Study Manual

International 1: Foundation in International Employee Benefits

Core Unit 1B

2020
Edition

Shaping the pensions professionals of tomorrow

in partnership with

International
Employee
Benefits
Association

The Pensions Management Institute (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.

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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.

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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 1: Foundation in International Employee Benefits seeks to provide an introduction to the following issues:

- The different employee benefits in an international context and the different ways these are designed, delivered, funded, communicated and administered around the world
- The respective roles of stakeholders involved in the provision of international employee benefits
- Pensions and employee benefit provision in France, Germany, Japan, the Netherlands, the UK, the USA and Switzerland and a regional overview of Europe and North America to highlight the different practices of employee benefit provision
- The legal and regulatory influences of the European Union on pensions/employee benefit design and financing

PMI is delighted to be working with the International Employee Benefits Association as the study support partner for International 1.

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: qualifications@pensions-pmi.org.uk

This manual is based on the syllabus for 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.

We have aimed to set out the material in an order which makes understanding easy and starts with an introduction to international employee benefits followed by more in-depth technical and country coverage. Although we aim to cover the subject in some depth, more detailed information to back up the material can be found in the public domain. The aim of the material is to provide an overview and explain the key issues, not to cover all items. The examination, however, is based on the syllabus and the contents of this study manual.

This manual contains the study material for International 1 and is assessed by an examination in April and October of each year.The second part of the Diploma in International Employee Benefits is contained in the study manual for International 2 which is examined in April each year. Although it is not compulsory to complete International 1 before International 2, we do recommend that students cover International 1 before International 2 as the latter does lead on from International 1 and assumes a certain minimum level of understanding. However, it is not necessary to have passed International 1 before attempting International 2.

Although the manual is aimed at students studying towards the International 1 examination, it is also useful general reference material for those new to the profession, those moving from the domestic to international employee benefit world or simply those looking for refresher material.

The material in this manual is set out as follows:

Part 1 provides an introduction to the course material. We discuss the importance of International Employee Benefit provision in a total reward context. For example: Why are international employee benefits provided when salary and bonus would seem an easier and more flexible tool? We then discuss some principles of benefit provision followed by an overview of the costs and benefits of provision.We finish this section – like all others – with a series of self-test questions.

Part 2 provides a detailed overview of the different types of employee benefits including retirement, share plans and risk benefits. What are typically the benefits provided by employers? How are they financed and funded and who actually delivers the benefit? What are the legal and tax constraints which impact on the level and nature of provision? The aim of this section is to clarify the main features of benefit provision and provide an indication of why benefits are provided and the key challenges in managing and administering them.

Part 3 details the role of the various stakeholders involved in the design, delivery, management, financing, monitoring and regulation of employee benefit provision.What does each party do and how do local roles differ from global ones?

Part 4 provides country profiles of France, UK, Germany, US, Switzerland, Netherlands and Japan plus a roundup of other countries in North America and Europe to highlight retirement and benefit provision in the two regions.

Finally, **Part 5** covers the background and role of the European Union in benefit provision. What legislation impacts on benefit provision and how has the EU put in place measures to encourage and facilitate cross border working and employee mobility?

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Aim:
To provide an introduction to the following issues:

- The different employee benefits in an international context and the different ways these are designed, delivered, funded, communicated and administered around the world
- The respective roles of stakeholders involved in the provision of international employee benefits
- Pensions and employee benefit provision in France, Germany, Japan, the Netherlands, the UK, the USA and Switzerland and a regional overview of Europe and North America to highlight the different practices of employee benefit provision
- The legal and regulatory influences of the European Union on pensions/employee benefit design and financing

1. **outline** the role of pensions and employee benefits as a key element in total remuneration
   analyse *the different elements of reward and how these motivate employees*
   explain *the role of employee benefits in relation to compensation and relational rewards*

2. **explain** the importance of pensions and employee benefits globally
   analyse *the reasons why pensions and employee benefits are provided and how these motivations change by country*
   explain *the general financial implications of pensions and employee benefit provision*

3. **demonstrate an understanding** of the main employee benefits and the factors influencing the provision of each of them
   analyse *each of the following:*
   - *pensions/retirement benefits*
   - *death and disability benefits*
   - *post and pre-retirement medical and health benefits*
   - *other long-service and post-employment plans*
   - *savings plans*
   - *share plans*
   - *other benefit-related topics including flexible benefit platforms, wellbeing/wellness and company cars*

4. **explain** the background to pensions and employee benefit provision and **describe** the different elements of provision
   analyse *each of the following:*
   - *design*
   - *delivery*
   - *funding and financing*
   - *administration*

5. **explain** and **distinguish** the roles of different parties involved in the provision of pensions and employee benefits

   analyse *the roles of each of the following:*
   - *employees*
   - *other beneficiaries*
   - *international employee benefits managers*
   - *corporate HR, finance and risk functions*
   - *employee representatives, e.g. works councils, trade unions,*
   - *trustees/fiduciaries*
   - *local actuaries*
   - *local regulators*
   - *vendors, including global custodians, investment managers and insurance company/multinational pooling secretariat*
   - *advisers*
   - *international benefits consultants*

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

   explain *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*

INTRODUCTION

This Part provides an overview and introduction to international employee benefits. Initially, we put their provision in a wider total reward context and cover the reasons why they are provided.The Part then covers the importance of benefits and typical costs of provision plus the challenges in managing and administering benefits. This Part acts as an introduction to the course material. It consists of a single Chapter.

1.1 EMPLOYEE BENEFITS IN A TOTAL REWARD CONTEXT

Each company or organisation has a corporate strategy which will set out the broad lines on how the company should operate to meet its objectives. In order to achieve the business objectives set out in this strategy, the employment objectives will need to be consistent with this strategy.To achieve these employment objectives, a company will provide a series of benefits in order to attract, motivate and retain the employees essential to their business. Along with salary, employee benefits provide a crucial element of this 'reward package'.

Although employee benefits are only one element of the reward package, they are an important, and often expensive, part that needs to be managed. But when we consider employee benefit provision, we do need to take into account the other elements of total reward as highlighted above.The important issue is to provide total rewards that meet your employment objectives; each element does not in itself need to do this but the overall package must do if corporate and business objectives are to be met.

Differences between compensation and benefits

There are a number of fundamental differences between compensation / salary and employee benefits.

- Salary is immediate and payable in cash. In many countries, there are minimum pay requirements or nationally bargained salary rates. Some employee benefit provision may be compulsory but mandatory employer-provided retirement benefits, for example, is still not widespread.

- Bonuses tend to be a flexible way of rewarding employees; payable when the company or individual (or both) perform well. Although cash-based, they are typically determined annually so can be removed or reduced when finances are less healthy. Employee benefits, on the other hand, tend to be longer term commitments and meet a specific need of the employee. As they have been promised as to a specific amount, removing or reducing them can be more difficult.
- Employee benefits tend to be more tax effective than salary.
- Salaries are easier to compare than employee benefits; indeed, employees have difficulties putting a value on the employee benefits provided to them. This is often due to the fact that employee benefits are only payable on the occurrence of a certain event (e.g. death or disability).

What is the definition of employee benefits? There are several interpretations but we normally consider employee benefits as rewards provided to an employee that have a measurable financial value but that are not salary and bonus. Another way of looking at this is that employee benefits are rewards with a financial value but that are:

- Benefits in kind (e.g. provision of medical services)
- Dependent on an event (e.g. life insurance, long service awards severance benefits or retirement benefits)

In practice, there are grey areas – is EUR100 paid towards a travel season ticket additional salary or a benefit? – but, for the majority of benefits including the most valuable ones, this definition holds true.

Motivation

Each employee is motivated at work by different factors. For some, an interesting and challenging job motivates more than simply the salary received. For others, a flexible work environment or long holidays are what count. For those with families, retirement benefits and life insurance may be considered the most important element. The skill of the benefit manager is to set an employee benefit package which motivates employees and, at the same time, meets cost constraints, legal requirements and, broadly, delivers it tax efficiently.

1.2 WHY PROVIDE EMPLOYEE BENEFITS?

Why are employee benefits provided by companies and organisations? Why not simply provide additional salary to employees? We touched on some of the reasons why employee benefits are provided above. We set out in more detail below the key factors influencing choice and level of provision.

1.2.1 To Meet Employment Objectives

Employee benefits are an effective tool to meeting employment objectives. The skill of the benefit manager is in knowing what impact benefits have on motivating employees compared to other Total Reward elements, how to target benefits effectively, and how not to over-provide. Employment objectives vary by situation and can be categorised into four groups:

- Recruitment: employee benefits help attract key employees
- Reward: benefits can reward employees (e.g. for long service)
- Retention: benefits can be an effective retention tool (e.g. defined benefit pension plans)
- Release /Redundancy: benefits can facilitate manpower planning, e.g. through early retirement or redundancy

1.2.2 Indirect Reasons

Although employee benefits are an effective employment tool, there is another reason why benefits are provided – because the company has to. We label these “indirect reasons”. In fact, they are constraints that push or require companies to provide benefits that, on their own, are not necessarily in line with their employees’ needs. These include:

- Legal requirement: a State may insist that the employer provides a certain benefit (e.g. maternity pay, holidays or pension) as well as establish the minimum benefit level that needs to be provided.

- Paternalistic or 'legacy' reasons: traditionally, a company may have provided benefits as it wanted to be seen as a good employer; it may have acquired companies with such a philosophy. Even though the culture of the company may have changed, it may prove difficult to reduce benefit provision, particularly in respect of existing employees.
- Tax incentives: probably the key driver of voluntary provision. Put simply these make it cheaper to provide an additional Euro in the form of employee benefits than an additional Euro of salary.These incentives may occur at the time of financing the benefits (payment of employer and/or employee contributions), during the accumulation of funds (special treatment of investment income or capital gains), or at the time benefit payments are made (reduced tax, tax free lump sum).
- Competition: if competitors are providing benefits, there will be pressure on the organisation to provide similar levels of benefits.
- Reputational Reasons: linked to the paternalistic factor above, employers may want to avoid the risk to reputation of providing inadequate employee benefits to their workforce. For example, where an employee dies and there are no death benefits for the spouse and orphans, there may be considerable moral pressure to make some ad hoc provision. Similarly, long-service employees reaching retirement age with no savings may present a challenge to the employer. Left to their own devices, most individuals under insure and fail to save adequately; the employer may feel it needs to fill the gap.

These factors vary considerably by the type of business, the type of employee, and the country in question. In addition, these parameters change over time: a company may change its business strategy; an employee's reward preferences change over the career or the company's age and service profile will evolve; at the same time, legislation and favourable tax rules in a country have the habit of being revised or even scrapped. In addition, for each employee benefit, these factors will have different weights in the cost/value balance; for example, some benefits may be less tax efficient but are more effective at motivating employees.

1.3 COSTS AND CONSTRAINTS OF BENEFIT PROVISION

How much do employee benefits cost to provide and what other constraints may apply? Clearly, the cost depends on the type and level of benefits provided and whether there are tax incentives or government financial support to do so. A general rule of thumb is that employee benefits may cost between 10% and 30% of salary (in addition to social security costs); as we will see in the individual country sections, financial commitments vary widely and can even double the cost of the salary of an employee when social security contributions and holidays are included in the determination of their cost.

Despite the reasons to provide employment benefits listed previously, the benefit manager will frequently hear the refrain from others that it is "easier to provide salary". The reasons given may include:

- "Salary is more transparent" – it is clear the benefit an employee receives from an increase in salary; it is often less easy identify the value of employee benefits.
- "Bonus rewards good performance; employee benefits cannot"
- "Employees love cash"
- "Salary is easy to administer"
- "Salary and bonus are more flexible"

The need to address these arguments is the role of the benefit manager. There are other management implications of employee benefit provision including:

- Compliance and governance requirements – plans should comply with all legal and tax regulations and be well run.
- Administration – benefits need to be efficiently administered and in the most cost-effective way.
- Communication – benefits need to be effectively communicated if their true value is to be appreciated by employees.

- Risks need to be assessed and managed.
- The financial and accounting implications of benefit provision are significant.

All these responsibilities will require effective management of the benefit plans and the use of professional advice where needed.

1.4 THE INTERNATIONAL ANGLE

As highlighted above, the importance and relevance of each of the reasons why benefits are provided and the constraints and management requirements vary by country. In such a complex benefit provision environment, the role of the international benefit manager will be challenging.

Managing international employee benefits is not simply about being aware of what is happening in each territory.The international benefit manager will ensure that the corporate employee benefit strategy (as part of the wider employment objectives of the employer) is applied and respected in each territory, this while taking into account the local factors (such as tax rules, culture and market practice) which influence provision. For example, what if the local market tradition is defined benefit pension provision but the company strategy says that only defined contribution plans are allowed? The key roles and responsibilities of the international benefit manager include ensuring that governance guidelines are respected, economies of scale are secured, and that the financial and risk implications of provision are known and managed. More detail on the role of an international benefit manager is set out in Part 3 Chapter 1.

Summary

This Chapter has attempted to define employee benefits, set out the reasons why benefits are provided as well as the challenges of providing them and touching on the international aspects of provision.The reasons why benefits need to be provided are constantly changing (changes in legislation, market positioning, costs and so on) as are the constraints (e.g. changes in accounting standards, reduction in tax incentives and State benefits). In order to maintain the effectiveness of benefit provision, ongoing management of benefit provision is required – looking not only at the design and level of benefits, but how they are financed and funded as well as administered and communicated to employees and beneficiaries.

The remainder of this material will set out in more detail various aspects of provision touched on in this Part. In Part 2, we detail the different types of benefit provision followed by the role of each stakeholder in Part 3. Part 4 highlights some of these issues in selected countries and Part 5 looks at the impact of the European Union in benefit provision.

Self Test Questions

- What is total reward?
- What is the difference between compensation and benefits?
- Why might a company provide employee benefits?

This Part details the characteristics of the main employee benefits provided by employers.

Each employee benefit responds to an employee need in a different way. If properly designed and communicated, it can therefore be used as an effective recruitment or retention tool. At the same time, employer choice on benefits to provide and their level will also be determined by what is tax effective and easy to provide and administer. Regulation will also play a role: in some countries, provision of a certain benefit is compulsory; in most countries, provision of specific benefits must follow basic rules. Employers will also look at what competitors are doing, but also want to have benefits that are consistent with their corporate objectives, culture (e.g. more individually-focused benefits vs. group benefits), and make-up of their workforce (age, service, mobility, etc.).

The benefits highlighted in this Part are selected for their importance for the employer in terms of costs, meeting employment objectives, and challenges in the management and delivery of benefits. They are the most common benefits provided although their relative importance will vary by country and region.

Many of the challenges for international benefit managers highlighted in this Part relate to the following issues:

- Financing and funding benefits
- Making benefits attractive to employees
- Administering benefits
- Managing the risks and challenges associated with benefit provision

This Part consists of seven Chapters

INTRODUCTION

Retirement benefits are the most costly and, arguably, the most complex of employee benefits to provide. Despite the attempts to standardise benefit provision through global benefit strategies, variations by country are large, reflecting different tax, legal and cultural differences. Accounting standards, globalisation, and tougher governance requirements have increased the attention on retirement benefits and their costs.This Chapter looks at the principles behind retirement provision and the key retirement issues a benefit manager will face.

1.1 INTRODUCTION AND DEFINITION OF BENEFIT

Retirement benefits can be defined as a benefit payable when an employee leaves service of an organisation due to age.Typically, both State Social Security systems and occupational retirement plans have a standard retirement age ('Normal Retirement Age' – NRA) from when the standard retirement benefit is paid. Normally, social security (as set by the State) and occupational retirement plans (as set by the employer) would have the same retirement age, but, especially as Social Security retirement ages are increased, differences do exist. Plans typically also allow payment of benefits either before or after the standard NRA, normally with reduction of benefit for the former and increase in benefit for the latter. Retirement benefits can be paid in lump sum form (i.e. a one-off cash payment at date of retirement), income drawdown or a series of lump sum, or in pension/annuity form (periodic payments of benefits for life or over a specified length of time,), or a combination of these options.

1.2 FORMS AND TYPES OF BENEFIT PROVISION

There are two main types of retirement provision; Defined Benefit (DB) and Defined Contribution (DC). The fundamental difference between the two types of provision is that at retirement, under a DB plan, the benefit payable will be determined according to a pre-determined formula and is, therefore, guaranteed. Under DC plans, benefits depend on the contributions paid into a pension fund and the investment return on these contributions.There is no guaranteed level of benefit at retirement for a DC plan.

1.2.1 Defined Benefit Plans

DB Plans provide a benefit at retirement according to a pre-determined formula or benefit rule which sets out the level of benefit to be paid.

Examples of a DB Plan include:

a. Lump sum benefit of 1 times monthly salary at retirement for each year of service. The benefit is paid at normal retirement age.
b. Pension annuity of 1.5% of final salary per year of service payable at normal retirement age (i.e. 60% of final salary after a 40 year career).
c. A lump sum of EUR 100,000 payable at normal retirement age.
d. A monthly benefit of USD 20 per year of service payable at retirement age.

In DB plans, the formula which determines the level of benefits paid generally includes the length of service and the salary at or near retirement (see examples a and b above). Other DB plan structures can include a simple lump sum benefit which is not related to salary or service or plans which depend on service but not salary (such as example d. above which is known as a 'Taft Hartley' plan and was traditionally common for 'blue collar' workers in manufacturing companies in the USA). The percentage amount in example b. above – 1.5% - is known as the "accrual rate".

1.2.2 Defined Benefit (DB) Plan Features

Plan Design

The form of DB provision depends on a number of factors. Although a global benefit strategy will set down the guidelines for retirement provision, the major influences on plan design are local:

- Local culture and tradition – what are the expectations of employees?
- Taxation – what level of benefit provision is tax-efficient for the employer and the employee?
- Regulation – are there minimum requirements to meet or benefit features that must be included?
- Competition – what are other companies providing?
- Other benefit provision – does Social Security provide a good level of benefit?

The first DB plans were based on the assumption that an employee was likely to spend his or her full career with the same employer. At the same time, it was felt that a married couple required around 60% to 70% of the working partner's final salary in order to enjoy the same standard of living in retirement as they had when working. This led to many plans targeting this level of benefit using a benefit formula similar to example b. above with benefit accrual of around 1.5% to 2% per year of service (assuming a working career with the sponsoring employer of 30 to 40 years).

Integration with State Provision

In principle, target-based retirement plan should take into account benefits provided from other sources. Benefits in such plans, therefore, are typically reduced if Social Security benefits in that country are generous to ensure that the employer is not "overproviding" in relation to that lifestyle protection target. There are a number of ways of taking into account State and other compulsory benefits:

- The employer targets a total benefit promise at retirement inclusive of assumed Social Security benefits. When company retirement plan benefits are paid, a State benefits deduction is made from the calculation of how much benefits are paid out by the company plan.
- Pensionable Salary is reduced from actual salary to take into account the part of income that will be 'covered' by Social Security.
- An approximate reduction in benefit amount payable is made to implicitly take into account benefits from Social Security (e.g. reduction in accrual rate).

Example: An employee earns EUR 50,000 per annum and has worked a full 40 year career. The company wishes to provide a target benefit of 60% of final salary, including retirement benefits payable from Social Security which amount to EUR 10,000 per annum. If the company wishes to design a plan on these lines, it has three broad options:

1. The company adjusts its benefit formula to ([1.5% x salary x service] – benefits payable from Social Security). It pays out EUR 20,000 in pension which together with the EUR 10,000 per annum from Social Security make up the target benefit of 60% of final salary.
2. The company defines pensionable salary as salary less 1.5 times Social Security pension. The company pension fund pays out a pension of EUR 21,000 (60% of EUR 35,000)
3. The company reduces the accrual rate to 1%. Indirectly taking into account benefits from Social Security. It pays out 40% of final salary (EUR 20,000) leaving the other EUR 10,000 from Social Security to make up the target benefit to 60%.

1.2.3 Defined Contribution (DC) Plans

In a DC plan, contributions are paid at a set rate - normally expressed as a percentage of plan members' salary - by the sponsoring employer or the member or both. The contributions are allocated to individual members' accounts. A range of investment funds is often offered to members to select where they want these contributions to be invested. However, this does vary by country; in some territories, the employer will make the investment choice (e.g. in Spain).

The benefits provided at retirement depend upon:

- The level of contributions paid by member and employer PLUS
- The investment return earned on these contributions LESS
- Any charges and expenses

At retirement, depending on local legislation, benefits are taken in pension or annuity, cash lump sum , income drawdown or a series of lump sum or a mixture of these. If part or all of the benefit is taken in pension or annuity form, a member's pension will also depend on the level of annuity rates - or 'conversion rate' of their accumulated fund to a pension payment- existing at retirement.

1.2.4 Benefit Levels

Some defined contribution plans have been designed with a "target benefit" level in mind, with the rate of contributions being set accordingly. Such a target might be to provide, for example, a pension of 50% of salary at retirement after 30 years of pensionable service.The contribution rates are then set to target this provision, based on an assumed rate of return on the pension fund account and other assumptions such as future increases in salary. The key feature of DC plans is that there is no guarantee that members will receive the target level of benefit.

Contribution rates payable by the employer and employee are set out in the plan rules. Some plans have an age-related scale of contributions, with the employer paying higher levels of contributions on behalf of older employees. This allows for the fact that contributions paid nearer to retirement typically buy less pension than contributions paid earlier, because those paid later have less time to earn investment returns. Such a benefit structure can also act as a more effective retention tool. Other plans may vary pension contributions according to the category of employee or the number of years of service. Another approach is 'matching', where the employer contribution depends on the contribution the employee makes. For example, in a simple structure, the employer may match on a 1:1 basis the contribution paid by the employee up to, say, a maximum of 6%.

1.2.5 Difference Between DB and DC Plans

The key difference between the two types of benefit provision is which party takes on the risk. Under a DB plan, the employer takes on the following risks:

- Poor investment returns means that there is not enough money to meet the benefit obligation
- Pensioners, as a group, live longer than expected in cases where a pension is paid (this risk does not exist if a lump sum is paid at retirement date)
- Other experience is less favourable than expected (e.g. salaries increase more than assumed or fewer people leave the company than expected in case of a non-vested DB plan)

In such situations, the employer may have to put more money into the plan.

Under a defined contribution arrangement, most or all of the risks are borne by the plan members or, alternatively, where a benefit/guarantee is being purchased, by the insurer. If investments underperform or the cost of annuities increases, the plan member will receive a lower pension than might otherwise have been available (unless this risk is carried by the insurance company). However, the company itself does not have to top up the benefit.

A number of 'hybrid' plans have arisen which attempt to balance the risk between the two parties – they are, typically, structured as a sort of DC plan with some elements of guarantee. A current popular choice is the Cash Balance plan. This operates on a basis similar to DC plans having individual accounts which grow with investment return, but there is typically a requirement that a minimum rate of return be credited to the account (e.g. a guarantee that the account balance will never decrease or that there will always be at least a minimum 2% return). For accounting purposes, these plans are accounted for on a DB basis.

In the last 20 years, there has been a large move to provision of retirement benefits on a DC basis where legislation allows. This is due to the desire of companies to reduce the financial risks attached, as a reaction to the requirements of international Accounting Standards, to control, if not reduce, retirement costs, and to design retirement plans seen as more appropriate for employees who are likely to change employer more frequently. More details on trends in retirement benefits are set out in study manual for International 2 as well as in the individual country Chapters.

1.2.6 Other Benefit Features

- Pension increases are sometimes granted on pensions once in payment. These may be automatically awarded (up to a limit) or granted on a discretionary basis.
- On death of the member, pension plan benefits typically pay a spouse's pension (normally at the rate of 50% to 60% of the member's pension) to the widow or widower until their death.
- Children's benefits may also be payable to children aged under a certain age at time of death of the member.
- It may be possible to take the retirement benefits before the NRA – in this case, the amount paid will be reduced.

1.2.7 Summary of the Advantages and Disadvantages of DB compared to DC Plans

Advantages		*Disadvantages*	
Employee	***Employer***	***Employee***	***Employer***
Understandable what you get at retirement	Can be good retention/recruitment tool	Inflexible (for short careers)	Investment risk
Level of guarantee valuable	Employee less easily disappointed with end result	"Doesn't reward me"	Mortality risk
Benefit consistent with actual needs	'Cheaper' than equivalent DC Plans	Unclear what benefit you get if you leave early	Expensive and not valued anyway
Typically generous	It's the employer's role to take risk; employer of choice; paternalistic	I don't have any say (no investment choice; no contribution choice)	I am not a pension fund; I am a company

1.3 BENEFIT DELIVERY

Benefit design reflects the benefits promised to employees and pensioners. The delivery of benefits is how this benefit is actually provided to members. There are a number of options:

i. Own retirement plan ('Self-administration')
ii. Insured arrangements
iii. Multi-employer arrangements
iv. Non-funded approaches (see below)

The choice of financing vehicle will depend on company-specific factors (e.g. size, industry), local factors (e.g. legislation, availability of vehicles), and global policy as well as the benefit design itself. More details on funding of retirement benefits are set out in the study manual for International 2.

1.4 FINANCING AND FUNDING

Under a DB plan, the employer guarantees that the amount paid at retirement is as set out in the formula under the plan rules. When an employee reaches retirement age (or other age at which they have rights to benefit), the retirement plan must ensure that there are sufficient financial resources to actually pay the benefit, be it a lump sum or pension amount. How they do this can be defined as the Financing Policy.

Unfunded Approaches

In some countries (e.g. Germany), retirement and other plan benefits may not be funded – i.e. no pool of assets is built-up to 'back' the benefit promise. There are two main forms under this approach:

a. **Pay-as-you-Go**. This simply means that the pension benefits are paid from the cash flow of the organisation when they fall due.
b. **Book Reserves**. Although benefit promises are not externally funded, a reserving item is set up in company accounts to reflect the company's future retirement obligations. This method of financing retirement benefits is very common in Germany and for some plans in the US and Japan.

There are a number of reasons why benefits may not be funded. An organisation may not fund benefits if it is a small company with limited cash resources or if funding vehicles do not exist in the country in question. Most State retirement systems do not fund retirement benefits; it is generally assumed they will honour their commitments. In some countries, such as Germany, it was felt that financial resources were best kept inside the company as working capital to fund business growth rather than being diverted externally in the form of pension contributions to be invested by third parties. Finally, benefits may not be funded if there are a relatively small number of individuals eligible for benefits or where the chance that a benefit will be paid out is low. However, in many countries, employers may not have the choice to follow this approach; regulations or tax rules may require or strongly incentivise them to fund their benefit promises.

Funding of Retirement Benefits

Typically, a pool of assets backing the benefit promises is built-up. This is becoming widespread because of the following reasons:

- Assets built up in advance in a separate fund from the employer provides plan members with the security that resources will be available to help meet the cost of benefits promised to them. The level of security depends on the funding level of the plan as well as regulations governing the security of investments.
- **Stability and Cash Flow.** If benefits are not funded, they must be paid from company cash flow as they fall due. This can lead to erratic cash outflow from year to year, which can cause financing problems for the organisation.
- **Taxation**. Tax relief and other fiscal incentives may be available on contributions made to externally-funded arrangements.
- **Accounting Practice**. Benefit promises should be accounted for as the liability accrues and, therefore, the expected cost of providing pensions should be charged against the employer's profits over the period during which the employer derives benefit from the employees' service. In practice, this means that the company will need to place a value on their benefit promises – a significant liability on their balance sheet. Without any assets backing this liability, the accounts of the company will show this as what could be a significant 'debt'.

Contributions

Benefits are typically financed on a 'balance of cost' basis; the employee pays a fixed percentage of salary and the employer pays the additional contribution required to meet the cost of benefits promised. As the benefit paid depends on a number of factors that are not certain (e.g. length of service, salary at retirement, etc.), the retirement fund requires an actuarial valuation to recommend the rate of contribution that should be paid by the employer and the current 'Funding Level' of the plan – how assets compare to liabilities at any particular time.

1.5 GENERAL LEGAL AND REGULATORY ISSUES INCLUDING TAXATION

Given the importance of retirement plans, which can have assets in the billions of Euros (including employee contributions), and the fact that they benefit from significant tax advantages in many countries, it is important that they are properly regulated. Regulation varies by country although the European Union also sets out certain minimum requirements which apply to retirement plans in the 28 Member States.

Typically, pension fund regulation applies to the following main areas:

- **Status of retirement plan**. Do retirement plans need to be separate entities from the parent company? If so, what legal form do they take and by whom will they be regulated?
- **Minimum and maximum benefits**. The State may require that a minimum level of benefit is paid to ensure members receive adequate retirement benefits (e.g. in Switzerland, employers are required to provide a minimum level of pension) or that maximum benefits are imposed to ensure that employers do not abuse generous tax advantages.
- **Investment**. Generally, regulations apply to the type of investment that is allowable, the concentration and diversity of investments, a maximum level of self-investment (the proportion of plan assets that can be invested in the sponsoring employer) and minimum rates of return that must be declared on members accounts (e.g. Chile, Belgium).
- **Retirement plan personnel** – regulations may impose a certain minimum employee representation and a minimum level of training for members of a supervisory board (e.g. Trustees in UK, Ireland).
- **Disclosure of information to members** – required elements and the frequency of its dissemination may be set down in regulations.
- **Account submission and disclosure of information** to authorities relating to the benefits provided by the plan.
- **Funding adequacy** – an actuarial report or valuation must be performed showing how assets that a retirement plan holds compare with the benefit promises. Regulations may also set down the [actuarial] method and basis [assumptions] used for these calculations.

Tax Treatment of Pension Plans

To encourage retirement provision in countries where such provision remains voluntary, states generally offer tax incentives for those participating in and providing pension plans. These tend to apply during one or more of the three phases of a pension plan financing:

. *Contribution Payment.*

- a. Employer contributions:
  - i. Contributions may be paid from pre-tax income thereby providing tax relief.
  - ii. They will not be considered as a taxable benefit for employees.
  - iii. They will not be subject to Social Security contributions.
- b. Employee contributions:
  - i. Contributions can be paid from pre-tax income (often described as being subject to ‘tax relief ’).
  - ii. They will not be subject to Social Security contributions.

II. Fund roll-up / accumulation.

- a. Plan assets may be exempt from capital taxes
- b. Income on investments may be considered as exempt from income tax.
- c. Capital gains realized within the fund may be exempt from income or capital gains tax.

III. Benefit Payment Phase

- a. Pension or annuity payments may be untaxed or taxed at a lower rate than other income, or granted special deductions or credits
- b. Lump sum benefits may be exempt from tax or subject to tax at a reduced rate. Lump sums received which are then invested to provide pension may have any immediate tax liability excluded or deferred.

It should be noted that there are limits on these tax incentives in almost all cases. In addition, tax exemption is typically just on contributions and this is simply a deferral of tax until the benefits come into payment. However, this is often considered a key advantage of approved retirement plans.

Benefit design is often based on an optimal use of tax incentives available in a country. Detailed tax information is set out in each country Chapter (Part 4).

1.6 KEY ADMINISTRATION AND MANAGEMENT ISSUES

Key Administration Issues

Good administration of a retirement plan requires adequate systems for recordkeeping, calculating benefit entitlements and tracking payments. These tasks are typically outsourced to third party advisers. Another important aspect is good communication with retirement plan members and pensioners; this can be achieved through clear and detailed benefit statements, internet-based tools, face-to-face meetings as well as telephone access.

