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# **Governance of the German Pension System**

## **Part III**

### **Third Pillar: Private Pensions and Wealth**

#### **Some Prospects on Third Pillar Pensions in Sweden**

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Research and Development

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## Twining Project AZ/13/ENP/SO/24

Support to the State Social Protection Fund on the introduction of funded elements within the insurance-pension system, establishment of non-state pension funds and development of the legal framework for regulating their activities

### ***Activity 4.1***

***In-depth presentation of the state pension system of the EU MS to relevant SSPF staff and other stakeholders***

21–22 July, 2014

- State Social Protection Fund
- 80 H. Zardabi Ave. ● Baku, Republic of Azerbaijan

# Introduction

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- Role and place of third pillar pension provision is different in Germany and Sweden.
- Financial regulation of third pillar pension provision in Germany and Sweden is rather similar because both regulations are shaped by international standards and European Union legislation.
- Examples are the Bale II standard for banks. Solvency II for insurance companies, IORP directive occupational pensions and a number of financial regulations applying to various financial institutions e.g. MiFID. Emir, etc.

# Perspective on Sweden

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- Model Savings Plans
  - Bank Savings Plans: Tax privileged retirement accounts
  - Insurance products
- Coverage: more than half of the working population
- Regulation and Supervision
  - EU Directives and Regulation (Internal market principles)

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# Institutional Design

# The German Version of Second and Third Pillar Provision (1)

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- Common features
  - Voluntary engagement
  - EET tax treatment (except: home ownership loans)
  - Tax allowances for families and low income earners
  - Annuities
  - Limitations to lump-sum payments

# The German Version of Second and Third Pillar Provision (2)

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- Occupational Pension
  - Right to occupational pension provision
  - Employer sponsoring is declining
  - Employee sponsoring and deferred compensation
- Private Commercial Pension Provision
  - Tax allowances beyond EET for low income earners and families
  - Current number accounts: around 16 million

# Model Saving Plan

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- After introductory period (2008)
- Tax privileged saving of 4 % of gross salary (up to threshold of Euro 66,000 ): Euro 2640
- Basic allowance Euro 154
- Child allowance: Euro 185 (300 for children born after 2007)
- Signing bonus of Euro 200 for young workers
- Basic contribution for small income earners: Euro 60

# The Design of Benefit Pay-out

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- Between overcoming myopia and creating products consumers want
- Principle and objective: Insurance of longevity risk
- Lump-sum payment limited to 30 percent of accumulated capital
- Life annuity
- Programmed withdrawal plan in combination with deferred annuity starting at age 85
- Home purchasing loan since 2008, 2010 ...

