Risk-Based Pension Supervision
- German Approach

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Risk-Based Pension Supervision - German Approach

Agenda

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2. Occupational retirement provisions
3. Motivations for Risk-Based Approach to Supervision
4. Adoption of Risk-Based Supervision
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   4.2 Stress tests
   4.3 Risk Scoring System
1. Germany’s Pension System

- Germany’s pension system is based on a three pillar approach:
  - **statutory insurance** (1st pillar)
  - **occupational pension schemes** (2nd pillar)
  - **individual pension provisions** (3rd pillar)

- For a **typical (median) retiree household**, pensions are paid by:
  - 1st pillar: **85%**
  - 2nd pillar: **5%**
  - 3rd pillar: **10%**
## 1. Germany’s Pension System

<table>
<thead>
<tr>
<th></th>
<th>Pillar 1</th>
<th>Pillar 2</th>
<th>Pillar 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing and coverage of claims</td>
<td>Statutory insurance</td>
<td>Occupational pensions</td>
<td>Individual pensions</td>
</tr>
<tr>
<td></td>
<td>Current pensions financed by charges of the working generation and taxes</td>
<td>Current pensions and claims covered by assets</td>
<td>Coverage by capital</td>
</tr>
<tr>
<td>Organisation</td>
<td>State controlled</td>
<td>Privately organised</td>
<td>Private</td>
</tr>
<tr>
<td>Obligation</td>
<td>Obligatory</td>
<td>Partly obligatory; occupational</td>
<td>Voluntary</td>
</tr>
<tr>
<td>Institutions</td>
<td>Social-security institutions</td>
<td>Unterstützungskassen, Pensionskassen/-fonds, life insurance companies, employers</td>
<td>Mutual funds, banks, life insurance companies</td>
</tr>
</tbody>
</table>
1. Germany’s Pension System

<table>
<thead>
<tr>
<th></th>
<th>Pillar 1</th>
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<th>Pillar 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of provision</td>
<td>Statutory insurance</td>
<td>Occupational pensions</td>
<td>Individual pensions</td>
</tr>
<tr>
<td>Pensions based on contributions</td>
<td>Pensions based on the commitment of the employer and/or on the development of investment</td>
<td>investment regulation depend on the chosen way of implementation</td>
<td>Rather liberal, dependent from chosen institution</td>
</tr>
<tr>
<td>Regulations on assets</td>
<td>no long term capital coverage, no investment regulation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
2. Occupational retirement provisions

- Voluntary system. In some areas, there are collective agreements providing for obligatory occupational retirement provisions or financial incentives for employees for deferred compensation.

- Since 2001 pensions reform, employees have had a fundamental right to deferred compensation.

- Occupational pension plans provided in Germany are defined benefit.

- About 15.3 million employees had occupational retirement provision in March 2003.

- There are five different types of implementing occupational pensions.
## 2. Occupational retirement provisions

<table>
<thead>
<tr>
<th></th>
<th>Direktzusage (book reserves)</th>
<th>Unterstützungs kasse (support funds)</th>
<th>Direktversicherung (direct insurance)</th>
<th>Pensionskasse (pension institutions)</th>
<th>Pensionskassen (pensions funds)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual claim against the pension facility</td>
<td>No pension facility</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Legal right to continuation with individual contributions on termination of employment</td>
<td>no</td>
<td>no</td>
<td>possible</td>
<td>possible</td>
<td>possible</td>
</tr>
<tr>
<td>Guaranteed minimum interest rate</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>Collection of assets</td>
<td>Internal</td>
<td>External</td>
<td>External</td>
<td>External</td>
<td>External</td>
</tr>
</tbody>
</table>
## 2. Occupational retirement provisions

