

**The future of occupational pension schemes:
challenges and opportunities of demographic
change in Germany**

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Demography and occupational pension schemes

In the coming years, Germany's baby boomers, those born between 1955 and 1969, will gradually retire from the labor force. As a result, the number of people in employment will fall and the number of people in retirement will increase. As a pay-as-you-go system, the statutory pension insurance depends on a balanced relationship between contributors and beneficiaries. As a result of demographic change, contributions to the statutory pension insurance or tax subsidies will have to be increased. The resulting pressure for reform may also lead to lower pension levels or a higher retirement age. A similar situation can be expected in other developed countries, where old-age provision is also largely based on pay-as-you-go financing.¹

For funded occupational pension schemes, aging also poses challenges, albeit of a different kind. These challenges relate primarily to demographic change in the workforce, which has a particular impact on occupational pension schemes and entails significant additional costs. This leads to an increased demand for qualified workers to manage these changes, which is met by a tight labor market. However, this change also offers an opportunity to strengthen occupational pensions as an important complementary element for stabilizing old-age provision in a world where pay-as-you-go systems are reaching their limits.

Baby Boomer Generation Retires

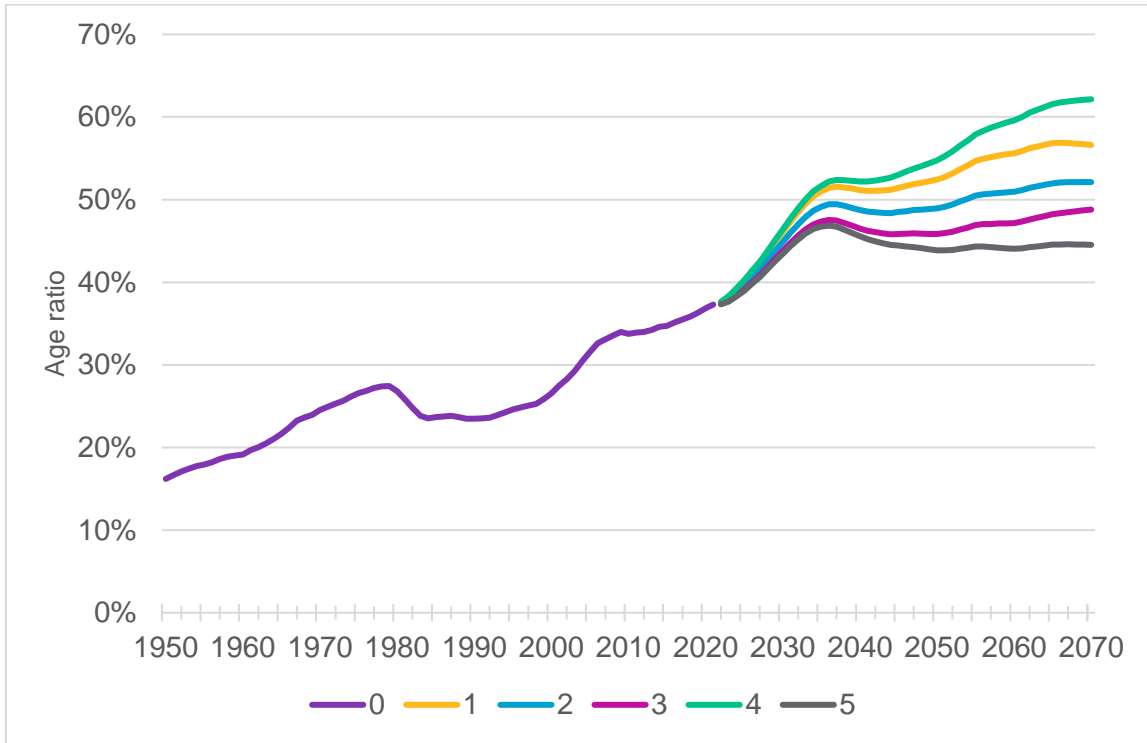
It has been predicted for decades - and now there is no way around: the baby boomers are retiring. At the same time, significantly fewer young people are entering the labor market.² As a result, the old-age dependency ratio - the ratio of older people (65 years and above) to younger people (20-64 years) - will rise in the coming years, before stabilizing at a higher level for a few years from 2038 onwards in the best-case scenario. This applies essentially to all scenarios of the current 15th coordinated population projection.³ The reason for this is the low fertility rate, which since the 1970s has been well below the rate of 2.1 children per woman that would allow the population to remain constant in the long term. The number of children is not sufficient to replace the parent generation. At the

¹ Cf. OECD, Pensions at a Glance, 2021, https://www.oecd-ilibrary.org/finance-and-investment/pensions-at-a-glance-2021_ca401ebd-en