# Additional Design Features

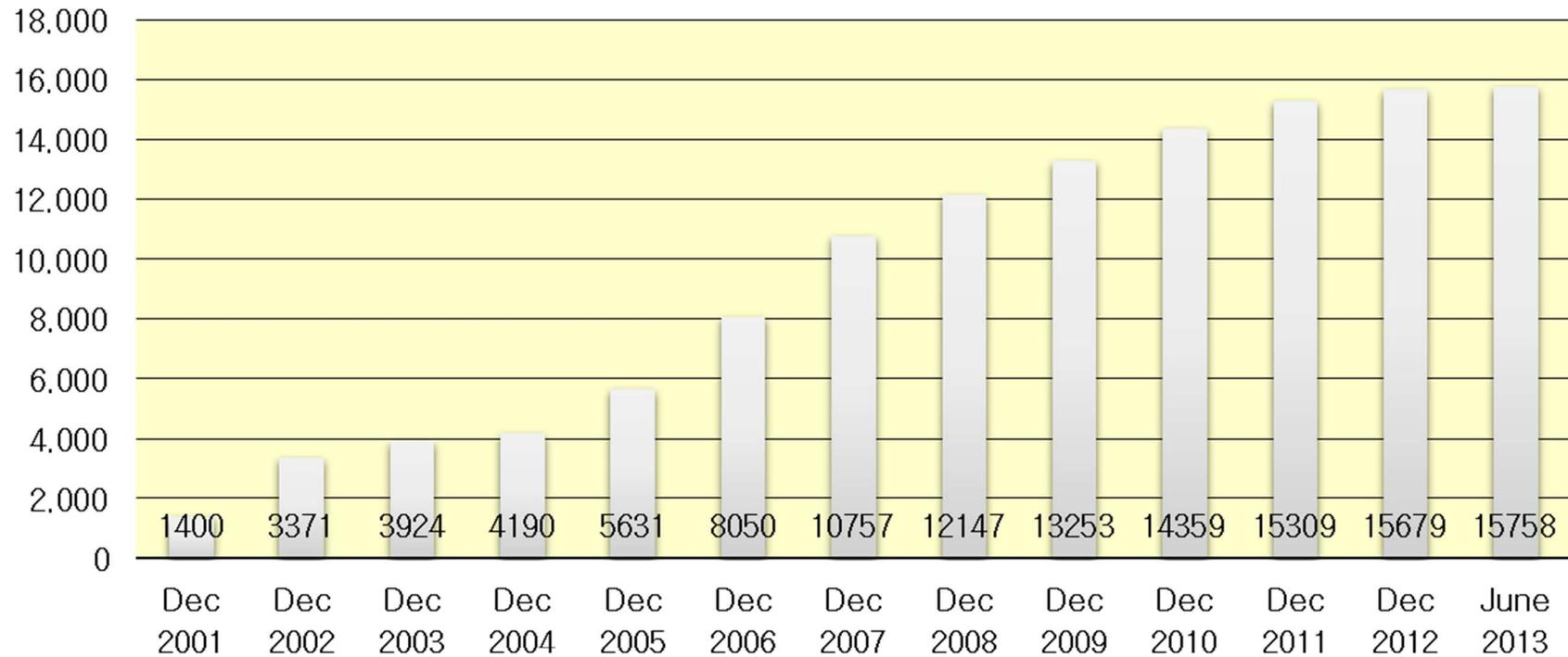
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- Options:
  - Survivor benefit
  - Invalidity benefit
- Guarantees: Principal is guaranteed
- Deferred taxation, EET tax regime
- Support of low income earners and families with children
- Information and disclosure rules

