Pensions Management Institute

ACHIEVING PENSIONS EXCELLENCE

Study Manual

International 2: Managing International Employee Benefits

(Applying the Principles Covered in Foundation in International Employee Benefits)

2020 Edition

Shaping the pensions professionals of tomorrow

in partnership with

International Employee Benefits Association

ABOUT THE PMI

Founded in 1976, the Pensions Management Institute (PMI) is the UK's largest and most recognisable professional body for employee benefit and retirement savings professionals, supporting over 6,500 members in 32 countries.

PMI's members, represented in 8 regions, are responsible for managing and advising some of the largest institutions in the world accounting for £1trillion invested in pensions. We promote excellence through a range of services for the benefit of members, the wider economy and with over six million now saving as a result of automatic enrolment, society as a whole.

The purpose of the Institute is *"To set and promote standards of excellence and lifelong learning for employee benefits and retirement savings professionals and trustees through qualifications, membership and ongoing support services"*.
To achieve this, PMI:

- **Promotes** and embeds professional standards, setting the benchmarks for best practice
- **Produces** qualifications that have a reputation for excellence and ensure that employee benefits and retirement savings professionals, whether they are scheme managers, consultants, administrators or trustees, are educated to the very highest standards and the latest legislation
- **Provides** continued lifelong learning designed to strengthen the knowledge and skills of employee benefit and retirement savings practitioners in performing to the best of their ability
- **Plays** a pivotal role shaping the industry, working with Government and collaborating with other bodies on research and thought leadership on key issues
- **Presents** an annual conference and a wide range of technical seminars from entry-level to those for highly experienced professionals
- **Provides** industry-leading insight, including PMI News, PMI TV, Expert Partner insights, newsletters and blogs to keep practitioners abreast of the very latest developments in a rapidly-changing industry
- **Proactively** has a voice in mainstream and social media with a presence on Twitter and LinkedIn

www.pensions-pmi.org.uk

The Pensions Management Institute
Floor 20
Tower 42
25 Old Broad Street
London
EC2N 1HQ
Telephone: 020 7247 1452
Facsimile: 020 7375 0603

Published by The Pensions Management Institute, Floor 20,Tower 42, 25 Old Broad Street, London EC2N 1HQ

INTERNATIONAL EMPLOYEE BENEFITS ASSOCIATION

IEBA is the world's leading association providing education, information and professional development opportunities in the constantly evolving world of International Employee Benefits. Working with the Pensions Management Institute, IEBA runs a Diploma in International Employee Benefits, to meet the professional needs of individuals working for consultancies, insurance companies, and pensions/benefits/reward departments of employers around the world.

IEBA was set up to promote increased knowledge and professionalism amongst those involved with international employee benefits. In addition to the establishment of the Diploma, its objectives are to facilitate the exchange of information between IEBA members on matters relating to international employee benefits; to take any appropriate collective action on international employee benefit matters; and to maintain liaison and exchange views and information with other organisations in the same field. Membership of IEBA is open to anyone with an interest in international employee benefits, regardless of country of residence. The Association now has over 800 members, and has local branches organising IEBA meetings in 9 countries.

THE AUTHORS

This material was written and reviewed by the following individuals and organisations:

This material was written and reviewed by the following individuals and organisations:

Tim Reay, Mercer and other Mercer colleagues.
Nigel Bateman, Willis Towers Watson and other Willis Towers Watson colleagues
Colin Haines, Aon Hewitt, and other Aon Hewitt colleagues
Carl Hansen, BWCI

FOREWORD

PMI was formed in 1976 to promote professionalism amongst those working in the field of pensions. Today, we are acknowledged as the institute for pensions professionals. We have developed study and examination facilities leading to a nationally recognised qualification – the Advanced Diploma in Retirement Provision. This embraces all aspects of law and practice relating to the management of workplace pension arrangements. The Advanced Diploma is a comprehensive and in-depth qualification for retirement benefit professionals. It is the qualification component for Associateship (APMI) of the Pensions Management Institute (PMI).

The structure of the Advanced Diploma was comprehensively revised for first examination in 2016. This revision was to ensure that the syllabuses were up to date and the qualification continues to meet the needs of users. The Advanced Diploma framework comprises five core units and seven specialist units. To complete the Advanced Diploma students will need to complete eight units as set out below.

The foundation of the qualification is formed of four core units. These compulsory units cover all aspects of retirement provision in the UK, including regulation, administration, financing and investment. There is an additional option covering international employee benefits. The core units are assessed by a two hour examination. The core units are then followed by specialist units. Students choose either, or both, of the Tier 1 specialist units - Defined Benefit Arrangements or Defined Contribution Arrangements as most appropriate for them. Depending whether both or just one of the Tier 1 specialist units are selected either one or two further specialist units can be selected from the Tier 2 specialist options including Reward, Retail Pensions or International Employee Benefits. These choices allow the students to select those areas that best fit their current work or future career aspirations. Finally the Professionalism and Governance Unit must be completed by all Students. All of the specialist units are assessed by 3 hour written examinations.

There are several Diploma level qualifications comprised of units from within the structure of the Advanced Diploma for those who do not want or need to complete the Advanced Diploma. These have also been revised as part of the changes to the Advanced Diploma.

The Diploma in Retirement Provision (DRP) includes all four UK focussed core units and either of the Tier 1 specialist units (Defined Benefit Arrangements or Defined Contribution Arrangements). The DRP would be completed by all those who proceed to complete the Advanced Diploma.

The Diploma in Employee Benefits and Retirement Savings (DEBRS) is ideal for those who need to understand pensions in the wider savings and employee benefits context, and consists of two of the core units and the Tier 2 specialist Reward unit.

The Diploma in Regulated Retirement Advice (DRRA) consists of two Tier 2 specialist units: Taxation, Retail Investment and Pensions; and Retail Advice and Regulation. It is an appropriate qualification for the FCA regulated activity “Advising on Packaged Products” which includes pensions and retirement planning and advising on pensions transfers.

The Diploma in International Employee Benefits (DipIEB) consists of the two internationally focussed units: the Foundation in International Employee Benefits core unit and the Tier 2 specialist unit - Managing International Employee Benefits. These units have been developed in partnership between PMI and the International Employee Benefits Association.

Those who wish to complete the Advanced Diploma can opt to take the units that comprise the DRP, DEBRS, DRRA and/or DipIEB on the way to becoming Associate Members of PMI. Alternatively, those who only wish to sit those Diplomas can become Diploma Members of PMI on completion.

FOREWORD

There are many benefits to be gained from studying for, and attaining, these qualifications. These include the body of knowledge and understanding gained and its application to practical situations, a demonstrated commitment to learning and development, and enhanced status, confidence and opportunities for career progression.

Undertaking this rigorous professional qualification places demands on students and we are committed to supporting studies with quality learning provision. Under the banner "Shaping the pensions professionals of tomorrow" we are delighted to be working with some of the UK's leading companies and firms within the pensions industry who have taken on the role of study support partners. In each unit the study material comprises a study manual and access to a web-based distance-learning course designed to prepare students for the examinations.

International 2: Managing International Employee Benefits seeks to build on the material covered in International 1: Foundation in International Employee Benefits to develop an understanding of the following issues:

- The employee benefit objectives of a multinational company
- The funding and risk management aspects of providing employee benefits
- Management of risk benefits
- Pensions and employee benefit provision in Brazil, China, India and Russia and a regional overview of Africa, Asia and Latin America to highlight the different practices of pensions and employee benefit provision
- Benefits for internationally mobile employees
- The employee benefit implications of mergers and acquisitions
- Trends in employee benefit provision

PMI is delighted to be working with the International Employee Benefits Association as the study support partner for International 2.

Further details on the other units that comprise the Advanced Diploma and the work of the PMI can be found on the website. We hope you will enjoy studying for the Advanced Diploma. We welcome feedback and this should be directed to the Qualifications Department at PMI, e-mail: vjackson@pensions-pmi.org.uk

This manual is based on the syllabus for International 2: Managing International Employee Benefits (applying the principles covered in International 1: Foundation in International Employee Benefits). It has been designed so that the structure and content of the course are accessible, logical and easy to follow. The material is revised every year and we welcome comments and suggestions for improvement.

This manual contains the material for International 2 and is assessed in the April 2018 examination. One of our aims is for the material to cover the application of the principles covered in International 1 as well as covering specific issues such as employee mobility, accounting and employee benefit trends.

Although it is not compulsory to complete International 1 before International 2, we do recommend that students study International 1 before International 2 as the latter builds on the issues covered in International 1 and assumes a certain minimum level of understanding. **As stated in the syllabus, it is recommended that candidates note that the examination questions in International 2 may apply the principles covered to the context of the case study countries covered in International 1 as well as those covered in International 2**. Candidates may request an up-to-date copy of the International 1 course material from the PMI if necessary (subject to have previously purchased International 1 course material in the last 3 years).

We believe that the manual is also useful as general reference material for those new to the profession, those moving from the domestic to international employee benefit world, or simply those looking for material to refresh their knowledge. .

This manual includes information relevant as at October 2017.

The material in this manual is set out as follows:

Part 1 provides the link between International 1 and International 2 material and discusses how the principles developed in International 1 can be implemented in practice.

Part 2 covers the issues to be considered in the development of an appropriate international benefit strategy. It discusses the key objectives of a multinational in respect of employee benefits and covers the critical issue of corporate governance, including different country approaches and company examples. The section considers how benefits are managed in practice, including the split of responsibilities between corporate and local stakeholders, and ends with the local considerations to take into account when putting into place an appropriate benefit strategy and management structure.

Part 3 covers financing and funding issues of employee benefits. It explores the key objectives of funding employee benefits and how the risk management of benefit provision should be carried out. The different funding approaches and the influence of regulation on the approach chosen (such as minimum funding levels) are discussed. The risk issues relating to funding including appropriate investment policies, asset allocation and the transfer of risk to providers is also covered. The section finishes with an overview of accounting standards and how these are increasingly impacting on funding decisions.

Part 4 provides a detailed review of the management and provision of risk benefits.

Part 5 covers country profiles of Brazil, Russia, India and China plus a regional review of Asia Pacific, Latin America and the Middle East and Africa, to highlight retirement and benefit provision trends in these regions.

Part 6 covers issues around mobile employees, including the different approaches adopted (e.g. home and host country), particular challenges related to employee mobility and the objectives and characteristics of international benefit plans.

Part 7 discusses the employee benefit issues relating to mergers and acquisitions. Benefit issues are becoming increasingly important in mergers and acquisitions, both in the pricing and preparation of any deal, but also in post-transaction integration.

Finally, **Part 8** discusses future employee benefit trends and the factors which are likely to impact on benefit provision such as demographic changes and climate change.

For reference, the following exchange rates applied as of 13 October 2017:

	Chinese Yuan Renminbi (CNY)	Brazilian Real (BRL)	Russian Rouble (RUB	Indian Rupee (INR)
1 Euro € (EUR)	7,78	3.72	67.55	76.46
1 US Dollar $ (USD)	6.58	3.15	57.16	64.70
1 British Pound £ (GBP)	8.74	4.19	75.93	85.99

CONTENTS

Aim:

To build on the material covered in International 1: Foundation in International Employee Benefits to develop an understanding of the following issues:

- The employee benefit objectives of a multinational company
- The funding and risk management aspects of providing employee benefits
- Management of risk benefits
- Pensions and employee benefit provision in Brazil, China, India and Russia and a regional overview of Africa, Asia and Latin America to highlight the different practices of pensions and employee benefit provision
- Benefits for internationally mobile employees
- The employee benefit implications of mergers and acquisitions
- Trends in employee benefit provision

The candidate must be able to:

1. **outline** the employee benefit objectives that multinational companies have and the factors taken into account in the development of an international employee benefit strategy

   analyse *each of the following:*
   - *summary of benefit objectives*
   - *factors to take into account in the formulation of a benefit strategy*
   - *typical elements contained within a benefit strategy*
   - *measures of effective benefit strategies*

2. **describe** the funding and risk management aspects involved in provision of retirement benefits, in particular defined benefits arrangements.

   explain *each of the following:*
   - *what elements are covered when considering the funding and financing policy*
   - *differences between funding and accounting valuations and choice of funding method approaches and vehicles for retirement benefit funding*
   - *elements taken into account in the risk assessment and management of employee benefits including investment, mortality and other risk elements*

3. **describe** the importance of managing risk benefits and outline the activities that are carried out

   analyse *the aspects related to the insurance of benefits including assessment of risk, choice of benefits to insure, choice of provider, multinational pooling and captives*

4. **describe** typical pensions and employee benefit practice and environment and **outline** the factors influencing benefit design in the selected countries and regions

   analyse *each of the following:*
   - *economic and employment background*
   - *social security benefits and financing*
   - *compulsory benefits and voluntary plans*
   - *delivery of benefits*
   - *funding and financing of benefits including investment of plan assets*
   - *regulatory and tax framework*
   - *administration of benefits*

5. **explain** the issues relating to internationally mobile employees in respect of their pensions and employee benefits and **describe** the possible solutions to the different challenges in mobility of employees
   analyse *each of the following:*
   - *types of transfers of employees*
   - *social security issues*
   - *occupational pension issues*
   - *European Union regulations and influence*
   - *home country, host country, international plan approaches*
   - *legal, taxation and financing issues*
   - *other benefit provision*

6. **demonstrate an understanding** of the pensions and employee benefit issues in respect of mergers and acquisitions
   outline *the general features of mergers and acquisitions and the employee benefit implications*
   explain *the general international and potential country specific problem areas*
   analyse *pensions and employee benefit policy and strategy in respect of mergers and acquisitions*

7. **outline** the current and likely future global trends in pensions and employee benefit provision
   analyse *each of the following:*
   - *key trends and pressures influencing pension and benefit provision*
   - *economic, social, demographic and labour market changes and their impact on benefit provision*

EXAMINATION NOTE: Candidates for International 2 are expected to be familiar with the material covered in International 1: Foundation in International Employee Benefits. It is therefore recommended that

- candidates attempt International 1 before International 2; and
- candidates note that examination questions may apply the principles covered in International 2 to the context of the case study countries covered in International 1 as well as those covered in International 2.

INTRODUCTION

In International 1, we explained that there are a number of reasons why companies provide employee benefits. One of the key reasons is for companies to remain competitive in the workplace. Therefore, employees expect certain benefits to be provided as a matter of course whilst other benefits are offered as a way of making the employment package attractive. An attractive employee benefit package will support the company's desire to attract, reward and retain the best employees for its operations, and will help to distinguish them from the competition. However, in order for these employment objectives to be met, benefits need to be effectively managed. This Part looks at the principles underlying the management of benefits.

This Part consists of a single chapter.

1.1 WHY EMPLOYEE BENEFITS NEED MANAGING

We also learned in International 1 that the employee benefits offered by different companies have varied characteristics. For example, different employee benefits will have different cost and risk implications for the company. Some of the risks that companies face from offering employee benefits are:

- Financial/accounting
- Compliance/regulatory
- Reputational.

There are various actions that companies can take to mitigate some of these risks, and this is a key responsibility of those who are involved with the management of employee benefits within the company. Most companies employ an individual responsible for managing employee benefits, whether at a local country level, or at a global level where they take responsibility for some or all of the company's countries. This individual typically sits within the HR function, but given the nature of employee benefits and in particular, the associated risks, other parties also become involved. Therefore, the finance, risk and legal departments all potentially have a role to play in the ongoing management of employee benefits (which was covered in the material in International 1). Managing a company's international employee benefits is challenging. There are numerous stakeholders who are involved. Some form of employee benefits are generally offered in all countries where a company is operating. However, the form that employee benefits take and how they are delivered will vary by country and by benefit type. This diversity adds to the complexity. As mentioned above, there are risks involved with administering employee benefit arrangements; these also vary by type and potentially by country. Finally, of course, it must not be forgotten that there is an end user for these employee benefits - the employee. It is essential that what is offered meets their needs – which also vary significantly by country – and, as a consequence, supports the company's objectives of attracting and retaining the best employees.

Juggling all of these factors is a complex task. Multinational companies tackle this challenge in different ways. The resources they make available will often reflect their organisational structure, as well as their geographical spread and the type of business they operate. However, a common approach amongst the larger multinationals is the appointment of an International Benefits Manager with responsibility for overseeing all of the different employee benefit arrangements that the company might operate. The task of the International Benefits Manager is to provide leadership in this area and to coordinate the different corporate functions within a multinational company to ensure that the broad aims, as they relate to employee benefits, are met.

In this Chapter, we consider how multinational companies apply the principles that have been discussed in International 1. Each company is different; therefore, it is difficult to generalise how companies approach the management of employee benefits. Rather than attempt to reflect all the different techniques that companies could utilise, the following is a general approach that many multinational companies follow.

1.2 HOW COMPANIES MANAGE THEIR EMPLOYEE BENEFITS

The management of employee benefits is often referred to as 'governance', and how this is handled varies by company.

A key starting point among many companies is to establish a set of principles, often in the form of an Employee Benefit Policy that defines how the company will tackle certain issues associated with their employee benefits. The more sophisticated or complex structured companies may establish more than one policy document to cover a number of different areas. For example, there may be policy documents for:

- plan design principles
- approach towards selection of providers
- minimum governance principles required at a local level
- company's attitude to risk and investment decisions

The aim of these policy documents is to guide the various stakeholders as they make decisions around the operation of employee benefit arrangements, and to ensure a consistent approach. In other words, the policy documents help to define the strategy of the company and then support managers in the day-to-day operational management of the employee benefits at a local country level.

For some companies, the International Benefits Manager is the "owner" of these policy documents and, as such, retains responsibility for the strategic direction set out within them. The International Benefits Manager is responsible for updating the documents in the light of changing events, as well as helping individuals within the organisation interpret the policies as they apply in different countries. Another important role of the International Benefits Manager is to report to corporate headquarters on the benefit arrangements that are operated by the group, the risks that are being taken and changing circumstances. Some companies may request an annual update to the Board.

For other companies, placing these responsibilities in the hand of just one individual is too restrictive and not sufficiently inclusive, given the different stakeholders involved. Some companies therefore establish a governance committee that meets to provide oversight of all its benefit arrangements around the world. This committee brings together representatives from Finance and HR as well as potentially Risk and Legal. The exact remit, agenda and operation of these committees varies by company and will reflect the internal culture and delegation of authority within the company. However, the committee typically focuses on the most important issues, often primarily on the financial risks posed by the largest pension schemes. However, the committee may also consider broader issues such as other financial risks, as well as supporting and refining the company's benefit policies. A governance committee would also have a direct interest in legislative changes and the issues that may impact their benefit arrangements.

We discuss governance issues in more detail in Part 2.

1.3 KEEPING ON TOP OF CHANGE

The key challenge for an International Benefits Manager is trying to keep on top of all of the different changes and issues that might have an impact on employee benefits around the world. Most of the major consultancies will provide news feeds and publications identifying issues that may require action. However, this information needs to be filtered and only those items relevant to a particular multinational considered. An experienced International Benefits Manager will have mastered how to assimilate all of this information and keep track of what is important, while ignoring those items which are not relevant and identifying areas where information is not available. It is impossible for an International Benefits Manager to retain all of the information. Therefore, a key skill to have is an efficient approach to filtering this information and to be able to delegate appropriately.

1.4 UNDERSTANDING WHAT BENEFITS A COMPANY HAS

For larger multinational companies, there is often an internal community who have a vested interest in knowing and understanding the different benefits that operate within the company. In this case, some multinationals find it valuable to establish a database which captures the key information about the different employee benefit arrangements operated by the company. Typically, such a database will be online, allowing different users from around the world to access the same information in real time. Some of this information may be regarded as confidential and, as a consequence, access to the information may be selectively restricted to allow local managers to access only the information that they are responsible for.

The establishment of such a database and its ongoing maintenance is a significant task; therefore, companies do not undertake this decision lightly. However, those companies that do invest the time to gather and maintain the information generally find it invaluable to have this data available almost instantly. This can be very useful for comparing plans, dealing with specific expatriate issues, and addressing policy issues, as well as being prepared with information to support acquisitions and divestitures. Such databases should also facilitate the administration and provision of benefits.

In addition to having access to firm-wide data, an international benefits manager may well work with one or more international benefits consultancies. The large consultancies each have teams of consultants (often referred to as international or global consultants) whose role is to provide expert advice on multi-country issues, as well as co-ordinate the services delivered at a local level for its multinational clients.

Summary

Understanding, maintaining and managing employee benefits worldwide is a challenging task. It requires specific skills and experience, and companies approach the challenge in different ways. Most do not require that this obligation sits with one individual, but rather involve interested parties in various ways. Successful management of employee benefits is a team effort, often guided by a set of principles and involving both headquarters and local company resources.

Self Test Questions

- What risks are associated with providing employee benefits?
- Why do employee benefits need managing?
- What role does an international benefits manager perform?

INTRODUCTION

This Part sets out how a multinational company is governed and what this means for the management of international employee benefits. It covers corporate governance structures and provides examples of how specific companies deal with decisions on pensions and employee benefit issues.

This Part consists of a single Chapter.

1.1 THE GLOBAL ECONOMY

All businesses today are subject, to a greater or lesser degree, to the effects of global market competition. Over the last 20 years, dramatic advances in computer technology, telecommunications and transportation have enabled companies to enter markets that were previously beyond reach. The world's financial markets are now strongly inter-linked and, as seen in the 2008 global financial crisis, a financial problem in one country can quickly have financial consequences around the world. For example, the full impact of the 2016 European Union (EU) referendum in the UK is still unknown, and may not become clear for many years, but global markets reacted instantly to the result. Around the world we also see how the public and private sectors are increasingly interdependent.

Competing successfully in the global marketplace requires a global approach to management of certain aspects of business operations. The complexity of many global businesses also means that it is essential that companies have good and effective governance management structures in place in order to oversee the running of the business.

1.2 WHAT IS CORPORATE GOVERNANCE?

In most countries, it is a requirement that a publicly-listed company has a board of directors who are ultimately responsible for the management of the company. Companies will therefore adopt a "corporate governance" framework which sets out mechanisms, processes and relations by which a company is controlled and directed.

Companies have to consider local corporate governance guidelines. Many corporate governance codes and requirements have been developed in various countries by stock exchanges, financial reporting organisations, and institutional investor organisations. Companies based in these countries often follow these codes even where it is not mandatory to do so.

The Organisation for Economic Co-operation and Development (OECD) has published a set of Principles of Corporate Governance which have become an international benchmark for policy makers, investors, corporations and other investors worldwide. The OECD has stated a number of benefits from having good corporate governance:

- Policy makers are now more aware of the contribution that good corporate governance makes to financial market stability, investment and economic growth
- Companies better understand how good corporate governance contributes to their competitiveness
- Investors, including pension funds, realize they have a role to play in ensuring good corporate governance practices, thereby underpinning the value of their investments.

In the UK, a classic definition of Corporate Governance was given by the Cadbury Committee in 1992 when it published the UK Code on Corporate Governance:

> *"Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place .The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting."*

One global company has stated that the key to good corporate governance is having the right strategy, leadership and control structures in place to produce and sustain the delivery of value to shareholders. Good corporate governance, and its visibility, gives confidence to all associated with a company that it is being managed well and that value is being created.

1.2.1 Examples of Corporate Governance Structures

In the **UK and USA**, most multinational companies will have a Board of Directors elected by shareholders. Some members of the Board may be corporate officers involved in the day-to-day running of the business, e.g. the Chief Executive Officer (CEO) or Managing Director and the Chief Finance Officer (CFO) or Finance Director, whereas others may be appointed independently. Company directors have statutory responsibilities for the overall management of the company. The Board of Directors will generally make all significant decisions relating to the business, but delegate the day-to-day running of the business to an Executive Team or Management Group. Members of this group will include the CEO and other key senior Executives. In the USA, the CEO often acts as the Chairman of the Board, whereas, in the UK, it is now unusual for a CEO to also act as, or become, Chairman of the same company.

The Board of Directors will usually set up Committees with responsibility for certain areas. For example:

- An Audit Committee with responsibility for reviewing the company's financial controls, financial statements and working with external and internal auditors
- A Remuneration Committee with responsibility for determining the company's policy for remunerating senior executives (including pay, bonus, other incentives and pension arrangements), approving the creation of employee share schemes and determining targets for bonus or performance share scheme
- A Nominations Committee with responsibility for reviewing the structure of the Board, recommending any changes to the Board and finding new Board members
- A Risk Committee with responsibility for monitoring the company's risk management activities and approaches to deal with risk. Risk Committees are often found in financial service companies.

Multinationals in countries like **Switzerland and Ireland** often have similar corporate governance structures to their peers in the UK and USA.

In other European countries, such as **Germany and the Netherlands**, two-tier board structures can often be found. An Executive Board, made up of company executives, will be responsible for day-to-day operations of the company, whereas a Supervisory Board, hires and fires the members of the executive board, determines their compensation, and reviews major business decisions. Unlike company boards in the UK and USA, Supervisory Board members will be made up entirely of non-executive directors representing shareholders. Given the power of Works Councils and trade unions in these countries, the Supervisory Board may be required to include employee representatives.

Swedish companies often have a single Board which includes trade union appointed members, independent directors and the CEO.

Japanese companies often have complex ownership structures, with interlocking business relationships and shareholdings. However, their corporate governance is often similar to that found in Europe, with an independent board of directors overseeing the management of the company and looking after the interests of the company's shareholders.

1.2.2 Sarbanes-Oxley

Companies listed in the USA must comply with the US Sarbanes-Oxley Act of 2002.This Act was passed into legislation following a series of accounting scandals and collapse of companies, including Enron and WorldCom, in the early part of the 21st Century.

The Act introduced major changes to corporate governance practices. It brought a new legal and regulatory focus on internal controls and made the CEO and CFO responsible for these controls. It required the CEO and CFO to certify on a regular basis that the controls were working and required companies to produce an internal control report in conjunction with the company's external auditors.

As a result of Sarbanes-Oxley, US-listed companies have changed the way that information is reported to company directors and how decisions are made. In relation to pensions, this has resulted in greater scrutiny on international benefit programmes and the selection of US GAAP accounting assumptions.

1.2.3 Involvement of Employees in Corporate Governance

Employees play an important role in contributing to the long-term success and performance of a company, and will normally have important legal rights. The OECD Principles of Corporate Governance provides guidelines to companies on how employees should be involved in corporate governance. The Principles contain the following references to employees:

- The degree to which employees participate in corporate governance depends on national laws and practices, and may vary from company to company as well.
- In the context of corporate governance, performance enhancing mechanisms for participation may benefit companies directly as well as indirectly through the readiness by employees to invest in firm specific skills.
- Examples of mechanisms for employee participation include: employee representation on boards and governance processes that include consideration of employee viewpoints in certain key decisions through consultation with works councils or other representative bodies.
- With respect to performance enhancing mechanisms, employee stock ownership plans or other profit-sharing mechanisms are to be found in many countries.
- Pension commitments are also often an element of the relationship between the company and its past and present employees.
- Where such commitments involve establishing a legally separate fund for the pension assets, those governing the fund should manage the fund for the beneficiaries. In some countries it is a legal requirement that the funds are managed independently from the company. Trustees may be appointed and in others, a Pension Board or other structure may be required to ensure actions are in the best interests of the beneficiaries in the first instance.

1.3 MULTINATIONAL BUSINESS ISSUES

In order to manage a programme of international remuneration and benefits effectively, it is necessary to understand the dynamics of global competition and the global economy.

As soon as any company decides to expand its operations beyond a single home country jurisdiction, it faces a different set of management requirements. These extend to virtually every facet of its business; e.g. marketing, distribution, manufacturing, packaging, financial reporting and human resources.

Consumers in one market will respond differently to advertising, product features, packaging and colour schemes from those in another market. Financial reporting and disclosure requirements are different from country to country. Local legislation may impose tariffs on goods manufactured outside the country or economic alliance (e.g. the EU). Note the trade impact of the leave decision in the EU referendum in the UK in 2016 is yet to be determined. Transportation and distribution mechanisms and costs may be very different from those in the company's home country.

There are many differences between countries in the field of human resource management. Approaches to recruiting that may be successful in one jurisdiction may fail completely in another. Customary remuneration elements may differ dramatically. Terminology that sounds similar or familiar can have different technical meanings in two different jurisdictions. This is true, even in different jurisdictions where the language is the same. A form of benefit that may be favoured in one jurisdiction, and may even be more valuable than a customary local alternative, may not be well received in another jurisdiction.

Details and operation of labour and employment laws differ dramatically. Trade unions have legal rights of representation in some countries that encompass whole regions or industries. These differences make it imperative that companies enter new markets with care and with an in-depth understanding of local market conditions. Ideally, an international benefits strategy should be developed in consultation with the business or HR managers in the various local jurisdictions where the company has operations and as it expands internationally.

1.3.1 Impact of Corporate Governance on International Benefits

Within the area of international benefits, the company directors will ultimately be responsible for ensuring that local benefit programmes meet local legislative and reporting requirements, and will need to ensure that they are being managed appropriately.

Good corporate governance can be achieved by establishing broad benefit policies which may take the form of principles or philosophies with regard to the provision of benefits, their type and the way they are financed and controlled. This set of broad policies essentially provides a framework upon which specific benefits in any local jurisdiction are based.

The policies are likely to set out who is responsible for making decisions. For example:

- The board of directors would normally sign off any decisions where there would be a very material impact on the company's financial statements (for example, closure or termination of a major plan, significant changes to benefits, major changes to investment strategy, treatment of pensions in mergers and acquisitions etc.)
- Less material decisions (e.g. closures of smaller plans, minor plan changes) may be delegated to Executive Management, particular individuals (such as the CEO, CFO or HR Director), or a Global Benefits Committee. These groups/individuals would also be responsible for making recommendations to the board of directors
- Day-to-day decisions may be delegated down to particular individuals depending on the nature of each decision and the structure of the company. It will also cover which decisions should be made centrally (e.g. by a Compensation & Benefits Director or Group Pensions Director) and which can be made at a local level

- Even where decisions can be made locally, some companies will require local entities to consult headquarters before making changes to their benefit plans. This allows central oversight of all benefit changes and helps ensure a consistent approach in different countries. There may be a materiality limit set to ensure that minor changes with little financial impact do not need to be approved centrally.

It is important to recognise that the approach taken to manage benefits varies from company to company. Normally, decision-making for benefits will be carried out in a similar way to decision-making for other business activities. However, again this does vary company to company dependent on its structure.

However, just as policy must be consistent with overall corporate strategy, the structural approach to management of international benefits must be consistent with a company's overall management structure and organisation. If business lines and local country business units are managed in an autonomous fashion, it is more difficult to employ a centralised management structure for benefits. In a decentralised management structure, local managers will naturally be more resistant to corporate dictates regarding local benefit details. Conversely, in a highly centralised structure, the vital input of local managers to the design and competitive practices for local benefits may be missing.

It is important to recognise that, in many cases, significant economies of scale may be achieved by a degree of centralised management, regardless of the overall corporate management structure and organisation. Many multinational companies operating in dozens of jurisdictions will likely have significant numbers of employees in only a few of these. In these cases, it is often impractical to assign responsibility for local benefit programmes entirely to local management. The issues are simply too complex to be adequately managed in the "spare time" of a local manager who has other primary, more business-critical, responsibilities, such as sales and marketing or production.

1.3.2 Examples

The following examples show how some specific companies make decisions in relation to pensions. The approach to other employee benefits may be similar depending on the magnitude of the cost and risk. Pension risk is often the most significant employee benefit risk for a company, and companies have to provide this information in their annual report and accounts (under US and International accounting standards) – subject to materiality.

Example 1

Global engineering support services company; headquartered in UK; 27,000 employees; £3bn pension liabilities

The company provides a number of defined benefit (DB) and defined contribution (DC) schemes. All the DB schemes are closed to new members except where DB pension provision is mandated for former public sector employees transferring into the company in relation to specific contracts and where legally required.

The large size of the DB schemes means that pensions are a key risk for the business.

The company has set up a governance committee responsible for its three largest schemes to improve the effectiveness of trustee/pension boards, sub-committees and advisers as well as to enhance trustee/pension board training and decision-making. An investment sub-committee operates across the three largest schemes to implement a consistent investment strategy.

The company's Group Pensions Manager, who reports to the Group Finance Director, keeps strategic pension matters under close review, implements risk reduction measures and reports regularly to the Board.

Example 2
Global consumer goods company; headquartered in Europe; c 170,000 employees; 17bn pension liabilities

Some of the Group's businesses have DB schemes, most of which are closed to new entrants. The largest plans, representing 80% of total liabilities, are based in the UK, Netherlands, USA and Germany,

The schemes are exposed to movements in interest rates, fluctuating asset values, and increased life expectancy. Changes in any of these factors could potentially increase the cost of funding the schemes and therefore impact the group's profitability and cash flow.

The Group has a Code of Business Principles and has developed policies in relation to the management of its pension funds around the world. The group has set pension investment standards which requires pension scheme assets to be invested in a range of investments (subject to meeting local statutory requirements).

The Group's governance structure requires all significant transactions or arrangements in relation to pensions to be approved by the Group's Board of Directors.

All of the Group's DB plans are subject to regular actuarial review either by actuarial consultants or actuaries employed at Group level. The Group's policy is that the most important plans, representing 80% of its DB liabilities, are subject to a complete actuarial valuation each year. Other principal plans, representing a further 15% of liabilities, have their liabilities calculated every year by an updating of previous calculations. The remaining 5% of plans have their liabilities valued every three years. Asset values for all plans are determined every year.

Example 3
Global engineering company; headquartered in Sweden;47,000 employees; SEK 15bnpensionliabilities

The company has significant DB plans in Sweden, Finland, Germany, UK and USA. However, the company seeks to provide DC plans to its employees and, in recent years, has closed DBs plans as far as possible for new hires.

It has established a "Pensions Supervisory Board" to ensure the efficient administration of these plans and management of pension plan assets. In addition, local pension fund boards have been established in each country and are responsible for compliance with local legislation and local agreements.

Example 4
Global industrial company; headquartered in Germany; 50,000 employees; 5bn pension liabilities

The company has DB plans in 30 countries and DC plans in 31 countries. The main pension plans are in Germany, UK, USA, Australia, Netherlands, South Africa and Switzerland.

The company has set up a Global Pension Committee which is responsible for pension governance worldwide and defines a clear set of rules for managing plans. The Committee's responsibilities include monitoring the competitiveness of new pension arrangements as part of the overall remuneration package in each country, and evaluating the financial and accounting implications of benefit changes. The committee members include the Chief Executive Officer, the Chief Financial Officer and representatives from Human Resources, Group Treasury, Group Accounting & Reporting and Global Pensions.

1.3.3 Other Roles of a Global Benefits Committee

It can be seen from the above examples that information provided in accounts often focuses on the management of pension risks. This is not surprising given the relative size and complexity of many companies.

Global Benefits Committees will often have responsibilities for other benefits. For example:

- Monitoring and controlling the company's total spend on employee benefits
- Setting policies for the benefit design across the company
- Determining how benefits should be financed, including the insurance arrangements (for example, the use of a multinational pool and a captive insurance company)
- Design changes to current plans or establishing new plans
- Monitoring the investment strategy and the legislative developments
- Agreeing the level of benefits to be provided to senior executives and internationally mobile employees
- Approving the treatment of employee benefits in merger and acquisition situations
- Appointing global providers or listing preferred service suppliers.