Key Management Issues

Management of a retirement plan has become increasingly complex but also more sophisticated over the last 20 years. The current environment requires a continual assessment of risk and costs related to retirement benefit provision – pressure for good management and corporate governance comes from regulators, investors, members and auditors.

The key areas of management are:

1. Compliance with national regulation
2. Actuarial issues and funding for DB Plans.
3. Accounting issues for DB plans
4. Managing retirement benefits and investment risk
5. Appointing third party advisers
6. Member communication

At the international level, the challenge in respect of the global corporate benefit strategy is to establish guidelines for retirement plan practice which bring the management of each country's plans under a coherent and consistent approach.

Summary

This Chapter has provided an overview of retirement benefits. This has included a description of the different forms and types, the nature of the benefits provided and the ways they are funded. It concluded with a summery of the key management and administration issues for retirement benefits.

Self Test Questions

- What are the main types of retirement benefit?
- What are the differences between DB and DC plans?
- How can they integrate with State provision?
- How are these benefits regulated?

INTRODUCTION

Risk benefits provide financial protection against the hazards of life that interfere with earning capacity. They protect employees, and their dependents, against loss of earnings or savings due to illness, accidental injury, disability or death.

2.1 INTRODUCTION AND DEFINITION OF BENEFIT

Risk benefits protect the employee and dependents, as well as the employer, against the financial implications of death, illness or disability of the employee. In this Chapter, we provide an overview of:

- **Death Benefits** – a lump sum or continuing income paid to specified dependents of the deceased
- **Disability Benefits** – a benefit payable on partial or total inability to continue working on the part of the employee
- **Medical Benefits** – a benefit enabling provision of medical services to an employee (including possible extension to dependents)

Note that post-retirement medical benefits are covered in Chapter 3.

2.2 FORMS AND TYPES OF BENEFIT PROVISION

One key difference between risk and retirement benefits is the contingent nature of the former. The benefit paid out depends on an event taking place (e.g. death) and is not directly related to the premiums and contributions paid by employer and employee. The aim is, above all, to provide a benefit which responds to the need created by the event.

2.2.1 Death Benefits

Companies typically distinguish pre- and post-retirement death benefits as the needs in the two cases are normally different. The different levels and forms of payment should depend on the need of the dependent, but will also reflect the legal and tax environment in the country plus the level of death benefits provided by the State. Benefit levels and structures grew up based on a traditional view of family structures and employment patterns - the husband worked and the wife looked after the children at home. The death of the male breadwinner, therefore, left the family with few resources; the role of a paternalistic employer was to ensure that the family was supported. Changing lifestyle and employment profiles mean that many employees are deferring marriage, may be having children later, and, may have a partner also with a career. Despite this, the pattern of benefit provision has not changed greatly in many countries although, e.g., where benefits were just payable to widows in the past, they are now provided to widowers as well.

Typical Practice on Death before Retirement

- Provision of lump sum and/or an income to the surviving spouse
- Children's pensions also provided up to a certain age of the child (or linkage to educational status)
- Lump sum benefit is typically a multiple of the salary of the employee

Typical Practice on Death after Retirement

The needs of the surviving spouse are very different on death after retirement. A widow or widower aged 30 or 40 will typically have young children to look after and may have to give up a career to do so. A surviving spouse aged 60 and above is unlikely to have the same responsibilities.

In the past, patterns of work meant that a widow may not have built up a sufficient pension and a "spouse's pension" on death after retirement reflected this. Typically, a spouse received a benefit of:

- 50 to 60% of the member's pension (e.g., if the man was receiving a pension of EUR 10,000 per annum, on death of the member, the woman would receive a pension of EUR 5,000 to 6,000 per annum until her death)
- There may also have been children's pensions in the unlikely event of children aged under 18 (or 25 in some cases).

Most plans have made little or no change to the provision of dependent benefits despite these changes in work patterns and the recognition that many women have built up their own pension entitlement. However, it must be acknowledged that women normally continue to accrue less benefit entitlement due to career breaks for rearing children so any such changes may need further time to be recognized. Further, although in some States, Social Security benefit systems are moving towards benefits based on individual entitlement, most continue to have recognition of family-based entitlement to protect dependents.

The employer retirement benefit payable on death may be based on an accrued calculation (e.g. based on salary and service at date of death even If not yet vested), a prospective calculation (e.g. a proportion of the pension that the employee would have earned had he carried on working until retirement at the current salary), or, particularly, if insured, as a percentage of the member's salary at death (e.g. 30%).

Despite the move to Defined Contribution retirement provision, the death benefits provided through a company retirement plan have generally remained 'Defined Benefit' in nature. This is mainly because the benefit is supposed to respond to a need which is then defined as a lump sum amount or percentage of salary. Although this poses challenges regarding the financing of such benefits, many employers choose to insure these benefits.

There are complicating issues when retirement benefit can be taken as a lump sum – which raises the question of whether it is necessary to maintain a spouse's benefit in this case – and when the member has a choice of the type of annuity that he or she can purchase at retirement with his accumulated savings and may elect to choose a pension without a corresponding spouse's pension.

2.2.2 Disability Benefits

Disability or Invalidity occurs when, following an accident or illness, an employee can no longer fulfil previous work responsibilities; disability can include either physical or mental elements. The benefit paid out depends on the degree of disability which is assessed, expressed as a percentage. The assessment may be that there is a total inability to work (i.e. 100%, although often the margin between 67% or 70% is similarly treated) or partial, where an individual can perform the same task as before but not to the same capacity or can perform another task within the same organisation which may be at a lower salary.

A further part of the assessment is whether the disability is permanent or temporary. In the latter case, recovery is expected and any regularly-paid benefit would cease. Even if disability has been assessed as permanent, the payment may be conditional on regular re-assessment of the status. The modern trend is for the employer, or more commonly an insurer, to be actively involved in the in recovery of the employee where feasible.

The setting of benefit levels on disability must respond to a need and, at the same time, encourage a return to work where this is possible. In addition, as benefit levels depend on the degree of disability, judging the level of disability is critical in determining the level of benefit to award. This is, by its nature, subjective and will change over time; the involvement of a doctor is required and regular checks needed to assess the state of the employee. It should be noted that, in many European countries, the initial assessment of degree of disability will be carried out by the State Social Security agency; this may be determinative for insurers, or, at minimum, offer strong guidance. Companies will also need to take into account any disability benefit paid by the State; historically, in many countries employers provided a top-up to State disability benefits to a target level of replacement income. As governments reduce the level of benefit provision, companies may be faced with increasing disability benefit costs.

Benefit levels will therefore depend on the country in question, the level of State provision, and the tax and legal framework as well as the nature of the disability. In some countries, State disability provision is means-tested (e.g. Australia). The country Chapters set out examples of disability provision but typically benefit structure may consist of the following elements:

- On total and permanent disability, an income replacement is typical. Many plans provide a disability benefit equal to the death benefit (e.g., equal to the pension that the individual would have earned had he stayed in service until retirement). Others may provide income replacement of 50% to 75% of salary (this may be inclusive of benefits received from Social Security). There may be an enhancement in cases of severe disability where constant care is required.
- On total but temporary disability, companies may provide a simple proportion of salary to the employee. This tends to be around 50% to 75%; enough to ensure that the individual can meet living costs but low enough to encourage a return to work.
- On partial disability, practice varies widely. Where permanent, a lump sum payment is often made. Where temporary, an income payment during the recovery period may be available. In some countries, the government sets minimum benefits that need to be provided by employers (e.g. 5 states in the USA mandate short term disability pay by employers). For short term sickness, companies would typically provide salary continuation.

2.2.3 Medical Benefits

Medical benefits include benefits or provision of medical services to an employee, possibly extended to dependents. They can take many forms and depend on the culture and tax treatment in the country, as well as the employee profile, expectations, and level of State provision. Benefits may include:

- Payment of part or all of medical expenses incurred by the employee
- Hospital surgical and accommodation benefits
- Arrangements with providers facilitating discounted costs or shorter waiting times
- Contribution to the medical insurance premium of the employee
- Various spouse or children benefits

Some of these benefits may be provided through flex benefit plans (e.g. dental). Some benefits are aimed at maintaining the employee in good health such as free medical check-ups, stress counselling, and wellness benefits aimed at a healthy lifestyle. These benefits are discussed in more detail in Chapter 7.

Due to the reduction in accessibility of State medical provision in some countries, many companies have taken on at least some role in the provision of medical benefits, with the aim of getting the employee back to work as soon as possible. In addition, in some countries (e.g. Switzerland), medical services is provided by the private sector (financed by employer and/ or individual) with the State playing a minimal role. However, increasing medical costs plus the ageing of the workforce in many countries mean that companies are faced with significant year-on-year increases in their medical costs. Management of these benefits is becoming increasingly challenging.

2.3 BENEFIT DELIVERY

2.3.1 Death Benefits

Employers have the choice to self-insure (pay the benefit themselves from cash flow) or insure part or all of the benefit with an insurer. Pre-retirement lump sum death benefits are typically insured with a provider. On the death of the employee, the insurer pays the benefit directly to the beneficiary. For larger companies, which may self-insure part or all of the benefit, the benefit is paid out of cash flow (either of the company or the pension fund). For retirement benefits on death, these are harder to insure and the monthly payments may come directly from the company or its retirement plan.

2.3.2 Disability Benefits

As for death benefits, employers have the choice to self-insure (pay the benefit themselves) or insure part or all of the benefit with an insurer. The benefit in the former will come from the company cash flow (either of the company or its pension fund); in the latter, the insurer will pay directly. There are, however, a large number of administrative and medical requirements in the assessment of the level of disability before any payment is made. For this reason, most companies would insure the benefit to take advantage of these services provided by the insurer.

2.3.3 Medical Benefits

The delivery of this benefit very much depends on the nature of the benefit. The employee may receive the medical service direct from the provider (doctor or medical clinic) pre-selected by employer or insurer or may receive a financial allowance leaving the employee the role of choosing the medical provider him or herself. Larger companies are likely to negotiate special terms with the medical service providers.

2.4 FINANCING AND FUNDING

Risk benefits are often insured wholly or partly with an insurer. The decision depends on the size of the company, how risk averse it is, and what type of benefit is provided.

The risk management process underlying this choice involves three steps:

- **Identification of Risk** – the employer will set out the financial implications of its risk benefits.
- **Measurement and Assessment of Risk** – the probability of the event occurring - or frequency - and the size of the financial pay-out will be estimated
- **Treatment of Risk** – usually, through one of three methods; a reduction of the risk (e.g. through a change in the benefit or through preventative measures), a transfer of risk, or financing (either self-insurance or insurance)

The decision on insuring the benefit will depend on the frequency of the event and the magnitude (i.e. level of payment). Employers will aim to insure low frequency events (e.g. death and long-term disability) with a high financial implication. High frequency events with low magnitude (such as short-term sickness) will typically be self-insured.

Where partial insurance is selected, there are a number of different products and parameter limits which could be adopted, including Stop-Loss insurance (coverage against multiple claims) and Excess of Loss insurance (coverage against large individual claims).

Approach	Advantages	Disadvantages	When used
Self Insured	Reduce costs: avoid margins and insurer expenses Tax reasons More appropriate for cash flow benefits (eg disability	Employer takes all the risks	Predictable small and short term risks Pension Funds with free reserves for death and disability Cash flow benefits Large companies
Full Insured	Reduced risk for the employer Direct access to insurer expertise Services and administration	Expensive – employer pays the margin and expenses of the insurer No financial incentive for employer to reduce risk	Small companies. Lump sum death benefits. Risk averse companies
Partial Insured	Sharing of risk means better rates for the employer Incentive to reduce risk -> better workplace practices	May be complicated to administer Some exposure to risk	Many large and medium sized enterprises Cover risks linked to catastrophes

Larger employers may set up their own insurer – known as a captive. In addition, most large employers may seek to combine the risk benefit exposure in different territories to insure these with one insurer or a network of insurers (known as multinational pooling).

2.5 GENERAL LEGAL AND REGULATORY ISSUES INCLUDING TAXATION

Legal and Regulatory Issues

National legislation may require the provision of death and disability benefits by employers at a certain minimum level, usually in connection with an accident at work. Where a more general benefit is required, these are often at a low level and may be means-tested. In addition to eligibility, there may also be legislation regarding non-discrimination – the same benefit must be provided to all workers.

For medical benefits, there is typically less legislation regarding the provision of benefits by employers.

Taxation Issues

Tax treatment varies widely by country. The comments below are general.

Death and Disability Benefits

The cost of financing death and disability benefits is normally allowed as a business expense. In some countries, financing of these benefits is carried out through the pension fund.

Lump sum death benefits are normally tax-free or taxed at a reduced rate for the employee. Income benefits, such as spouse's pension or disability pensions, whether paid from cash flow or by an insurer, are normally taxed as income.

Medical Benefits

For medical benefits, tax treatment varies by country, but there may also be different tax treatment depending on how benefits are provided. For example:

a. An additional allowance paid towards the cost of a medical insurance premium will typically be taxed as additional salary for the employee
b. Payment of medical insurance premium by the employer in some countries may not be treated as a taxable benefit
c. Direct provision of medical coverage through third-party providers may be fiscally more effective in some countries

This is addressed in the relevant country Chapter.

2.6 KEY ADMINISTRATION AND MANAGEMENT ISSUES

Key Administration Issues

The benefit manager will need to coordinate with the insurer to ensure that coverage is in place and that benefits are quickly paid to beneficiaries when due. This is particularly important in the case of death and disability benefits where the financial need is immediate. Benefit entitlements need to be clearly explained to employees prior to any event so effective communication is important.

Key Management Issues

The benefit manager will need to effectively manage the provision of risk benefits and this is likely to involve some or all of the following tasks:

- Ensure coverage of employees at all times: the risk to the employer is that a benefit payment is due but is not covered by the insurer or that there is a gap in provision. This may also be an issue during an M&A or other change in ownership.

- Choice of insurer: Clearly provision of risk cover at the lowest price is an aim but the choice of insurer will also depend on the quality and range of services provided plus underwriting requirements (e.g. does the insurer require a medical examination of the employees, is there a 'free cover' limit, etc.). The benefit manager will also need to manage the pooling network, if any.
- Management of risk: whether the risk is self-insured, fully insured or partially insured, it is in the interest of the employer to reduce risk within the organisation. These measures can include improving workplace safety, ensuring appropriate breaks are taken by employees, health prevention measures (such as free check-ups), counselling and stress management measures and promoting 'wellness' measures to improve general health, such as encouraging gym membership through discounted fees.

There are a number of management issues directly related to the provision of disability benefits. There will be a significant focus on control of costs and risk:

- Primary measures of risk control are preventative measures to reduce the incidence of disability (e.g. better working conditions but also screening of employees)
- Secondary measures of risk control focus on measures to minimise the benefit costs once payment has started, including encouragement to get employees back to work and checks on fraud

Medical benefit management will also require a good control of costs which are increasing rapidly in every country. At the outset, there needs to be consideration of what benefits to offer and once the benefit structure is established, the choice of providers and financing choices will become important.

Summary

This Chapter has provided an overview of risk benefits. This has included a description of the different forms and types, the nature of the benefits provided and the ways they are funded. It concluded with a summary of the key management and administration issues for risk benefits.

Self Test Questions

- What are the main types of risk benefit?
- How are the main benefits delivered?
- What are the main taxation issues around these benefits?

INTRODUCTION

Many employers provide medical benefits to their employees, either because the State does not provide medical benefits, or in order to supplement or to substitute for the medical benefits provided by the State. In some cases, medical benefits continue to be provided by the employer after the employee has retired. These are known as "post-retirement medical benefits" and need to be considered separately from in-service medical benefits as they give rise to a long-term liability for accounting purposes, in a similar way to pension benefits.

3.1 INTRODUCTION AND DEFINITION OF BENEFIT

In most developed countries, residents are entitled to medical benefits provided by the State as part of the Social Security system. These may be delivered in various ways, such as through a national health service or a national system of public or mandated private medical insurance.

Many employers consider it in their interest to supplement these benefits for their active employees and possibly their dependents, either by paying for any gaps in coverage (for example, where the State does not reimburse the full cost of medical treatment), or by providing alternative coverage (for example, where there is a long waiting list for State-provided treatment and private treatment can be obtained more quickly). These benefits are discussed in Chapter 2 above.

Some employers also offer, or have in the past offered, medical benefits to their retirees, i.e. to people who retired from employment from that employer. These are referred to as "post-retirement medical benefits".

Although this post-retirement benefit may appear similar to "in-service" medical benefits, post-retirement medical benefits, as a long-term liability, are usually considered separately. While in-service benefits are usually financed on a "risk benefit" or annual premium basis, an employee who has just retired with an entitlement to post-retirement medical benefit will look forward to a future stream of benefits, typically, for the remainder of life.This commitment needs to be valued (for accounting purposes) and recognised in a broadly analogous way to a retirement benefits.

3.2 FORMS AND TYPES OF BENEFIT PROVISION

The large majority of post-retirement benefit plans are in the United States. Recent changes to make private medical insurance more readily available are discussed in Part 4, Chapter 4. Direct provision of State medical benefits generally is only provided to over-65s (Medicare) or people on very low incomes (Medicaid).

Accordingly, employer-provided medical care is generally regarded as the most important employee benefit, and often represents a higher cost to the employer than retirement benefits themselves. This focus on the high value of employer-provided medical care in-service has led employers to consider that continuation of provision in retirement would be similarly valued.

The form of the post-retirement benefit is influenced by the benefit already provided by the State. So, in the case of the United States, a typical post-retirement medical plan benefit will be split into two parts:

- For those aged under 65, where Medicare is not yet available: a continuation of the "in-service" benefits provided to the employee before they retired.
- For those aged over 65: a lower level of benefit, in order to supplement the benefits provided by the State Medicare scheme (which does not for example reimburse the full cost of prescription medicines).

It is important to note that post-retirement medical benefits in the United States are typically "unvested" during employment. In other words, employees who leave employment before retirement generally forfeit their entitlement to post-retirement medical benefits. Most post-retirement benefit plans were either collectively-bargained for the unionised employees or provided to senior management, on an individual or collective basis; accordingly, these benefits were, effectively, rewards for loyal service until actual retirement. With the diminishing power of unions, the financial impact of these plans in industries under economic constraints, and changing patterns of employment, most of these plans are now being withdrawn or reduced as no longer needed

Other countries where post-retirement medical plans may be found include **Belgium, Brazil, Canada** and **South Africa**. Some larger companies provide them in Asia (**Hong Kong, Indonesia, Taiwan**) but this is unusual. In the United Kingdom, some large companies provide this benefit for senior executives.

In many cases these benefits are no longer available for future retirees, as companies seek to reduce risks relative to long-term liabilities.

In **France**, companies are obliged to offer employees the right to continued participation in the "in-service" medical benefits plan, but the employer is not obliged to contribute to the cost of this, and very few do so

3.3 BENEFIT DELIVERY

Benefits are generally delivered in the same way as "in-service" medical benefits, either:

- *through a medical insurer*: the employer pays an insurance premium to an external medical insurance company, which then provides and administers the benefit.
- *through a Third Party Administrator* (TPA): the employer directly pays the cost of medical treatment through a TPA, which is often an insurer that is providing Administrative Services Only (ASO).

One growing approach in the US has been to transition from a traditional employer-sponsored plan to a private exchange approach, allowing retirees choice, concierge-style decision support, and potentially equal or better benefits for equal or less money. Individual retirees are able to use an exchange to apply the same funding to choose the benefit model that best suits their individual requirements.

3.4 FINANCING AND FUNDING

Post-retirement benefits are generally financed and funded in the same way as "in-service" medical benefits, either:

- Insured: the employer pays an insurance premium to an external medical insurance company, which then provides and administers the benefit.
- Unfunded: the employer directly pays the cost of medical treatment.

Both approaches give rise to liabilities under international accounting standards that need to be disclosed under international accounting standard IAS19 or US accounting standard ASC715-60. The benefit plans are often contributory (that means that the individual needs to pay a premium as a member contribution to the plan) which reduces the overall cost exposure of the company.

Significant escalation in the costs associated with financing and funding such benefits has led to a dramatic decline in employers' desire to provide such benefits, and, also, their looking for means to contain the liabilities and risks, through closing plans and, in some cases, buying out liabilities.

3.5 GENERAL LEGAL AND REGULATORY ISSUES INCLUDING TAXATION

The body of regulation in the United States is not as comprehensive for employer-provided post-retirement medical benefits as it is, for example, for employer-provided retirement benefits. In particular, there is no requirement for vesting of benefit for employees who leave before retirement, as noted above.

In addition, an employer in the United States may choose to withdraw the right to the benefit from existing employees at any time. In practice, when a scheme is withdrawn, its withdrawal often only applies to employees below a certain age (e.g. 55); those above that age, as well as existing retirees who are beneficiaries, will, in such a case, continue to be entitled to the benefit.

In Brazil, legislation allows for a special regulation: If a medical plan requires member contributions and the member retires after a minimum service period of 10 years the member is entitled to continue the plan during retirement. This often leads to additional benefit liabilities to the sponsoring employer. Hence a number of companies are reviewing their delivery of the medical plans in Brazil.

In France, the healthcare system consists of two pillars:

- the first pillar (State scheme) provides reimbursements via social security;
- the second pillar is private insurance, mostly set up by employers. The reimbursement structure is very complex and varies depending on the rates charged by the medical service providers. As a result, the social security reimbursements also vary depending on the rates charged.

Developments in France in 2014/15 required employers to review their medical plans for active employees:

- The “Medicare basket” in France guarantees to all the employees an access to a private health insurance with minimum coverage guaranteed.
- The “responsible contract” 2014 reform sets some minimum ceilings to ensure a minimum coverage to all employees, but also places caps on the amount of the reimbursements to discourage medical practitioners charging very high consultation fees. It also limits reimbursements on optical care to avoid abuse from opticians recommending frequent change in glasses.

In other countries, general employment law applies regarding the right of an employer to withdraw entitlement to benefit.

3.6 KEY ADMINISTRATION AND MANAGEMENT ISSUES

There are no particular administration or management issues in addition to those applying to “in-service” medical benefits (see above), other than the following:

- the additional requirement to keep track of beneficiaries who are not employees of the company; in practice, the beneficiaries are likely also to be beneficiaries of the employer’s pension plan
- in the United States, the need to take account the Medicare plan for over-65s and, therefore, to provide two different scales of benefit according to the age of the beneficiary.

The delivery of medical plans may result in a significant administration burden to the company. Although the handling of claims is typically done through the insurer or a service provider the employer will need to educate individuals on their choices between the benefit plans offered by the company.

Summary

This Chapter has provided an overview of medical benefits. This has included a description of the different forms and types, the nature of the benefits provided and the ways they are funded.

Self Test Questions

- What are the main types of post-retirement medical benefit?
- How are these benefits delivered?
- What are the main issues with these benefits?

INTRODUCTION

This brief Chapter outlines some other long-term benefit plans that may be encountered, in addition to those covered earlier in this Part.

4.1 INTRODUCTION AND DEFINITION OF BENEFIT

Some companies offer other forms of employee benefits that do not fit neatly into the benefit categories such as retirement and risk benefits mentioned elsewhere in this Chapter. The common features of the benefits we will cover in this section are:

- The benefits are likely to have some age- and/or service-related element to them, either to define whether an employee or former employee is eligible for the benefit or in the calculation of the actual benefit to be paid to the employee or former employee;
- Typically, the benefit is paid either as a lump sum or in instalments over a short period;
- Often, but not always, the benefit is paid while the employee remains in service.

The international accounting standard recognises this different class of benefit and they are typically covered by the section of IAS19 devoted to "Other long-term employee benefit plans".

4.2 FORMS AND TYPES OF BENEFIT PROVISION

The nature of these benefits varies. Below, we have provided some examples and the countries where these benefits might be found.

Jubilee or long-service awards

These are an award or cash payment made based on an employee achieving a certain number of years of service completed with the company. Below is an example of one such award programme taken from the Swiss subsidiary of a multinational company:

Number of completed years' service	10	15	20	25	30	35	40	45	50
Award as % of employee's monthly salary	25%	50%	75%	100%	75%	25%	100%	25%	100%

The above example provides an amount based on a percentage of monthly salary. However, some companies may provide physical items, rather than cash, e.g., a commemorative item, like a gold watch.

Jubilee benefits or long-service awards are quite common in a number of different countries (for example, Germany and France). Sometimes the benefits are provided as a result of national or locally collectively-bargained agreements, or, simply, voluntarily offered by the company.

Long-term compensated absences (for example, long-service leave or sabbatical leave)

These benefits are similar to jubilee or long service awards, but, instead of providing a monetary amount or gift, the employee is entitled to a period of paid leave of absence from the company. An example of this benefit is in Australia where there is a statutory long-service leave entitlement. There, the minimum amount of entitlement varies by State and applicable industry agreement.

For example, in the State of Victoria, an employee is eligible to take 8.67 weeks of paid leave after completing 10 years of service with a particular employer; the benefit is delivered as paid leave rather than cash payment. The timing of taking this leave is negotiated between individual and employer. After 10 years, an employee continues to accrue additional Long Service Leave entitlement at the rate of one week's leave for every 60 weeks' employment (i.e. approximately 0.867 weeks per year).

Alternatively, if a Victorian employee leaves service (e.g., resigns, is terminated or dies in service) after 7 years' continuous service, then the accrued long service amount is paid out as cash (although the amount itself is prorated accordingly).

The rate of benefit accrual, eligibility periods on various modes of triggering eligibility, and ability to cash out, all vary by State and industry agreements.

Termination indemnities

These are lump sums payable on the individual leaving the company's service. Termination indemnities are typically specified by law and set out in some detail as they are often payable in place of the 'notice period' for ending the employment contract (i.e. severance payment or 'compensation for loss of office').

Generally, this type of benefit would be payable if the employee is dismissed without 'cause' or the employer has failed or otherwise unable to give notice. In most, but not all cases, the employer may be able to withhold payment only in circumstances in which an employee has been dismissed 'for cause'.

Although not common, in a few countries, provision for payment may be specified to include voluntary resignation, i.e. any leaving service triggers the payment.

In most cases, the termination indemnity is also triggered where the employee is unable to continue working due to death or disability.

This requirement to pay the benefit may be extended to cover leaving service at retirement (see below), especially where it may be provided instead of a mandatory company-sponsored retirement provision.

The level of benefit offered varies by country, but, generally, is around one month of pay for each year of service. The statutory formula for indemnity payment in Greece for white collar staff, for example, is set out below. This is applicable in cases where the required notice of termination has not been given; otherwise, the employer is required to pay only 50% of the indemnity amount shown.

Length of service	**1-4 years**	**4-6 years**	**6-8 years**	**8-10 years**	**Additional years up to 28**
Award as multiple of monthly salary	2	3	4	5	+1 for each additional month up to a maximum of 12 months

The termination indemnity in Italy (known as TFR) is based on annual pay (at the rate of 1/13.5th of earnings) accumulated in an individual account with the prior years' account balance being increased by a formula (75% x inflation rate + 1.5%). It is an example of a country where the payment is due for virtually any leaving service situation, although its application has been broadly altered for most employers to the equivalent of a funded retirement benefit.

Termination indemnities are quite common and are also found in countries such as Turkey, South Korea, and Mexico amongst others.

Similar long service-related payments made in connection with leaving service may be referred to as End of Service Gratuities (common throughout the Middle East) or Gratuity plans (on the Indian sub-continent).

Retirement indemnities
These are similar to termination indemnities, but the benefit is payable on the individual's retirement from the company. Therefore, if an employee voluntarily leaves the company and is not immediately eligible to draw a retirement benefit, e.g., in France from the State, then no retirement indemnity is payable.

These benefits are not common but, for example, may form part of the collective labour agreements that operate in France. The formula provided in France depends on the national collective labour agreement operated by the company. The amount also varies depending on whether the employee voluntarily retires or is asked to retire. The retirement indemnity payable in France for employees in the Chemical sector is as follows:

Number of years service at retirement	5	10	15	20	25	30	35	40
Multiple of Final Monthly Salary (in the event of voluntary retirement)	1.5	2.5	3.0	4.0	4.5	5.0	6.0	7.5

Early retirement arrangements
These plans (often called pre-pension plans) provide a short-term income or 'bridging' pension payable prior to an employee reaching State or normal retirement age. These early retirement arrangements can be individually negotiated or may follow national or local collective labour agreements.

Deferred compensation payments
As part of the company's remuneration package, certain employees may be required to defer receipt of a cash payment, or be entitled, as part of a formal plan, to defer a portion of their salary/bonus. The period of deferral may vary but typically will be more than a year from the end of the period over which the payment would have been earned.

For example, an employee may earn a bonus entitlement based on service rendered through calendar year 2013 but the employer specifies that the payment is deferred and would only be payable on 31 December 2015, provided the employee is in service at that point in time. Alternatively, the employer may offer a formal plan whereby the employee may elect, prior to earning his salary/bonus in calendar year 2013, to defer receipt until 2016, often offering a financial incentive to do so.

Deferred compensation arrangements are commonly found in the USA and Germany where, in both countries, the employee can potentially benefit from tax advantages, at least by shifting the tax lability to a later year. Companies may also use these arrangements as a way of retaining employees within the organisation by linking entitlement to the payment to continued service until the specified payment date.

4.3 BENEFIT DELIVERY

The options available for benefit delivery for other long-term employee benefits are similar to those used for retirement benefits. Therefore, other long-term employee benefits can be funded or unfunded. Generally, companies leave these entitlements unfunded because:

- Typically these payments are financed solely by the employer and the employer can use its cash better within the business during the period until the payment is required.
- There are no particular tax incentives available which encourage companies to accumulate funds to meet these obligations.
- The point at which these payments are payable or the amount that might fall due is often difficult to determine (for example, the point at which someone might early retire or determining how many of the employees might achieve 10 years of service is difficult).

Although the traditional approach has been to leave these arrangements unfunded, some companies have now started to explore funded alternatives, particularly for termination indemnities. This switch is emerging because companies are increasingly concerned about the significant unfunded obligation that they have accumulated and the potential drain on the company's cash flow when these benefits fall due.

4.4 FINANCING AND FUNDING

Given that most companies leave arrangements unfunded, companies do not need to worry about how much funds should be set aside each year. Instead, companies simply meet the benefits as they fall due from cash flows in the year in question. This method of funding is referred to as pay-as-you-go and is described in more detail elsewhere in this material. Although companies only meet the benefits as they fall due, under international accounting rules, it is still necessary for companies to recognise these liabilities in their year-end accounting statements. The exact accounting treatment for each of these other long-term benefits is governed by the particular accounting standard that the company adopts, e.g. US GAAP or IFRS. However, the general principle is that the cost of these liabilities should be recognised over the period in which the benefits accrue rather than simply being recognised as and when the cash payment is made.

It is worth noting that often these other long-term employee benefit plans are comparatively small and, therefore, companies may not follow the strict accounting treatment on the grounds of materiality. A common issue for due diligence work as part of an M&A transaction is to make sure that these other long–term employee benefit plan liabilities are identified and then valued correctly.