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Coverage

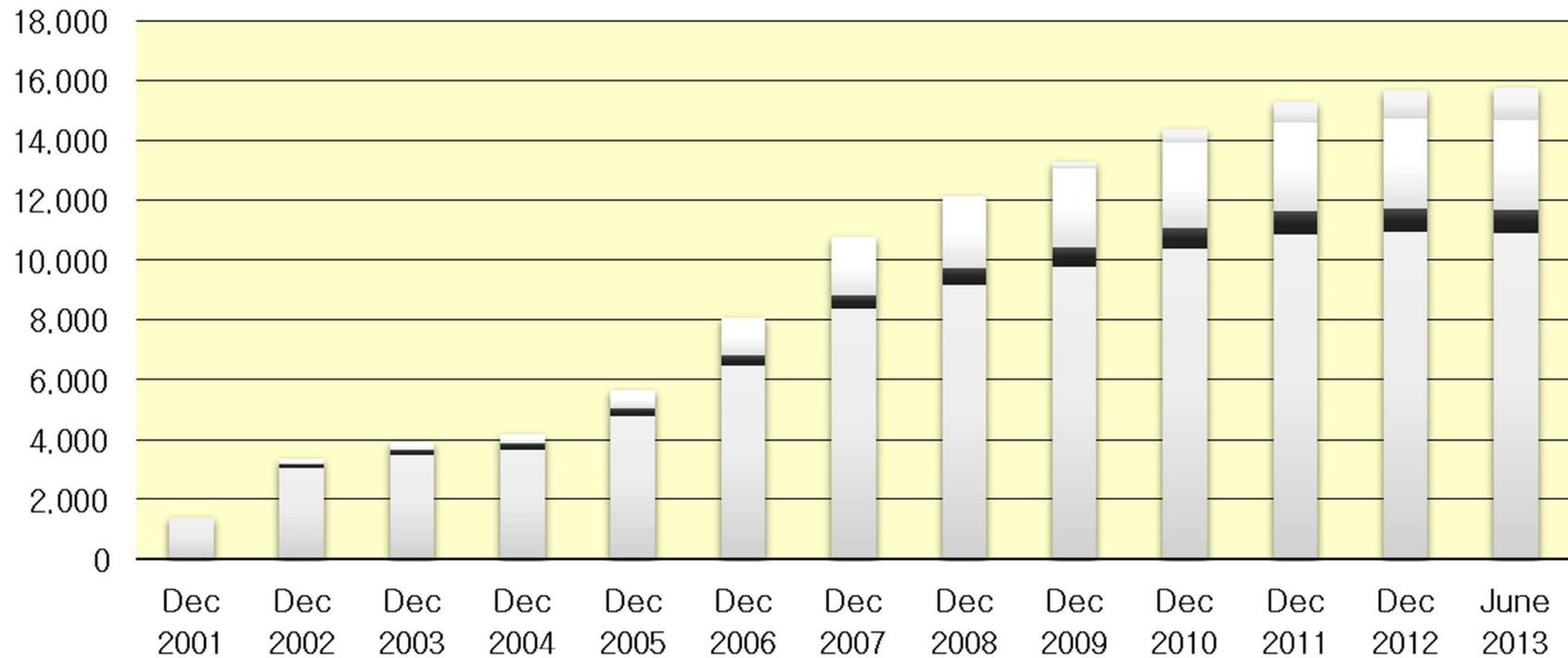
# The Spread of Riester Pensions



Source: BMAS

■ Total