1.4 INTERNATIONAL BENEFITS MANAGEMENT

This section looks at the role of Global Benefits Committees, and the balance of responsibilities between corporate headquarters and local management

1.4.1 Global Benefits Committees

Historically, companies have dealt with pension schemes at an individual country level with limited global oversight. However, in the last couple of decades many multinational companies have set up Global Benefits Committees to manage their worldwide benefit arrangements. The examples in the previous section include companies which have set up these types of committees.

Reasons for setting up a Global Benefits Committee include:

- Pension and employee benefit risks are seen as substantial business risks and need to be managed in the same way as other business risks
- Multinationals have expanded, e.g. by buying other businesses, and now have significant legacy pension arrangements across a range of businesses
- Companies have increased focus on corporate governance
- Changes to accounting standards have meant that there is greater visibility of pension costs and liabilities
- Companies are becoming more centralised with more decision-making and policies being made at head office level rather than at local level.

Committee members often comprise directors from various parts of the company including human resources, finance, treasury and tax. Some committee members may also be on the company board, e.g. the CFO, especially where there are significant pension financing risks relative to the business.

The Global Benefits Committee is likely to have a number of responsibilities, often set out in a Terms of Reference document. These could include:

- Providing recommendations to the Company Board on significant pension changes, e.g. plan changes, mergers of plans, major changes to investment strategy, approving new plans
- Making decisions in relation to benefit plans where it has been given authority to do so by the Board, e.g. less significant changes to benefit plans
- Implementing decisions made by the Board
- Developing global benefit guidelines for the management of benefit plans around the world. These guidelines could include funding, accounting, investment strategy and benefit design.

- Developing a risk management framework to identify, monitor and manage key pensions risks
- Keeping an up-to-date register of benefit plans around the world
- Working with local management to ensure that local plans have effective governance structures and comply with applicable laws and local regulations
- Reviewing the affordability and competitiveness of benefit plans around the world
- Selecting and reviewing the performance of multinational pooling providers.

1.4.2 Corporate and Local Management Roles

Not all decisions in relation to benefits will be made centrally or by a Global Benefits Committee.

Benefit programmes are one area where an appropriate balance between corporate and local responsibilities is most likely to achieve optimum results. Such a balance can be achieved in a variety of ways. In the general case, allocation of responsibilities between local and corporate management for benefits should be based on a combination of factors and required functions. Considerations include:

- corporate resources and skill sets
- local resources and numbers of employees
- the nature of local business activities and the number of jurisdictions involved
- the fact that certain functions lend themselves more naturally to corporate or local management.

A company that is in the early stages of expanding its business operations into foreign markets will generally not have the in-house experience and expertise with foreign benefit programmes locally. In the early days, it may be desirable to provide support for establishing and managing local benefits from a corporate human resources or financial area. As such, there may be greater initial dependence on external advisers.

Many companies who have simply left these responsibilities to local managers in start-up operations find, to their dismay, that they have plans that must be redesigned significantly as the business grows and matures or has inadvertently exposed the business to undue and unacceptable levels of risk. It is always less difficult, and much less costly, to get it right the first time. Companies embarking on their first foreign expansion are well-advised to develop policies from the outset and consider longer term issues, rather than waiting until problems arise. It should be remembered that, by their nature, many benefit plans, in particular those covering retirement, are very difficult to amend when in place due to legal and/or employee relations issues.

Different multinational companies employ a variety of management models for international benefits. In general, it is desirable to have at least an oversight responsibility at a corporate level. Some companies centralise the responsibility for all design initiatives in a corporate international benefits function. Others leave the initiative for design changes at a local level, but require corporate review and approval of all design proposals. The corporate role may be either a hands-on management responsibility or more a consultative resource. Both approaches can be successful, but it is essential that the roles and responsibilities are clearly defined at the outset.

Benefit management functions that may be more appropriately carried out at a corporate level include:

- financing, auditing and financial reporting
- management of risk and asset pooling
- management reporting
- legal compliance/oversight (although close interaction with local management will be essential).

Those which may be more appropriately shared between corporate and local management include:

- administration and/or selection of local administration service providers
- communication to employees
- government reporting
- selection of local professional advisers.

In most cases, circumstances will dictate the precise allocation of responsibilities. In some cases, it should be recognised that local involvement will result in more effective longer term management of benefit programmes. It should not be overlooked that, with increased globalisation, significant efficiencies can be achieved by combining the 'buying power' of the local benefit programmes in such areas as investment management, professional advisers and risk management.

1.5 INTERNATIONAL BENEFITS POLICY

Most of the largest multinational companies have some form of international benefits policy. Such policies may be formal and written or may simply be a statement or understanding of corporate philosophy. Levels of detail differ substantially, as do the underlying approaches to policy. Unfortunately, in some companies the only policy is the absence of one. In other companies, policies are so detailed and inflexible that they restrict local management from making sensible business decisions required to respond to market conditions. Some may be too comprehensive and, consequently, miss the key strategic policy areas that the organisation wishes to emphasise or risk not being read at all. This section provides a discussion of the factors that should be considered in the development of an effective long-term policy.

1.5.1 Strategic Considerations

Any corporate policy governing employee remuneration and benefits should be consistent with the organisation's characteristics and strategic business goals. It should be related to the realities of the business and the competitive positioning and labour markets within which the company operates. Remuneration policies that are not consistent with the overall goals and strategies of a company invariably fail; consequently they are either ignored or discarded.

Similarly, an international benefits policy cannot be developed in a vacuum. Neither can it be developed successfully with reference only to the business environment of the parent entity's home jurisdiction. It must relate to the characteristics of the particular company and must take into account the substantial differences in legislation, practice and labour market competition that are encountered across a variety of jurisdictions. Where the global business operates across different industries, this must also be considered.

1.5.2 Corporate and Employer Objectives

The foundation of a workable international benefits policy is clearly defined corporate objectives. Objectives may be somewhat different in different countries or may be generally consistent on a worldwide basis. Typically, companies aim to consider employee benefits within the context of total remuneration, at least to some extent. The principle areas that could be covered under objectives for employee benefits are:

- definition of the relevant competitive market and/or employee benefits
- desired market positioning with respect to remuneration
- scope - i.e. definition of the elements of remuneration to be considered as employee benefits
- requirements, if any, regarding consistency
- recognition of the existence of, and need for, compliance with local legislation
- the organisation's tolerance to risk (including the definition of risk)

1.5.3 The Labour Market

Since a company's first consideration in establishing pay and benefit programmes is the competitive labour market, it is necessary to identify the sector or sectors of the market that represent competition for labour in the specific circumstances of each employer and within each market. In general, the first reference is to the industry in which the employer competes as a business and often, therefore, as an employer. It is important to recognise that a company may compete for different segments of the labour market in different jurisdictions or locations. It will be recruiting in one segment if, in a given location, its entire workforce is sales and marketing staff. If, in another location, the majority of employees are production workers, its competitive concerns will address that segment. It is not sufficient to only know that a company is in the "computer industry". It is also necessary to understand the nature of its operations in each country. One computer software company may sub-contract the majority or all of its manufacturing and packaging while another may handle those functions internally.

Companies will compete for labour within their own industries for certain categories of employees but may also compete in the general local or national market for others. In general, clerical employees are recruited locally, but do not require any industry-specific experience or training. Financial or Information Technology employees may be recruited from a broad cross-section of industry. Senior management positions may be filled from a national or even international market, within or outside a particular industry sector.

However, most companies will identify an industry sector with which they compete for business and, generally, for labour. Examples might include the banking, automotive, hotel or computer industries. In some cases, a broader industry classification may be more appropriate. A bank might identify its labour market competition as being "the financial services sector", including banks, building societies and insurance companies. A computer software company might identify its labour market competition as the wider "high-technology sector", including hardware manufacturers, other software publishers and semiconductor companies. In all cases, a clear definition of the competitive labour market for each multinational company is a first step in developing appropriate policies.

1.5.4 Market Positioning

In general, a company with "competitive" pay and benefits is considered to be providing total remuneration to employees within a reasonable range from the mid-point (median) of the market. In fact, many companies attempt to position their pay and benefits at or near this level. Some companies, however, take a different approach. Some will intentionally pay above the market with the aim that such a strategy will enable them to attract the best employees and reduce turnover in the employee population. Some will pay substantially below the market median with additional elements or levels of cash pay and/or benefits contingent on individual, unit or corporate performance. Except in unusual circumstances (e.g. a company so attractive that attracting and retaining employees is not a competitive issue), very few companies will intentionally set pay levels below the measured market range. There are, however, dangers in sticking to a 'market median' approach. Other companies' practices may be difficult to compare to a particular company, as no two companies have exactly the same business mix; information may not be up to date; and the exact nature of compared job positions is likely to differ. Benefit managers will need to use the information available to set the most appropriate benefit levels within their organisation.

1.5.5 Cross Border Consistency

The last element of variable employer objectives deals with consistency among groups of employees and across borders.

Many companies will have values which will drive benefit design principles which can apply across borders. For instance, a given company may have a policy of providing the same benefits to all employees with the only differentials being tenure and income level because it believes that equal levels of respect should apply to all employees and is a non-hierarchical organisation. For example, a lump sum death benefit of a fixed multiple of annual salary will automatically provide higher benefits for relatively higher paid employees but will be a consistent level, expressed as a multiple of salary. Conversely a lump sum death benefit that is a fixed lump sum will provide a relatively lower benefit to higher paid employees. Another company may intentionally provide greater levels of benefits for management and executive employees because it fits with their own values and HR strategy.

Increasingly, companies will also have a preference as to whether DB or DC pension plans should be adopted in local countries. The majority of multinational companies typically have a global DC philosophy (in particular in relation to pension benefits for new hires) although there are some exceptions (due to legislation and company practice). In developing an international benefits policy an employer must consider the extent to which it is desirable to achieve some level of consistency in pay practices across borders. The approach to benefit design and delivery may be consistent without necessarily indicating that benefits should be the same in different jurisdictions. One company may establish a policy that targets a competitive level of benefits with reference only to each local labour market and the form of benefits typical in that market. Another may mandate a consistent above market position in all countries, even though it might be unnecessary from a competitive perspective in some countries. Motives for such a policy approach might include the ability to move employees more easily among countries or a corporate remuneration strategy that transcends local market conditions.

It is important to note that "consistent" does not mean "same". Consistency in approach may be accomplished using a number of different specific benefit design elements, applicable to local markets. There have been a number of companies in the past who have failed to recognise that distinction; a decision they eventually came to regret. Attempting to impose the specifics of one country's customary benefit designs in other jurisdictions can be a recipe for disaster.

1.5.6 Legal Constraints

An employer must recognise that, although legislation in different jurisdictions may contain common themes or threads, the laws of each are different in detail and must be followed. It is also important to appreciate that multinational companies may encounter situations where the laws of the parent company's home jurisdiction will conflict with the laws of a subsidiary's jurisdiction. This most frequently comes into play when dealing with employees assigned across borders, as well as when a company desires to establish a single benefit policy or plan that covers employees in multiple jurisdictions.

1.5.7 Other Considerations

In developing an international benefits policy, companies should also consider whether it wishes to express views or preferences on other factors, whether general, industry or company specific. For example, the degree of flexibility/choice made available to employees, the organisation's tolerance for risk (including considerations of what constitutes risk) and the extent to which the organisation is comfortable to be innovative or "leading edge" in developing benefit programmes.

Below is an example of a brief statement of policy with regards to benefit structure. Similar policy statements will also be needed to apply to other features such as accounting, risk, investment (including DC) and funding as well as suppliers (e.g. insurers and administrators).

Example

International Benefits Policy – XYZ Chain of Fast Food Restaurants. Outlets in over 60 countries.

Our employee benefits strategy reflects our global corporate objectives but also takes into account local constraints and considerations such as tax rules, the nature of the labour market and legislation.

We have three main categories of employees: local staff who work in restaurants and may stay between 6 months and 2 years with the company (although some will go on to local management positions); local management who are responsible for restaurants and tend to stay in one country; and Head Office staff who have longer tenure and include Finance, HR, Administration and top management of which a small number will change their country of residence on a regular basis.

General Principles

In establishing employee benefit programmes in any local jurisdiction, it is the Company's policy that benefit plans should be designed to provide benefits:

- that are customary in the local market for locally based employees in the first two job categories cited above
- that pension benefits are delivered on a DC basis unless local legislation requires DB provision
- that risk is effectively managed and decisions regarding the insurance of benefits lies within the risk policy of the company
- that benefits support our employment strategy in the recruitment and retention of employees and that they are considered in the framework of total rewards (including compensation and other HR policies)
- that benefit provision is consistent with the local constraints in respect of tax and regulatory requirements.

Policies in Respect of Different Category of Employees

- For local based non-management staff, the company's policy is to provide employee benefits in line with minimum legal requirements. We recognise that such employees will typically stay for a short period and we will reward these employees more through other Total Reward measures. However for longer service local employees, we will ensure that their benefits respond to their needs in respect of life insurance and disability
- For locally-based management, we will aim to provide benefits at or slightly above market median levels
- For Head Office staff, we will aim to provide benefits at or slightly above market median levels
- For key management level employees we will aim to ensure above market median benefits at around the 60% percentile level and we recognise the importance of benefits as a tool to facilitate the transfer of key management level employees between countries.

The policy statement makes specific reference to differentiation among categories of employees. For locally-based short-term employees, benefits are not likely to be a significant recruitment or retention issue. For local management and head office staff, the company will wish to ensure that it is competitive compared to its peer group. For the internationally mobile employees, it is important that benefits allow and facilitate transfers. It would not be uncommon for such an enterprise to establish a separate, cross-border set of benefits for management employees with benefits for all other employees designed on only a local basis.

The policy would also include more details on selecting and assessing providers as well as the insurance of risk benefits (including the pooling policy) and financing and funding principles.

Variations on Benefit Strategies

The example above illustrates a hypothetical benefit strategy for a multinational. Each company will have different strategies which depend on a number of factors:

- Business Strategy: Do they compete on price, or is innovation of product offering how they differentiate themselves?
- Presence: A company mainly present in Europe will place a different emphasis on benefits from one in Asia
- Attitude to Risk: This will impact not only the type and level of benefits provided but how these are financed (e.g. the extent to which insurance is used)
- Size of the organisation and local resources: A large organisation with sufficient local benefit management resources will need less centralised policies and be able to exploit economies of scale
- History: Does the company have employees in a mixture of arrangements as a result of its history and any previous acquisitions?
- Employee relations: Does the company have a works council or is have or governed by any collective labour arrangements whether directly with the union(s) or by commercial sector obligations?

Some examples of different approaches and emphasis in policy include:

1. A small cash-poor company may emphasise the need for employees to take on or share the risk in their benefit provision (e.g. DC pension plans, Medical co-insurance/co-pay etc.).
2. A company competing on price will emphasise cost efficient and relatively low benefit provision.
3. A company that wishes employees to stay on ly a short period of time will emphasise short-term benefits (e.g. softer benefits); a company which invests in employees 'training with a long pay back period ,for example, will need to put in place benefits (and a reward structure) that encourage retention of these key employees.
4. A company that wishes to minimise risk will aim for DC provision and use of insurance for risk/other benefits.
5. A decentralised company will provide greater autonomy to its local offices and the strategy will have fewer "Global Standards".
6. A company wishing to support a high degree of employee mobility will need to ensure benefit consistency between offices to facilitate the transfer of employees or have in place a Global Mobility policy.

1.6 IMPORTANT LOCAL CONSIDERATIONS

This section outlines specific local aspects which must be taken into account in local benefit planning and the putting into place of an appropriate international benefit strategy.

1.6.1 Employee Needs

In establishing policy and designing local benefit programmes, companies will be well advised to consider the actual needs of employees. Such consideration must be made in relation to the actual and/or projected future employee demographics, local social insurance provision and cultural practices of each location. A benefit that may be highly valued in one jurisdiction may be of little importance in another. This can be done by employee surveys, looking at take up rates of optional benefits, the use of focus groups or offering choice through flexible benefit arrangements.

Whereas substantial private medical cover is considered essential in the United States, it is of minor concern in many other countries where medical care is an integral part of state provision. A lifetime pension may be very important in many Western countries where the elderly tend to live on their own. In other cultures, older persons may live with and are cared for by adult children or other family members. In those countries, lump sum retirement benefits are more appreciated.

Within these broad generalisations, it is recognised that individuals have different needs based on their specific circumstances.

Providing unnecessary or unwanted benefits is generally a wasted expense. Providing benefits that employees do not know about or understand is also generally a wasted expense. In developing policy, consideration of these issues will result in more robust policies and much more effective benefit programme design. It may therefore be appropriate to offer more flexibility in the benefit programmes offered to employees, so that (within financial constraints) employees choose the benefits that most meet their needs. Flexible benefit programmes can help control costs whilst maximising employee value. However, flexible benefits are not available in all locations and typically require a minimum headcount to be used.

1.6.2 Legislative Framework

Although the legislative framework governing employee benefits in different countries will often be based on similar themes, specifics vary to a great extent. Forms of benefit that may be tax efficient in one jurisdiction may offer no tax advantages at all in others.

Legislation in some countries simply will not recognise the existence of forms of benefits that are typical in others. The term “legislation”, in this context includes all types and forms of statutory, regulatory and administrative laws, as well as case law in jurisdictions where many detailed interpretations are ultimately left to the courts.

It is important to recognise that the laws and regulations governing employee benefits in different countries also vary greatly in their complexity. In most English-speaking countries, and many others, employee benefits legislation in recent years has been changing very rapidly. In the UK alone, modifications to pensions law over the last 30 years have been continual. This has also been the case in the United States, where employee benefit statutes, regulations, administrative rulings and applicable court decisions amount to tens of thousands of pages. A coherent policy needs to recognise the existence of these variations in complexity, without necessarily attempting to anticipate specifics. In fact, such detailed anticipation is, in policy terms, a virtual impossibility.

In all applications of an international benefits policy, it is the practical limitations which must always be at the forefront of an international benefits manager's mind. An example to illustrate this point would be the strong growth in companies wishing to implement DC retirement plans for their employees around the world. This has as much to do with cost and risk management as with meeting the philosophical aim of greater personal responsibility.

In some countries, however, legislation has not permitted the establishment of DC plans. Historically, the legislative structure in countries such as Germany and Japan did not readily support the establishment of DC arrangements in tax efficient ways although changes are now gradually taking place in both these countries. In other countries, the availability of individual retirement investment vehicles may be extremely restricted. Accordingly, any international benefits policy that demands implementation of DC strategies could come into conflict with local legislative, tax and investment restrictions. Where this arises, flexibility in practical implementation of any policy must be managed, seeking where possible, to maintain the philosophical approach as far as possible.

1.6.3 Culture, Custom and Practice

A critically important factor, both in establishing policy and in designing specific benefit programmes, is recognition that local culture and custom are as important as compliance with local legislation.

Different cultures involve fundamentally different views of a myriad of issues. In some Western cultures, legal requirements with respect to governmental reporting and filings are critically important and failure to comply can have very serious consequences. In other jurisdictions, there is a much different view of time. In Japan, for example, there is a much longer term view of nearly everything. As a result, the urgency for immediate action that may be felt by Western management is simply neither shared nor appreciated by local Japanese managers or service providers. Westerners often find these sorts of differences frustrating. However, in dealing with benefit programmes for employees in other cultures, it is usually best to learn to understand the differences in culture that may underlie such frustration.

Cultural differences may also be an important factor in local benefit design and legislation. The provision of lump sum retirement benefits mentioned earlier is one example. Differing views regarding holidays and other forms of paid absence are another. Most Europeans, accustomed to four to six weeks of annual holiday entitlement are horrified at the holiday allowances offered in North American or Asian countries. Conversely, citizens of other relatively lower tax jurisdictions find it hard to imagine the tax rates in many European countries.

It is absolutely essential that those charged with either managing or advising on international benefit programmes recognise that "different" is simply different; not "wrong". Understanding underlying cultural causes of difference in custom and practice will stand the manager or adviser in good stead when dealing with other countries.

1.6.4 Pan-National Economic and Political Alliances

Cross-border economic and/or political alliances such as the EU or the North American Free Trade Agreement are of increasing relevance. Until recently, they have had little substantive impact on local benefit design or provision. However, within the EU, instances of pan-European legislation have started to have an effect on local legislation governing employee benefits. Many countries also have bilateral agreements related to social security coverage for employees on short-term work assignment in another country. These agreements, further discussed in Part 6 (1.5), often differ due to significant variances in social security provision across the covered countries. A careful review of the details in each case is required. As mentioned above, the impact of the 2016 leave decision in the EU Referendum in the UK on the economy, pension and benefits is as yet to be determined.

Summary

This Chapter has provided an overview of the governance framework that is relevant for employee benefits in an international context.

Self Test Questions

- What are the benefits of good corporate governance?
- What factors impact on an international benefits policy?
- What local considerations impact on international benefits strategy?

INTRODUCTION

This Part consists of a single Chapter. It focuses on the funding and risk management of pension benefits and reflects the influences of the dramatic change in the financial and regulatory climate for plans since the 1990s. In this Chapter, reference to "pension" may also be considered to include retirement benefits payable in lump sum form. Issues relating to financing other employee benefits (e.g. death and disability benefits) are covered in Part 4.

This Chapter deals primarily with occupational defined benefit (DB) pension plans. Under defined contribution (DC) plans, contributions are paid by members and the sponsoring employer in accordance with a set formula. Therefore, there are typically no benefits to be funded other than what the DC account balance will provide. However, it should be noted that DC plans which contain any guarantees (e.g. mandated DC plans in Switzerland) are, in effect, DB plans for accounting purposes. These require effective risk management just like more traditional looking DB plans.

Most countries also have separate pension plans for public sector employees, with the government often a country's largest employer. These plans tend to have relatively generous benefits funded on a "pay-as-you-go" basis, i.e. benefits are paid direct from government revenues as they fall due; there are no assets set aside to pre-fund future benefit payments. As a result, the fiscal burden of these plans can be very significant in future years.

Funding and risk management strategies for occupational benefits vary significantly between different countries and also within each country. The application of these frameworks may vary considerably, such as between funded and unfunded arrangements and between private sector and State sponsored plans. However, many of the fundamental issues are common.

Until the latter part of the 1990s, pension funds globally experienced very favourable financial conditions. As a result, many plans in some countries (e.g. the US, UK and Canada) became overfunded and plan sponsors reduced or even eliminated their contributions. Since the start of the new millennium, this situation has changed dramatically.

First, the combination of declining asset values with declining interest rates drove down the funded position of most plans and resulted in sharply escalating employer contributions.

Second, changes in financial reporting requirements significantly increased the level and volatility of the pension-related charges on company balance sheets and income statements. At the same time, regulations increased in response to the notable failure of some larger schemes. The result has been a trend towards DB pensions being considered a legacy risk issue to be managed away, rather than actively embraced as a recruitment or retention tool. Continued volatility in the financial markets, including the recession of 2007/08 and the 'debt crisis' of 2011 to 2013, led to significant additional declines in the funded position of plans and further pressure on plan sponsors.

These changes have caught many plan sponsors off guard. As a result, many sponsors have closed their DB schemes and have shifted to DC plans, or changed the pension plan design to reduce the risk exposure to the company. There has also been a significantly increased focus on better management of the underlying pension risks.

1.1 OBJECTIVES OF FUNDING AND RISK MANAGEMENT

Pension benefits can be costly and complex to provide. Benefits promised to employees will not, typically, have to be paid until many years later. The resulting payments may continue to the end of an employee's life, and, perhaps, for many years after, in the case of survivors' benefits (if paid as annuities).This gap between the benefit promise being entered into and the final discharging of the promise usually gives rise to the need for a funding or financing strategy, and a system of related investment, governance and regulatory arrangements.

Those responsible for paying for or managing the arrangements must manage a wide range of financial, demographic, business and political risks. The interests of different stakeholders may not be fully aligned. Arrangements may cover assets and liabilities valued at billions of Euros. Robust risk management is required to ensure the risks being taken are properly identified, disclosed, and managed. This section looks at the principles behind funding and risk management and the key issues plans must address.

1.1.1 Funding Objectives

"Funding" is the setting aside of assets kept separate from the plan sponsor's other assets and against which plan members have the first right of claim for satisfaction of their promised benefits.

The primary objectives of pension plan funding are to:

1. Maintain the long term viability of the plan;
2. Provide security of member benefits;
3. Provide stability of company cash flows;
4. Take advantage of positive accounting effects, and
5. Take advantage of tax incentives for the company and / or plan members.

1.1.2 Objectives of Risk Management

Pension risk should be considered in the context of the wider business risks an organisation faces. For example, the risk of extra contributions being required at short notice could result in cash flow problems for the business and is likely to affect other parts of the business from which cash must be drawn. Also, volatile figures in the pension plan accounts could affect the perceived profitability and stability of the business and hence the availability and cost of capital through investment markets.

For some plans, risk mitigation rather than risk monitoring may be a priority, particularly in the case of closed plans. Available methods of risk mitigation may include buy outs, buy ins [a buy-out is where a pension fund transfers liabilities to an insurance company. A buy-in is where a pension fund purchases an insurance policy that it holds as an asset of the pension fund and the insurance policy pays certain liabilities] , hedging strategies, increasing the funding level or granting the plan a charge over the assets of the sponsor, amongst others possible solutions. These options should be considered against the risk objectives and risk tolerances of the business as a whole, so that any risk management strategies within the pension plan are aligned with the business's overall risk strategy.

Risk management of pension plans typically includes the following steps:

- Plan design taking into account long term funding risks and sponsor appetite for risk.
- Staff training.
- Maintaining registers of risk.
- Cashflow controls.
- Plan policies covering, for example, investment strategy, exercise of discretionary powers, funding policy and member disclosures.
- Use of professional advisers, and details of the regular review of these advisers.
- Managing conflicts of interest.

- Sponsor covenant assessment.
- Clear and documented audit trail of key decisions, e.g. written advice from advisors, meeting minutes of the plan's governing body.
- Service level agreements with key suppliers.
- Independent audits.

Actuarial valuations can also be used to aid understanding of the risks faced by an organisation in respect of any pension plan of which it is the sponsoring employer. Methods such as sensitivity analysis (assessing how expenses and liabilities change with changes in assumptions) or scenario testing can illustrate the uncertainty in the results of the valuation. They can also identify and highlight the importance of the different underlying sources of risks. The results of the valuation and sensitivity tests can be used to provide measures of risk that are useful in supporting decisions made by interested parties with a variety of different risk appetites, including the organisation's risk committee. Valuations and funding updates are the most common way of monitoring risk in pension plans, but the underlying risks can also be monitored, e.g. through regular fund monitoring or investment managers performance reports.

12 TYPES OF FUNDING APPROACHES

Pension funding can be achieved through various financing approaches including:

- Establishment of an external pension fund (such as a foundation or trust) which is legally separate and distinct from the employer
- Through purchase of an insurance contract with a life insurance company
- Through book reserves (see details below on book reserve funding in Germany).

One of the most fundamental decisions to be taken in deciding how to fund benefits is whether the employer should pay an insurer to provide the required benefits or whether they should retain the funding risks within the plan that the employer sets up.

Under the insurance approach, a premium is paid to an insurer to provide the agreed benefits. The primary advantages of insuring are:

- Cost certainty for the sponsor and minimal risk that further contributions will be required (although this depends on the nature of the benefit promise and the agreement with the insurer).The insurer takes on the risk of unanticipated increases in life expectancy and inflation, investment performance, medical expense costs, etc.
- If the benefit promise is between the insurer and employee then the employer and/or trust may have no direct liability in respect of these benefits. That limits the employer's risk exposure.
- The insurer may be able to provide cost-efficient related services, such as making payments to members, administering records and providing relevant professional advice.
- It may be cheaper to outsource the provision of a benefit to a company specialising in that area, as the third party may be able to benefit from economies of scale that the employer cannot.

Alternatively, an employer or benefits trust might retain and fund the benefits itself. Usually this is done to:

- Retain control of the benefits. Benefits cannot easily be amended once insured. An insurer will have their own administration arrangements for the employees' benefits, but the employees may regard their employer as ultimately responsible for how those operations are carried out.
- Reduce cost. Insuring benefits involves a risk transfer for which the insurer will levy a charge within their premiums. Insurers are usually subject to more stringent regulatory requirements, requiring them to hold lower risk (and lower returning) assets than occupational benefit schemes. An employer may therefore be able to provide the same benefits at lower overall cost to itself by retaining the investment and liability risks.

There is wide variability in the financing methods required or permitted in different countries, and, in many countries, plan sponsors have more than one option available. In countries with traditional DB plans (where the plan sponsor is responsible for funding any deficits), such as Canada, Ireland, Japan, UK, Switzerland and the US, pension funds must be set up as separate legal entities that are not tied to or treated as life insurance companies. In the US, UK, Canada and Ireland, these separate legal entities are required to be trusts.

In other countries, where the plan participating employer(s) is less closely linked to the pension fund and the pension fund may underwrite any deficits that emerge, pension funds are often set up as a special type of stand-alone life insurer or are regulated like an insurance company. For example, industry-wide funds in Denmark and Pensions kassen in Germany utilise a form of life insurance for benefit provision. In Norway, Finland and Sweden, pension funds are set up as insurance companies, while in Iceland and the Netherlands, pension funds are regulated similarly to insurance companies.

Book reserve financing, which, is essentially, a "pay-as-you-go" approach to funding benefits (described in detail below), is an option for plan sponsors in Austria, Germany and Sweden.

Book Reserve Financing in Germany

Germany's pension financing/funding environment is radically different from all other major DB countries. The labour and tax laws in Germany do not require (or even encourage) plan sponsors to fund their pension obligations in an external fund. Instead, companies typically back their pension commitments with company assets and set up a notional financial reserve on their local and international financial statements in respect of their pension liabilities. The primary benefit of this approach is that the employer is entitled to a tax deduction for the accruals for pension cost but can retain the cash or assets within the business. Thus, employers are encouraged to finance their pension obligations on this "direct pension commitment" basis. In case of employer insolvency, there is a comprehensive mandatory insurance system operated by the German Pension Protection Fund, the PSVaG, financed by all plan sponsors.

In recent years, as a result of changes to international financial reporting standards and pressure from financial analysts, many German employers have moved to match their pension obligations with dedicated investments, including insurance policies or mixed bond/equity portfolios. One of the vehicles used is the Contractual Trust Arrangement (CTA). Under a CTA, the company earmarks certain business assets as being held for purposes of the pension liabilities. The CTA creates a legal framework that establishes the pension claim on the earmarked assets. The benefit of the CTA is that, while German tax law still recognizes the CTA assets as company assets (so the integrity of the book reserve system is maintained), the applicable accounting standards recognize CTA assets as substantive pension plan assets, thus allowing these to be deducted from pension liability amounts when determining balance sheet positions under international accounting standards.

13 REGULATORY FRAMEWORK FOR FUNDING

13.1 Role of Regulators

Funding regulations play a central role in the operation of DB pension plans by ensuring that benefit promises are backed by a sufficient pool of assets to pay the promised benefits and protect plan members from the plan sponsor's creditors in the event of bankruptcy.

In addition, funding regulations should ensure:

- An adequate minimum level of funding to eliminate deficits and encourage surplus development when plan sponsors finances are strong
- Help maintain stable costs and minimize volatility of cash flows.

Depending on the country, there may be two governmental bodies or departments that are concerned with pension funding – the labour (or social security) ministries and the tax (or financial) authorities. The labour ministries are concerned about protecting the rights and interests of plan members. The key areas of regulation are around plan design (minimum levels of benefits, plan eligibility, member rights, etc.), prudent investment of plan assets and sound funding policy.

The tax authorities define the maximum (often tax deductible) levels of funding that plan sponsors and plan members can make to the plan. The tax authorities are primarily concerned about pay out of excessive benefits to plan members and payment of unnecessarily high tax-favoured contributions into the plan.

Other Government departments (e.g. National Bank) may also be involved in overseeing pension plan operations.

The primary areas where regulators may influence funding include:

- Frequency of required actuarial valuations to assess the financial status and funding requirements of the plan – this is usually set at 1 or 3 years.
- Actuarial funding method – while allowable methods vary, there is a trend toward required use of the unit credit and projected unit credit methods. These methods are consistent with those required for financial accounting purposes and are more transparent and easier to understand than other methods. The unit credit (or accrued benefit method) is the method underlying solvency valuations, which are increasingly becoming the focus of the pension regulators.
- Actuarial assumptions – may be prescribed by regulators or chosen by the actuary; generally each major individual assumption should represent a best estimate.
- Valuation of assets – generally assets are valued at market value or smoothed market value. Using market value can be problematic as it can contribute to large and volatile swings in funding levels. Opponents of smoothing, who include some members of the accounting profession and some financial analysts, indicate that it distorts reality. However, if funding is viewed from a long-term perspective, then smoothing can provide for the accumulation of assets in a structured and sound way.
- Insolvency protection – in several countries, measures are in place to provide at least partial protection of the accrued pensions of members in the event plan assets do not cover the liabilities following the insolvency of the plan sponsor. These include the Pension Protection Fund (PPF) in the UK and the Pension Benefit Guarantee Corporation (PBGC) in the US, which are funded by levies on all covered plans. In Germany, there is a statutory requirement for insolvency insurance through the PSVaG for all book reserved promises.

One area where regulations have had a significant impact on pension plan funding and design is with respect to the ownership of any surplus assets that emerge from funding the plan. In theory, since all the many risks associated with the plan are borne by the plan sponsor, then any favourable experience under the plan should also flow back to the plan sponsor, including the ability to withdraw a part of any funding excess that develops.

In most countries, this level playing field has been withdrawn. While employers may be able to use surplus to fund their future contributions, they cannot recover surplus assets or, if they can, they are subject to significant taxes in excess of the initial tax benefits received. This situation where employers bear the downside risk but have little or no ability to share in the upside has significantly reduced the incentive to fully fund pension plans or to continue with DB plans.

132 Minimum Funding Standards

Historically, minimum funding standards were focused on a long-term view of the pension plan. The underlying basis for setting funding requirements was a "going concern" actuarial valuation (i.e. assuming that the plan would be ongoing), which defined the minimum required funding payments in respect of:

- The cost of benefits earned in the current year (i.e. the "normal cost" or "current service cost" as defined by the actuarial funding method used).
- Amortisation of any unfunded liability (including potentially separate rules for amortising increases in liabilities for retroactive plan improvements and experience deficits).

More recently, minimum funding standards have focused primarily on benefit security. As a result, the underlying basis for setting minimum funding requirements has shifted to solvency valuations aimed at ensuring that the pension fund assets equal or exceed the accrued liabilities at each valuation date.

While there are significant differences in the minimum funding standards between countries, the primary differences are in the method of calculation of the plan's assets and liabilities and in setting the timeframe over which any unfunded liability is amortised.

The accrued liabilities are typically defined as the vested benefits payable on termination of employment or the benefits payable to the members in the event the entire plan is terminated.

Discount Rate Considerations

The liability and pension expense calculations are very sensitive to the discount rate chosen. A small change in the assumption can lead to significant changes in these amounts. Regulations aim at imposing or guiding the discount rate chosen to ensure that calculations reflect an appropriate value of liabilities and expense.

The prescribed discount rate is normally defined as:

- A specific rate
- The current market yield on a specific group of securities (i.e. the yield on long-term government bonds)
- The implicit annuity purchase rate (i.e. the discount rate that would generate liabilities equal to the estimated cost of purchasing immediate or deferred annuities from a life insurance company).