4.5 GENERAL LEGAL AND REGULATORY ISSUES INCLUDING TAXATION

Legal and Regulatory Issues

In some countries, such benefits are legally mandated by the Government and it is up to the employer to provide the required benefit. Although the Government may set down certain funding requirements, normally, decisions regarding financing these benefits are left to the employer. As these are benefits in defined benefit form, if they are material, they should fall under the requirements of the local and international accounting standards, where applicable.

Taxation Issues

Again, the tax treatment of financing and payment of these benefits depends on the country in question and the relevant legislation. For example, the payment of the benefit may be taxed in the same way as income or the beneficiary may benefit from a reduced (or zero) taxation rate. Similarly, the financing of benefits by the employer, through funding or the creation of book reserves, is often fiscally efficient.

4.6 KEY ADMINISTRATION AND MANAGEMENT ISSUES

Key Administration Issues

There are a number of record keeping issues to take into account to ensure that each employee's date of entry to service is taken into account and any breaks in employment are correctly calculated. Coordination between the employer and the third party administrator to ensure payments are made on time is also important.

Key Management Issues

These benefits may be material in a number of countries (e.g. Greece and Turkey) and the Benefit Manager needs to ensure that they are properly accounted for. In addition, the cash flow requirements need to be analysed and modelled – the nature of the benefit plus the fact that payments may become due at similar times – to ensure that this does not place any constraints on other areas of the business.

Summary

This Chapter has provided an overview of a variety of long-term benefits. This has included a description of the different forms and types, the nature of the benefits provided and the ways they are funded.

Self Test Questions

- What are the main types of long-term benefits?
- How are these benefits delivered?
- What are the main issues with these benefits?

In a number of key international markets, employers use savings plans to extend the options for employees to save beyond pure retirement savings vehicles. The plans may allow some voluntary withdrawal of funds during the plan's operation period (possibly in restricted circumstances), and, normally, such savings benefit from favourable tax treatment as made or when withdrawn at the end of the savings period or both.

5.1 INTRODUCTION AND DEFINITION OF BENEFIT

Savings plans are established by employers to offer employees the opportunity to make savings, typically, on a tax-efficient basis, either alongside or instead of share and retirement plans. The plan structure is often dictated by tax considerations in the specific country, making it difficult or impossible to offer the same plan across the multinational company's operations or on a 'cross-border' basis.

The key differentiating features of the savings plans outlined here are that:

- They involve either direct employee contributions, which may be from gross (pre-tax) or net (post-tax) pay, or made indirectly by means of salary sacrifice.
- They often allow some voluntary withdrawal of funds (possibly in restricted circumstances such as house purchase or marriage), as opposed to requiring a death, disability or retirement event to occur,
- In some cases, employers may establish them on a group basis for their employees (rather than simply being an individual savings product available in the local market). This typically leads to improved terms and reduced charges relative to individual contracts.
- Whilst some investment in employer shares may be involved, this is not the sole purpose of the plan.

Such plans may take many different forms, including salary sacrifice arrangements, matching contribution plans and plans where employer contributions are made with reference to company profits. The main reasons for offering plans are:

- To establish an alternative or supplementary form of funding for benefits
- To take advantage of favorable tax treatment
- To encourage a savings mentality among employees
- To offer the opportunity to employees for the funding of house purchase, education and other life events
- To provide a vehicle for employees to acquire and hold shares in the employer

The tax factor is, however, key; the prevalence of savings plans in a particular country is directly linked to the availability of a favourable tax environment.

There are some other variations on the employer-sponsored savings approach:

- There are a number of countries in emerging markets where long-term savings structures may be used as a proxy for retirement plans. In some countries, tax regulations encourage this and in others (e.g. Middle East) it is a positive decision to encourage saving with certain clawback clauses. However, there is no single prevalent practice.
- Some plans, principally aimed at retirement savings, will allow partial withdrawal for specific purposes, particularly, so-called Provident Funds. For example, 30% of contributions to the mandatory savings vehicle in Malaysia, the Employee Provident Fund (EPF), are allocated to an account that can be used for purposes such as purchasing a first house, financing education of the employee or dependent children, provision of medical care within the family, as well as offering early withdrawal at age 50. Similar plans exist in Singapore (the Central Provident Fund) and New Zealand (Kiwi Saver).
- Some plans are established on a collective basis, e.g. by unions (across employers in the sector) or employee co-operatives (within an employer), and made available to employees through the support of the employer.

- Severe medical cost inflation affects many countries which has led some to introduce tax relief to assist with medical expenses; companies have accordingly established alternative vehicles for the funding of healthcare provision. For example, in the US, the concept is of a Health Savings Account (HSA), a tax preferred account owned by an individual that is used to pay for current and future medical expenses. It is funded by tax deductible individual contributions to which employers may contribute within limits.

5.2 FORMS AND TYPES OF BENEFIT PROVISION

Country examples:

United States

- 401(k) plan
  So named for the section of the tax legislation establishing the plan requirements. Eligible employees may make contributions from salary on a pre-tax or post-tax basis (subject to specified limits). An employer is not required to contribute but may commit to make contributions on the basis of a profit-sharing formula, a matching percentage of employee contributions or through non-elective [fixed] contributions. However, structured, a key requirement is that employer contributions not discriminate in favor of 'highly compensated' employees. Employer contributions are usually subject to service-related vesting rules and may be subject to being invested in employer shares. The employee's 401(k) account is portable (i.e. on leaving service, the funds can be withdrawn and 'rolled over' into another employer's qualified plan (subject to its plan rules) or to an Individual Retirement Account).
  401(k) plans are commonly used as the defined contribution vehicles for employer-sponsored retirement savings.
- HSA (Health Savings Account) – see above

Canada

- Group Registered Retirement Savings Plan (GRRSP)

A GRRSP offers members special benefits, such as pre-tax contributions via payroll deduction, favourable interest rates and lower investment minimums, which they would not normally receive individually. Plan Sponsors may, but are not required to, contribute to the GRRSP. Technically, there is no "employer contribution" as it is taken into the employee's income and is reported on the annual tax return. Effectively, the employee's income is being increased by the amount that is being referred to as the employer's contribution and that increase is being contributed to the GRRSP. Although the plan is geared to retirement, early withdrawals are possible. Such a withdrawal is taxed as regular income.

- Group Tax-Free Savings Account (TFSA)
  A TSFA allows employees to contribute up to CAD 5,500 (2017) per year from post-tax earnings, with the ability to carry forward any unused TFSA allowance. Savings accumulate tax-free within the account and withdrawals are non-taxable.

France

- Plan d'Epargne Entreprise (PEE)
  The PEE is a voluntary collective savings plan that allows employees to invest funds with financial help from their employer. All employees with at least 3 months' service must be eligible. The employer's matching contributions are exempt from income tax and Social Security charges (although now subject to a specific Social surtax of 20%). Employees can contribute voluntarily up to 25% of their annual salary; it has become common practice that these are matched by the employer. The annual employer matching contribution per employee cannot exceed the lower of three times the employee contribution or 8% of the Social Security Ceiling (this limit increases by 80% if contributions are invested in company shares). Funds invested are subject to a five-year holding period and can only be withdrawn during this period for specific reasons (for example, termination, retirement, or disability).

UK

- Save As You Earn (SAYE)
  An SAYE plan (also known as Sharesave) offers an opportunity for employees to purchase shares in their employer at both a discount to the market price and with tax advantages.

  The SAYE plan must be open to all employees with 5 years' service or more, although, in practice, any eligibility service period is significantly shorter. The plan allows employees to save, by payroll deduction, from post-tax earnings between GBP 5 and GBP 500 monthly over either a 3 or 5 year period.

  The SAYE plan is established effectively under two contracts. The first is a savings contract, approved by the tax authorities, with a bank or building society. The savings are credited with interest and, upon completion of the contract period, a bonus paid, both on a tax-free basis.

  The second is a share option contract from the employer enabling the purchase of shares in the employer (parent company) at the end of the savings period. The option price may be set at up to a 20% discount to the market price at grant. Tax is not payable on the option grant by the employee; neither is there any social charge liability on employer or employee.

  On completion of the savings period, the employee is able to take the savings amount or exercise the option to acquire the shares. On taking ownership, the employee will be subject to income tax on any dividends and capital gains tax on any share sale (although there is a possibility of transferring the shares directly to other tax-favoured investment vehicles). The employer is able to take a corporate tax deduction on the gain standing in the shares on exercise.

Mexico

Employers are able to provide an annual tax-advantageous savings plans to employees. Under the terms of the savings plan, employees may withdraw up to 50% of their accumulated account balance as a low-interest loan. At the end of the savings year, the account is settled and the balance paid to the employee tax-free. The savings plan is financed by the employee and the employer can make a matching contribution (that usually equals employees' contributions) that is 53% tax deductible and free of social charges. The tax limit for the employer contributions is 13% of the lower of the employee's monthly earnings or ten times the monthly UMA (a federal economic factor that replaced the minimum wage for this purpose from 2016). Any excess payment will cause withholding taxes while the amount contributed up to the legal tax limit will remain tax-free

Netherlands

Company savings plans became popular in recent years due to tax advantages. . However, one of the difficulties in managing a global workforce is keeping abreast of the every-changing rules in each country. For example, in the Netherlands, two recent savings plans have been eliminated while a third has been implemented. The two cancelled plans were:

- Life Savings Plan ("Levensloop") (no longer in effect):
  Under this plan, employees could save up to 12% of their salary to allow for taking unpaid leave in the future. The maximum savings balance within the account is 210% of salary. Contributions to the savings account is not subject to income tax, but there is liability to Social Security contributions and employee insurances; on payout from the account when leave is taken, the savings are subject to income tax. The "Levensloop" was closed to new entrants from 1 January 2012 although those who participated in a plan prior to that date and had an account balance of at least EUR 3,000 may continue until 2022. A proposal to replace the "Levensloop" by the "Vitaliteits-regeling" (Vitality-plan) was not implemented.

- Spaarloonregeling (Wage savings plan) (no longer in effect):
  Under this plan, an employee could save an amount up to EUR 613 annually from pre-tax salary. The employer was liable to 15% wages tax on the total amount saved by all its employees. The "Spaarloon" programme stopped effective 1 January 2012. Present savings have been paid out tax free as each portion has been unblocked over the 4 year plan period (account holders were given the opportunity for a one-time full withdrawal in 2013).

  The third plan was implemented this year due to the introduction from 2015 of a salary cap of EUR 103,317 (2017) on company retirement plans (see Part 4, Chapter 6). This new type of savings plan has been introduced to enable investment for supplemental retirement provision. Under the structure, contributions are made from post-tax income and invested, with withdrawals from the account not subject to income tax.

5.3 BENEFIT DELIVERY

Savings plans typically will be established with third party providers: banks, insurers, or dedicated administrators and investment fund managers.

5.4 FINANCING AND FUNDING

Savings plans may be funded by the employer or the employee, or both, largely depending on the tax treatment. The different approaches are described above in respect of each type of arrangement.

5.5 GENERAL LEGAL AND REGULATORY ISSUES INCLUDING TAXATION

Legal Issues
These vary enormously by country and will impact the design features of the plan as set out above.

Tax Issues
Probably the key driver of savings plan design - the tax regimes of countries - vary widely. In addition, there may be different savings plan options within a country.

5.6 KEY ADMINISTRATION AND MANAGEMENT ISSUES

Savings plans are generally administered by external service providers. The employer needs to ensure that plans are well-managed and the benefits and terms and conditions are clearly communicated to employees.

Summary

This Chapter has provided an overview of a variety of savings plans. This has included a description of the different forms and types, the nature of the benefits provided and the ways they are funded.

Self Test Questions

- What are the main types of savings plans?
- How are these benefits delivered?
- What are the main issues with these benefits?

Employee share plans are a valued part of the employee compensation package. They are used widely by publicly-listed companies, and, to a lesser extent, by privately-held companies, to recruit, retain and reward employees. Share plans have developed over the last fifty years into a major reward component involving two parallel themes: the all-employee (broad-based) plans to build wider employee engagement in the business, and the executive share plans designed to reward and motivate senior management.

6.1 INTRODUCTION AND DEFINITION OF BENEFIT

Share plans offer employees an ownership opportunity in the employing company, or an associated company, at either no investment cost or at a discount to the market price of the shares. Where an employee share purchase is involved, this may, depending on individual country tax legislation, be paid out of pre- or post-tax income.

There are many different types of such plans that either offer free shares, shares at a discount or an option to purchase shares, with exercise prices which can be at the market price or at a discount or premium to the market price (known as share options)

The award of shares may be conditional on the employee or company meeting certain performance targets. These are often known as performance shares. In the US they may also be referred to as restricted stock units (RSUs), although in the UK this term generally means shares which vest subject to a period of employment only (i.e. no performance condition)..

Each company has different reasons for introducing an Employee Share Plan, or indeed multiple plans, but the main reasons cited are:

- Helps align employee behaviours with company objectives and with shareholder interests.
- Allows employees to share in the success of the company.
- Helps retain employees where there is a period before share ownership rights can be exercised.
- Allows fast-growing, but cash-poor, companies to substitute its shares for a portion of pay it would have had to make to employees.
- Favourable tax treatment (mainly for all-employee plans).

The final factor is considered key: generally the prevalence of share plans depends on their tax treatment, although the growth of “executive” plans has had less to do with tax breaks. In reality, there is only a handful of countries where tax treatment is particularly favourable, or, at least, well structured, for the introduction of share plans. Key countries where this is the case are France, the United Kingdom and the United States.

6.2 FORMS AND TYPES OF BENEFIT PROVISION

There are three main types of share plans which are set out below.

Share Awards – shares are given to an employee at no cost.The award of shares depends on the criteria set by the company.This can be related to the employee meeting performance targets, the performance of the company (e.g. increase in share price relative to the market or to its competitors), as a reward for long service, as an alternative to a cash bonus or simply as a substitute for salary (particularly for companies with limited cash resources). There may be a waiting period before full ownership of the shares transfers to the employee – typically the vesting period is 3 or 5 years, with the shares being transferred either in full at the end of the vesting period, or in annual tranches for the duration of the vesting period.

Phantom plans provide an alternative share-based cash payment which mirrors the value which would have been delivered had the actual share plan been applied. For example, companies can settle in cash Share Appreciation Rights (SAR), which are awards where an individual receives a (cash or equity) amount equal to any

appreciation in the value of a certain number of shares over the time between the date granted and the date on which the person exercises the right. As a further example, phantom Restricted Stock Units may provide an equivalent cash payment to that which would have been delivered in shares under a Restricted Stock Plan. The advantage of share awards is that they can be a strong reward, recruitment, retention and motivation tool.

Share Purchase Plans - an employee has a right to purchase shares either at a discount to the market price or on a tax-favoured basis (e.g. out of pre-tax income).The discount is set by the employer but may be driven by tax advantages or constraints (e.g. in the US, within broad-based share purchase plans, discounts up to 15% are not taxed as a benefit in kind on purchase). The number of shares that can be purchased will be limited – again, often for fiscal reasons; this value may be expressed as a percentage of salary or a flat annual amount.

The main advantage to the employer of a Share Purchase Plan is to encourage employee share ownership; the employee is making an active decision to purchase shares and demonstrating an active commitment to the business. There is no direct cost to the employer in offering the discount compared with providing the equivalent value to the employee in cash. The retention and motivation impact is also strengthened if employees need to wait a certain amount of time before they receive their shares.

Share Options - right to purchase shares at a defined price over a defined time period, typically, commencing at a future date. Share Options are more likely to be targeted at a small number of senior employees although the UK gives tax breaks to all-employee share option plans.

The main advantages of Share Options are: (i) their retention and motivation impact – employees might need to wait for a certain amount of time before they receive the shares and the right to exercise the options may be linked to performance of the company during the option period (more commonly where the exercise price is heavily discounted) and (ii) the fact that employees' money is not at risk until the option is exercised (choosing the time of exercise also allows the point of taxation to be chosen under many plans). Potential disadvantages of options are that: (i) they may encourage employees to sell their shares as soon as they acquire them, in order to recoup their investment and to pay any tax due, (ii) during the option period the employees are not actually shareholders of the business so some of the motivational value may be lost, and (iii) there will be no motivational effect if the market share price falls below the exercise price during the exercise period (i.e. the option is "underwater" and hence valueless if exercised at that point in time).

Variations on Share Plans

A significant attraction of share plans is that the design can be varied to closely meet the objectives of the company. A number of parameters and variables can be changed:

Eligibility – to which employee or group of employees is the share plan open? The company may want to target only senior employees or have an aim to widen share ownership in the whole organisation.

Vesting Period – this is the waiting period before an employee can exercise their rights to purchase shares, or before shares that have been acquired cease to be subject to a risk of forfeiture. A longer vesting period acts as a more effective retention tool, but can also be demotivating if it is seen as too lengthy to foresee actual receipt of the plan value.

Discounts – the terms under which shares can be purchased will clearly impact on the attractiveness of the share plan but a higher discount (or free matching shares) will obviously have a higher cost to the company. However, if new shares are issued, there is no cash cost to the company (although there will normally be an accounting charge) but the holdings of other shareholders will be diluted. Note that corporate governance legislation in some countries such as the UK restricts the extent that such dilution is allowed.

Performance Link – the terms under which individuals can receive their share awards will also vary according to the company's aims. For example, the number of shares or options awarded may depend on a certain share price increase or total shareholder return (taking account of share price changes and reinvested dividends) of the company relative to its peer group.

Country examples:

United States

ISO Plans (Incentive Stock Options)

- An approved and tax advantageous stock option plan, mainly used for executives but sometimes for all-employee plans as well.
- Option must be granted with the exercise price at, or above, current fair market value and the term (option expiry date) must be less than 10 years. An annual limit on exercise of USD 100,000 effectively limits the value of shares over which options are granted to that annual amount.
- Shares must be held for at least 1 year from date of exercise and at least 2 years from date of grant to be eligible for tax advantageous treatment (namely, that the option gain is taxed as long-term capital gains rather than ordinary income).

Section 423 Plans (Employee Share Purchase Plan or ESPP)

- This is a tax-advantageous all-employee plan enabling the purchase of employer shares through payroll deduction at a discount.
- The maximum discount to market price is 15% (the plan can provide the discount be measured by reference to the lower of the price at the start of the offer or at the date of purchase).
- The maximum annual share purchase is USD 25,000 measured by reference to the actual share price at the start of the offer.
- The discount is not taxable as income although any gain on share sale will be taxed under normal rules.
- Purchase from accumulated payroll deduction and the term of the offering period must be less than 27 months (5 years if no discount is being offered).

United Kingdom

SAYE (Save As You Earn or Sharesave) (see Part 5 Section 5.2)

Tax-advantaged SAYE plans offer employees an option to buy shares in the company with funds accumulated by deduction from net (after tax) pay over 3 or 5 years. Employees contract to save up to GBP 500 a month. At the end of the savings term they can withdraw their funds in cash or exercise their options to buy shares within a 6-month window.The exercise price is fixed at the outset at up to 20% below market value at that time. Any bonus or interest under the savings arrangement is tax-free. Gains on option exercise are generally not taxable as income, but capital gains tax will be payable on the sale of shares. The employer receives a corporate tax deduction for the option gain.

CSOP (Company Share Option Plan)

This is a plan offered to employees of the employer's choosing, usually senior managers, where, during the course of the plan, options over company shares to a total exercise price of GBP 30,000 can be awarded.To gain any tax relief, options must be exercised between 3 years after grant and 10 years after grant.The exercise price must not be lower than market value at grant.Any gain on exercise is normally not treated as income (it may attract capital gains tax when the shares are sold). Options in excess of the GBP 30,000 limit are often granted on similar terms but on a non tax-advantaged basis.The employer receives a corporate tax deduction for the option gain.

SIP (Share Incentive Plans)

Share Incentive Plans allow for several ways of getting shares into the hands of employees. Companies can use any combination of these mechanisms (each of which may have a qualifying service requirement of up to 18 months), which are:

Free Shares – each year, the employer may offer up to GBP 3600 worth of shares to each employee in any tax year.These shares are normally held in trust for between 3 and 5 years before they can be sold by the employee. They might be forfeited if the employee leaves during the first 3 years.The offer may be subject to performance conditions and are sometimes used as a form of profit-sharing. Shares are not subject to income tax or national insurance contributions when they are awarded, although tax relief is clawed back if shares are sold within 5 years. Gains on the sale of shares from within the plan are free of capital gains tax.

Partnership Shares – are shares bought by employees out of pre-tax income.The money, up to GBP 1800 for the tax year (or 10% of salary if lower), is deducted from salary and may be accumulated for up to 1 year before being used to buy shares.Tax relief is clawed back if shares are sold within 5 years.

Matching Shares – are free shares given to employees who buy partnership shares (up to a maximum match of 2:1). Terms are generally the same as for free shares. Matching shares may be subject to forfeiture if the related partnership shares are sold within 3 years.

Dividend Shares – are bought with dividends paid on SIP shares. The SIP rules may require reinvestment of dividends, or give the employee the choice. Dividend shares are tax-free after 3 years.

Except in the case of dividend shares, the employer will get a corporate tax deduction for the benefit provided.

EMI Options (Enterprise Management Incentive Options)

These are tax-favoured share option arrangements similar to CSOPs but with higher limits designed to support smaller independent companies. These are intended to help provide attractive incentives to enable them to attract senior employees.

To benefit from the tax advantages, the company, the employee and the option itself must meet certain qualifying conditions including (but not limited to):

- The purpose of the options must be to attract or retain the employee, not simply to gain a tax saving.
- The value of unexercised EMI options granted by the company must not exceed GBP 250,000 per employee in a 3-year period and GBP 3 million in total at any time.
- The company's gross assets must not be more than GBP 30 million.

France

When it was introduced in 2005, this was originally very favourable: the free shares' regime provided for a full exemption from social security contribution for the employer and a fixed rate of 41 per cent (including social contributions) for employees.

The tax benefits for employees had however decreased over the years: for awards made on or after 28 September 2012, free shares were subject to the normal sliding scale of personal income tax. New tax law (the "Macron" law from 2015) has made free shares attractive once again.

Non tax-advantaged arrangements

Employers often use share plans which do not enjoy tax favoured treatment to reward or retain executives. It gives greater flexibility and allows bigger awards to be made.

These arrangements usually fall into one of the following types:

- Share Option Plan (normally with an exercise price equal to fair market value at grant)
- Long Term Incentive Plan - where shares are awarded subject to conditions, usually as to service and performance. Awards may be structured as conditional awards (restricted shares), nil exercise price options or forfeitable shares.
- Deferred Share Bonus Plan – Where part of an employee’s bonus is provided in the form of a share award, (structured in a similar way to an LTIP award except that they are not subject to performance). The award is often subject to compulsory share sale restrictions. Where it is not, the employer may provide a supplemental matching award to encourage voluntary deferral

6.3 BENEFIT DELIVERY

Share Plans may be managed in-house by the company or out-sourced with the administration carried out by a third party. More detail is set out below in Section 6.6.

6.4 FINANCING AND FUNDING

Share benefits may be funded by the employer or the employee or both. The different approaches are described above in respect of each type of arrangement. Where a plan requires the issue of new shares, even if there is no direct cost apparent, these newly issued shares will dilute the company’s capital base (i.e. there is an explicit cost to the company‘s shareholders).

6.5 GENERAL LEGAL AND REGULATORY ISSUES INCLUDING TAXATION

Legal Issues

These vary widely by country and will impact on the design features of the plan as set out above.

For example in the UK, all listed companies often require the adoption of share plans by shareholders at a general meeting; they are also subject to disclosure and other reporting requirements.

At a European level, the EU Prospectus Directive requires a company to issue a prospectus when making a public share offer, which may include making an offer of share options/awards to its employees. This Directive was recently amended to exempt most companies from this requirement in respect of employee share schemes as long as specific criteria are met.

Tax Issues

Probably the key driver of share plan design, the tax regimes of countries vary widely. In addition, different share plans within a country may also vary. For example, in the UK, for most plans (SAYE, CSOPs and SIPS), no income tax or National Insurance Contributions (NICs) are payable at award grant or upon acquisition of the shares. For non tax-advantaged plans, tax is payable when ownership of the shares transfers to the employee and/or when the transferred shares cease to be subject to restrictions.

6.6 KEY ADMINISTRATION AND MANAGEMENT ISSUES

All-employee share schemes are generally administered by external service providers. The practice is more variable for senior executives' arrangements. Smaller schemes tend to be administered in-house, whereas schemes covering larger groups of employees are more likely to be administered externally.

Whilst similar plan structures are found throughout the world, the national tax and regulatory regimes tend to influence, if not dictate, the specific design, and which particular types of arrangement are favoured. Employers who wish to provide share-based benefits to employees who are based overseas need to check the regulatory and tax position of the country in which the employee is working. There may also be complex legal and tax issues when an employee changes country of employment between the grant and vesting of an award or performs duties in more than one country during that period.

Cultural differences similarly affect the use of these plans. A workforce with little interest in share ownership is unlikely to be motivated by the offer of shares or options, preferring equivalent cash benefits.

The use of share-based benefits for senior employees is widespread globally. These individuals are more likely to be internationally mobile and, perhaps, more subject to the influences of UK and US practices.

Summary

This Chapter has provided an overview of a variety of employee share plans. This has included a description of the different forms and types, the nature of the benefits provided and the ways they are funded.

Self Test Questions

- What are the main types of employee share plans?
- How are these benefits delivered?
- What are the main issues with these benefits?

Employers provide a range of other benefits which vary considerably by country and by the business sector in which the company operates.This Chapter looks at the different types of benefits provided and what drives their design, financing and provision. In addition we look at flexible benefits – a framework of giving choice to employees in the employee benefits they receive.

7.1 INTRODUCTION AND DEFINITION OF BENEFIT

Previously in Part 2, we looked at retirement, risk benefits, post-retirement medical benefits, savings plans and share plans.This Chapter aims to summarise the other employee benefits provided by employers.These benefits vary widely and their provision depends on the company, the country of operation (in particular, the applicable tax and legal framework) and the profile of the workforce.

An employee benefit has been defined as a reward to an employee which has a financial value but is not salary or bonus although, in reality, there may be grey areas over drawing a distinction. Even though some of the rewards below are allowances and sometimes taxed in the same way as salary, the aim is to provide a benefit that is not salary, but is paid or provided in respect of a certain need or to compensate a cost the employee suffers. For some employers, there may be a large number of these benefits and we have categorised them into the following broad groups:

a. Holiday and Flexible Working Hours
b. Transport and Travel
c. Meal or Food Provision or Vouchers/Allowances
d. Health/Wellness – these benefits are generally aimed at ensuring employees stay healthy and, therefore, differ from the medical benefits described in Part 2, Chapter 3.2
e. Training and Development
f. Other Benefits (for family or entertainment vouchers, etc.)

This is not an exhaustive list and, particularly in the US, there may be over 50 different benefits available to employees. Many of these benefits are optional or there is a maximum benefit allowance from which employees choose the benefits they receive.They are, therefore, often provided via a flex benefits plan.

We also consider flex benefits in this Chapter– this is not an employee benefit in itself but simply a means of giving the employees choice in respect of the benefits they receive.

7.2 FORMS AND TYPES OF BENEFIT PROVISION

These are often deemed ‘softer benefits’ and are normally less costly to provide than traditional employee benefits but often with a high employee value perception. Where cash is involved, it is a requirement that, where selected, it must be spent on a particular benefit.

There are lots of different benefits and we describe the main ones below:

a. Holiday and Flexible Working

- Holidays are specific days when employees do not work, but are paid as if they did. Mandatory holiday entitlement, as set by law, varies from country to country and, also, may vary within the country depending on the age of the employee (e.g. 5 weeks minimum in Switzerland for those aged under 20 while for others it is 4 weeks) or by type of work. Employees on permanent or indefinite contracts are entitled to paid vacation and, it is becoming more and more common to include part-time and, even, temporary workers. Provision of a holiday entitlement which exceeds the legal minimum has become an effective recruitment and retention tool. Flex an

benefit plans may allow the purchase of extra holiday entitlement or the sale of vacation days down to the minimum level. Some companies offer the opportunity to participate in a Holiday Bank allowing employees to save up unused vacation days for longer periods away from work.

- **Flexible Working hours** have become an effective way of motivating employees but also of recruiting from target groups that, with more rigid working hours, would not have been able to accept a job. Flexible working can include part-time working (e.g. a 3-day week), longer but fewer working days (e.g. full time job but over 4 days a week), change in working hours (e.g. starting at 11am and finishing at 7pm) or other combinations. This helps employers satisfy the demands of employees; it may also assist the employer in serving its customers without incurring additional costs, such as overtime.
- **Sabbaticals and other long term leave** are also an effective way to motivate employees but also provide a break from work and a chance to renew ideas, reduce stress or develop their professional competencies.

b. **Transport and Travel** can include the purchase of a public transport ticket for commuting or the provision of a car parking space.The advantage of providing such a benefit is that it may not be taxable and responds to a real need of the employee. Where provided through a company loan facility, even though the value is small, it presents a cash flow opportunity to the employee and the ability to take maximum advantage of discounts offered by the transport provider.

c. **Meal or food allowance**.This can take the form of a canteen at the work place providing free or subsidised food, luncheon vouchers (tickets restaurant), or an allowance. In many countries, within limits, these benefits are not treated as taxable to the employee.

d. **Health/Wellness**.The interest in providing such benefits is twofold; firstly, they are often attractive benefits to the employee; secondly, the provision of such benefits helps to keep the employees healthy, reduce stress and increase productivity. Benefits can include free or discounted health check-ups, discounts to spa and wellness centres as well as subsidised gym membership, purchase of bicycles and the provision of showers at work.

e. **Training and Development** is typically an HR issue but can also be considered an employee benefit if allowances are provided and the individual can choose the training.

f. **Other benefits** include maternity or paternity leave or pay above the legal minimum requirement, child care vouchers, reduced price theatre and cinema tickets and so on.

Flex Benefits

A flex benefit plan is a means of giving employees choice regarding their employee benefits. It allows a partial or full choice of a range of different benefits and typically will include the more traditional benefits such as retirement benefits and life insurance as well as some of the 'softer' benefits referred to above.

How does it work?

There are a number of different approaches but two systems predominate:

A. A core benefit package is provided. In addition, a notional allowance is provided to each employee (normally as a percentage of salary) with which additional benefits can be purchased

Example: ABC provides a retirement plan and life insurance of 1 times annual salary on death. It also provides a 'flex allowance' of 5% of salary to each employee. The employee can then choose to use part or all to increase the retirement contributions or life insurance benefit or divert the remainder to secure other benefits offered by the employer (for example, increased holiday entitlement, child care vouchers or dental costs).

B. A standard uniform benefit package is provided to employees. They can then sell some of their benefits to purchase other benefits offered by the company.

Example: ABC provides a retirement plan with a 15% employer contribution, life insurance of 4 times annual salary on death, 25 days holiday a year and pays all of the medical premiums of the employee. It allows employees to trade some of these benefits for other benefits. For example, the employee may choose to receive a lower retirement contribution and lower death in service benefit (e.g. 10% contribution and death benefit of 2 times annual salary) and use this saving to purchase more holiday, company car, restaurant vouchers and child care vouchers. There will however be minimum levels of benefit that must be maintained (e.g. you must have at least 8% retirement contribution and 2 times salary death benefit) to avoid employees making short-term choices or selecting against the plan.

