Allianz International Pensions

What’s **happening** in…

September 2014

…Germany?

The difficult balancing act between sustainability and adequacy

Triggered by a particularly challenging demographic situation, the German pension system has undergone **several reforms during recent decades**, which were aimed at securing the long-term sustainability of the public pension system.

By partially substituting pay-as-you-go public pensions with **funded pensions**, a genuine multi-pillar approach to old-age income provision has been adopted: additional **private pension schemes** are now essential to maintain living standards in old age.

Private pension schemes have been subsidized. The framework for occupational pensions has been modified, strengthening the **emphasis on defined contribution (DC) systems** and giving workers the legal right to convert part of their salary into contributions to deferred compensation plans.

Although the diffusion of voluntary individual and occupational pensions has risen on average in the last decade, **retirement income adequacy** might become an important concern, especially for vulnerable groups. ►

15 years of reforms: Where does Germany stand?

The demographic situation in Germany is particularly challenging. Due to the mixture of low fertility rates and increasing life expectancy, the ratio of elderly (aged 65 years and above) to working-age people (aged 15 to 64 years) – the old-age dependency ratio – increased from 22% in 1990 to 32% in 2010 and is projected to climb to 60% in 2050 (UN, 2013). Such an outlook threatened the financial sustainability of the German pension system. For the majority of employees the public ‘pay-as-you-go’ (PAYG) scheme provided the main part of retirement income. The existing occupational schemes and private savings programs made up only a small part and were taken up mainly by higher income earners and self-employed. Consequently, the system has undergone several reforms over the last two decades, aimed at ensuring its long-term sustainability. The public pension system moved from a traditional defined benefit (DB) scheme to a system that mimics a notional defined contribution (NDC) program. Furthermore, a general paradigm shift has been triggered: by partially substituting PAYG-financed pensions with funded pensions, a genuine multi-pillar approach to old-age income provision has been adopted.

Even for the average earner, the German pension system is based today on a broader approach. In addition to the mandatory public pension system, a means-tested minimum pension financed by taxes was introduced in 2001, together with tax deductions and direct subsidies to strengthen the voluntary pillar, which includes both occupational and individual pension schemes. Mandatory individual saving accounts do not exist in Germany.

The first pillar

The public pension system used to be very generous, granting low retirement ages and replacement rates high enough to maintain the accustomed standard of living after retirement. However, in the face of the underlying demographic trends, this was unsustainable. A series of reforms introduced several mechanisms to stabilize the system and achieve sustainable contribution rates. On the one hand, early retirement possibilities have been drastically reduced, while the statutory retirement age has been increased; and on the other hand, a cap to the contribution rate has been set by law and the development of pension benefits has been linked to the system’s dependency ratio, as well as to the (fictitious) contribution rate to private pension accounts. Consequently, the pension payout will be gradually reduced during the coming years. ►

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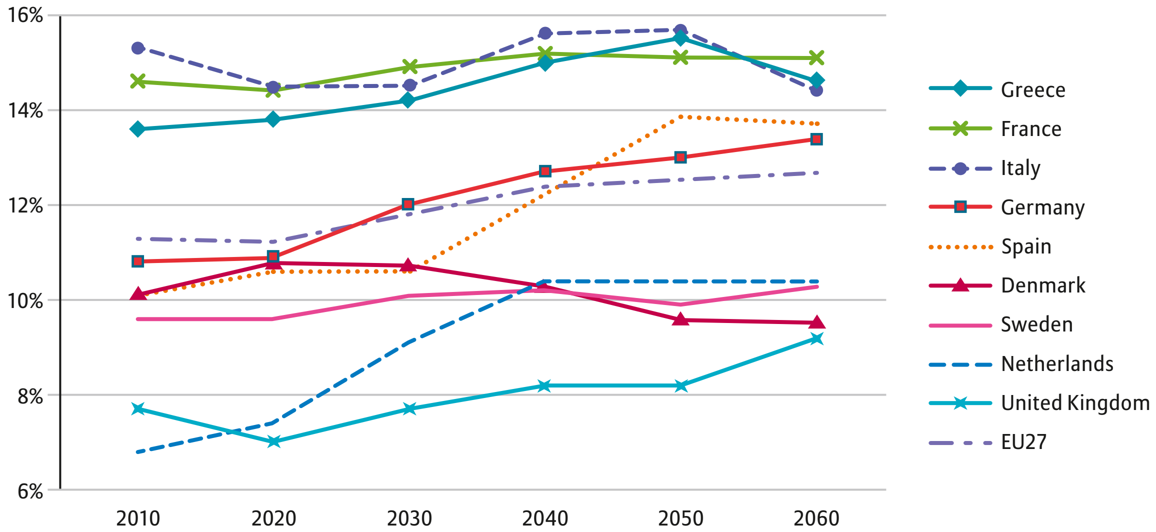
In contrast to past trends, the measures adopted in 2014 strengthen the first pillar of the pension system, **extending public pension claims** for workers with long contribution histories and older women with children in particular.