Regulators are increasingly requiring use of discount rates that reflect yields on government bonds, which represent a market-based approach to valuing the liabilities.

The rules on amortising unfunded liabilities vary across countries. Some countries allow long periods (up to 10 years) of under-funding (e.g. Canada, Finland, Ireland, Japan, Switzerland, UK and US), whereas other countries require the build up of ongoing solvency margins and a much faster return to fully funded status (e.g. Denmark, Germany, Netherlands, Norway, Sweden).The first group of countries correspond to those with traditional DB plans, where benefits are secured by the plan sponsor, while the second group of countries typically have pension funds that are more detached from the plan sponsor (either a form of life insurance or pension insurance companies). For example, the Netherlands requires plans to maintain a 5% solvency margin but they have up to 3 years to reach that threshold if they fall below it.

In contrast to other countries, the UK does not have a defined minimum funding requirement that applies to all pension funds. Instead, there is a requirement to establish a fund specific funding target and a reasonably short recovery plan in case of underfunding. In practice, most recovery plans in UK are no longer than ten years, although there are exceptions to this general rule.

133 Maximum Funding Standards

Maximum funding standards are imposed by the tax authorities to prevent the build-up of excessive assets in the pension fund and to restrict the tax deductions that may be utilised by plan sponsors in respect of their funding contributions.

Overfunding generally results from strong investment returns on pension plan assets. Overfunding can also occur if the actuarial assumptions used to determine the funding level turn out to be overly conservative (for example, if mortality experience under the plan is better than anticipated or if actual average salary increases are lower than what had been assumed in the actuarial valuation).

In the event that a plan becomes overfunded, most countries require the plan sponsor to take corrective actions such as:

- Reducing future contributions to the plan (i.e. taking a "contribution holiday").This is the easiest and most common corrective action.
- Refund the excess assets to the plan sponsor (this approach is not permitted in some countries, such as Belgium, Switzerland, and often in Canada).
- Voluntarily improve benefits to members to use up the excess assets (typical approaches would be increases in non-retired member accrued benefits (actives and deferreds) or pensions in payment).

A few countries impose sanctions or taxes on plan sponsors or on pension funds in the event of overfunding. For example, special excise taxes are levied in the US while additional taxes are levied on withdrawals of excess assets in the UK.

Example: Setting an Appropriate Funding Policy

Most plan sponsors make only the minimum required contributions to the pension fund in accordance with the applicable minimum funding standards.While funding the minimum required may be a strategic policy for some plan sponsors, for many others, it is the "default" position.

Potential advantages of funding more than the minimum required include:

- Favourable tax treatment – a plan sponsor may enjoy an immediate corporate tax deduction and indirectly benefit from the tax-free earnings on invested monies.
- Reduced long term costs – a larger proportion of plan costs will be provided through investment returns; also, an improved funded position may also reduce administrative expenses (e.g. frequency of required actuarial valuations, reduced PPF levies in the UK or PBGC premiums in the US).
- Improved short-term results – sponsors can avoid short-term problems that could result from underfunding such as benefit restrictions, member notices of underfunding, regulatory scrutiny, etc.
- Enhanced benefit security for plan members.
- Reduced P&L charge – the earnings on the additional funding contributions which are assumed for a given period would reduce the sponsor's P&L charge.
- Greater predictability of contributions – as a funding cushion can be built up in good years to help shield against future volatility.

Ultimately, a plan sponsor's funding policy will depend on the nature of their business and their financial objectives. Some typical funding policies corresponding to various business objectives are described in the table below:

Business objectives	Funding policy
• Conserve cash • Free up cash for strategic use within the organisation • Willing and able to accept more volatilepension contributions in the future	Contribute the minimum
• Maintain predictable, stable cash flows • Keep plan funded at a specific level based on a target liability • Treat pension funding as a form of deferred compensation for current employees • Willing to fund even when not required	Contribute a level percentage of pay
• Maximise corporate tax deductions • Minimise pension expense • Willing to risk funding "too much" and not being able to get the excess out (through contribution holidays or otherwise)	Contribute the maximum
• Avoid at-risk status, benefit restrictions, PBGC/PPF premiums, notices to employees regarding underfunding, regulatory scrutiny • Willing and able to accept more volatile pension contributions in the future	Contribute amount necessary to avoid certain triggers

The key steps for establishing and maintaining an appropriate funding policy are:

1. Establish the plan sponsor's current and future strategic financial objectives— especially, short-term and long-term availability of cash; the specific economic and business conditions that could affect the employer's ability to fund the plan; and, the tax position of the employer.
2. Coordinate the funding policy with policies around investments and benefits. For example if the company's investment policy is to employ a liability driven investment (LDI) strategy that matches the investments to the duration of the plan's liabilities, then the expected funding volatility should be substantially reduced.
3. Develop a preliminary funding policy and indicate the specific objectives of the policy.
4. Analyse and stress test the policy to see how it will react to changes in economic conditions and refine as necessary.
5. Implement and monitor and re-evaluate the funding policy at regular intervals.

1.3.4 Current Developments in Funding

The challenging economic environment for pension plans since the start of the millennium has highlighted some of the deficiencies in existing funding regulations. A key problem is that significant required increases in funding often coincide with economic downturns when plan sponsors are least able to afford the increases in costs. Conversely, funding regulations may permit contribution holidays when economic times are good and additional costs affordable. An objective of funding regulatory reform should therefore be to make funding more counter-cyclical.

Some of the recent trends and developments in pension funding are described below:

- **Funding relief measures.** Following the recent economic recession in 2007/8, regulators in some jurisdictions adopted emergency funding relief measures to ease the financial burden of substantially higher funding requirements placed on plan sponsors following the recession. Most of the relief measures, while temporary, concentrated on extending the amortisation periods over which funding shortfalls would be funded. As an example, in March 2012, the U.S. Senate passed a law which allows DB pension plans to base their contribution calculations on interest rates over a 25-year average rather than current market interest rates.This had the effect of lowering the contributions that companies needed to pay into their pension plans.

- **Letters of credit (LOC)**. LOC's are purchased by the plan sponsor from a bank to cover all or a portion of the plan's solvency shortfall in the event of default by the plan sponsor (i.e. the bank would pay the face amount of the LOC under certain circumstances). LOC's would be held in the pension fund and counted as an asset for solvency funding purposes thereby reducing the plan sponsors funding obligations in respect of the portion of the deficit covered by the LOC.
- **No benefit improvements if plan is underfunded**. New legislation in certain jurisdictions would forbid benefit improvements in severely underfunded plans or require full funding of any benefit improvements so that the overall funded position of the plan does not decrease.
- **More constructive approaches to overfunding**. Some countries, such as Canada, US and Japan, set a maximum limit on the allowable funding level, requiring contributions to stop or cease being tax deductible when a specific funding level is reached. However, allowing overfunding would provide a buffer in the event asset values plunge. The problem is made more complicated because surplus assets may not be recoverable by the plan sponsor. While these and other countries have recognised the problem, and some constraints have been relaxed, no simple and effective solutions have been developed.
- **Risk-based approach to supervision**. Under a risk-based approach to the supervision of pension plans, funding requirements would reflect the specific risk factors faced by the pension fund and its various stakeholders. Risk factors would include the key financial risks operating on the plan (i.e. market, longevity and insolvency risks), the flexibility to adjust the benefit promise up or down, and the flexibility of contributions by the plan sponsor and plan members to cover deficits.

In summary, given the move to more market based valuation methods for funding (and accounting purposes), companies can expect continued volatility in their future funding requirements. Regulators will need to continue with some initial efforts to provide additional funding flexibility for plan sponsors in covering their deficits while also providing incentives to establish funding buffers in good economic times.

1.4 RISK MANAGEMENT

Benefit plans, and particularly retirement plans, are technically complex, involving layers of operations and responsibilities within an organisation, from the corporate board to local management and, where in place, to trustees or foundation boards.

The ultimate financial risk in running a pension plan is that the sponsor's assets will be insufficient to meet the benefits promised to the plan's members. In its most general sense, risk manifests itself in volatility which can be seen in a company's balance sheet or P&L instability, or via higher unexpected funding requirements.

In managing risk, companies will take into account not only the negative (downside) risk, but also the potential for gains (upside risk).

1.4.1 Governance Processes

Most companies will want to have a governance framework in place that identifies and enables mitigation of financial risk and volatility. Implementing a global benefit policy gives companies more control over benefit design and plan management, which in turn helps it to reduce pension risks and costs.

A successful governance framework is likely to involve the following:

- Effective committees with the appropriate skills and knowledge to be effective in their decision-making.
- Written policies or guidelines, e.g. covering exchange of information with members and plan managers; managing conflicts of interest; policy for benefits relating to corporate transactions; and, review process for advisors and service providers.

- Appropriate accountability, including clear roles, responsibilities and authorities to act.
- Rigorous supervision and monitoring (i.e. of administrative processes, investment management, and legal and regulatory developments).
- Effective information flow between all stakeholders.
- Consistent company view on benefits issues and provision.
- Clear understanding on risk taking and the respective roles and objectives of the sponsors, plan members and plan managers (such as trustees).

Monitoring is one of the main pillars of a strong governance framework. The funding position of a DB plan should typically be monitored at least annually and its asset performance should be monitored either quarterly or monthly. An increase in the use of global custodians or asset pooling approaches makes this regular information flow more feasible than in the past. More detail on governance is covered in Part 2 (1.2) of this studymanual.

1.4.2 Investment Policy

The ultimate objective of a funded benefits arrangement is that the assets of the fund (the existing assets, future contributions due and investment returns) accumulate to meet the cost of benefits payable under the plan. Where a plan specifies certain benefits to be funded, the aim of the funding and investment policy is to ensure that the pool of assets built up is sufficient to fund the promised benefits. Conversely, where benefits are not specified (as in a typical DC plan), the aim of the contribution and investment policy is to maximise, subject to an acceptable level of risk, the final asset pool out of which benefits can be purchased at retirement.

In developing an investment policy, plan sponsors should set out an overall investment objective for the plan that:

- Represents their best judgment of what is necessary to meet the plan's liabilities given their understanding of the contributions likely to be received from the employer and the employees; and
- Takes account of their attitude to risk, specifically their willingness to accept underperformance due to market conditions.
- Conforms to their organisational strategy or value in areas like sustainable development, ethics, etc.

Examples of a typical plan investment objective are:

- Return-based objective – to achieve a 100% funding level on a specified basis over the next ten years;
- Risk-based objective – limit the chance of breaching an 80% funding level on a specified basis to a 1 in 20 chance over the next ten years.

These are more suitable than traditional objectives used in the past, which may have been expressed in terms that have no relationship to the underlying liabilities, such as, performance relative to other pension funds or to a market index.

Most pension plans take professional advice on their investment strategies and a large number of plans delegate some investment decisions to investment managers.These are given the authority to invest plan assets within a pre-agreed mandate reflecting the investment objectives and risk appetite of any relevant parties. The performance of investment managers is usually measured against a chosen benchmark which should be set relative to the overall investment strategy of the plan.

1.4.3 Setting Asset Allocation

The typical goal of an investment policy is to set an asset mix that will meet the investment objectives within an acceptable degree of volatility.The asset mix is defined as the broad, long term allocations to the major asset classes (i.e. equities, bonds, property, alternatives investments, cash, etc.).The split between equities and bonds is perhaps the most critical decision.

Long-term bonds most closely represent the characteristics of pension plan liabilities by nature and term.When interest rates change, bond prices move in the opposite direction to pension liabilities, and, therefore, bonds provide a good hedge against the risk of changes in interest rates (especially when the duration of the bondsis close to the duration of the plan liabilities).

By contrast, equities have historically provided the highest returns and could potentially improve the funded position of the plan, helping to keep funding contributions at an acceptable level.That said, over the last decade, returns on equities have underperformed some other asset classes.

Other asset allocation considerations include:

- Split of equities between domestic/foreign equities and the region/sector mix. At least part of a plan's assets are likely to be in a different currency to the plan's liabilities; therefore, measures to manage the currency risk might need to be considered.
- Split of bonds between government bonds (gilts), index-linked bonds and corporate bonds. Index-linked bonds can provide a better hedge if a portion of the plan's liabilities are linked to inflation. Corporate bonds have higher expected risk/return than government bonds.Also, given that accounting liabilities are measured using corporate bond yields, corporate bonds can provide a better match to a companies' accounting liabilities.
- Role of alternative asset classes (i.e. hedge funds, private equity, commodities, and structured Liability Driver Investment (LDI) products). Alternatives can provide the plan with a higher level of diversification which can reduce market risk.

Average allocation to broad asset categories among DB plans in European countries vary significantly. Plans in Belgium display the highest bias towards equities (45%) and are closely followed by those in Ireland and Sweden. The UK had very high bias towards equities but has shown a declining trend in recent years (from 64% in 2004 to 37% in 2014).Allocation to equities in other European countries is lower by comparison, for example, as low as 14% in Germany for plans not backed by CTA. In the majority European countries, bonds are the dominant asset category.

In setting a target asset allocation for a pension plan, it is important to establish the plan sponsor's investment philosophy with respect to:

- Extent of the equity risk premium
- Efficiency of various markets
- Merits of active versus passive management
- Diversification potential of foreign equity investment
- Risk of foreign currency exposure
- Active management value added expectations
- Asset mix management value-added expectations
- The use of derivative vehicles (calls, swaps, LDI overlays, etc.).

These investment judgments are fundamental to key decisions on investment policy and investment structure.

Example: Active versus Passive Management

There are many advantages as well as disadvantages to active versus passive management:

Active Management:	**Passive Management:**
• Offers the opportunity to add value to the index	• Offers no potential to add value
• Also creates possibilityof underperformance	• Reduces underperformance risk
• Allows opportunity to protect value in falling markets	• Provides little ability to protect value infalling markets
• Incurs higher investment management fees	• Benefits from lower investmentmanagement fees
• Imposes need to monitor manager's portfolio construction and performance	Ease of administration and monitoring (portfolio dictated by index)
• Avoids issue of Indices becoming "riskier" as market concentration increases	

The asset allocation decision will also be impacted by the specific characteristics of the plan including:

- Type of plan (final average, career average, hybrid, etc.)
- The plan's time horizon (ongoing or winding up)
- Whether the plan is still open to new entrants and/or future benefit accruals
- The current funding position
- The maturity of the plan's liabilities (i.e. ratio of active to inactive liabilities)
- The financial strength of the plan sponsor.

Plan sponsors which wish to significantly reduce the risks underlying the plan or to target a certain level of benefits might choose to adopt a matching strategy.This type of investment strategy involves holding a portfolio of assets which will respond in the same way to changes in demographic and/or financial conditions as the liabilities. Adopting a perfectly matched strategy is usually impossible; in practice, a matching strategy usually focuses on holding a portfolio of assets which responds in a similar way to the liabilities due to changes in financial conditions. This is usually done either by holding bonds with a pay-out pattern which is similar to the expected liability payment pattern, or using a derivative based Liability Driven Investment approach. In the case of the latter, an LDI-manager would typically be tasked with constructing a portfolio using a mix of financial assets (predominantly bonds and derivatives, such as swaps) with the objective of matching the expected benefit payment structure.

144 Investment and Other Risks

For DB plans that are heavily invested in equities, the predominant risk is likely to be investment risk.This arises from turbulence in the equity markets and the poor match between equity assets and pension liabilities. Alternatively, simply holding bonds does not remove investment risk because movements in interest rates can expose any mismatch in the duration of assets and liabilities.

Other common risks for DB plans include (but are not limited to):

- **Longevity risk** – this is the risk of underestimating the length of time plan members will spend in retirement collecting pension benefits from the plan.
- **Inflation risk** – this is the risk that inflation is higher than anticipated. Many plans have benefits that are linked to inflation, such as post-retirement benefit increases; for pensioners, inflation risk represents the erosion of the purchasing power of fixed pensions due to inflationary increases in the cost of living.
- **Credit risk** – there are two main potential issues for pension plans associated with credit risk.The first is the risk of the company defaulting on its obligations to funding the plan.The second is that the 'credit spread', the difference between the return on 'risk free' investments and 'risky investments' (in particular, high quality corporate bonds), may change over time; This is particularly relevant if the pension plan assets are invested in 'risk-free' government bonds, but the bonds used as a reference in setting the discount rate for the valuation of the pension obligations are corporate bonds.This can lead to a mismatch between the assets and the liabilities.

- **Currency risk** – this is a significant risk if a pension plan holds investments outside of their home country/currency; currency risk represents the changes in either domestic or foreign currencies leading to changes in the value of the plan's assets and/or liabilities when expressed in domestic terms.
- **Regulatory risk** – this is the risk that government will impose new costs on employers (particularly in respect of accrued pensions) that were not a feature when the plan was first established.

In addition, there may be a Talent Risk (where benefits are not sufficient to attract and retain employees) and Reputational Risk (where the image of a company maybe affected when it cuts back or provides sub-standard benefits).

Under typical DB structures in many countries, all or most of these risks are borne by the plan sponsor. However, there is a trend in a number of countries for plan sponsors to increasingly share some or all of these risks with plan beneficiaries. Every company has a different appetite for risk. All firms have an explicit and implicit budget for risk and are used to taking measured risks. If this risk budget has been exhausted for the overall enterprise, then a concerted effort should be made to reduce pension risks.Alternatively, the plan sponsor may feel that there is room in the risk budget for, say equity risk in the pension plan, however, the upside reward for taking longevity, interest rate and inflation risks may not be justified.

1.4.5 Developments in Risk Transfer

There are a number of recent developments in helping plan sponsors manage and reduce the risks underlying their plans.These include liability driven investments (LDI), buyouts, swaps, and longevity solutions.

Liability Driven Investment (LDI)

LDI focuses on pension fund performance benchmarked to a company's pension liabilities rather than to equity market performance. It captures a range of different investment techniques that seek to identify risks that the plan sponsor feels are suitably rewarded and to mitigate those that are not.This can be as simple as moving from a portfolio of equities to one of bonds, but, more commonly, involves the purchase of interest rate and inflation swaps to more carefully match the actual benefit cash flows.

Buyouts

A buyout is a bulk annuity policy secured with an insurance company that ensures that all benefits are met in exchange for an upfront premium.A buyout, followed by a scheme termination or wind up, is a popular method of obtaining a complete liability exit for the company.The only risk remaining for the members of the plan is the risk of insurer default, and this is mitigated by insurance regulation, stringent solvency standards for insurance companies in most countries, and, in some cases, industry-wide reinsurance for life insurance companies (such as provided through Protektor in Germany).

Swaps

A swap is a privately agreed derivative contract, i.e. not traded on an exchange. These are known as Over the Counter (i.e. bespoke) derivatives. The swap counterparties agree to exchange fixed interest payments for floating rates of interest for an agreed period of time. The swap market is very flexible and will allow exact hedging of a nominal liability at interbank rates of interest.This provides a distinct advantage over matching with bonds where the timing of interest payments is not flexible; most hedging strategies can lead to an unnecessary exposure to movements in the yield curve and reinvestment risks.

Inflation swaps involve parties agreeing to pay / receive a fixed rate of inflation (applicable to an agreed set of payments) overtime in exchange for floating actual inflation. Actual inflation is not known until the end of the swap, when the difference is settled.

Longevity Solutions

While buyouts provide the ultimate cover for eliminating longevity risk, there are now products available from the capital markets to separate the longevity risk from the investment risk for those sponsors that wish to retain the assets and seek upside potential. This allows plan sponsors to fine tune their risk budget, allowing them to take gains where they wish and to lock down risk in areas that provide little upside.

Alternatively,longevity solutions can be used as the final piece in a risk reductionprocess,which alongwithinvestment measures can allow schemes to be managed with limited volatility. The principal vehicle for longevity risk transfer proposed by the capital markets is a longevity swap. Longevity swaps work in the same way as interest rate or inflation swaps in that one set of payments is exchanged for another. Payments made by the counterparty reflect the actual experience of the plan's membership while the plan makes payments to the counterparty based on an agreed upon longevity assumption. If experience results in fewer deaths than agreed upon, then a net payment is made to the plan thus providing a hedge against increased pension payments.While there have been a number of such transactions in the UK in recent years, such products have yet to be adopted in continental European pension markets.

1.4.6 Benefits Policy

A company's Benefits Policy is an important part of an integrated risk management framework that also includes the Funding Policy and Investment Policy. The Benefits Policy sets out the overall corporate philosophy and guiding principles for the level of benefits provided to employees and the degree to which benefit design should involve risk sharing between the company and employees. Specifically, the policy should set out the retirement benefits the company wants to offer its employees, as well as the process for considering benefit improvements or reductions and the degree to which plan design can be used to mitigate risk and achieve acceptable levels of risk for all stakeholders.

There are many ways that plan sponsors can use plan design to manage the risk of their pension plans including:

- Closing their DB pension plans and providing a DC or hybrid plan for new hires or for future benefit accruals.
- Reducing either accrued (if permitted) or future benefits.
- Introducing or adjusting employee contributions to the plan.
- Adjusting benefits to provide lump sums rather than pensions at retirement (thereby reducing the company's longevity risk exposure).
- Limiting the earnings and/or earnings increases that are used for purposes of calculating pensions (for example, excluding variable compensation and bonuses from pensionable earnings or adopting a career average earnings formula rather than a final average earnings formula).

In addition to the above, the growth of "Hybrid" plans in recent years (primarily in Japan, the UK, the Netherlands and the US) is largely in response to the desire to shift the level of risk sharing between employers and employees.

Types of hybrid scheme designs include:

- Cash balance plans – benefits are calculated on the basis of a notional individual account that earns a specified rate of return, which can be a fixed percentage, the return on a specified index or the average return on several funds selected by the employer. Benefits can be paid in a lump sum or with the account balance converted into an annuity.
- DC top up – members receive DB accrual on their pay up to a limit defined in the plan rules, and DC benefits above that level.
- DB underpin – the benefit at retirement is the higher of the annuity that can be purchased by an accumulated DC fund and the accrued DB.

1.5 ACCOUNTING FOR LONG TERM EMPLOYEE BENEFITS

1.5.1 Background

In this section, we cover the disclosure of a plan's assets and liabilities in sponsoring companies' public financial statements. Note that the legal structure through which benefits are provided (e.g. pension trusts) may also prepare their own accounts but that is a separate topic and not one covered by this Chapter.Typical long-term employee benefits include pension benefits, post-employment medical and life insurance benefits, long service or sabbatical leave, 'jubilee' benefits, termination benefits and profit sharing plans. This section, excludes the accounting of share-based payments which are subject to different accounting standards.

Including employee benefits in financial statements is intended to help users understand the nature, costs, and risk exposure of a company's benefit commitments.They are primarily aimed at investors and analysts but may also be used (depending on how publically available they are) by employees and their representatives, government and regulatory agencies, and by those working in the benefits industry.

Until the late 1980s, pension costs were often recognised in company accounts on a cash basis, i.e. when the benefits were paid out to plan members or when funding contributions were paid into the plan. However, under this approach, substantial liabilities can build up before benefits start to be paid out. Similarly, contributions paid in a particular accounting period may not directly reflect the cost of benefits granted during the account period because:

- They may relate to benefits from earlier periods, e.g. additional contributions required for past service benefits; or
- The contributions paid may be in respect of that period's employment but not accurately reflect the value of the benefits, e.g. because the contributions are worth less than the estimated cost of providing the benefit.

Since the late 1980s (depending on the country and applicable accounting standard), companies have been required to show in their accounts the cost of benefits accrued in the year. This approach takes the view that pensions are simply a form of deferred wages. There are different requirements and options depending on the country where the company is based.

The way in which employee benefits are accounted for can affect both the balance sheet and the disclosed profit and loss for the year. Hence, the accounting treatment can impact on benefit provision and the company's risk management strategies. The move to "mark-to-market" accounting has increased the transparency of DB liabilities within company accounts and introduced a significant source of volatility into both their balance sheet and profit and loss statements.

The first pension accounting standards allowed "discounted income" and "smoothed" approaches, which meant that funding levels and pension costs were relatively stable over time.

Subsequent changes to accounting standards mean that asset values now closely follow market movements and liability values and costs are similarly driven by changes in financial markets rather than by stable long term assumptions. Pension costs are volatile from year to year, reflecting market movements in long term bond yields and implied inflation.This feature has contributed to long-term trends in long-term benefit provision:

- Increased transparency and awareness of DB costs and risks.
- Greater concern by financial analysts and company management over the company's pension funding position and costs.
- Reduction in DB provision and switch to DC provision.
- Investment strategies shifted to reduce volatility compared with 'high quality' bonds, e.g. resulting in a shift from equity towards long-term bonds, reducing long-term return expectations, and thus increasing the total funding cost of such arrangements.

152 International Accounting Standards

Over the last 25 years, there has been a gradual convergence of accounting requirements around the world.The International Accounting Standards Board (IASB) sets International Financial Reporting Standards (IFRS).The European Commission required listed European companies to use IFRS for financial years beginning on or after 1 January 2005. This was a key step in the convergence process, and IFRS (also referred to as International Generally Accepted Accounting Principles or International GAAP) has been adopted more widely. The other major set of accounting standards in use are the United States' generally accepted accounting principles (US GAAP).The IASB and the US Financial Accounting Standards Board (FASB) are working towards convergence of these two sets of standards.

Each standard has specific text dedicated to employee benefits accounting:

- IAS 19 (revised) for companies reporting under IFRS; it is the revised version of IAS 19 and is in mandatory application in periods ending after 1 January 2013.
- FAS 87, 88, 106, 132(R) and 158 (collectively referred to as "FAS") for companies reporting under US GAAP.These standards have recently been reissued under the heading "ASC 715-30" (Accounting Standards Codification 715-30).
- FRS 17 for companies reporting under UK GAAP.

The objective of these different standards is to prescribe, for employee benefits, valuation methodology, assumptions guidance, accounting principles and disclosure requirements. The main principle underlying each of these standards is that the cost of providing employee benefits should be recognised in the period in which the benefit is earned by employees, rather than when it is paid or payable.

153 Accounting for DB and DC Plans

For accounting purposes, a DC plan is one under which the entity pays specified contributions but has no legal or constructive obligation to make further payments, as the benefits paid to beneficiaries are based on the value of an accumulated account balance consisting of contributions paid and investment earnings thereon. For this type of scheme, the company's pension cost for accounting purposes is simply its contributions in the period concerned.

It should be noted that, in some countries, minimum guaranteed investment returns under DC type arrangement leave an investment risk with the employer, and, therefore, require such plans to be treated as DB plans (e.g. Switzerland).

The remainder of this section focuses on DB plans.
For accounting purposes, a DB plan is defined as any plan other than a DC plan.

There are two basic concepts underlying the accounting for DB pension plans:

1. ***Net asset or liability reported on balance sheet***.A value is placed on the sponsoring entity's long-term benefit promises that have built up to date and the corresponding assets used to back those liabilities.The Net Asset or Liability representing the difference between the assets and benefit obligations is reported on the balance sheet.
2. **Pension cost reported on income statement.** This section reconciles changes in the balance sheet assets and liabilities over the accounting period and records the costs, losses and profits to be recorded for that period in respect of the benefit arrangements. These items might be recognised in different areas or under different headings in the accounts, including the profit and loss statement ("P&L"), the Statement of Total Recognised Gains and Losses ("STRGL") or Statement of Other Comprehensive Income ("OCI") depending on the accounting standard concerned.

Valuing the Assets and Liabilities

Assets are generally taken at fair market value as of the accounting (measurement) date.

The DB obligation ("DBO") under IFRS and projected benefit obligation ("PBO") under FAS is the present value of expected future payments required to settle the obligation resulting from employee service in the current and prior periods calculated under the projected unit credit cost method.

Valuations should be carried out with sufficient regularity such that the amounts recognised in the financial statements do not differ materially from those that would be determined at the balance sheet date.

Assumptions used for the purposes of such valuations must meet the following criteria:

- Each assumption must be management's best estimate.
- Assumptions must be internally consistent (or "mutually compatible").
- Financial assumptions (discount rate, salary) are based on market expectations at the measurement date for the period to maturity of the benefits while other assumptions are long term best estimates.

The rate used to discount estimated cash flows should be determined by reference to market yields at the balance sheet date on high quality corporate bonds (usually taken as AA rated, although this is currently a point of contention amongst various market participants).This means the value of the projected benefits is that of the theoretical portfolio of corporate bonds that would be expected to meet the benefit payments. This measure differs from the expected funding cost (which will usually be determined in part by the investment strategy of the plan) and the cost of discharging the sponsor's liabilities to an arm's length third party entity such as insurer (since their pricing basis will not be exclusively based on corporate bond yields).

Determining the Pension Cost

The precise details vary by accounting standard but profit and loss charges generally 'recognise' some or all of the following elements (those not recognized in P&L will be shown elsewhere in the accounts as other income/losses):

- Service cost – the estimated value of benefits accruing over the period.
- Interest cost – the interest calculated using the discount rate on the liabilities over the period.
- Expected return on assets – the expected investment return (calculated using the expected return on assets assumption) on the fund assets over the period after allowing for the effects of monies paid in and out of the plan (contributions in and benefit payments out). Note that under the latest revision of the IFRS accounting standard, the expected return on assets is defined to be equal to the discount rate.
- Actuarial Gains and losses – gains and losses will occur when assets and liability values inevitably turn out to be other than expected; gains and losses also arise from changes in actuarial assumptions; these gains and losses can (or must) sometimes be recognized immediately, or may be spread over a number of years depending on the applicable standard.
- Past service cost – the increase in liabilities due to improvements in benefits relating to previous accounting periods (may be recognized in full in the year the past service is granted or amortized over a number of years).
- Settlements – occur when benefit obligations are fully transferred out of plan to the members or to third parties, for example when annuity contracts are secured in the name of the member.
- Curtailments – occur when benefit obligations are reduced but remain in the plan, e.g. following a redundancy exercise, members' benefits may have a lower value than had they remained in service.

Summary
This Chapter has provided an overview of funding and risk management.This has included an outline of different approaches to funding as well as the regulatory framework.

Self Test Questions

- What is a discount rate?
- What are the main objectives of pension funding?
- What are the different approaches to funding?
- What are the main accounting standards in this area?

INTRODUCTION

The materials in this Part consider multinational pooling and captive insurance companies as applied to employee risk benefits. This Part consists of a single Chapter. The International 1 study manual sets out the different risk benefits that may be offered by multinational companies for their employees, as well as the different approaches to financing and funding, through self-insurance, full insurance or partial insurance. Reference was also made to the use of pooling or captive insurers by larger employers.This Chapter expands on those concepts.

Insurance is based on the principle of the law of large numbers, which means, that the number of claims in a group of employees can be estimated more accurately the larger the group of employees. Large insurance contracts allow "experience rating", either through end-of-year price adjustments based on actual experience in the year (profit sharing), or the use of the contract's own past experience to determine the future premium.

Conversely, for a small group of employees, the outcome is harder to predict. Insurance policies purchased for small groups are therefore rated according to the insurer's overall portfolio experience and typically build in margins to protect the insurer from adverse experience. Where a multinational is operating in many countries, these margins may create inefficiencies in the financing of benefits.

Further inefficiencies arise through:

- Medical underwriting restrictions applicable to smaller groups of employees;
- minimum premium tables, or tariffs, set by local supervisory authorities (though the number of countries imposing these are reducing in number);
- legal or commercial barriers to experience-rate policies.

The multinational may consider establishing regional or global insurance policies. However, these typically face barriers:

- Some countries require insurance to be placed with locally established or admitted insurers. Regulations in these countries may prohibit the purchase of insurance from non-admitted insurers;
- Whilst the purchase of insurance from non-admitted insurers may not always be prohibited, some countries may still impose tax penalties on non-admitted insurance policies. For example, premiums paid may be treated as taxable income for employees and/or benefits received may be taxable upon payment
- Difficulties in administering policies that cover employees in multiple countries;

One exception to this arises through the European Union (EU) and European Economic Area (EEA) 'Freedom of Services' principles, which broadly allow insurers authorised and regulated in one EU or EEA member state to write business in another EU or EEA member state on a basis equivalent to that of a locally regulated insurer in the latter member state. Using this, a few insurers have established so-called pan-European risk contracts, allowing a multinational to cover life and disability benefits for its employees in multiple EU countries through a single contract, although these are subject to a number of restrictions.

With this exception, the vast majority of multinationals have continued to establish local insurance policies in the markets in which they operate in order to satisfy local requirements and benefit from tax advantages, but have established multinational pools, or used captive insurers, to overcome the inefficiencies.These are described in more detail in the remainder of this Chapter.

1.1 MULTINATIONAL POOLING

Multinational pooling can be defined as:

'The linking together of group insurance contracts, effected in two or more countries by subsidiaries of a multinational corporation, for the purpose of combining claims experience under these contracts.'

Through pooling local contracts, the size of the overall insured group increases, thereby justifying experience rating for the multinational. The experience rating applies through the aggregation of the local policy experiences, with the possibility of dividends being released to the multinational when the overall experience is positive.

1.1.1 How Does a Multinational Pool Function in Practice?

Under a pooling arrangement, a multinational's local benefit plans are insured with an insurer that belongs to a network of insurance companies. Each year, the network draws up an account (the 'multinational account') for the parent company, which shows the totals of:

- Income, for example:
  - Premiums paid to the insurers
  - Investment income
  - Decrease in reserves.
- Outgo, for example:
  - Claims paid by the insurers
  - Taxes payable locally
  - Commission payable locally
  - Local Profit sharing
  - Increase in reserves
  - Local administration and risk charges.

A charge to cover the insurers' expenses and risk exposure (which typically includes a 'profit' element for the insurer) is deducted from the balance of the income and outgo. Any remainder is paid to the multinational company as a dividend, commonly called the 'international dividend'.The accounting period is typically a year, except in smaller cases where the period may be extended.

The effect of pooling is to therefore free up margins from the premiums paid locally and provide experience rating across the local contracts.

If the result of the calculation is negative, the multinational usually pays no extra in the year. In the event that claims and other outgo exceed premiums and other income a "loss" or deficit will occur.The basic mechanisms to protect against such losses are "stop loss" (any aggregated losses over a specified amount are written off annually) or "loss carried forward" (aggregated losses are carried forward), with multiple variations of these approaches available.

The risk charge made by the network depends on its risk exposure, which depends on the mechanism chosen to protect against losses.The higher the risk exposure, i.e. the likelihood of the network having to cover losses, the higher its risk charge.

More details on the different systems and risk charges are set out below:

The Stop Loss System
With this system, any aggregated loss over a specified amount at the end of the accounting period is cancelled (i.e. written-off) by the insurers. An additional charge is levied as part of the pool expenses, which is typically between 3% and 6% of pooled premium.

The Loss Carried Forward System
Under this system, any overall loss is carried forward to the account for the following year, to be offset against any surplus arising in the subsequent year(s). A positive overall balance at the end of the second year (after deduction of the year 1 loss carried forward) will be paid out as an international dividend. A negative overall balance will be carried forward to the third year, and so on.

There can be several variations of 'loss carried forward', including:
- unlimited loss carried forward
- a maximum amount of loss carried forward
- a limit on the time period for carry forward of a loss arising in a particular year
- a contingency fund, under which the network withholds a proportion of surplus in a fund to be used to help finance any future losses; the effect is to aid the smoothing of any fluctuations in experience.