Aims and advantages of flex plans

The idea behind flex is simple: you let employees choose what benefits they receive. Employees feel motivated and empowered by the choices and, as an employer, you provide benefits that are valued. By having to make an active choice, employees become aware of the package and benefits offered by the employer.

Companies say that the main reasons for introducing flex benefits are:

- To attract and retain employees
- To improve productivity and general health of employees
- To make tax and Social Security savings (when compared with providing additional salary)

What conditions are required to consider the introduction of flex?

- *Country where flex is possible*. Flex only really works in countries where legally it is possible, there are tax advantages, and there is a low level of compulsory benefits. Countries where flex benefits are already highly prevalent include the US, UK, Ireland and Spain.
- There is a key, relatively costly benefit that can be flexed—medical in the US; company car in the UK—without increasing benefit cost to the employer
- *Company culture is consistent with aims of flex.*
- *An effective administrative platform* is essential to ensure that the process can be managed effectively and efficiently. This includes online tools and effective communication.
- *Employee expectations and profile* – it is important that employees understand and value a flex benefit system.
- *HR and finance back up and buy in.*

To ensure a flex plan is successful, it must be well communicated and understandable, simple to make choices, and provide a good range of benefits.

What are the disadvantages of flex?

The main disadvantages occur when flex is introduced in an environment where it is not appropriate (e.g. if the company culture is not consistent with such a plan). Other factors that may cause a flex plan not meeting its objectives are listed below together with possible solutions to these problems:

- The plan is too complicated – the solution is to ensure that there are not too many options offered (typically, employers offer between 5 and 15 different types of benefits)
- Employees don't understand the flex plan– the solution is to use good communication, both on-line and face-to-face, to ensure employees appreciate the benefits provided and how the system works.
- Management and administration requires too much time and effort – many companies outsource their flex plans accordingly
- Not tax efficient – the solution is to seek out good tax advice and ensure the plan takes advantage of the possibilities set out in tax regulations

- Anti-selection costs – this is a key problem and may impact on the cost of some of the benefits. If, for example, an employee chooses increased life insurance cover, it is likely that they are in less good health than someone of the same age who does not choose to increase the coverage. The life insurer will realise this and increase the life insurance cost making the benefit less attractive. The main way round such a problem is to provide a relatively high level of 'core' (compulsory benefit) and / or put a cap on the maximum amount of additional coverage that can be bought.

7.3 BENEFIT DELIVERY

Softer benefits are typically provided directly (e.g. canteen for meals) or indirectly through vouchers (e.g. childcare vouchers) or discounts negotiated with suppliers. So called 'Affiliation Agreements' with providers of some of the benefits ensure that the employer buys the benefit at below the market price.

For flex benefits, the delivery itself does not change. Benefits are still provided by the same provider but the choice and election of benefit is carried out through the flex plan. It is, therefore, critical that a good administration system is put in place as employees may have up to 15 different benefits and may choose to change regularly the amount of each benefit they elect to receive. Companies often choose specialist providers to run and manage their flex benefit plan.

7.4 FINANCING AND FUNDING

As these benefits are short term and often in the form of direct provision or allowances, the cost is implicitly paid out of cash flow. There is, therefore, no funding or pre-financing required; the cost appears as an employee expense in the accounts. For flex benefit plans, the employee benefit cost itself does not change appreciably, but there may be increased costs related to the administration platform chosen.

7.5 GENERAL LEGAL AND REGULATORY ISSUES INCLUDING TAXATION

The provision of softer benefits is driven by company and employee culture but also by the tax environment and the level of compulsory benefits provided.

Tax Treatment of Employee Benefits
Each country will have its own way of treating such benefits. Some may be exempt from tax and not treated as a taxable benefit; others may be considered the same as additional salary. Even with the same type of benefit, tax treatment may vary depending on whether the benefit is provided directly (where it might not be taxed) or simply financed through an allowance (typically taxed as salary). Benefit design is often based on an optimal use of tax incentives available in a country. More detailed tax information is set out in each country Chapter.

7.6 KEY ADMINISTRATION AND MANAGEMENT ISSUES

Key Administration Issues
The key to a well-valued flex benefit plan or the provision of 'softer' employee benefits is that the provision of benefits is carried out seamlessly and with minimal additional costs. Efficient IT platforms ensure that this can be done in practice and allow a clear explanation and delivery of benefits to the employee. As noted above, many companies outsource the administration and management of their flex benefits plan. For the other benefits highlighted above, HR may administer benefits, but this requires close collaboration with the finance function as well as IT and third party providers.

Key Management Issues

Although there are less obvious risks related to the provision of softer benefits, management should still be aware that these benefits need to be well managed (good communication, appropriate delivery of benefits, appropriate benefits provided etc.). The correct level of core benefits provided is an important factor. If these benefits are too low, there is a danger that employees are underinsured for important benefits such as life insurance. If they are too high, the choice of additional benefits is limited and employees may be dissatisfied.

Managing the relationship with benefit providers – particularly insurers, but also, where relevant, medical facilities – will need to be done actively to ensure good quality benefits and service provided at reasonable cost.

Summary

This Chapter has provided an overview of a variety of benefits that can be offered by employers in addition to those covered in earlier Chapters. It has also covered flexible benefits and how flexible benefit plans operate and the advantages and disadvantages of them. The Chapter included a description of the different forms and types, the nature of the benefits provided and the ways they are funded.

Self Test Questions

- What are some of these other benefits?
- How are these benefits delivered?
- What are the main advantages and disadvantages of flexible benefit plans?

PART 3 THE ROLE OF DIFFERENT PARTIES INVOLVED IN THE PROVISION OF INTERNATIONAL EMPLOYEE BENEFITS

OVERVIEW

This Part details the role of the various parties involved in the design, delivery, management, control and regulation of employee benefit plans. To ensure that plans are well run, employers will call on a range of experts, both within the organisation as well as external experts, professional advisers and service providers. At the same time, regulators for the territories in which the benefit plans operate may monitor the operation of benefit plans to ensure they meet all requirements concerning operation, provision of benefits and disclosure of information to beneficiaries.

This Part comprises twelve Chapters.

1.1 BRIEF DESCRIPTION OF ROLE

An employee is an individual who works for an employer in return for some form of financial consideration subject to a contract of employment.

The most common form of contract of employment is an indefinite contract where the employee works full time for the employer for an unspecified period of time. However other contracts are possible such as a temporary contract where the employee works full time for a fixed period of time, such as six months or one year. Another form of contract, which may be either indefinite or temporary, is a part-time contract where the employee works a specified number of hours or days per week which are less than those of a full time employee. In some countries, part-time contracts are more common than in others.

For most employers, employees will constitute the largest group of individuals receiving employee benefits.

Employees will have a vested interest in having benefit programs which meet their needs.

2.1 BRIEF DESCRIPTION OF ROLE

As stated in Chapter 1, most beneficiaries of employee benefits are often (but not always) employees. However, employees are rarely, if ever, the sole beneficiaries. There will be other beneficiaries. These other beneficiaries may be divided into three groups:

- Contingent beneficiaries of retirement benefits, risk benefits and medical benefits;
- Employers; and
- Independent contractors

Contingent beneficiaries of retirement, risk and medical benefits: Individuals working directly for a company will typically not be the only recipients of employee benefits; others linked to the employee beneficiary may be entitled to benefits as well. For example, on the death of an employee, financial dependents such as widow/widowers and orphans might benefit from retirement and/or lump sum life insurance policies. Similarly family members will often be included in company-sponsored medical insurance policies, although family cover may be subject to a contribution from the employee. Furthermore, named third-party beneficiaries may benefit from life insurance policies in addition to family members.

Employers: Although in many cases, the employer is a corporate entity, in others, the owner(s) of the business may be individuals and included in the business's benefit plans. Furthermore, in some countries, the manager of the business may, for legal purposes, be considered an 'owner' rather than an employee (e.g. the Geschäftsführer in Germany). As a result of this special status, separate arrangements to include in the company benefit plans may need to be made.

Independent contractors: The legal relationship between a company and an independent contractor will be governed by a commercial contract, rather than a contract of employment. For the contractor as an individual, this is also referred to as being self-employed. Contractor status is often used purposely to exclude the individual from employment rights and participation in benefit plans. However, as tax and social cost advantages may be available to both parties, the commercial arrangement may include provision of company benefits to the contractor.This is seen, from time-to-time, for senior executives and directors in certain countries.

INTRODUCTION

This Chapter sets out the roles and responsibilities of an international benefits manager.

While requiring that the organisation's employee benefit strategy is successfully put in place, his or her key challenges will also revolve around the need to ensure costs are controlled, risks are well managed, and benefits are appreciated and valued by employees. The international responsibility of an international benefits manager means needing to decide where corporate responsibility ends and local decision-making takes over, as well as being able to take a global overview of all the different benefit programmes offered by the organisation.

3.1 BRIEF DESCRIPTION OF ROLE

The international benefits manager is responsible for ensuring that the international benefit strategy of the organisation is successfully put into place. In practice, this means ensuring that global benefits provided are in line with corporate business objectives, risks are managed and mitigated, and that other tasks (governance, meeting legislative and taxation requirements, disclosure to members, etc.) are carried out efficiently and effectively.

3.2 ROLES, TASKS AND OBJECTIVES

3.2.1 Objectives of an International Benefit Manager

Ultimately, the role of the international benefits manager exists to control costs and manage the risks associated with the organisation's benefit plans in the different territories where it operates. For example, the management of a pension plan has become increasingly complex and sophisticated over the last 20 years. The current environment typically requires a continual assessment of risk and costs related to employee benefit provision. External pressure for good management and corporate governance comes from regulators, investors, members, employees and auditors.

The key challenges of benefit management are:

- **Ensuring benefit provision is in line with business objectives.** Are benefits provided positioning total rewards at the right place compared to the local competitive labour market?
- **Ensuring benefit plans run smoothly** – benefits should be administered correctly, properly accounted for, and paid out when due.
- **Compliance with regulatory requirements** – benefit plans must follow local regulation. Regulatory requirements are updated often and one of the roles of the international benefits manager is to keep up-to-date with new legislation and act accordingly to ensure compliance.
- **Actuarial issues and funding for DB pension plans.** DB pension plans need regular valuations. The international benefits manager will need to ensure the funding level is monitored in line with local legal and regulatory requirements, the risks associated with the plan(s) are appropriately managed, and that benefits that require actuarial input (e.g. early retirement factors) are calculated correctly
- **Accounting issues for plans.** The international benefits manager may be involved with the corporate accounting requirements and may need to coordinate with other parties within the organisation (e.g. finance) and externally (e.g. actuaries and auditors) to ensure supply of information to enable appropriate calculation of profit and loss and balance sheet items and proper disclosure for accounting statements.
- **Managing pension and investment risk.** The international benefits manager will be responsible for managing risk for benefit plans at a global level. This will involve decisions around insurance, structure of benefit design and financing of benefits as well as issues related to DB pension plans such as longevity and investment risks.
- Appointing third-party advisers. Procedures need to be put in place, and followed to ensure this is done on a systematic basis. Increasingly, the international benefits manager works with corporate procurement to appoint external advisers.

- **Member communication and disclosure** needs to be in line with local legislation and regulations and also meet 'best practice' requirements.The international benefits manager will need to ensure the company's benefit plans are communicated effectively to maximise employee understanding and appreciation.

3.2.2 The International Dimension

The duty of the international benefits manager will be to delegate the responsibilities for some or all of the role, tasks and objectives in the previous Part to local benefit managers, while, at the same time, being ultimately responsible for the company's strategy. It is the international benefits manager's role to set down guidelines for the local office to ensure that the tasks and responsibilities delegated to them are carried out.

At the corporate level, the international benefits manager has a number of overriding objectives:
- Effective management of benefit risk
- Ensure global design consistency (where appropriate)
- Achieve global economies of scale
- Compliance with legal and regulatory requirements
- Facilitate improved pensions governance
- Support international mobility at the global level
- Support M&A activity at the global level

A good international benefits manager will ensure that these corporate objectives translate into advantages for the local operation. In particular, the international benefits manager will ensure that the local office will:
- Have access to global expertise and 'best practices'
- Monitor the competitiveness of its employee benefits plans compared to those offered by others, including helping to define the local market
- Improve local purchasing power and economies of scale
- More effectively manage the time spent by local operations on employee benefits matters
- Accommodate international mobility at the local level enabling the sending of assignees out and receiving assignees in
- Facilitate M&A activity at the local level

The international benefits manager will need to clarify local and global responsibilities (see 3.2.4) for these tasks.

The international benefits manager will use an effective International Benefits Strategy as the basis to ensure that both sets of objectives (i.e. at the corporate level and local level) are met in practice. This will set out the principles and guidelines for the management of employee benefit plans.

3.2.3 Development of an International Benefits Strategy

An International Benefit Strategy (IBS) should:
- Be consistent with the company's business strategy and employment objectives
- Take into account the local labour market (e.g.'production workers', marketing professionals, etc.)
- Reflect desired market positioning in the relevant labour market (e.g. targeting median total reward or top quartile positioning whether that is specific to the industry or general market)
- Encourage benefit consistency across borders (where appropriate)
- Lay down the principles and guidelines regarding practical considerations that management of benefit plans will entail (legal, administration, taxation, etc.)

One of the biggest challenges for an international benefits manager is to ensure consistency across operations. Consistency is important, as it means that:

- The global benefit strategy supports the global business strategy in each country of operation
- It strengthens overall equity of benefit provision by applying similar principles in different countries
- It facilitates the mobility of employees across the organisation e.g. those changing countries where working)

In practice, local factors will play a significant role in benefit design and may put pressure on the global consistency of benefit provision.

3.2.4 Factors to Consider in Designing an IBS

The following aspects should be considered in the development of an IBS:

Structural & Organisational. Is the company de-centralised with units operating autonomously or commanded more from the centre? The latter will normally be the case when there are a small number of employees in one particular country, or for an organisation that is expanding into new countries.

Corporate vs Local Management. The right balance is required and will depend on the skills and resources available locally, the nature of the business and which functions are involved. When an organisation is expanding into new countries, more corporate centre involvement will be required.

Design Considerations. These will be based on local (market) practice, global policy and tax/legislation. In practice, local realities will largely influence plan design.

Financing and Funding Alternatives. The decision will depend on tax, legislation and local culture.

Risk Management and Control. This will depend on the type of business and company size.

Operations. The IBS will detail how ongoing monitoring of compliance with external accounting, legal, tax and market changes will occur, as well as what internal governance is required (inventory of plans, plan change approvals process, etc.)

Professional Advisers. The processes for selection, appointment and ongoing quality monitoring should be set out.

3.2.5 Management of Risks

An international benefits manager will need to effectively manage the risks related to benefit provision. This will be done using local benefit managers and professional advisers and will cover the following risks:

- Currency risk
- Legislative risk. Legislative risk includes the impact of changes in Social Security benefits and offsets, the requirement to increase pensions by a minimum rate or meeting a minimum rate of investment return
- Economic and investment risk
- Reputational risk.

3.3 RESPONSIBILITIES AND LEGAL ISSUES

As referred to in section 3.2, one of the key roles for the international benefits manager is to ensure that all legal requirements are met, both locally and at corporate level, including:

- Proper disclosure of information to members and beneficiaries
- Submission of documents to regulators and tax authorities
- Ensuring investment is in line with legal restrictions (e.g. if there is a maximum proportion of pension plan assets that can be invested in equities)
- Meet the accounting standard requirements

Complying with local regulation is a task typically carried out by the local office, but the international benefits manager needs to be informed of any issues arising and needs to be kept abreast of significant regulatory changes by the local office in order that the international benefits manager may consider potential risk involved with these changes. Where the local office is small and without a dedicated Human Resource function, the management of all these tasks will likely fall to the international benefits manager.

3.4 RELATIONSHIPS WITH OTHER PARTIES

Many of the responsibilities in the previous sections require the direct coordination and involvement of other third parties. Even the largest multinationals with substantial in-house capabilities are likely to use outside expertise. In some areas, such as accounting disclosure, this is compulsory.

It is important that the procedures for selecting and appointing external advisers and administrators are set down in writing. This procedure is likely to include the basis on which a shortlist of advisers is drawn up (e.g. the worldwide presence of a global actuarial firm or the minimum assets under management for an Investment Manager). The procedure under which tenders are assessed (content of the adviser's proposal, time for presentations, etc.) will also be set down.

Once appointed, the performance of advisers will be assessed on a regular basis and the procedures whereby they can be changed will be stated in the contracts (e.g. notice periods, service standards).

It is important to set out clearly where the responsibility and tasks of the international benefits manager end, where they start for the professional adviser, and where they may overlap.

The relationship of the international benefits manager with other stakeholders depends on the company but, in general, he or she will work with:

- The finance function, including the CFO for financial aspects
- Local Benefit Managers
- Members and beneficiaries, including their representatives
- Legislators, regulators and tax authorities

3.5 GLOBAL VERSUS LOCAL ROLES

One of the key challenges of an international benefits manager is to ensure an appropriate division of roles and responsibilities. Section 3.4 above covers some of the considerations that need to be taken into account in this decision-making process.

Although each organisation is different, duties and roles typically carried out at corporate level include:

- Financial and accounting;
- Management of risk;
- Oversight of asset performance;
- Legal compliance and governance.

Roles typically carried out at local level, or shared with corporate would include:

- Administration (including selection of local service providers);
- Communication;
- Local reporting and compliance;
- Appointing local professional advisers (this depends on the organisation. In some companies, all appointments are made at global level. In others, this is permitted at local level although corporate may have a list of preferred providers or recommend use of the local office of a global actuary or global benefits adviser).

Summary

This Chapter has provided a brief overview of the role of the international benefits manager including the typical objectives and responsibilities. It has incldued a summary of the main relationships and the global and local roles.

Self Test Questions

- What are the main objectives of the international benefits manager?
- What are the main relationships of the international benefits manager?
- What are the key responsibilities of the international benefits manager?

INTRODUCTION

The Human Resources (HR) function is responsible for an organisation's employees. They are involved throughout the career of an employee – recruiting, managing and leaving service – ensuring that they are productive during their time in the company. It is responsible for the employee's wellbeing while in service. A key tool to achieve these goals is therefore the employee benefit package. In the past 30 years, HR has moved from a purely administrative function within organisations to a more strategic function, and will, therefore, work closely with other parties involved in the provision and management of employee benefits.

4.1 BRIEF DESCRIPTION OF ROLE

The HR function has traditionally used the compensation and benefit package (as well as other measures) as one of the key tools in ensuring that the employment strategy and objectives of an organisation are met. In practice, this means that the right employees are recruited and rewarded so as to maximise their productivity and overall contribution to the organisation. The HR function will use a range of tools to ensure that employees are motivated – including removing any barriers to employee motivation – so that employees contribute to the growth and profitability of the organisation.

The HR function has developed a more strategic role over the last 30 years. The HR function can, however, consider the broader reward picture and can, therefore, put the importance of employee benefit provision into context. HR may be involved in decision-making processes regarding the provision of employee benefits, their establishment, maintenance and review.

4.2 ROLES, TASKS AND OBJECTIVES

4.2.1 Objectives of the HR Function

The HR function will aim to ensure that an organisations business strategy is achieved and that its employment strategy is consistent with this. In reality, this means operating an employment strategy that ensures that employees are as productive as possible and that the employees' goals are consistent with the company's wider objectives. The success of the HR function is measured in several ways, including:

- the levels of turnover of employees, especially those in key roles
- cost-efficient provision of total reward packages
- employees' levels of motivation and satisfaction

4.2.2 Tasks of the HR Function

There are four main strands to the HR function, which operate within different levels of the organisation:

a) **Strategic role** – ensuring that business objectives are met. From a compensation and benefits perspective, the HR function will likely participate in, if not drive, the broad decision-making process regarding Total Rewards and the positioning of employee benefits within this.
b) **Employee relations role** – ensuring that employees are effectively recruited and their motivation and productivity is maintained through the application of appropriate policies. The HR function may be the day-to-day contact point for employees and employee representatives and, therefore, acts as an important channel of communication to and feedback from employees regarding, among other things, their benefit package.
c) **Administration role** – ensuring compliance with legal requirements and regulations and proper recordkeeping.
d) **Change management role** – given that one of the main reasons for the failures of mergers and acquisitions relates to employee issues, the HR function should play a leading role when there is a significant change in the organisation (not only during an M&A, but also when there are other workforce changes, such as redundancies).

4.2.3 Specific Tasks

In order to fulfil the objectives and the main strands of activities highlighted in the previous two sections, the HR function will be responsible for a number of defined tasks, normally in collaboration with other functions within the organisation and/or outside advisers and vendors:

Workforce planning – identification with colleagues across the organisation of staffing needs and associated cost implications.

Recruitment of employees – liaison with recruitment agencies, design of selection and interview processes, methods of selection, discussion of compensation and benefit packages.

Employee benefit provision – input into the benefit package, its objectives, costs and how it can be communicated and implemented to ensure it is appreciated by employees.

Induction and orientation – including awareness of company culture as reflected by the compensation and benefit policy.

Training and Personal Development Programme – including the process for carrying out Performance Appraisals.

Absence management – HR will help to identify problems and take appropriate action to address these.

Administration of benefit programmes – even when carried out by third-party providers, the HR function will likely set down the operational criteria for the provider and take part in the selection process.

Employee relations – HR will act as liaison between employee representatives and the company, or between individual employees and the company as well as managing legal issues

4.3 RESPONSIBILITIES AND LEGAL ISSUES

The HR function has a number of legal responsibilities. Examples include compliance with local employment regulations and personal data protection.

4.4 RELATIONSHIPS WITH OTHER PARTIES

The HR function will liaise closely with:

- The International Benefit Manager and local benefit managers – to ensure that benefits provided are consistent with the company's business strategy.
- The Finance function – to ensure that compensation and benefit costs are aligned with company budgets.
- Benefit Plan Administrators – to obtain relevant benefit information for employees and to ensure that benefits are managed and administered correctly.
- Other advisers and third-party providers – to obtain access to relevant information and receive advice.
- Regulators – to ensure that all legal and regulatory requirements are met.

4.5 GLOBAL VERSUS LOCAL ROLES

Typically, due to the importance of an understanding of the local labour market, national regulations and the importance of employee relations, most of the tasks referred to above are carried out at a local level.There are, however, Global HR functions whose main roles may include:

- Setting the framework for 'best practice' in line with corporate governance policy
- Operational guidance (e.g. how to perform certain tasks)
- Overseeing HR practices worldwide to ensure global consistency
- Organising worldwide training programmes
- Facilitating employee mobility, i.e. country to country transfers

Summary

This Chapter has provided a brief overview of the HR function including the typical objectives and responsibilities. It has incldued a summary of the main relationships and the global and local roles.

Self Test Questions

- What are the main objectives of the HR function?
- What are the main relationships of the HR function?
- What are the key responsibilities of the HR function?

INTRODUCTION

This Chapter sets out the roles and responsibilities of a multinational organisation's finance function. These include the financial implications of the benefit programmes within the organisation. The importance of the financial aspect of benefit provision has increased rapidly over the last 20 years and the finance function will be actively involved in the management and monitoring of benefit plans, particularly in relation to their costs.

5.1 BRIEF DESCRIPTION OF ROLE

The finance function within an organisation consists of those responsible for the financial management of the organisation. Although each organisation will differ in structure, typically, the head of the finance function will be the Chief Financial Officer and will manage a team responsible for the financial management of the organisation.Two important roles within the finance function that impact on benefits are:
- Financial controller
- Treasury manager

The introduction and application of International Accounting Standards acted as a catalyst in the increasing involvement of the financial controller in benefit plan operations.Treasury's involvement has increased as companies have taken a greater interest in how the company's benefit plans are financed and how assets are invested.

5.2 ROLES, TASKS AND OBJECTIVES

5.2.1 Objectives of the Finance Function

The finance function will aim to ensure that:
a) Benefit plan costs and liabilities are known, calculated correctly and that information regarding them is easily accessible from other areas of the organisation
b) Current and future benefit plan costs and liabilities are controlled and meet cost constraints as set down by the finance function.
c) Risks to be reported in the organisation's financial statements (balance sheet and profit & loss) arising from certain events (e.g. restructuring and plan changes or multiple death-in-service claims) are managed and, if necessary, some or all of the risk is transferred away, e.g. through insurance or other means.
d) Correct entries are made in the organisation's report and accounts, and other financial reporting requirements in respect of benefit plans are met.
e) The organisation complies with all legal and tax-related regulations concerning the financing of its benefit plan promises

5.2.2 Specific Tasks

In order to fulfil these objectives, the finance function will liaise closely with the international benefits manager and local benefit managers as well as other plan advisers and providers.Tasks undertaken or coordinated by the finance function may include:
- **Benefit Inventories**: set up to document plan benefits and their financial implications
- **Pension and Medical Plan funding valuations**: carried out with the resulting reports provided to the Finance function so that it is kept fully informed of the financial status of plans, future cash requirements, and the future liability implications on a regular basis
- Management of the **annual benefit plan accounting valuation**. The finance function will be involved throughout the process from assumption setting to the collection and disclosure of final results, all in accordance with the prescribed accounting standards

- Involvement in the **risk management process** – assessment of the risk profile of the benefit plans, decision-making regarding transfer of risk, and the purchase of any appropriate insurance cover.The finance function may also be involved in the selection of any multinational pooling network and will certainly be involved in any decision to set up a captive insurance company to manage the reinsurance of risks in collaboration with the risk function.
- Analysing benefit plan costs, setting budgets and cost constraints, and liaising with benefit managers (including the international benefits manager) and HR function on the most effective level of benefit provision

The liabilities and assets in respect of pension plans will typically be substantially larger than other benefits provided. Therefore close monitoring of the financial situation by the finance function will be required for plans in all countries and this will include:

- A system of monitoring assets of local pension plans and ensuring that assets are invested appropriately
- Liabilities are appropriately controlled and managed.
- Audits and valuations of pension plans regularly undertaken by independent experts, such as plan actuaries
- Future cash contributions are at acceptable levels
- Advisers and suppliers are appointed and monitored by the finance function
- Any changes to pension plans or new pension plans received approval from the finance function
- Any change to legislation causing an increase in benefit costs is notified to the finance function so that the implications may be analysed

5.3 RESPONSIBILITIES AND LEGAL ISSUES

The finance function will be ultimately responsible for the accuracy of the organisations published financial reports and accounts. It will be held responsible by the organisation to ensure that costs and liabilities are monitored and controlled.

5.4 RELATIONSHIPS WITH OTHER PARTIES

Many of the tasks cited 5.2 require the direct coordination and involvement of other stakeholders including:

- International Benefit Manager – to ensure that the finance function has up-to-date information on benefit plans and to liaise with the international benefits manager when there are changes to benefit plans, or during any organisational change
- Actuary – to ensure that the finance function has access to up-to-date information on the current financial situation of benefit plans and the likely future trends in costs and liabilities
- Accountants – to ensure that there is coordination in the preparation of accounts
- HR function - Finance should work closely with the HR function to ensure that the benefits designed to attract and retain employees are delivered in the most cost-effective way
- Risk function – to ensure that risk is managed efficiently and that any transfers of risk (such as multinational pooling) are effected in accordance with the risk management policy

5.5 GLOBAL VERSUS LOCAL ROLES

Typically, the finance function is a global role, as it will operate at the corporate level of the organisation. However, there will be coordination with local finance and accounting functions which will be better informed of the local financial situation of benefit plans. Although this information is typically fed into a computerised inventory system and, therefore, may not require direct contact with local finance team, there are often situations where further information or clarification is required by the central finance function.

Summary

This Chapter has provided a brief overview of the finance function including the typical objectives and responsibilities. It has incldued a summary of the main relationships and the global and local roles.

Self Test Questions

- What are the main objectives of the finance function?
- What are the main relationships of the finance function?
- What are the key responsibilities of the finance function?

INTRODUCTION

This Chapter sets out the roles and responsibilities of a multinational organisation's risk function. The risk function is responsible for managing, among other things, the risk arising from the implications of the benefit programmes within the organisation.The analysis of the true risk arising from the benefit programmes provided by an organisation is a complex issue but, together with analysing financial implications of benefit provision has become increasingly important in deciding what type of benefits to provide and how to provide them. Indeed, the increasing trend towards Defined Contribution pension provision is, in great part, driven by the desire to reduce employer risk.

6.1 BRIEF DESCRIPTION OF ROLE

The risk function within an organisation manages, amongst other tasks, the employee benefit risk. Although the main focus is typically on 'Benefit Payment Risk' – when benefit payments are greater than expected – other sources of risk also exist and these also need to be managed and mitigated.

6.2 ROLES, TASKS AND OBJECTIVES

6.2.1 Objectives of the Risk Function

The aim of the risk function is to optimise the 'Risk/Return trade off '. As we saw in Part 1, one of the key reasons that employee benefits are provided is as a tool to recruit and retain employees. The return from employee benefits is thus seen in improved workforce capability and higher productivity. However, providing employee benefits is also a risk to the organisation. The risk function must manage this conflict and place the organisation at the correct position in the trade-off between 'Risk' and 'Return'.

Once the 'Risk/Return trade off ' has been considered, and an acceptable level of risk determined, one of the most important financial decisions an organisation must make regarding employee benefits is whether to directly assume or transfer this risk. For the risk that is retained, the risk function responsibilities include taking measures to mitigate the risk.

6.2.2 Types of Risk

The types of risk that must be managed include:

Benefit Payment Risk – this is the risk to the organisation's financial statements (balance sheet and profit and loss account) of benefit payments being more than expected. The risk to the balance sheet is that the organisation needs to use its assets to pay out benefits; a larger than expected pay-out will therefore risk depleting its assets below an acceptable level.The risk to the profit and loss account is the impact of larger pay-outs on declared profit. For listed companies, negative impact of risks to the balance sheet and declared earnings will have implications for its share price and the ability to raise finance at an acceptable price.

> Defined Benefit pension plans assume that the employer takes on, for example, the longevity risk (i.e. plan members, particularly pensioners, living longer than expected) and investment risk (plan assets are not adequate at retirement to pay the promised benefits).A Defined Contribution Pension Plan transfers these risks to the employee, as the commitment of the employer is simply to pay the agreed contribution to the plan.

Currency risk – Are plan assets reported in one currency and liabilities in another? In most funded pension plans, there will be a diversification of assets, meaning that part of the assets will be held in a different currency to the liabilities. In some countries, there are no plan assets held. If this is the case, there is a risk to the organisation of plan liabilities increasing due to a movement in currency exchange rates.

> **Example**:
> The Swiss Franc appreciates by 15% against the Euro. For a pension plan with all its liabilities in Swiss Francs and 30% of assets in Euros, this represents a significant worsening of its financial position.

Legislative and Compliance Risk. The organisation must comply with all laws and regulations governing benefit plan operation. Legislative risk includes the need to provide certain benefits (e.g. disability benefits, holiday or maternity pay), to respect minimum levels of benefit provision (e.g. minimum employer contribution rates in Switzerland), to provide minimum rates of return on pension accounts (e.g. in Belgium) and meet any minimum pension increase requirements. Another 'legislative' risk relates to the situation where pension plans provide a total benefit including benefits payable from Social Security; when Social Security benefits are reduced, there is a corresponding increase in the benefit the organisation must pay from the benefits plan Legislative risk also includes the need to comply with local tax regulations which may limit the level or type of benefit that can be provided or the restrict the amount of contributions payable in a tax efficient way by employee and employer (e.g., in the UK).