Although these measures could help **improve the financial situation** of the affected groups, they do not specifically target retirement income adequacy, which remains an important issue to be tackled in the years to come.

Figure 1: Projections of public pension expenditure as % of GPD, 2010-2060 (selected countries)



Sources: EU Commission, 2012a.Table 2.8 and 2.9. Illustration: International Pensions

The average benefit of public pensions as a share of the economy-wide average wage will decline from 47% today to 38% in 2060 (EU commission, 2012b). The replacement rate for workers earning an average wage will be among the 10 lowest in the OECD countries (OECD, 2013).

Thanks to the changes implemented, Germany has managed to reduce its implicit debt and keep pension expenditures under control. Currently, they represent almost 11% of GDP, a value below the average for the EU27 countries (*see figure 1*). However, between 2010 and 2060, this figure is expected to increase by 2.6 percentage points against an average expected increase in the EU27 of 1.5 percentage points (EU commission, 2012a).

Whereas the medium and long-term financial sustainability of public pension expenditure has been improved, the implemented cuts in the pension benefits raise concerns about the adequacy of public pension. Currently, poverty rates among the elderly are definitely lower than in other population subgroups and are well below the OECD average. However, the outlook for future retirees may be quite different if they do not supplement their public pensions with additional income.

Indeed, the Federal Ministry of Labour and Social Affairs (Bundesministerium für Arbeit und Soziales, BMAS) includes pension benefits derived from private pensions (*in the form of both subsidized saving contracts – see next section – and private annuities*) in the projections of replacement rates for future retirees. As these projections show (*table 1*), the current net replacement rate can only be maintained in the future if an increasing share of the retirement income comes from supplementary private pensions.

Supplementary private pensions

A key element of the 2001 reform was the introduction of substantial incentives to foster the take-up of supplementary private pensions. The state subsidies can take the form of a direct allowance or a tax deduction, depending on which of the two types is more advantageous for the saver. The received subsidies are reduced proportionally if the contributions to the saving plan are below 4% of an individual's gross earnings, which is the amount considered necessary to compensate for the reduction in the public pension benefits. These individual savings arrangements, also known as 'Riester pensions', have been heavily regulated. Among other requirements, Riester products must be disbursed as lifelong annuities[1] and the accrued pension contributions must be guaranteed at the beginning of the disbursement phase. Not all individuals are eligible for the subsidies. The original intention of the regulator was to provide incentives to everyone affected by the reduction in the public pension system. Spouses of eligible individuals, ►

1 Up to 30% of the accumulated capital can be disbursed as a lump-sum payment at retirement.

Table 1: Replacement rates for an individual with 45 years of dependent employment on average earnings

Retirement entry year	Gross replacement rate [a]	Provided by			Net replacement rate [b]
		Public pension	Subsidized private pensions (Riester pension)	Private annuity	
2012	47.4%	45.5%	1.7%	0.2%	70.7%
2015	47.4%	44.6%	2.4%	0.4%	70.1%
2020	48.5%	44.0%	3.7%	0.9%	70.9%
2025	48.8%	42.3%	4.9%	1.6%	71.8%
2030	49.3%	40.6%	6.2%	2.5%	72.8%

a Pre-tax retirement income (out of public pensions, Riester pensions and private annuities) as a share of economy-wide average wage.

b Retirement income after taxes and health and long-term care insurance contributions as a share of economy-wide average wage, net of taxes and social security contributions.

