
2. Mandatory contributions of at least 8 percent of earnings
3. 65 percent to 80 percent target net replacement rate for average earners
4. Funded assets for the future of >100 percent of the country's GDP
5. A basic pension of at least 25 percent of average earnings

Unfortunately, the retirement income systems in Germany demonstrate major deficiencies in all of these areas:

1. The social security program is not sufficient to maintain a pre-retirement standard of living on its own, and only roughly every second German has access to a company pension plan. Although the majority of employees working for Germany's largest companies still receive corporate pension benefits, many of the employees working for small and medium-sized companies do not have access to a company paid pension plan.

2. Retirement contributions paid on behalf of an individual are in most cases significantly lower than the recommended minimum level of 8 percent of earnings. The social security program itself does not collect "contributions" that are used to finance an individual's pension entitlements; under the pay-as-you-go system, these amounts are simply used to pay the

current pensions in payment. This is very different from contributions being made to a funded pension plan as the current "contributions" only secure pension entitlements for the individual by means of the intergenerational contract, which based on the structure of the social security program, the low birth rates and increased life expectancy will almost certainly break down if fundamental changes are not made. For the portion of the population that does have access to a company paid pension plan, individuals usually receive contributions that are significantly lower than 8 percent of earnings.

3. An average earner with a full career behind them can currently expect a gross pension from the German social security program of approximately 40 percent of their final salary. The net (after tax) pension received will be somewhat higher, but only people who have either generous company pension benefits or who have saved privately at a significant rate, will reach a net replacement rate between 65 percent and 80 percent of final salary.

4. Each year since 2009, Mercer and the Australian Centre for Financial Studies (ACFS) have jointly conducted a research project with name "Melbourne Mercer Global Pension Index (MMGPI)." The objective of this research is to compare, contrast and evaluate different pension systems in major countries around the world. One aspect that is examined is to what extent assets have been set aside in order to pre-fund future pension obligations. According to the 2015 Global Pension Index, there were pension assets in Germany of less than 20 percent of GDP. The lack of pre-funding in the German social security system, which is the main source of retirement income for the majority of pensioners in Germany, presents a major issue here.

5. Germany has no "minimum pension" for low earners. According to the OECD-Study "Pensions at a Glance 2015," Germany has the lowest net replacement rate for low earners in all of Western Europe.

Unfortunately, one must come to the conclusion that the German retirement systems do not come close to fulfilling the requirements of an ideal retirement system. However, it does at least seem to have been accepted that changes do need to occur.

LESSONS FROM ABROAD: DEFINED CONTRIBUTION (DC) PENSION ENTITLEMENTS

Defined contribution plans have a number of advantages to companies when compared with defined benefit pension plans. Costs associated with this arrangement are simply the contributions, the company does not need to build up liabilities in its accounts with respect to the benefits earned. If managed properly, there are essentially no material risks (or opportunities) that remain with the company. This stands in stark contrast to defined benefit plans, for which a company is required to show liabilities in its accounts, and for which the associated costs and liabilities can be extremely volatile. As a result, many multinational companies

pursue the strategy of exclusively granting their employees defined contribution pension benefits, where possible.

Whether one looks to Australia, Canada, the Netherlands, Scandinavia, the U.S., the U.K., Asia, Eastern-Europe or Latin America, in most cases, defined contribution plans have become the vehicles of choice for providing company pension benefits to employees. Under all of the world's developed economies, there is only one country that stands out where this is not the case: Germany.

Germany has a very complicated set of pension laws. For instance, there are five different pension financing vehicles that can be used to provide company pension benefits. They all offer various plan design options, constraints and have different tax treatments. There are also a number of additional vehicles in the area of private pensions, such as *"Riester"* and *"Rürup"* products. Given this diverse landscape, it seems all the more astounding that tax advantaged "pure" defined contribution plans do not exist in Germany.

> Given demographic developments and the aging society, it is clear that current approaches will not be sustainable in the long term.

Is Germany really so different than the rest of the developed world? And why has Germany, unlike all other developed countries, decided to reject defined contribution pension plans as a viable alternative to providing retirement income?

The reservations that many Germans feel with regards to the pre-funding of retirement systems in general, and with regards to defined contribution pension plans please replace by: in particular, may be in part due to a general mistrust in the capital markets. The collective memory of periods of massive inflation during the great depression, as well as two world wars and the expropriation, loss of territory and economic collapse that followed, has likely left greater scars in the German psyche than many people may expect. Investments in the stock markets are still considered by many Germans to be fundamentally "speculative." But now, more than 70 years since the end of the World War II, is it not time for the German population to start seeing the capital markets as an opportunity rather than just as a source of risk?

A number of attempts have already been made to implement defined contribution pension plans in Germany, unfortunately without a great deal of success. The implementation of the "Pensionsfonds" vehicle in 2002 was intended to allow pension plan designs that were similar to defined contribution plans. However, benefits provided by means of a "Pensionsfonds" must be defined and the investment returns are subject to minimum guarantees, resulting in risks that can only be eliminated by using relatively expensive insurance options. The private pension products that were implemented, in particular the *"Riester"* and *"Rürup"* products, were also not successful.

The pension reform discussion that is underway provides Germany with the opportunity to set things right. A system of individual DC retirement accounts, with assets invested in the capital markets may finally be implemented.

These individual retirement accounts could also improve the portability of pension benefits in Germany. Currently there are no practical solutions that allow an employee to consolidate various pension entitlements that they may have received from different employers. Many pensioners receive their retirement benefits from a number of different sources leading to additional administrative burden for both the pensioners and the former employers. In a model with individual pension accounts, a transfer value could be calculated on termination of employment which is then paid into the individual's retirement account on a tax-sheltered basis. In this case, the former employer would no longer have a deferred vested pension entitlement to administer and the pensioner would ultimately receive their pension benefits from one source.

CONCLUSIONS

Demographic developments and aging societies create massive challenges for the retirement income systems in many developed countries. Although retirement systems can vary substantially from country to country, robust retirement systems do share common traits, such as a high degree of coverage in the population and a significant element of pre-funding. A broad-based discussion about reengineering the existing retirement income systems is underway in Germany. As part of this discussion, Germany would be well advised to seriously examine possible solutions for its demographic challenges which have effectively been implemented in other countries—in particular, the use of defined contribution pension plans. ■

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