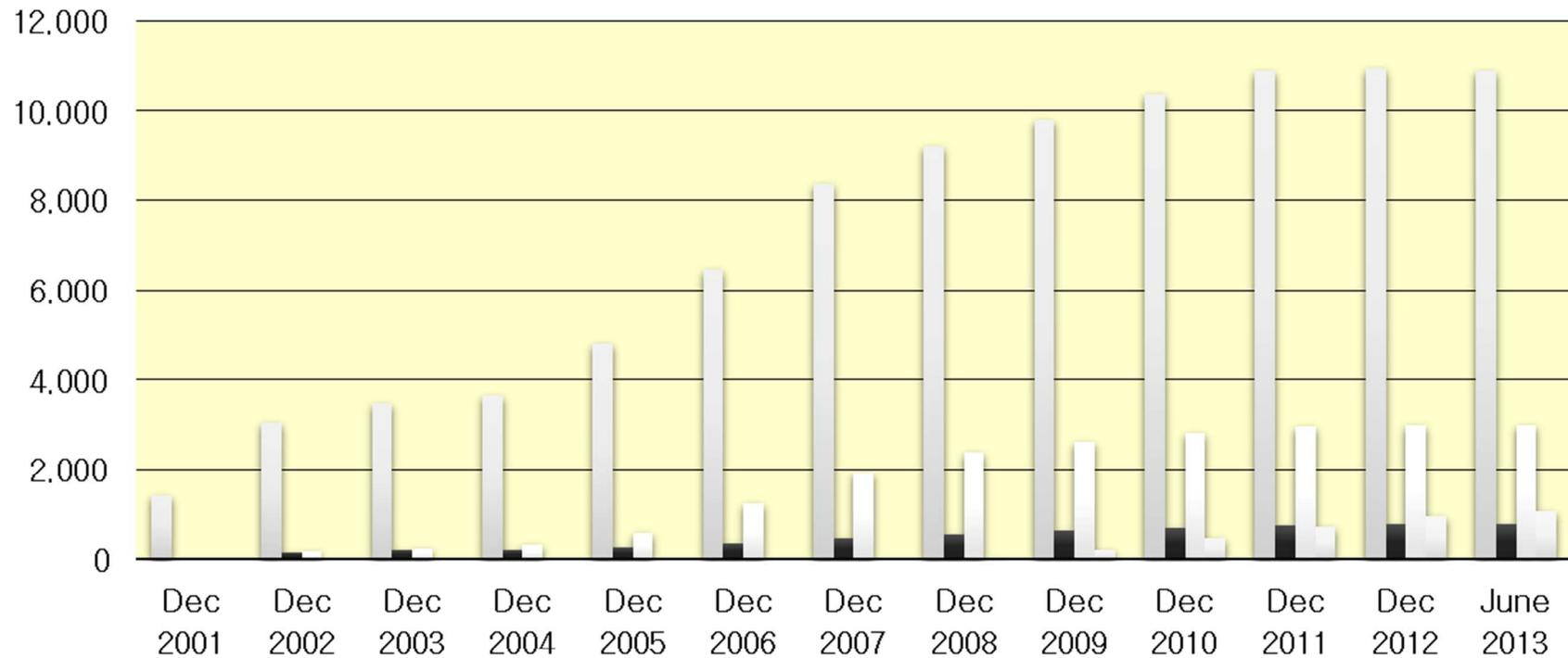
# The Spread of Riester Pensions



Source: BMAS

■ Insurance Contracts ■ Bank Deposits ■ Investment Funds ■ Home purchase savings

# The Spread of Riester Pensions

