

## 2. Insight into the German Pension Insurance Fund

### 2.1 Objectives

The main objectives of chapter 2 are to illustrate the role and relevance of the occupational pension scheme within the three-pillar pension system in Germany. The emphasis of this section will be centred on the expected or future role occupational pension funds may play given the funding issues the statutory pension system is facing. Demographic shifts in the society as well as radical changes in the labour environment are forcing legislators as well as regulators to position occupational pension solutions as a fundamental element of any pension mix, rather than a mere ‘add-on’ as they used to be perceived in the past.

Amongst the five different occupational pension alternatives available in Germany, our research study will focus primarily on German Pension Insurance Funds given their historic role, relative importance in terms of size as well as market share amongst Germany’s private sector corporations. The analysis we will conduct on the investment restrictions Pension Insurance Funds are subject to by prevailing regulation in Germany will provide valuable information for the portfolio composition of the empirical analysis. In addition, we will explore the average asset allocation mix Pension Insurance Funds have historically pursued and how they are invested today in times of economic uncertainty and financial distress. This information will determine our input parameters for the simulation study. Moreover, it is essential to understand pension benefit and contribution options these funds can offer to their members, as these components will have a crucial influence on the asset allocation strategy of the respective pension fund.

The structure of chapter 2 is as follows: first, a brief overview of the German pension system is given, with particular emphasis on the funding issues the statutory pension system is confronted with and the role played by the occupational pension scheme. Second, we will discuss the economic importance of Pension Insurance Funds within the occupational pension system and provide details on pension benefits as well as the scope of insured risk events covered by this pension fund type. Subsequently, we will focus in section 2.5 on all rele-

vant investment management considerations of Pension Insurance Funds that will be required to realise our research study.

## **2.2 Overview of the German Pension System**

### **2.2.1 Historical Context**

In this section, we will give a brief overview of the major historical developments and events that have shaped today's pension system in Germany. This review will enable us to understand the rationale for the creation of the occupational pension system, how it has evolved over time and how Pension Insurance Funds are positioned in an historical context.

#### **A. From the 19th Century to the Foundation of the Federal Republic of Germany (FRG) in 1949**

Although occupational pensions schemes have played historically a minor role in terms of economic relevance in Germany in comparison to the public pension system, they were founded first. Large industrial corporations<sup>46</sup> already created in the middle of the 19<sup>th</sup> century insurance institutions that offered to their employees and family members protection against the financial effects of death and disability.<sup>47</sup> Retirement insurance, nonetheless, which is nowadays the preeminent component of occupational pension schemes, was introduced at a later stage. The effort and rationale by the companies to offer occupational pension benefits to their workforce was purely voluntary, driven in the majority of the cases by a sort of paternalistic and caring sense of responsibility by the founder of the firm.<sup>48</sup>

The origins of the German public pension system date back to the era of Reich Chancellor Otto von Bismarck,<sup>49</sup> who introduced in 1889 a (compulsory) pension law for German workers. In its initial form, the pension system would cover retirement (with a retirement age of 70 years) and disability risks for em-

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<sup>46</sup> See Sabrowski (2007), p. 11 or Uebelhack (2011), p. 12.

<sup>47</sup> See Sabrowski (2007), p. 11.

<sup>48</sup> See Gieg (2008), p. 19.

<sup>49</sup> Otto von Bismarck (1815-1898) was German Reich Chancellor from 1871-1890. See Deutsche Nationalbibliothek (2012).

ployed blue-collar workers only.<sup>50</sup> As stated by the law, the pension contributions would be paid half by the employer and half by the worker.<sup>51</sup> The legislator established the capital funding methodology as the funding principle of the pension system.