Source: Federal Ministry of Labor and Social Affairs (BMAS), 2012a

however, are also entitled to receive the subsidies if they subscribe to a separate plan of their own.

After a relatively lackluster start, the demand for Riester pensions rose significantly after 2005, only to flatten again in recent years. The coverage rate among eligible individuals is currently around 40%. There is substantial heterogeneity in the diffusion of these subsidized individual saving schemes. While the uptake rates are fairly high among high-income households, low-income households have proven much more difficult to reach (Gerber and Zwick, 2010; Börsch-Supan et al., 2013). Nonetheless, coverage of private pensions is relatively high among low earners compared with other OECD countries, although the average contribution rate is lower than in other nations (Antolín and Whitehouse, 2009).

Occupational pensions

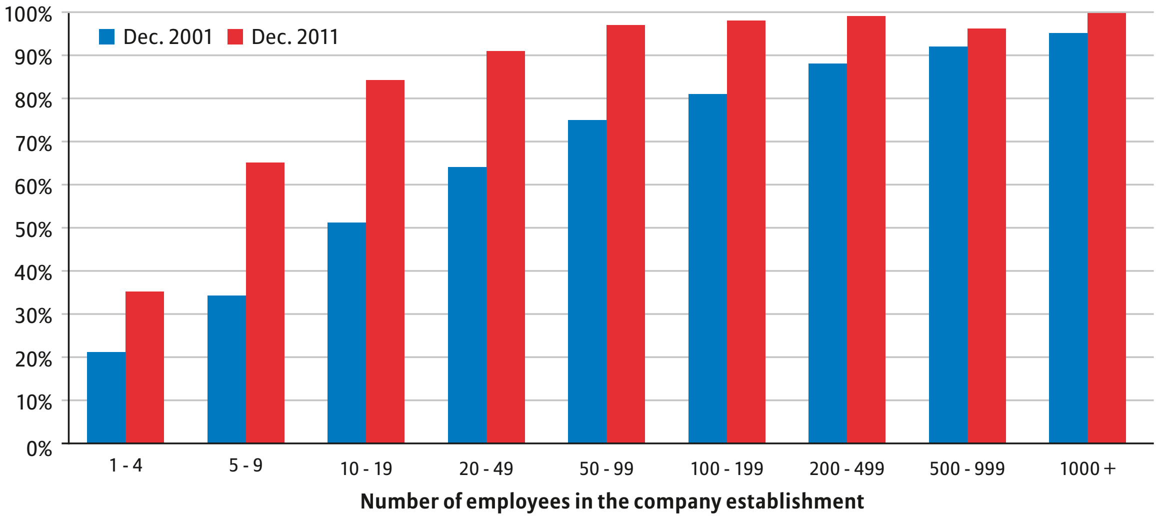
The 2001 reform substantially modified the framework for occupational pensions, strengthening the emphasis on DC systems. An important change was the introduction of the legal right of workers to convert part of their salary into contributions to deferred compensation plans.

Possibly as a result of the reform, participation in occupational pension schemes expanded during the 2000s after years of continuous decline. In the private sector, the percentage of establishments with an occupational pension scheme in place increased by 60%, from 31% in 2001 to 50% in 2011. At the same time, the percentage of employees participating in such schemes increased from 38% to 50%. As of 2011, approximately 17 million employees have acquired a claim to an occupational pension (BMAS, 2012b).

As with individual pension schemes, there is also substantial heterogeneity in the diffusion of occupational pensions for both employers and employees. Despite the legal entitlement to occupational pensions, not all employers have set up a scheme yet. Although the situation has improved since 2001, there are still substantial differences according to business sector and firm size. For example, while almost all company establishments with more than 50 employees have a scheme in place, at the end of 2011 only 35% of those with less than five employees had one (*see figure 2*). Consequently, while 84% of individuals working in firms with more than 1,000 employees participate in an occupational pension scheme, only 27% of those in smaller establishments do (BMAS, 2012b).

