

INPRS

INTERNATIONAL NETWORK OF PENSIONS REGULATORS AND SUPERVISORS

In cooperation with

Organisation for Economic Co-operation and Development



Organisation de Coopération et de Développement Économiques
Under the aegis of the Center for Co-operation with Non-Members

and the Partners for Financial Stability Program

EAST • WEST
MANAGEMENT
INSTITUTE



Room Document N°5, Session 1
PENSION REFORM AND LIFE INSURANCE IN GERMANY

By Volker Henke

**REGIONAL MEETING FOR THE EASTERN AND
CENTRAL EUROPEAN COUNTRIES**

Hosted by
The Government of Estonia

Tallinn, Estonia
7-8 February 2002
Sakala Keskus
Rävala pst. 12, 10143 Tallinn

Ladies and gentlemen,

I would like to thank you very warmly for giving me the opportunity to report briefly on the pension reform and life insurance in Germany.

To do so, I asked myself the following two questions which I would like to answer now:

1. *What is the socio-political context, what is the significance of life insurance in Germany and how is it supervised?*

2. *What are the developments, what are the key-elements of the new reform of the pension system in Germany?*

Please allow me the remark that my comments reflect my personal assessment and do not constitute any official description of the attitude of GDV.

On my first question: What is the social and socio-political context, what is the significance of life insurance within this context and how is supervision carried out?

Old-age provision, which in Germany includes life insurance, rests basically upon three pillars:

- statutory pension insurance,
- occupational retirement provision,
- private provision.

Statutory pension insurance has been the foundation of old-age provision in Germany since 1889. Pensions are paid on a pay-as-you-go basis, i.e. from current receipts. The current contribution rate for statutory pension insurance is about 20 % of income, up to a maximum of approximately 4.500.00 € per

month. Half of the contributions is paid by the employer, the other half by the employee. In addition, there are subsidies for statutory pension insurance paid from the state budget, which currently represent approximately one third of benefits. The so-called "standard pension" drawn after 45 years of insurance and average income will then be approximately 70% of the last net income; 1999 the standard pension was approximately 1.120.00 €.

This system has worked well during many decades, but is getting more and more under pressure. The reasons for this are **demographic developments**. Today we have a ratio between active and retired people of 2:1; in 2030 it will be 1:1. In fact, there are more and more old people with pension rights which have to be financed by less and less young contributors; there are more and more people who are unemployed for a long time and therefore pay only very small contributions for pension insurance and there are less and less citizens in Germany who pay contributions during 45 years at all.

Also the **occupational retirement provision** in Germany has got under pressure over the last few years as well since more and more state regulations have been introduced in this respect which – for instance, for tax reasons – have made the granting of pension commitments for staff members less and less attractive for companies.

These developments have direct and significant effects on life insurance.

Life insurance is continuously growing in importance:

Currently, the benefits paid by private life insurance companies represent approximately 28 % of the payments of statutory pension insurance institutions. This share will increase even more in the next few years. And nearly 50% of the formation of monetary wealth of private households is now done through insurance.

The number of existing life insurance contracts was approximately 88 million at year-end 2000. More than 55 % of households has one or more life insurances. Last year, benefits paid out to policyholders and surviving dependants totalled approximately 55 billion . Investments of German life insurers amounted to more than 500 billion in 2001. Thus, life insurance provides a high volume of funds for developing the capital market which are used for investments by both business and the state. That is why the insurance industry is the leading "institutional investor".

The **supervision of life insurance** companies takes place within the scope of the Law Concerning the Supervision of Insurance Enterprises and is carried out, as for other insurance classes, by the Federal Supervisory Office for Insurance.

There are some specific rules for the life insurance companies making life insurance very safe for the clients:

Specialization is obligatory for life insurance. This will ensure that life insurance may not be written together with non-life insurance which is subject to far greater risks and that problems with non-life insurance cannot have any effect on the interests of the life insured.

Since due to cancellation of prior approval the insurance products are no longer subject to being controlled by the Supervisory Authority beforehand, the insurance customer must be in a position to inform himself about the contents of the insurance cover before he places a policy with an insurance company. Therefore, the insurers are obliged to disclose a considerable amount of information. In particular the insurance customers have to be given the general insurance policy conditions, the rules for calculating the profit participation as well as the surrender values.

A number of requirements are to ensure a reliable tariff calculation. In particular a maximum technical interest rate is required to calculate the technical provisions. This interest rate was fixed to 4% in 1994 and has lowered to 3,25% in 2000 due to an overall low interest rate in Europe. As regards calculation of the premiums it is required that the premiums have to be calculated on the basis of adequate actuarial assumption and that the rates must be such to ensure that the insurance company can meet all its obligations under the insurance contracts, in particular that adequate technical provisions for the individual contracts can be established.