Bismarck's motivation for implementing a social system in Germany is a highly debated topic in the academic world. Without doubts, important demographic and social changes in Germany's population seem to have been one of the major reasons. Within the working class, industrial workers started playing an increasingly dominant role, while the previously dominating agricultural segment of the population was decreasing rapidly. Connected to this overthrow of structural elements within the society was a significant migration into urban areas. The new urban life, however, could not provide the same sort of social protection as people used to have within their families in rural zones. Poverty and social imbalances created a real threat to Germany's fast growing cities, making the implementation of a social welfare system necessary. Many historians, however, argue that the real motivation of Bismarck's reforms was the fast spreading ideology of social democracy amongst Germany's blue-collar workers. This political movement was perceived as a danger to the monarchy and to the ruling elites of the country at that time. Bismarck's pension system promise was thereby targeted to act as an incentive for the working class to stay loyal to prevailing powers.<sup>52</sup>

Germany's white-collar employees did not have any pension insurance coverage until 1911, when a separate social insurance to the prevailing scheme of 1889 was introduced. This differentiation of the German workforce, though intentional, created a two-class system, as white-collar employees benefited from higher pension benefits and longer entitlement periods than workers did. Furthermore, employees could already benefit from pension benefits from the age of 65 years onwards, therefore 5 years earlier than their blue-collar counterparts.<sup>53</sup> Self-employed citizens, on the other side, did not have any access to

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<sup>50</sup> Disability risk coverage played a predominant role in that time in comparison to retirement pension. Just before WWI, pension contributions would be allocated to 90% for disability benefits and only 10% for retirement payments. See Henning (1995), p. 273.

<sup>51</sup> See Doering (2000), p. 169.

<sup>52</sup> See Schmidt (1998), pp. 28-30.

<sup>53</sup> See Kohlmeier (2008), p. 7.

pension insurance until 1922, when some form of self-employment was included in the pension system.<sup>54</sup> Nonetheless, until today, a vast range of self-employment practises does not give any access to Germany's statutory social insurance coverage.<sup>55</sup>

Bismarck's statutory pension scheme defaulted in 1922/23, when hyperinflation destroyed the value of the asset base of the capital funded system,<sup>56</sup> thereby forcing the government to introduce a Pay-as-you-go (PAYG) arrangement, in which current contributions would be used to pay current benefits. During the economic boom of the early years of the Third Reich, low unemployment and an important capital injection by the government into the pension system led to a substantial increase in pension contributions and a surplus in the pension budget. The healthy state of the pension system persuaded the German administration to switch back to the capital funded system.<sup>57</sup> Unfortunately, the funding sustainability of the pension system was destroyed by the Nazi regime from 1938 onwards, as the underlying capital funds were used to finance the enormous rearmament that took place in Germany prior to the outbreak of WWII.<sup>58</sup>

## **B. From the Foundation of the FRG in 1949 to the Reunification in 1989**

The German pension system went into default after WWII, as a large proportion of the asset base had been invested into German government bonds and real estate, two asset classes that (almost) completely devalued due to the devastating effects of the war.<sup>59</sup> The allied forces that occupied Germany, nevertheless, decided to maintain the social system in place, although the level of contributions the system could afford to pay to its members remained at a very low level until the 1950s, when the economic boom in Germany led to a stabilization of pension finances.<sup>60</sup> In 1949, the first amendments were implemented

<sup>54</sup> Predominantly domestic work.

<sup>55</sup> Today's social insurance system continues to be focused around the concept of employment. As stated in Sec. 2 Par. 2 SGB VI, every employer is forced to be insured in the statutory pension insurance, health insurance scheme, long-term care insurance, accident insurance and unemployment insurance plan. A large number of self-employed activities, on the other hand, remain essentially uncovered by the statutory social insurance system under Sec. 2 SGB VI. See Kohlmeier (2008), p. 7 et seq. and p. 11 et seq.

<sup>56</sup> By the time of the monetary reform in 1924, the asset base of the pension system had decreased to just 10% of the value it had in 1910. See Doering (2000), p. 177.

<sup>57</sup> See May (2010), p. 89.

<sup>58</sup> See Doering (2000), p. 27 et seq.

<sup>59</sup> See Frerich, Frey (1993), p. 5 et seq.