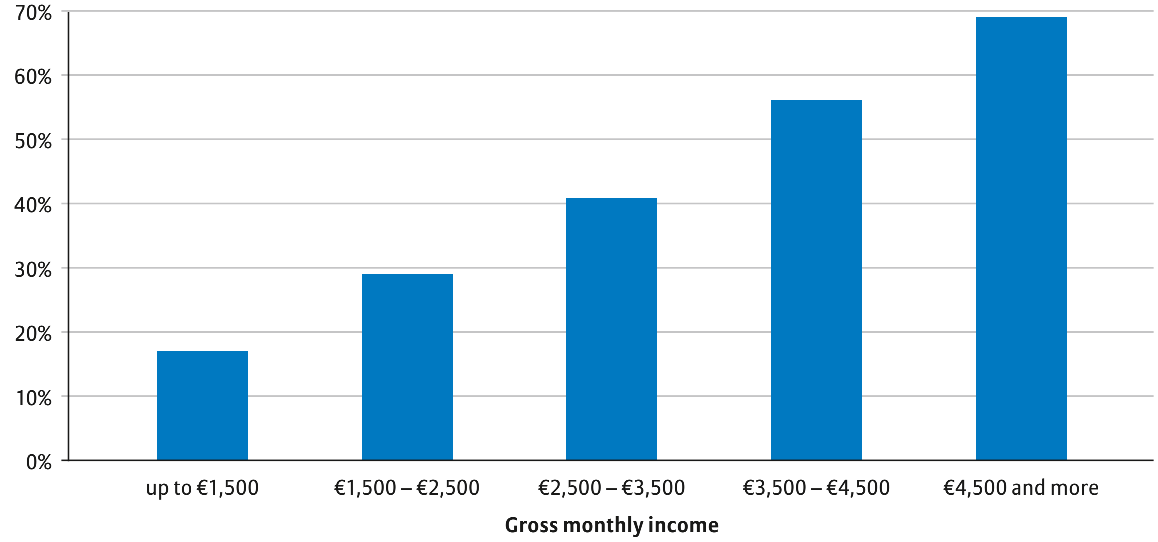
A recent survey conducted among employees also found a marked difference in the participation in occupational pension schemes according to various socio-demographic characteristics. For example, while only 17% in the lowest income bracket participate in an occupational scheme, almost 70% of those in the highest bracket do (*see figure 3*). ►

Figure 2: Company establishments with an occupational pension scheme in place by establishment size



Source: Federal Ministry for Labour and Social Affairs (BMAS), 2012b. Illustration: International Pensions

Figure 3: Employees in the private sector participating in an occupational pension scheme by gross monthly income



Source: Federal Ministry for Labour and Social Affairs (BMAS), 2012c. Illustration: International Pensions

What about adequacy?

The picture provided by the data on private pension coverage is double-sided. On the one hand, the diffusion of voluntary individual and occupational pensions has risen sharply in the last decade. Apparently, Germans are learning to take more responsibility in preparing for old age. On the other hand, however, the development has flattened in recent years and some groups are lagging behind. More worryingly, participation rates in supplementary pension schemes (occupational or private) are particularly low among low-income earners. In Germany, pension claims are closely related to income earned during an individual's working life, meaning those earning below-average wages will also receive low public pensions. Workers earning half the average wage and retiring after a full career can expect the second-lowest net pension replacement rate among OECD countries (OECD, 2013). Without additional resources, they are more at risk of falling below the poverty line after entering retirement. ►

Although the 2001 reform introduced a minimum social security guarantee for the elderly, the level of benefits provided is again one of the lowest among the OECD countries (OECD, 2009). Thus for the years to come, retirement income adequacy might become an important concern for vulnerable groups. Many are aware of the issue already and, according to a recent study, 86% of adults expect an increase in old-age poverty rates in the coming decades, while almost 40% of them believe they will rely on social assistance for retirees (Lamla and Gasche, 2012).