² See Federal Statistical Office, Demografischer Wandel: Anteil der Bevölkerung ab 65 Jahren von 1950 bis 2021 von 10% auf 22% gestiegen, Press Release No. N033, June 7, 2023, https://www.destatis.de/DE/Presse/Pressemitteilungen/2023/06/PD22_N033_12.html

³ Cf. Federal Statistical Office, 15th coordinated population projection, 2022, <https://www.destatis.de/DE/Themen/Gesellschaft-Umwelt/Bevoelkerung/Bevoelkerungsvorausberechnung/begleitheft.html>

same time, life expectancy has risen steadily in recent decades and averaged 83.2 years for newborn girls and 78.2 years for newborn boys in 2021.⁴



Old age dependency ratio: number of persons aged 65 and above as a percentage of the number of persons aged 20 to 64. Source: Federal Statistical Office, "15th coordinated population projection" (variants 0: realized old-age dependency ratio, 1: G2L2W1, 2: G2L2W2, 3: G2L2W3, 4: G1L3W1, 5: G3L1W3) <https://www.destatis.de/DE/Themen/Gesellschaft-Umwelt/Bevoelkerung/Bevoelkerungsvorausberechnung/begleitend.html>

The figure illustrates the evolution of the old-age dependency ratio for some selected variants, starting from a ratio of 37% for the year 2021. This value means that in 2021 there were 37 persons of retirement age for every 100 persons of working age. In 2000, the old-age dependency ratio was 27, and it is expected to increase significantly in the coming years. The top and bottom curves of the old-age dependency ratio in the figure show the variants with the oldest and youngest populations, respectively. In the first case, this results from a combination of low fertility and low net migration with a strong increase in life expectancy (variant 4: G1L3W1). In the second case, the opposite is assumed: high fertility and high net migration are accompanied by only a small increase in life expectancy

⁴ As a result, life expectancy has decreased slightly compared to the last pre-pandemic year, 2019: By 0.6 years for boys and 0.4 years for girls. Cf. Federal Statistical Office, Lebenserwartung in Deutschland seit Beginn der Pandemie gesunken, Press Release No. 313, July 26, 2022, https://www.destatis.de/DE/Presse/Pressemitteilungen/2022/07/PD22_313_12621.html

(variant 5: G3L1W3). The projected old-age dependency ratios for 2035 are 47% and 52%, respectively, while for 2070, they are 45% and 62% respectively. The three variants in between each assume a moderate development of birth rates and life expectancy (variants 1-3 with G2L2). They differ only in the assumed net migration, with a larger (positive) balance being associated with a lower old-age dependency ratio.

Labor market in transition

The first effects of demographic change on the labor market are already evident in the shortage of skilled workers, although this effect has been mitigated in recent years by higher female labor force participation and higher (net) immigration. It is still possible to make even better use of the existing domestic labor force potential, e.g., by further increasing the full-time employment of women, generally increasing weekly working hours or extending working lives.⁵ However, the progress made in recent years and decades makes this increasingly difficult. Fundamental changes are also not to be expected because some developments are partly counteracted by policy. One example is the pension for those with particularly long insurance records, also known as "pension at 63," which runs counter to the gradual increase in the statutory retirement age to 67.

In the past, Germany has been very successful at recruiting workers from (or relocating work to) nearby EU countries, tapping into the foreign labor pool. In 2021, for example, 46.7% of immigrants came from EU countries (excluding the UK). However, this path is becoming more difficult as other EU countries face similar demographic challenges to Germany. Italy stands out here; only France is slightly less affected by aging.⁶

For many qualified people from outside the EU, Germany is not attractive enough compared to the Anglo-Saxon immigration countries. There are many reasons for this. They include language barriers, complicated and lengthy recognition procedures, excessive bureaucracy, and a lack of hospitality. The new Skilled Worker Immigration Act will do little to change this.

What does this mean for Germany's population structure? Even in the most optimistic scenarios with high net immigration, further increases in female employment and even better integration of other groups that have so far been less involved in the labor market, there will be a numerical shift from the working population to the retired over the next 15 years. This change, reflected for example in the rise in the old-age dependency ratio (see the figure), will be permanent and not just temporary. It is therefore important to use other

⁵ Fuchs, Johann; Doris Söhnlein and Brigitte Weber, Demografische Entwicklung lässt das Arbeitskräfteangebot stark schrumpfen, IAB Kurzbericht 25/2021, <https://doku.iab.de/kurzber/2021/kb2021-25.pdf>

⁶ Federal Office for Migration and Refugees (BAMF), Migration Report 2021, 2022, https://www.bamf.de/SharedDocs/Anlagen/DE/Forschung/Migrationsberichte/migrationsbericht-2021.pdf?__blob=publicationFile&v=10

options to meet the many challenges of old-age provision, not least because of the resulting lower growth dynamics.⁷

Further approaches to old-age provision

One way of countering the particularly strong demographic dependency of old-age provision is to move towards funded elements. In the following, we will take a closer look at the public and corporate options that can be considered as a complement to private solutions against the backdrop of demographic developments.