Investment Risk. Investment risk may include local requirements for the plan to invest in certain types of assets, which may then lose value in relation to the plan's liabilities.

Reputational Risk. Although intangible, this risk arises when an organisation receives adverse publicity or damages its brand through a poorly considered decision. This includes poor communication to employees, so that the risks of plan membership are not fully understood or appreciated resulting in benefits expectations not likely to be realised, or when a poorly administered plan leads to member discontent.

Operational Risk. The operation and management of benefit plans is itself open to risk; from breakdown of systems to confidentiality issues. A full risk assessment of the plan's operation needs to be made at outset and reviewed at regular intervals.

Talent Risk. If benefits are not appropriate, the employer risks losing key staff and may face the inability to recruit replacements.

6.2.3 The Risk Management Process and Reduction of Risk

The risk function will set up a risk management process to monitor and analyse the risk inherent in the company's benefit arrangements. This is a three stage process:

Risk Treatment

One of the most important financial decisions an organisation must make regarding employee benefits is whether to directly retain or transfer financial risk. In some cases, local law will limit the scope of such decisions; this will vary according to the type of benefit.When the risk function makes the decision of whether to retain or transfer risk, they will consider:

- The predictability of risks and the cost of transferring predictable risks;
- The absolute levels of risk;
- The company's ability to handle catastrophic risk;
- The availability of suitable risk transfer mechanisms (e.g. appropriate insurance cover) and their cost;
- The spread of risk across adequately large populations; and
- The ability to manage and control risk.

Certain employee benefits represent very predictable levels of risk, provided the population is sufficiently large to achieve both spread of risk and predictability over relatively short time periods. An example of predictable risk is short-term sickness benefit (income replacement) in a relatively large, primarily white collar employee population. In most cases, an employer would not seek to transfer such risk by purchasing insurance.

Other benefits, such as lump sum death-in-service (group term life assurance) or long-term disability income replacement represent less predictable levels of risk in the near term. In most cases, employers do purchase insurance to cover all or a portion of these risks. However, you may come across instances when a lump sum death-in-service benefit is not insured, such as within a very large UK pension plan.

For international employee risk benefits (medical, death and disability), employers often have relatively small numbers of employees spread over a number of countries, with larger numbers in only a few countries. In these situations, most multinational companies will choose to insure these risks.They may utilise a multinational risk benefits pooling arrangement as a method of spreading risk across borders and, thereby, reducing exposure and unit costs. A very large employer may, however, directly assume (or reinsure via its own captive insurance company) part or most of the risk, with insurance cover only to protect against catastrophic risk or single year incidence above predicted levels.

Typically, pension benefits are not insured but, in some countries, the only available and tax-efficient option for pension benefit provisions for relatively small groups of employees is some form of pension insurance contract.

6.2.4 Retained Risk

The risk function will seek to reduce and mitigate any risk that is retained through:

1. **Primary Measures:** these are preventative measures taken to reduce risk and include Health and Safety at work measures, such as limiting working hours, requiring regular breaks or wearing safety equipment in manufacturing operations. Pre-employee screening (e.g. requirement to perform medicals for key employees). Other wellness measures (e.g. reduced price gym membership, free health check-ups, etc.)
2. **Secondary Measures** focus on reducing benefit amounts once in payment, most notably for disability cases by encouraging return to work or reducing fraud.

6.3 RESPONSIBILITIES AND LEGAL ISSUES

The risk function is likely to report to the CFO and be accountable for any decisions taken regarding risk management transfers.

6.4 RELATIONSHIPS WITH OTHER PARTIES

Management of risk requires coordination with other stakeholders to ensure that accurate and up-to-date information is available to make the correct assessment of risk:

- International Benefit Manager and local benefit plan administrators – to ensure that up-to-date information on benefit plans is available
- Actuary – to ensure that an appropriate assessment of risk is made, the risk function may work with the plan actuary to calculate the potential risk under different scenarios
- Finance function – to ensure that the financial implication of different risk scenarios is considered and budgeted for
- HR function – to put in place Risk Reduction Measures at a global and local level
- Insurers, Insurance Brokers and other advisers – to ensure that the transfer of risk is carried out in the optimal and cost-efficient manner

6.5 GLOBAL VERSUS LOCAL ROLES

Although the risk function exists at a global level, there will however be coordination with local operations to ensure information is collated and risk reduction measures are successfully implemented. The transfer of risk may also occur after discussion with local operations and their providers, although any multinational pooling may mean that this has to be decided upon at a global level.

Summary

This Chapter has provided a brief overview of the risk function including the typical objectives and responsibilities. It has incldued a summary of the main relationships and the global and local roles.

Self Test Questions

- What are the main objectives of the risk function?
- What are the main relationships of the risk function?
- What are the key responsibilities of the risk function?

INTRODUCTION

Since the eighteenth and nineteenth centuries employees in Europe and elsewhere have often been represented by their own organisations for the purpose of collective bargaining and the protection of their rights as employees. Historically, the first of these representative organisations were Trade Unions. However, in the early twentieth century, a new type of representative body was developed in Continental Europe (most notably in Germany) known as a Works Council.

It is the role of Employee Representatives to negotiate with employers on behalf of employees and others on matters of collective concern to all employees. Employee Representatives may be drawn for the employer's own workforce, in the case of Works Councils, or appointed by the Trade Union either internally or assigned from outside. In the European Union, both models are common, depending on the labor relations history in that country. Outside Europe, the Trade Union appointed representative is the norm.

In the European Union the Employee Representatives and Employers are often collectively referred to as the "Social Partners".

7.1 BRIEF DESCRIPTION OF ROLE

A simple definition of a Trade Union is that it is mutual benefit organisation for its worker members, the principle activity of which consists in negotiating the terms and conditions of employment and other working conditions on their behalf. Trade unions typically negotiate rates of pay, work rules, complaints procedures, rules governing hiring and firing, employee benefits, and health and safety issues.

A Works Council is a body representing workers' interests at a company or site level. It is an important body in the negotiation of employee benefit terms and conditions and provides a link between the employer and its workers.

7.2 ROLES, TASKS AND OBJECTIVES

Objectives of Employee Representation

The key objectives of Employee Representatives can be summarised as follows:

- **Protecting Employee Rights** – the organisation of workers into a larger negotiating body with the aim of increasing their bargaining power with their employer
- **Reducing workplace conflict** – employers negotiate with one body which can then use its communication channels to ensure the message is consistently received by the workers it represents
- **Efficiency of negotiation of terms and conditions** – the employer negotiates with one body representing its employees with agreements reached binding on the relevant workforce

Roles and Tasks

The roles and responsibilities of a Works Council are generally defined by national legislation. However, their influence also depends on the working culture in the country in question. Countries with a history and tradition of worker organisation and rights tend to see Works Councils playing a large role in negotiations related to salaries and employees benefits. In other countries, where employment law tends to be less worker friendly, Works Councils may have reduced influence.

In addition to this internal role of working with management within the business, Works Councils typically play a complementary role with respect to national/regional agreements between the employer organisations and the Trade Unions. The negotiations may set the guidelines at a national level but the Works Council in that industry sector or company is then tasked to set local conditions within the framework of this national agreement. Works Councils will also be heavily involved when there is a proposed reduction in benefits or changes to benefit structures.

Works Councils are widespread in Europe both at a national level and EU level (see Part 5). In Western Europe, Joint Consultative Committees (UK), Comité d'entreprise (France) and Comité de empresa (Spain) are three examples, although German Works Councils (Betriebsrat) are perhaps the most well-known in Europe.

Example: Germany: Labour agreements are made at the national level between employer representatives and national unions. Once these agreements are in place, companies (or sites/factories) then negotiate with Works Councils in order to put in place an appropriate set of local agreements based on them.

7.3 RESPONSIBILITIES AND LEGAL ISSUES

The legal structure and responsibilities of works councils and trade unions vary considerably by country. There may be requirements concerning the constitution of Works Councils, including rules governing election of members to them.

7.4 RELATIONSHIPS WITH OTHER PARTIES

A key relationship of the Employee Representatives is with the employer. There will be regular meetings between the two parties and lines of communication remain continuously open, even though there will be negotiations at set times of the year or in relation to certain events (e.g. mergers, restructuring). Other relationships may also exist between the local benefit manager or employee relations manager of the employer, the relevant national authorities, and the pension and benefit plan administrators.

7.5 GLOBAL VERSUS LOCAL ROLES

Although Works Councils are a country level issue, since 1994, the European Union has become involved in setting requirements for European-wide Works Councils – 'European Works Councils' (EWC). The EWC Directive was set up to ensure that workers will have a line of communication to the management of any multinational operating within the EU enabling the workers to be kept informed of any proposed restructuring or changes to the organisation affecting the workforce within the EU, including benefit plans. The EWC Directive applies to companies with at least 1000 employees within the EU and at least 150 employees in each of at least two Member States. More details of EWCs and this Directive are set out in Part 5.

Summary

This Chapter has provided a brief overview of the role of Employee Representatives including the typical objectives and responsibilities. It has incldued a summary of the main relationships and the global and local roles.

Self Test Questions

- What are the main objectives of Employee Representatives?
- What are the main relationships of Employee Representatives?
- What are the key responsibilities of the Employee Representatives?

INTRODUCTION

This Chapter looks at the legal structures of individuals and entities ('Trustees') who hold assets on behalf of benefit plan beneficiaries and are required to manage these assets in the interests of plan members.

8.1 BRIEF DESCRIPTION OF ROLE

A trust is the legal holder of property ('assets') on behalf of a beneficiary. A trust is the legal structure in which these assets are held. This legal structure only exists in some countries – typically those with Common Law roots – and has been used as the vehicle through which pension plan assets are held. In other countries, where trusts do not exist, there may be equivalent structures such as foundations which are used to hold pension assets. A trustee, who is responsible for management of the trust, can be a person or a company ('trust company').

A fiduciary duty is the legal obligation the trust and its trustees have in holding the trust assets /property on behalf of the beneficiary or beneficiaries. A fiduciary relationship also exists between a retirement plan administrator and plan beneficiaries. Fiduciaries are the general term in some countries for the bodies managing assets and interests for beneficiaries.

8.2 ROLES, TASKS AND OBJECTIVES

The trustees of a pension plan have a number of duties and roles including:

- **Implementing the terms of the pension plan** (e.g. in the UK. the Trust Deed and Rules) – ensuring that members only receive the benefits they are entitled to in accordance with this document
- **'Prudently' investing pension plan assets**
- **Being impartial between the different categories of trust beneficiaries** (e.g. not preferring the interests of active employees over pensioners)
- **Administering the plan in the best interest of the beneficiaries**

The pension plan's trust deed usually expands on these duties and the trustees' responsibilities listed above.

Carrying out tasks

Trustees are generally held to a 'prudent person' standard and are required to ensure that they are competent to carry out the duties they are entrusted with. They will typically secure the services of professionals such as actuaries and investment managers to ensure that they can carry out their duties according to the trust deed and rules.

8.3 RESPONSIBILITIES AND LEGAL ISSUES

Trust law and the definition of fiduciary duty does vary by country but, in general, trustees can be held jointly and severally liable under the law of a country if it is felt that they are not carrying out their duties in accordance with trust law and the plan's Trust Deed and Rules.

8.4 RELATIONSHIPS WITH OTHER PARTIES

Given the importance of the role of plan trustees, it is important that they seek professional advice where necessary. In addition, they will need to maintain a close relationship with the plan's sponsor. Common relationships include with:

- The Plan Actuary who will advise the trustees on the financial position of the plan and future funding requirements.
- The Plan Sponsor (Employer) – the trustees will need to be in constant dialogue with the employer. Indeed, in many countries, the employer will have one or more representatives on the Trustee board and be directly involved in the decision-making of the trustees (but recognising the potential conflict of interest, such a trustee must not take the employer interest into account over that of the trust itself and its beneficiaries).

- The Investment Manager – the trustees are required to invest pension plan monies in a prudent way; they will appoint, monitor and change investment managers, if required, which carry out the investment of plan assets on their behalf.
- The pension plan accountants will draw up annual reports and accounts for the pension plan.
- The plan auditors will ensure that the accounts are a true and fair reflection of the financial situation of the pension plan.
- The trustees may also need to liaise with other advisers (e.g. pension plan lawyers and administrators) to ensure that benefits are being paid correctly and that the trustees are meeting their legal and fiduciary duties.

8.5 GLOBAL VERSUS LOCAL ROLES

The trustee's role is very much a locally-focused one given that trust law only extends to the country in which the trust is established, even if the beneficiaries may reside elsewhere. As noted, for other countries, alternative structures (such as the Pension Foundation in Switzerland) which have similar non-profit status under which a fiduciary duty to act in the interest of beneficiaries also exist. It is important that the International Benefit Manager of an organisation is aware of these local relationships.The international benefits manager should also be aware of the constraints on changing benefit provision contained in plan trust deeds and rules along with any obligations of consultation with other stakeholders, particularly the plan trustees and membership, in order to achieve such changes. Indeed, the international benefits manager may become a trustee of a plan or attend meetings in a company capacity.

Summary

This Chapter has provided a brief overview of the role of trustees and fiduciaries including the typical objectives and responsibilities. It has incldued a summary of the main relationships and the global and local roles.

Self Test Questions

- What are the main objectives of trustees and fiduciaries?
- What are the main relationships of trustees and fiduciaries?
- What are the key responsibilities of trustees and fiduciaries?

NTRODUCTION

A local pension plan actuary will be responsible for ensuring that the long-term financial sustainability of a company's pension plan is maintained by periodically assessing its financial health. The actuary will also be involved in a number of other benefit related aspects, including: the calculation of benefits for employees; modelling alternative economic scenarios; pricing of benefits in flexible benefits plans; and calculating the disclosures required in relation to national and international accounting standards, e.g. in organisations' published reports and accounts.The calculations for accounting purposes may be carried out by a different actuary to avoid any conflict of interest.

9.1 BRIEF DESCRIPTION OF ROLE

An actuary is a specialist in the assessment of risk and long-term financial predictions. He or she will use probability and statistical theory as the basis for assessing current and future employee benefit promises, as well as providing advice in respect of the management of such risks. The actuary is generally required to be professionally qualified through rigorous examinations and experience, although these requirements do vary by country.

9.2 ROLES, TASKS AND OBJECTIVES

The roles and responsibilities of a local plan actuary will depend on the country's legislative and regulatory requirements under which employee benefit plans operate as well as the type of benefit plan itself. Traditionally, actuaries have only been involved with Defined Benefit pension plans. However, in recent years, their involvement in Defined Contribution (DC) plans has increased as employers realise that the risk inherent in pension plans has not disappeared on the move to a DC plan but simply been transferred – fully or partially - onto employees. With the growth of medical plans, as well as increasing costs of disability benefits, the role of local actuaries has evolved significantly over the last 20 years.

Objectives of an Actuary

The key objectives of a local actuary can be summarised as follows:

- **Ensuring financial sustainability** of the pension (or benefit) plan in the long term
- **Meeting local regulatory requirements**
- **Providing other advice** and analysis to the employer or the Plan Trustee in respect of the pension and other benefit plans, including local custom and practice

Key Roles and Tasks

1. **Assessing the financial situation of a Defined Benefit pension** plan to ensure that the long-term financial sustainability of the plan is maintained. The actuary will perform regular valuations of Defined Benefit pension plans to assess the level of funding (how the value of assets compares to the value placed on liabilities) and recommend an appropriate employer contribution rate to meet its long-term commitments of the plan. The actuary may also recommend other measures (e.g. introducing less generous early retirement factors) to ensure this objective is met.
2. **Ensure compliance** with national legislation, e.g. in relation to minimum (and maximum) funding levels and appropriate disclosure of information.
3. **Calculation of plan expense and liabilities in a company's report and accounts for the purpose of accounting standards**. This task will require the actuary to use appropriate methods and assumptions, as set out in national and international accounting standards, in calculating the liability and expense amounts.
4. **Advice and analysis** related to pension plan design options (e.g. early retirement benefits or the change of benefit provision from Defined Benefit to Defined Contribution).

5. **Calculation of benefits** – benefit calculations in certain situations (e.g. early leaver benefits) may be complex and require the actuary to calculate or check the benefit entitlement, or draw up calculation methodology or factors to enable the plan administrator to correctly determine the benefit.
6. **Advice on the setting up and management of Defined Contribution pension plans** including projection of member benefits and the setting up of any reserves required where there are minimum investment return requirements to be met.
7. **Involvement with other benefits provision**. Some examples include:
   a. Determination of cost of benefits provided under a flexible benefits plan. For example, life insurance benefits in such arrangements will need to be priced in a different way when the employee can opt for different levels of coverage. This is due to the possible of adverse selection against the plan by the employee.
   b. Advice regarding multinational pooling of risk or the setting up of a captive insurance company.
   c. Calculation of plan liabilities and required contributions in respect of post- and pre-retirement medical plans.
8. **Other areas of involvement** include the carrying out of asset liability modelling and assessment of investment performance. The actuary may also become involved with keeping pension plan trustees linked to the other advisers, most notably, investment managers.

9.3 RESPONSIBILITIES AND LEGAL ISSUES

Although legal responsibilities and duties vary considerably by country, the actuary's responsibilities are to ensure that calculations are professionally carried out in accordance with any legislative guidelines or requirements and that the information disclosed meets minimum standards. Actuaries are responsible for the accuracy of the calculations they produce.

Professional standards set by the body representing actuaries provide more onerous constraints relating to the actuary's conduct. Such professional standards include:
- The actuary to recognise and appropriately manage conflicts of interest.
- The required levels of competencies an actuary needs as well as the requirement to undertake continuous professional development.

The professional bodies governing actuaries will also prescribe and manage the actuarial qualification system and produce guidance on issues such as setting assumptions, actuarial methods and levels of disclosure in reports produced by the actuary.

9.4 RELATIONSHIPS WITH OTHER PARTIES

The most important relationship the plan actuary will have will be with those involved with the management and key stakeholders of the pension plan itself, i.e. those responsible for overseeing the pension plan operation and for taking strategic decisions (e.g. the Pension Fund Foundation or Board of Trustees). The plan actuary needs to be well-placed to inform these stakeholders on the financial situation of the plan, the options to ensure the long-term sustainability and the impact of any legislative changes on the plan. Regular meetings will be set up to report on these and other aspects. The actuary will also be in close contact with the pension plan administrators (e.g. to ensure that benefit calculations are performed correctly), as the administrators role involves the day-to-day operations of the plan.

Other important relationships include:
- **The organisation's Finance function, including the Chief Financial Officer** – in respect of the financial implications of the benefit plans offered by the organisation.

- **The International Benefits Manager and Local Benefit Manager** of the organisation – providing strategic advice on the pension plan and other benefit plans. The benefit managers will be concerned that the company's benefit plans are effective in the recruitment and retention of employees at a cost which is acceptable for the organisation. The actuary will advise on how benefit plans can be changed to ensure that this objective continues to be met. Note: in order to avoid any conflict of interest, the actuary advising the company may be different from the actuary who advises the pension plan foundation or board of trustees.
- **HR function** – the actuary may input on the measures required to ensure that key employees are attracted to the company and then retained. This may include benefits for senior management, or certain groups of employees with skills that are valuable to the organisation.
- **Third-Party providers** – the actuary may need to liaise with insurers and investment managers to ensure all information can be collated for the valuation of the benefit plans.
- **Regulatory Authorities** – the actuary will liaise with the local Regulatory Authorities to ensure that regulations are adhered to and any tax approval is maintained. In practice, this could mean that information required by the local regulator is provided complete and within the prescribed time scales.
- **Auditors** – the actuary will work with the auditors to ensure that the latter can correctly audit the benefit plan as part of the trust's, and, where relevant, the company's, statutory report and accounts.

9.5 GLOBAL VERSUS LOCAL ROLES

In the past, multinational organisations may have simply considered each individual country responsible for the operation of their benefit plans and left each country free to appoint the local actuary of their choice. In the past 30 years, there has, however, been a move to appointing a Global Actuary – namely one actuarial consultancy is used and each local actuary is simply based in the local office of the consultancy. The coordinating actuary will normally be based in the same territory as the organisation Head Office and will coordinate the global actuarial services provided to the organisation. The move to such an arrangement has arisen partly from the requirements of the International Accounting Standards, which requires consistent treatment of local benefit plan valuations. The Global Actuary's role is to ensure that calculations are provided by each of the local offices on a consistent basis and in accordance with agreed time limits.

The Global Actuary will also have the role to ensure that economies of scale can be realised and that information about the organisation's worldwide benefit plans can be collated. This ensures that the organisations Head Office is aware of the types of benefit plans operated by local offices and can, therefore, fully assess the financial implications.

Local actuaries continue to play an important role, but increasingly are part of a wider relationship with their client company's Head Office; information technology transfer now makes this easier.

Summary

This Chapter has provided a brief overview of the local plan actuary including the typical objectives and responsibilities. It has incldued a summary of the main relationships and the global and local roles.

Self Test Questions

- What are the main objectives of the local plan actuary?
- What are the main relationships of the local plan actuary?
- What are the key responsibilities of the local plan actuary?

INTRODUCTION

The local regulator will have a significant impact on the nature of benefit provision in the country in question. Not only will regulations shape plan design through imposed minimum (and maximum) benefit requirements, but pension plan funding levels will also depend on minimum and maximum limits set out in national regulation. In addition, regulations regarding maximum tax incentives will also impact on plan design and funding levels.

10.1 BRIEF DESCRIPTION OF ROLE

The local regulator can be defined as the body responsible at a local level to ensure that the legislation is applied in practice. It will typically issue guidelines for benefit plans to follow. .'Local level' in this context may mean national but for countries whose legislation is organised on a federal basis, this may be at state or canton level (e.g. Australia and Switzerland).The local regulator may be specifically set up to solely monitor pension plans (e.g.'The Pensions Regulator' in the UK) but may also be part of an existing financial regulatory body (e.g. the Dutch National Bank in the Netherlands or a country's insurance regulators). In addition, there may be two separate regulatory bodies that monitor pension and benefit plan operations – one responsible for ensuring adequate funding and governance of benefits; and another who will ensure that plans adhere to tax regulations (often the country's tax authorities).

This Chapter is mainly concerned with the regulation of retirement plans given that these have the largest financial implications and have generally been built up with the aid of employee contributions. Regulations concerning other benefit provision, such as risk benefits and medical benefits, generally relate to an enforced minimum level of benefits that need to be provided.

10.2 ROLES, TASKS AND OBJECTIVES

Objectives of the Local Regulator

The key objectives of the local regulator in allocation to retirement plans are to:

- **Protect Employee and Member Rights** – by ensuring that the benefit plan is well run and, most importantly, has adequate funds to meet the benefit promises made
- **Ensure transparency** – employers are required to disclose certain information to ensure that members are informed and that the plans operations can be monitored
- **Avoid the abuse of tax incentives** – regulations will seek to ensure that retirement plans do not over fund simply to take advantage of any tax incentives.

Roles and Tasks

The regulator's approach may vary and generally will depend on the legal structures of the country in question, as well as tradition, culture, status and the expertise of professional bodies and the local regulator. For example, in the UK the Pensions Regulator adopts a risk based approach in when regulating pension funds.

The following are examples of different approaches and examples of instruments and approaches to regulation:

a. Regulation may set out the **legal form** in which retirement plans can be set be up, e.g. a trust, foundation, insurance company – the relevant legislation regarding these structures is then applied.
b. Regulation may be **'light touch'** with the pension funds themselves responsible for ensuring that benefits are provided to members, with them becoming liable to legal action if this is not the case. The pension fund may be required to use the services of certain professionals who are themselves regulated (e.g. trustees, auditors and actuaries), or are subject to stringent professional codes of practice. That is the retirements are not directly regulated but it is the professionals engaged in managing the plan who are regulated.

c. Regulation may set out **broad requirements** for retirement plans to follow. For example, they may require that liabilities are fully funded at all times, but leave the choice of assumptions and methods to the plan.
d. Regulations may be more **prescriptive** e.g. set out assumptions and method required for determining liabilities; specify the level of employee representation on pension plan management boards (e.g. at least 50% in Spain); prescribe the minimum level of benefits that a retirement plan must provide; detail the information that must be provided to members and how often.

Non-Compliance

Compliance with regulations needs to be assessed on a regular basis if those regulations are to maintain credibility. The ability of a regulator to do this depends on its powers and reach as well as the quantity and expertise of its staff. There are various measures that can be applied to retirement plans or those involved with their management for non-compliance. These include fines, disqualification of trustees and managers, and the removal of tax incentives.

Specific Areas of Regulation

1. Disclosure Requirements – information to be provided to members of the plan and regulators.
2. Funding - minimum and maximum levels to ensure adequate funding and to avoid the abuse of tax incentives. Regulators may provide guidance on the methods and assumptions to use to assess funding levels.
3. Qualified persons – minimum levels of training, experience or the requirement to hold professional qualifications may be applied to those managing the pension fund and for those advising it.
4. Minimum benefits – regulators will ensure that conditions set out in legislation for the benefits structure are complied with. These include conditions such as minimum benefits for DB plans or minimum levels of contributions for DC Plans; maximum vesting periods; rules on benefits payable to early leavers (e.g. deferred pensions must be increased at a minimum rate); minimum pension increase rates; the form in which retirement benefits must be taken (e.g. maximum amount in cash form); minimum spouse and orphan benefits payable on the death of a member and minimum disability benefits.
5. Investment Restrictions – regulators often provide guidance on the types of investments allowable and the maximum levels of investment in each asset class. A ‘self-investment’ limit may also be applied in many countries whereby a retirement plan cannot invest more than a specified percentage of pension fund assets in securities of the plan’s sponsor.
6. Member representation – regulations may impose minimum levels of employee representation on plan management boards and the requirement to get approval for significant benefit changes.
7. Other measures include non-discrimination and equality of treatment

Example
Country Examples: The country chapters in Part 4 set out more details regarding the regulation of benefit plans in those territories. Each country has a different approach and will use a mixture of the methods referred to above. Please refer back to the country chapters for the role of the regulatory bodies in the countries covered in this study manual.

10.3 RESPONSIBILITIES AND LEGAL ISSUES

Local regulators are typically a governmental body and, therefore, must ultimately answer to the government of the country concerned. Individual employees within the regulator may be legally responsible for work undertaken or be regulated by a professional body, for example, a qualified professional such as a lawyer, actuary or accountant.

10.4 RELATIONSHIPS WITH OTHER PARTIES

Regulators will maintain a close relationship with the plan's sponsor and other pension fund professionals, such as actuaries, lawyers and auditors.

10.5 GLOBAL VERSUS LOCAL ROLES

National legislation remains the key driver of benefit provision practice. However, within the European Union, pan-European legislation has taken an increasingly important role in the last 20 years. The main areas of EU involvement are:

- Minimum levels of benefit provision (mainly applying to employment terms such as maximum working hours and minimum periods of maternity leave rather than employee benefits)
- Consultation rights for employees on their employment benefits through Works Councils
- Equal treatment between men and women (e.g. same retirement ages)
- The Insurance Directive which simplifies the approval and regulation of multinational insurers
- The (IORP) Pension Directive which sets out minimum standards for pension plans in the EU and facilitates labour mobility and cross-border pension plans

These aspects of EU requirements are set out in more detail in Part 5.

Summary

This Chapter has provided a brief overview of the local regulator including the typical objectives and responsibilities. It has incldued a summary of the main relationships and the global and local roles.

Self Test Questions

- What are the main objectives of the local regulator?
- What are the main relationships of the local regulator?
- What are the key responsibilities of the local regulator?

INTRODUCTION

The term vendors describes providers of services to a pension or benefit plan. These services are those that the benefit plan deems that it cannot carry out itself or that it is more cost-effective for an outside party to provide or where Regulations require. These services can be a crucial element of a benefit plan's operation; therefore, the management of relationships with vendors by the international benefits manager and local benefit managers is important.

11.1 BRIEF DESCRIPTION OF ROLE

A vendor is a commercial organisation specialising in the provision of services to a benefit plan. They are also known as third-party providers, and provide a range of services to the plan.

11.2 ROLES, TASKS AND OBJECTIVES

The benefit plan will decide to appoint a vendor if those responsible feel they are unable to carry out a certain aspect (or aspects) of the plan's operation, it is considered that a specialist provider can carry out the function at a lower cost and/or to a higher quality, or if it is required by law. The aim of using a vendor is therefore to ensure the benefit plan meets its commitments to members, regulators and other stakeholders in an optimal way. From the vendor's point of view, they will aim to provide a service in a professional manner and to maximise their profit while operating within any legislative and regulatory requirements and applying general good practice.

The roles and tasks of vendors depend on the nature of the service provided. A list of some of the services vendors provides is set out below, although this list is not exhaustive:

11.2.1 Vendors in Respect of Pension Benefit Provision

- **Investment Managers** will be appointed to invest the assets of a pension plan according to the instructions agreed with the trustees, pension foundation or plan management board. Any document governing the operation of the plan will also be referred to, as well as any regulations regarding minimum and maximum investment limits or allowable investments.
- **Custodians** may hold the assets of the pension plan on behalf of the pension plan. Custodians are typically banks or other financial institutions. By being a nominee owner of the assets of the pension plan, they aim to safeguard the interests of the beneficiaries by preventing the plan sponsor, and other unauthorised persons, from accessing the funds.
- **Pension Plan Administrators** – the employer or Trustees may prefer to sub-contract the day-to-day administration of the pension plan to a third-party provider. The employer may not be large enough to justify the setting up of its own administration function in-house, or the employer/Trustees may simply prefer an external company to provide what is not a core activity for the employer.
- **Trustees or Management Board** – a pension plan may appoint a company to perform trustee or management duties for the pension plan.
- **Insurers** – although insurers will generally play a role in the coverage of death and disability benefits, a pension plan may decide to 'buy out' pensions in payment. Instead of having to pay pensions out of pension fund assets and contributions, the plan may prefer to pay a lump sum over to an insurer which then becomes responsible for making the outgoing regular pension payments, thereby transferring the investment and longevity risk.
- **Communication**– many employers are aware that the effectiveness of a pension plan in recruiting and retaining employees depends on the perceived value of the plan. This in turn depends on the quality and impact of communication – from brochures and booklets to online tools. Organisations/trustees will often appoint communication specialists to carry out this role on their behalf.

11.2.2 Vendors in Respect of Other Benefit Provision

- **Insurers** will provide coverage for the risk benefits payable to members and their dependents. These benefits include lump sums or pensions payable on the death-in-service of an employee, disability benefits and medical benefits.
- **Medical Service Providers.** An increasing number of employers provide medical benefits to their employees. In many cases, this may simply be the payment of a medical insurance premium but may also involve the direct provision of medical services to the employee. In the latter case, the employer will contract the services of a specialist medical service provider which will manage the medical service provided to employees.
- **Absence Management** – a number of employers use external providers to monitor their absence management policy. These services may also include disability case management and counselling.
- **Flexible Benefit System providers** – an effective Flexible Benefits system needs an efficient choice platform, including supporting administration and IT system. Most companies do not perform this task themselves and instead subcontract this to a specialist provider
- **Share Plan Administrators** – the management and administration of any Share Plan will typically be subcontracted to a specialist provider.
- **Communication** – as for pension plans, effective communication increases the perceived value of a benefit plan. Therefore, this function is often subcontracted to a specialist provider.