The Loss Free System
The Loss Free system differs from those outlined above in not having any built-in insurance protection against accumulated losses. If the experience balance is negative at the end of the accounting period, then the deficit is recoverable by the network from the contract holder, together with interest as specified in the agreement. It is thus "loss free" to the insurance network and not to the contract holder.

The advantage of the loss free system to the contract holder is that there is no risk charge.The ultimate objective of the Loss Free system is for the organisation to retain risk. In this respect, the purpose of a Loss Free pool is similar to that of Self-Insurance and Captives (see below). This approach requires that the multinational has a certain level of tolerance towards risk and volatility.

Some pooling systems also incorporate protection against high claims (also known as "Pooling Points"), which have the effect of limiting the amount charged to the account in respect of large individual claims. The premiums relating to any potential claims over the Pooling Point level will also be excluded for pooling purposes.

Risk Charge

Under either the stop-loss or loss carried forward system, the insurance network carries a risk of having to meet the cost of an overall loss in a pool. It therefore applies a 'risk charge' to cover this.

Under the stop loss system, the network has to meet the cost of an overall loss immediately at the end of the accounting period. Most networks will base the risk charge on an amount that corresponds to the probable risk of loss involved in the pooled contracts, although a few may use a 'proportion of surplus' method, whereby a percentage of surplus in the account is retained to cover the stop-loss charge and the insurer's share of profits.

The risk charge under a loss carried forward system has to take into account the risk of loss involved in any of the variations listed above and the charge, at least in part, can still be based on statistical principles. However, a major risk, which has to be borne by a network, is the cancellation of the contract by the contract holder while there is still a deficit in the account. Exposure to this risk is at its greatest in the simplest form of the loss carried forward system where there is no provision for cancellation of losses by the insurer in any circumstances.

As mentioned, under the loss free system, there is no risk charge. Cancellation of the contract would require immediate repayment of any deficit by the contract holder.

Choice of Loss Treatment System

The stop-loss and loss carried forward systems can be said to be actuarially equivalent in terms of the expectation of loss in the long term. In the short term, however, the financial returns under the two systems in respect of any given exposure will vary according to the actual pattern of claims fluctuations in the period. Payment of a stop-loss premium, which represents a commitment of present resources against expected future returns, could have the effect of increasing the risk charge component of the insurer's expense retention in the multinational account by as much as 200% or 300%.

1.1.2 Potential Advantages of Multinational Pooling

Advantages associated with pooling include:

- Cost savings from favourable experience over the assumptions made in the premium basis for claims, investment income and expense of administration
- Coordinated financial information (for both premiums and claims) for each policy in the pool.The account is invaluable for comparing the costs in each country and identifying potential areas of concern (e.g. excess claims)
- Liberalised underwriting terms; evidence of health requirements often being based on the total of covered employees. This may mean that no underwriting is required in practice when the sums assured do not exceed the "free cover level" calculated based on the global population
- Facilitation of transfer of staff across borders with automatic continuation of coverage on the same underwriting terms
- Greater influence with local insurers because a network will exert its influence with its associated carriers to ensure that even small plans receive good service
- Employee benefit information provided by the network in respect of local social security systems and occupational benefit practice
- Reduced requirement to re-market benefit contracts each year, potentially reducing company work load and broker costs.

1.1.3 Possible Disadvantages of Pooling

In order to pool with a network, each insurance contract must be underwritten by the local member insurer of that network.This may mean a change of local insurer for some of a multinational's operating companies.

The management of the local subsidiary may be unwilling to transfer its employee benefit insurance from its present local insurer to the chosen network's local insurer for a number of reasons including:

- The network insurer may not offer equivalent cover
- The network insurer's premium rate and/or policy terms and conditions may not be as competitive compared to another provider
- The service standards of the local network insurer may be perceived as poor
- There may be a reciprocal business relationship between the subsidiary and the current insurer
- Close personal relationships may exist between members of the management of the subsidiary and staff of the current insurer.

1.1.4 Choice of Multinational Pool

The choice by the multinational of the appropriate pooling network will be based on both quantitative and qualitative criteria.

Quantitative factors deal with minimising costs and maximising surplus, and include the following:

- Administration charges
- Risk charges
- Method of crediting interest on reserves held, premium income, unpaid local dividends and rates of interest credited
- Proportion of total premium pooled – networks may exclude high sums assured and therefore reduce the total premium pooled.

Qualitative factors are often seen as equally important and can include:

- 'Latent pool', also known as a "pool of convenience" – where contracts already exist with a number of insurers belonging to the same network it may be possible to establish a pool immediately without having to change local insurer
- Geographic match for a network against the insurance cover for the multinational. Even where a network is present the points made above under Disadvantages need to be considered to ensure that suitable cover is available
- Systems of loss treatment offered – stop-loss, loss carry forward, loss free
- Underwriting provisions – availability of higher 'free' cover than with another insurer, or, indeed, a complete waiver of medical evidence
- Termination conditions – not all networks will release 100% of the mathematical reserves on termination of the pooling agreement or on termination of the local contract
- Financial reporting – the frequency, quality, volume and style of information in the multinational accounts vary by network
- Captive capabilities – the ability of the network to enter into reinsurance agreements with the client's captive, if required (see below)
- Economical reserving – some networks may consider reducing or eliminating some reserves in return for a client guarantee of full reinstatement in the event of cancellation of the multinational (or local) contract
- Service quality – the ability to deliver a high quality service to staff and management both at the subsidiary and parent company level, which may be measured through a service level agreement.

1.2 CAPTIVES

A Captive Insurance Company is an insurance company established primarily to provide insurance coverage to its owner or parent company. The owner enterprise is the principal beneficiary of the insurance. Many large multinationals operate one or more captives, although, historically, these have been, and continue to be, used mainly for the purpose of providing property and liability cover.

Captives may operate either as a direct (or primary) insurer or as a reinsurer. In the employee benefit environment, most captives function as reinsurers underwriting the risks of their parent(s) through fronting with local 3rd party insurers. Local legislation, administrative challenges and/or good governance practice often prohibit captives from insuring employee benefit plans directly, although, in some cases, captives may obtain a license in a local market for this purpose. For a multinational company, a market by market approach is not generally practical and, typically, a captive solution will be implemented with a multinational insurance network to achieve local insurance cover – see below.

There are two principal ways in which captives are used to support the provision of employee benefits for a multinational:

- Passive Agreement – This is simply a multinational pool where the captive becomes a substitute for the multinational and, as the multinational pooling contract holder, receives the multinational dividend
- Risk Transfer – Premium and risks are transferred to the captive using a treaty reinsurance approach. The captive takes all or part of the direct underwriting risk of the insured contracts.

Under the Risk Transfer approach, the multinational typically appoints one or more pooling networks to manage the local fronting and administration requirements. For each network, a single reinsurance contract is established between the network and the captive. Premiums continue to be paid at the local level, typically annually in advance (as opposed to other local patterns of payment); are collected net of local expenses by the network; and ceded (paid over), net of central expenses, to the captive. The captive can then invest these amounts in line with other captive assets.

All claims are paid locally as under a pooling arrangement. On a quarterly basis, the network prepares a report, the "bordereau", showing income and outgo, and the captive reimburses the network for claims paid.

In addition, where possible under local regulations, reserves previously held locally may also be transferred to the captive.

1.2.1 Advantages of a Captive Approach

The use of a captive as a financing vehicle may allow a multinational to manage and reduce the cost of risk as a result of the following:

- Cash flow advantages, in particular, where premiums are paid annually in advance
- Investment returns on premiums and reserves transferred to the captive
- Reduced administration expenses through the use of a global preferred provider;
- Reduction or elimination of the insurer's underwriting profits
- Better information to understand and manage claims, both at corporate and local level
- Possible further savings by assessing the need for broker services and local profit sharing arrangements.

In addition, there may be non-financial advantages:

- Networks will provide detailed reporting at each quarter end, whereas under pooling the annual report will typically become available 6 months after year end
- Improved claims and cost management through enhanced reporting
- Increased control of benefit plans, e.g.
- Control over price setting
- Custom benefit design and the provision of benefits to meet the company's definition of benefits rather than the commercial insurer's definition
- Can be used to make ex-gratia payments where an independent insurer would decline the claim
- Risk is managed centrally with tailored reinsurance protection
- Diversification of the captive's overall portfolio as a result of writing a new and potentially un-correlated line of business
- For US companies,potential tax advantages for existing property and liability captives through writing"third party" or "unrelated" business in the form of employee benefits.

1.2.2 Additional Requirements of a Captive Approach

In addition to the disadvantages shown in 1.2.3 in relation to pooling, a successful captive solution requires the following:

- Risk appetite – detailed analysis to ensure a clear understanding and acceptance of the level of risk and volatility being retained
- A strong central mandate for the implementation of a single global solution
- Commitment to ongoing management and governance requirements, which may be significant
- HR, Risk and Finance departments within the multinational to work together as a team
- Effective communication to all stakeholders of the business goals and issues, financial and non-financial benefits, and roles/responsibilities
- Management of local considerations, including the type of benefits offered (employee contributions, local dividends) and adjustment of the premium payment cycle
- Review of local requirements – permission to transfer reserves and premiums may be subject to type of benefit plan, local regulations and captive domicile. Premiums and reserves for life, disability, accident and medical benefits can often be transferred to a captive. Reserves for retirement benefits and corresponding assets are not typically transferred to a captive.

1.2.3 Captive Conclusions

Whilst there has been a steady increase over many years, the use of captives for employee benefits remains limited to very large multinationals, and there are arguments that some of the advantages described for captives may be achieved through a sophisticated approach to multinational pooling.

The use of a captive for employee benefit risk financing is usually a corporate strategic decision.Where feasible, the transfer of employee benefit risk to a captive can have a similar effect as self-insuring at a global level the risks associated with employee benefits. With suitable reinsurance protection, it could, in principle, contribute to an efficient risk financing approach for the corporate group as a whole.

Summary
This Chapter has provided an overview of the management and provision of risk benefits. This has included an explanation of multinational pooling and the advantages and disadvantages of it. It also outlined the captive approach.

Self Test Questions

- How is multinational pooling defined?
- What are the advantages of multinational pooling?
- What are the disadvantages of multinational pooling?
- What are the advantages of the captive approach?

PART 5 COUNTRY AND REGIONAL PROFILES

OVERVIEW

This Part provides a number of country and regional profiles.

These profiles include an economic and employment overview, a summary of pension and risk benefit provision, and finally an introduction to medical and other benefits typically offered.

This comprises 5 chapters; one each for Brazil, Russia, India and China as well as another for a regional round up of Asia, Africa and Latin America.

INTRODUCTION

A voluntary pension system to complement social security is available to all employees in the form of occupational or personal pensions. Under this system, companies can either participate in closed pension funds for their employees, or contract with the provider of an open pension fund.

The provision of death, disability and medical benefits is generally widespread. Other benefits usually provided include transportation and subsidised meal/lunch vouchers.

1.1 ECONOMIC AND EMPLOYMENT OVERVIEW

Brazil has been identified as one of the world's leading emerging market economies, assuming, in recent years, a much more prominent economic and political role in Latin America and beyond. Following years of growth slowdown, Brazil is showed signs of recovery in 2017. Brazil had maintained high levels of employment during the recession years but unemployment has been rising (12% in 2018) and real wages has been increasing as inflation has declined. Brazil still occupies a high rank among the world's largest economies (9th position). However, the political crises plaguing Brazil since the end of 2015 has influenced the economic environment.

With approximately 100million workers, Brazil is the world's fifth largest national labour pool. About 70% of the labour force is employed in the service sector, followed by manufacturing which accounts for about 25% and agriculture accounting for around 5%.

Employment is governed by the Consolidated Labour Law (CLT), which is often supplemented by federal and state decrees. Brazil has a more rigid employment environment than other Latin American economies (for example, Argentina, Chile and Mexico), but lower termination costs. Companies are required to register with the relevant labour union in their industry sector and location, which is in charge of negotiating collective arrangements and representing its members. Both employer and employee (whether a union member or not) pay a mandatory union contribution.

1.2 PENSION AND RISK BENEFIT PROVISION

Overview: pensions consist of two different elements – the Social Security is a general regime for private sector workers and some public sector workers (Regime Geral de Previdência Social), and a complementary system available to all workers; there are also special regimes for public sector workers. The general regime is mandatory to all private sector employees, while the complementary system is privately-managed and voluntary. The latter has grown in the past few years but challenges remain. Since mid 2015 the process of implementation of private pension programs is stagnant, as companies are not increasing costs due the political and economic crisis in Brazil

1.2.1 General Regime for the Private Sector

Social Security is a defined benefit (DB) using a 'pay-as-you-go' system which is State-financed under a single pillar scheme. Employees may qualify for a contribution pension (long-service pension) or an age pension.

Retirement eligibility for the long-service pension requires a minimum contribution period of 35 years for men and 30 years for women. Early retirement may be taken for men from age 53, provided 30 years contributions have been made and, for women from age 48, provided 25 years contributions have been made.

For the age pension, an individual may qualify having made at least 180 months contributions. The retirement age is 65 for men and 60 for women.

In 1999 the system went through a major reform so rules vary depending on the year of affiliation. For workers covered under the pre-1999 system, retirement eligibility for the long service pension is linked to a minimum contribution period of 30 years for men and 25 years for women.

Currently, the Brazilian Government is currently considering some changes to social security benefits as a result of the budget deficit and worsening fiscal situation in Brazil. Brazil's President has proposed a social security reform that would set a minimum retirement age of 65 for men and 62 for women. As of January 2018, the measure had not cleared Congress.

Benefits
For those claiming either the long-service pension or the age pension, the benefit calculation depends on the date of joining the system.

Age pension
For someone who joined the system after November 28, 1999, the pension is equal to 70% of final pensionable earnings (FPE) with an additional 1% for every year of contribution up to 30 years. FPE equals the best 80% of total monthly earnings. The minimum benefit is 100% of the legal minimum salary per month (BRL 954 as of January 2018). The maximum pension is BRL 5,839 per month in 2019. Individuals who joined the system before November 28, 1999, may opt for a basic pension which is 70% of FPE adjusted by the Fator Previdenciario (an actuarial factor based on contribution rates, period over which contributions were paid, age and life expectancy).

Long-service pension
The basic benefit is 100% of FPE to which the Fator Previdenciário factor is applied.

A spouse/partner and orphan's pension (children under age 21) is payable if the deceased was in receipt of a pension or, if not, after 24 months of contribution (immediate in case of occupational accident or occupational disease) and is equal to 60%-100%, according to the number of beneficiaries, of the actual or projected retirement benefit the deceased would have been entitled to. For spouse/ partner up to the age of 43 in the date of death, the benefit will be paid for a number of years according to his/her life expectancy. For a disabled spouse/partner or spouse/ partner with more than the age 43, the benefit will be paid for a lifetime.
Disability benefits equal to a monthly pension of 100% of the FPE are paid.

Financing
Employer contributions to Social Security are 20% of total payroll, without a ceiling.

Employee contributions range between 8%-11%, with a maximum monthly earnings ceiling of BRL 5,839 (2019). Employee contributions are 11% if monthly earnings are between BRL 2,920 (2019) and BRL 5,839 (2019); or 9% if monthly earnings are between BRL 1,752 (2019) and BRL 2,920 (2019); or 8.0% if earnings are less than BRL 1,752 (2019).

These finance old age, disability, and survivors' pensions as well as cash sickness, maternity, health, workers' compensation and unemployment benefits and family allowances.

Taxation
Employee and Employer contributions are tax deductible.

Trends
Despite a recent increase in employee participation, only half of the working population is covered by Social Security.

1.2.2 Complementary Pension Regime
Complementary pensions have a long history in Brazil and the country has the oldest system in Latin America. A voluntary, privately-managed fully funded regime is available to all workers - Regime de Previdência Complementar (RPC). Plans are organised as occupational and individual pension plans, managed by closed and open pension legal entities.

Closed pension entities are similar to Pension Trusts. Open Pension Entities are largely managed by banks and insurance companies. Compared to closed pension entities, open pension plans can have disadvantages in the form of less flexibility in making investment decisions, higher asset management fees and less administrative control.

According to the OECD, Brazil has today the ninth largest complementary pension fund system in the world. In 2018, Brazil pension funds represented total assets of USD 223bn, or 13% of the country's GDP.

The main objective of the complementary pension regime is to provide supplemental social security benefits. Most companies provide defined contribution (DC) plans to all of their employees. Group life insurance is also common, providing in addition accidental death or injury, disability and spousal life insurance.

Regulation
Law 109 of 2001 governs the complementary pension plan regime. Law 11,053 of 2004 and Resolutions 06 of 2003, 13/2004, 09/2012, 10/2012 and CMN 3.792/2009 and 3.846/2010 provide additional legal framework on investment regulations and funding vehicles.

Open and closed pension funds are covered under different regulatory environments. In the case of closed funds, the State Superintendent for Private Pension Plans (Superintendência Nacional de Previdência Complementar - Previc) is the supervisor, while open funds are governed by the Superintendent of Private Insurance (Superitendencia de Seguros Privados - SUSEP).

Closed pension funds are not-for-profit entities that can be established on a single or multi-employer basis or by labour unions, with assets being independent from the plan sponsor. For the establishment of a closed pension fund, the approval of the Superintendent for Private Pension Plans is required.

In terms of governance, closed pension funds have to be comprised of a governing board responsible for setting up management regulations, a supervisory board and an executive directorate, responsible for the plan's administration. Certain regulations apply for being eligible to participate in any of these bodies. For example, since 2014, 100% of a closed pensions funds' board of directors need to have a pension certification. Stricter rules apply to pension funds sponsored by state-owned enterprises.

The open pension fund entities offer their services to employers, employees and the self-employed. An employer may contract to provide a plan to operate within the open fund, normally managed by insurance companies, and offer it to its employees.

In terms of plan design, individual plan rules (for both closed and open funds) cover issues such as admissions, waiting period (if applicable), benefit structure and formula, revaluation of contributions and benefits and must make this information available to its participants.

Vesting rules differ depending on the financial vehicle used. The maximum vesting period is three years in the case of closed fund entities, while, for open funds, the employer has more flexibility on vesting period selection. It is important to note that the legislation about this issue is not completely clear, and some insurance companies place restrictions in this area.

Portability of assets is flexible for both closed and open funds.

Benefits and Financing
DC plans typically target a retirement income of 50% to 60% of earnings, with retirement benefit being based on contributions and accrued returns on investment.

Employee contributions above 12% of annual gross income are not tax effective. Employee contribution rates range from 5% to 7% for Pensionable Earnings which corresponds to covered earnings minus a breakpoint, to reflect an indirect Social Security offset.

In the case of DC plans, employer contributions are usually in the form of a matching contribution. The employer match ranges from 100% to 200% of employees' contributions. An increasing matching percentage, according to years of service, is becoming more common.

In DB plans, the target retirement income, including social security, is 50% to 70% of final earnings, including Social Security, after a maximum 30 year career. Accrual rates are often set between 1.5% and 2% pay per year of service. Contributions depend on the annual actuarial valuation results required by law and usually are paid 100% by the employer for private companies and split evenly between employer and employee for state-owned companies. Normal retirement age ranges from 60 to 65 with early retirement age at 55.

Although not required to do so, complementary plans may also provide other benefits such as disability, death benefits and early retirement.

Benefit payments at retirement can be paid up to 25% as a lump sum and the remaining balance being paid as programmed withdrawals or a life annuity.

In case of termination of employment before retirement, plans generally allow former employees either (1) to continue accruing pension rights by making employee contributions (no employer contribution), to vest benefits to be paid at retirement age (deferred benefits) or (2) to cash own contributions out.

Funding vehicles and typical investment profile

Funding of company sponsored retirement plans can be managed as a closed entity (or a Closed Pension Fund similar to a Trustee Fund in the US) or an open entity (an Open Pension Fund for corporate and individual plans). The most common type of open entity is the PGBL (Plano Gerador de Benefício Livre), which is similar to 401(k) plans in the US. These are typically preferred for plans with fewer members. Redeemable life insurance plans (VGBL – Vida Gerador de Beneficio Livre) are also quite common.

Closed pension funds can be in the form of DB, DC or hybrid ("variable contribution"). Variable contribution plans are generally DC in the accumulation phase and shift to DB during the pay out phase and/or pay risk benefits, such as disability and death. Funds sponsored by unions, professional associations or by the government must be DC in form.

Closed pension funds have higher administrative costs, but lower asset management fees. They are usually more popular amongst large and medium-size organisations. Open funds are generally selected by small and mediumsize organisations.

Pension plans must be fully funded by law and both plan participants and sponsors are accountable for resolving any underfunding.

Investment of assets in closed pension funds can be carried out by the fund itself or contracted out to a 3rd party asset manager.

On average, pension funds currently invest about 60% in bonds, between 20% and 30% in equities, around 3% in real estate and 4% in loans or other investments.

Profitability is defined by the performance of the assets in which the pension fund has invested; therefore, there is no guaranteed return. Fund managers have been increasingly investing in variable income assets, mostly in equities. Resolution CMN 3.846/2010 passed by the National Monetary Council, introduced new regulation in terms of pension fund investments. The maximum investment in equities was increased from 50% to 70%, while foreign investments can now account for 10% of the portfolio.

The following investment restrictions apply to pensions assets:

Bonds Up to 100% (up to 80% low credit risk bonds)
Equities Up to 70%
Structured products Up to 20%
Real Estate Up to 8%
Foreign Investments Up to 10%
Operations with participants Up to 15%

Source: Secretaria de Previdência Complementar

No more than 5% of the pension fund assets may be invested in any one single company.

Accounting and Actuarial Issues
Effective December 2012, a new accounting standard, CVM695/CPC33(R1), was introduced as part of the Brazilian authorities' efforts to converge local requirements with IAS19R requirements.

It is the supervisory body's responsibility to set minimum economic-financial and actuarial security standards, with the objective of ensuring liquidity and solvency of pension plans. In this respect, Resolutions 10 of December 2012 and 16 of November 2014 give a framework to the allocation of pension plan surplus and treatment of deficits.

Resolutions 18 of March 2006 and 15 of November 2014 lay down technical conditions (minimum mortality table, interest rates etc.) that must be followed when conducting actuarial valuations for the closed pension fund entities.

The National Council for Pension Funds (CNPC) is allowing closed entity pension funds to insure biometric actuarial risks, such as those related to longevity, disability, death and deviation from biometric assumptions. An insurance contract signed by the pension fund is required. Resolution 17, published on April 2015, allows pension funds to:
- Perform an economic and actuarial feasibility study,
- Obtain fund board members' approval,
- Amend plan rules for the insurance contract, and
- Change actuarial statements to align with the new provisions.

Taxation
Contributions to private pension plans are tax-deductible (with certain limits) for both the employer and employee.

Pension benefits are taxed as income.

In terms of employee's income tax rules, the legislation allows employees to choose between two different income tax alternatives, as shown below. Again, the legislators' main goal is to encourage savings and benefit those with longer participation periods. The employee will need to choose the applicable tax system when they join the plan and can change this in certain specific circumstances.

Progressive for 2017

Up to 1,903,98 - Zero
From 1,903.99 to 2,826.65 7.5 142.80
From 2,826.66 to 3,751.05 15.0 354.80
From 3,751.06 to 4,664.68 22.5 636.13
Above 4,664.68 27.5 869.36
The values and rates (%) are defined by the government. With this option the pensioner can adjust the tax paid during the year at the end of year during the annual income tax adjustment exercise.

Regressive (specific for pension benefits)for 2017

Up to 2 years 35%
From 2 to 4 years 30%
From 4 to 6 years 25%
From 6 to 8 years 20%
From 8 to 10 years 15%
Above 10 years 10%

With this option the pensioners cannot adjust the tax paid during the year at the end of year during annual income tax adjustment.

Market Practice and Trends
In general, supplementary plans are increasingly important due to lack of confidence in future levels of Social Security benefits. The prevalence of supplementary retirement plans is already high among medium and large companies, but the need to supplement social security is increasingly recognized among smaller companies.
As in many other parts of the world, there is a trend towards DC plans. Hybrid plans, also known as variable contribution plans are growing in popularity. About 97% of plans are either DC or variable contribution.
Due to decreased investment returns, there is a developing trend to offer three or four investment funds to employees (100% in fixed income, 80%–90% in fixed income + 10%–20% in equities, 65%–75% in fixed income + 25%–35% in equities).

Pension plans are implementing financial education programmes and giving participants information and tools to plan their retirement benefit.

The biggest challenge remains low coverage, with only about 10% of the labour force currently affiliated to an occupational pension plan.

1.3 MEDICAL AND OTHER BENEFITS

Basically all large and medium-sized multinationals provide supplemental healthcare benefits, due to a poor quality of care within the Social Security programme, and long waiting times for treatment. The benefits are generally in the form of contracts with predetermined medical care benefits delivered by a closed network of clinics and hospitals, as well as reimbursement of medical expenses for mid to higher level employees. Benefits covered are: outpatient services, hospitalization, prescription drugs (only for hospitalization), dental (normally on a 50/50 cost-sharing basis between employer and employee) and optical.

Companies are encouraged to pay 100% of the premium. When employees contribute to the plan (to part of the plan or are given the option to buy additional benefits), the medical legislation requires that companies must give the option to employees to maintain the medical plan in case they are laid off or retired. According to current research, 49% of companies (local and foreign-owned) pay 100% of the benefit premium; 51% make some kind of contribution to the health plan, for all employees or at least some levels of employees. Wellness and cost control measures are becoming more common.

In August 2017, the national agency of supplemental health plans (ANS) issued a public consultation on improving the portability of private healthcare schemes. Members of company-sponsored health schemes would now be able to change plans without a grace period. In addition, the requirement that members only switch plans during the 120 days following the contract’s first anniversary would be dropped.

Although employer provided life insurance coverage is not mandatory by law, it is offered to employees by a large majority of the companies (94%). Life cover often includes death and accidental death and disability benefits. It is also common to provide death cover to spouses and dependants.

There are additional employer provided benefits such as:

- funeral allowance or assistance
- food allowance (about half the companies provide cafeteria services to employees and, the other half,
- a meal voucher worth on average BRL 21 per working day)
- transportation allowances (statutory commuting allowance for employees with low salaries and which
- transportation costs to and from work exceed 6% of the base salary).
- Mobile phones and company cars are generally provided at a senior management level. Share participation
- opportunities in Brazil are not widespread.

Summary

This Chapter has provided an outline of pension and other benefits set against the economic overview.

Self Test Questions

- What are the main features of the economy?
- What is the extent of private pensions coverage?
- What is the extent of State pensions provision?
- What other non pension benefits are important?

INTRODUCTION

There is a three pillar pension system in Russia, which started with the pension reforms in 2002. The main idea was to supplement the existing Pay-As-You-Go system with a funded defined contribution (element for younger eligible participants.

The first pillar is represented by a basic Pay-As-You-Go element which provides minimum retirement social benefits (to disabled, survivors' pensions, pensions to retired before 2022 etc.).

There is also a compulsory defined contribution (DC) second pillar financed by the employer via taxes. It consists of two parts: Insurance part and Accumulative part.

The third pillar is represented by voluntary individual and corporate pension plans. Supplementary retirement plans offered at the employer's initiative are not yet widespread in Russia; there has been little historical employer provision and the market is still developing. However, as the market is developing, there is an increasing trend among larger and foreign-owned companies to provide this benefit to complement the low pension level provided under the social security system.

The State provides medical care to all citizens but the standard of care is regarded as low, and it is common practice for companies to provide supplementary health benefits to their employees and dependants.

Contributions to:	Employee's annual income base (RUB)	Tax rate (%)
State Pension Fund	Up to 1,021	22
	Excess of 1,021,000	10 (applicable to the excess)
Obligatory Medical Insurance	Total annual income	5.1
Obligatory Social Security	Up to 815,000	2.9
	Excess of 815,000	0

The salary base for social taxes is adjusted by the Government annually. There is no employee contribution.

Summary of some macro data as of 2017:

Population	~ 146.8 million
Number of economically active population in Russia	~ 75.9 million
Number of unemployed	~ 3.8 million
Number of people working who are older than State retirement age-	~ 36.1 million
Number of retired people	~ 43.1 million
Average pension in 2015	13,480 Russian Rubles (RUB)
State retirement age	55 for women and 60 for men

21 ECONOMIC AND EMPLOYMENT OVERVIEW

The political instability in Ukraine, and the falling/volatile oil price, means that Russia's financial situation has recently materially deteriorated. In particular, the RUB against the US dollar has declined from 33 RUB in the middle of 2014 to almost around 65 RUB in mid 2019

The main challenges for the country are to invest in innovation and diversify the economy as well as dealing with a declining population.

After a number of financial crises (in 1998 and 2008) various business sectors in Moscow have shown exponential rates of growth till late 2014 when the situation around Ukraine influenced negatively the whole Russian market. On the labour market, we can witness the following trends: growth of number of vacancies has slowed down, competition among job seekers has increased, and average salaries have been frozen. In spite of these facts, unemployment in big cities is still under control and number of vacancies is still growing in Moscow and St. Petersburg.

Russian unemployment hit a historic low of 4.3% of the total labour force of about 72 million in mid-2019. Moscow has the lowest unemployment rate in Russia standing at just over 1%.

There is a highly flexible labour market with significant staff turnover. Contracts of employment are governed by legal provisions and to a lesser extent by collective agreements and individual negotiation. Contracts can be permanent or fixed-term, although the use of a fixed-term contract must be justified.

Employers are still in strong competition for qualified staff: all major international groups have already set up companies in the local market and many of them have vast production facilities all over Russia. Together with major Russian enterprises these companies are in search of professionals both in production and management, while local graduates do not always meet the high HR standards for such companies (fluent foreign language, enough working experience, international environment practices etc.). Qualified job seekers are very selective in choosing a better employer with secure and well-compensated jobs, with more focus on social security benefits. As a response to this employers offer more attractive compensation programmes augmenting short-term compensation tools (bonuses and other cash-related programmes) with long-term programmes (corporate pension plans, stock option plan, mortgage plans, etc.).

At the same time, the overall political and economic climate in Russia is likely to delay adoption of company sponsored pension plans in Russia.

22 PENSION AND RISK BENEFIT PROVISION

Overview: Prior to 2015, the retirement pension from the social security system consisted of three components:

- A flat-rate Fixed Basic Amount (FBA)
- A notional account comprising employer payments that have been transferred to the individual's pension account in the State Pension Fund (PFR)
- A mandatory funded defined contribution part comprising of individual pension accounts, applicable only for those born after 1966.

However, from 2015, a new earnings-related pension has been introduced that will eventually replace the FBA and PFR. Individuals entering the workforce beginning in 2015 will be automatically covered by the new system. Workers already in the system will be transferred automatically into the new system for future service. Transitional rules apply for past coverage under the old system.

The replacement ratio (retirement pension as a percentage of salary immediately before retirement) for pensions offered by the State system (1st and 2nd pillars) is very low, amounting to around 20-25% for workers on average earnings, though it may be even lower in large cities such as Moscow and St Petersburg for workers with higher salaries.

2.2.1 Pillar 1

Benefits
The first pillar is represented by a basic Pay-As-You-Go element which provides minimum retirement social benefits (to disabled, survivors' pensions, pensions to retired before 2022 etc.).

Financing
Pillar 1 is financed from employers' tax to the State Pension fund as 6% of the salary up to 1,0201,000 RUB p.a. and additional 10% of the salary exceeding 1,021,000 RUB p.a (2019 rates)

2.2.2 Pillar 2
Pillar 2 consists of two parts: An Insurance part and an Accumulative part.

The so called Insurance part of the State pension constitutes personal accumulations which are used to pay pensions to today's pensioners with the Government's promise to compensate these accumulations to their owners upon their retirement. The Insurance part of the pension is adjusted in line with the inflation level. The so called Accumulative part of the State pension for those born after 1967 is a DC, fully funded system, where the benefit depends on the accumulated pension assets (based on the accumulated capped contributions paid over the employee's period of service) and expected pay-out period.

The Accumulative part of the State pension for those born after 1967 is the only chance for an individual to influence their future pension accumulations by selecting a non-State pension fund for proper investment of these accumulations. Before 2016 the choice (free of charge) could be made once a year. Starting from 2016, the Accumulative part of the State pension (for those born after 1967) will be preserved only for those people who select a non-State pension fund and make a respective application to confirm to keep his/her Accumulative part. Otherwise the Accumulative part will be transferred to the Insurance part and will be converted into points/ scores (see below).

Due to the State Pension Fund budget deficit, irrespective of the employees' choice on the Accumulative part,(as described above), new contributions to the Accumulative part for all eligible employees will be kept in the State Pension Fund during 2014-2016 to supplement the Insurance part of the State pension to cover the budget gaps. This measure will lead to a possible risk that the Accumulative part will not be fully funded.

Regulation
The administration and management of the 2nd funded pension pillar is carried out by the Russian State Pension Fund; however there is a possibility to opt out and choose to have contributions to the Accumulative part of pension to be paid to one of the non-State pension funds. Employees can choose one of the around 50 pension funds (members of the State guarantee system and with a due license) to manage their pension assets. Non-State pension funds are controlled and regulated by the Central Bank of Russia.

Benefits and Financing
Insurance part of pension is financed from employers' tax to the State Pension fund as 16% of the salary up to 1,021,000 RUB p.a. for those born before 1967 and those who refused the Accumulative part of pension.

Accumulative part of pension is financed from employers' tax to the State Pension fund as 6% of the salary up to 1,021,00 RUB p.a. for those born after 1967 and those who confirmed their will to keep the Accumulative part of pension. In this case contributions to the Insurance part of pension for such employees will be 10% of the salary up to 1,021,000 RUB p.a..

Pillar 2 State pension benefit is calculated as a sum of two parts: The Insurance part of pension and the Accumulative part of pension.

The Accumulative part of pension is calculated by dividing these accumulations by 228 months (average living period of 19 years after retirement) if life-long pension is selected. The pensioner may also opt for term-life pension not less than 10 years.

The Insurance part of the pension has a new formula as of 2015, where future pension rights will be calculated not in RUB but in abstract points/scores depending on a number of parameters (individual contributions amount, length of service, retirement age, number of individual pension coefficients, cost of the point in a particular years etc.). The calculator is available on the site of the State Pension Fund of Russia.

The value of a pension point will be determined on an annual basis, adjusted by the rate of inflation. In 2019 one point is equal to RUB 87.24 The minimum number of pension points required for retirement in 2017 is 11.4 and will gradually increase to a minimum of 30 points by 2025, when the system is fully operational. The minimum number of contribution years also increased from seven to eight years as of 2017 and will continue to do so until it reaches 15 years in 2024. Additional points are given if the person decides to postpone his retirement after reaching official retirement age.

Taxation
Contributions to Pillar 1 and Pillar 2 plans are free from corporate tax for employers and income tax for employees. Pension benefits are also payable free of tax.

Market Practice and Trends
Given its short history, it is difficult to draw conclusion regarding market practice and the take-up rate among employees.

2.2.1 The Third Pillar - A Voluntary Pension Arrangement.

A company (or individual) can choose from two types of pension providers in the open market, which both enjoy certain tax incentives for employers. One possibility is a ‘pension insurance agreement’ with an insurance company licensed for 3rd pillar pensions; such an option often combines retirement savings with a life insurance component. Another option is via a non-State pension fund.