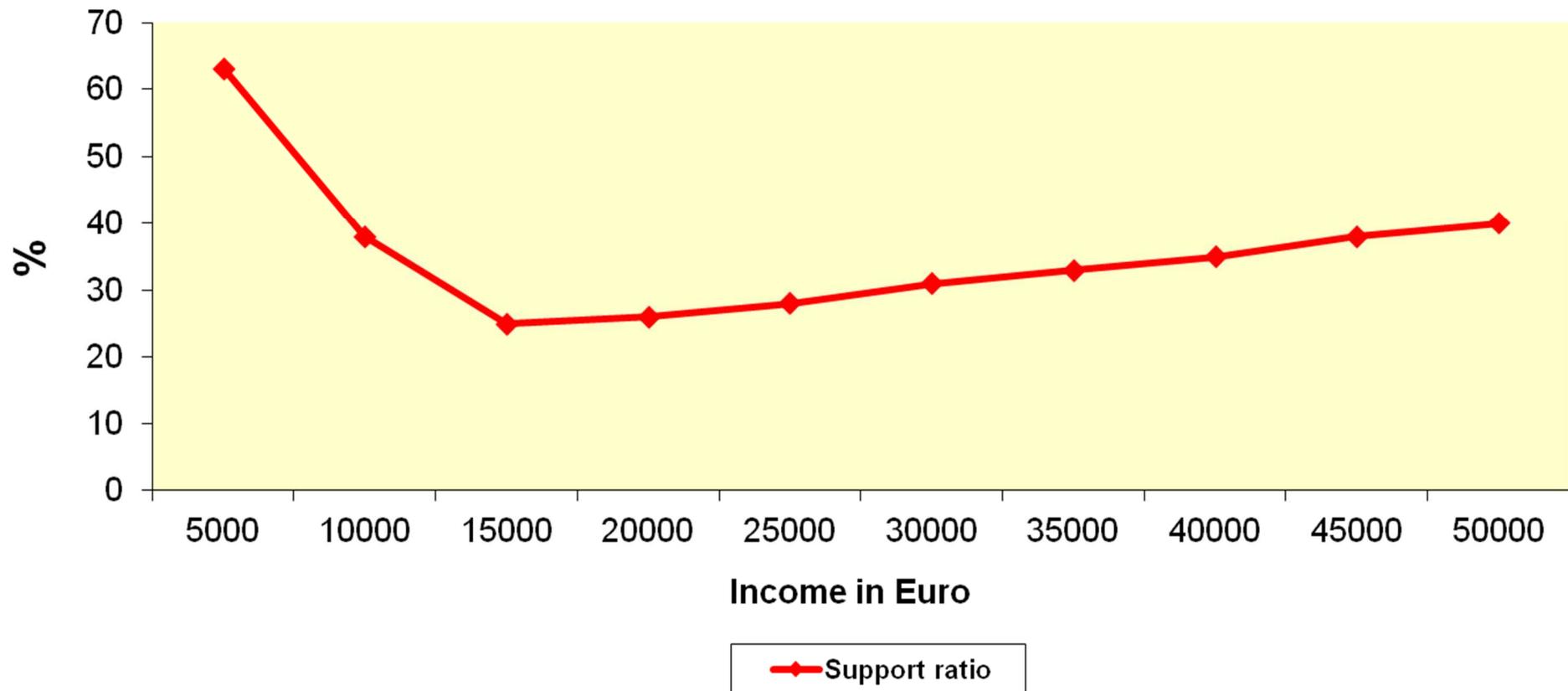


Source: BMAS

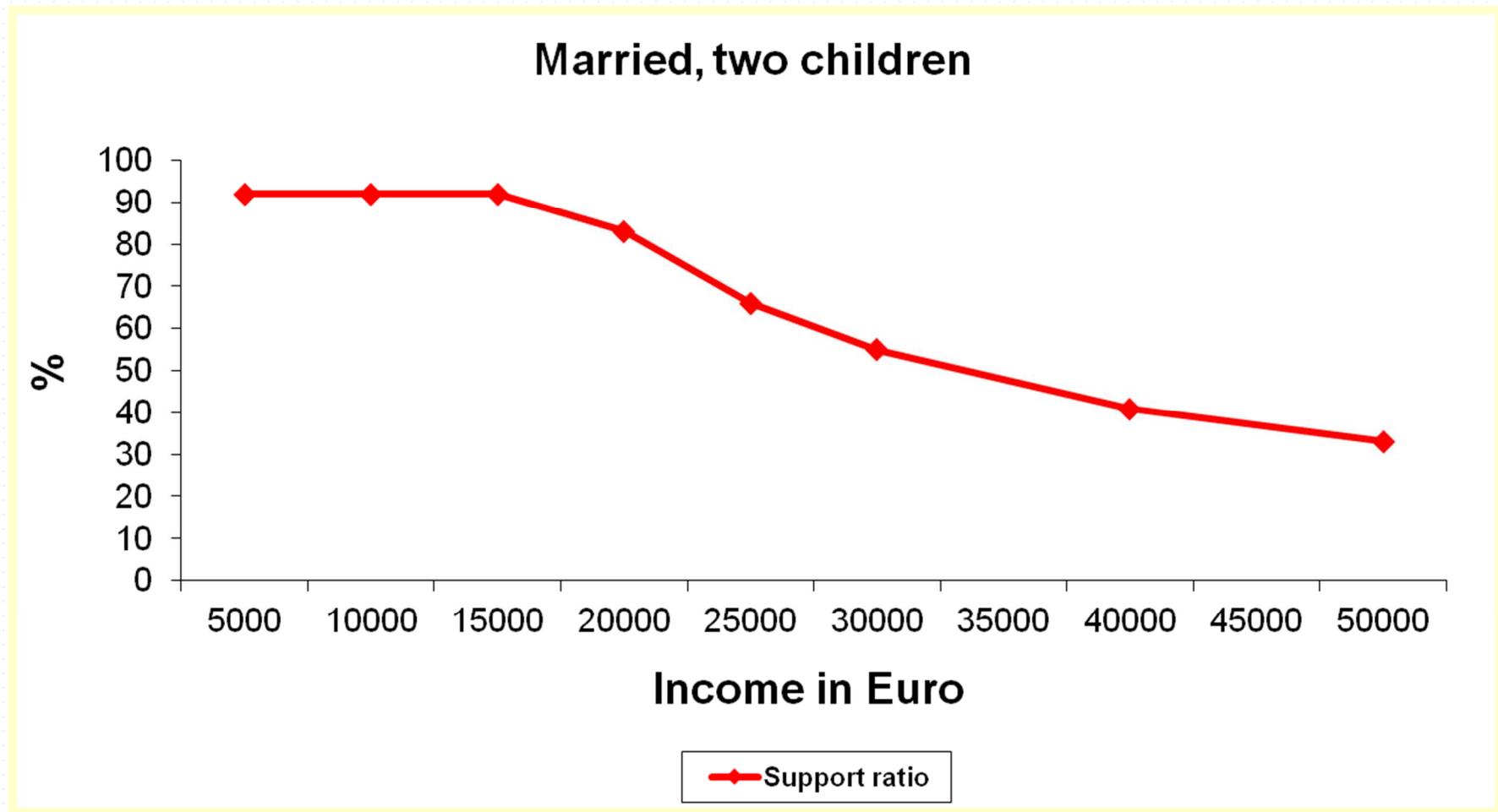
■ Insurance Contracts ■ Bank Deposits ■ Investment Funds ■ Home purchase savings