The 2014 pension reform

In spring 2014, the coalition government formed after the previous year's general election passed a new bill of reform. In contrast to the trend set in previous years, the measures adopted strengthen the first pillar of the pension system, extending public pension claims for selected groups. In particular, workers with a long contribution history and individuals whose children were born before 1992 will benefit. The former will be able to retire two years before the legal retirement age with a full pension, while the latter will receive a supplement to their pension (*for a more detailed description see the box below*).

The implemented measures have been highly controversial due to the high costs (estimated at about €10 billion per year), which will be financed mainly through the public pension system. The increase in the contribution rate has been estimated at 0.3 percentage points ►

THE GERMAN PUBLIC PENSION SYSTEM AND THE 2014 REFORM IN DETAIL

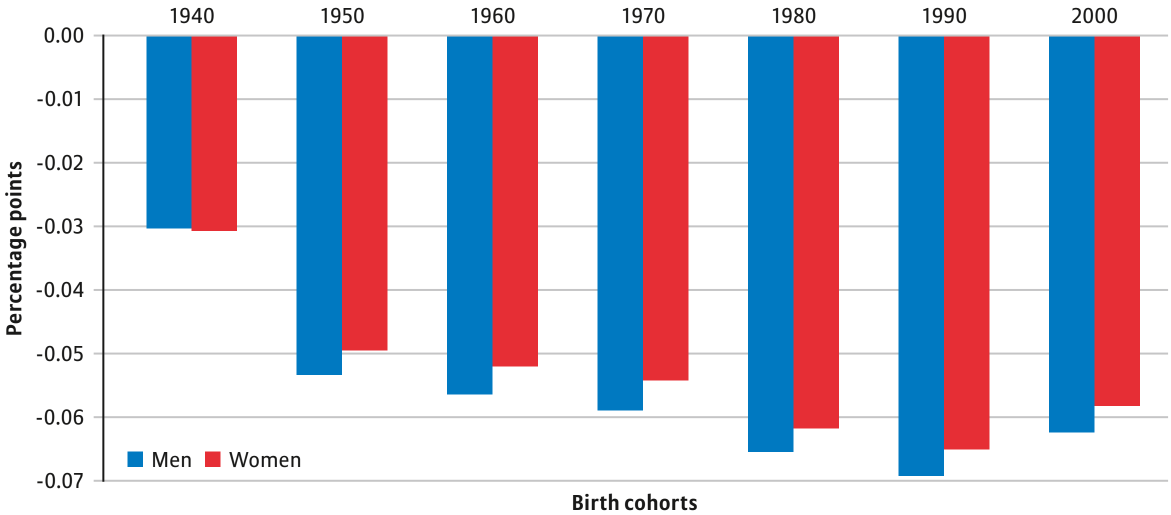
The mandatory public pension system covers employees only, with civil servants and individuals in professional services having their own mandatory pension schemes. The self-employed do not have any mandatory pension scheme and must provide for themselves.

The public pension is based on an earnings-related points system, whereby contributors accrue a certain amount of 'pension points' depending on their wage. A year's contribution at the average earnings of the contributors earns one pension point, whereas contributions based on higher or lower incomes earns proportionally more or fewer points. To determine the pension benefit the sum of the points acquired is multiplied by a "pension value", which is adjusted every year based on the development of the gross wages, of the contribution rate to the statutory pension and of the ratio of pensioners to contributors. Currently, each pension point is worth about 28€.

Extra points are credited for periods spent caring for a child and are considered in the administrative records as periods in which contributions have been paid. The entitlements for child-raising are tax-financed. Before the 2014 reform, only one pension point was credited for children born before 1992, whereas three points are credited for children born in 1992 or later. Following the reform, an extra point is now credited for each child born before 1992. Thus, each child born before 1992 increases the pension benefit of the recipients by approximately €30 per month. Individuals are entitled to receive these extra points irrespectively of their employment status. Although the parents can decide to split the entitlements, almost all the recipients are women, leading to this part of the reform to be called the *Mütterrente* ('mother's pension'). However in theory fathers can also claim the extra benefit.