Only about 30% of multinationals have implemented supplemental pension plans. These are typically DC plans, with employer matching rates. Typical contribution rates are 6% of salaries for employers and 4% of salaries for employees.

While the vast majority of third pillar pension arrangements are DC, defined benefit (DB) plans, although rare, can be found: DB plans occur in only about 2% of cases where a supplemental plan is in place.

Taxation

Employers’ contributions to life insurance or pension funds are tax deductible for corporate profit tax purposes within 12% of payroll fund, if pensions are paid upon State pension grounds. Employees’ own contributions are tax-deductible within RUB 120,000 per year.

Employees with a pension plan both at a non-State pension fund or insurance company do not immediately pay individual income tax on employer-paid pension contributions; income tax is deferred until they start receiving pension benefits. Currently, income tax is low (flat rate of 13 per cent) and is likely to increase in future so this advantage may not be as clear as on first sight. For insured pension plans, employer pension contributions are taxed as income to the employee only in case of early policy termination. Tax will be withheld when the surrender value is paid out to employee; otherwise, the benefits are tax-free when paid. Contributions paid by employer for employee for insured pension plans are subject to Social Security Contributions.

For the purposes of Social Security Contributions, these pension insurance contributions are summed up with employee's salary.

There is a proposal to change the tax treatment of contributions to insurance companies in order to equalize them with non-State pension funds, so far with no success.

Market Practice and Trends

Due to very low social security income replacement ratios for average and high earners, it is expected that both companies' and employees' interest in third pillar arrangements will continue to grow. There was an increase in the number of companies providing such plans from 6% in 2004 to around 30% in 2019. However the pension market has largely stagnated and failed to grow significantly in recent years.

2.3 MEDICAL AND OTHER BENEFITS

Every Russian citizen is entitled to medical care; however, the quality of Russian State medical facilities is considered poor. As a consequence, companies typically provide a corporate voluntary medical insurance (referred as VMI in Russia) to their employees and dependants.

Typical VMI Plans include the following benefits:

- out-patient cover
- in-patient cover (emergency and planned hospitalization)
- dentistry cover
- ambulance cover
- home aid cover

The programme cost is driven by the perceived standard of the clinics chosen to provide services for the programme; these can vary significantly. The scope of services included, however, is usually quite similar. The insured only receives treatment in the chosen clinics in a particularly chosen city and usually clinics settle the costs directly with insurance companies without the insured paying cash (obviously, for the provision of benefits excluded from the plan programme the insured would have to pay out-of-the-pocket). Deductibles are not typical for the Russian market.

Clinics with English-speaking staff, which are often sought by international assignees, are available in Moscow and St.-Petersburg and usually fall into the most expensive clinics category.

Dependants can also be covered under corporate VMI contracts for the same level of benefits; however, a premium surcharge can be applied. Spouses and children over age 18 usually incur an adult premium while other children are priced by age group, typically, 0-1 and 1-17.

Travel insurance in Russia is provided under VMI programmes. Travel insurance in Russia covers medical emergencies. All services are organised through the insurance company's Call Centre. International Travel insurance (either free of charge or for additional premium) covers emergency and other urgent cases worldwide except insured's home country. The cost of such policy depends on the sum insured which usually has fixed levels: 30,000/50,000/100,000 EUR/USD. Additional risks, such as loss of luggage, trip cancelation, legal expenses, etc. can be included into the policy for an extra premium contribution.

The premium paid by an employer for a VMI programme can be tax deductible up to an amount of 6% of the total payroll. In order to qualify for tax relief, the contract must be signed for not less than 12 months.

Life insurance and AD&D benefits are also commonly provided by companies. Critical illness cover is becoming more common, but it is not yet universal market practice.

Main risks offered under life insurance on the Russian market are the following:

- Death due to any cause or due to accident only
- Invalidity (long-term disability) due to any cause or due to accident only
- Dismemberment
- Critical illnesses
- Short-term disability
- Hospitalization
- Surgery.

The premium for the programme depends on the chosen risks (number of risks, if risk is chosen due to any cause or accident only), sums insured, age and gender, professions (white collar/blue collar) and total number of insureds.

The typical market practice would consist of the following risks and sums insured:

- Death due to any cause – 2 x Basic Annual Salary ('BAS')
- Invalidity/Disability (3 levels) (1st level – 100% of Sum Insured (SI), 2nd level 80% of SI - due to any cause, 3rd level – 60% of SI –due to accident only) – SI = 2 x BAS
- Dismemberment – up to 1xBAS
- Critical illnesses – 1xBAS

It is not a common market practice to insure dependants under the corporate life/disability insurance contracts. The premium paid for voluntary life insurance programme is tax deductible to the company provided it does not exceed 15,000 RUB per person. The actual deductible amount is calculated using the following formula (15,000 RUB x the number of insured). In order to qualify for tax relief, the contract must be at least 12 months in duration.

Flex benefits are not popular in the Russian Federation. Only 4% of companies provided such plans in 2011, 8% of companies provided such plans in 2012, and 9% of companies provided such plans in 2014 (Benefit Data Source Russia 2012 report).

Summary

This Chapter has provided an outline of pension and other benefits set against the economic overview.

Self Test Questions

- What are the main features of the economy?
- What is the extent of private pensions coverage?
- What is the extent of State pension provision?
- What other non pension benefits are important?

INTRODUCTION

The concept of a strong, universal social security system has never existed in India. The primary reason has been the fact that India has been a developing country over many decades with the second largest population of all countries to support. As such, historically, the government has directed economic and financial resources towards current development and growth rather than focusing on the retirement and social security needs of the population. Although the government has embarked on a number of social and financial reforms in the last few years, the effects will take time to filter to the population at large. More than 60% of the country's population is rural-based with agriculture being the primary occupation. As such, one of the major social issues is the large percentage of the labour population being unorganised, informal and not covered by social security.

For the formal employment sector, there are statutory laws aimed at providing social security to workers employed in factories, mines, plantations, railways, and commercial establishments. Through these statutory laws, companies are obligated to provide basic retirement, sickness, disability, and death benefits.

3.1 ECONOMIC AND EMPLOYMENT OVERVIEW

Historically India's economy has been agriculture-based with a majority of the workforce engaged in that sector. However, the share of agriculture as a part of GDP has been consistently falling, especially following the aggressive liberalisation of many industrial and commercial sectors carried out in the early 1990s. In the last decade, India has had one of the fastest growing services sectors and a stable manufacturing sector. It is now the world's seventh-largest economy with GDP expected to continue to grow annually in the range of 6.00% to 8.00% in the medium term, making it one of the fastest growing major economies in the world. This is expected to be achieved on the basis of a young workforce, proficiency in English, a healthy savings rate and India's prospects as an attractive foreign investment destination.

3.2 PENSION AND RISK BENEFIT PROVISION

Provident Fund

Where an establishment employs 20 or more people, it falls under the requirements of the Employees' Provident Funds and Miscellaneous Provisions Act, 1952. (A long-standing proposal to reduce this threshold to 10 employees was discussed at length but was rejected by the Government at the end of 2016.).

The Provident Fund is a statutory defined contribution (DC) savings plan where both the employer and employee contribute and the funds are accumulated to provide retirement benefits to employees.

The Provident Fund benefit has two sub-plans:

a) The Employees' Pension Scheme (EPS) is a defined benefit (DB) scheme provides a pension at retirement. It is funded by employer contributions and the national government.
b) The Employees Deposit Linked Insurance Scheme which provides benefits in case of death of an employee who was a member of the scheme at the time of death

The Provident Fund benefits are regulated by the Employee's Provident Fund Organisation (EPFO) consisting of representatives of the Government, Employers and Employees. Typically, the funds are managed by the EPFO. It is also possible for an employer to apply for an exemption from EPFO and manage the Employee Provident Fund (EPF) on behalf of its own employees through setting up an exempted Trust. However, in this case its trust must provide an investment return each year that is at least as much as that declared by the EPFO in that year, and if it fails to do so for three consecutive years, or if the employer encounters financial difficulties, then it loses its exemption and the assets are surrendered to the EFPO.

Eligibility:
All employees, including casual, part-time, and daily labourers, with monthly pay under INR 15,000 and working in enterprises with 20 or more employees must be enrolled. Enterprises with fewer than 20 employees can voluntarily participate.

Employers may extend participation to employees earning in excess of the ceiling.

Employees covered by an occupational retirement plan that is equivalent to or better than the EPF can contract out.

Contributions:
Both employee and employer contributions total 12% of basic salary. The employer contribution is also liable to an administration charge of 0.5%.

The mandatory contribution is on basic salary up to the maximum salary of INR 15,000 per month. However, it is common practice for employers, which have elected to extend participation to higher earners, to pay contributions on the full basic salary.

The monthly employer contribution of 12% is split, with 8.33% (capped at INR 1,250) to the EPS and 3.67% (plus any excess) to the EPF account. (A special employer contribution rate of 10% applies for employers with less than 20 employees, split as 8.33% to the EPS and 1.67% to the EPF account.)

The government finances the employer EPS contribution (8.33% of pensionable salary) for the first three years of employment for each qualifying employee starting employment on or after 1 April, 2016 with a gross salary of less than INR 15 000 per month.

All of the employee contribution is directed to the EPF account.

Benefit Entitlement:
The Provident Fund benefit is in two parts: the EPS pension benefit, financed by the EPS contributions, and the EPF benefit, financed by the remaining contributions to the EPF account.

a) Employee Provident Fund account
EPF benefits are payable as a lump sum benefit equal to the accumulated employer and employee contributions plus investment return. Benefits are payable on retirement, on or after normal retirement age; upon permanent emigration from India; in the event of termination, including leaving service under a voluntary termination scheme; on changing employers to one not covered by the EPF; and, after two or more months of unemployment. Members can also claim partial withdrawals for various special expenses such as the purchase of a home, to pay for a child's education, or in the event of disability.

The retirement age is not fixed and follows company provisions.

b) Employee Pension Scheme
An employee who is age 58 and has 20 years of service upon termination of employment is eligible to receive a full retirement pension. If an employee has worked for at least 10 years, but fewer than 20 years, they are eligible for a "short service" pension. Early retirement is possible from age 50. The EPS pension benefit is based on the individual's pensionable service and covered salary based on the following formula:

(Pensionable salary x Pensionable service) / 70

The benefit is paid as an annuity, although some options regarding term and benefits payable on death do exist.

Pensionable salary is the average monthly pay of an employee in the 12 months preceding the date of cessation of membership of the pension fund capped at INR 15,000 per month.

The EPS pension is subject to a minimum of INR 1,000 per month. There is pressure to increase this to INR 2,000 per month but no agreement on whether it would be the labour ministry, the finance ministry or the EPFO itself to would finance the guarantee.

The monthly pension is capped at INR 7,500 per month.

Gratuity
Where an establishment employs 10 or more people, it also falls under the Payment of Gratuity Act, 1972. This defines a minimum lump sum benefit that must be paid to the employee on leaving service, including retirement, death or disability. The Act also defines the eligibility criteria, vesting and retirement age.

Eligibility:
All employees of establishments with 10 or more workers who leave service with the company after at least five years' continuous service.

Benefit Entitlement:
The gratuity benefit is payable as a lump sum, based on the employee's final salary at leaving. The minimum gratuity payable is equal to 15 days' salary per year of continuous service or part thereof (if at least 6 months has been completed) up to a maximum benefit limit of INR 2,000,000.

The maximum tax-free gratuity is INR 2,000,000. Some companies provide gratuities in excess of the tax-favourable ceiling, but it is not common.

Contributions:
Employers are not required to fund gratuity benefits in advance. Most employers pre-fund the gratuity, a few use a pay-as-you-go approach. There is a trend among the largest companies to set up a separate Trust for funding purposes. The maximum regular taxable allowance for such companies' contributions is 8.33% of salary.

Survivor Benefit Regulations
In the case of the EPF account, EPS pension and gratuity benefits, there are mandated survivor benefits payable.

For EPF account and gratuity, the accrued lump sum benefit at the time of death is payable. For the gratuity the minimum 5 year service requirement does not apply.

The EPS provides for surviving spouse's and orphan's pensions. The monthly surviving spouse's pension ranges from a minimum monthly pension of INR 1,000 up to the retirement pension to which the individual would have been entitled had he or she retired on the date of death. There is a provision of pension for orphans as well. In addition to the above, the EPF has an insurance scheme, the Employees' Deposit Linked Insurance scheme (EDLI).

The lump sum benefit from the deposit-linked insurance fund scheme is equal to 30 times their monthly salary (salary capped at INR 15,000), plus 50% of the average balance in the personal provident fund account during preceding twelve months or during the period of his or her membership, whichever is the shorter. The overall benefit is capped at INR 600,000.

The employer contributes an additional 0.5% of the employee's basic salary, with salary capped at INR 15,000 per month, to this scheme.

Other Risk Benefit Regulations
Depending on the sector of employment, companies must also comply with the Employees' State Insurance Act (ESI) and the Workmen Compensation Act (WCA), each with different benefit provisions.

ESI covers most of the private sector, and is applicable to factories employing 10 or more persons and establishments with 20 or more employees, such as hotels, restaurants, clubs, cinemas, newspaper establishments, transport agencies, and shops. It is applicable to all employees earning up to INR 21,000 per month. However, ESI is not yet operational in the following states: Andaman & Nicobar Island, Manipur, Arunachal Pradesh, and Mizoram.

The WCA covers establishments not covered by the ESI Act. It applies to hazardous employment as specified in the legislation and covers workers in factories, mines, plantations, and railways, as well as journalists, news photographers, and employees recruited in India but sent overseas for work.

The ESI system is administered by the Employees' State Insurance Corporation (ESIC) with the assistance of State governments. The WCA is administered by private insurers.

Temporary Disability Benefits:
The ESI benefit is payable after a three-day waiting period. The amount payable varies but is generally equal to about 90% of average daily wages. Under the WCA, benefits are payable after a three-day waiting period. They are equal to 25% of monthly wages, payable monthly in two instalments.

Permanent Disability Benefits:
Benefits available under the ESI scheme are linked to a standard benefit rate, which in turn is based on the employee's average daily wages. Benefits for permanent disability can be for a limited period or life, depending on the nature and extent of the invalidity.

Health Benefits from ESIC:
There is no universal healthcare system. Both the central and State governments have general and specialized hospitals for the public on behalf of the ESIC. Treatment in most government hospitals is either free or at a nominal cost. Benefits generally include inpatient and outpatient treatment by general practitioners and specialists at government facilities and private institutions contracted with the ESIC. The plan also covers surgery, maternity/obstetrics, laboratory services, drugs, and prosthetics.

There are also some cash sickness and maternity benefits provided under the ESI system.

All ESI benefits are financed by employer contributions of 3.75% of an employee's pay, and by employee contributions of .75% of pay. The salary ceiling for contributions is INR 21,000 per month.

Funding vehicles and typical investment profile

Provident Fund
The Employees' Provident Fund organization (EPFO) announced that it would pay 8.65% on account deposits for the fiscal year 2018-19 after having paid 8.55% for 2017-18.

As described above, companies can apply to contract out of the Provident Fund portion of EPF and set up their own exempt trust that provides at least the same benefits and investment returns. (It is not possible to contract out of the EPS portion.) It is believed that about 2,000 employers have set up their own EPF trusts. Contracted out trusts must comply with an investment pattern applicable to EPFO as notified by the Government, which is primarily directed to government/state securities.

Gratuity
Employers sometimes set up a Trust to fund Gratuity benefits. In order for the Company and Trust to benefit from tax concessions, the Trust must register and comply with the applicable income tax rules. Companies have the choice of self-investing or using an insurance company. The latter can offer various forms of funding products, including capital and investment return guarantees. It is most common to go for an insured approach with a traditional cash-accumulation scheme which is similar to a deposit administration set up.

Under the self-investing approach Trusts must adhere to the following investment pattern broadly described below. Investment in Equities by Trustees is very low and not common at all.

Investment Category	Asset allocation
Government Securities	Minimum 45%; Maximum 50%
Debt Securities and term deposits of banks	Minimum 35%;Maximum 45%
Money Market Instruments	Maximum 5%
Equity and equity related instruments	Minimum 5%; Maximum 15%
Exchange Traded Funds/ Index Funds	Exchange Traded Funds, Index Funds and derivatives included as equity and equity related instruments
Asset Backed Securities, Units of Real Estate/ Infrastructure Investment Trusts	Maximum 5%

Accounting and Actuarial Issues
DB plans like Gratuity required valuations for accounting purposes under the Indian Accounting Standard AS 19, which is based on IFRS standards as issued by the IASB. In particular, it mandates the use of the Projected Unit Credit method to value the liabilities.

Taxation
Contributions:
a) Employer contributions to a Provident Fund are fully tax deductible for both the employer and employee.
b) Employee contributions to a Provident Fund are tax-deductible for the employee up to specified limits of INR 150,000, as prescribed annually under Income Tax laws, including other investment avenues qualifying for tax exemptions.
c) Employer contributions to a tax-approved Gratuity Trust are tax-exempt up to 8.33% of salary applicable to the Gratuity scheme.

Benefits: Pensions are taxed as income. Provident Fund lump sums are tax free and Gratuity lump sums are tax free up to INR 2,000,000.

3.2.2 Superannuation
The number of companies providing supplementary pension benefits (in addition to the mandatory provident fund and gratuity) is declining because of low portability and the young workforce prefers cash compensation over retirement benefits. However, Superannuation provision for senior management remains common as a retention device.

DB pension schemes have mostly closed or converted to DC arrangements in the last decade since as the DB schemes had become extremely difficult to afford. Salary increases in India continues to be amongst the highest in the world affecting viability of such DB arrangements.

The DC superannuation schemes have an employer contribution rate of 15% of basic pay as this is maximum tax deductible contribution rate. Employee contributions are not common.

Some multinational companies are implementing new investment options in a DC superannuation plan. There is increasing awareness of pension plan governance among companies. There is a growing interest among employers to provide NPS. The advantage of implementing NPS is not only from the cost/admin perspective to the employer but also the advantage that employees get transparency, portability, an online access to their accounts so if they leave the company they can continue as a personal plan or their new employer can contribute.

3.2.3 Voluntary Individual Pension
The Central Government introduced the National Pension System (NPS) with effect from January 1, 2004 for Government employees, and extended it in 2009 to all citizens of India on a voluntary basis. A Pension Fund Regulatory and Development Authority (PFRDA) oversees and regulates the NPS.

The NPS is a DC based system, with two types of sub-accounts created by individual subscribers:
- Tier-I non-withdrawable pension account providing retirement benefits from the normal retirement age, and
- Tier-II withdrawable savings account providing benefits with a discretionary withdrawal facility.

The system is designed to be very low cost, with low minimum contribution requirements.

At age 60, a minimum of 40% of the Tier 1 account balance must be used to purchase an annuity. The remaining account balance can be taken as a lump sum, either immediately, or deferred and remaining invested in the NPS.

No new contributions will be accepted, and partial withdrawals will not be permitted during the period of deferment. However, the subscriber is permitted to withdraw the deferred lump sum at any time before age 70 with written application or notice.

Financing is through a fund with any of the Pension Fund managers appointed by the PFRDA.

Employee contributions are typically equal to 10% of pensionable salary, and are tax-deductible for the employee up to specified limits as prescribed annually under Income Tax laws (maximum of 10% of salary currently INR 150,000 in totality for all types of allowable contributions including those to NPS).

Employer contributions typically range between 10% and 15% (maximum legal contribution rate) of total pensionable salaries and are tax deductible for the company and not subject to perquisite tax for the employee, within a maximum of 10% salary.

On retirement, up to 40% of the total benefit receivable is tax free. Lump-sum benefits receivable on death are tax-free. Pension benefits are taxable as income when they become payable, but pension payments to a beneficiary in the event of an employee's death are not taxable.

33 MEDICAL AND OTHER BENEFITS

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Summary

This Chapter has provided an outline of pension and other benefits set against the economic overview.

Self Test Questions

- What are the main features of the economy?
- What is the extent of private pensions coverage?
- What is the extent of State pension provision?
- What other non pension benefits are important?

INTRODUCTION

The goal of the current social insurance system is to transition from a defined benefit (DB) pay-as-you-go system to a three-pillar model, to incorporate all employees in urban and rural locations. Core supplemental benefits in China can be categorised as:

1) Wealth accumulation (supplemental pension plans, nonretirement savings plans, and supplemental housing plans);
2) Health care benefits (group inpatient/outpatient insurance, maternity insurance, medical check-ups, dependent medical insurance, critical illness insurance, and hospital cash allowances);
3) Risk benefits (group life insurance, group accidental death and dismemberment (AD&D) insurance, group employer liability insurance, travel insurance, and dependent life insurance); and
4) Paid time off (annual leave, additional holidays, paid sick leave, and family leave)

4.1 ECONOMIC AND EMPLOYMENT OVERVIEW

Since the establishment of the People's Republic of China (PRC) in 1949, the Communist Party has ruled the country. Formally, the government and the Communist Party are separate institutions with complementary powers; however, there is considerable cross-membership. Xi Jinping is Head of State after serving as Vice- President since 2008.

China's economy has experienced tremendous growth since 1979, expanding by an average of around 9.4% until 2012. The growth rate has slowed down in recent years, and the Chinese government has targeted 6.5% to 7.0% annual GDP growth as preferable and sustainable. To date, economic growth has been driven by investment growth, net exports, and robust domestic demand.

The economy is managed through five-year plans and 15-year development programmes. The goals for the current five-year plan include balanced economic growth, "valued added" production, reduced reliance on exports, and increased domestic consumption.

Employment terms and conditions are mainly established by the Labor Law, which became effective on January 1, 1995 and applies to all types of companies. The Labor Contracts Law, effective January 1, 2008, substantially changed a number of terms and conditions of employment covered by the Labor Law. Earlier Regulations for Labor Management in Foreign-Invested Enterprises, promulgated jointly by the Ministry of Labor and the Ministry of Foreign Trade and Economic Cooperation and effective beginning August 11, 1994, apply only to joint ventures, wholly foreign-owned enterprises, and Chinese-foreign joint stock companies.

Generally, the Labor Law and Labor Contracts Law do not supersede all earlier labour regulations, only those earlier provisions which are in conflict with them. Therefore, the Regulations for Labor Management in Foreign-Invested Enterprises still apply in some circumstances. There also are some areas of the two documents where the interpretation may be unclear, and the local labour authority should be consulted. City and provincial labour authorities also issue their own labour regulations, which are sometimes more favourable to workers or employers than the national laws and regulations.

4.2 PENSION AND RISK BENEFIT PROVISION

Since 1949, China's pension system has gone through several stages of reform precipitated by change in the political, economic, and social environment.

4.2.1 Social Security

The latest social insurance pension plan in China was set up by State Council Document No. 26 issued on July 1, 1997 and updated by Document No. 38 in 2005. The plan is broadly in line with World Bank Recommendations and aims to move the DB plan, pay-as-you-go system to the three-pillar model which aims to incorporate all enterprise workers and self-employed in cities and townships.

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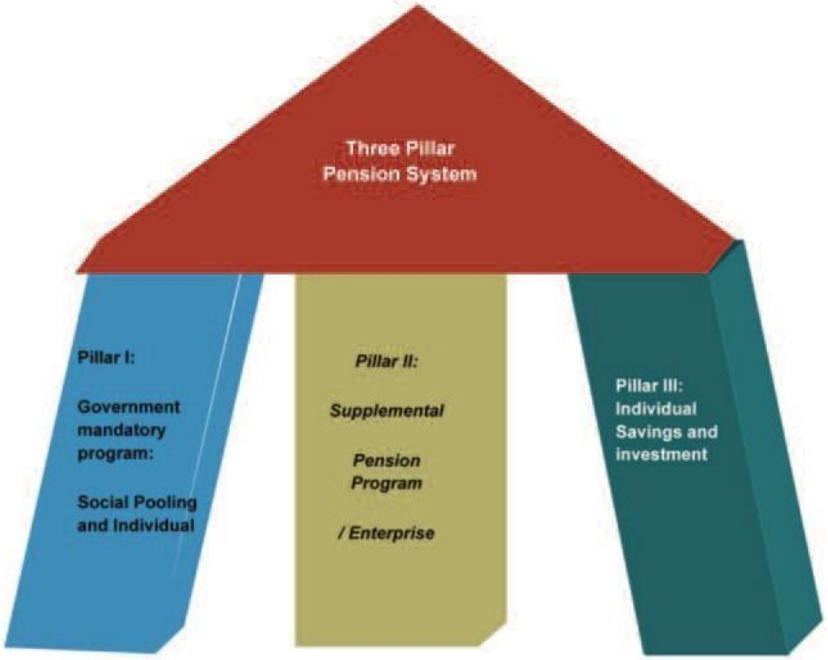

Pillar I, as recommended by the State Council issued Document No. 26 and the World Bank, the government mandatory programme, is composed of two parts: Pillar IA, which is the "social pool" and Pillar IB, which consists of individual accounts.

Promulgated July 1, 2011, China's first national law on social security—the Social Insurance Law—provides for the establishment of five basic systems—basic pension insurance, basic medical insurance, work injury (workers' compensation) insurance, unemployment insurance, and maternity insurance. Previously, only regulations were issued by the government.

The Law's major provisions include:

- Foreign nationals, including employees in foreign-owned representative offices, are required to be enrolled in the social insurance system. While this requirement was included in earlier regulations, many cities did not implement systems which allowed the participation of foreign nationals.
- Basic pension, medical, and unemployment insurance are portable for individuals moving between provinces or cities.
- With regard to old age pensions, the minimum contribution period is 15 years. Individuals who reach the statutory retirement age may continue to pay contributions until the contribution period attains 15 years. If the individual still does not have 15 years of contributions after 5 years of additional contributions, he or she may make a lump-sum payment to purchase the balance contribution years needed. Alternatively, the individual may transfer his participation to a new social insurance system for rural areas or urban residents or withdraw the amount in their personal account in a lump sum.
- Contribution rates are still determined at the provincial and city level.
- Employers are subject to additional notification requirements—they must inform employees of the details of their social insurance contributions on a monthly basis. Also, the local social insurance authority has new powers to recover unpaid contributions, and there is increased liability for noncompliance.
- There are some exceptions: foreigners employed in China who are nationals of countries with existing bilateral or multilateral social insurance agreements could be partly or fully exempt. At present, such agreements are only in place with South Korea and Germany.

Retirement Age
The retirement age for males is age 60 (age 55, if working in certain hazardous industries) and for females either age 55 for cadres (salaried jobs) or age 50 for other workers.

The China Human Resource Security Bureau has been conducting a feasibility study into increasing the normal retirement age (from 60 to 65) due to its aging population and financial pressure relating to social pension adequacy. This topic has been openly discussed. The central authorities believe the increase in retirement age can significantly increase social pension security. Others, however, worry that the change will reduce labour turnover making it more challenging to young job seekers.

Benefits
Retirement benefits offered by the system at retirement are:

- A basic pension benefit from the social pool part of 1% for each year of contribution service (minimum of 15 years of contribution) multiplied by the average of the revalued contribution base and the city average salary (CAS);
- A monthly benefit from the individual account part calculated as the accumulated individual account balance divided by a factor related to gender and age at retirement, as determined by the government.
- Transitional benefits are provided from the social pool for individuals with service years prior to the current pension system being established

Financing
Currently, employers generally contribute 16% or less of total payroll to Pillar IA, depending on their location (province and city).

Employees contribute to their individual accounts (Pillar IB). The rate is 8% of an individual employee's pay.

Both employer and employee contributions are subject to a minimum amount of 60% and a maximum amount of 300% of the CAS.

Taxation
Employee contributions are tax deductible. Employer contributions are treated as a business expense and are tax deductible. Any employer contributions in excess of the statutory amount are considered non-deductible.

Benefits in payment are tax free.

4.2.2 Supplementary Pension Arrangements
Supplemental pension benefits—employer-sponsored pension benefits on top of the social security pension—represent Pillar II of China's three-pillar pension system. Supplemental pension plans have developed quickly in recent years and in a variety of forms. The majority of employers which offer these plans consider them instrumental in the retention of their employees or offer these plans as part of their global practice.

Insured Pension Products
All major national domestic insurers (including China Life, China Pacific, Ping An Life, Tai Kang Life, and New China Life), as well as some foreign-owned insurers that have obtained group insurance licenses, have been marketing group pension products mainly in the form of a Participating Group Annuity Contract. The key feature of some products is a guaranteed investment return (usually 2.5%) with an additional profit-sharing feature (70%–75%).

Most of these products have a defined contribution (DC) design, with both employers and employees making contributions, often on a matching basis. Some companies have turned these products into capital accumulation benefit programmes that are offered to key employees as a retention tool.

Book Reserve
Some foreign companies have chosen to provide supplementary benefits through a benefit promise or book reserve. Under this method, the employer allocates notional contributions to an internal company account.

The labour authority does not look favourably on this approach, since it provides little security for employees' benefits. Employers are not permitted to take a tax deduction for any notional contributions to book reserves.

Benefits become a deductible expense only upon payment and are treated as taxable income at that time.

From an accounting perspective (IFRS or US GAAP), this is treated as a defined benefit plan.

Enterprise Annuity
The Enterprise Annuity (EA) is a government advocated and authorized supplemental pension plan, a "qualified" plan. All EA plans must be filed with the Ministry of Human Resources and Social Security (MOHRSS).

EA plans can operate only through a trust arrangement, and they must be managed by licensed service providers. Investment management and custodian must be separate, and as a result, EA funds are considered more secure.

Employee contributions to an EA are required.

Once a plan is qualified as an EA, enterprises receive tax incentives for employer contributions. Since 1 January 2014, both employer contributions and employee contributions (up to a certain limit) are exempt from individual income tax when the contributions are made. Upon payment, benefits are treated as taxable income and subject to individual income tax.

Plan Design
In order to offer an EA plan, employers are required to participate in the mandatory basic pension and be up-to-date with their contribution responsibilities. They must be able to make the additional contributions and need to have a collective agreement process in place with the employees.

The plan provisions must be put in writing in a formal plan document. The document must address eligibility, funding, administration, fund management, accounting, benefit payment options, plan management and supervisory process, and any circumstances under which contributions may be suspended.

Eligibility
For an EA plan, employers should generally make the plan available to all local national employees, upon completion of their probation period.

Foreign national employees may be allowed to participate in the EA plan only after they have been covered by social security insurance.

Plan Type and Contributions
The EA is a DC plan with individual accounts. Both employers and employees are required to contribute. The maximum annual employer contribution is limited to 8% the total payroll of the previous year. The maximum total contribution (employer and employee) must not exceed 12% of the total payroll of the previous year. The employer contribution rate usually varies by employee's age, length of service, job category, or other criteria (e.g., performance targets). However, the amount of the employer contribution for any individual should not exceed 5 times the average employer contribution for all plan members.

Vesting
Employee contributions are fully vested immediately. Employer contributions do not have to vest immediately, but must vest within a maximum of 8 years.

Benefit Payments
The account balance is payable at the statutory retirement age (currently, age 60 for males and age 55 or 50 for females, depending on labour category), on death, or on establishing permanent residence outside of China. On retirement, the account balance is payable as a lump sum or in instalments. On death and permanent emigration, the account balance is payable as a lump sum.

Employees who change jobs can transfer their account to their new employer's EA plan. Employees who terminate their employment to continue their education, join the army, withdraw from the labour force, or join a new employer that does not offer an EA plan may leave their account with their former employer's EA plan administrator. Individuals who leave the PRC to establish permanent residence abroad must withdraw their balances and close their accounts.

Investments
Fund assets consist of employer and employee contributions and investment returns.

Assets must be invested according to EA regulations; these may be placed in bank deposits or managed by qualified investment managers. In today's market, qualified investment managers include licensed mutual fund companies, pension insurance companies, and securities companies that are authorized to manage separate accounts.

Asset allocation is restricted by EA guidelines, which are updated periodically. Limits are put in place on asset classes such as equities which are perceived as "risky".

Taxation
Currently, employers receive a corporate tax deduction in respect of their contributions to an EA. This is, however, capped at 5% of payroll.

With regard to individual income tax (IIT), the government issued Doc#103 in 2013 that allows EA to use tax deferral mechanism on plan contributions; employer contributions are tax-deferred until the benefits are withdrawn.

For employee contributions, a deduction is available for up to 4% of pensionable salary, capped at 3 times CAS. The employee is required to pay individual income tax when the benefit is withdrawn.

Plan Management and Operation
Plan provisions and plan changes must be approved by employees through a collective agreement mechanism, which may be a labour union or committee of employee representatives. The plan document should be filed with the MOHRSS in the city or province in which the enterprise is registered (or at a level higher than district or county).

Non-EA Trust
The non-EA trust plan was created by EA providers to remove the restrictions of EA plan design. It replicates the trust and plan governance model of EA. It not only provides flexibilities in plan design but also has no filing requirements with MOHRSS. However, it does not have the tax advantages that are granted to EA. The non-EA trust plan is not very common although it can be found in some multi-national companies which do not want to be constrained by the strict requirements of EA.

Nonqualified Savings Plan
Nonetheless, nonqualified supplemental pension plans are still permitted and preferred by many enterprises. These are mostly private-owned companies or multinational companies (State-owned enterprises are not permitted to offer non-EA plans). Generally, these pension plans are administered by insurance companies, or through internal book reserves. Nonqualified plans may be either DB or DC with eligibility and vesting schedules determined by the employer. Employee contributions are possible but not required. As in many other countries, nonqualified supplemental plans do not receive favourable tax treatment for employee and employer contribution.

4.2.3 Pillar III – Individual Savings and Investments
The China Finance Bureau is rolling out of a deferred-tax individual pension insurance pilot programme in three pilot cities, including Shanghai in 2018. The intention is to encourage people to purchase supplemental retirement provision through tax incentivised products. However, whether such a scheme can be carried out across the country will depend on how local governments strike the balance between sacrificing current tax income on the one hand and a long-term support towards financial security in retirement on the other hand.

4.3 MEDICAL AND OTHER BENEFITS

With the privatization of the health care system, employees increasingly have been looking to employers to provide
With the privatization of the health care system, employees increasingly have been looking to employers to provide comprehensive health care coverage. To distinguish themselves as "employers of choice" and help employees avoid high health care costs, employers have begun to develop their own health care benefit strategy in China.

A large proportion of multinational companies in China provide some kind of supplemental health care benefit to employees. Almost all plans are paid completely by the employer; the employee makes no direct contribution. The typical plan covers 90% of outpatient and 100% of inpatient costs with a combined maximum annual benefit of CNY20,000 to CNY30,000. Dependant coverages, for children and unemployed spouses, are also seen.

Given the persistent dysfunction within the administration of the health care system, employers also must be prepared to provide employees with more education regarding general health management, appropriate insurance coverage, and cost sharing. The "one child" policy was amended by the National People's Congress with effect from on January 1, 2016, since when all couples have been allowed to have two children rather than being restricted to one.

The prevalence of group life insurance has been increasing steadily with market development and employers' increasing awareness of risk benefits. Employers may choose to provide stand-alone life, accident, travel, or employer liability insurance or any combination of these benefits. The cost of these benefits is typically fully paid by employers.

Employer liability insurance is a type of coverage used by some employers for various tax and cost reasons to provide death and accident coverage to their employees. For this latter, the company is usually the beneficiary, but the insured event is the death or disablement of the employee. Most policies cover only work-related accidents while some provide 24-hour coverage; non-accidental death may be excluded. The company (almost) always pays the claim amount onward to the employee (or the employee's beneficiary).