# Incidence of allowances and tax breaks (1)

## Single, without children



# Incidence of allowances and tax breaks (2)



# Incidence of Tax Allowances

Gross Annual Income	Distribution in Percent		
	2007	2008	2009
<b>Euro</b>			
<b>Below 10,000</b>	30.3	31.3	29.8
<b>10,000 – 20,0000</b>	20.3	19.8	20.0
<b>20,000 – 30,000</b>	19.6	19.0	18.6
<b>30,000 – 40,000</b>	14.3	14.1	14.7
<b>40,000 – 50,000</b>	7.2	7.2	7.6
<b>Above 50,000</b>	8.3	8.6	9.3

# German Pension System: Riester Pension

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- Potential size of the market: 40 million contracts
- Currently about 16 million contracts (2nd quarter of 2013)
- Mostly insurance contracts
- 3 million investment fund contracts
- 1 million: Home purchasing savings
- About 450 active providers

# German Pension System: Riester Pension

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- Cumulated household savings about €40bn (mid 2013 estimate)
- Cumulated subsidies about €16bn (mid 2013 estimate)
- Total capital, including returns on investment:
  - No statistics available
  - Research project underway
- Target replacement rate of gross salary (after 40 years) approximately 18 percent (on top of 40 – 42 percent from the statutory pension insurance)
- Incomplete take-up of tax subsidies

# Counselling and Financial Advice

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- Counselling services of administration of statutory pension scheme
  - general information on private pension provision
  - 200 more staff members; training courses
  - Forecast of old age pension from statutory pension scheme
- Expansion of consumer protection organisations
  - Consumer information
  - Double checking of company ads
- Expansion of commercial financial advisors
  - activities became more visible

# Consumer Education and Financial Literacy

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“Altersvorsorge macht Schule” or “Pension planning gets popular”

- German Pension Insurance and Federal Ministry of Labour and Social Affairs; Employers’ organisation, Trade unions
- Course programme in Centres for Adult Education (Volkshochschulen), since 2007
- Pension planning and Purchasing
- 17,000 participants in 1,400 courses
- Cost of project: Euro 3.4 to 4m
- Evaluation

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# Principles of Regulation and Supervision

# EU Supervisory Architecture of Financial Markets

## Steering Committee

**EBA**

National Banking  
Supervision

**EIOPA**

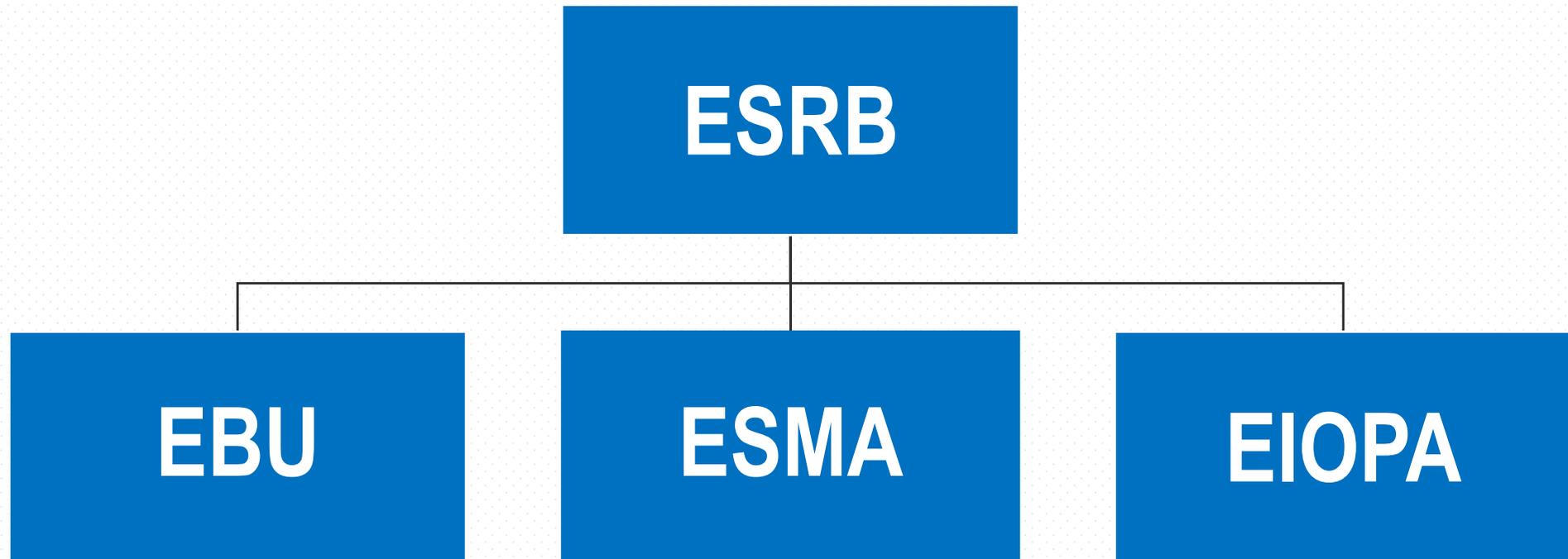
National Pension  
and Insurance  
Supervision