<sup>60</sup> See Hockerts (1980), p. 67.

by the allies, which were aimed at introducing some level of dynamic adjustment of pension benefits to the price level in the economy.<sup>61</sup> Despite these modifications, pensioners in the post-war period represented the largest segment of the impoverished German population.<sup>62</sup>

In 1957, major pension reforms were introduced. First, the level of benefit entitlement after retirement was increased considerably to enable pensioners to maintain a living standard similar to the one pre-retiring. Second, pension calculations became dynamic by adjusting for changing living conditions, in particular price inflation and changes in gross salaries, thereby enabling pension members to benefit from the economic growth of the country in the post-war period.<sup>63</sup> In addition, independent pension systems for self-employed farmers, public service employees and craftsmen were introduced.<sup>64</sup> The 1957 reform ended basically the static pension system of the Bismarck era and established the pension framework that is still in place in Germany today.<sup>65</sup> 1972 marked a crucial moment in the history of Germany's public pension system, as important changes were implemented that led to the vastest expansion of pension benefits after WWII. Early retirement at the age of 63 years was introduced, more than 10 million beneficiaries received a 14.4% benefit increase with further increments in subsequent years and pension entitlements for minimum wages were announced.<sup>66</sup>

The German occupational pension system, in the meantime, lost economic significance as a form of salary substitution upon retirement, in particular after the 1957 pension reforms. Benefit entitlements provided by occupational pension solutions became mere remuneration instruments and played a rather complementary role in the retirement finances of pensioners.<sup>67</sup> Despite the decreasing economic importance of occupational pension plans, their market share continued to expand in the 1960s and 1970s. Direct Pension Commitments, in particular, were the predominant alternative offered by companies to

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<sup>61</sup> The act is called 'Sozialversicherungs-Anpassungsgesetz' from 1949.

<sup>62</sup> See May (2010), p. 90.

<sup>63</sup> See Schmaehl (2007), p. 12 et seqq.

<sup>64</sup> See May (2010), p. 93.

<sup>65</sup> See Ruerup (2002), p. 137.

<sup>66</sup> See Hermann (1990), p. 120 et seq.

<sup>67</sup> See Gieg (2008), p. 19.

their employees.<sup>68</sup> In 1974, the institution of the BetrAVG (Law for the Improvement of the Company Pension Scheme) was a milestone for the occupational pension scheme, as this act created the first legal framework for the second pillar of the German pension system.<sup>69</sup>

The decade of the 80s represented a period of consolidation for both the public and the occupational pension systems. The economic downturn, combined with the option of early retirement introduced in the 1972 reform, put considerable pressure on the funding of the public pension system, leading to important cutbacks in 1983/1984 and 1989, respectively.<sup>70</sup> The pessimistic economic outlook of the period also had a negative impact on the occupational pension system. As a consequence, the number of members and pension plans stagnated during the entire decade. In addition the high unemployment rate led many skilled employees to accept job contracts without pension plan.<sup>71</sup>

### **C. From the German Reunification in 1989 To Date**

The reunification of the FRG with the socialist-dominated German Democratic Republic (GDR) posed a real threat to the pension system of a unified Germany given the very different living standards in both countries. At the time of reunification, the ratio of average income in the East to the average income in the West had expanded to 1:28.<sup>72</sup> Hegelich (2004), for example, criticises the integration of both welfare systems into one single scheme “resulted in disintegration”.<sup>73</sup> The German legislator was subsequently forced to finance the significant funding gap created by the merger of both pension systems and the attempt to offer similar benefit levels in the Eastern part of Germany to those prevailing in the wealthier West. As Merten (2000) argues, the adjustment of both systems made Eastern pensioners the “true winners of the reunification”.<sup>74</sup> Oc-

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<sup>68</sup> See Sabrowski (2007), p. 11 et seq.

<sup>69</sup> See May (2010), p. 97.

<sup>70</sup> The major elements were the increase of the social security contributions to 18.5% of gross salary in 1983/84 and the increase of the minimum age for retirement to 65 years. See May (2010), p. 98.

<sup>71</sup> See Sabrowski (2007), p. 12 et seq. Historically, occupational pensions plan were offered almost exclusively to employees with a high position as some form of additional remuneration component.

<sup>72</sup> See Merten (2000), p. 317. This number takes into account the then prevailing exchange rate.

<sup>73</sup> Hegelich (2004), p. 82.