Top priority has been given to guaranteeing that the obligations under the insurance contracts can permanently be met, i.e. that the interests of the insured are not put at risk. This is done by the Insurance Supervisory Authority taking care that the insurance companies will always dispose of an adequate solvency. Moreover, the German Insurance Supervisory Law contains in addition to the requirements concerning the calculation of tariffs and technical provisions a number of rules on the investments of insurance companies in as much as these assets serve to represent the technical provisions, i.e. to meet the claims of the insured. These assets have to be invested according to the principle of utmost security and profitability while maintaining liquidity of the insurance company at all times and ensuring proper mix and diversification of these assets.

Another unique requirement of German life insurance is the fact that assets representing the statutory mathematical provisions have to be kept in a **special fund** and entered each in a register. This fund has to be managed separately from any other assets. The assets of the fund cannot be disposed of without the approval of a trustee to be appointed by the Supervisory Board of the company and whose appointment has to be confirmed by the Supervisory Authority.

So I think it is no surprise that we never had an bankruptcy of an insurance company in the last 50 or so years.

Now on to my second question: What are the key elements of the new pension reform in Germany?

In mid-May 2001 a reform concept has been adopted and is in force from 1 January which provides for additional state subsidization of private old-age provision, but on the other hand dispenses with strong increases in contributions for statutory insurance and thus also with corresponding increases in benefits.

This pension reform consists of three parts:

- **The first part comprises a series of measures to reduce costs and thus stabilize contributions for existing statutory pension insurance. This includes a reduction of**

expected pension increases from 2003. In the past, statutory pensions have basically increased in line with increases of average wages. From July 2001 a new wage-related adjustment formula will be introduced. In the future, not only the contribution for statutory pension insurance, but also the contribution for subsidized old-age provision on a funded basis is to have a slow-down effect on pension adjustment. Furthermore, cutbacks have been provided for with regard to occupational disability and permanent disability pensions as well as surviving dependants' pensions. Thus, contributions for pension insurance (of which the employer and the employee pay one half each) will not rise to more than 22 % even in the long term.

- **The second measure improves the situation of citizens with extremely low pensions. In the past, these have been entitled to benefits according to the regulations for so-called "social welfare". Basically, every citizen whose income is lower than the minimum rate stipulated by law is entitled to social welfare benefits. However, the applicant has to disclose his financial situation and the state may possibly require repayment of social welfare benefits from the next of kin. The reform ensures that pensioners with low pensions automatically receive benefits of the same amount as social welfare as retirement benefits without, for instance, relatives running a risk to have to pay for this.**
- **The cutbacks in statutory pension benefits are to be compensated for by subsidization of voluntary old-age provision on a funded basis. Payments into different forms of investment are qualified to be subsidized provided these fulfil certain requirements, making it very similar to the statutory persons insurance.**

Entitled to receive state subsidies are in principle all persons, being members of pension systems of the first pillar. This rule excludes self-employed persons and civil servants (Beamte).

The most important requirements to be met by third-pillar products are the following:

- **Benefits may not be paid out before attaining the age of 60 or before payment of statutory old-age pensions starts.**
- **A promise has to be made according to which at least the funds paid in have been preserved when the client retires.**
- **Clients are entitled to lifelong monthly pensions.**
- **Clients are entitled to switch between different products.**

In addition, the state introduced a number of requirements intended to enhance consumer protection, even though pension provision carriers find these requirements difficult to administrate:

- **Commissions payable to distribution agents must be spread over a period of at least ten years (as opposed to the current actuarial practice of “zillmerizing” sales costs during the first couple of contract years)**
- **Consumers must be informed by the pension provision carrier about all inherent costs relating to contract conclusion (i.e. absolute amount and time spread) and contract changes, costs of depot management and costs in case of swapping products (i.e. termination/ transfer costs)**
- **Consumers must also be informed annually throughout the term of pension provision contract about the financial utilisation of their contributions, the level of accumulated capital as well as the investment criteria of the provider/ carrier (i.e. to which extend ethnic, social and environmental interests are considered by the provider during the process of investing premiums or savings contributions).**

All of these criteria must be reflected in contractual conditions. In order to qualify for state endorsement providers must submit standard contract conditions to a specified Pension Product Certification Office with the Federal Insurance Supervision Authority. The certification office examine compatibility with legal standards (criteria outlined above), but can neither

examine all individual contracts nor would it provide a formal quality assessment of the product. However, this certification is required in order to claim state subsidies or tax relief for private pension provision under the reform scheme.

The range of admitted products includes models such as:

- **Conventional private pension insurance**
- **Unit-linked life/ pension insurance**
- **Bank savings plans**
- **Investment funds/ pension funds**

The reform will also have repercussions on other pillars of the pension system:

Officially, the new state-promoted individual supplementary pension provision is relating to the so-called first pillar (mandatory pension system). However, in practical terms employees willing to engage in supplementary provision may decide whether they participate in a company pension scheme (second pillar) or purchase a completely private pension product (third pillar).

Germany has now also admitted the establishment of pension funds. This general admission encouraged several non-financial corporations to consider establishing their own pension funds. Both trade unions – with millions of worker-members – and industrial enterprises will now offer pension funds to their members or employees.