Long-term disability (LTD) insurance is currently not common in China. The statutory work injury programme is the primary source of this type of coverage. In addition, the company may be directly responsible for salary continuation and some medical costs until the level of disablement is determined (which could take some time); some companies purchase insurance to cover this risk.

Housing benefits
Housing funds are administered by provincial or municipal government agencies overseen by the Ministry of Housing and Urban-Rural Development. Although the housing fund is not technically covered by the Social Insurance Law, it is generally considered a form of social insurance in China because the contributions from both the employer and the employee are mandatory.

Similar to other social security programmes, covered pay is based on the employee's average monthly salary of the prior year up to a certain multiple of the prior year's CAS. Most commonly this multiple is three times the CAS, but can vary between different provinces.

Both employers and employees are normally required to contribute to a government housing fund (usually at the same rate) to help individuals save money for the purchase of a home on a tax-favourable basis.

Employees are also able to apply for a loan from the housing fund at an interest rate that will be lower than the commercial lending rate. The rules and design of local plans vary; however, they must still adhere to central government guidelines.

The current national guideline for contributions to a housing fund is in the range of 5% to 12%.

Some employers provide supplementary housing benefits as contributing more than the minimum contribution required by local government. Other cities set a fixed rate for government housing fund contribution and allow supplemental contribution to the same fund.

Some employers may also provide supplemental housing benefits to employees.

Summary

This Chapter has provided an outline of pension and other benefits set against the economic overview.

Self Test Questions

- What are the main features of the economy?
- What is the extent of private pensions coverage?
- What is the extent of State pensions provision?
- What other non pension benefits are important?

INTRODUCTION

In each of these regions, each country's social security and legislative environment for benefits is different. Therefore, it is inappropriate to group together countries that are next to each other and then generalise about what is provided within that group. There are always going to be exceptions to any generalisation and, as we have seen in other Chapters of this Part, there are many different ways to provide employee benefits.

Notwithstanding the above, there are often similarities between certain countries within a region. Therefore, the purpose of this Chapter is to supplement the individual country summaries with some common issues found within each region.

5.1 ASIA PACIFIC

Retirement benefits
A common theme in many Asian countries is that, culturally, it remains more usual for the family to look after their elderly relatives, if compared to for example European culture. Consequently, both State and company-sponsored retirement arrangements are less well developed than in Western countries. In terms of benefit type at retirement, in Asian countries a lump sum benefit at retirement is often more highly-valued than the prospect of an income stream for life.

Another theme across Asia is that defined contribution arrangements are more common in both the State and private sector than defined benefit promises. For quite a few Asian countries, employers skipped over the era where providing a defined benefit plan was common and, instead, have only ever offered a defined contribution plan to their employees.

A number of countries in the Asian region operate compulsory State-sponsored defined contribution programmes. These take a number of different forms. For example, in **Singapore** and **Malaysia**, there are mandatory, centrally run, Provident Funds that are effectively the equivalent of Social Security. In **Australia**, every employer must contribute a certain percentage of pay (known as the Superannuation Guarantee, currently 9.5%) into a complying superannuation ("super") fund or retirement savings account. The choice of underlying investments of the super fund or retirement savings account typically rests with the employee. Similarly, the Mandatory Provident Fund legislation in **Hong Kong** sets out a basic employer-sponsored regime. Typically, these defined contribution arrangements provide a lump sum at retirement; as a consequence, actual pension provision is less common within the region.

The **Singapore** Provident Fund also offers employees the option to use some of their fund assets to buy a home, with limits to safeguard their retirement adequacy.

Employment benefits
Service-related gratuity benefits or termination indemnities are required in a number of countries but such programmes may not need to be funded. Examples include **India, Korea** and **Taiwan**.

Risk benefits
Risk benefit coverage is common across the region. A common practice seen by some larger employers is to supplement often modest State-sponsored medical programmes.

Flexible benefits
More recently, a number of employers in countries throughout the region have sought to increase the attractiveness of their employee packages by providing more flexible benefit structures.

5.2 LATIN AMERICA

State provision and termination payments dominate employee benefit provision throughout the region.

Retirement benefits
State benefits are often the primary pension source for individuals across many countries in the region. Against this background, Chile pioneered a new form of State pension provision almost forty years ago. Instead of compulsory contributions into a single Government-sponsored arrangement, these contributions were diverted into one of a number of Government-approved private funds which could be selected by the employee. This model was subsequently followed to some degree in Peru, Ecuador and Colombia. Argentina also adopted this model for a period but the Government subsequently renationalised these funds in 2008.

Employment benefits
Throughout Latin America, the provision of a legally-mandated termination indemnity remains an important employment benefit. This may be externally funded as is the case in Brazil or Colombia, or it may become the basis of the company-sponsored retirement plan as in Mexico.

Risk benefits
Multinational companies will typically offer risk benefits, such as life and accidental disability lump sum insurances, as a minimum supplemental benefit.

5.3 MIDDLE EAST ANDAFRICA

Within the Middle East, levels of pension provision vary extensively. Countries such as **Turkey** provide Western levels of State benefit, and some of the six countries of the **Gulf Cooperation Council** (GCC, consisting of Saudi Arabia, Kuwait, the UAE, Qatar, Bahrain and Oman) provide even more extensive benefits, although provision is limited to nationals only (only about half of the population of the GCC countries are local nationals).

However, a common feature within labour law in many countries is the termination indemnity or End of Service Gratuity. (In Iraq, a new labour law took effect on 7 February 2016, and among other things it introduced a defined benefit end-of-service gratuity.) In general, these plans pay a lump sum benefit, typically based on the number of years of service the employee has worked for the company and the employee's final salary prior to leaving the company. An example might be one month's salary per year of service. This benefit may be payable on leaving service upon contract completion, retirement, dismissal without cause or, even, resignation. In most countries, these benefits are unfunded with consequent concerns about both the corresponding employer liabilities and the potential cash flow consequences arising from significant numbers of departures over a short period. As a result, some companies and financial providers are exploring ways of funding these benefits for the future.

Employer provision of supplementary retirement plans remains unusual. However, it is possible that death and disability benefits may be in place, especially where expatriate workers are involved - life insurance for locals is often considered problematic on religious grounds—and where employers may be required, by law or custom, to pay compensation in case of work-related death or disablement. There is an expectation that they will be provided with private medical expenses insurance, and, in a limited but growing number of locations, it is actually compulsory for expatriates. In 2017 **Turkey** introduced "auto-enrolment" whereby all Turkish employees under 45 must be enrolled into an individual pension plan, although an employee can subsequently decide within two months to opt out of the plan.

In Africa, there is a mixture of custom and practice. Some countries, especially those with an English law heritage, have adopted trust law and use this as the basis for their pension provision. The resulting legal and benefit structures often appear quite similar to those historically seen in the UK (such countries include **Kenya**, **Zambia** and **Zimbabwe**). Some of the French-speaking countries of North Africa follow pension structures that would typically be found in France (for example, **Algeria** and **Morocco**). Modest steps towards mandating company retirement provision are being experienced throughout Africa.

The most developed market in Africa is **South Africa**, where large single employer multi-employer and industry-wide pension funds are common, and are referred to as DC Umbrella funds with participating employers (cross industry). Although there is a significant trend towards the use of Provident Funds, this is now changing due to some recently passed new legislation and other new regulations that are expected to align the tax deductibility of contributions towards pension and provident funds as well as harmonising the retirement benefit payments that both types of funds provide, although discussion of this has been postponed to 2021. Almost all South African funds are now operated on a defined contribution basis. Although there have been proposals to introduce a social security system, welfare benefits, and especially healthcare facilities, remain minimal. Consequently, a large proportion of employers provide medical benefits for employees and their families through private medical funds.

As a general rule, pension legislation is relatively unsophisticated in many African countries and, consequently, there is considerable freedom as to how pension and employee benefits can be provided. In some African countries however, only certain insurance providers are licensed (or admitted) in the country where the policy is sold. It may still be possible for non-admitted carriers to do business though where there is a special need that cannot or will not be met by the admitted carriers. Generally, a key constraint in Africa is the lack of strong employee benefit providers. This has led to many companies setting up their own arrangements rather than rely on local providers.

Summary

This Chapter has provided an outline of pension and other benefits set against the economic overview for these regions.

Self Test Questions

- What are the main features of these regions?
- What is the extent of private pension coverage?
- What is the extent of State pension provision?
- What other non pension benefits are important?

INTRODUCTION

In this Chapter, we shall examine the features surrounding provision of benefits to Internationally Mobile Employees (IMEs) — those employees moving across national borders. While there are numerous variations of such cases, the large majority fall into three basic categories:

- Those who are transferred for a limited period of time, usually retaining a substantive connection with their home employer during the assignment, and are intended to return to work for that employer (often referred to as a secondment)
- Those who are transferred permanently (or at least indefinitely) from one country to another
- Those who are fully mobile and expected to move from one assignment to another within the corporate group (sometimes referred to as globalists, career expatriates or global nomads).

1.1 TYPES OF INTERNATIONALLY MOBILE EMPLOYEES

1.1.1 Home-based IMEs

In this circumstance, the employee is being sent by his Home country employer to work for a Host country employer within the corporate group. This is most commonly for a limited period of time, typically 1 – 5 years, with the intention on the part of both the employer(s) and employee that, at the end of the assignment, the employee will return to work for the Home country employer. (Note that shorter assignments, particularly of less than 6 months, are often regarded as little more than extended business trips with no special arrangements required beyond standard business travel accident insurance.)

A simple variation on this would be those employers which have a special internal category for highly mobile employees and, as a consequence, transfer all those within this category to a new Home country for their employment. This may be the country where the company headquarters is located or even a specially established employment vehicle (e.g. a Global Employment Company or GEC) in an attractive location for tax, Social Security and employment law purposes. This transfer of employment is regardless of whether the employee may have ever worked in, or has any other connection with, that country. This new Home country is then used as the base for all future transfers for this employee. In some organisations, this type of employee may be referred to as an 'international cadre'.

There is a growing trend within organisations to, inter alia, monitor short term assignments, ensure policies for specific IME groups are in place and amended as necessary, ensure compliance and avoid risks around insurances and medical coverage for their home-based international mobile employees. This trend reflects increasing scrutiny and compliance requirements from regulators.

1.1.2 Host-based IMEs

In this circumstance, the employee is being transferred within the corporate group from one employer (Home country) to another employer (Host country), typically, with the intention that the Home employment will be terminated and a new employment with the Host will be established. The transfer is usually intended to be permanent and there would be no intention to return Home with that employer ("no return ticket"). In case of any further mobility on the part of this employee, this new Host country may be seen as the applicable Home-base if for example the further mobility was in the form of a short-term secondment.

A variation of this would be those instances where, often because of the nature of the reward package, or even due to employment law constraints, a Home-based assignment is not possible, but adoption of Host country terms and conditions is followed. In this case, the employment contract may be suspended (or lie dormant) pending return for continued employment or, alternatively, termination. On return, there is a resulting service break (between the pre-assignment and post-assignment periods), causing a potential loss of benefit if that benefit is service-related. In this case, consideration may need to be given as to whether any adjustment or compensation needs to be made, and, if so, how that will be determined.

1.1.3 "Globalist", "Career Expatriates" or "Global Nomads"

In this circumstance, the employee is recruited with the intention of having a mobile career with the organisation, or perhaps becomes so mobile at some point in his career that there is no longer any real link with a Home country. The employee will not necessarily have a Home country to which reference can be made for reward purposes. In particular, this lack of a Home-base would require consideration as to alternative approaches to methods of benefit provision rather than following any particular national model. Nowadays there is a trend to move away from this category of international mobile employees due in part to the cost and management implications of such positions.

1.2 BACKGROUND

IMEs are often provided with extensive benefits in addition to their basic reward package. Especially for those where retention in the Home country salary and benefits structure is desired, mobility packages are designed to include a number of incentives and either direct benefit provision or allowances designed to remove the economic loss factor from the employee's decision to take on an assignment. These may include any of the following:

- Foreign Service Premium (FSP): an incentive payment made in respect of the employee taking on an assignment abroad. The premium may be a one-off payment or made for a number of years during the assignment. This is often expressed as a % of salary and usually paid for the duration of the assignment. However, this benefit is increasingly seen as expensive and its value questioned. Only around a half of employers now pay it.
- Hardship Allowance/Danger Pay: these are incentive payments made in respect of difficulties which may be experienced in the assignment location, such as political and economic instability, law enforcement and quality of infrastructure, etc.
- Location Allowance: an incentive payment targeted at a specific assignment location, considered to be a more modern approach, that substitutes for both the FSP and Hardship Allowance.
- Housing: this may be either a direct provision of housing at the assignment location, or an allowancemade to enable the assignee to provide own housing arrangements. It is usually defined in relation to the income level and accompanying family members of the assignee applied to housing costs experienced by assignees in the Host location. In some mobility policies, there may be an offset of housing costs assumed to be saved by the employee in the Home location.
- Cost of Living Allowance: this is a payment to compensate for the increased cost of living the assignee is expected to incur in the assignment location. It is usually calculated on the differential between a measured basket of goods and services in both Home and Host locations. That differential is then applied to the notional spendable income of the employee in the Home country estimated from data using income level and accompanying family members of the assignee. In some mobility policies, there may be a downward adjustment or offset for assignment locations which show a negative cost of living differential.
- Educational Provision: this is either a direct provision of schooling costs, or an allowance to enable the assignee's school age children to continue their education while the employee is on assignment. It is a recognition that most children will not, due to language, curriculum or educational standards differences, be able to move directly into the local State school; attendance at an International School or similar would need to be organised, typically in the assignment location.
- Assistance for Spouses: a payment to assist the accompanying spouse of the assignee in finding work locally during the assignment or, less often, to partially compensate for loss of family income.
- Tax Equalisation/Tax Protection: a payment structure designed to ensure that the assignee is not exposed to higher taxation on his assignment package than would have been applicable in the Home country (the "protection" approach), or to ensure that the net assignment package value is delivered in the Host country, with no loss or gain experienced due to different taxation levels (the "equalisation" approach)

For all IMEs, consideration must also be given to the need to continue to provide adequate protection under Social Security, Retirement, Medical and other family protection benefits. This would be achieved either through retention in the Home country system or through an alternative structure. This is especially important for the assigned employee who will not be familiar with how the corresponding systems in the Host country operate, as well as the impact on prior financial planning and being under a different legal system (such as inheritance rules in case of death).

13 INTERNATIONAL ASSIGNMENTS – ADMINISTRATION

Assignment Documentation

With specific reference to benefit provision, it is crucial that any provision is clearly documented, particularly with reference to promises made in addition to the normal benefits framework. This, and proper recordkeeping during the assignment, will minimise disputes which may arise in future regarding entitlements at retirement or on leaving service. As a minimum, a basic data checklist should be compiled and its location noted. This should include:

- Basic employee data
- Assignment details, including any commitment the employer may be making about status on return, or indeed how the extension or continuation in the Host country is to be handled (e.g., localisation after an initial period)
- Details of existing benefit provision, the proposed benefit provision while on assignment, and any commitments which the employer may be making; intentions with respect to Social Security coverage may be discussed but no promises made outside the employer's control
- Which company will be the employer during the assignment, and copies of employment contract, assignment letter, termination by mutual agreement (where relevant to the transfer).

Each assignment should be communicated clearly to the employee both in respect of the reward package and career development as well as the type of assignment, and, ideally, all parties—both sending and receiving employers—should be involved throughout, from pre-departure to post-return. This includes appropriate discussions with the spouse to ensure they are as well settled as the employee at the beginning of the assignment as well as during it. A common reason for the failure and early termination of an assignment is the failure of the employee's family to settle in: Spousal support or family counselling, cross cultural awareness training for the spouse and relocation support make an important difference.

The typical communication is an Assignment Letter, or, for more permanent moves, a replacement employment contract. The key items to include are:

- Term, location, and conditions of the assignment, especially where these will vary from those applicable under the current employment contract
- Details of the assignment role and reporting lines, including, where applicable, continuing relationships with the Home employing company
- Details of the compensation package and allowances
- Details of the benefit package during the assignment (see list of key issues below).

Additionally, questions are likely to rise in respect of Social Security membership, payment of benefits to a foreign resident, and the possibility of transferring pension assets to another country. While these questions are often time consuming and complex to answer, establishing a clear policy approach is an important first step as to how these will be treated.

*If the employee remains in the '**Home**' country plan during his assignment, key issues include*	*If the employee is being transferred to a '**Host**' country plan, key issues include*	*If the employee is joining an **International Pension Plan** as a Global Nomad, key issues include*
• how pensionable salary is to be determined (and how this may relate to actual earnings in the host country) • benefit implications if the employee does not return home to work at the end of the assignment (such as termination or onward further assignment) • how, if at all, employee contributions and additional voluntary employee contributions can be made • the income tax and company tax implications for such continued participation • and special terms and conditions for risk benefit coverage	• how the new plan operates and level of benefits to be expected for the relevant transfer period • income tax and company tax implications • how the benefits accrued to date in the Home country plan will be treated, and what the position would be for these benefits on return home • benefit position in the event of an onward assignment during or after the transfer period, on return home or on leaving service	• how the IPP operates and level of benefits to be expected • income tax and company tax implications, especially any negative impact (e.g. loss of tax relief) • how the benefits accrued to date in the Home country will be treated, for example, will they be vested deferred or available for transfer to the IPP • What happens to the accrued IPP benefits on return home, transfer to another location, or leaving service

14 INTERNATIONAL ASSIGNMENTS – CHALLENGES

International mobility is complex from both a technical perspective—involving as it does the interaction of two or more national systems—and a Human Resources perspective. In this latter area, poor employee selection for assignment and trailing spouses and families are key factors in assignment failure (defined as an earlier return than planned or leaving the organisation), a costly experience for both employer and employee. Employees must be ready to adjust to different conditions and remain culturally aware to succeed in this new working and social environment. Efforts to engage the spouse in terms of any present career being given up, both as to financial loss and occupying time while in the new location need to be made. This, and the feeling by a spouse with children that the children's' education is not being adequately addressed, are the most commonly cited reasons for assignment failure.

Other practical challenges may include:
How best to organise medical coverage? In almost all countries (with the notable exception of the United States), most medical care is arranged either through the State system or through nationally-based private insurance. Home country systems rarely extend any benefit to an employee who is expatriated away from that Home country and, if they do, as with the EU/EEA, only at the basic care level. While Host-based provision may be substituted during an assignment, there will often be 'gaps' in cover to be considered—if there is a serious accident or illness, the family will most likely want to return home where there may no longer be any cover in place; also, on returning home at the end of assignment, an employee re-joining a medical insurance arrangement may be treated as a new joiner with coverage restrictions or higher premiums involved. A suitable International Medical Policy may be the appropriate route to ensure continuity of coverage and medical repatriation.

What happens if the assignee overstays beyond the initial period envisaged? Although some mobility policies address the issue, most assignment letters fail to do so. The usual provision and the usual intent of employers is to "localise" the employee if he stays beyond the assignment period; this can raise employment contract concerns and may imply termination at a cost. From the benefits perspective, the employee would join the benefit plans of the Host country employer, at a time when most employees will want to remain in the Home country plans (particularly the retirement plan).

1.5 SOCIAL SECURITY AGREEMENTS BETWEEN COUNTRIES

Any employee moving to work in another country will become liable to Social Security obligation in that country; this would usually also apply to the employer even if the employer has no presence in that country. While some countries have domestic legislation which exempts those continuing to be employed from outside that country (for example, the UK allows such an exemption during the first 52 weeks working in the UK), this is seldom for more than a period of months and is not applicable at all where there is a local employer. Furthermore, some countries' domestic legislation "follows the employee" by continuing liability while working abroad (for example the UK for the first 52 weeks' working outside the UK).

1.5.1 Primary Purpose of SSAs

Social Security Agreements (SSAs), or treaties, have been agreed between countries for the primary purposes of:

- avoiding the potential for double contributions (in Home and Host countries simultaneously), and
- ensuring that benefits accrued in respect of partial careers are protected.

SSAs may be implemented on a multi-lateral basis (e.g., the European Union) or on a bilateral basis between pairs of countries. The network of SSAs is extensive among developed nations, and is growing, but is by no means universal.

For those migrants moving between countries where there is not an applicable SSA, there should be an examination of the contribution requirements in each country, the eligibility requirements and benefit rules for short periods of service or partial careers, and any benefit payment restrictions in respect of those no longer resident in the country. Alternatively, some countries may offer the potential of a partial or total refund of contributions on subsequent departure from the assignment location (such as China, Germany, India and Japan), in exchange for benefit rights which would otherwise be lost.

In serving these primary purposes, there are three principal designs of SSA:

- The **totalisation model**, where each country provides for eligibility for benefits to be determined by the total service credited in each of the countries, and for benefits to be determined using that total service credited and then pro-rated in proportion.
  Example: within the EU, each Member-State has agreed that any internationally-mobile employee will receive a benefit from each country in which the employee has service credited based on the total of service among all the relevant countries, with the benefit to be paid by each country to be equal to the higher of (a) the benefit accrued based on actual service in that country, or (b) the benefit using the total service reduced pro rata to the actual service in that country.
- The **reciprocal credit model**, where each party agrees that in respect of an internationally-mobile employee who works in the other country and returns, the Home country will pay the benefit as if the employee had never left the country (e.g., UK-Canada, Brazil-Portugal).
- The **contributions-only model**, where the foreign national does not have to pay contributions in the country of assignment (e.g., UK-Japan).

Examples of some of the SSAs in place as of 2019 include:

	Australia	Brazil	China	France	Germany	India	Japan	Netherlands	Spain	Switzerland	UK	USA
Australia		--	--	--	TTL	--	TTL	TTL	TTL	TTL	ter	TTL
Brazil	--		--	TTL	TTL	--	TTL	--	TTL	--	--	--
China	--	--		--	Cont	--	--	--	--	--	--	--
France	--	TTL	--		EU	TTL	TTL	EU	EU	EU	EU	TTL
Germany	TTL	--	Cont	EU		Cont	TTL	EU	EU	EU	EU	TTL
India	--	--	--	TTL	Cont		TTL	Cont	--	Cont	--	--
Japan	TTL	TTL	--	TTL	TTL	TTL		TTL	TTL	TTL	Cont	TTL
Netherlands	TTL	--	--	EU	EU	Cont	TTL		EU	EU	EU	TTL
Spain	TTL	TTL	--	EU	EU	--	TTL	EU		EU	EU	TTL
Switzerland	TTL	--	--	EU	EU	Cont	TTL	EU	EU		EU	TTL
UK	--	--	--	EU	EU	--	Cont	EU	EU	EU		TTL
USA	TTL	--	--	TTL	TTL	--	TTL	TTL	TTL	TTL	TTL	

Key (2017):
Cont = agreement covers contributions only
EU = European Union regulations apply
TTL = agreement uses Totalisation approach

ter = agreement terminated

1.52 Secondary Purpose of SSAs

A secondary purpose of SSAs is to "carve out" those employees who are working temporarily in the other country to enable them to be retained in their Home country system during the assignment, thereby continuing to credit service in the system to which it is intended they will return, and to avoid paying contributions in a system where the service credited will likely be small. The objective is to treat the employee, on their return, as if they had "never been away".

While there are many variations depending on the specific agreement, the outline requirements are usually:

- The employee is currently in the Home country system;
- The employee is being assigned by the employer resident in the Home country to work in the partner country;
- The assignment is limited and must not be intended to exceed a specified period, usually between 2 – 5 years (most agreements do not provide for renewal at the end of the period, although there may be discretion to extend that temporarily by the authorities involved if it is the best interest of the employee).

In 2010, the European Union revised its treatment of the internationally-mobile employee. The old rules (dating back to 1972 when there were six Member States) and the new rules (which came into force in 2010) are set out below:

SUMMARY	OLD RULE [REG 1408/71 & 574/72]	NEW RULE [REG 883/2004 & 987/2009]
Temporary transfers Art 14 1408/71 Art 12 883/2004	Employees being transferred temporarily by their Home country employers to work in another Member-State for a period not expected to exceed 12 months, may be retained in the Home country Social Security system. Further requirement that the individual not be replacing another employee on temporary transfer. [Form E101] For employees who unexpectedly overrun their assignments, an extension for up to a further 12 months may be obtained [Form E102]	Although the same principles apply, the new time limit not expected to exceed is 24 months with no provision for renewal. [Form A1] This will now include workers recruited with a view to working in the other Member State provided that, immediately before transfer, these individuals were already subject to contributions in the Member State where the Employer is established
Special cases Art 17 1408/71 Art 16 883/2004	For those employees being transferred with particular reference to the needs of the Home country employer, specialist job skills are involved or it is in the best interest of the employee that the employee be retained in the Home country Social Security system, by mutual agreement of the Competent Authorities, and with the consent of the individual, retention for may be granted. It is generally accepted that the maximum period for which this would be granted was 5 years	As before, but the 5 year limit is no longer explicitly applicable. *[Note: it is not clear if, in practice, the effect will be to open up to longer limits generally or result in more close scrutiny of applications to grant only shorter periods more often, or whether 5 years will remain the norm. It is commonly believed that the latter is the most likely scenario.]*
Application	All EEA/Switzerland nationals and legal residents of those Member States (Denmark opted out of extension to legal residents)	All EEA/Switzerland nationals and legal residents of those Member States (Denmark continues to opt out of extension to legal residents; the UK has announced it will only apply the new rules to EU nationals).
	Regulations cover retirement, sickness, maternity, invalidity, accidents at work, unemployment and family benefits	As before plus inclusion of pre-retirement schemes

1.6 OCCUPATIONAL RETIREMENT PROVISION (COMPANY RETIREMENT PLANS)

Applicable rules with respect to retirement provision normally depend on (a) the country of employment and (b) the country of residence of the employee. When an employee is being transferred internationally, one or both of these are changing and the resulting provision is driven by the policy and practices of the corporate group within which the employee is moving.

1.6.1 Home Country Retention

In the case of an employee on an assignment with the intention to return to the Home country employer, the simplest and most straightforward approach would be to retain the individual in the Home country occupational retirement plan for the period of the assignment. This is consistent with Social Security (described above) and usually matches with the employee's expectation and long-term financial planning.

In trying to achieve this "retention" goal, an examination should be made of two basic aspects:

- Do the rules of the Home country legislation and those of the plan itself permit such retention?
- How will that participation be treated in the Host country from a regulatory and tax perspective?

For the first, the legislation allowing plan participation is often employment-driven, so any change of employment may disqualify continued participation. In some limited cases, such as the US, a change of residence may disqualify the employee, unless the plan rules specifically have been extended to cover such situations.

In the second, rules with respect to mandatory plan participation may be in place—although there may be exceptions for temporary employees or for those covered elsewhere, and, indeed, may mirror the treatment under Social Security.

Countries which offer favourable tax treatment to retirement plans may limit those advantages only to those established within the country itself. In the past, it was rare to see even plans which were analogous to those of the Home country granted the same treatment, although some only required minimal qualification to achieve that position (e.g. Hong Kong).

More often, however, no such domestic treatment is accorded unless:

- there is a tax treaty in place (the US, in particular, has adopted a tax policy to ensure than any new treaty has a provision on treatment of contributions), or
- as a result of a multilateral agreement, the most significant example of which is the EU IORP (Institution for Occupational Retirement Provision) Directive combined with support from the European Commission to require non-discriminatory tax treatment of plans established in other Member States.

1.6.2 Host Country Adoption

The simplest approach is to treat the employee's change of country as involving separate employments with the employee leaving the Home country plan and joining the Host country plan.

While this is simple, it may not be considered fair, with some companies wanting to take at least minimal action to protect the transferring employee by allowing past Group service (i.e. with other subsidiaries of the multinational employer) to count towards eligibility and vesting rules in the Host country plan.

Some companies may go further and, where it is clear that a loss of benefit will result from the transfer, take steps where possible to enhance the benefits accruing in the Host country plan or supplement the deferred benefit in the Home county plan, or both, to avoid or to minimize this loss.

An alternative for more permanent transfers is to consider whether the deferred benefit in the former Home country has to be frozen, or whether it may be available to transfer. Some countries require transfer values to be taken (e.g. Switzerland), while others permit transfer values to be taken but do not require it (e.g. Belgium). There are cases where a domestic transfer is possible but where the same possibility, or the same tax and regulatory treatment, is not available in the case of an international transfer, although if a country were to attempt to impose this within the European Union, the European Commission would very quickly start legal action on the grounds of discrimination (as it did with Denmark). For those that do allow an international value transfer, there may be restrictions on the types of plans permitted or the benefits that can be provided.

On the other side of the mobility picture, the plan to which the transfer value is proposed to be paid must be able to accept it in the regulatory environment it operates, including meeting potential tax liabilities and limits, and needs to be able to accept it subject to any conditions which the transferring plan or foreign tax authority may impose.

1.6.3 Alternative Provision Methods

For those employees where retention in a Home-based plan is not available, or where no suitable Host-based plan exists, there remain a number of potential solutions for the employer to consider as alternative approaches. Each has its advantages as well as potential disadvantages.

International Pension Plan

The potential of using an 'offshore' vehicle — i.e. a plan which is neither in the Home or Host location — for funding the desired benefits. This is considered in more detail below.

Cash, or a Retirement Allowance

In any situation where a benefit may be expected, and that benefit is proving difficult to arrange, a potential answer is always to consider a cash alternative. It is of course simple to provide. This cash may be delivered immediately or deferred; it may be unrestricted or made subject to payment conditions to prove it is being invested for retirement. The employee, if he values making long-term provision, can choose among potential personal pension products available, or, for flexibility, given that this cash may well be net of any taxes owed, consider investments offering a long-term savings opportunity free from restrictive tax rules applicable to retirement plans.

Direct Unfunded Pension Promise

It is not the case that all retirement plans are funded; a plan can consist solely of a contractual promise by the employer. (This is also known as an "unfunded plan" and is a widespread method of pension provision in many countries, notably in Germany.) However, there will probably be concerns about the security of that promise where there are no assets set aside, as there can be no certainty that the employer will still be around to pay the benefit at a retirement date well into the future.

- A pension promise may be attractive where there is perceived to be a gap in provision and no decision as to how to fill it has been decided upon
- It can be useful where only small numbers of employees are involved and establishing a formal funded arrangement is seen as uneconomic
- It is typically used also where funding a benefit may present tax, investment or administrative challenges.

As noted, the key concern from the employee is the level of security accorded to the promise made, even to the point of whether the promise is recorded in a way that the company would acknowledge it at time of retirement from some distant past.

For the employer, the concern is that is it an unfunded liability, and unless recorded and valued from time to time, the cost may become unmanageable. Further, there may cash flow difficulties when the benefit comes into payment, not to mention the concern as to which company within the Group may have to meet the cost.

In all cases, it is critical that any unfunded obligations be clearly and transparently documented in order to minimise disputes that often arise many years later about what was promised and who is responsible for financing it.

1.7 INTERNATIONAL PENSION PLANS (IPPS)

1.7.1 Reasons for Creating IPPs

While the creation of a pension plan in one location to provide a stable retirement arrangement for the benefit of an employee who spends part or all or his career in several locations is certainly one of the major incentives for a multinational employer to create an international pension plan ("IPP"), it is certainly not the only motive. Companies typically create IPPs in order to overcome difficulties encountered with national plans for the following categories of employee:

- Internationally Mobile Employees
- Employees in countries where local retirement arrangements are considered unsatisfactory for a variety of motives e.g. political instability, weakness of currency or lack of local competent or trustworthy service providers
- Employees with individual informal or unfunded promises
- Special arrangements for senior managers, often motivated by the need to provide tax efficient saving plans
- Unusual individual cases, possibly unique to a particular company

Various surveys indicate that somewhere between 10% and 30% of companies with internationally mobile employees had established separate international pension plans to provide retirement benefits to these employees, likely with well over 1,000 such plans currently in existence.

There are other pressures in the international plan market, such as the US Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standard (CRS), and the development of regional retirement arrangements (for example Pan-European plans). We expect that the number of globally mobile employees to continue to grow and the arrangements to increase in complexity.

1.7.2 Definition of an IPP

Once one understands the motivation for creating an IPP, it is relatively easy to devise a simple and broad definition. An IPP may be defined as:

"A retirement or savings plan containing members who are typically international staff that is specially created to serve certain special needs of its members or the sponsoring employer which are not adequately met by national retirement plans."

1.7.3 Selection of "Domicile" (Location) of an IPP

Traditionally, the domicile or location of an IPP selected is one where there is a relative lack of regulatory restrictions other than the minimum needed for protection of pension fund assets. This flexibility is important bearing in mind the special needs of the members of an IPP. In addition, the IPP has also traditionally been placed in a location that is free of local taxes (potentially important given that the location of the IPP is usually neither the Home nor the Host country for the employee) or at least offers a benign and attractive tax regime for the IPP as far as local taxes are concerned.

However, other factors should also be taken into account when selecting a location. Typical criteria in the selection process include:

- Political and economic stability
- Flexibility and sophistication of local law; for example, if a trust structure is desired, the location should have a well-established trust law regime (Bermuda, the Channel Islands and the Isle of Man are examples of jurisdictions with well-established trust law regimes)
- Potential for exemption from FATCA and CRS reporting
- Availability of competent and experienced local service providers
- Reputation as a sophisticated financial service centre
- Freedom from local taxes, but also, ideally, tax recognition by the home countries where members are tax resident—it should be noted that, typically, home countries will not recognise the pension regimes of these international finance centre locations for tax purposes
- Minimal benefit restrictions and the ability to take benefits in lump sum form
- Freedom from exchange controls
- Linguistic ability e.g. multilingual staff retained by service providers. (Luxembourg, Switzerland and Liechtenstein are good locations from this point of view).

Territories which meet many of the above criteria and where IPPs are typically located include:

- Bermuda
- Channel Islands (Jersey and Guernsey)
- Isle of Man.

The above jurisdictions are often referred to as "offshore" locations.

Another group of European countries which in the past have been considered as suitable offshore locations for IPPs are now either governed, or at least affected, by the EU IORP (Institution for Occupational Retirement Provision) Directive. These jurisdictions require special consideration in as far as the EU IORP directive has removed certain positive features which formerly made the jurisdictions attractive for IPPs, while at the same time it has added other positive features not possessed by the above list of jurisdictions. These countries include:

- Luxembourg
- Ireland
- Liechtenstein
- Malta
- Cyprus.

1.7.4 EU-based IORP vs "Traditional" IPP

The EU IORP operating on a multi-country basis falls within the broad definition of an international pension plan above, and can be considered as an alternative to a traditional IPP. However, an IORP regulated by the EU IORP Directive is subject to considerable regulatory restrictions which are antipathetic to the usual motives for creating an IPP. For example, the EU IORP Directive requires full funding for defined benefit arrangements which in itself is sufficient to deter most sponsoring companies from using an IORP as a vehicle for such plans. However, all countries within the EU and EEA are required to recognise a properly established IORP for tax purposes and will grant it the tax privileges normally offered national plans. Therefore, contributions should be tax deductible and fund accruals not subject to current taxation. This is a considerable advantage.

It should be noted that it is the lack of home country tax recognition which constitutes a major disincentive for creation of a traditional IPP in an offshore location. Therefore, the fact that an IORP now provides the promise of such tax recognition by most European jurisdictions will mean that an IORP located in Europe should not be discounted as an alternative to a traditional IPP in an offshore location.