11.3 RESPONSIBILITIES AND LEGAL ISSUES

Each vendor will be responsible for providing the services agreed as part of the contract with the organisation/trustees/plan management board. A contract will be agreed and bind the vendor to a series of commitments regarding the quality of services provided (service level agreement). Any disputes between the parties will normally refer to the contract and be settled by negotiation or referral to the courts. National law or regulations will normally play less of a role in the operation of the contract, unless there is criminal behaviour or negligence on the part the vendor.

11.4 RELATIONSHIPS WITH OTHER PARTIES

Each vendor will need to have a close relationship with the international benefits manager, local benefit plan managers and plan sponsor. There may also be relationships between the vendor and other advisers/vendors. For example:

- The investment managers will need to liaise closely with the local actuary. This is essential as the investment manager will need to take into account the profile of the liabilities of the pension plan (amount, timing, nature, etc.) in determining an appropriate investment strategy:
- The investment manager will also liaise closely with the plan accountants and auditors in the completion of financial reports and accounts, as well as the trustees or pension plan management board:
- The insurers will need to liaise closely with the administrators of the plan so that claims are paid as quickly as possible:
- Other plan administrators will liaise with the plan accountants to ensure proper financial recording of benefit payments.

11.5 GLOBAL VERSUS LOCAL ROLES

With increased globalisation, multinational organisations are increasingly moving towards global vendors where one company provides all the services in each territory where the multinational operates. Multinationals are likely to appoint a preferred provider; local operations are then encouraged to appoint the local representative of this provider. The advantages of such an approach to the organisation's Head Office are:

- That it is easier to monitor and control one provider.
- There can be economies of scale that can be realised.
- Advantages of better insurance terms than are available when buying on a local level.
- Collation of information for reporting purposes is easier to organise. From the local operation's point of view, using global providers may afford it access to a greater range of services than if only a local agreement was made.

Summary

This Chapter has provided a brief overview of the role of the vendor including the typical objectives and responsibilities. It has incldued a summary of the main relationships and the global and local roles.

Self Test Questions

- What are the main objectives of the vendor?
- What are the main relationships of the vendor?
- What are the key responsibilities of the vendor?

INTRODUCTION

Advisers are commercial organisations that provide advice and guidance to those responsible for managing benefit plans within an organisation or company. The key difference between vendors and advisers is that advisers often carry out tasks that the employer does not have the skills to carry out, or that regulations insist that someone independent of the organisation must carry out the tasks, whereas in the case of vendors, the choice is typically whether the employer wishes to carry out the tasks itself or not.

12.1 BRIEF DESCRIPTION

Advisers provide guidance on the management of a company's benefit plan(s). They are often professionally qualified and include lawyers, actuaries, accountants and consultants. We have also included insurance brokers in this as, although not strictly advisers, they do advise the employer on the choice of insurance provider(s).

In many countries, employers are required to use advisers who have a certain minimum level of skills and experience (e.g. the requirement to use a qualified actuary to carry out a funding valuation of a benefit plan). Where this requirement does not exist, companies may use advisers in situations where they do not have the expertise to perform the task, or that they feel it is good corporate governance to involve an independent expert.

12.2 ROLES, TASKS AND OBJECTIVES

An adviser will bring a certain level of experience and skills to advise the employer or the plan. Using their professional expertise, advisers will aim to ensure that the plan is managed correctly from a financial and corporate governance point of view.

The roles and tasks of each adviser are set out below:

- **Lawyers** – with increasing emphasis on good corporate governance and the need to comply with local and EU legislation, the importance of good legal advice has increased over the last decade. Lawyers are heavily involved in a range of areas including:
  - **Drafting rules of benefit plans**. To avoid an ambiguous interpretation of the benefits to which an individual is entitled, lawyers will ensure benefit rules are clear and limit the interpretation to what the employer wishes to provide. In countries where trust law applies, **lawyers will also draw up the Trust Deed** which sets out the roles and responsibilities of trustees.
  - **Individual agreements with employees**. In certain cases, key employees may receive individual employee benefit promises to facilitate their recruitment or retention. To avoid any future dispute, a lawyer will assist in the drawing up of the letter or document which summarises the benefit promise.
  - **M&As** – when a company is purchasing part or all of an organisation, the lawyer will be closely involved to ensure a limit on the liability that the employer assumes. If, for example, the employee benefit liabilities being taken on are not clear, the employer will ask for indemnities from the Seller to limit these liabilities, and the lawyer will assist in the drafting of these indemnities.
  - **Terms and Conditions of vendors and advisers** – may also be drawn up by the lawyer to ensure that the basis under which a service or advice is provided is clear, and that the process by which a contract can be terminated is documented/unambiguous (e.g. number of months' notice).

- **Actuaries** will advise the employer or pension plan on the financial aspects of the pension and other benefit plans. The role of the Global Actuary is also set out in Part 3, Chapter 8; its tasks are to ensure close control and coordination of the financial management of an organisations global benefit plans. In particular, the role of the Global Actuary will include:
  - Coordination of accounting exercises, including those required by International Accounting Standards
  - Setting and monitoring common standards for the provision of locally provided actuarial services to ensure consistency of treatment and reporting
  - Facilitating economies of scale in actuarial advice
  - Providing global risk management advice
  - Liaising with other experts
- **Accountants** – produce the financial statements as part of an organisation's annual report and accounts. This is a critical task for an organisation. The expenses and liabilities related to the company's employee benefit provision will require close liaison between the plan actuary, which will provide the key disclosure figures, and the accountants, which are responsible for producing the report and accounts. The accountants will also need to verify that all elements represented in the annual statements accurately reflect the facts. For example, they will need to verify cash flows by liaising with the plan administrators and check the level of plan assets by liaising with its investment managers and custodians.
  The accountants will also need to check the assumptions used in the calculation of benefit expense and liabilities and will work closely with the actuary in this area, including whether the assumptions align with actuarial and global accounting standards.

- **Auditors** – pension plan accounts must be audited. In addition, accountants will audit the organisation's annual report and accounts including the elements relating to employee benefit plans
- **Consultants** – most organisations will use the services of a consultant in advising them on improving the effectiveness of their benefit plans, improving corporate governance and for providing benefits in the most cost effective way. Consultants will look at all aspects of the organisation's benefit provision and advise on different approaches that the organisation can take. There are a number of steps in the process:

Consultants will work closely with the organisation and may offer advice on a range of issues including:

a) The level and type of benefits that should be provided by the organisation and the implementation and/or management of the benefit plans
b) Provision and delivery of benefits (e.g. insured solution)
c) Advice on improving processes (e.g. more efficient benefit payment processes or selection of vendors)
d) Minimising employer risk and/or reducing employee benefit costs

e) Improving corporate governance processes
f) Miscellaneous areas of advice around employee mobility, setting up a Pan European pension plans, advice on employee benefit implications as a result of a merger/acquisitions, new country start-ups, etc.

- **Insurance Brokers** will advise the employer on the best provider(s) of insurance cover for the benefits they wish to insure. Although the insurer is often chosen on a price criteria, other factors will also be important; level of service, geographical presence, products offered and underwriting requirements.

12.3 RESPONSIBILITIES AND LEGAL ISSUES

Each adviser will be responsible for providing impartial and honest advice, as agreed between themselves and the organisation. There should be a mutual understanding that the adviser will avoid any conflict of interest; this is particularly important where advisers may recommend a particular investment or insurance product, and, as a result, are remunerated on a commission basis.

A contract will be agreed between the organisation and the adviser and will bind the adviser to a series of commitments regarding the quality of advice provided. Any disputes between the parties will normally refer to the contract and be settled according to negotiation, arbitration, or by referral to the courts.

National law or regulations will normally play less of a role in the operation of the contract, unless there is negligence or criminal behaviour on the part of the adviser. A further consideration is the threat of sanctions from professional organisations for misconduct or failure to prevent conflicts of interest by an adviser (e.g. for actuaries, accountants and lawyers).

12.4 RELATIONSHIPS WITH OTHER PARTIES

Each adviser will have close relationships not only with the benefit plan manager of the organisation, but also with other advisers and vendors. For example: the actuary will liaise closely with the accountant and auditors in the production of the organisations report and accounts in line with national and International accounting standards; the lawyer and actuary will work closely together on an M&A transaction; consultants will discuss with plan administrators the best way to ensure benefits are managed efficiently.

12.5 GLOBAL VERSUS LOCAL ROLES

As with vendors, multinational organisations are increasingly moving towards using global advisers where possible to ensure consistency of advice and provision of services. Part 3, Chapter 8 already covers the possible reasons for the appointment of a Global Actuary. There may also be preferred providers for the other advisory services, and local operations are encouraged to appoint the local representative of this provider. The advantages of such an approach to an organisation's Head Office are that it is easier to monitor and control; there are potential economies of scale that can be realised; the collection of information for reporting purposes is easier to organise. From the local operations point of view, using global advisers may allow it access to a greater range of services compared to local advisers as well as better insurance terms (e.g. free cover limits).

Despite the move to a globalisation of advisory services, local legal, actuarial and accounting advice is still invariably needed and, therefore, the role of any global adviser is to ensure that this local advice is correctly interpreted at a global level.

Summary

This Chapter has provided a brief overview of advisers including the typical objectives and responsibilities. It has included a summary of the main relationships and the global and local roles.

Self Test Questions

- What are the main objectives of advisers?
- What are the main relationships of advisers?
- What are the key responsibilities of advisers?

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.

It comprises eight chapters; one each for France, United Kingdom, Germany, USA, Switzerland, the Netherlands and Japan as well as another for a regional round up of Europe and North America.

INTRODUCTION

This Chapter describes some of the general principles and notable features of the employee benefit environment in countries across Europe and North America. In the other chapters of Part 4, we will address in more detail the benefits in seven countries, mainly in Europe: France, Germany, the Netherlands, Switzerland, and the United Kingdom as well as Japan and the United States.

1.1 OVERVIEW

Social Security and corporate employee benefits need to be considered against a background of the general economic and political environment that varies from country to country. In particular, the role of the State in benefits provision is, and is accepted by the population to be, a matter of specific social and economic policy. An example of this is the debate in the US during the Obama presidency as to the extent to which the State should be responsible for providing medical care to the population. The fact that this could be a controversial issue was seen to be hard for many Europeans to understand; in European countries, and many other developed countries around the world, a national system of medical care for all residents is almost taken for granted.

1.2 PENSION AND RISK BENEFIT PROVISION

1.2.1 Social Security

Retirement Age
Historically, State retirement systems have always had a "normal" retirement age, a time at which having to work was intended to end. In some countries, more flexibility, within limits, was considered to be needed and it is possible to start to draw a State pension earlier or later than the normal retirement age.

It is important to understand that State systems which have moved towards a defined contribution (DC) approach still need to manage the age at which the State pension starts to be drawn, particularly, if they are financed on a pay-as-you-go basis. In funded DC plans, choosing a different retirement age has no impact on the finances of the plan because the accumulated fund at retirement is used to buy an annuity or otherwise finance a retirement pension, and there is, by definition, enough money in the fund to do this. In contrast, in pay-as-you-go DC plans, where contributions received into the system are used to finance benefits paid on a year-to-year basis, the incidence of the benefit payments is important and can have a significant overall financial impact on the system.

Retirement ages do vary from country to country, but the following general points can be made:

- Even where there are significant variations in life expectancy from one country to another, it is striking that very few countries in Europe have ever had a normal State pension age of less than 60, and none currently has one of more than 70.
- Many countries used to offer a lower State pension age for women, despite the fact that women live longer than men in all countries where mortality statistics are prepared. This is increasingly no longer the case, due to the impact of sex equality legislation.
- The combination of increasing life expectancy, ageing populations (due to lower birth rates now than in previous generations), and lower economic growth in some cases, has led to significant imbalances in the financing of Social Security systems. Aside from policies to increase immigration or increase birth rates, there are only three measures that can be taken directly on the system itself: increase contributions, reduce the level of benefits, or reduce the period of time for which the benefits are paid, usually, by increasing the retirement age. The third option is finding increasing favour among Governments. In the 20th century, a retirement age of 65 for men, and 60 for women, was relatively common; in the 21st century, the trend is increasingly to 67 or 70 for both.

Most State systems have a fixed retirement age, or perhaps a retirement age that depends on the employee's year of birth (usually as a result of increases being phased in). Some systems feature a retirement age that also depends on the length of service of the employee, allowing employees with longer service to retire earlier. One argument in favour of this is that "blue-collar" workers tend to enter the workforce earlier and their life expectancy is shorter than their university-educated counterparts, who start work later but live longer.

Example: In **France**, the State pension may be drawn up to five years earlier than the normal retirement age. Normally, drawing the pension earlier will result in a reduction in the level of pension, but this reduction is waived if sufficient years of contributions have been credited.

Example: In **Italy**, the State pension may only be drawn earlier than the normal retirement age if sufficient years of contributions have been credited.

We are, however, starting to see explicit links between normal retirement age under state systems and life expectancy in some European countries.

Example: In the **UK**, the State Pension Age (SPA) is increasing in phases to 67 for men and women by 2028. The Government has introduced a regular and structured method for considering future changes in the SPA.

Example: In the **Netherlands**, the State retirement age will gradually be raised to 66 in 2018 and 67 in 2021, and, thereafter, will be linked to rises in life expectancy.

Benefits

As far as Social Security retirement provision is concerned, there is a contrast between the "welfare" and "insurance" approaches:

- a "welfare" system will concentrate limited resources on those who need it most, since the role of the State is seen to be to prevent citizens from becoming destitute and to provide them with a minimum standard of living which is not intended to be generous
- an "insurance" system where the benefits are more explicitly linked to the contributions paid, and there is no objection in principle to generous benefits as long as they have been financed by sufficient contributions.

Example: Denmark operates a "welfare" State retirement system: the same level of State pension is paid to all eligible residents (subject to a reduction if still in receipt of employment income).There are no State pension contributions as the benefit is financed out of general taxation.

Example: Portugal operates an "insurance" State retirement system: there is no ceiling on the State retirement benefit, calculated as a function of earnings without limit; but the same is true of the contributions, so a high earning employee pays very high contributions and receives a very high pension as a result.

"Welfare"-type benefits are necessarily small; what is sufficient for the poorest citizens will be immaterial for the wealthier ones. In contrast ,"insurance"-type benefits are in some (not all) cases relatively generous. This reflects an expectation that the State should provide the main source of retirement income for the majority of the population.

Example: Italy operated a defined benefit (DB) Social Security pension system until the 1990s, with a maximum benefit of 80% of salary, and with a very high salary ceiling (in some cases unlimited). From 1993, this was progressively replaced by a DC system. In order to reflect the primary role of the State in providing retirement income to Italy's citizens, the notional contribution rate for accrual to the pension accounts was set at 33% of earnings, with a very high earnings ceiling.

Most Social Security systems provide a DB, i.e. a benefit that is not simply linked to the amount of contributions paid. In "welfare" systems, the benefit is not linked to the employee's salary whereas in "insurance" systems there is a link, although the salary taken into account is usually limited. Common benefit designs include:

1 "flat-rate" pensions where the same amount is paid to all eligible pensioners, as long as a minimum period of service has been completed (if not, the pension may be "pro-rated")
2 "defined benefit" pensions, where the pension formula is of the form

P% x service x average covered earnings

where "service" may be limited to a maximum (often 35 or 40 years), and "average covered earnings" may be the average of the best n years of earnings over an employee's career, usually revalued to retirement in line with inflation or some other index, and subject each year to the Social Security earnings ceiling.

Note: In the case of "defined benefit" pensions, States have found that increasing the period over which earnings are averaged (n), or calculating average revalued covered earnings using revaluation factors that are less than the corresponding consumer price inflation factors, reduces the benefit (and, therefore, the overall cost of the system) in a less visible way than perhaps reducing the percentage P in the formula above, increasing contributions, or increasing the retirement age.

- "defined contribution" pensions, where the pension is explicitly derived from an accumulation of the contributions paid (by employer and employee) over the employee's career, expressed as a capital sum at retirement and then converted using a suitable factor into a retirement pension.

Note: In the case of funded Social Security systems, "defined contribution" pensions can operate in the same way as any other defined contribution arrangement, with the accumulating contributions credited with investment returns on the fund. However, in the case of unfunded Social Security systems where no investment returns arise, the accumulating contributions need to be revalued in line with a suitable factor. **Italy** uses annual increase in gross domestic product (GDP) for this purpose. In this way, the systems are in fact similar to "cash balance" occupational pension plans (see Part 2 Chapter 1).

In almost all cases, pensions in retirement are linked directly or indirectly to some form of consumer price index, either by formula or by an annual political decision. They also, generally, include some form of survivor's pension; such that after the pensioner dies, a [dependent] surviving spouse or partner will continue to receive a proportion of the pension.

Financing

We have seen that Social Security systems may follow the "welfare" or the "insurance" model, and may be DB or DC in design.

It is important to recognise that in neither case, with some notable exceptions, is it usual for the State to set aside contributions and accumulated funds for the purpose; nearly all State welfare and pension systems are financed on a "pay-as-you-go" basis. One argument for this is that if the State were to fund for the benefits by buying Government bonds, it would be lending itself money and the net effect would be zero.

Example: Hungary introduced a system of partly-funded State pensions and funded non-state provision. A portion of the State contributions were paid to individual funds for each employee. However, in 2010, as the economic crisis drained away revenues, the Government gave retirement plan members the choice to keep their private plans and give up the right to a state pension or transfer their accumulated funds into the state system. This "nationalising" of individual investment accounts - effectively confiscating them in exchange for a future (unfunded) promise of a retirement pension - returned monies to the Government for its operating expenditure.

The design of "insurance" systems should, in theory, relate the benefits explicitly to the contributions. However, financial pressure to seek new sources of revenue and political pressure to focus these new contributions on higher earners has increasingly led to contributions being less related to benefits, particularly for higher earners.

Example: In many countries, such as Belgium, Social Security contributions are not subject to an earnings ceiling, but benefits are. Employees earning in excess of the Social Security earnings ceiling pay additional contributions on additional earnings but do not earn additional benefits as a result. The additional contributions are effectively an income tax, although, in practice, as these typically help to fund the entire benefit system, the principle of social solidarity is a key justification.

In some cases, both for "insurance" and "welfare" systems, Social Security contributions are separately identified by programme. It is possible then to measure the annual operating surplus or deficit of the retirement programme (i.e. total contributions received minus total benefits paid). The existence of a continuing, indeed growing, deficit is then used as a justification to amend the benefits or contributions or both.

In other cases, contributions have become less and less related to the benefit calculation. Setting the contribution rates then becomes more of a political decision.

Example: The United Kingdom levies "National Insurance" (NI) Social Security contributions on employees as well as income tax. However, both NI contributions and income tax receipts are paid to the same authority (Her Majesty's Revenue & Customs, or HMRC). Until the 1980s, the UK Government published a breakdown of the total NI contribution to show how much was spent on what benefit. Since then, it has not done so, and does not separate NI and income tax in terms of allocating finances. For example, it cannot be said that the National Health Service is financed only by NI contributions, or, indeed, only by income tax.

Taxation

In most countries, Social Security contributions are paid by both employers and employees. Employer contributions are tax deductible as a business expense. They are not included in the employee's income as a taxable benefit.

In most countries, employee contributions are tax deductible for income tax purposes. Exceptions to this include the **United Kingdom** and **United States**. In Germany, there is a tax limit on deductibility which typically means that a portion of the contributions of higher-earners will not qualify.

Most countries subject Social Security pensions in payment to income tax, although this may only apply to a portion of the payment, as in the United States, or special reliefs for pensioners may be available. In Germany, where the State pension was originally exempt, a transition to full taxation in 2040 is operating (the taxable percentage is set by reference to the year in which the pension commenced).

Social Security pensions are also not generally subject to Social Security contributions (with some notable exceptions such as **France** and **Germany** where contributions for health care are deducted from Social Security pensions).

This means that when considering the "replacement rate" (an employee's retirement income expressed as a percentage of income immediately before retirement), it is important to consider the "net" position (after tax and after Social Security contributions). A pre-tax pension of 80% of pre-tax salary before retirement may well represent an after-tax "replacement rate" of nearer 100%.

Trends

We have already identified some of the trends in Social Security provision above. The most important trends are:

- Increasing life expectancy, an ageing population, and slower economic growth in many cases are causing strains on the finances of Social Security systems worldwide
- Increasing life expectancy is leading to increases in State retirement ages; this is seen as controversial in a small number of countries
- Financing pressures are causing the role of Social Security to be reassessed, particularly for higher earners; the link between contributions and benefits is becoming more tenuous
- Attempts to introduce a funded component have encountered several obstacles: the fact that one generation would effectively pay twice (i.e. paying for their parents' or grandparents' pensions on the pay-as-you-go system, while simultaneously building up funds for their own pensions), the need to offer guarantees relating to investment returns, and the lack of market investments sufficiently large to actually absorb all the contributions being made, other than through Government bond issues. In addition, the political temptation to make other use of the accumulated funds in times of crisis (Hungary being perhaps the most extreme example – see above).

1.2.2 Employer-Provided Benefits

The dividing line between Social Security and employer-provided, or occupational, retirement provision is sometimes unclear, typically, in circumstances where a mandatory provision is imposed by the State. Examples include:

- France – the régimes complémentaires levy compulsory contributions at rates that cannot be chosen by the employer; they are used to finance retirement benefits on a national, pay-as-you-go basis. But they are run by non-State institutions and the contributions and benefits are decided by employer and employee representatives appointed to them, in contrast to the French Social Security system where they are decided by the State. (It should be pointed out that these systems are so similar to Social Security that they are expressly included in the EU Social Security treaty – see Part 4 Chapter1 and Part 5.)
- Italy – for companies with over 50 employees, the TFR (trattamento fine rapporto or termination indemnity) is the obligation to pay one additional month's salary each year, either into a pension fund or otherwise directly to the Social Security authorities who "administer" it on the employer's behalf. In the latter case, it is used to finance a leaving service benefit on a pay-as-you-go basis, distinct from the regular Social Security retirement benefit.

In most cases, though, employer-provided (or "occupational") retirement plans can be defined as plans where the employer, either individually or collectively (such as through an industry-wide association), has an influence over some aspect of the retirement plan; in the vast majority of cases, the employer may freely decide to design, implement and contribute to the plan, within the constraints of legislation.

Occupational retirement plans may be grouped into the following broad categories:

- Design : DC or DB
- Form of benefit : single lump sum or regular pension (or a combination)
- Method of funding: self-administered, insured, or "unfunded".

We examine below examples of each of these in turn.

Benefit Design

As discussed in Part 2 Chapter 1, the design of retirement plans covers a spectrum from "pure DC" to "pure DB". At the "pure DC" end, contributions are paid by employer and/or employee, and the resulting benefit is based on the accumulation of the contributions and any investment return credited to the plan, giving a capital sum at retirement age which is either paid out as such or converted into a series of regular pension payments.

The investment return and conversion into pension is dependent on external factors and no further payment is required from the employer in relation to the period of service in question. At the "pure DB" end, the benefit is defined in terms of a formula usually including salary and period(s) of service, and the ultimate cost of the benefit is met by the employer, perhaps offset by contributions by the employee which are, however, fixed (either in relation to pensionable earnings or the employer's contribution) . In between, there are various types of benefit design where the risks are shared between employer and employee, often called 'hybrid' plans.

Example: Historically, Norway did not permit DC plans, they are now relatively commonplace.

Example: Denmark required all retirement plan assets to be "ring-fenced" for each employee, or, in other words, for each employee to have their own identifiable "pot" of assets, thus effectively prohibiting the "cross-subsidies" or "solidarity" underpinning all DB plans. In practice, it imposed DC provision for all.

It is important to understand that from an accounting perspective, any plan that is not "pure DC" from the employer's perspective, i.e. where there is a risk, however small, of the employer having to make further contributions in respect of a prior period of service, is by definition DB.

In the majority of countries there is a clear trend away from DB and towards DC plans, due in part to global benefit strategies of multinational employers, combined with international accounting standards (discussed more fully in International 2) that are being adopted by an increasing number of countries and which require proper recognition of DB promises in companies' accounts.

Form of Benefit at Retirement

An occupational retirement plan will provide a retirement benefit in either or both of the following forms:

- a single lump sum at retirement, or
- a regular pension payment starting at retirement, usually monthly, and usually until the retiree's death.

In the latter case, a reversionary spouse's/dependent's pension is sometimes payable: when the retiree dies. This means that a proportion (typically 50% or 60%) of the pension is paid to the dependent spouse or civil partner, with perhaps a smaller proportion (typically 10%) being paid to dependent children while they are still minors or undergoing full-time education.

The majority of retirement plans provide lifelong pension payments. The main exceptions are:

- retirement indemnities – lump sums paid by employers, often in the context of industry-wide or national collective agreements or legislation, and usually (but not always) unfunded (see also Chapter 4 at 4.2)
- countries where the tax treatment of lump sums on retirement is favourable compared to pensions. If this is not the case and lump sums are taxed as income, a single large payment could push the retiree into a higher tax category for the year of receipt. The higher rate of tax would discourage the retiree from receiving the benefit in single lump sum rather than regular pension form.

It is important to understand that, in the large majority of cases, the choice between annual pension and single lump sum is determined by tax considerations.

Example: Belgium offers a concessionary rate of tax on lump sums from retirement plans. Despite recent modest increases of the concessionary rate, it is still less than the typical marginal rate of income tax paid by retirees, thus encouraging retirees to take their retirement benefit in lump sum form. Even if they consider that a regular series of payments might suit them, it would typically be more efficient for them to take the cash and use it to purchase a pension annuity.

Example: the United Kingdom allows retirees to take 25% of their retirement benefit in lump sum form free of income tax. The majority of retirees in the UK take this option, although in many DB plans, the "commutation factors" – the "rate of exchange" between the annual pension and single lump sum – may not have been updated to reflect longer life expectancy, and, therefore, the amount of lump sum offered in exchange for pension given up may not reflect its true lifetime economic value.

In some cases (such as the Netherlands), retirement plans may only pay benefits in lifelong pension form; lump sum payments from the pension plan are prohibited. However, the Netherlands is introducing legislation to allow DC plan members to not have to purchase an annuity immediately. Instead, the member can retain some control over how the funds are invested after their retirement.

Method of Funding

Employer-provided retirement plans can be funded in one of three principal ways:

- self-administered: the plan has a separate legal identity, receives contributions from the employer and, perhaps, from the employees, invests and accumulates assets, and pays the benefits when they fall due
- insured: the plan is in the form of a policy or contract with an insurance company or similar institution. The insurance company receives the contributions from the employer and, perhaps, from the employees, manages the assets and pays the benefits when they fall due. It also may offer guarantees relating to investment returns, lifelong annuity payments, etc., but does not always do so
- unfunded: direct payment of benefit from employer to beneficiary when they fall due.

Self-administered plans, by their nature, require a considerable involvement by the employer, and are, therefore, prevalent where this is an effective solution, i.e. generally where retirement plans are large enough to justify this approach. This is the case in countries such as **Ireland, the Netherlands, Switzerland** and the **United Kingdom** in Europe, as well as some other countries, such as **Canada, the United States, South Africa**, etc. Common factors among these countries are

- size, i.e. the existence of companies employing enough employees to justify this approach
- a favourable tax system offering tax reliefs on contributions paid to suitable retirement plans. Without such tax relief, it is doubtful whether such plans would have developed
- the limited role of the State in providing for retirement benefit, leading to many employers supplementing their employees' retirement income
- many commentators believe that the existence of a less prescriptive legal system (i.e. common law as opposed to Roman law) has facilitated the emergence of employer-specific legal entities established to provide retirement benefits to their employees.

Insured plans, or insurance contracts, are, by their nature, simpler to establish, requiring only a contract to be signed between the employer and the insurance company. The latter will generally fulfil all the required administrative and reporting duties. The reasons why some employers favour the self-administered route are flexibility (insurance contracts are by their nature more "standardised" than the "clean sheet" approach afforded by self-administered arrangements) and cost per head (there is a point at which the economies of scale of the self-administered approach outweigh the extra effort required). They are prevalent in countries where the role of the State is more significant and, therefore, the contribution required to an occupational plan is smaller per employee. This approach may also be used in countries where legislation is less flexible, plan form, design or financing choices are limited, and, therefore, there are fewer advantages in taking a self-administered approach.

Unfunded plans, or "direct pension promises", are perhaps the simplest to establish but require a long-term commitment from the employer, as the employer is responsible for payment of the benefit until the death of the retiree (and any follow-on beneficiaries). In contrast to most insured plans where the insurer generally bears all

the risks relating to payment of the pension once the pension has started to be paid, these remain entirely with the employer. In practice, this approach is usually taken for tax reasons:

- either because of specific tax advantages granted to unfunded plans; these are no longer as usual as they once were, the most notable example being Germany, or
- because no tax relief is granted, or tax penalties are payable, on the funded alternatives. Examples include executive plans in many countries such as the United States and the United Kingdom.

Retirement Age

The normal retirement age in most DB plans is typically linked to the State retirement age. This is particularly important in countries where the State benefit provides a significant part of a retiree's income. It would be unlikely in such a case that the employee would be able to afford to retire before State retirement age, receiving only the occupational retirement until that point.

Historically, female normal retirement ages were in many cases lower than their male equivalents, although these are increasingly being harmonised.

It is important to understand that the notion of normal retirement age in a DC plan is not as significant as in a DB plan. This is because the retirement benefit in a DC plan is the pension that can be purchased by the fund accumulated at retirement, whenever that may be. As long as the conversion factors (for converting the fund at retirement into an annual pension) are actuarially fair, there should be no overall impact on the plan's finances (apart from cash flow timing issues) if an employee decides to retire earlier rather than later.

Also, recent legislation in the EU is in the process of outlawing the concept of normal or "default" retirement ages in employment contracts. Although there are many exceptions, the objective of the legislation is to prohibit employers from dismissing employees purely on the grounds of age. The concept of "normal" retirement age in retirement plans will no doubt need to be revisited, with retirement (i.e. ceasing to work and starting to draw a pension) becoming possible at a range of ages.

Finally, in countries as part of national workforce management programmes, partial retirement is possible in years leading up to normal retirement. In Germany, under an Altersteilzeit (old-age part-time) working arrangement, the employee works part-time for which he receives a proportion of his salary and also becomes eligible for a proportion of the pension for the period.

Taxation

Taxation is an important issue as it is a key driver for the design of retirement plans. Many instances of design differences from one country to another may be explained as a consequence of different tax systems, offering advantages in a different way at different levels in respect of each different plan design.

Students will often encounter descriptions of pension taxation systems as "TEE",“ETT“, and "EET". This refers to the three stages at which taxes may be levied in relation to pensions: on contributions paid into a fund, on investment returns on assets in the fund, and, on pensions or other benefits paid out of the fund. So, an EET system is Exempt-Exempt-Taxed:

- contributions are exempt from income tax (i.e. income tax relief is given on contributions); the norm is that this refers to the individual who is not taxed in respect of the employer's contributions or own contributions
- investment income earned by the fund is exempt from taxation (income tax or capital gains tax); the norm is that this refers to both tax-free accumulation within the fund and not attributed to the beneficiaries
- benefits paid out of the fund are taxed to the recipients (e.g. as income).