Market analysts assume that the current reform will largely increase the share of corporate pension schemes within the three-pillar-model of Germany's pension system. Most certainly, corporate pension schemes will grow beyond their current 5% market share, because there are certain cost and taxation advantages for employees if they decide to utilise the state subsidies or tax relief for investing into company pension schemes. For example employees

from now on have a legitimate claim to a corporate pension scheme or a group insurance (Direktversicherung). If the employer opts for a corporate pension scheme instead of a private cover he is entitled to receive the full amount of tax rebates from 01.01.2001 and not only from 01.01.2008. And these products do not need a certification. And due to the smaller distribution and management costs these products will be more cost effective.

That is why many observers expect that two third of the potential turn over through the new state funded pensions will go to the insurance industry; but from these another two third will go to the corporate pension scheme or other products of the second pillar.

The state promotes this private old-age provision through direct allowances and possibly, in addition to this, through tax advantages, i.e. through tax exemption of contributions up to a certain limit. This approach follows the system developed for subsidies for children (“Kindergeld”) Subsidization is to start in 2002 with a possible deduction of special expenses to the extent of 523 and is to increase to a maximum of 2 100 by 2008. The contribution will thus be made up of the own contribution of the insured and the allowance granted by the state. This is designed to replace future reductions of the payments of the statutory pension insurance.

The following model calculation applies to the first year of full subsidization (2008):

A family with one child has only one breadwinner and gross income is 75.000.- € per year. The maximum contribution for private provision qualified to be subsidized will then be 2.100.- €. The family will be granted a basic allowance of 154.- € per adult (308.- € all together) and an allowance for one child of 185.- €. The family may then indicate its savings contributions as special expenses in its tax return. This results in an additional tax relief of 204.- €. The actual self-financing will thus be 1.588.- € and the share of subsidization by the state will be appr. 33 %.

While contributions for the different forms of new supplementary old-age provision are paid from pre-tax income, the monthly pension due at maturity is to be fully taxed. This constitutes a change in the form of taxation which will possibly be introduced for all other forms of old-age provision as well.

It is expected that among the different competing types of products, which will also include occupational retirement provision such as pension funds, clients will to a large extent choose products of insurance companies. Since this type of provision is voluntary, there are naturally no exact figures on the extent to be expected. However, for the final phase in 2008, the Federal Government estimates state subsidies of approximately 10 billion .

In this respect, the insurance industry is competing with alternative offers of banks or investment funds as to the design of products which have to meet legal requirements. In any case, however, it is to be expected that the insurance industry will attract a considerable part of this additional market potential. The criteria for the state-supported products are in principle designed in favor of typical insurance products. For example forces the required guarantee of repayment of normal value of contributions investment funds that wish to offer pension products to take precautions against negative repercussions of declining stock values – e.g. by investing part of the regular pension savings contribution into an insurance policy and that, moreover, the public will be made aware of the key importance of additional private protection for old age and that, in the long run, new clients are thus won for the insurance industry.

At any case, the current reform constitutes a change in paradigm of the German pension system. Even through the actual change is not particularly thorough and there are many administrative shortcomings, some of the psychological and political barriers that previously stifled serious reform projects now seem to have been overcome and further steps towards extended individual responsibility by employees for their personal retirement provision can be expected during the next decade.

While contributions for the different forms of new supplementary old-age provision are paid from pre-tax income, the monthly pension due at maturity is to be fully taxed. This

constitutes a change in the form of taxation that will possibly be introduced for all other forms of old-age provision as well.

The original clear basic concept, i.e. to support the citizen's own efforts to provide for old age through state sponsored tax benefits, has become complicated and no longer effective in part. At the same time, there are different tax procedures for different products that the citizens apply for old-age provision. One example here is the treatment of capital investment in equity funds, or treatment of savings for the purchase of apartments or houses.

Furthermore, there are different systems and tax processes for pensions from the state or state controlled institutions.

Traditionally in Germany "Beamte" civil servants or state employees with a special statutory status do not pay any contributions to the pension system. The state pays them a life-long "pension" on retirement, for which the civil servants have not paid any contributions.

These pensions paid by the state to its civil servants are subject to tax unlike "contributory" pensions. Civil servants do have to pay tax on their pensions.

This inequality has led to a complicate case before the highest German court (Federal Constitutional Court), where the civil servants are demanding equal treatment regarding taxation. A ruling is anticipated in late summer or autumn of this year. Most observers believe that the court will determine in favor of the fundamental argument, i.e. the right to taxation equality.

Legal tax experts and very many politicians have also argued for some time in favor of unification of taxation, based on a so-called "downstream taxation", i.e. taxation related to the benefits of the pension provision scheme rather than the contributions to the provision scheme.

There is therefore good reason to believe that the system for taxation of old-age provisions, including life insurance, will be completely converted to taxation of benefits in the near future, and that contributions will generally not be subject to taxation in future.

Thank you for your time!