Factors favouring creation of an EU IORP for internationally-mobile employees include:
- Situation where the majority of members live in Europe
- Tax recognition and tax privileges offered by European states are considered of paramount importance
- Desire for multilingual service providers and culture.

Factors favouring creation of a traditional IPP for internationally-mobile employees include:
- Situation where many members live outside the EU
- Desire for maximum flexibility and freedom from regulatory restraint
- Defined benefit arrangement desired
- Tax recognition and receipt of tax privileges from European states not considered of vital importance.

Many multinational employers will have one or more IORPs and IPPs as part of a well-designed employee benefits programme.

1.7.5 IPP – Design Considerations

In establishing international benefit plans, employers tend to take into account the following key factors:
- Duration, nature and location of assignments of the potential members
- Benefit expectations in relation to corporate benefits philosophy
- Taxation issues—while the IPP is seldom tax-favoured in itself, careful plan design can be used to enhance the tax-effectiveness in relation to certain countries, for example by avoiding vesting of benefit which may trigger a tax liability
- Flexibility—establishing a plan where there are minimal rules applicable may give the opportunity to design the plan to fit the requirements of the employees in question without the constraint of legislation driven by tax requirements, for example, nature and timing of benefit distributions
- Whether there should be any integration with Social Security, mandatory plans, or other company provision to which the member may be entitled.

The design of benefits in international benefit plans vary substantially, but can broadly be divided into the following two groups:
- Top-up plan to provide additional benefits to that which the members may be accruing in the countries in which they work ("umbrella plans" which top up all accrued local benefits to a defined formula)
- Replacement plans for local participation, using similar benefit formulae, on the basis either that the members will not join those plans that the benefits from them would be small or unable to be received, or because of the short period of service the member's entitlement will never vest.

IPPs may be defined benefit, defined contribution or hybrid, although most IPPs being established are currently defined contribution. Plans may be used for more creative reward solutions, such as deferred compensation and bonus sacrifices. It is also not uncommon for the plan design to adopt a Provident Fund approach whereby the plan benefits are available as a lump sum (rather than having to administer a continuing income), and the benefit is distributed at a specified retirement age, or even, on leaving service (leaving no administration tail, i.e. the only plan members are active employees, as members leave the plan as soon as they cease active service).

1.7.6 IPP – Investment Vehicles and Legal Vehicles

International retirement plans are usually funded using either:
- mutual funds/UCITS (Undertakings for Collective Investment in Transferable Securities) managed by fund managers, or
- life insurance policies provided by insurance companies (often simply referred to as 'insured plans')

The choice of the investment vehicle is usually governed by the legal vehicles available in the jurisdiction selected to host the IPP, although to a certain extent the jurisdiction selected and the legal vehicle selected may be interdependent, since it is often the nature of the particular investment vehicle which attracts the sponsor to the given jurisdiction in the first place.

Locations historically linked to Britain and employing English common law, such as Ireland, Bermuda and the Channel Islands, generally offer trusts as the standard legal vehicle; while Continental European jurisdictions employing civil law and where the concept of a trust does not exist in national legislation, such as Luxembourg, offer non-profit associations (e.g. ASBLs) or foundations as the legal platform for IPPs. In both cases, these legal vehicles typically invest in mutual funds/UCITS.

1.8 NOTES ON A SELECTION OF COUNTRIES

1.8.1 Introduction

This sub-section summarises tax and regulatory matters, which need to be reviewed when a company wants to keep an expatriate in its Home country tax approved plan. We shall consider each of the designated countries as a "Home" and "Host" country but students should be aware that the tax/regulatory position can frequently change. This can be caused either by deliberate action within a country or, through some regulatory amendment intended to apply locally but which has failed to take account of possible consequences impacting expatriates retained in a non-local arrangement. The situation therefore requires constant monitoring.

Generally, an expatriate who is employed by the Home country employer (i.e., is working abroad for that employer in its foreign office or branch and is paid by the Home country employer) can remain in the Home country plan. If, as is more frequently the case, a foreign subsidiary or associated company employs the expatriate, the position may well be different. In either case, it is also necessary to check whether tax problems arise in the Host country.

Where two EU/EEA Member-States are involved, the domestic rules with respect to plan retention, plan recognition, potential for transfer values, and taxation may have been overridden or modified by treaty, Directive, or action from the European Commission. For example, local tax treatment which is deemed to be discriminatory is regarded by the Commission as unenforceable, and individuals or employers who are subjected to such taxation (such as the differential treatment of transfers of accrued rights to other pension plans depending on whether they are in the same Member State or in another Member State, as was attempted by Denmark) are encouraged to notify the Commission who will take legal action against the offending Member State on their behalf. Most of these issues have been discussed previously but should be kept in mind when considering what will be the applicable treatment in the particular instance.

1.8.2 Australia

As the 'home' country: An expatriated employee can (subject to certain local plan residence restrictions) remain in the Australian plan provided the rules allow, but the foreign employing company must adhere to the rules of the plan as a Participating Employer in order to contribute on behalf of the employee to the Australian plan.

As the 'host' country: An incoming expatriate may qualify for exemption from the Superannuation Guarantee Levy (SGL) which requires certain minimum contributions to a locally regulated plan. Exemption from the SGL depends on the type of visa issued and position held. The provisions for exemption are set out in some detail in legislation but, in general, the expatriate must be a senior executive in a full time position, carrying substantial executive responsibility, and holding qualifications appropriate for the position. Alternatively, exemption may apply under the terms of a bilateral agreement on double superannuation. Australia has concluded such agreements with several countries.

No employer tax deduction is allowed on contributions to the home country plan. Employer contributions are subject to Fringe Benefit Tax unless the expatriate is a "temporary resident". A "temporary resident " is someone who holds a temporary visa, neither they nor their spouse is treated as an Australian resident under the Social Security Act, and who meets certain other tests. In either case the expatriate is not taxed in respect of the employer's contribution and employee contributions are not deductible.

Transfer of assets to/from foreign plans: Normally, asset transfers to non-Australian plans are not allowed. However, temporary residents leaving Australia permanently are permitted to cash out their benefits (subject to Australian withholding tax), and this cash out can be in the form of a payment to an overseas plan. Where an Australian fund pays a cash benefit or transfers an amount into an overseas fund, the payment is normally taxed at 35% (45% from some Government plans) although amounts in respect of contributions from after tax income are not subject to tax.

Transfers of assets into an Australian plan are permitted, subject to the rules of the Australian plan allowing this. Any transferred amount in excess of the expatriate employee's vested benefit (amount to which the employee is properly entitled) will be taxable as income to the employee. Alternatively the employee can opt for the tax to be paid from the transfer value. Transfers to any one plan at any time are limited to AUD 450,000 (AUD 150,000 if the person was 65 or more at the previous 1 July).Where the person is aged 65 or more at the time of the transfer,the transfer can only be made if the person has been gainfully employed for at least 40 hours in any 30 consecutive day period since the previous 1 July. Transfers are not allowed after age 75.

If the transfer is made within six months of the employee becoming resident in Australia, any transferred amount to which the employee is properly entitled, including any interest credited to the benefit from the date the employee became resident of Australia to the date of transfer to the plan, may be credited to the Australian plan without tax being paid.

Payments received outside of six months of taking up residence may give rise to further taxation consequences. The amount by which a benefit, to which the employee is properly entitled, increases from the date of becoming a resident to the date of transfer or payment to the Australian plan will be included in the employee's assessable income or taken from the transfer value if the employee so elects.

In addition to the potential tax referred to earlier (in respect of transfers after six months of becoming resident), a further tax of 46.5% may apply to part or all of amounts transferred. Transfers (including amounts split between a number of plans) will be aggregated with other contributions from after tax income. Any excess over $150,000 in a year will be subject to an additional tax of 46.5%. However "bring forward"provisions enable those under 65 to bring forward their limit for the following two years, so amounts of up to AUD 450,000 can normally be transferred without incurring this additional tax (assuming no other after-tax contributions have been made in the same period).

Note: once transferred into the Australian Superannuation system, the transferred benefit becomes subject to "preservation" rules which prevent withdrawal of the benefit from the Australian Superannuation system until retirement or satisfaction of some other statutory condition of release.

1.8.3 France

As the 'home' country: There are two types of expatriate to consider:

- A "detached" expatriate (détaché) i.e. one that still contributes to French social security
- A "real" expatriate (expatrié) i.e. one who contributes to the host country social security system and not to French social security.

For a 'detached' expatriate, all the benefits accrue as if the employee was still in France for both the basic State pension and the linked complementary ARRCO/AGIRC pension system. This is possible for a period depending on the social security treaty with the 'host' country. After that period, if the 'detached' expatriate is not allowed to benefit by an exemption, the voluntary insurance plan (described below) can be adopted.

An expatriate not contributing to French social security may be able to continue in the French mandatory arrangements:

- if the French employer has signed an agreement with the relevant Caisses allowing all expatriates to continue to participate while on assignment to a foreign employer, or
- on an individual basis through the Caisse des Français à l'Etranger (CFE) for basic social security and the Caisse de Retraite des Expatriés (CRE-IRCAFEX) for the mandatory ARRCO/AGIRC systems. Contributions to these plans are voluntary for the employee, and the employer can reimburse part of the cost to the employee, in lieu of direct contributions.

Where the French employer operates a supplementary private plan, continued membership for an expatriate hinges on whether or not he or she remains eligible according to the objectively defined category in the plan rules.

As the 'host' country: The incoming expatriate is required to participate in French social security and (as a result) the ARRCO/AGIRC complementary system. Expatriates on short-term assignments who have been retained in their "home country" social security system by virtue of a social security agreement (SSA), and who therefore do not have to contribute to French social security, are also exempt from having to contribute to ARRCO/AGIRC.

Exclusion from a private occupational plan will depend on the wording of the eligibility conditions in the French plan rules.

Generally, employer contributions to a foreign plan are treated as (and should be declared as) taxable income to the employee, and employee contributions to a foreign plan do not attract tax relief. However, exceptions apply as follows:

- A plan elsewhere in the EU and approved for cross-border membership under the IORP directive, as long as membership is on the same basis as would attract tax relief if it were located in France (in particular, that all employees in an objectively-defined group are members); note that this is rarely the case with individual expatriates sent to France
- A plan in a country with which France has a double taxation treaty which specifically provides for this (e.g. the UK and the US), and where the conditions in the treaty are satisfied; normally these require membership of the home country plan before the employee moved to France

In respect of plans in these countries, employer and employee contributions are tax deductible and the employee is not assessed on the employer's contribution, subject to all deductions being limited in the same way as for French plans (Article 83 of the Tax Code).

Transfer of assets to/from foreign plans: transfers to or from the mandatory French arrangements are not possible. Transfers to or from supplementary plans may be possible in some circumstances, but will depend on the type of plan and the specific rules, and may not necessarily be tax-efficient.

1.8.4 Germany

As the 'home' country: In the case of a "book-reserved" German plan, i.e. a direct pension promise from the employer to the employee, the employer can promise benefits to the expatriate employed by a foreign subsidiary or associated company (and maintain a tax deductible book reserve) provided the expatriate provides some 'economic benefit' to the German company. This is limited to a certain period agreed prior to the assignment by the employer and employee. The period is usually between one and five years and would normally be documented by a suitable contract. Examples of 'economic benefit' are that the employee gets relevant experience abroad or performs a control function on behalf of the home country employer. An actual salary payment is not necessary as the pledged benefits are deemed to be 'payment' in consideration of the service provided.

In the case of a pension fund (Pensionskasse or Pensionsfonds) or support fund (Unterstützungskasse), the expatriate must be employed by the German company to retain active membership. Benefits continue to accrue as normal provided the assignment is in the interest of the home country employer, employment has not been discontinued and the accruing benefits have been explicitly agreed.

Tax deductions are available for the German employer if the host employer reimburses it for the contributions paid. However, the reimbursement constitutes taxable income so that the tax situation for the German employer is neutral.

If the above requirements are not met, membership may be continued as a deferred member (without further accruals), assuming the employee has contractually vested or legally vested rights at date of transfer.

As the 'host' country: The expatriate can be excluded from the German occupational plan if the rules allow. Employer contributions to a foreign plan are tax deductible although the employee may incur a benefit in kind tax in respect thereof. Employee contributions are not tax deductible. If the foreign plan is deemed a book reserved plan or a support fund by the German tax authorities, the expatriate is not assessed for tax on the employer's contribution. If the foreign plan is considered as direct insurance or a pension fund, the employer's contribution is treated as additional taxable income to the employee. However, the German company can pay a flat rate tax in lieu of the employee's tax, but only to a low limit.

If the plan is located elsewhere in the EU and approved for cross-border membership under the IORP directive, tax reliefs may be available up to local German limits but the plan would have to correspond to a German plan.

Transfer of assets to/from foreign plans: Although it is not impossible to transfer assets into a German plan, there are practical difficulties. A "book reserve" plan is not a legally-separate or legally-identified entity and the assets would just be being invested directly into the employer's business. No tax is payable on the transfer-in for support funds. If the German plan is a direct insurance arrangement or a pension fund, the transferred assets become part of the individual's policy reserve and the transfer-in amount is taxed on entry to Germany. Transfers out of a German plan are only possible in respect of the excess assets over the legally vested minimum benefits, but no tax is incurred on the transfer.

1.8.5 Japan

As the 'home' country: An expatriate can remain in the Japanese plan indefinitely in most cases. The employment contract must also remain with the Japanese company. If the assignment involves separation of employment with the Japanese company, plan participation ceases and the accrued benefits become payable to the employee.

As the 'host' country: Exclusion of an expatriate from the local plan depends on the employment contract and the plan rules. Eligibility for tax approved plans is non-discriminatory.

Foreign plans are not tax approvable in Japan so that, although the company can take a tax deduction on contributions, these would be assessed to tax on the expatriate as additional income. It is unlikely that employer contributions would be taxed unless paid to a defined contribution plan where individual accounts can be identified. Employee contributions do not receive a tax deduction.

Transfer of assets to/from foreign plans: A transfer of assets to or from a Japanese plan is not feasible. However, on leaving the employment of a Japanese company the employee is, strictly speaking, entitled to the appropriate withdrawal benefit paid as a lump sum. The lump sum is subject to withholding tax but a liquid asset does become available.

1.8.6 Netherlands

As the 'home' country: It is possible for a Dutch expatriate on the payroll of a foreign company to remain in the Dutch plan as an active member. In practice, this is possible where the foreign employer is related to the Dutch employer. The Dutch employer continues to contribute to the home country plan and is normally reimbursed by the local employer.

As the 'host' country: It is possible for an expatriate to remain in the foreign plan as an active member and be excluded from the local Dutch plan if the rules allow. In the case of an industry-wide pension plan, whether the expatriate can be excluded from the local plan may hinge on the employment contract and status of the expatriate although it is possible to request a dispensation from participation in the (obligatory) industry wide plan.

Favourable tax treatment of contributions to a foreign plan is only allowed if:

- the foreign pension plan is formally 'approved' as acceptable to the Dutch authorities,
- the expatriate was an active plan member immediately prior to transfer to the Netherlands, and
- the expatriation is between related companies.

This concession is subject to certain conditions and is normally limited to five years. Employer and employee contributions are tax deductible, as for a domestic plan, and the employee is not assessed in respect of the employer's contributions.

Transfer of assets to/from foreign plans: Transfers to or from a Dutch plan can be made if the rules permit. Approval by the supervisory authority is required for which strict rules apply, unless the transfer is to a plan which falls within the scope of the EU IORP Directive and there is an undertaking that any lump sum commutation of benefits in future will not exceed the applicable Dutch limits. Separate approval by the tax authorities is required and a withholding tax applies unless specific consent is obtained, except, again for intra-EU/EEA transfers.

1.8.7 Spain

As the 'home' country: An expatriate can remain in the Spanish plan if it is a qualified company retirement plan, as long as an employment contract existed with the plan-sponsoring employer at some point in time. If the plan is non-qualified, the employee could remain as a member if the plan rules allow. Employer contributions for expatriates would have the same tax treatment as contributions made for other employees. The tax treatment for the employee would differ based on the specific tax situation of the expatriate.

As the 'host' country: Expatriates can usually become members of a qualified company retirement plan depending on the plan rules. Given the non-discriminatory rules and the fact that all employees must be eligible for benefits after a maximum of two years of service, it would be unusual for an expatriate not to be covered.

Exclusion from a non-qualified plan, where the rules can be more flexible, is feasible although not very common. If the expatriate remains in the home country plan the Spanish employer's contributions to it would be tax deductible but assessed as additional taxable income to the expatriate who would not receive tax relief on his or her own contributions.

Transfer of assets to/from foreign plans: Transfers of assets into a qualified company retirement plan in Spain are possible, although the transferred-in assets would be taxed on the employee and for all purposes would be considered as a voluntary employee contribution. It is not possible to transfer pension assets out of Spain.

1.8.8 Switzerland

As the 'home country: an expatriate can remain in the Swiss plan for so long as Swiss Social Security contributions continue to be made, either as a result of retention through a social security agreement (SSA) or by continued voluntary membership. Once liability towards Swiss Social Security ceases, the expatriate must leave the employer's plan.

As the 'host' country: an expatriate must join the Swiss pension plan, at least in respect of the mandatory portion (BVG), upon becoming a member of Swiss Social Security. When not participating in Swiss Social Security under the terms of an SSA, the expatriate may meet the mandatory BVG participation through a certification process that any continued foreign retirement plan membership meets the minimum provision requirements. This certification is not required of expatriates who are EU/EEA nationals.

Transfer of assets to/from foreign plans: when an expatriate leaves Swiss employment, the accrued plan value is required to be transferred to a new employer's plan, or an alternative plan (including the possibility of using a default fund). For those leaving Switzerland, it is possible to take the plan value as an immediate lump sum but subject to taxation at the time. For those leaving to move to an EU/EEA Member-State, the value representing the minimum mandatory BVG portion must remain in Switzerland.

Swiss plan administrators may accept foreign transfer values subject to the plan rules permitting.

1.8.9 UK

As the 'home' country: There are no restrictions on membership of either an occupational or personal pension plan. There is no limit as such on contributions by or on behalf of a member resident outside the UK. However, contributions (or increases in benefit value) above the Annual Allowance (£40,000 p.a. in 2017/18 for those with "earnings" under £150,000) will attract a UK tax liability on the member in the same way as applies to UK resident plan members.

As the 'host' country: An expatriate does not have to join the employer's plan in the UK as membership of employer plans must be voluntary. Where they remain in their home country plan, the UK will recognise the plan for UK tax purposes if the plan and the individual meet the requirements for "Migrant Member Relief". Most non-UK retirement plans that are recognised for tax purposes in their home country are in practice acceptable, provided they undertake to meet certain UK reporting requirements. Individual members will normally meet the requirements provided they were in the plan and receiving tax relief locally before coming to the UK. If Migrant Member Relief is granted, employee and employer contributions will be tax deductible within the same limits as apply under UK registered plans. In the absence of Migrant Member Relief, member contributions are not deductible, and employer contributions are not deductible until the benefits are eventually paid out. However, the member will not be taxed on the value of employer contributions

Note: formal submission is not required for tax approved plans in Canada, Denmark, France, Ireland and the US by virtue of the reciprocal double taxation agreements with the UK, in circumstances where reciprocal tax relief on pension plans is granted by the agreements.

Transfer of assets to/from foreign plans: Transfer to an overseas plan is generally permitted. The international transfer regime permits authorised transfers (untaxed) to be made to foreign retirement plans which have registered with HM Revenue & Customs (HMRC) as a Qualifying Recognised Overseas Pension Scheme (QROPS).

In order to qualify as a QROPS, the receiving plan must pass a number of tests. The requirements include (but are not limited to) the following: the plan is open to local residents, conditions relating to tax regulations in the particular country, the earliest age from which benefits can be paid, the country of establishment and its regulatory framework and the form of the benefits payable. The plan will also need to comply with specific reporting obligations to HMRC.

The UK then permits transfers without UK tax consequences provided the plan has agreed to notify HMRC if there is a subsequent payment from the QROPS which would have been an unauthorised payment had it been made from a UK registered plan, provided the member is tax resident in the UK or has been resident in any of the five tax years prior to the payment.

Transfers of assets into the UK from foreign plans are permitted with no immediate tax liability.

1.8.10 USA

As the 'home' country: One of two sections of the Internal Revenue Code (IRC) applies in determining whether an expatriate can remain in the US tax qualified plan, as follows:

(i) Under Section 406 (IRC) US citizens or residents employed by an entity in which a US employer has a 10% or greater interest will be treated as employed by the US employer for the purposes of the US company's qualified retirement plan. This is subject to:
- the US company extending social security coverage to all of the US citizens employed by the foreign affiliate under a formal agreement (known as a Section 3121 (l) agreement) with the US Treasury Department;
- the US plan documents expressly providing for continuation on behalf of US expatriates employed by the foreign affiliate;
- the US plan covering all other US citizens and residents employed by the foreign affiliate, and
- US expatriates not being covered by another employer's funded plan in respect of earnings fromthe foreign affiliate.

(ii) Under Section 414 (IRC) the US parent company can cover employees of a foreign affiliate which, together with the parent company forms a 'controlled group'. This generally requires an 80% or more direct ownership by the parent. Application of Section 414 is more flexible than Section 406 because:
- it allows selective coverage of US expatriates employed by a foreign affiliate;
- does not require extension of US social security coverage to all US citizens employed by the affiliate, and
- allows coverage of some or all of non-resident aliens in the US plans.

US tax law poses a particular problem for US expatriates in that US citizens must file a tax return relating to worldwide income, irrespective of where they are resident. This means that, strictly speaking, if they are included in a non-US qualified plan, they may be liable to US tax on any employer contributions. However, that part of the plan benefit corresponding to such contributions (and any employee contributions), excluding any investment gain, would not again be subject to US tax at the time of payment.

Note: The double taxation treaty between the US and the UK explicitly allows US expatriates to contribute to UK plans and benefit from the same US tax relief as would apply under a US qualified plan.

As the 'host' country: An expatriate should, strictly speaking, be allowed to participate in the US tax qualified plan from the time he or she fulfils the plan's eligibility conditions, which must be non-discriminatory. Employer contributions to a foreign funded plan are tax deductible by the employer, but treated as additional taxable income to the employee. This is applicable unless there is a substantial risk of forfeiture of benefits by the employee such as a funded defined benefit plan in France, which has no vesting on termination of employment prior to retirement. Employee contributions to a foreign plan do not attract any US tax relief. The terms of a few of the double taxation conventions agreed between the US and other countries (for example the UK) allow for the mutual recognition of each other's retirement plans for tax purposes under certain circumstances.

Transfer of assets to/from foreign plans: Transfer of assets to or from a tax qualified US plan is not permitted, as a foreign plan would be non-qualified. Transfers from a 401(k) US plan to an overseas plan may sometimes in practice be achieved by electing to withdraw the benefit in cash, with the transfer being subject to tax (and a 10% additional excise duty) on withdrawal. Such a "transfer" is only worthwhile if the subsequent payment into the "receiving" foreign plan attracts tax relief, otherwise the employee would suffer double taxation.

Summary

This Chapter has provided an overview of issues surrounding internationally mobile employees.

Self Test Questions

- What is a home-based internationally mobile employee?
- What is a Social Security Agreement?
- What is host country adoption?

INTRODUCTION

A corporate transaction involves a price being paid for a company or business, and will often include employees transferring from one company group to another.

A transaction can have a significant impact on employees' benefits; this will need to be managed throughout the process.

Placing an economic value on transferring benefit obligations can be a key element to purchase price negotiations, especially where significant defined benefit (DB) pension obligations exist. Where relevant, the intended treatment of benefit entitlements, funding and related insurances and the impact on employees and former employees should ideally be specifically agreed and documented in any sale agreement. Where alterations are being made impacting current or former employees, these will need to be communicated to employees and their representatives, and may require consultation.

This Part comprises a single Chapter. This Chapter covers the typical issues that arise when a change of ownership occurs in respect of a company that has employee benefit obligations. This could involve, for example:

- A transfer of business assets (an "asset sale")
- A transfer of shares in a company (a "share sale")
- The establishment of, or a contribution to, a Joint Venture
- Outsourcing of tasks and/or processes to a third party.

In many cases, a transaction will involve a combination of the above (e.g. a sale of shares of certain legal entities together with a transfer of specified business assets).

In this Chapter, we only focus on the considerations arising from, and implications for, long-term employee benefits (excluding equity based plans and other long-term incentive plans) and insured benefits.

1.1 BASIC STRUCTURE OF A TYPICAL TRANSACTION PROCESS

Every transaction is different, but there are various stages that are common to most:

a) An initial courting phase after which the buyer and seller decide whether to proceed with more detailed discussions. A heads of terms sheet, or similar document, setting out the key areas of understanding between the parties is often agreed at this stage.

b) Due diligence. During this phase, a potential buyer has the opportunity to review the seller's business and to form an opinion of the expected income from the business as well as the associated costs and risks.

c) Contract negotiations and signing of the sale and purchase agreement, and any other related agreements (e.g. transitional services agreements).

d) Closing the transaction (i.e. the time of the actual transfer of the business from seller to buyer). This generally occurs within several months after signing, but can be delayed further if, for example, the competent competition authorities require time to assess whether the transaction can go ahead in its envisaged form.

1.2 IMPACT OF THE TRANSACTION ON EMPLOYEE BENEFITS

The transaction itself may impact employee benefit plans directly, and their insurance or other financing vehicles. We set out below some of the issues to consider.

Insurance Policies

Insurance policies may have been issued on a Group-wide basis, or be subject to specially agreed terms as a result of being part of the Seller's wider insurance cover. In addition, the policies may be part of a Seller's multinational pool. The business being sold may not be representative of the wider Seller's group as a whole; as such, it may be subject to higher or lower risk premiums. If the new policy covers a much smaller group of employees than previously, or has a higher claims experience, more stringent underwriting requirements are also likely.

Unless the existing insurance policies were issued on a standalone basis to the entity being sold, new policies will be required for the business being sold. These new policies will need to be implemented in time to ensure that there are no gaps in coverage for transferring employees.

The purchaser may wish to review the level of self-insurance to ensure that it is comfortable with the level of risk that is not externally insured. In addition, it may be able to achieve economies of scale by combining with existing insurances or pooling arrangements of its own.

Membership of Multi-Employer Benefit Plans

It is often possible to maintain membership of multi-employer benefit plans, but this should be specifically checked. In some cases, membership is limited to companies with a specific industry classification or to public sector employers, for example.

Even if membership can be continued, a buyer may not wish to remain in the plan, particularly, if there are significant unfunded risks existing within the plan or the buyer has its own plans which it would prefer to use.

Buyer Participates in the Benefit Plans of the Seller

A seller will generally not want employees of a third party to participate in its plans. Lack of control over cross-subsidies within a plan and responsibility for legal and regulatory compliance are usually the main reasons.

Benefit Plans to Transfer to Buyer

Where the primary sponsor of the benefit plan is a legal entity that will be sold, then the benefit plan will usually pass to the buyer as part of the transaction. In this case, a "reverse carve-out" may be required in the event that some employees who are remaining with the seller participate in the plan. These employees will, therefore, need to be transferred out into another plan of the seller.

"Carve-outs" of Benefit Plans

If employees of both the buyer and seller participate in a benefit plan, then usually only the employees of the group "owning" the plan will be able to remain as active members of the plan. The other employees will need to leave the plan (to be "carved out"). Sometimes a limited transitional period of grace is granted to provide sufficient time for consultation and the establishment of a replacement arrangement. This period is often referred to as a "participation period".

As noted above, some multi-employer plans may not permit continued membership of a buyer's employees.

Special payments may be demanded in some situations by the benefit plan if an employer ceases to participate. Two examples of this are as follows:

- A multi-employer plan that is not fully funded. Here we give two specific situations that are commonly encountered:
- in the US, an employer leaving a multi-employer plan is generally required to make a special contribution equal to its share of the deficit measured on an accounting-type basis;
- in Germany, the public sector pension plan, VBL (Versorgungsanstalt des Bundes und der Länder), is only partially funded, and an immediate contribution is required upon leaving the plan, calculated essentially on an insurance type basis.
- A seller's pension plan in the UK, where a participating employer is being sold. In this case, the Trustees of the pension plan are able to demand a payment from the company leaving the plan equal to its proportionate share of the estimated deficit on the basis that all the liabilities of the plan were to be secured by insurance policies.

In such situations, it is common for the seller to meet the cost of such exit payments, if it is clear that such payments could or will be triggered. The logic here is that the payments are either in respect of the period of service during which the seller owned the business, or the payment would be due to the seller's plan. Alternatively if it is expected that the buyer will have to make these payments, this can be considered as part of any adjustment to the agreed purchase price of the business. Nevertheless, uncertainty over the timing, amount and tax implications of such payments can often complicate matters further.

Increases or Reduction in Benefits Triggered by the Transaction

The actual level of benefit promised to an employee can be directly impacted by the transaction itself unless special provisions are made to stop this happening, for example:

- Employees may be forced to leave a benefit plan before their benefits have fully vested
- Even if accrued benefits have fully vested, the treatment as a deferred member may be worse than as an active member (e.g. linking to future salary increases may be lost)
- A collective agreement may apply in the company into which employees are being transferred giving employees entitlement to membership of a different plan
- The transaction may trigger special payments to some employees that would be included within the definition of pensionable pay, unless specifically communicated otherwise.

The buyer and seller will often make special agreements to ensure that the impact of such factors on costs and benefits is minimized, provided these particular issues, inter alia, are identified in advance. For example, the buyer could agree to count service with the seller for vesting purposes in its own plans. The seller could agree to fully vest benefits for employees leaving its plans as a result of the transaction, even where the usual vesting conditions have not been satisfied.

An integral part of the business case for the transaction may be realizing synergies that would require a reduction in headcount. Such **restructuring** may have a significant impact on employee benefit obligations:

- Some pension plans provide for enhanced benefits upon redundancy, resulting in additional costs
- Some benefit plans provide benefits early on redundancy (e.g. the termination indemnity— "Abfertigung"— in Austria)
- In many countries, a Social Plan will need to be agreed in the event of collective redundancy. A social plan will set out the scale of redundancies and the process to be followed to determine which employees are selected for redundancy. Often such a selection is made on the basis of a points system, with points being awarded for such things as age, years of service, degree of disability, number of dependants. The social plan may also provide for enhanced benefits for those impacted.

Some (particularly, very senior) employees may have "**change of control**" clauses in their employment agreements. "Change of control" clauses are generally triggered if the employee leaves service for specified reasons within a defined period following the transaction involving a change of control of his/her employing company. Such contracts may provide for cash payments and/or improvements to pension plan benefits, and may make it harder for a buyer to retain such employees.

1.3 DUE DILIGENCE

Key Focus Areas and Materiality

Due diligence is the buyer's opportunity to assess the business that it wants to acquire, along with all the assets, liabilities and risks that go with it.

Generally the focus of due diligence from the perspective of employee benefits will be on:

- Identifying all material employee benefit plans and liabilities associated with the business
- Quantifying what liabilities, and plan assets, are being taken on
- Understanding the expected future cost and contribution requirements of the plans
- Identifying the key risks associated with the plans
- Assessing the likely cash flow requirements
- Reviewing the accounting treatment of the plans and understanding the implications of adopting the buyer's accounting methodology
- Verification that all relevant legal and regulatory requirements have been met
- Checking that all relevant legal documentation and member communication is in order
- Reviewing any recent or pending disputes and their outcome or expected outcome
- Understanding the implications of the transaction on the benefit plans, and any additional costs or liabilities that could be triggered by the sale
- Understanding where ongoing support from the seller is likely to be desirable or necessary.
- Understanding whether the buyer's plans for the business have any implications for inherited benefit plans

The scope of due diligence of employee benefits needs to be well defined. Often "pensions" due diligence is understood to encompass all long-term employee benefits including not just pension plans but also long service awards (e.g. 'jubilee payments), retiree medical plans, termination indemnities, early retirement plans, death and disability plans.

The aim for the buyer and its advisers should be to ensure no gaps or duplication in the work of the various due diligence work streams, and a clear understanding of the business being acquired.

Assessing Financial Costs and Risks

A key element of a due diligence process will be to define the appropriate price to pay for a business, as well as the most significant risks that could impact on value.

The value of employee benefit liabilities transferred is uncertain…
Employee benefit liabilities are often very long-term in nature. Neither the ultimate amount payable in benefits nor the amount that would need to be invested today to meet a given liability are known. The benefit amount payable may be dependent upon date of death, future inflation, salary increases, marital status at death, etc., and future investment returns are unknown.

…and is dependent upon the nature of the buyer
The buyer may have plans for the business that would impact the timing or amount of benefits due (e.g. restructuring plans, plans to change the benefit plans). In addition, the risk that a buyer can afford to take will impact on the amount of insurance required; similarly, the amount of investment risk that the buyer is prepared to take which in turn will affect the expected investment return it can hope to achieve. The accounting standard used by the buyer may also impact on the buyer's perception of liability amount.

Where the employee benefit-related liabilities are significant, a specific adjustment for them will typically be made in the purchase price, along with adjustments to allow for other assets and liabilities that will transfer. The assumptions used to carry out the actuarial valuation of the liabilities can have a very significant impact on the value placed on the liabilities, and, as a result, the actuarial assumptions are often the subject of negotiation. A buyer often uses its own accounting assumptions as a benchmark.

There is no one correct way of determining the impact on purchase price of the employee benefit liabilities transferred. However, often we see that employee benefit obligations are taken into account in commercial transactions by splitting the obligations into:

1. The liability that relates to service prior to the purchase (including, where relevant, the future increases expected to be applied to the past service accrued benefit).
2. The benefits to be earned as a result of future service accruals.

Commonly, an IFRS or US GAAP basis of valuation is used. The funded status is taken as the amount of unfunded benefit liability, which represents a "debt" of the business. In the event that there is a surplus, the theoretical asset is often reduced to take account of the fact that any benefit to the company will at best be deferred and also may end up being diluted, e.g. through additional discretionary benefits being granted.

Often this value of "debt" is used as the basis for a price reduction. In practice, however, it should be recognized that not all deficits are equal. In Germany, where no minimum funding standard exists, and the company's only obligation is to pay the benefits when they finally become due, an IFRS deficit of □1m is different in nature to a □1m IFRS deficit in a UK pension plan, where the trustees may well be pushing for a far higher level of funding over a short period, and, ultimately, are seeking to secure the benefits with insurance policies at a far higher cost than IFRS. Many buyers will also look to plans' contribution requirements as well as their impact under accounting standards in forming a view on benefit liabilities.

Some obligations are generally missing from an IFRS or US GAAP definition. These include any additional liabilities triggered by the transaction itself, or obligations that are permitted to be carried off balance sheet, such as membership of certain multi-employer plans, even though it may be well known that significant deficits exist.

In most countries, a corporation tax deduction can be enjoyed when contributions are made to a pension plan. This would reduce the value of the deficit to the company (provided sufficient taxable profits exist against which to claim a deduction).This deferred tax asset should be reflected in the valuation of the "debt" relating to past service.

In some cases, assets and liabilities relating to employee benefits may be found in various different positions in the balance sheet. Particularly in these cases, care needs to be taken that such assets and liabilities are not omitted or double-counted in the business pricing model.