<sup>74</sup> Merten (2000), p. 317.

cupational pension structures lost further importance during these times, even suffering a decrease in number and membership.<sup>75</sup>

The costs and financial implications of the German reunification, combined with the high number of repatriates from Eastern Europe, who also benefited from pension entitlements, as well as the increasing aging of the German population put the pension system in jeopardy. The pension reforms introduced between 1999-2002 (for more details see appendix A) were intended to cause a paradigm shift in the German pension systems. The objective of the German legislator was to promote the second and third pillar of the pension system so as to disburden the statutory pension scheme from its long-term financing challenges. Capital-funded pension plans were sponsored, in particular with the *AltZertG* (2001) and *AVmG* (2002) law bills. As part of these developments, the 'Riester-Rente' for private pension plans and the Pension Fund for occupational pension schemes were introduced.<sup>76</sup> Overall, the reforms emphasized the expansion of the second and third pillar with the objective of incentivising citizens to take responsibility of their pension financings as well as reducing the role of state pensions.<sup>77</sup>

## **2.2.2 Institutional Structure**

### **A. Overview of the German Pension System**

The German pension system is structured similarly to most pension schemes in developed countries. The system is composed of three elements ('three-pillar-system'): (1) a statutory (basic) public pension scheme (first tier), (2) occupational pension schemes (second tier) and (3) individual private pension plans (third tier). The overall pension system has mandatory as well as voluntary components, while there are also aspects that are regulated and administered by the public service or the private sector.<sup>78</sup>

#### **A.1 Statutory Pension System (First Tier)**

The statutory public pension system represents the largest pension insurance component in Germany, with almost 80% of all pension benefits paid out

<sup>75</sup> See Sabrowski (2007), p. 12.

<sup>76</sup> See May (2010), p. 102 et seq.

<sup>77</sup> See Busemeyer (2005), p. 573.

<sup>78</sup> See Schmaehl (2005), p. 119.

to pensioners originated from this source. Approximately 80% of German employees are member of the first tier pillar. The state pension scheme has such an economic importance in Germany that approximately 10% of the countries gross domestic product (GDP) runs through this system.<sup>79</sup>

### ***A.2 Occupational Pension System (Second Tier)***

Occupational pension schemes have been introduced in both the public and the private sector. Within the public sector, in general all employees are covered by some form of supplementary pension plan, which comes usually in the form of collective agreements and offer defined benefit structures to its members. These pension arrangements are normally integrated within the German social pension insurance. In the private sector, approximately 51%<sup>80</sup> of companies offer occupational pension schemes, although the distribution is unequal between male and female employees and also depends on the respective industry sector. Collective agreements on occupational pension schemes in the private sector have historically played a minor role, although they have gained significance after the 2001 pension reform.<sup>81</sup>

### ***A.3 Individual Private Pension Schemes (Third Tier)***

Retirement plans within in the third tier have many different investment alternatives. Common instruments in Germany are savings plans, real estate objects and investments into equity or investment funds. Not all of these investments an employee may decide to undertake are allocated exclusively for retirement provisions, so that a clear distinction of funds assigned to the third tier is a difficult task. In addition, there are pension plans that are subsidised by the legislator and which have been introduced in recent years (e.g. the 'Riester-Rente' in 2001).<sup>82</sup>

## **B. Economic Importance of the Pension System**

### ***B.1 The German Pension System in the European Context***

Figure 2 compares the distribution of pension benefits amongst the three pension tiers in the European context. As the chart illustrates, the public pen-

<sup>79</sup> See Duenn, Fasshauer (2009), p. 112.

<sup>80</sup> See Bundesministerium fuer Arbeit und Soziales (2008), p. 11.

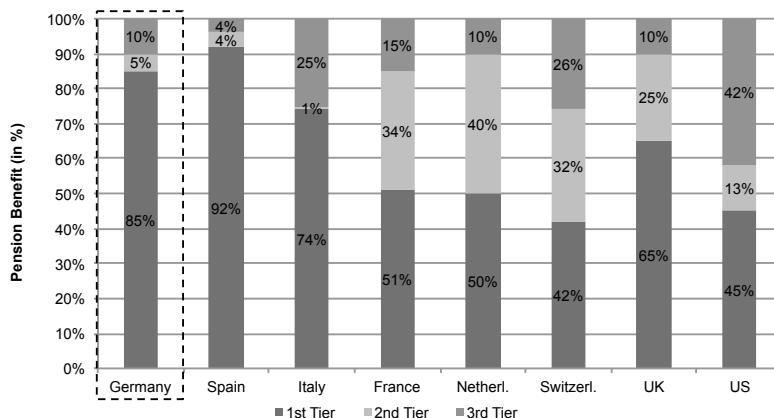
<sup>81</sup> See Schmaehl (2005), pp. 119-121.