To qualify for a public pension, individuals need to accumulate a minimum of five years (60 months) of contributions and to reach the state pension age, which is gradually increasing from 65 to 67 years. Individuals who have contributed to the system for at least 35 years can retire at 63 with permanent benefit reductions, although these adjustments are smaller than actuarially fair (Börsch-Supan et al., 2004). Those with very long contribution histories (at least 45 years) are allowed to retire with a full pension before the legal retirement age. Before 2014, years spent in unemployment were explicitly excluded from the calculation of the qualifying period of 45 years and the retirement age without deduction was set at 65 years. With the 2014 reform, periods in which individuals have received unemployment benefits are now included in the qualifying period. Furthermore, the deduction-free retirement age for these individuals has been temporarily lowered to 63 years. A gradual increase back to 65 years is already embedded in the law.

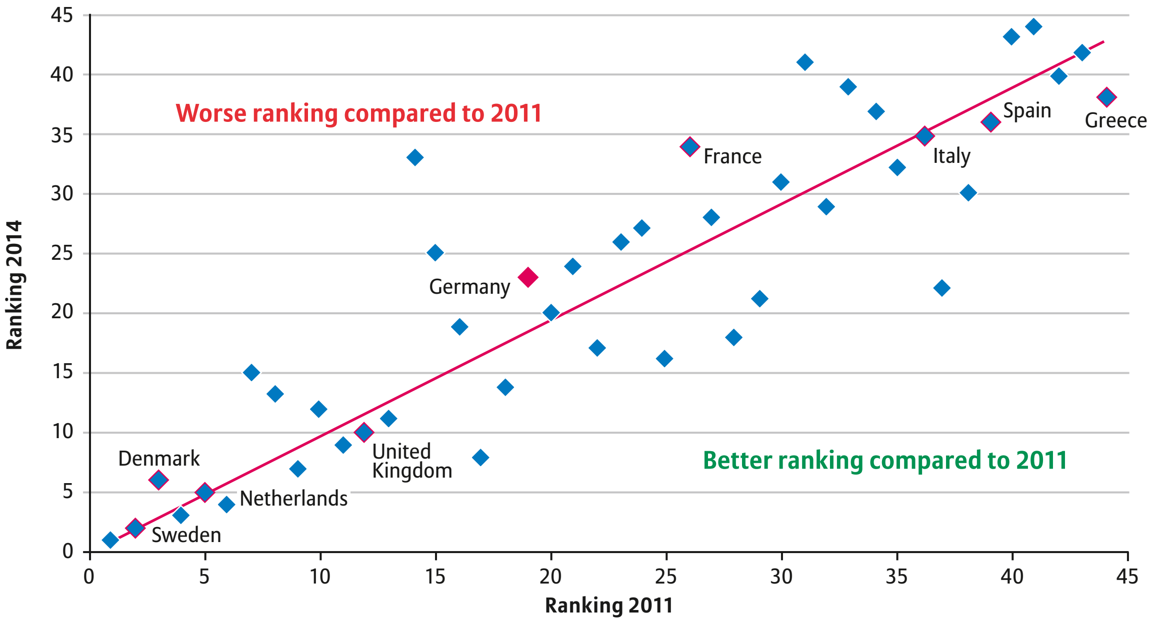
Figure 4: Change in the implicit nominal rate of return of the public pension scheme as effect of the 2014 reform for different birth cohorts, based on average earner with 45 years of contributions



Assumptions: Unmarried individual entering the labor market at the age of 20, earning an average wage in every year and retiring at the age of 65. The individual lives exactly according to the cohort's average remaining life expectancy at age 65 (data from www.destatis.de). Development of past nominal wages, contribution rates and pension benefits taken from: German Pension Fund, 2013 'Rentenversicherung in Zeitreihen.' Future development of nominal wages set at 3% per year. Development of the contribution rate and of the standard pension level after 2013 with and without reform as estimated in Bach et al., 2014a.