**ESMA**

National Securities  
and Markets  
Supervision

# Supervisory Architecture

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# EU Supervisory Architecture of Financial Markets

<b>INSTITUTION</b>	<b>TASK</b>
<b>European Central Bank (ECB)</b>	<b>Systemic Risk Board: System Stability Surveillance, macro-prudential oversight</b>
<b>European Banking Supervisory Authority (EBA))</b>	<b>Banking supervision</b>
<b>European Securities and Markets Authority (ESMA))</b>	<b>Stock exchange and securities trading Credit Rating Agencies</b>
<b>European Insurance and Pension Funds Supervisory Authority (EIOPA)</b>	<b>Insurance and pension funds supervision</b>

# EU Supervisory Architecture of Financial Markets

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## Tasks, Rights and Powers (I)

- Definition of mandatory technical standards of supervision for national supervisory authorities
- Guidelines and recommendations for financial business
- Direct directives and instructions regarding particular financial institutes or national supervisory authorities in case of looming emergencies.
- Responsibilities for carrying out the day-to-day business of supervision remain with national supervisory authorities.
- Distribution of powers between EU and national level: disagreement resolution

# EU Supervisory Architecture of Financial Markets

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## Tasks, Rights and Powers (II)

- Direct directives regarding cross-border active companies case of disputes between national supervisory authorities
- Direct directives, in case national supervisory authorities repeatedly do not comply with European rules of supervision. [??]
- Responsibilities are restricted to measures not interfering with fiscal and financial responsibilities of member states.

# Financial Market Regulation (selection)

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- European Directives
  - Banks: Capital Requirement Directive IV
  - Insurance Companies: Solvency II Directive (in preparation)
  - Markets in Financial Instruments Directive (Trading, Risk exposure and management)
  - EMIR (European Market Infrastructure Regulation)
  - UCITS (Units of Collective Tradable Securities)
  - AIFMD (Alternative Investment Fund Manager Directive)

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# Principles and *Methods* of Funding

# *Insurance Companies*

## Business Model – Principles

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- Insuring biometric risks: Age, invalidity, longevity, provision for survivors
- Options, guarantees, safety-driven product in comparison to investment funds or certificates
- Assurance model
  - Future pension based on contributions
  - Benefits determined by actuarial calculations (and by business strategies) from capital stock, surplus from mortality and technical insurance)
- Safety margin: Supervision and PROTEKTOR
- SOLVENCY RISK due to low interest rates

# *Insurance Companies*

## Full Funding

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- Development of demand, turn-over, employment and profits
  - Endowment; allocation to reserves
  - Premium income (2008): €79.6bn
  - Asset allocation and investment in line with prudent person principles
  - Quantitative and qualitative requirements: actuarial funding reserve, investment limits
  - Regulation and supervision: Federal Financial Supervisory Agency (Bundesagentur für Finanzdienstleistungsaufsicht – BaFin)

# Insurance Companies

## Asset Allocation (% of total)

Asset Class	2007	2008
Investment funds (real estate)	23.9	24.4
Loans, covered loans	17.1	17.3
Bonds, covered bonds	31.2	31.0
Bank deposits	16.4	16.7
Shares	3.8	3.6
Other (7 items, largest < 2.3%)	7.6	7.2

# *Insurance Companies*

## Asset Allocation

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- Bonds
- Real estate
- Real estate credit, hypothecary credit
- Shares
- Other instruments
- High concentration of assets in, government bonds, incl. covered bonds; corporate bonds, secondary bonds (banks) and real estate
- Exposure to banks: 64.2% of assets (€442.7bn)
- Low exposure to stock markets
  - 2007: 8.5% of assets
  - 2008: 4.8% of assets (2.7% un-hedged)