The attraction of an EET system, which is the most widespread pension taxation system around the world (subject to various limits on reliefs given), is that the tax benefits are obtained “up front”.TEE or TTE systems rely on the contributor having the confidence that the Government in question will not simply change the rules before the contributor retires, restricting or eliminating the future tax reliefs that were promised.

Example: the European Union encourages Member States to adopt the EET system, although some States including the UK operate a system that is partly ETT. The exceptions are Luxembourg (TEE) and, in the case of some plan vehicles, Germany.

Finally, it is important to remember the significance of social charges (contributions other than income tax that are payable by employers and/or employees on salaries), and to ensure that exemption from income tax also implies exemption from social charges. If not, the relief is effectively only partial, and, in some countries, such as France, employer and employee Social charges are much more significant than income tax, except for the highest earners.

1.2.3 Pension System Examples

Below are some further examples of different pension structures that have developed in Europe and North America which illustrate some of features described above.

Turkey

Turkey illustrates a generous social security system that might have been found in Western European economies 30 or 40 years ago. Due to the favourable demographics currently, there is less pressure to reduce the cost of the current system. One area of generosity is the relatively low retirement ages, although Turkey is addressing this with a gradual increase in the retirement age.

Turkey also illustrates a mandatory benefit system (termination indemnities) as well as an emerging third pillar pension market, first established in 2004. Further details are provided below.

Current retirement ages for Social Security are 60 (M) and 58 (F), but are increasing to 65 for men by 2046 and for women by 2048.

State Benefits

Contributions: 21.5% - 27% of salary for employers; 15% for employees. Both are capped at earnings ceiling.

Benefit: the system now provides a pension of 2% of pensionable salary per year of service; maximum benefit is 90% of provision.

The minimum monthly pension is at least 35% (or 40% if the employee has a spouse or child under their responsibility) of the minimum monthly wage.

Compulsory termination indemnities

These require the employer to pay an amount equal to 30 days’ gross salary in the event an employee leaves the company (payable in almost all circumstances of departure, so death, disability, voluntary resignation, retirement etc.). Given the DB nature of this obligation, companies are required to establish a provision in their balance sheet to meet reflect this future obligation.

Private Provision

Initial pension legislation dates back to 2004, but new arrangements were launched in 2013. The system currently includes 17 pension companies (typically insurers and banks’ subsidiaries) with 201 funds. The system is DC using individual policies to which the employer can contribute. Employer contributions up to 15% of the employee’s salary or annual minimum wage (whichever is lower) are deductible by the employer.

The employee's contribution cannot be deducted from income tax; however, the Turkish Government matches 25% of employee contributions up to annual minimum wage. Full vesting requires 10 years in the system, although access to funds is possible before with loss of tax incentives. Retirement benefits can be taken from age 56.

Poland

Poland is a good example of a country that has reformed its social security and supplementary retirement systems. In effect a new environment was introduced for those below the age of 30. Those aged over 50stayed in the old system, whilst the rest had a choice.

- Social security (Pillar 1): Notional DC plan. Mandatory contributions of **17.22%** must be paid in **equal share** by the employer and employee. The account value of each member's funds are increased using an indexation rate as set by the Government. At retirement, the account value is converted to a pension at retirement using factors related to life expectancy.
- Compulsory employer-sponsored pension provision (Pillar 2): each participant chooses one of 13 pension funds (OFEs) into which there is a contribution of 2.3% of salary. Again it is required that the cost of this is shared equally between employer and employee
- Voluntary employer-sponsored or individual plans (Pillar 3). There are limited incentives for Pillar III (employer contributions were exempt from social charges) although the income roll up is free of tax. This reform was praised by many as the natural heir to the Chilean pension system.

However, like many other countries in Europe, Poland was forced to scale back the system in the wake of the 2008 financial crisis and considerably reduced the share of contributions to Pillar II. Under reforms in 2014, participation in Pillar II will become voluntary rather than compulsory. More than half of the assets accumulated in privately managed Pillar II pension funds (OFEs) will be transferred to Pillar I.

Sweden

Sweden is another example of a country with a compulsory second-tier pension system. Their system was last reformed in 1999; with all those born after 1954 participating in the new system. The new system provides:

Social Security: the employer contribution is 31.42% of total pay (which covers not only pensions, but also a number of other social benefits), employees pay 7% of a capped amount

The pension benefits consist of three elements

- Income Pension – financed on a Pay-As-You-Go basis by employer contributions representing 16% of an employee's gross annual income.
- Premium Pension – financed through an additional contribution from the employer equal to approximately 2.5% of the employee's gross annual income.
- Guaranteed Pension – for those who have never worked or with low lifetime income

The system targets an overall benefit of 55-60% of salary after 40 years

Compulsory second-tier

The pension coverage provided to employees via their employer, as a component of salary, which is also known as collective agreement pension, the ITP Plan (for salaried employees) and SAF-LO (for workers) are examples of two DC plans established under a collective agreement. For employers that are members of the Swedish Employers Confederation, provision through these plans is mandatory; for other employers adhering is by irrevocable choice. Non-participating employers normally establish a broadly equivalent-value occupational DC plan in order to provide a competitive benefit for their employees.

There is limited need for voluntary pension, but that which does exist consists of private pension insurance based on voluntary savings.

Canada

Like many other countries, the Canadian system operates on three pillars. However, in Canada, the pension system is more complex since most private sector employers are covered by provincial legislation. National legislation can have some influence or be the primary source in the case of banking and national transportation sectors. A number of provinces have or are in the process of implementing new legislation.

Social Security:

- Old Age Security – flat rate pension funded by tax revenue. Benefit depends on years of service; maximum is CAD564 per month (the benefit is means-tested and tapers down to 0 if income is between CAD 72,809 and CAD 117,909 per annum).
- A Guaranteed Income Supplement (GIS) can top up benefits to CAD 764 per month if certain conditions are met
- Canada Pension Plan (or Quebec Pension Plan) – CPP is funded by 4.95% (QPP rate is 5.25%) contribution payable by both employer and employee. Pension is based on service and earnings with a maximum pension of around CAD 1,065 per month.

Private Pension

The private sector continues to shift away from DB pension plans. This strategy is typically executed in a multi-phased approach beginning with the freezing of the DB provisions. More frequently, private sector plan sponsors are looking for opportunities to de-risk their programmes with an "end game" of exiting the DB programmes at the most opportune time. This de-risking strategy tends to follow a glide path approach where the plan's asset mix shifts more to a fixed income bias as the solvency position of the plan improves over time. Public sector and multi-employer programmes continue to favour DB plans.

DB plans are often salary-related (i.e. career average or final average typically averaging over 3 or 5 years). Many of these programmes require employee contributions typically ranging between 4-5% of salary. Traditionally, such plans had a 1.5% or 2% accrual rate inclusive of State benefits.

Summary

This Chapter included a brief overview of Europe and North America that outlined the scope and nature of both public and private retirement benefit arrangements. It has drawn out common themes across the regions.

Self Test Questions

- What is the impact of retirement age on retirement benefit design across Europe?
- Where are hybrid arrangements most common?
- What is the impact of taxation on retirement benefits in these regions?

INTRODUCTION

A generous pension is provided by the State as well as compulsory bipartite "complementary schemes" (AGIRC and ARRCO, operated on a national level by employer and employee representatives). Employer-provided supplementary retirement benefits have not been widespread, with relatively low contributions/benefits, and generally focused on higher earners. Social Security reimburses most, but not all, of the cost of medical treatment; the majority of employees benefit from employer-provided supplementary medical insurance which pays for some or all of the difference. Employer-provided death and disability benefits are widespread in larger companies. Flex benefits are relatively rare.

21 ECONOMIC AND EMPLOYMENT OVERVIEW

France is one of the main economies of the EU. However, the country's economic fundamentals have suffered the impacts of the economic and financial crisis of 2008 and of the subsequent sovereign debt crisis in Europe:

- The public debt has risen;
- The market has become less competitive;
- The French companies have lost market share;
- The unemployment rate has risen significantly;

Therefore, the strategy for recovery initiated in 2012 is articulated around 3 pillars:

- Balancing the public accounts;
- Implementing reforms to improve the corporate competitiveness, ease the regulations and stimulate investments, growth and innovation ;
- Fighting unemployment (9.6% currently against 5.9% for the OECD), especially the long-term unemployment rate;

Some positive results can already be seen: the public deficit has decreased from 5% of GDP in 2012 to 3.4% in 2016, i.e. the pre-crisis level. Economic growth reaches 1.2% in 2016 and is projected to 1.4% in 2017 (from 0.3% in 2013) and the private sector is now finally hiring again.

France has strict employment and labour laws as they apply to employment contracts, wage and hour, terminations and anti-harassment and discrimination laws. The terms and conditions of employment are determined by statute, case law, and collective agreement. At the national level, employee-management relations are characterized by consultation and cooperation. Trade union confederations and the employers' associations meet to study and seek solutions for employment problems, such as skills development and training and unemployment.

As a result of legislation adopted in 2007, the Government is required to consult with unions and employers' associations on all proposed reforms affecting individual or collective employment relations, employment, and vocational training, with the goal of negotiating national inter-industry agreements. If an agreement is reached, it provides the framework for proposed legislation; if an agreement is not reached, the Government is free to draw up its proposed legislation. Each year, the Government is required to develop an agenda for "Social dialogue".

Despite the collaboration between the "Social partners" (government, employees, and employers), workplace conflict persists. Strikes are generally called during periods of corporate restructuring, especially if the unions and management cannot reach agreement on a "job protection plan". They also are used as a political tool to protest against Government or EU policies.

One particular feature of employment in France is the separate legal status of cadres—broadly, management and professional employees. Some aspects of employment legislation are different for cadres and other employees [non-cadres]. As far as employee benefits are concerned, national collective agreements generally prescribe different benefits for cadres and non-cadres, particularly concerning end-of-service indemnities; the national complementary pension scheme AGIRC is for cadres only.

France raises much more revenue from social charges than it does from income tax. Employers typically pay charges of up to 45% on earnings paid to employees, while employees pay up to 25% in social charges, most of which are deductible for income tax. But the allowances for income tax are such that, for example, an average earner with a non-working spouse and 2 dependent children is unlikely to pay any income tax at all. The highest marginal rate of income tax is currently 45%.

2.2 PENSION AND RISK BENEFIT PROVISION

Overview: A compulsory pension is provided from at least two sources to all private employees: the basic Social Security scheme and the ARRCO national complementary scheme; the AGIRC national complementary scheme provides a third source for cadres. Each provides a benefit broadly based on revalued career-average earnings on defined slices (tranches) of earnings; most employees may expect a pension of 40%-65% of final salary (those whose salary increases faster and particularly later on in their careers, will see a lower replacement rate). Some, particularly larger, employers offer supplementary insured arrangements (nowadays almost all defined contribution (DC) except for some legacy plans). Lump sum death and disability benefits (in addition to the Social Security benefits) are provided by almost all medium and large employers.

2.2.1 Pillar I: Social Security (CNAV Régime Général)

The first source of pension consists of a 'pay-as-you-go' State provision. Retirement age is subject to a relatively complex definition explained below. Different arrangements apply to public sector employees and to employees in some former State-owned industries.

Retirement Age

As of 2010, employees may retire at any time between age 60 and 65. An individual's "full-rate" retirement age is the age at which he or she achieves the required number of quarters (periods of 3 months) of coverage in the system for a "full-rate" pension, subject to a minimum of age 60 and a maximum of age 65. (There are a number of special cases which are outside the scope of this text.) Legislation was passed in November 2010 increasing these minimum and maximum ages in steps from 2011 to 2017 up to 62 and 67 respectively (there are special provisions to allow certain employees with disabilities, very long careers, who worked in arduous jobs and women who have raised at least three children to be able to continue to retire at 60 or even earlier).

The required number of quarters of coverage for a "full-rate" pension has been increasing steadily since 1993 when it was 150. Since 1 January 2009, it has been increasing from 160 by one-quarter per year reaching 164 in 2012. It will increase as needed to keep the ratio of the contribution (coverage) period to the average pay-out (retirement) period at 2:1; it is expected that, by 2035, the required number of quarters would be 172.

Benefits

The Social Security pension calculation is based on the following formula:
Where

$$\text{Rate} \times \text{Averaged Salary} \times QA / QMAX$$

- Rate = the maximum rate of 50% is reduced by a percentage determined by the difference between the number of quarters credited and the number of quarters required to receive the maximum rate, with consideration for individual's age and total period of insurance. The most advantageous calculation for the individual is used.The minimum rate is 37.5% for individuals born in or after 1953.
- Averaged Salary or Average Annual Earnings = Average covered earnings (up to Social Security ceiling) in the best 25 years during the employee's career, for all individuals born after 1948. Covered earnings are revalued to retirement age, but the applied revaluation factors are not the same as, and have historically been lower than, the increases in the Social Security ceiling. (For example the 1990 ceiling revalued to 2016 is less than the 2016 ceiling, and therefore the pension for someone retiring in 2016 on a full-rate pension will always be less than 50% of the 2016 ceiling because of the averaging effect.)
- QA = Actual quarters of coverage within the Régime Général (not exceeding QMAX), which include both periods of contributions paid to the various basic schemes and periods treated as such, i.e. periods of cessation of work in case of sickness, maternity, disability, industrial injury, military service, unemployment, etc.
- QMAX = Required quarters for a 'full-rate' pension (see Retirement Age above)

Important Note: Therefore, if someone retires before the maximum retirement age and without the required number of quarters for a "full-rate" pension, they suffer two reduction factors applied to the full-rate pension of 50% of averaged salary: first, the QA/QMAX factor, and second, the reduction in the 50% rate itself.

Reversion pension and widowhood allowance

Reversion pension: Subject to specific conditions of age and income, reversion pensions are paid to surviving spouses or surviving former spouses aged at least 55, whose income is below a given level. Persons whose spouse died prior to 1st January 2009 and who fulfilled the qualifying conditions at that date, are entitled to a reversion pension from age 51.The amount of the reversion pension may not exceed 54% of the deceased spouse's pension or the pension to which the deceased spouse would have been entitled.

Widowhood allowance: paid under certain conditions to support the surviving spouse until they find a job or go back to work. It is a temporary benefit payable to any person under 55 years of age whose personal income is below a certain level (□2,260.27 per quarter).The amount of the benefit is □ 753.42 per month.

Financing

Contribution rates to URSSAF for the Régime Général amount to 6.90% (employee) and 8.55% (employer) of salary up to the Social Security ceiling (□39,228 p.a. in 2017), and a further 0.405% (employee) and 1.90% (employer) on total salary, for old age and survivors' pensions. "Salary" in this context means total cash remuneration, plus the cash value of some taxable benefits-in-kind.

Taxation

Employee contributions are tax deductible. Employer contributions are treated as a business expense. Benefits in payment are treated as taxable income.

Trends

Continued increases in life expectancy and an increase in the ratio of pensioners to active employees (despite a high, by European standards, birth rate) mean that corrective action will continue to be required for the foreseeable future.

222 Pillar II: Complementary Schemes (ARRCO and AGIRC)

In addition to the general Social Security system, all private-sector employees are covered by mandatory complementary pension schemes. These are pay-as-you-go schemes designed, in theory, whereby the contributions collected will be in balance (often called 'répartition') ; for EU purposes, the systems are considered part of the Social Security system and are included in the scope of the EU Social Security treaty (regulation 883/2004 which replaced 1408/71) rather than the EU IORP Pensions Directive. They are "bipartite" (managed by representatives appointed from the trade unions and employer federations), although the State negotiates a subsidy every few years to finance the cost of unreduced retirement at ages below the maximum State retirement age.

ARRCO (Association for Employees' Supplementary Pension Schemes) and AGIRC (General Association of Retirement Institutions for Executives) are each technically federations of a number of individual schemes or "caisses", although, in practice, they can each be regarded as one scheme. All ARRCO caisses offer the same terms for their benefits; all AGIRC caisses off the same terms for their benefits. Note that from 1 January 2019 ARRCO and AGIRC will be merged into one single grouping of caisses.

Both AGIRC and ARRCO are "points-based" systems: contributions are used to buy pension points, which are converted into pension rights on retirement.

There are several key variables to consider:

- Tranches A, B, C, which are slices ("tranches") of earnings:
  Tranche A = earnings up to the Social Security ceiling (SSC [2017]: €39,228)
  Tranche B = earnings between 1 and 4 times SSC (for non-cadres ARRCO only covers earnings up to 3 x SSC)
  Tranche C = earnings between 4 and 8 times SSC

- Reference Salary: this is not a salary at all, but instead can be considered as the purchase price of a point. 2017:
  ARRCO €16,1879
  AGIRC €5,6306
- Point Value: This is the annual value of a pension point (conversion rate); for retirements in
  2017: ARRCO €1.2513
  AGIRC €0.4352

- Contribution Rate Technically, the "contractual" contribution rate. This is the percentage contribution applied to each tranche of earnings that buys points. The standard contribution rate for 2017 is as follows:
  - *Non-cadres:* 6.20% of Tranche A and 16.20% of covered earnings in Tranche B, to ARRCO
  - *Cadres*: 6,20% of Tranche A to ARRCO, and 16.44% of Tranches B/C to AGIRC.

  Some companies have legacy historical arrangements whereby the ARRCO contribution rate is higher (usually 8% in such cases).
  The employer/employee split is as follows:
  ARRCO 60%/40%
  AGIRC Tranche B 62%/38% (approx.)
  AGIRC Tranche C: freely chosen by the employer, although, in practice, the split applicable to AGIRC Tranche B is usually applied.

- *Note that when ARRCO and AGIRC merge on 1 January 2019, the contribution rates will be harmonised as follows:*
  - 6.20% of Tranche A (earnings up to the Social Security ceiling)
  - 17%% of Tranche B/C (earnings between 1 and 8 times SSC)
  - Employer/employee split 60%/ 40%.

- *Taux d'appel:* This (usually translated as "call-up rate") is currently 125% although it will increase to 127% with effect from 1 January 2019.

The contractual contribution rate is multiplied by the taux d'appel to determine the amount the employer and employee actually pay [2017]:

System	Tranche	Employer	Employee	Total
ARRCO	TA (up to SSC)	4.65%	3.10%	7.75%
	TB (between SSC and 3 x SSC)	12.15%	8.10%	20.25%
AGIRC	TB	12.75%	7.80%	20.55%
(split rate on TC is set by employer)	TC	12.75%	7.80%	20.55%

Example: Consider a cadre with a salary of □80,000 p.a. in 2017.Tranche A earnings amount to €39,228 and Tranche B to 80,000-39,228 = €40,772; there are no Tranche C earnings.

ARRCO: Contractual contribution 6.20% x 39,228 = 2,432.14 per year.
Reference salary (i.e. purchase price of a point) in 2017 = €16.1879
Points purchased in 2017 = 2,432.14 / 16.1879 = 150.2
Value of a point in 2017 = €1.2513
Value (in 2017) of rights acquired in 2017 = 150.2 x 1.2513 = €188.0 p.a.
Actual contribution paid in 2017 including taux d'appel:
Employer 2,432.14 x 125% x 60% = €1,824.10
Employee 2,432.14 x 125% x 40% = €1,216.07

AGIRC: Contractual contribution 16.44% x 40,772 = 6,702.92 per year.
Reference salary (i.e. purchase price of a point) in 2017 = €5.6306
Points purchased in 2017 = 6,702.92/ 5.6306 = 1,190.44
Value of a point in 2017 = €0.4352
Value (in 2017) of rights acquired in 2017= 1,190.44 x 0.4352 = €518.1 p.a.
Actual contribution paid in 2017 including taux d'appel:
Employer 6,702.92 x 125% x ~62% = €5,194.76
Employee 6,702.92x 125% x ~38% = €3,183,89

The ultimate "replacement rate" (retirement benefit as a percentage of final salary) depends, as in all DC or career-average schemes, on the individual's career progression: of two employees with the same final salary and years of service, the one promoted later in his career will expect a lower replacement rate than the one promoted earlier. However, including the Social Security benefit, typical replacement rates could be between 40% and 65% of final salary (TA + TB) after a full career. (Senior managers will expect lower replacement rates due to their steeper salary progression over their careers with TC earnings usually in latter part of career).

Retirement Age

The retirement age in ARRCO and AGIRC is linked to the State retirement age, but the reduction factors for early retirement are different (and more generous).
Pensions may be paid without reduction for early retirement

- at the maximum State retirement age (i.e. 65 increasing to 67), or
- from the "full-rate" retirement age, as long as a State pension is also drawn at that point (note: this does not apply to points arising from contributions on Tranche C, which are always subject to reduction if drawn before the maximum State retirement age).

The reduction for early retirement is 22% (i.e. the pension as calculated above is then multiplied by a factor of 0.78) if paid 5 years early.

Additional periods of contribution required from 1 January 2019
For employees retiring on or after 1 January 2019, an adjustment is made according to whether they have additional periods of contribution over and above those required for a "full-rate" State pension (see above):

- If the employee has achieved the number of quarters of coverage required for a « full-rate » State pension, the ARRCO/AGIRC pension will be subject to a reduction (« malus ») of 10% for the first three years
- This "malus" will not be applied if the employee has achieved four additional quarters on top of the number required for a « full-rate » State pension

If the employee has achieved 8 (or 12 or 16) additional quarters on top of the number required for a "full-rate" State pension, the ARRCO/AGIRC pension will be increased ("bonus" by 10% (or 20% or 30% respectively) for the first year of payment only.

Taxation
Both employer and employee contributions are fully tax deductible. Pensions are taxed as income.

Market Practice and Trends
As these are compulsory schemes, employers are obliged to follow the rules that are determined on a national basis.

The ARRCO and AGIRC schemes, being financed on a pay-as-you-go basis, are particularly sensitive to demographic trends (the proportion of contributing employees to retired employees) as well as to unemployment rates. The schemes intend that the reference salary increase in future in line with average earnings, whereas the point value is expected to increase in line with price inflation (and has fallen short of this in the past). Between 2013 and 2016, the point value did not increase. Therefore, the "value for money" of a pension point, i.e. the ratio between the price paid for it and the pension that it generates, is deteriorating over time and is likely to continue to do so. (Of course, the same can be said for most funded plans where increasing longevity is causing DC annuity rates or DB contribution rates to increase.).

The 30 October 2015 ARRCO/AGIRC agreement provides for a further deterioration in the "value for money", and the point value is increasing by one percentage point less than price inflation in the years 2016, 2017 and 2018.

223 Pillar III: Supplementary Pension Arrangements
Many employers, particularly larger ones, provide supplementary pension arrangements to their employees. These can be divided into two types.

Defined Contribution
There are two types of DC plans in France: Article 83 plans and PERCO (plan d'épargne pour la retraite collectif).

"Article 83" plans are insured (except for a very small number of legacy plans), and around one-third of companies provide this benefit. Most of these are set up in the form of contracts with annual declared (positive) investment returns, i.e. where the value of the accumulated fund cannot reduce from one year to the next. Failing to provide this guarantee could lead to legal challenges from employees unless the plan is 100% employer-financed (which is becoming increasingly unusual).

An Article 83 plan must be established with a fixed employer contribution in respect of all employees within an objectively defined category of employees. What this latter means has been subject to much litigation, but these categories are now generally regarded as being: all non-cadres, all cadres (with possible restrictive criteria to focus on cadres supérieurs i.e. senior management), or combinations of these.

The plan may also have mandatory fixed employee contributions as well as providing a feature allowing additional voluntary contributions.

Where the total of fixed contributions (Article 83 and PERCO) does not exceed 8% of earnings (up to an earnings ceiling of 8 times SSC), there are no income tax consequences for the employee. Voluntary contributions up to 10% of earnings (again subject a ceiling of 8 times SSC) are also tax deductible. Employer contributions are subject to the general social levies on income (CSG-CRDS).

Where the total of employer fixed contributions (Article 83 and PERCO) does not exceed 5% of earnings (up to an earnings ceiling of 5 times SSC), Social charges are settled through a payment equal to the 20% of the contributions.

At retirement, the account value must be converted to an annuity which is subject to income tax and general social levies.

PERCO is a more recently developed offering, and, due to its greater flexibility, is proving to be the market's retirement vehicle of choice. It is available to those employers which already operate a savings plan for employees (PEE or PEI). It is a voluntary arrangement offering tax advantages for employees who contribute. The employer can contribute, including offering the possibility of a 'matching' structure. Payments into the plan from profit- sharing and savings plans may also be made. Finally, PERCO are able to accept transfer values from other plans including savings plans and other PERCO.

The employee can contribute (in total combined with other savings plans) up to one-quarter of the previous year's gross remuneration. A minimum annual contribution of maximum □160 might be set. There is no tax advantage to this contribution.

The employer may not contribute in excess of the lower of:

- 16% of the SSC (€ 6,276.48 in 2017) or
- three times the employee's contribution.

This contribution is tax deductible, not subject to income tax or social charges on the employee. The employer contribution is fully tax deductible but liable to a flat-rate 20% social. Contributions into the plan made from profit-sharing and savings plans are not subject to income tax or social charges.

Beneficiaries' rights are vested and locked until retirement, but they can be unblocked before that in some cases:

- Death of employee or spouse;
- Disability (employee, spouse, children);
- Over indebtedness of the employee;
- Real estate acquisition (valid for the main residence only);
- Residence renovation after a natural disaster event;
- Unemployment benefits expiration;

At retirement, the employee can elect to take a pension subject to advantageous income tax treatment plus 1% medical contribution and general social levies. Depending on the age at which the pension commences, only 30%-70% of the payments are taxed. If a capital lump sum is elected, there is no income tax but the portion representing investment gains made is subject to social charges.

Due to flexibilities on financing for both companies and employees, the PERCO is becoming the most prevalent supplementary pension plan.

Defined Benefit

DB plans are either in the form of direct promises from the employer to the beneficiaries, or insured, whereby the insurance effectively acts as asset manager for the period before retirement (i.e. without providing any DB guarantees) and where assets at retirement are withdrawn from the fund to buy an annuity with the insurance company. Therefore, in the case of an insured plan, the assets all relate to active employees and there are no retirees.

In both cases, the benefits do not vest until retirement, i.e. if the employee leaves service before retirement, then all rights are lost. In practice exceptions can be made for employees leaving after age 55. Another condition to receive the benefit is often that the employee has a minimum period of service (e.g. 10 or 15 years).This non-vested requirement is so that the contributions paid to the (funded) plan do not give rise to an immediate income tax liability.

Generally, the pension is 1% to 1.5% of final pay per year of service limited to 35 years, inclusive of State benefits and mandatory plans. The target benefit is typically 50% to 65% of final salary (inclusive of social security and mandatory plans) after a full career. An overall cap typically applies – for example 16 times the Social Security Ceiling (SSC) or annuity limited to a percentage of pensionable salary. More and more plans provide an additional formula: target benefit of 10% to 20% of final pensionable salary with no regard to mandatory plans.

Early retirement is usually permissible from age 60 (to 62) if condition for a full social security pension is met. The law allows maintenance of pension rights for pre-retirees, II or III disability, or dismissal after the age 55, if the person does not begin new professional activity before retirement. Pension is payable at retirement age.

Most DB plans are now closed and new employees are offered DC plans. Many DB plans were, in fact, replaced by DC plans, as the (generally required) consent of the employee representatives was easier to obtain once they understood that DC benefits were vested, so people leaving service before retirement would become entitled to a deferred pension instead of losing all the benefit from the scheme.

Contribution is tax-free. Regarding social charges, the employer can opt for:

1. 24% charge on premiums paid for funded plans. In the plan is unfunded, the charge of 48% of the IAS19 service cost was banned in 2010;
2. 16% contribution on the pension implemented before 1 January 2013;
3. 32% contribution on the pension implemented after 1 January 2013;

In 2014, an additional tax on pension exceeding eight times' SSC but applicable on the whole pension, was increased to 45% although this has been contested as unconstitutional in November 2015 and two years later the matter is still not decided.

23 MEDICAL AND OTHER BENEFITS

There is a national health care fund in which all employees participate. Contributions to the fund are paid as Social charges on total cash earnings at the rate of 12.89% for employers and 0.75% for employees. This fund reimburses a portion of medical costs, e.g. 80%-100% of the cost of hospitalisation, 70% of doctors' fees, 65%-100% for most prescribed drugs, etc.. These percentages are applied to a centrally-negotiated scale ("tarif de convention") but are not mandatory and many private practitioners charge higher fees. Additional small flat-rate contributions from individuals are also applied in some cases e.g. €0.50 for each prescription drug.

Many larger local companies and most subsidiaries of foreign multinationals offer supplementary health cover which typically reimburses part or all of the cost gap, whether due to the co-pay element or higher actual charges incurred or both. From 2016, all employers will be required to offer to their employees a group medical insurance with specified minimum benefit levels (Decree 2014-1025 of 10 September 2014). For plans which only meet the minimum mandated levels, employers are required to pay at least 50% of the contribution. Most existing plans are likely to have benefit levels which exceed the minimums in the Decree but compliance should be confirmed.

Most employees are also provided with death and disability insurance (prévoyance) by their employers on a shared premium basis. The prévoyance insurance provides lump sum benefits on death (typically related to marital status and number of dependent children) and on disability. Spouse's pension and pensions for dependent children until they finish full-time education (rente d'education) may also feature.

Other benefits typically provided include subsidies for public transport (employers must pay 50% of the cost of the monthly public transport ticket travel to work), and either subsidised canteens or meal tickets (ticket restaurant).

Flex benefits are not popular in France due to the relatively high level of minimum coverages already provided, the fact that tax relief depends on all employees in a group category being given the same benefits, and, the relatively conservative demands of employees.

Savings Plans (Plans d'épargne d'entreprise, or PEE) are widespread due to the tax advantages granted. When combined with a tax-approved profit-sharing arrangement, they can be a very efficient way of remunerating employees. Detailed information on their operation is outside the scope of this Chapter. (See Part 2, Chapter 5.2).

24 RETIREMENT PROGRAMME CHANGES INCLUDED IN FRANCE'S MACRON LAW

French companies with fewer than 50 employees would be allowed to set up collective retirement savings plan (PERCO) under the Macron law (French) intended to foster economic growth. Participating companies would be exempt from the social charge on contributions to the PERCO plans for the first three years of implementation, and the social charge would be reduced to 8%, down from 20%, in the following three years. Other proposals applicable to PERCO plans for all employers would lower the social charge to 16%, down from 20%, if the plans reduce older employees' risk exposure and invest a defined percentage of funds in certain firms.

The new law also set performance standards for corporate officers of listed companies with DB plans who are eligible for additional pension benefits. The additional benefits are capped at 3% of salary.

Summary

This Chapter begun with a brief economic overview and then outlined the scope and nature of pension benefit arrangements. It also mentioned briefly medical and other benefits provided.

Self Test Questions

- What State retirement benefits are available?
- What type and level of private retirement benefits are offered?
- What medical benefits are provided?