Public equity fund

One way is to build up a capital stock. The so called “generational capital” (Generationenkapital) introduced by the German government is a step in this direction. The aim is to use the returns on the built-up capital stock to reduce the contribution rate to the statutory pension insurance. However, the desired effect can only be achieved if it is possible to build up a sufficiently large capital stock. The current capital stock of EUR 10 billion is still far too small for this purpose. A further increase is currently being discussed by the German government. However, no decision has yet been made for the next few years and beyond. In the event of a further increase, relief can only be expected in the medium to long term. The “Capital for Generations” is not expected to have any effect in the short term.

Occupational pensions - challenges and opportunities

Another way to strengthen the funded element of old-age provision is through occupational pension schemes. It should be noted, however, that even this system is not unaffected by demographic trends for several reasons.⁸ First, the age structure of employees and beneficiaries within a company also follows the demographic trend in Germany. This means that with the retirement of the baby boomers, many employees will retire within a short period of time. As a result, the number of beneficiaries is rising sharply.

In addition, it is particularly relevant for administration that the transition to retirement is a very cost-intensive part of the overall occupational pension administration cycle. One of the features of the schemes that contributes to the high cost of the transition is that

⁷ Economist, The Baby-bust Economy: How Declining Birth Rates will Change the World, 2023, <https://www.economist.com/weeklyedition/2023-06-03>

⁸ See WTW, "Digitalisierung in der bAV-Administration," 2023, <https://www.wtwco.com/de-de/insights/2023/06/digitalisierung-in-der-bav-administration-2023>

employees may have multiple entitlements from different commitments, which may require complex checks or calculations. Managing the associated workload will be an additional burden for many pension plan administrations. In addition, the organization of the occupational pension schemes is also affected by the skills shortage problem described above.

How can this situation be addressed? The first step is to become aware of this double burden of demographic change. Administrators are preparing for the expected challenges by prioritizing digitization. However, many administrators are facing difficulties in recruiting staff, which makes the digital transformation more difficult.

The second step is to develop strategies based on these findings. When it comes to digitizing administrative processes, the focus is on communication and on processes that particularly affect baby boomers approaching retirement age. On the other hand, the digitization of services for beneficiaries is lagging behind. In particular, new developments in the field of artificial intelligence (AI) offer great potential, provided that they are applied in a data protection-compliant manner. There are opportunities to make processes more efficient and thus address the shortage of skilled workers, while at the same time increasing the scope of services, especially in communicating with plan participants and beneficiaries.

There are already use cases that have proven themselves in practice. These include the digitization of incoming mail, the categorization of incoming inquiries, automated responses to inquiries, and chatbots. Generative AI significantly expands the possibilities of the latter application in particular allowing more complex queries to be captured and answered automatically. It is foreseeable that this technology will not only change the customer experience, but will also be used to support the entire case processing up to software development. According to AI experts, this is just the beginning. More complex activities, such as regulatory monitoring and managing the associated complexity could also be taken over or at least significantly assisted by AI in the future.

In addition to these operational challenges, occupational pensions have a unique opportunity to strengthen their position as an instrument of old-age provision in the perception of employers and employees. Employees' appreciation of occupational pensions will increase with the foreseeable reduction in the benefit level of statutory pension insurance. In the competition for skilled workers, employers will offer even more attractive company pension benefits in order to attract and retain employees. As a study by WTW shows, these goals can be achieved with the right design of occupational pension plans.⁹ This is

⁹ See WTW, "Global Benefits attitude Survey (GBAS)," 2022, <https://www.wtwco.com/en-us/insights/2022/06/2022-global-benefits-attitude-survey>

an opportunity that must be seized, despite the increased demands that an aging society will place on occupational pension plans.

Waiting is not an option

Demographic change and its consequences cannot be stopped. Preparing for this change is critical to meeting the associated challenges. To this end, it is important that all stakeholders are aware of the consequences of demographic change. Only then will individuals be able to plan their pension provision accordingly or adapt the pension instruments they already have in use, which always requires a longer time horizon.

In the short term, pension administrators will have to adapt their operations to the demographic changes. The expected additional workload will be met by a tight labor market in Germany. One obvious solution is to accelerate digitization. The use of new technologies (e.g. artificial intelligence), as is already happening in some service areas, can help manage this transformation and should be part of any forward-looking strategy.



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