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"Pension reform in Germany and key supervisory challenges"

Keynote Speech

by

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"Pension Trends and the Changing Supervisory Landscape"

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in Berlin

Dr Odundo,

Mr Laboul,

OECD Delegates, IOPS Members and colleagues,

Ladies and gentlemen,

It is an honour for us, BaFin, to organise this year's OECD and IOPS Global Forum on private pensions, and to have the opportunity to discuss pension trends and the changing supervisory landscape with the distinguished circle of experts here today.

Ladies and gentlemen, pensions matter! Pension provision is one of the *most important* fields of labour, social and financial policy. It is supposed to enable people to enjoy an adequate retirement and prevent poverty in old age. And it accumulates capital that companies in every sector of the economy can use for investments. Pension provision is therefore of great relevance both from a micro and a macroeconomic perspective.

As you know, pension systems differ from one country to another. For reasons of tradition, because consumers, beneficiaries or employees in country A have different preferences to those in country B, and because of differing statutory requirements. You only have to think of the three pillars comprising the 'state pensions system', 'occupational pensions' and 'personal pensions'. There are countries where personal pensions play a greater role than occupational pensions. As far as occupational pensions are concerned, there are classic *defined benefits* countries and countries where there are only *defined contributions*. Anyone who wants to assess the value of a retirement pensions system must make the effort to look closely and avoid generalisations.

Although the systems differ, the reform efforts in the individual countries do exhibit certain common features. They all aim at sustainability and above all, at finding a way to prevent poverty in old age. The question of fairness between the generations has also been under scrutiny. And a major concern is often how to deal with demographic changes. You will hear about these and other points today and tomorrow from speakers from various countries.

What are retirement provisions like in Germany? What needed to be reformed and why? Let me expand briefly: here in Germany, there has traditionally been a strong public pensions system. About 80 per cent of total pension benefits currently come from this pay-as-you-go system, which is funded by contributions from the working population and by tax revenues. The proportion of funded occupational pension schemes and the personal variant has been rather low until now, when considered in relation to Germany's economic importance. In view of the demographic trend in our country, this system would not have been sustainable in the long term. The German population is getting older on average, and in absolute terms, could even shrink. In just a few decades, the ratio of pensioners to people in work who contribute to the pay-as-you-go system, will reach 1:1. If German legislators had stood idly by as this demographic trend continued, contribution payments to the state system would have continued to increase. Of course, the same applies to employers' costs, which would have spiraled – and that in the face of increasing international competition. So legislators *did* act. The system was reformed and structural changes were made.

The reforms began in 2001. The government at the time introduced a demographic factor into the state pensions system in order to reduce the level of benefits by curbing pension increases. In addition, retirement age was raised in several stages over a period of almost 20 years from 65 to 67 years. I was born in 1961 and will have to work until I am 66 years and 6 months old in order to receive my full statutory pension. In order to compensate for the reduction in pension benefits from the pay-as-you-go system, the government is subsidising the second and third pillars: occupational and personal pension schemes. The financial incentives are a combination of tax breaks, exemption from social security contributions and direct payments to savers.

What has been achieved so far? Occupational pensions are much more widely used than in 2001. The number of employees entitled to benefits from occupational pensions has risen by five million to 19.6 million (2015). More than 60 per cent of all employees are now entitled to the second pillar of occupational pensions. The state-subsidised personal pension product is also a success. Over 16 million so-called Riester contracts, named after their intellectual father, former Labour and Social Security Minister Walter Riester, have been taken out so far. Today, 70 per cent of all employees who are insured under the public pillar are also entitled to occupational pensions or have taken out a Riester contract. In this manner it was possible to stabilise the contributions to the state pensions insurance.

This all sounds like a resounding success and it is. Yet: many challenges still lie ahead of us. Occupational pensions are widespread among large employers; among small and medium sized enterprises on the other hand, they are much less common. In addition, the proportion of people who actively contribute to their pensions is greater among those with higher incomes. The steps taken so far are clearly not reaching people on low incomes to a sufficient extent. 50 per cent of all employees in the lowest income category, i.e. earning less than 1,500 euros per month, have neither an occupational pension nor a personal pension contract. These people are potentially the most seriously affected by poverty in old age. Something that can further exacerbate the situation is the low level of interest rates. In order to compensate shortfalls in the first pillar, today's working population needs to save more money as interest rates remain in decline. The second session today will deal with this problem.

Further reforms might be needed. At present, discussion is ongoing about whether occupational pensions can be made more common, particularly among small and medium-sized firms. Of course, occupational pensions could be made mandatory - including an opt-out possibility. However, that would not fit too well with the *voluntary* character that occupational pension schemes have had so far in Germany.

Let me add a few words about supervision. We regulators are faced with a series of key supervisory challenges. One of them – this, I assume, is a concern for you as much as for us – is the low interest rate environment. How badly a country is affected by this, how the risks are shared and what role the supervisory authorities play, depends primarily on the specific design of the pensions system and the range of products.

Let us take a look at Germany – starting with life insurance. The decisive factor is: does the insurance company provide guarantees or, as in the case of unit-linked life insurance, does the insured bear the investment risk? In particular if guarantees are given, which has always been the case in Germany, then of course it is the primary duty of the supervisor to ensure that the benefits are paid out in the long-term. The way this is done in Germany is that the companies bolster their provisions and pay out less in profits, thus increasing their risk-bearing capacity. BaFin is monitoring this adaptation process very closely, especially by demanding medium and long-term forecasts, by carrying out a large number of audits and by an ongoing dialogue with the undertakings. Market-consistent valuation, which is to be carried out in the future according to the European Solvency II Directive, will help reveal the risks to which the undertakings are exposed. However, it is clear that the undertakings will need to be given time to make the necessary adjustments. Part of this process means that insurers will have to think seriously about their product range. This doesn’t mean abolishing each and every guarantee, but rather developing intelligent solutions that meet customers' requirements for secure and calculable benefits and are still affordable for the insurance undertakings.

What consequences does the low interest rate environment have for occupational pensions? That depends very much on the decision by legislators and the social partners of whether to promise benefits or contributions. If pension funds themselves give a guarantee of retirement pension benefits and the employer is not liable, the risk situation is comparable to that of life insurers. The challenges for supervisors are also similar.

Often, employers promise defined benefits, so that *they* are ultimately responsible for pensioners' benefit entitlements. In Germany that is always the case. So the promised financial support of employers is a second safety net, in addition to the assets of the pension fund. In order to cover the risk of the employer going out of business, there are also pension protection schemes in Germany and some other countries. The German pension protection scheme covers the pension promises made by over 90,000 employers who represent the majority of the whole German economy and finance the pension protection scheme. Above all, it is those additional security mechanisms, sponsor support and pension protection schemes that distinguish pension funds from life insurers. These differences also justify different supervisory rules, and a different role for supervisory authorities.

Ladies and gentlemen, after having taken a brief look at reforms and the low interest rate issue in Germany, I am looking forward to hearing what new developments are occurring in other countries. Tomorrow, the Forum will be looking at other fascinating topics: the role of large pension funds in a country's economy, consumer protection in occupational and personal pensions and the insights from behavioural economics for the design of the pension pay-out phase. I greatly regret that I shall not be able to be here tomorrow. But my colleagues will tell me all about it. Our work as supervisors is changing. Let us shape this change process together, and inspire each other. I wish all of us an interesting meeting, and many fruitful discussions.