

Déjà vu in Deutschland?

Stephen Richards, David Stevenson, and Paul Ernest discuss pensions and insurance in Germany.

TUMBLING EQUITY MARKETS. Life insurers with dangerously weak balance sheets. A lack of assets backing occupational pensions. State pensions in a mess. Unpopular private pension products. A rising tax burden. Creaking health service finances. It all sounds familiar to UK readers, but the above actually describes the Federal Republic of Germany.

The equity markets alone tell a sorry tale. The FTSE-100 fell by over 40% from the start of 2000 to the end of 2002. However, the main German stockmarket index, the DAX 30, fell even further during this time period, at a whisker under 60%. Worse still, many companies listed on the *Neuer Markt* have either gone bust, been de-listed, or collapsed after accounting scandals. As a result, *Neuer Markt* itself is to close.

Life insurers

German life insurers are restricted to investing a maximum of 35% of their assets in equities, but the steep falls in share prices have still been hard to bear. A survey by Fitch, a ratings agency, showed many German life insurers to be weakly capitalised and the industry was put on 'negative outlook', meaning credit downgrades are probably pending.

The nature of historical German life business means insurers are also exposed to onerous policyholder guarantees. One reason for the weak capital bases is historical competition on with-profits business bonus rates. Although investment returns have been poor for some time, many insurers have only recently started to reduce their reversionary bonus rates, which for 2002 were still between 5.5% and 7%.

Although the supervisory authority denies German insurers are in trouble, it has introduced a new insurer of last resort, 'Protektor'. Any insurer in difficulties must follow a three-stage process. The first stage involves the insurer presenting a plan to the authorities, followed by – stage 2 – the execution of the plan. If this is unsuccessful, the insurer must seek a merger partner or buyer. If this fails, the third stage is reached, whereby *Protektor* assumes all contractual liabilities.

Occupational pensions

In Germany the state pension is the major part of retirement income, with company-sponsored pensions playing a much smaller role. A worker earning the average salary over 45 years will retire on a gross state pension of approximately 48% of average gross final salary. Under the German tax system, the majority of pensioners pay no tax on their state pension. Coupled with reduced social security contributions, the average worker actually retires with a net income close to 70% of net pre-retirement income.

Occupational pension schemes do exist, but with one major difference: pension promises do not have to be funded and a large proportion of liabilities are simply accumulated on the employer's balance sheet, leading to problems in the event of an employer's insolvency. With the record number of 37,000 corporate bankruptcies in 2002, claims on the guarantee fund are rising steeply.

Some larger companies have a type of funded trust arrangement (contractual trust arrangement), set up to take advantage of certain tax and accounting benefits. However, the government dislikes their unregulated nature and has therefore introduced an alternative concept, *Pensionfonds*, which have a good degree of investment freedom, but with a full set of prudential regulations. The regulatory and capital cost of establishing a *Pensionfond* is prohibitive for all but the largest employers. This would be a natural market for insurers, except that the limited tax concessions have proved unappealing to employers and employees alike.

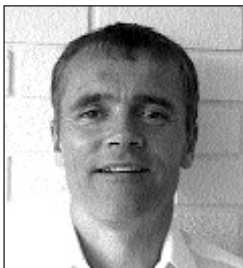
State pensions

Germany's pay-as-you-go pension system is vulnerable to rising longevity (more money paid out), high unemployment (fewer contributions collected), and a declining support ratio (fewer contributing workers per pensioner). In December 2002, Germany's unemployment rate was high, at 10.1%. The contribution rate – split equally between employer and employee – has just been raised to 19.5% of gross band salary, while the upper band limit was raised substantially from €4,500 to €5,100. The government also reduced the liquidity reserve to 50% of monthly outgoings. Without these changes, the government claims the contribution rate would need to have risen to 19.9% of band earnings.

Recent reforms to the state pension entitlement formula aim to keep the contribution rate below 20% until around 2020, and under 22% until around 2030. Nevertheless, further reform is almost certain to be necessary. A commission has been formed to examine the sustainability of the social security systems and is due to report in October 2003. Possibilities include raising the state pension age from 65 to 67 and making public-sector employees pay contributions for the first time. Successive governments have traditionally shied away from making fundamental, and unpopular, reforms to the state pension system.

Private pensions

Around the time the UK government introduced stakeholder pensions, the German government also made a tentative foray into private pensions for the masses, known as 'Riester-Rente' ('Riester pension', named after the employment minister who introduced it).



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The views expressed here are those of the authors and not of their respective employers.