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# Performance and Results

# German Pension System: Riester Pension

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- Cumulated subsidies about €16bn (mid 2013 estimate)
- Total capital, including returns on investment:
  - No statistics available
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- Target replacement rate of gross salary (after 40 years) approximately 18 percent (on top of 40 – 42 percent from the statutory pension insurance)
- Incomplete take-up of tax subsidies

## Coverage is key

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- What are the medium and long-term consequences of lowering retirement age in Germany likely to be—for the German pension system and for the country's economy?
- What are the most important reasons why some are concerned about this change?
- Which elements of the current pension system are most in need of reform and why?
- What should be the guiding principles behind future reforms to the pension system?

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# Challenges

# *Insurance Companies*

## Risks (I)

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- Lacking trust into financial market integrity
  - Recreation of investors' trust will need time.
- Economic recession: development of demand, turnover, employment, income and profits
  - Increasing early cancellations of contracts would increase liquidity requirements.
  - Problems of allocations to reserves
  - Problems to fund guarantees, when interest rates are low.
  - Lacking capacity to save hampers future market growth.

# *Insurance Companies*

## Risks (II)

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- Financial market development
  - Reduction of value of assets (shares, investment funds, etc)
  - Exposure to banks
  - Mega-Risk: HRE Hypo Real Estate ???
  - Low interest rates for save fixed income instruments (government bonds make financing of guarantees and options difficult.
    - Guaranteed interest rate (average): 3.4%
    - Market net interest rate: 3.6%
    - Required interest earnings: 3.1% on actuarial reserves
  - Risk of interest rate changes

# *Insurance Companies*

## Risks (III)

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- Rate of return risk: low interest rates in the Euro area
- Product transparency and understanding
- Standardisation of products; pensions are simple products (in principle)
- Curbing cost rates

# *Insurance Companies*

## Opportunities

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- Learning
  - Advantages of diversification
  - Advantages of insurance model (risk sharing, collective saving)
- Financial instruments
  - Higher supply of fixed income instruments (government bonds) makes funding of annuities easier.

# *Old age pension insurance*

## Systemic risks (I)

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- Loss of credibility and trust, in particular for financial investments
- Shortcomings of pension planning
  - Lacking information and understanding
  - Lacking transparency of product descriptions (ex ante)
- Dependency of employment on exports
- Limits to portfolio diversification
  - Domestic: Correlation of labour market and financial market risks
  - International: World wide spread of crisis
- Inflation
  - Lacking protection against long term loss of purchasing power

# *Old age pension insurance*

## Systemic risks (II)

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### Overstretch of State capacities to respond to challenges

- Monetary policy: conflicting objectives
  - Low rate of inflation
  - Stability of financial institutes
  - Exit strategy
  - Long-term orientation and management of monetary policy undefined!

# *Old age pension insurance*

## Systemic risks (III)

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### Overstretch of State capacities to respond to challenges (contd.)

- Fiscal policy:
  - Limitations to public debt (crowding out)
  - Lacking engagement in international policy coordination
  - Credit risks accumulated in state owned financial institutes
  - Volatility of tax revenues increased: re-funding of lowered wealth generates new tax losses in a system of deferred taxation of pensions

# *Old age pension insurance*

## Systemic risks (IV)

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### Overstretch of State capacities to respond to challenges (contd.)

- Orderly market policy and financial market regulation
  - Ideological strategy definition: Believe and trust in market forces versus devoutness in governmental capacity to resolve economic problems
- Credibility and time in-consistency of policies

# *Old age pension insurance*

## Systemic risks (V)

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### Re-regulation of financial markets fails.

- Working out the details of regulations is time consuming.
- Consensus on re-regulation of financial markets evaporates.
  - Solvency II ( on capital requirements, supervision and risk management) enacted !!
  - Regulation for occupational pension plans is still missing.
- International agreements: Financial Stability Forum, BIS, G7, G8, G20; conflict of interests
- New regulation provides misguided incentives ! ?

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Vielen Dank!  
Thank you very much!

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