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<th>Unterstützungskasse (support funds)</th>
<th>Direktversicherung (direct insurance)</th>
<th>Pensionskasse (pension institutions)</th>
<th>Pensionsfonds (pensions funds)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments restrictions</td>
<td>none</td>
<td>none</td>
<td>yes</td>
<td>yes</td>
<td>virtually none</td>
</tr>
<tr>
<td>Insolvency insurance by Pension Security Association (Pensions-Sicherungs-Verein VVaG)</td>
<td>yes</td>
<td>yes</td>
<td>Subject to conditions</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Supervision</td>
<td>no</td>
<td>no</td>
<td>yes (by BaFin)</td>
<td>yes (by BaFin)</td>
<td>yes (by BaFin)</td>
</tr>
<tr>
<td>Supervised entities</td>
<td></td>
<td>160</td>
<td>109</td>
<td>24</td>
<td></td>
</tr>
</tbody>
</table>
3. Motivations for Risk-Based Approach to Supervision

The reasons for moving towards a risk-based approach are mainly:

- **Equity crisis** including the increasing volatility on the capital markets
- **Low yield** environment
- Integration of all three sector supervisory authorities to **one single integrated market supervisory authority**
- Improvement of **allocation of supervisory resources**
- Future requirement of **Solvency II** in Europe
4. Adoption of Risk-Based Supervision

4.1 Measures

The **following measures** were introduced:

- Scenario calculations/forecasts
- Amendments to section 341b (2) of the Commercial Code
- Policyholder protection corporation (PROTEKTOR and MEDIKATOR)
- Two new supervisory returns
- Stress tests
4. Adoption of Risk-Based Supervision

4.1 Measures

- Detailed rules on investment management and internal control procedures
- Reduction of maximum guaranteed rate of interest
- Special commissioner
- Supervision of holdings
4. Adoption of Risk-Based Supervision

4.2 Stress tests

Stress tests

• Have been introduced in 2002.

• Aim at identifying those insurance companies that do not operate an appropriate investment policy.

• The stress tests scenarios simulate a short-term adverse development on capital and real estate markets.

• Depending on the result of these scenarios the insurance company is subject to certain notification obligations towards BaFin.
### 4. Adoption of Risk-Based Supervision

#### 4.2 Stress tests

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A 35</strong></td>
<td>Decrease in the market value of shares by 35%</td>
</tr>
<tr>
<td><strong>R 10</strong></td>
<td>Decrease in the value of fixed-income securities by 10%</td>
</tr>
<tr>
<td><strong>RA 25</strong></td>
<td>Simultaneous decrease in the market value of shares by 20% and in fixed-income securities by 5%</td>
</tr>
<tr>
<td><strong>AI 28</strong></td>
<td>Simultaneous decrease in the market value of shares by 20% and in the market value of real estate by 8%</td>
</tr>
</tbody>
</table>
4. Adoption of Risk-Based Supervision

4.3 Risk Scoring System

Risk Scoring System

- Should enable the classification of the supervised entities into risk classes (traffic-lights model) in all stages of the supervisory process by using quantitative key figures and qualitative criteria.

- Risk classification is currently done via methodological survey.

- Assessment of “impact” of the supervised entity on the market and “quality” of the supervised entity.

- As a result, the supervised entity can be classified into one of the possible fields of the following risk matrix.
### 4. Adoption of Risk-Based Supervision

#### 4.3 Risk Scoring System

<table>
<thead>
<tr>
<th>Impact</th>
<th>Quality</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>high</td>
<td>high</td>
<td>1A</td>
<td>2A</td>
<td>3A</td>
<td>4A</td>
</tr>
<tr>
<td>medium</td>
<td>medium</td>
<td>1B</td>
<td>2B</td>
<td>3B</td>
<td>4B</td>
</tr>
<tr>
<td>low</td>
<td>low</td>
<td>1C</td>
<td>2C</td>
<td>3C</td>
<td>4C</td>
</tr>
</tbody>
</table>

- **4A**: Low impact, high quality
- **4B**: Medium impact, medium quality
- **4C**: High impact, low quality
- **4D**: Very high impact, very low quality
4. Adoption of Risk-Based Supervision

4.3 Risk Scoring System

- Results of risk classification have been used for supervisory planning in 2006, namely the planning of the on-site inspections.

- It is envisaged that in the long term an automatic assessment system will be introduced.
Thank you for your attention! Q&A?

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