Source: International Pensions, own calculations

Figure 5: Allianz Pension Sustainability Index (PSI). Change in ranking between 2011 and 2014



Source: Allianz Asset Management, International Pensions. Countries are ranked from best (1) to worst (45)

between 2014 and 2035. At the same time, the pension level[2] will be an average 0.6 percentage points lower in comparison to a scenario without reform (Bach et al., 2014a). Consequently, although even current retirees have to pay for it, the reform package puts an additional burden on future generations, who will pay higher contributions to receive even lower pension benefits. Indeed, the negative effect of the reform on the implicit rate of ►

2 The standard pension level is the ratio between the gross pension of an individual who has been employed for 45 years at the average earning rate and retires at the legal retirement age, and the average wage in the same year.

return of the public pension scheme[3] is larger for the younger cohorts (*see figure 4*).

The introduction of a deduction-free early retirement has given rise to particular discontent. Critics of this measure note that in the face of an aging population and an upcoming skills shortage, it is not wise to set strong incentives for experienced workers to retire early.

Although the reform is not destabilizing the German pension system it does not improve its sustainability either. In this respect, the Allianz Pension Sustainability Index (PSI) provides a useful summary. Despite still ranking in the mid-range, in the 2014 version Germany lost a little ground in comparison with 2011 (*see figure 5*).

In terms of adequacy, the implemented reform was not specifically targeted at addressing current or future old-age poverty, although in some cases it could help improve the retirement income adequacy of the beneficiaries (*see box below*).

Outlook

With the baby-boomer generation approaching retirement age and life expectancy at older ages on the rise, Germany is about to feel the consequences of an aging population. While past reforms have been relatively successful in improving the sustainability of the pension system, more could be done to improve its adequacy.

The agreement settled in 2013 by the coalition government includes plans to supplement the pension benefits of individuals with long contribution histories but low pension entitlements. According to the program, additional contributions to a private pension scheme (individual or occupational) will be necessary to qualify for the pension top-up. The proposed measure specifically addresses the problem of old-age poverty among vulnerable groups and sets additional incentives to participate in private retirement savings schemes. However, only the participation and not the volume of the contributions paid into the private scheme is considered as a qualifying criterion. As participating in a private pension scheme does not automatically mean building up adequate additional retirement savings, a stronger focus on the volume of the contributions could be useful to address the adequacy problem.

Vulnerable groups, like the self-employed not covered by mandatory pension schemes or individuals with short or intermittent employment histories, are currently not targeted by the reform plans. Effectively preventing old-age poverty requires measures focused towards these groups. The coalition agreement also mentions the ►

WOMEN'S OLD-AGE POVERTY AND THE MÜTTERRENTE

Old-age poverty has a strong gender dimension. Poverty rates among women of retirement age (65 years and older) are generally higher than among men of the same age (OECD, 2008) and Germany is no exception. Indeed, according to the German statistical office, almost 70% of the recipients of the state minimum pension in 2003 were women. Although over the years the proportion of male recipients has steadily increased, women are still the majority, representing 63% of the recipients in 2012.

The new *Mütterrente* will mainly benefit older women. Besides increasing the pension benefits of women who already receive an old-age pension, the measure will help women who were not entitled to a public pension to fulfill the minimum contribution period, providing them with an additional income source. According to a recent study, the *Mütterrente* will primarily benefit low- and middle-income pensioner households (Bach et al., 2014b).

However, the reform does not benefit households that rely on the minimum pension (about 3% of the women above the age of 65). In the means-testing procedure all financial resources are counted (including all public and private pensions) and the minimum pension received is cut by the same amount. Consequently, the extra entitlements provided by the *Mütterrente* will not change the financial situation of these households, unless they no longer qualify for the minimum pension as a result of the extra entitlement.

3 The implicit rate of return of the public pension is the rate such that the discounted value of payments to the system equals the discounted values of the benefits received.

intention to strengthen the diffusion of occupational pensions, particularly in small and medium-sized enterprises, although no clear strategy is currently defined.

Besides supporting the set-up of additional private pension savings, promoting longer working lives may also help improve retirement income adequacy. To this extent, fully eliminating early-retirement incentives and setting appropriate reduction rates in the public pension system to ensure actuarial neutrality would be desirable (e.g. OECD, 2012).

To introduce more flexibility into retirement and to encourage the lengthening of the working life, the coalition government plans to uplift restrictions in the labor legislation. This should facilitate the employment of workers beyond the retirement age. There is a long way to go before the difficult balance between sustainability and adequacy is reached.

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