If the past service debt is determined as described above, then the liability relating to all past service accruals of benefit should have been recognized in the price adjustment. In assessing the future profitability of the business, only the service cost (i.e. the expected cost of future accruals of benefit) should be included as a charge to profits. Any amortization, interest cost or expected return on asset amounts included in P&L projections actually relate to past service benefit accruals, so their inclusion in projections of profitability would result in double counting. The service cost should be adjusted to reflect any change in the expected cost of providing the benefits after the sale (e.g. as a result of losses of economies of scale or changes in the covered population).

Assumptions Made of the Transaction Structure

Assumptions over the nature of the transaction for each legal entity concerned (asset sale or share sale, employees covered etc.) can have a significant impact on the findings of the due diligence.

For those unfamiliar with transactions, it can come as an unwelcome surprise to find that a transaction expected to be an asset deal, suddenly, in last minute negotiations, ends up being a share deal (with more liabilities being transferred as a result), or that a key employee with significant employee benefit liabilities attached who was originally expected not to transfer, then did so. Often in such situations, those at the centre of the negotiations are unaware of the employee benefit-related implications of such changes, unless their advisors have specifically made them aware of this.

Vendor Due Diligence/Fact Books

Historically, due diligence relied on raw data provided by the seller, originally in paper form in physical data rooms, and, subsequently, though use of electronic data rooms Over recent years, there has been greater use made of Vendor Due Diligence reports and Fact Books in sale processes. These can have advantages for all parties involved.

Vendor Due Diligence Reports are due diligence reports that are ultimately intended to be addressed to the buyer of the business, even though they are commissioned by the seller. They should be prepared as if the client is the buyer (although, in practice, the seller will often exert some influence over the way in which issues are presented).

Fact Books are generally addressed to the seller and are prepared based entirely upon the information supplied by the seller, without further comment on whether the figures or accounting treatment are correct or appropriate from the perspective of a prospective buyer.

The process that the seller needs to go through to prepare the Vendor Due Diligence or Fact Book can speed up the subsequent process considerably. The advisers preparing the report will have asked for the data required, and will have asked questions to resolve points of uncertainty. Just the process of pulling together all the relevant information can take many weeks.

The seller will have the opportunity to review the findings of the report, and can plan how it wishes to deal with the issues raised. In some cases, the issues raised will be sufficiently material to change the intended strategy in some respects.

In situations where multiple bidders are expected, the provision of a Vendor Due Diligence or Fact Book can reduce the time and expense required for potential bidders to reach the stage of being able to make an indicative offer quite considerably. The number of questions to the seller should also be reduced, allowing them to invite more potential bidders to the process.

Confirmatory Due Diligence

At the end of the initial due diligence phase, binding bids are usually provided which may be subject to specifically defined areas of required confirmatory due diligence. After this point, a shortlist of bidders, or a single preferred bidder, will be permitted to undertake confirmatory due diligence. Often, certain very sensitive information is not released until this stage, or, indeed, until final contract negotiations are underway. This may include executive contracts and remuneration details, for example.

1.4 SALE AGREEMENT

Key Points Generally Covered

A sale agreement will, as a minimum, define:

- precisely what is being sold
- the price being paid
- any pre-conditions that need to be satisfied and the timing at which the sale legally takes effect ("closing")
- the obligations of, and the promises made by, the buyer and seller
- how any failure to satisfy any of the agreed conditions will be dealt with
- the process to deal with any resulting disputes.

As far as employee benefits are concerned, the key points will be to define:

- which employees are included in the transaction
- which benefit plans exist that include employees due to transfer to the buyer
- which benefit plans transfer to the buyer, and which remain with the seller
- any changes to be made to the benefit plans (e.g. immediate full vesting in seller's plans for transferring employees forced to leave the plans as a result of the sale)
- restrictions on changes to plans prior to closing, and on levels of benefits provided to transferring employees after closing (including potentially salary increases that may impact on benefit levels)
- any commitments of buyer or seller
- which plan assets and liabilities will transfer
- exactly how the purchase price is to be adjusted to reflect the amount of employee benefit assets and liabilities transferred, along with the responsibility to calculate and check the relevant figures. If the assets and liabilities are known and well defined, then an up-front adjustment to the price is common. If there is uncertainty, then it is most common to carry out a valuation after closing. In this case a mechanism needs to be agreed to ensure that the actuarial assumptions remain appropriate at the effective date of the calculations
- responsibility for setting up and communicating any new plans required.

Representations, Warranties and Indemnities

Within the sale agreement, the buyer and seller may make representations and provide each other with warranties and/or indemnities.

- A representation is a statement presented as fact by the buyer or seller.
- A warranty is a statement under which the buyer or seller promises that a statement is true or that a specific action will be made.
- An indemnity provides specific protection to the buyer or seller in respect of a specific action or risk.

Minimum and maximum claim amounts under the warranty and indemnity clauses may be defined. Generally, an indemnity provides a greater level of protection than a warranty.

Transitional Services Agreements
The buyer may need to continue to have services from the seller for a period in order to give the buyer sufficient time to set up its replacement arrangements. Such services most frequently include HR or payroll support in countries where the buyer does not previously have a presence, but may also include the ability to remain in the seller's benefit plans for a limited period (e.g. 6 months) after closing.

The terms on which such services will be provided are usually set out in a Transitional Services Agreement.

Consultation and Communication Requirements
In many countries, there are consultation and communication requirements that must be carried out prior to certain actions taking place. In the area of employee benefits, in cases where benefits are provided for under works council or union agreements, negotiations and agreements with these parties are likely to be required before any changes to these benefits can be made. Depending upon the nature of the plans and any proposed changes, a consultation process or, even, individual plan member agreement, may be required.

During an acquisition process, there will usually be a considerable amount of change, and, as a result, also a large quantity of employee communication. Depending upon the changes to employee benefit arrangements, there may be some legal communication requirements. Above this, employers will generally want their employees to be given as much information as possible in respect of their future working environment, role, and compensation and benefits.

Particularly where changes as at closing will be made, it is likely that the seller will be responsible for this communication (as the employees remain employees of the seller up to this point in time). Nevertheless, the communication may also play a part in defining employee reaction to the changes, and could contain commitments that will be binding on the buyer. As a result, it is often desirable to oblige the seller to agree, or at least, consult on, such communications with the buyer. The buyer must be careful not to become a bottleneck in this process causing counter-productive delays.

1.5 PERIOD BETWEEN SIGNING AND CLOSING

The due diligence process is often focused on key liabilities, costs and risks. The period between signing and closing can provide the opportunity to begin gathering full information on the benefit plans together with the management responsible for the business, and to begin detailed planning on the Day 1 changes and on subsequent post-acquisition harmonization.

If the proposed transaction requires prior clearance of the competent competition authority, then access to the seller is likely to be restricted at least until this clearance has been granted and any other third party approvals required have been given (e.g. shareholder vote).

Transfer of Employees
In the case of a sale of assets, it will be necessary for any employees due to transfer to a buyer to transfer to the employment of a new legal entity. In some countries, this will happen automatically by law (e.g. in many EU countries if their work is exclusively related to the business being sold). In others, the employee's agreement to the transfer will be required, either implicitly or explicitly. For example, in Germany, an employee has a month during which he/she can refuse the transfer and elect to remain an employee of his/her current employer.

Outside Europe, transfer of employment by law due to an asset sale of a business is not common; this typically means termination of employment for all affected employees by the seller with the buyer needing to prepare for re-hiring the workforce it requires.

It is advisable, if not essential, to discuss the proposed transaction with employee representatives, works councils or affected unions.

Preparing for Plan Carve Outs

If employees will need to be transferred out of a benefit plan as a result of a transaction, then the buyer will need to decide whether they can be included in an existing buyer plan or will need to have a new replacement plan. The seller may agree (or be committed under the sale agreement) to undertake the required communication and/or consultation to permit the changes to be effective from closing. If the existing benefits are going to be impossible or disproportionately costly or administratively complex to implement, then an alternative plan or additional remuneration may be offered instead.

Establishment of New Plans

Even if new plans are going to be established on a mirror image basis to the corresponding existing plans, it can take a considerable amount of time to get the plans up and running: the plan documentation and communication will need to be drafted and checked; agreement may be required from works councils; new policies may be required for insured plans; tax authorities may need to review and approve plan documentation; payroll systems may need to be programmed.

Ideally, the responsibility for setting up the new plans should be defined in the sale agreement to avoid misunderstandings later.

Ensuring Continuation of Risk Insurances

Generally insurers are prepared to continue to provide coverage to employees being carved out of existing insurance policies, provided that cover is continuous and that a minimum number of lives are being insured to enable inclusion within a group contract. If the group size is too small, then individual policies may be required. This may also result in restrictions on the cover provided in future.

Where an employee is already claiming under a seller policy (e.g. he/she is in receipt of a disability pension), it may be most efficient to leave this employee with the seller to avoid loss of insurance cover.

Depending upon the timescales involved, it may be impossible to have full policy documentation in place before the risk cover commences. In these situations, the main priority is to ensure that the insurance company has issued a certificate of cover or similar confirmation that it is 'on risk' for the required benefits.

Communication

It is in the interests of both the buyer and seller to make sure that all the communication that is required to give effect to the new plan arrangements has been made. In particular, it is most important to ensure that employees are aware of any reductions in benefits, or restrictions in insurance cover, to avoid subsequent claims on either employer.

1.6 AT AND AFTER CLOSING

Implementation of New Plans

Replacement plans must be in place by closing where membership of seller plans ceases at this point. Failure to ensure this could lead to gaps in insurance cover, or in the case of defined contribution (DC) plans could leave the employer facing claims for lost investment returns, as well as compliance risks in countries where it is mandatory to offer some form of plan.

Post-Acquisition Harmonization of Plans

Where the buyer has existing employees in a country where it is acquiring further employees from the seller, there will almost inevitably be inconsistencies between pay and benefit levels and structures between the existing and newly acquired businesses.

The extent to which this is an issue will depend on many factors including:

- The extent to which the employees are performing similar tasks and are based in the same locations;
- Whether the same legal employing entity employs both sets of employees, and if not, the number of transfers that can be expected between the two entities.

If harmonization of benefits is desired, then this should ideally form part of a harmonization of total compensation. The risk of a levelling up resulting in additional costs is greater if each element of compensation is viewed in isolation.

1.7 JOINT VENTURES AND OUTSOURCING DEALS

Special Considerations

Joint Ventures are set up most commonly to bring together non-core business resources and intellectual property from two organizations with the intention of enhancing value and ultimately selling the combined business.

When a Joint Venture is formed, business assets and employees are transferred from the two organizations into the Joint Venture, which is then owned jointly.

As a result, each Joint Venture party is simultaneously a buyer and seller, and the same considerations as described elsewhere in this Chapter apply.

Due to the ongoing ownership structure, there is typically a much closer relationship with the companies contributing to the Joint Venture than in a usual sale process. In particular, it is common for employees to be moved to and from the Joint Venture during its lifetime. The employee benefit provision for employees who move to and from the Joint Venture and basis upon which any employee benefit assets and liabilities transferred as a consequence are to be treated, should be agreed at the outset. This will avoid confusion and complications when employees move and when such subsequent transfers occur.

In an outsourcing deal, responsibility for various tasks and processes within a company ("the client") are outsourced to a third party provider ("the outsourcing provider".) This may result in the transfer of the employees from the client to the outsourcing provider, along with benefit entitlements and corresponding liabilities.

As for a joint venture, there is an ongoing relationship after closing, this time between the client and the outsourcing provider.

It is important to agree up front how the costs relating to benefits and liabilities transferred are to be calculated and paid for during the lifetime of the contract. This agreement should also specify what happens at the end of the contract should it not be renewed, for example, when the third party provider is replaced or the client once again takes over responsibility for the services that were outsourced.

Summary

This Chapter has provided an outline of the impact of mergers and acquisitions on employee benefits.

Self Test Questions

- What are some key employee benefit issues likely to be impacted during a sale or merger?
- What should due diligence focus on in the context of employee benefits?
- What should be covered in a typical sale agreement?

INTRODUCTION

This Part will discuss some of the trends that currently affect the provision of international employee benefits, or are likely to in the future. The world of international employee benefits and the factors that impact on their provision, regulation, financing and management are continually changing. It can therefore be a challenge in itself to keep on top of changing events. In this Part, we have split the trends between those that represent current hot topics and those that might represent future longer term trends that will affect employee benefits.

This Part comprises a single chapter.

1.1 CURRENT TOPICS

Some of the current issues that are facing international employee benefit managers are as follows:

- People Living Longer
- The Desire to Reduce Risks Relating to DB Pensions
- The Changing Nature of State Pension Provision
- Expansion into New Territories
- Increased Mobility
- Impact of Global Financial Crisis
- Changes in Accounting Standards
- EU Pension Directive Update
- US legislation on healthcare (ACA) and foreign investments (FATCA).

We explore these issues and the impact for an international employee benefit manager in the paragraphs below.

1.1.1 People Living Longer

Increased longevity affects employee benefits in a number of ways. First, the cost of retirement provision will increase, since the period over which pensions have to be paid will increase. In the context of current low interest rates reducing investment returns, the problem is compounded.

For companies with defined benefit (DB) pension obligations that provide benefits in life annuity form, this clearly puts a strain on the funding of these arrangements, since plan rules dictate that benefits have to be paid for life. The longer the retired employee lives, the longer the payments must continue and hence the funding cost rises. Most DB plans are still financed on what is referred to as "balanced cost funding", which means that employee contributions are fixed (often as a percentage of salary) and any additional costs that arise have to be met by the company.

In most countries around the world, it is impossible to change the vested rights that have already been accrued by the employee in respect of past service. Therefore, this increased cost burden has to be accepted by the company for past service. However, for future service, companies may be able to amend employee benefits. Some companies have sought to either increase the retirement age (to increase the available funding period and reduce the period over which benefits have to be paid), or reduce the benefit being accrued, or increase the proportion of costs borne by employees. Where possible, companies will look to provide a lump sum benefit at retirement rather than annuity payments.

Issues relating to people living longer are not just restricted to DB schemes. For those companies operating defined contribution (DC) schemes, the money that their employees will need to accumulate to deliver the same level of pension for life will have to increase. The financial risks of a DC plan rest with the employee. Therefore,

it is the responsibility of the employee to anticipate and fill this funding gap. However, employers still worry about the potential exposure that they may face if employees feel they can no longer afford to retire. This will make employment planning more difficult. So, employers are starting to engage with employees in respect of retirement planning through effective communication. In addition, employers are including their DC plans within their global governance framework by taking a more active role in monitoring fund performance and costs.

Beyond company-sponsored provision, the issue of people living longer clearly also affects State pensions and their financing. Governments around the world have sought to address this issue, primarily through increasing the State pension age, i.e. the age at which benefits can be drawn. Generally, and unlike company pension provision, Governments are able to make changes that apply to both past and future rights earned under the social security programme. These changes are often introduced gradually and announced many years ahead of the actual change, so that citizens can prepare their financial arrangements to plan for the delay or reduction in State pension provision.

The issue of people living longer can also impact upon other post-employment arrangements, such as post-retirement medical schemes.

1.1.2 Reducing DB Pension Risk

DB pension schemes present a number of risks and companies continue to seek to reduce these risks. The most obvious way to limit DB risk is to cease to provide such benefits for new employees as well as, where possible, to cease future accrual of benefit within such plans for existing employees. Another example would be where companies have sought to encourage employees to take up options that reduce (or even eliminate) the company's DB risk exposure. An example would be encouraging employees in the US, or in Ireland to take what is referred to as an enhanced transfer value through a lump sum payment of their benefits. This is where a former employee is encouraged to give up their DB pension right in exchange for an improved transfer value, paid to another scheme.

There are other risks within a DB pension scheme and a number of companies have taken other actions to hedge against these risks. We describe some of these below:

Increasing longevity has been a key risk for DB pension schemes. A few companies have explored ways to mitigate this risk through the purchase of mortality swaps and other instruments, where a third party takes on the risk for some or all of the future increase in life expectancy.

Over the last 20 years, Governments in various countries have sought to increase the level of funding to be maintained by occupational pension schemes. Meeting these funding standards has forced companies to take a shorter term view on the level of funding required to ensure that these new minimum standards are met (and therefore avoid the consequences, which might entail higher company contributions).The accounting standards used to measure pension obligations have also changed- in particular, they now require that any funding deficit in the pension scheme is placed immediately on the company's balance sheet.

The above changes in funding requirements have meant that companies have felt less able to take a high degree of equity risk in their pension schemes, given the relative volatility of equities compared to bonds. Therefore, companies and their pension schemes have focused on ways of minimising the investment risk. Some companies and their pension schemes have investigated what is known as liability driven investment (LDI - see Part 3 section 1.4.5).This is building a portfolio of Government and corporate bonds aimed at more closely matching the cash flows that are expected from the pension schemes in the future.

Companies have also looked at investment rate and inflation risks and consequently explored the use of interest and inflation rate swaps. These protect pension schemes from movements in both the interest rate and inflation. Companies will acquire these derivative products when they are trying to hedge against one or other of these risks. Their intended goal is to stabilise the plan asset value to more closely reflect their liability measure. Often for these purposes, the liability measure used is the accounting standard i.e. for example IAS19. Obviously, there is a cost in purchasing such instruments but those companies that acquire these instruments see this price as worth the certainty derived from investing in these instruments.

1.1.3 Changing State Provision

Many Social Security systems around the world were designed after World War II. At that time, there were many more people working than were retired. Since then, with a declining birth rate and people living longer, there are now many more citizens who are retired and the working population has reduced. Over the next 40 years, it is expected that this trend towards the increasing proportion of beneficiaries to workers making contributions will continue.

Most Social Security systems are designed based on a pay-as-you-go principle. Therefore, the contributions collected at any point in time are used to pay the benefits for those who are in retirement at that time. With the gradual ageing of a country's population, many Governments have acknowledged that they are on a path whereby they will not collect enough funds to meet the benefits promised to retirees. This is a phenomenon that has affected many Governments around the world. However, some Governments are much more directly impacted than others because of the relative generosity of their pension systems. Particular examples are France, Greece and Italy. In these countries, employees of average income could have expected to retire on a State pension of up to 60% of their income prior to retirement and often from quite early retirement ages, from as early as age 50 or 55.

Governments have responded to this financial pressure in a number of ways. Initially, contributions were increased so that employers and employees paid more to deliver the same benefits. However, Governments have also had to address the generosity of the benefits provided. Generally, the age at which benefits can be drawn has been increased around the world. This trend continues with many western Governments introducing staggered increments to retirement age. Most western Government retirement ages now fall between 65 and 70. However some Governments have also tackled the level of benefit that an individual can expect to receive after their retirement. In those countries operating very generous Social Security provisions, there have been a series of gradual reductions in the level of benefits that are to be provided. These changes take many forms from reducing accrual rates, different methods of calculating the benefit or requiring longer periods of service before a full benefit entitlement can be achieved. Whatever the approach, all amendments have been designed to reduce the level of benefits drawn, increase contributions or to increase the age at which full benefits are received.

In addition to changing the level of benefit that individuals can receive from a State system, a small number of countries have moved away from the system of pay-as-you-go to introducing some element of pre-funding. Almost invariably, these arrangements are DC in nature. An example of this is in Sweden, where the State now operates a partially-funded DC structure.

Social security changes are not only restricted to pension provision. Governments offer healthcare services in a variety of different forms. Some are financed through general taxation, while others are separately financed by explicit contributions. In some countries, Governments encourage private health coverage and limit their own programmes to those unable to provide for themselves.

Obviously all of these changes pose particularly challenging questions for governments, employers and the population related to intergenerational equity, affordability and sustainability, adequacy of future benefits and long-term care, company benefit provision, vendor product design, etc. Many of these questions are likely to cause significant social tension and upheaval, and inevitably will involve trade-offs in the future.

1.1.4 Expansion into New Territories

Many multinationals have expanded their geographic footprint and established presences in new emerging markets. This expansion can be a result of setting up new manufacturing facilities in lower-cost locations or pursuing new markets for the multinational company's products. Often the markets that companies enter are the emerging markets (e.g. Brazil, Russia, India, China and certain other economies in Eastern Europe, Asia, Africa and Latin America). Almost by definition, these markets have less developed employee benefit environments and because of their lower cost base, employees' priorities are often focused in other areas, e.g. better working conditions, training and development, improving base pay, other perquisites, etc. However, over time, benefits take on an increasing importance. This is especially true in some of these countries, where State provision of benefits is low. There is also an incentive for companies to offer certain types of benefits which allow their employees to be more productive. This would be the case for companies offering medical insurance plans to ensure their employees have basic cover in order to return to work quickly following illness or accident.

The expansion into a new country presents a multinational company with challenges. Initially, the company may well have limited numbers of employees and, consequently, will not have sufficient resources to warrant a full-time local HR resource. Therefore, either the new local management is tasked with taking on this role or the country receives HR support from outside the country. Often these HR resources are focused on basic compliance and compensation issues and do not have the depth of expertise and country knowledge to adequately address the benefits issues in the country. In these circumstances, it can be harder to impose the multinational company's policies and approach. Each country will always claim that it has unique circumstances that mean the corporate policy needs to be adapted to a less mature or advanced commercial and regulatory framework. These challenges are even greater when the expansion has been a result of an acquisition. In these cases, there will already be an established policy/practice and it will require delicate negotiation to align the current approach to that of the newly acquired entities.

1.1.5 Increased Mobility

As companies expand abroad, the amount of employee movement between different locations also tends to increase. These moves can be for a number of reasons including: transfer of specific technical knowledge and expertise, introducing management experience/corporate procedures into a local operation, providing career development or accommodating an individual's desire to work in another location.

Mobile employees, or expatriates as they are often called, bring their own challenges and some of these issues are discussed elsewhere (Part 6). Over the last 30 years, there has been a general trend to reduce the cost of the international assignments as global trade has expanded and movement of employees around the world has become more usual. Special living and hardship allowances for mobile employees have been gradually reduced or removed for certain countries and benefits – previously all-encompassing guarantees of the better of home or host country benefit terms - have been replaced by simpler, lower cost alternatives. However, mobile employees are often key to the company's operations and there may be a conflict between the need to control costs and risks and the desire to ensure that the transferring employee is well motivated and stays in the organisation.

1.1.6 Impact of Global Financial Crisis

In the summer of 2011, global financial markets fell significantly in response to worries over the size of Government, corporate and consumer debts and deficits. Although interest rates are at historic lows, the cost of servicing ever increasing debts is becoming prohibitive and rating agencies are questioning creditors' abilities to service these debts in a period of low or no growth.

As a response to these worries, many Governments enacted cuts to social security benefits that will affect the financing and level of benefits. Given the size of Government debt in most countries in Europe, Japan and North America, we are likely to see an extended period of low growth, high unemployment and cuts in generous State pension and medical care. Employee benefit managers need to ensure that their benefit strategy takes this environment into account in setting the nature and level of benefits provided to employees and particularly, how they are financed. Increasingly Governments are attempting to transfer some of the responsibility of providing certain benefits, previously guaranteed by the State, on to employers.

In addition, as a result of the economic crisis and quantitative easing, interest rates have fallen significantly in the Eurozone, UK and US during 2014 and have remained low since. This has placed significant pressure on insurers and pension funds that are required to discount cash flows using market interest rates. In response to this pressure, supervisory authorities in a number of countries have very recently announced changes to the way that discount rates can be calculated by local insurers and pension funds.

Regulatory authorities in Netherlands, Denmark and Sweden have also introduced flexibility in the way that discount rates can be set. Although these changes mainly benefit the insurance industry, similar changes are being considered for Dutch pension funds. Insurers that wish to take advantage of this new flexibility will also be subject to new rules on the paying out of shareholder dividends. In Ireland and Spain, Governments are considering the use of sovereign bonds to reduce the burden on pension funds and plan members. However, the approach varies significantly: in Ireland, they can be used by DB plans to reduce funding liabilities; in Spain, the Government is consulting on whether they can be used to increase the level of calculated assets in DC plans.

In addition, certain countries have been looking to the tax treatment of pension fund contributions and investments to help fill the gaps in the general taxation revenue. In the US, legislation to delay the requirement for funding pension plans was introduced as way to encourage companies to increase taxable revenue by allowing an option to use higher than market interest rates to calculate funding requirements in an attempt to increase tax revenue on corporate profits. In the UK and France, Governments have increasingly limited the pension benefits accruing to individuals, especially the highly paid, by implementing prohibitive levels of excise tax on these plans. Also in the UK, recently proposed legislation would facilitate larger draw-downs of accrued benefits from DC plans in an effort to increase immediate revenue on lump sum distributions from employees' accounts.

These are just some of the recent examples of actions taken by governments and regulators affecting benefit provision, funding and financing in these challenging economic times. And we are likely to see more changes and refinements in the future. Consequently, international employee benefit managers need to find ways to stay abreast of the legislative changes affecting benefits provision in the countries in which they operate.

1.1.7 Changes in Accounting Standards

Broad-based changes to IAS 19 have come into effect for financial years starting on or after 1 January 2013.The changes focus on greater transparency and provide fewer opportunities to smooth or amortise costs. There is also an increased emphasis on disclosure of the risks underlying the plans.

The key changes are as follows (see Part 3, section 1.5):

- Elimination of the "expected return on assets" component of pension cost; instead a net interest cost will be computed on the net asset or liability (surplus or deficit) using the discount rate
- Immediate recognition of all gains and losses through Other Comprehensive Income (OCI)
- Presentation of the pension cost in three components;
  a. service cost
  b. net interest cost
  c. re-measurements
- Clarify the areas where in practice different approaches are adopted
- Substantial new disclosures

As a result of the changes, companies will need to assess the impact on their accounts and may need to reconsider their risk management strategies.

On the agenda, there are also changes related to asset ceiling limitations (e.g. IFRIC 14), potential changes to the accounting treatment for hybrid plans and an ongoing discussion, albeit slow and complex, between the IASB and its equivalent in the US (FASB) related to potential convergence of accounting standards.

1.1.8 EU Pension Directive Update

The European Commission (EC) is reviewing the EU Pension (IORP) Directive and following a Qualitative Impact Study during 2012/13, the European Commission has issued its proposals for a new Pensions Directive – IORP II Directive on 27 March 2014.The new directive will replace the current one.

The objective of the IORP II Directive is to facilitate the development of occupational retirement savings by

- Improving governance and transparency of IORPs – thereby ensuring regulatory consistency and enhance protection for members
- Promoting cross-border activity and increase the number of such plans
- Helping long term investment

In 2011, the EC asked EIOPA (European Pension Supervisory Agency) for advice. EIOPA published its advice in February 2012 following public consultation with Governments, industry bodies and professionals and multinationals. EIOPA recommended the use of a "holistic balance sheet". This aims to give a broader assessment of pension funds, by allowing for items such as the strength of the sponsor as well as capital requirements to withstand adverse conditions. However, it is not clear how the proposals would work in practice, how the results of a holistic balance sheet would be used and what the impacts would be on financing.

The new proposed Directive, albeit refined in various areas from the original draft and excluding the contentious minimum solvency requirements, has been approved by the EU Council on 30 June 2016 and the European Parliament on 24 November 2016. It is expected to take some time - say by late 2018/early 2019 - to be enacted and implemented fully into local regulations and practice.

(See International 1: Part 5 Chapter 1 section 1.5 for further information).

1.1.9 US Legislation on Healthcare (ACA) and Investments (FATCA)

While the Affordable Care Act (ACA), also known as Obamacare, has been in various stages of implementation since 2010, there are still many aspects of the law which have yet to be fully implemented and other aspects that have produced additional complications for international managers of employee benefits, even when the company is not predominantly located in the US. One of these is the requirement for all employees in the US to be covered by an ACA compliant plan. For companies which previously covered international assignees while in the US under a home country plan or through an international plan, they will need to ensure that these plans meet certain criteria or they risk paying fines for non-compliance. In addition, high excise taxes on plans considered very generous will be introduced in the coming years which will increase interest in limiting the plan benefits to the minimum amounts. Uncertainty continues over if and when any changes the Trump administration might make and implications for employer plans.

The Foreign Account Tax Compliance Act (FATCA) was implemented with effect from 1 July 2014 and is an attempt to prevent tax evasion by US citizens through the use of offshore accounts. Foreign Financial Institutions (FFIs) are required to enter into information sharing agreements with the US tax authority (IRS) or face a 30% withholding tax on US-sourced investments. Generally any company or provider which covers US persons under retirement, deferred compensation or savings plans or receives income from US capital or investments may be required to assess the implications of FATCA. Determining what non-US plans a company might participate in or sponsor which have FATCA reporting implications is an additional task for international benefits managers which will need to be reviewed initially and then re-assessed for continued compliance each year. The US has entered into numerous bilateral agreements which do, generally, exempt local pension plans from FATCA reporting; the status of each non-US location in this respect would need to be confirmed.

1.2 FUTURE LONG-TERM TRENDS

In addition to the current topics, there are some long-term trends that an international benefits manager is likely to encounter. Some of these are:

1.2.1 Economic Shift to Asia

The increasing economic strength of China and the emergence of a number of Asian economies has led many companies to turn their attention to these rapidly expanding markets. Many Western multinationals have followed this opportunity by expanding rapidly into the region. Now, as the region's importance increases, companies are establishing regional headquarters to develop and exploit the increasing economic importance and local talent.

This gives rise to a number of considerations for a multinational company. One example is the role that employee benefits play in the overall employment package compared to some of the more developed countries. For some of the emerging markets, these are much less financially significant and, in many cases, not common practice. The multinational company needs to adapt its focus on those elements of the employment package which are considered key whilst ensuring that basic governance requirements for employee benefits are maintained. Another example is the emergence of regional headquarters which may prompt the multinational company to consider an adapted regional policy for benefits instead of mandating a single global policy.

However, over the long term, some of these countries face serious demographic challenges, some with changes occurring much more rapidly than in Europe and North America. In China, the workforce is likely to peak in the next 10 years, and in Russia the population is expected to significantly reduce over the next 30 years. The ageing of the population is also likely to put economic and social pressures on some countries' Governments and their ability to provide appropriate social benefits.

Salaries are already increasing rapidly in China and many companies that moved to the country 10 years ago as a low cost centre are now leaving the country for the next opportunity as costs spiral upwards.

1.22 Predominance of DC Plans and Emergence of Hybrid Plans

As many companies tackle the risks within their DB plans, they find that increasing numbers of their employees only have provision through a DC plan. Indeed, many multinationals now find that more than half of their workforce only has DC provision. However, companies are currently spending the vast majority of their management/governance time managing the legacy DB plans. We would expect that over time, this focus should shift and more effort and attention will turn to the DC plans. As yet, many companies have not yet defined their version of "best practice" for managing DC arrangements, but this is changing as the risks around these plans are becoming more apparent.

Even though the employees bear the investment risk, there are a number of areas where the company has a valuable role to play. Best practice would consist of developing a yearly calendar of activities and some of these might include:

- Supporting the investment monitoring of investment providers to ensure the fund choice available remains appropriate
- Monitoring investment choices made by employees to ensure that broadly appropriate decisions are being taken
- Maintaining regular and informative communications with participants
- Ensuring the providers supporting the scheme continue to meet their obligations including maintaining reasonable levels of costs.
- Ensuring the governance committee of the plan undertakes its role appropriately

In some countries, there has been a move towards a sharing of risk, where DC plans are offered but the employer provides some form of guarantees (e.g. minimum investment returns). Such structures may be a response to Government regulations but also a recognition that employees are either not able to manage the pension risk themselves effectively, or that there is a role for employers to provide a base level income benefit for the employees at retirement.

1.23 Flexibility in the Work Place

There is an increasing initiative to provide greater flexibility in the workplace. Employees are seeking more flexible working practices to accommodate child care needs, to support work/life balance, to help in training and development/career enhancement etc. Equally, employers are motivated to support these initiatives to help retain and attract the best talent. If companies with limited budgets can also shape packages to best meet the employees' needs, then employers get the best "value for money" for their employee spend.

In terms of benefits, greater flexibility manifests itself in a number of ways. The most obvious is through offering a flex programme. This allows the employee to make choices to best suit their particular needs. In recent years, regulatory, product and technological developments have allowed flex programmes to become much more sophisticated and diversify the available choices across benefits. However, flex programmes are not the only way that flexibility can be introduced into benefits. Within a benefit, employees can be given the choice of different levels of provision, e.g. different contribution rates to a DC plan or different levels of health cover within a medical programme. Also, covering dependents or extended family is an attractive option in some emerging markets, where buying medical cover in the open market is more difficult and/or expensive. Furthermore, some flex programmes also offer the ability for voluntary employee-funded top-ups to leverage off potential savings from collective buying power.

1.2.4 Health/Wellness

Many progressive companies are recognising the benefits of a healthy workforce and are investing significant time and energy into programmes that support good health and wellness. There are numerous ways that companies can tackle wellness. Common themes from those organisations that have invested heavily in this area include strong education/communication programmes and building in incentives to encourage a good, healthy lifestyle, for example, discounts to medical premiums for attending gyms a certain number of times a month. We expect more companies to see the benefits of wellness programmes and multinational companies may well explore ways of applying lessons learned from one country to others around the world.

1.3 FUTURE DEMOGRAPHIC AND HEALTH CHANGES

Although the last 50 years have seen a steady increase in life expectancy, it is not obvious that this trend will necessarily continue or, at least, it may not be as uniform as in the past. There are already sections of the population where life expectancy is actually decreasing: more expensive natural resources, reduced medical services as State finances are squeezed, the impact of diseases such as diabetes and increasing obesity are all downward pressures on life expectancy improvements.

Medical systems are likely to be increasingly under pressure dealing with diabetes and the effects of obesity. This could lead to increased costs for companies as States try to transfer some of the responsibilities of providing medical coverage onto employers.

1.4 CLIMATE CHANGE AND NATURAL RESOURCE CONSTRAINTS

Two of the big unknowns over the next 30 years will be the dual impact of climate change and natural resource constraints.

Man-made climate change may lead to significant global warming (with regional variations), with global temperatures predicted to rise by between 2 and 5 degrees Centigrade by 2100. Although there is general scientific consensus on the causes and likely temperature changes caused by the phenomenon, the actual impacts on agricultural yields, extreme weather events and human migration, to name just three, are harder to predict. Benefit managers may consider this out of their remit but the risk function in most large organisations will need to consider possible implications of the different scenarios for their organisation.

A more pressing change, and one perhaps easier to predict, is the scarcity of natural resources, most importantly that of energy. Many experts believe that we are entering a period where energy costs from existing sources are going to rise, supplies of natural resources will become unstable or close to being depleted, and with a transition to other energy sources failing to be put in place in time. Other minerals and natural resources (e.g. lithium, rare earth minerals and even water) will become scarcer and more expensive, causing changes to employment patterns, the relative price of labour versus resources to increase, and a negative impact on economic systems.

Benefit managers, as well as the finance and risk functions, need to allow for likely changes in the economic and financial environments when making important decisions regarding the provision of benefits and how they are to be financed and funded. Critically, ongoing review and refinement of all aspects of the benefit programmes and their management will be needed to ensure they remain fit-for-purpose as these uncertain environmental and market developments evolve.

Summary

This Chapter has provided an outline of some of the latest trends and developments in employee benefits.

Self Test Questions

- What is happening to State provision?
- What is ACA?
- What is happening to DB provision?
- What are the trends affecting future benefit provision?
- How are international benefit managers responding to these trends and developments?