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Proposals To Reform Germany's Pension System Could Open Market, Benefitting Retirees and — Potentially — Insurers

If Germany's coalition government follows through on recommendations from a focus group convened by the Federal Finance Ministry for reforms to the country's pension system, it could open the way for insurers and other providers of retirement products to offer new options for German retirees. Potentially, the changes could spur competition among financial services firms and lead to better pension benefits.

Background to the Proposals

The current coalition government indicated its intent to reform the German pension system when the parties entered into their 2021 coalition agreement. Numerous stakeholders, industry and consumer representative bodies have since published blueprints for future reform.

The coalition government established a focus group, led by a representative of the Federal Finance Ministry, and consisting of representatives from various other federal ministries (including the Ministry of Labour and Social Affairs and the Ministry for Economic Affairs and Climate Action), industry bodies and consumer organisations. It also considered views from the German Central Bank, the German financial regulator (*Bundesanstalt für Finanzdienstleistungsaufsicht* or BaFin), the German state pension insurer and the Federal Chancellery.

The focus group was tasked with assessing the current landscape of retail retirement products and recommending proposals for reform. The focus group delivered its report and recommendations in a July 2023 report (Report). The federal cabinet has since considered the Report and instructed the federal Finance Ministry to publish concrete proposals for legislative reform in 2024.

The Retirement Savings Market in Germany

The German retirement savings environment consists of three pillars:

- Compulsory pension insurance (*Gesetzliche Rentenversicherung*), to which employees (and other specified categories of persons, *e.g.*, eligible self-employed tradespeople, teachers and farmers) make pension contributions by way of salary deductions. These contributions are matched by employers. Benefit levels are set by the state and the system is administered by public corporations at state and federal levels.
- Occupational schemes (*Betriebliche Altersversorgung*) involving a combination of employee and employer contributions and, in some circumstances, state funding, implemented through a variety of structures. Potential structures include umbrella pension insurance policies and employer-established pension funds. These may be administered by providers that have been set up by specific employers (individually or as a group) or third-party providers.
- Private products (*Private Vorsorge*), which are voluntarily purchased by retail consumers. Plans that meet eligibility criteria benefit from state subsidies.

The Standard Formula

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Insurers as Providers of Private Retirement Products

Insurers play a key role as providers of retail retirement products in the German market. Certain products (*Kapitallebensversicherung*) combine features of traditional life insurance and retirement investment products. These hybrids may offer a payout in the event of the policyholder's death, similar to a traditional life insurance product. In addition, part of the premium paid by a customer is invested in an account managed by the insurer, similar to a retirement savings product. The insurer may also guarantee that customers receive at least the amount of premiums paid, together with a minimum return on their investment, and/or receive a guaranteed minimum annuity payment on retirement. If the invested premiums outperform the guaranteed minimum return, the surplus may be made available as an increase to the minimum guaranteed annuity or withdrawal. Thus insurers act as providers of retirement savings products and asset managers, in addition to their traditional role as life insurers.

German pension products may also provide a guaranteed minimum return (including a guarantee against loss of the invested capital) or a guaranteed annuity payment in retirement. Such products may be offered as insurance policies, where providers effectively insure policyholders against negative performance of the invested capital.

Capital guarantees are a mandatory component of certain products (such as *Riester* products) and therefore a prerequisite for savers to benefit from certain types of state top-up funding for their contributions. The Report noted that providers that grant capital guarantees will effectively be required to invest premiums in lower-risk securities (often fixed income securities), which significantly reduces potential future capital growth and therefore the amount of payments to beneficiaries during retirement. A low interest rate environment had already caused numerous providers to stop offering other categories of life insurance products with 100% capital guarantees (instead guaranteeing just 60% to 80%), and reducing the maximum guaranteed return that life insurers were permitted to promise their customers to 0.25%.

The Report additionally noted that certain categories of products require a portion of the capital to be converted into an annuity, which must be guaranteed at its full amount for the lifetime of the beneficiary. Coupled with strict regulatory requirements regarding mortality assumptions and reserving requirements, this leads to relatively low pay-outs for beneficiaries.

The Report's Recommendations

Capital guarantees: The Report concluded that increasing the percentage of capital invested in equities and real estate is likely to result in higher returns on capital, and therefore additional funds available for distribution to beneficiaries in retirement. As capital guarantees reduce long-term returns by requiring providers to invest in conversative asset classes, they should no longer be a prerequisite for preferential treatment and state top-up funding for certain investment-based product categories. The guarantee requirements should be relaxed for insurance-based and hybrid products. However, providers would remain free to offer products incorporating capital guarantees to savers who wish to benefit from this feature.

Additional product categories: The Report recommended that additional categories of investment-based products become eligible for state top-up funding, subject to a certification process. This product would permit savers to invest in unit funds and other equity securities while benefitting from state incentives. Similar products already exist in other jurisdictions, for example in the form of self-invested personal pensions in the U.K.

Flexible use of capital: The Report recommended introducing additional flexibility for consumers to decide how to use their saved-up capital at retirement, including by purchasing an annuity that pays a higher monthly amount for a limited period (rather than requiring the annuity to run for the life of the beneficiary).

Reducing costs to consumers: The Report noted the long-term effect of fees and costs, which reduce the amount of distributions available to pensioners, and recommended measures to reduce compliance burdens and increase competition between providers.

This recommendation coincides with a guidance notice published by the German financial regulator BaFin in June 2023, which called on insurers and insurance distributors to scrutinize the "value for money" offered by their products to consumers, in particular with regard to product fees and costs, as well as incentives and commissions offered to distributors. This highlights that this area remains a focus point for regulators.

Next Steps

Following publication of the Report, the federal cabinet considered the focus group's recommendations and instructed the federal Finance Ministry to publish specific proposals for legislative reform in 2024.

Given the composition of the focus group — containing representatives from three federal ministries as well as contributions from key German financial regulators — the Report's recommendations offer helpful insight into the government's thinking. Insurers will therefore be eagerly anticipating the release of the Finance Ministry's proposals.

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Considerations for Insurers and Savings Product Providers

To the extent the Report's recommendations are reflected in the Finance Ministry's reform proposal, wide ranging changes to the German retirement savings market can be expected, including:

- **Liberalization of market access:** The current requirement to provide capital guarantees to enable products to benefit from state subsidies has restricted the pool of providers that are able to offer such products. Life insurers have benefited from this restriction and become incumbent forerunners in the market. If savings products (which simply allow customers to make deposits and to invest those deposits into unit funds or equities) become eligible for additional state funding that is currently only available for guaranteed products, additional players may look to enter these markets. This includes incumbent players that already offer such products (but which are not currently eligible for subsidies), or new players that are attracted to the German market by the reforms.
- **Flexibility in product offerings:** Less restrictive regulation regarding capital guarantees would also allow insurers and other providers to offer a wider range of savings products to consumers. This may also increase competitiveness in the market as consumers benefit from a broader range of options.
- **Annuity purchases:** The Report's recommendations would also challenge the assumption that a lifelong annuity is the default use for savers' capital upon retirement. Moving away from such annuities could drive changes in consumer behaviour as savers withdraw a portion of their savings pot as a lump sum upon reaching retirement age. Alternatively, such a change may drive an increase in the types of annuity products available to consumers, as providers offer limited-term (rather than lifelong) annuities or other hybrid products. In addition, if annuities are no longer "baked into" the products chosen by savers, specialized players may enter the market, offering savers the ability to purchase an annuity with all or part of their savings pot.