Sales have been disappointing so far. By the end of 2002 there were around 3m individual Riester contracts in force, and around 2m occupational arrangements. Limited yet highly complicated tax benefits have not made Riester pensions especially attractive to savers. Fund management groups have been unable to compete as providers, since only insurers can provide the required (and onerous) mandatory guarantees. However, Riester pensions are not popular with insurers either, largely due to complex administrative requirements. Tax relief is variable, linked both to the contribution and the number of children of the policyholder. Insurers have adopted a range of different charging structures, making it difficult to compare products across different providers. The consumer press has also attacked the lack of transparency of charges.

Taxation of savings

With a budget deficit in excess of the 3% limit specified by the Eurozone's stability and growth pact, the newly re-elected 'red-green' coalition is faced with cutting public spending or increasing taxes. The government has opted to increase taxes, including the introduction of a flat-rate capital gains tax on shares and property purchased after November 2002. The re-introduction of a 'wealth tax' was also discussed, but as yet there is no immediate likelihood of either this or a tax on the maturity proceeds of life insurance policies, as had been mooted in 1999.

After a constitutional court ruling in spring 2002 requiring the government to bring the taxation of civil servant and statutory pension scheme pensions into line by 2005, the government established a commission to make recommendations on the taxation of contributions to, and benefits from, all forms of retirement provision, including life insurance policies.

The commission reported in early 2003 and recommended a move to deferred taxation for all pension arrangements. In effect, this means all new pre-funded arrangements will be taxed identically. The introduction of a new deferred annuity contract with non-inheritable benefits and full tax was also proposed. Premiums should receive full tax relief.

This is to be part of a three-pillar savings system. Pillar 1 will consist of this new deferred annuity contract, and the state (or civil servants') pension. Pillar 2 will consist of private or occupational arrangements under which benefits should be taken partially in cash, but mostly as a life annuity. Contributions will be tax-exempt up to a limit, but there will be penalties on early surrender, or inheritance of a lump sum. Pillar 3 will consist of capital accumulation contracts.

It is with the third pillar that contention arises: the commission has proposed a level playing field, and this would mean removing the tax freedom granted to cash lump sums from endowment assurances. Naturally, the life insurance industry does not like this. Currently, life insurance enjoys a highly favoured and anomalous basis with returns free of taxation after 12 years if at least five years' premiums have been paid. It

remains to be seen if acceptance of the commission's report will lead to a surge in sales of endowments similar to that seen in 1999 when a tax on life policy proceeds was last planned (but later withdrawn).

The commission also proposed the equalisation of taxation of civil servants' benefits and state pensions, to be phased in gradually from 2005 to 2040.

Another EU-inspired tax development of great significance is the proposed withholding tax on savings income. This proposal results from the refusal of certain territories (Luxembourg, Austria, Switzerland) to amend their strict laws on banking secrecy and disclose the savings income of non-residents to their respective tax authorities. The issue is highly significant for the many wealthy German savers who use these territories to hide income from the German tax authorities. It also affects the territories themselves, with the risk of substantial capital flight from either disclosure or the withholding tax.

Health insurance

With its breadth and quality of treatment, the German health system ranks amongst the very best in the world. Unlike the UK's NHS, the German system of delivery is decentralised with self-employed doctors and many private and not-for-profit hospitals. There are no queues or waiting lists as such.

While the quality of the German service high, its long-term affordability is questionable. Most employees pay compulsory health insurance contributions into their choice of state-supervised (but privately managed) fund, called a *Krankenkasse*. There are no risk-based premiums in this social insurance: contributions are a flat percentage of band salary, regardless of risk or even the number of people covered (non-earning spouses and children are covered by the main wage-earner's contributions). Although people can change their *Krankenkasse*, regulations inhibit real competition between the funds on the basis of price and benefits. Contribution rates have risen steadily in recent years: the rate varies by *Krankenkasse*, but most lie in a narrow range just under 15% of band salary. This cost is split between employee and employer, but these rates are unsustainable for an ageing population with ever more frequent and expensive treatments.

After the election, the government pushed through an emergency act which placed more pharmaceuticals under price control and froze the fees charged by doctors and dentists. The income above which people could contract out of the state system was raised substantially, and increases in contribution rate are permitted only under certain exceptional circumstances. The act is being challenged in the constitutional court by one of the federal states.

The nature of the beast

The UK and German insurance and savings industries remain – like their economies – very different beasts. Nevertheless, any UK actuary would instantly recognise and understand most of the factors causing problems for German actuaries. □

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For further discussion on the German market, see 'International Expansion: A UK Perspective', *British Actuarial Journal*, Volume 6, part 1, No 26, pp10–27