German Company Pension Reform 2018

On Friday, July 7, 2017, as one of the final steps in the legislative process, Germany’s Federal Council adopted the newest pension reform – the so-called ‘Betriebsrentenstärkungsgesetz’. When the law comes into effect on January 1, 2018, it will lead to a paradigm shift in German company pensions. In particular, there are two major changes. Pure “Defined Contribution” plans, which to date have legally not been permissible, now become possible. Furthermore, company pensions have traditionally been seen as part of the relationship between the employer and the employee. Now, a separate pension fund established and managed by the social partners (unions and employers’ associations) takes over the responsibility for the pension plan. Employers no longer have a contingent liability.

Background
The latest company pension reform is part of a series of reforms to strengthen the German retirement system making it more resilient to demographic changes. In 2001, the benefits of the German state retirement system were reduced and limited to a level deemed as long-term sustainable. At the same time, the government established the legal right for employees to participate in a company pension plan financed by salary sacrifice and introduced incentives to promote the attractiveness of company and private pension plans (e.g. Riester allowances). Despite these measures, evidence from numerous surveys shows that the prevalence of pension plans significantly lags behind the goals set by the government. Only 60% of the working population participates in a company pension plan. Among low-income earners and in small companies, the participation ratio is significantly lower.

Objectives of the reform
The current reform intends to reduce obstacles which prevent small companies from establishing company pension plans and increase incentives which are tailored for employees with low incomes. The government hopes for the reform to be more successful than past efforts by including the social partners and introducing a “Defined Contribution” approach.

Defined Ambition
With the reform social partners are urged to agree on an attractive and well balanced “Defined Contribution” approach. Employers who join such plans are released from any pension liability which is transferred to the overarching pension fund. The pension fund which is supervised and managed by the social partners becomes responsible for the investment of pension assets and payment of pensions. The benefits are based on a
“defined ambition approach” which allows for variations in the benefit levels depending on how well investment goals are achieved. Guarantees backed by insurance-type arrangements are not allowed. Further details, such as risk sharing and smoothing mechanisms between the plan participants, need to be agreed on by the social partners.

Exclusiveness of Collective Agreements

The “Defined Contribution” approach is only possible via a collective bargaining agreement set up by the social partners (unions and employer associations/employers). Companies may join such an agreement regardless whether they are a member of the respective employer association or not. However, employers are not allowed to set up such an autonomous plan at company level. Social partners are also permitted to implement automatic enrollment (opting-out model) under which employees must actively elect to opt out from participation of the pension plan. While the new approach represents a new form of company pension plan, it does not replace existing types of pension promises.

Other changes

In addition to the availability of the new approach, there are several other amendments to make company pension plans more attractive. These changes come into effect without any company action:

- **Increase of tax-exemptions for contributions to external pension plan** (Direct Insurance, Pensionsfonds and Pensionskasse)

  The annual tax-exempt pension contribution amount of 4% of the Social Security Contribution Ceiling (€ 76,200 in 2017) plus € 1,800 will increase. From January 1, 2018 on, up to 8% of the SSCC can be contributed tax-free to an external pension plan. However salary-sacrifice contributions in excess of 4% of SSCC are still subject to social security contributions.

  Other small enhancements provide more flexibility regarding catch-up contributions for past service (periods without income) and contributions based on termination payments.

- **Pension allowances for low-income employees**

  For employees with a monthly income of no more than € 2,200, discretionary company contributions (30%, between € 240 and € 480) are reimbursed by the tax authorities. This reimbursement is only available for newly established plans financed by Direct Insurance, Pensionsfonds and Pensionskasse regardless of whether the plan follows a Defined Ambition or a traditional DB approach.

- **Savings of social security passed on to employees**

  After a transition period, employers are required to pass on their saved social security contributions (flat rate of 15%) resulting from a salary sacrifice arrangement to the employees. This regulation applies to new pension plans set up after January 1, 2019 and will become applicable to legacy pension plans from January 1, 2022 on (only if financed by Direct Insurance, Pensionsfonds and Pensionskasse).

- **Numerous further regulations**

  In addition to the changes described above, there are several other amendments which are all intended to encourage employees to increase their efforts to privately save for retirement (e.g. increase of the Riester allowance; introduction of deduction amounts for pensions in the context of income-tested welfare benefits).
Conclusion

While the core purpose of the current reform is to encourage the social partners to establish “Defined Contribution” agreements, some amendments could be immediately applied by companies to enhance existing pension plans.

Employees may request to increase their salary sacrifice contributions to Direct Insurance, Pensionskasse and Pensionsfonds to take advantage of the higher tax-exemptions. Existing contracts may therefore need to be reviewed whether such an increase is possible. In many cases, this may not be possible, so alternative insurance products would need to be developed.

Companies should closely monitor the negotiations between the social partners. The new “type of pension promise” opens a range of innovative options that both decrease the employer’s pension risk and increase the employee’s opportunity for higher return.

We do not expect that any of these collective agreements will be established before mid-2018. Nevertheless, it is helpful to explore potential opportunities now.