<sup>82</sup> See Duenn, Fasshauer (2009), p. 113.



sion system plays a predominant role in all industrialised countries, although at different penetration levels. While in Germany (85% market share), Spain (92%) and Italy (74%) the public pension scheme is doubtlessly the major source of pension benefits, in some developed countries the second tier and third tier achieve similar market shares. In Switzerland, for example, public pensions represent only 42% of total average pension benefits, while occupational pension schemes obtain 32% and private pension plans 26% of market share. The US is also a peculiar market, as the first tier embodies 45% of all pension benefits, the second tier 13% and individual private pension solutions up to 42%. These numbers are also a reflection on the role social security systems play in the respective countries. While in some countries private sector and individual pension plans are necessary to guarantee an adequate pension benefit level upon retirement (i.e. US, Switzerland, Netherlands, France, UK), some countries rely primarily on statutory pension schemes (i.e. Germany, Spain, Italy).

Figure 2: Origin of Pension Benefits in Europe and the US (2005, in % of a Two-Person Household)



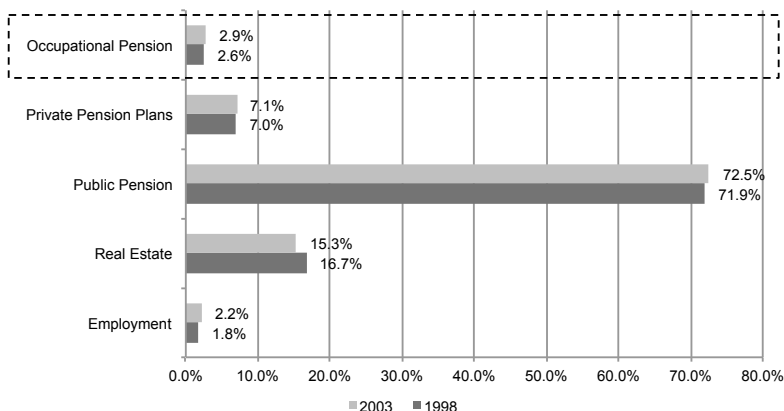
Source: FAZ (2005), p. 24.

## **B.2 Pension Income Distribution in Germany**

Furthermore, we have analysed how the gross income of an average German pensioner is originated. This figure goes beyond the sources of pension benefits discussed in the previous section as also non-pension income is considered. The German Federal Statistical Office has published empirical data for the years 1998 and 2003 that show the income distributions of a one-person

pensioner household. Figure 3 summarises the main findings. Public pension plans remain hereby the main source of income for Germany's pensioners with more than 70% of weight, followed by real estate ownership<sup>83</sup> with 15% and benefits sourced from private pension solutions. Occupational pension schemes remain with 2.9% relatively unimportant as income stream for today's pensioners.<sup>84</sup>

Figure 3: Gross Income Distribution of German Pensioners (1998 vs. 2003)



Source: Own figure, based on Statistisches Bundesamt (2007), p. 594. Note: Data shows distribution of gross income of German pensioners in 1998 and 2003, respectively, for a one-person pensioner household. Numbers are an average for Western and Eastern Germany.

An analysis of Germany's three-tier system by Deutsche Rentenversicherung Bund (2005) comes to interesting conclusions in connection to the relevance of the second and third tier of the pension system. While the authors of the study state that the public pension system will remain the predominant source of pension benefit income in the foreseeable future, they also conclude that both the second and third tier will have to play a much more dominant role than they than currently in order to provide sufficient supplementary retirement benefits to pensioners. Moreover, the report analyses the distribution of the potential pension entitlement of all three pension tiers amongst employees of the age range 40-60 years to get a better insight into the potential future distribution of Germany's pensions.<sup>85</sup> Figure 4 summarises the breakdown of two different target

<sup>83</sup> For real estate assets, the Federal Statistical Office includes income generated through rent but also outright real estate ownership.

<sup>84</sup> See Statistisches Bundesamt (2007), p. 594.

<sup>85</sup> See Deutsche Rentenversicherung Bund (2005), pp. 12-15.

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