INTRODUCTION

The UK operates a classic three-pillar pension system. The first pillar is the State provision which currently is a flat rate pension – new State Pension. This replaced the two tiers first pillar - the Basic State Pension (a flat rate pension) and Additional State Pension (both are flat-rate arrangements) - from 6 April 2016.The second pillar is occupational supplementary provision with mandatory automatic enrolment and requiring minimum level of contributions. The third pillar is voluntary private pension provision.

Comprehensive healthcare is provided under the National Health Service but may be supplemented by voluntary private provision. Some death and disability benefits are provided by the State but these are typically supplemented by voluntary private provision – including employer-sponsored plans.

3.1 ECONOMIC AND EMPLOYMENT OVERVIEW

The UK joined the European Union in 1973. However, on 23 June 2016 the UK held a referendum to decide on whether to leave or remain in the European Union. The public voted by 52% to 48% to leave the European Union. The Government triggered Article 50 of the Lisbon Treaty on 29 March 2017 which will formally start the process for the UK to leave the European Union.

The UK has an open economy and is a leading trading power and global financial centre. Recent decades have seen a continuing trend away from public ownership of key industrial and utilities sectors. Services, particularly banking, insurance, and business services, account for the largest proportion of Gross Domestic Product (GDP), whilst industry continues to decline in relative importance. Because of the large economic role played by financial services, the UK was hit particularly hard by the global financial crisis that began in 2008.

Key terms and conditions of employment are set out in legislation. Contracts of employment do not have to be in writing. However, employees are entitled to a written statement of their main employment terms within two months of starting work. Other employment rights include: paid annual leave of at least 28 days a year (this may include public holidays); statutory sick pay; statutory maternity leave and pay; the right to request flexible working. There is a national minimum wage which depends on age – for example from 1 April 2017 workers who are aged 25 and over are entitled to pay of at least the National Living Wage which is GBP 7.50 per hour; workers who are aged under 25 cannot be paid less than the National Minimum Wage which range from GBP 4.05 for those aged 16-17 to GBP 7.05 for those aged 21 and over. There is a different rate for apprentices.

It is a criminal offence to employ anyone who does not have the right to work in the UK.

Trade union membership has declined steeply since the 1970s and remains strongest in the public sector.An employee has the right to join a trade union, and cannot be refused a job, dismissed, harassed or selected for redundancy because they are a member of or wish to join a union. Conversely, an employee also has the right not to join a trade union, and cannot be refused a job, dismissed, harassed or selected for redundancy because they refused to join.

3.2 PENSION AND RISK BENEFIT PROVISION

Overview: A three pillar pension system is in operation. The three pillars are:

- State Pension which is a flat rate pension based on an individual's National Insurance Contributions (NICs) records. It replaced the old two tiers benefit from April 2016.Those who retire before 6 April 2016, are still entitled to benefits under the old system which comprises of:
  - Basic State Pension - a flat-rate benefit, entitlement to which depends on the individual's National Insurance Contribution (NIC) record, and

  - the Additional State Pension which is a flat rate benefit. It replaced the old State Second Pension from 6 April 2016.The State Second Pension was a partly earnings-related pension, based on a proportion of earnings between an upper and lower limit.
- Supplementary employment-related pension provision –through automatic enrolment in an employer-sponsored plan with minimum contributions required.
- Voluntary private provision - typically through contract-based individual retirement savings plans marketed by financial service providers.

State Pension Age (SPA) is the earliest age from which State Pension can be claimed. It is different for men and women; and depends on the year of birth. SPA for men is currently 65. SPA for women is in the process of rising from 60 to 65 between 2010 and 2018. Further planned increases will take the equalized SPA to 66 by 2020, 67 by 2028 and 68 by 2039. Legislation also now provides for a periodic review of SPA at intervals of no more than six years – in the light of changes in longevity expectations.

3.2.1 Pillar I – Tier 1 Basic State Pension (BSP) and State Pension

Benefits

The amount and eligibility criteria for the Basic State Pension have changed from 6 April 2016.

For those who reached SPA before 6 April 2016, and have paid, or been credited with, sufficient NICs, a full BSP of GBP 122.30 per week is payable from SPA for the UK tax year 2017/18.A married individual (including one in a civil partnership) to claim the higher of the benefit based on own NIC record or that of the spouse/partner. In the latter case, the maximum combined BSP would be GBP 195.60 per week for the UK tax year 2017/18.

For those with an incomplete NIC record (currently, 30 years being credited), a proportionately lower BSP is payable. A system of credits applies to those who have been out of the workforce due to illness, maternity, caring responsibilities, unemployment etc.

On the death of a spouse or civil partner, it is possible to claim a pension based on the spouse or civil partner's NIC, where the individual has no State pension entitlement in his or her own right, or if that entitlement is below a set level.

From 6 April 2016, those reaching SPA on or after this date will be entitled to a new State Pension. This will be a flat-rate pension of GBP 159.55 per week for the UK tax year 2017/18.A minimum of 10 qualifying years will be required for any benefit entitlement under the new State Pension.

The ability to qualify on a spouse's/civil partner's NIC record and/or inherit a survivor's pension is no longer available to those who reach SPA after 6 April 2016.

Transitional rules will apply to those individuals who have paid or deemed to have paid NICs before 6 April 2016.The State Pension will be calculated as follows:

- A Starting Amount which is based on an individual's National Insurance record before 6 April 2016 and is the higher of:
  - The Basic State Pension and Additional State Pension (see section 3.2.2 below) the individual would have been entitled to for qualifying years before 6 April 2016; and
  - The new State Pension the individual would have been entitled to assuming it had always applied for qualifying years before 6 April 2016.

A deduction is then applied to this amount for the period(s) that the individual was contracted out of the Additional State Pension.

Financing

The BSP and the new State Pension operates on a 'pay-as-you-go' basis, through NICs. These are payable on bands of earnings as follows:

Tax Year 2017/18 Earnings per week (GBP)	Employer (%)	Employee (%)
Primary Threshold to Upper Earnings Limit 157 – 866	n/a.	12.0
Secondary Threshold to Upper Earnings Limit 157 – 866	13.8	n/a.
Above Upper Earnings Limit Above 866	13.8	2.0

Taxation

BSP and new State Pension in payment are treated as taxable income and the tax is withheld at source.

Trends

From 2011, the annual indexation of BSP has been subject to a triple guarantee: the highest of:

- growth in average earnings
- growth in prices (Consumer Price Index – CPI)
- 2.5 percent

This is to continue under the new State Pension. However, this is being reviewed by the government.

3.2.2 Pillar I – second tier State Second Pension (S2P) and Additional State Pension

An earnings-related top-up to the BSP has existed since 1961 but has changed in form many times over the intervening period. It works on a 'pay-as-you-go' contributory basis, through the National Insurance system. S2P replaced the former State Earnings Related Pension Scheme (SERPS) in 2002. As with the BSP, there are credits granted for people with a long-term illness or disability and certain of those who care for them.

It is possible for an individual to give up all of the S2P and, instead, receive a benefit at least as good under either an occupational or personal pension plan. This is known as "contracting out". Since April 2012, the ability to contract-out using a defined contribution plan or money purchase personal pension plan has been withdrawn; from April 2016, it is no longer be possible to contract-out through a defined benefit plan.

Individuals who contract out of S2P pay a lower NIC through rebates payable into their occupational plan or personal pension plan. These years will not count for contributions credit under the new State Pension which requires full NICs to have been paid.

From 6 April 2016, S2P has been replaced by the Additional State Pension.

Benefits
Under S2P, benefit accrues at different rates on two separate bands of earnings before April 2016:

There is a flat-rate accrual of GBP 93.60 per annum for each year from April 2015 to the tax year before SPA for earnings between Lower Earnings Limit (LEL) and Low Earnings Threshold (LET) – GBP 5,824 and GBP 15,300 2015/16.It is noted that the flat-rate accrual will not be reviewed after the 2015-16 tax year as S2P has been replaced by the Additional State Pension from 6 April 2016 (see below).

The second band is between the LET and the Upper Accrual Point (UAP) - GBP 15,300 and GBP 40,040 for 2015/16. Benefit accrues on this band of earnings at 10% over an assumed working lifetime of 44 years (approx. 0.23% p.a.).

The Upper Accrual Point is frozen, so that indexation of the LET will eventually reduce the second band to nil – the entire benefit then being flat-rate. However, the Government has accelerated this transition.

From 2016, S2P has been replaced by the Additional State Pension for those who reached State Pension Age before 6 April 2016. It is a flat rate pension payable in addition to Basic State Pension. The amount payable will depend on National Insurance Contributions records.

S2P was originally due to become entirely flat-rate by 2030 but this has been brought forward to 2016. For those retiring after April 2016 with entitlement under S2P, transition provisions are in place to ensure the retiree receives the higher of the benefit as calculated under the old system and that of the new State Pension.

For those who reach State Pension Age on or after 6 April 2016, a new State Pension will be payable. (See section 3.2.1 above).

The annual indexation of S2P in payment is in line with the growth in prices (CPI).

Financing
S2P operates on a 'pay-as-you-go' basis, through NICs shown in the table above.

Taxation
S2P and Additional State Pension in payment are treated as taxable income. Tax is deducted at source.

323 Pillars II and III Supplementary Occupational and Voluntary Private Provision
The vast majority of voluntary pension provision is delivered via employers and is, for larger employers at least, a standard part of the remuneration package. From 2012, employers have been required to automatically enrol workers in a qualifying scheme and pay minimum contributions in the plan (see Automatic Enrolment below).

A distinction can be made between trust-based occupational plans which are directly organised and delivered by employers; and group personal pension plans where, although the employer may organise the plan with a provider and contribute to it, the legal constitution of the arrangement is an individual contract between the member and the provider (typically an insurance company or investment house).

Trust-based plans may be DB or DC or a combination of both; personal pension plans are always DC.

Pre-retirement benefits on death (lump sum benefits and often also survivor pensions) are typically provided within DB plans; in case the employee is unable to work due to disablement, the plan may also provide for early payment of pension for ill-health.

For many DC plans, and all of those where personal pensions are being used, all risk benefits are externally provided. Lump sum benefits on death-in-service are common. Enhanced lump sums or, less commonly, income benefits may be provided for survivors; these would be supplemented by the value of the accumulated fund. In case of disability, provision for continuation of salary (typically known in the UK as Income Protection) may be provided for a period of years or until retirement. As the individual's pension account continues to be invested, the value would be available at retirement (or earlier death).

Automatic enrolment

Since 2012, large employers have been legally required to automatically enrol their employees into a workplace pension. This duty is gradually being extended to smaller employers over five years. This is probably the biggest pensions change in the UK for a generation and has dramatically changed the pension landscape for employers, employees and providers.

Employers must automatically enrol 'eligible' employees (see below) into a qualifying scheme - an occupational or employer-sponsored personal pension plan, which satisfies certain quality standards. The pension plan may be a UK registered pension scheme or a non-UK pension plan that satisfies certain criteria. Alternatively, they may use the National Employment Savings Trust (NEST) – a centralized, DC plan established by the Government in 2012. Employers can generally operate a waiting period of up to three months before mandatory enrolment, but an employee can opt into the scheme during that period.

Broadly, eligible employees are those who are:

- Between age 22 and the SPA.
- Earning in excess of the earnings trigger (GBP 10,000 for 2017/18).
- Working or 'ordinarily working' in the UK.

Employees who do not meet the criteria are still entitled to opt in – and different obligations apply depending on the category of employee.

No automatic enrolment duties apply in relation to an employee who is already an active member of an existing pension plan or who is eligible to join it in line with the automatic enrolment requirements. However, the plan must satisfy the necessary quality standards. Employers have significant communication obligations in relation to all employees and have to re-enrol employees who have opted out broadly every 3 years.

Regulation

The UK operates a highly complex regulatory system, particularly, where DB plans are concerned. The main regulatory body is the Pensions Regulator, whose main objectives are:

- To protect members' benefits under occupational and work-based personal pension plans.
- To reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund (see below).
- To promote, and to improve understanding of, the good administration of work-based pension plan
- To maximise employer compliance with employer duties and the employment safeguards; and
- In respect of its work concerning the funding of DB plans, it minimises any adverse impact on the sustainable growth of an employer.

There is a duty on all parties connected with a plan to inform the Pensions Regulator ("whistle blow") if they have reasonable cause to believe there has been a material breach of legislative requirements.

In order to benefit from a favourable tax regime, most plans register with Her Majesty's Revenue & Customs (HMRC). Registration requires compliance with a range of restrictions on the benefits, funding and investment.

The Pension Protection Fund (PPF) was established in 2005 to pay compensation to members of eligible DB pension plans, when there is an insolvency event in relation to the employer and where there are insufficient assets in the pension plan to cover PPF levels of compensation. Compensation is funded by an annual levy on qualifying plans.

Trends in Regulation: Regulatory activity has increased at an accelerating pace over the past 20 years or so. Much regulation has been aimed directly at protecting members' benefit entitlements on events such as employer insolvency and takeover/merger transactions, but successive governments have also introduced many controls on wider plan governance (e.g. record keeping; appointment of advisors; appointment of member-nominated trustees).The regulatory burden has fallen most heavily on DB plans.

From the EU, the Pensions (or IORP) Directive was finalised in January 2017 and member states have until January 2019 to implement it. IORP II focuses on governance of retirement plans and communication with members.

In addition, more regulations are being brought in to ensure good governance around DC plans and ensure a good communication strategy is in place.

Benefits

The Finance Act 2004 sought, broadly, to harmonize the benefit conditions under DB and DC plans. Under all arrangements, the tax regime allows benefits in the form of pensions (taxable) and lump sum (mostly tax free). The tax-free lump sum on retirement is normally up to 25% of the value of the member's benefits.

No benefits can be paid to members earlier than age 55, except on ill health. Once a pension provided through the plan, whether directly or through purchase of an annuity, has commenced, it must be payable throughout the member's life.

DC members have the alternative of taking an 'unsecured pension' (i.e. non-annuitized income, also known as "drawdown"), if plan rules permit. From 6 April 2015, members of a DC plan are able to take up to 100% of their fund value as a lump sum or unrestricted income drawdown at retirement. The tax free limits on lump sum payments will continue to apply with the balance taxed as income at the member's marginal tax rate.

Social Security legislation applies minimum vesting conditions to occupational plans. Currently, members with between three months and two years of membership acquire the right to either a cash transfer sum or a contribution refund. After two years of membership, the benefits vest fully within the plan, but members can choose to transfer their benefits to another pension plan. Vesting is immediate under personal pension plans. The Government is proposing immediate vesting for all DC plans – timescale for this is yet to be announced.

Minimum pension increases in payment are required under DB plans. Pensions in payment, accrued for service from April 2005, must be increased annually by the cost of living index (CPI) up to a maximum of 2.5%. For benefits accrued between April 1997 and April 2005, cost of living increases are also required but the applicable cap is 5%. No increases are required for pensions coming into payment from DC plans since April 2005 – where the choice of whether to include indexation in any annuity purchase is made by the member. Prior to April 2005, occupational DC plans were also required to give increases in line with prices capped at 5%.

Financing

Private sector DB plans must meet a statutory funding objective. Trustees and employers must agree a statement of funding principles, setting out the actuarial method and assumptions to be used in valuations. A full actuarial valuation must be completed at least every three years, with the plan actuary preparing intermediate actuarial reports in each of the intervening years. If the statutory funding objective is not met, a recovery plan must be put in place, stating how any deficit will be paid for. This is how the UK has interpreted the funding provisions of the 2003 EU-wide Pensions Directive.

Funding vehicles and typical investment profile

Trustees of occupational plans are required to prepare a statement of investment principles, after consulting with the employer and taking advice from an experienced investment adviser.

Defined benefit plans: Traditionally, most DB plans were invested on an "asset only" basis, i.e. the investment policy did not reflect their liability profile, with a very high percentage of assets in equities. This is changing; increasingly, funds are being invested in a way that reflects the plan's liabilities through adoption of plan-specific asset benchmarks.

The two main investment vehicles now used are:

- *Segregated funds* - where the trustees employ one or more investment managers to invest a distinct (segregated) portfolio of assets on behalf of the trustees; except for a small number of very large pension funds, investment management will be done by an external professional asset management company.
- *Pooled funds* - where the investment manager has complete responsibility for the individual securities purchased within the pooled fund's investment mandate. These funds are unitized and numerous funds' assets are pooled together. There is a range of products and providers in the marketplace. Trustees can choose to invest the plan's assets in either passively or actively managed products. Passive products aim to track a relevant benchmark index, while active products aim to outperform a relevant index.

Due to the move towards plan-specific benchmarks and specialist mandates, it is difficult to specify any "typical" investment profile. It is worth noting that there has been a significant move towards higher bond content in recent times with a corresponding reduction in equities. A bond content of around 30% (or higher) is now not uncommon.

Defined contribution plans: Most DC plans offer a range of investment options to members – typically through a range of pooled products. However, there is no formal requirement to offer choice or even to provide investment options with different risk and return characteristics. So-called "Lifestyle" investment options have grown in popularity; these involve an age-related strategy of investing for income and growth (equities) when the member is young and where there is a staged switch to cash/long-term bonds for capital protection as the member approaches retirement. Lifestyle funds are used often as the "default" investment fund in the majority of plans; the vast majority of DC members use their plan's default investment option rather than involve themselves in fund selection.

Accounting and Actuarial Issues

Occupational pension plan accounts: The Plan's Annual Report must include accounts, a certificate from the plan actuary and a statement from the plan auditor. Plan accounts must be produced within seven months of the end of the plan year. Plan auditors check the actuarial statements within the pension plan accounts for compliance with the Statement of Recommended Practice (SORP), which sets out expected practice, including explaining the funding position.

Financial Accounting Standards: All listed UK companies must prepare their accounts using International Financial Reporting Standards (IFRS). The IFRS standard for pension expense is IAS 19. Under the standard, all changes in a pension plan's funding position are to be recognized immediately in the balance sheet, although some elements of the changes are recognized in profit and loss (i.e. service cost, net interest cost, and any gain or loss on settlement) and some in other comprehensive income (i.e. experience gains and losses and changes in assumptions).

Non-listed companies have a choice between preparing their accounts under IFRS or local UK Generally Accepted Accounting Principles (GAAP). FRS 102 is the default standard for reporting under UK GAAP. It replaced FRS17 standard from January 2015. FRS 102 mandates a market value basis for assets and liabilities in a similar way to IAS 19 and uses an interest on assets approach. FRS 102 requires annual calculations by an actuary and, although these can be estimates based on the last full valuation, some employers will conduct full valuations annually.

Immediate recognition is required of surplus/deficiencies on acquisition and divestiture.

Taxation

Contributions: Employer contributions are usually wholly deductible, provided that they are paid wholly and exclusively for the purpose of trade.

The tax regime surrounding contributions to registered pension plans (including the accrual of benefits within DB plans) has become quite complex. The following basic principles can be applied:

- Any individual may save annually within a tax-approved plan and receive a tax deduction on the greater of GBP 3,600 or 100% of earnings
- The contributions value attributed to GBP 1 of benefit with a DB plan is GBP 20
- Tax relief is generally granted at the income tax rate applicable to the individual based on annual earnings within the tax year
- Contributions in any one year may qualify for tax relief up to the Annual Allowance (AA), the overall limit for the total of employer and employee contributions going into the plan. Any excess contributions are not eligible for tax relief and, where paid by the employer is a taxable benefit. The current AA, since April 2014, is GBP 40,000. In the 2015 post-election Budget, the government has announced further changes to the Annual Allowance for high earners – a tapered annual allowance has been introduced from April 2016, such that the annual allowance is £10,000 for individuals with income above £150,000. In addition, the period of assessment of pension savings for annual allowance is now aligned to the UK tax year.

There are also other situations where the Annual Allowance may be reduced (e.g., where benefits have been paid from a money purchase scheme under the Pensions Freedom regulations – see below).

Benefits: Pensions are taxed as income; up to 25% of the value of the member's benefits can be taken as a tax-free lump sum. The overall value of pension benefits for any retiring employee may not exceed the Lifetime Allowance (LTA). From April 2014, the LTA is GBP 1.25 million (previously, it was GBP 1.5 million). In the 2015 post-election Budget, the government announced that the LTA will be reduced to GBP 1.0 million from April 2016.

Benefits in excess of the Lifetime Allowance (LTA) are subject to a LTA charge of 55% when taken in lump sum form and 25% when taken as income; in the latter case, this is payable in addition to normal income tax. Benefits that do not conform to those prescribed under the registered pension plan tax rules will suffer tax penalties in the form of "unauthorized payment" charges.

Investments: Plans' income and capital gains are generally free of tax.

Market Practice and Trends

The market trend from DB to DC provision has accelerated in recent years (see automatic enrolment above). Where once employers were closing their DB plans only to new entrants, it is now common for them to be closed to all future accrual, with existing members offered future DC benefits only. The number of active members of private sector DB plans has declined from 4.9M in 1995 to 1.7M in 2012 (ONS - Occupational Pension Schemes Survey, 2012[1]).

1 http://www.ons.gov.uk/ons/dcp171778_328287.pdf

Whereas most UK DB plans traditionally operated on a final salary basis, for those employers wanting to retain a DB plan, there has been a shift to a career average salary basis, or, alternatively, a few have explored various risk-sharing arrangements, short of full-blown DC. In the pure DC arena, almost all growth has been via personal pension plans, rather than trust-based occupational plans.

The Government is hoping to create a new legislative category of "shared risk/defined ambition" pensions, which will "allow employers … to share risks more equably with savers", and facilitate innovation aimed at giving DC savers more certainty.

Pensions freedom

In the 2014 Budget, the Government announced far-reaching changes to the delivery of DC pension benefits. The changes are so fundamental and perceived to be so attractive that it is also considering a restriction on transfers from DB plans to DC plans to allay concerns about the impact on the economy should large numbers of people be attracted by the new flexibility offered.

Delivering on that announcement, from 6 April 2015, members of a DC plan have complete freedom to draw down as much or as little of their DC pension pot as they want, anytime they want at or after retirement, i.e. no caps and no drawdown limits.

The changes are expected to provide a much wider range of choices as to how individuals are able to benefit from DC plans and are expected to make DC pension provision much more attractive for individuals. The increased flexibility may, indeed, make a compelling case for employers still offering DB plans to existing or new employees to switch to DC.

33 MEDICAL AND OTHER BENEFITS

The National Health Service (NHS) provides healthcare to all permanent residents of the UK. The NHS provides medical and hospital care that is mostly free at the point of use. It is non-contributory with the costs paid for from general taxation. Health is a devolved issue, so there are some differences amongst England, Scotland, Wales and Northern Ireland. NHS services cover physical and mental health including primary care, in-patient care, long-term care, ophthalmology and dentistry.

Private health care has continued in parallel to the NHS, paid for largely by private insurance (often employer-sponsored). It, however, covers less than 10% of the population. Private health care is offered as an alternative to the NHS, generally offering non-emergency treatment (surgical/hospital) at a date and time of the employee's choice. Private medical policies will generally not provide for primary care (General practitioner) or long-term care but the costs of specialist consultants, diagnostics, and private hospital surgery and accommodation, up to specified maximum amounts, will be included.

As discussed above, most employers will provide employees with life insurance (3-4 times salary). Survivors may be provided with a pension if the employee was a member of a DB plan, but, otherwise, there may be an enhanced lump sum benefit only. Employer provision of disability benefits is somewhat less prevalent, although if a member of a DB plan, an ill-health retirement pension should be available. Otherwise, long-term disability benefits have historically been provided on an income protection/salary continuance basis (e.g. income replacement of 60% to 75% of salary, inclusive of State benefits), payable up to retirement; increasing costs have led some employers to reduce provision to a limited term (3-5 years) or, indeed, withdrawing from any provision at all.

Flex benefits are increasingly popular with both employers and employees. Pension contributions often form a key part of the flex package, particularly as this may confer National Insurance contribution savings. Other flex benefits may include childcare vouchers, critical illness insurance, flexibility on levels of death and disability benefits, medical, dental and optical insurance, gym membership, and personal accident insurance.

Other benefits which employers may offer include subsidized canteens, loans to buy season tickets for public transport, and car and bike leasing arrangements.

Share plans are common, with different forms available – subject to different regulatory terms and tax treatment. The most widespread forms are "Save As You Earn" share options and "Share Incentive Plans". (See Chapter 5 Savings Plans and Chapter 6 Employee Share Plans for more detail on these UK offerings).

Summary

This Chapter begun with a brief economic overview and then outlined the scope and nature of pension benefit arrangements. It also mentioned briefly medical and other benefits provided.

Self Test Questions

- What State retirement benefits are available?
- What type and level of private retirement benefits are offered?
- What medical benefits are provided?

INTRODUCTION

An earnings-related State pension can be supplemented by voluntary individual or company-sponsored retirement provision. State disability and unemployment benefits are provided; occupational death and disability benefits are relatively low outside company pension plans. Medical benefits are provided through a system of compulsory State-regulated medical providers (Krankenkassen) or private insurers; employers play a minimal role in healthcare. Flexible benefits are still uncommon.

4.1 ECONOMIC AND EMPLOYMENT OVERVIEW

Germany is a federal parliamentary republic of sixteen states (Bundesländer) with a high standard of living and a comprehensive Social Security system. Germany is one of the leading industrial nations and a leading exporter of engineered goods and technical equipment. It is the world's fourth largest economy by nominal GDP (2015 figures IMF) and benefits from a highly skilled workforce.

Employment is governed by written contracts. The labour market is highly regulated and relatively inflexible with considerable employment protection for permanent employees once the trial period is over. This has led to a significant increase in the number of employees with fixed-term contracts and the use of interim staff, particularly during periods of economic uncertainty. Many industries and large employers have collective agreements setting minimum levels of pay and other conditions of employment for workers, so-called "tariff" employees (typically, non-exempt employees below management level).

Other key employment legislation includes minimum annual holiday of four working weeks per year and maximum working hour legislation.

4.2 PENSION AND RISK BENEFIT PROVISION

Overview: pension consists of three pillars: an earnings-related Social Security pension, voluntary employer-sponsored pension plans, and individual retirement savings arrangements.

4.2.1 Pillar I: Social Security (Gesetzliche Rentenversicherung)

The first pillar consists of a 'pay-as-you-go' State pension provision providing benefits on retirement, death and disability in respect of salary up to the Social Security Contribution Ceiling (SSC).The SSC is EUR 76,200 for 2017 and EUR 68,400 in the five former East German states where the economic consequences of reunification remain on-going. Certain employee and professional groups (e.g. civil servants, lawyers, and mine workers) do not participate in the general Social Security programme but instead have alternative arrangements in place.

Benefit entitlement in respect of retirement, long-term disability and survivors' pensions arises once the employee has a 5 year contribution record.

Retirement benefits

The normal retirement age will increase gradually from 65 to 66 in 2023 and to 67 by 2029. The expected retirement income replacement ratio is around 50% for an average worker with earnings up to the SSC.

The calculation of retirement benefits depends on:
- the individual's career earnings each year and the relationship of this to the average contributory income of all contributors (national average earnings (NAE))
- the revaluation factors applied (inter alia, an entry age factor of 1.0 adjusted for the age at which the pension commences for early or late retirement)
- the number of qualifying years in the State scheme

Where annual earnings are equal to the NAE calculated, a points factor of 1.0 is awarded and then averaged over the career; where earnings are higher or lower, an adjustment is made to the points factor. Following adjustment and revaluations, the result is multiplied by the monthly pension value and then by the number of years applicable to determine the actual monthly pension payable.

Short term disability and sick pay

Employers are required to continue full pay to employees during their first six weeks of sickness. Thereafter, the Krankenkasse pays a sickness benefit of 70% of salary (but not more than 90% of previous net income) for a maximum of 78 weeks during any three year period.

Coverage for those with by private medical insurance may vary depending on the applicable tariff selected but will form part of the policy.

Long term disability

The disability pension varies with the degree of disability:

Number of Hours Able to Work Per Day	Benefit
No more than three hours ("fulldisability")	If disabled before age 60, determined as per old-age pension projected to age 62; otherwise, as per old age pension
Between three and six hours ("partial disability")	Half of the full benefit; unless no suitable work can be found, in which case the full disability pension will be paid

The disability pension may be paid until attainment of normal retirement age whereupon the old age pension is determined. The old age pension may not be less than the previous disability pension paid.

Death benefits

Survivors' pensions are a percentage of the notional disability pension (death before retirement) or the actual paid pension (death after retirement).The pension paid varies:

- for the first three months, the points factor used is 1.0 [100%]
- thereafter, provided the spouse is over age 45 (being increased to 47) is disabled, or is caring for a child under age 18, the points factor used is 0.55 [55%].
- otherwise, the points factor used is 0.25 [25%] and the benefit payment period generally limited to 2 years
- The survivor's pension however, is reduced if the spouse has his/her own income. The spouse's pension ceases on remarriage. The spouse pension is also provided for couples within a registered same sex partnership.

In addition, orphan benefits are provided with a points factor of 0.1 [10%] applied (0.2 if full orphan).

Long term care insurance

Long term care insurance provides allowances for nursing care services at home or within nursing homes.

Financing

The basic rates of Social Security contributions payable (2016) are shown in the table below:

Provision	Total contribution rate	Contribution ceiling
Pension, death and long-term disability	18.70%	EUR 764,200 [EUR 68,400 in former East Germany States]
Unemployment	3.00%	
Medical care (statutory)	14.60% (Average additional contribution of 1.1% of the employee)	EUR 52,200
Long term care	2.55% [+0.25% if over age 23 without child dependent]	

Contributions are split equally between employers and employees, except that over 23 year olds' without children have to pay an additional 0.25% contribution towards the cost of long term care. Furthermore, employees have to pay an additional contribution for medical care depending on the health insurance chosen. The average additional contribution amounts to 1.1%. Slightly different rates for long term care insurance apply in Saxony.

Taxation

The taxation environment is complex. The majority of employee contributions are tax deductible. Employer contributions are treated as a business expense. Benefits in payment are generally treated as taxable income.

4.2.2 Pillar II

Second pillar pensions, where provided, use a voluntary company retirement arrangement.

Benefits and Financing

Many companies, in particular large German employers and subsidiaries of multinationals, provide pension benefits for all of their employees; others may do so only for the executive levels. Historically, plans have been non-contributory, but some employers have introduced employee contributions in recent years.

Typical traditional plans provide a pension using an annual accrual rate of 0.2% to 0.5% of salary below SSC plus 0.6% to 2.0% of salary above the SSC multiplied by the number of years of service either on a final or career average pay basis. These plans, therefore, target retirement income at 10% - 20% of final salary up to the SSC plus 40% - 60% above the SSC after a full career.

In some industries, companies often had career average benefits or fixed amounts per year of service, where the fixed amount may depend on the level or grade of the employee.

Pension promises have a contractual nature in Germany, which makes changing and, in particular, reducing them difficult, even for future service accruals of benefit. As a result, many traditionally-designed plans remain as closed legacy arrangements, with new plans with reduced benefit provision opened for new hires. As a result, it is common for employees with different hire dates at the same company to receive different pension benefits, and, indeed, for a company to have employees earning pension entitlements at any given time under several different arrangements, most of which are closed to new entrants.

Where plans are still open to new entrants, they tend to be contribution-oriented plans (i.e. the benefits are linked to the amount of contributions paid). Pure defined contribution (DC) plans are not possible in Germany, as the capital value of the contributions paid in must always be guaranteed. Depending upon the plan design, it may be possible for the company to insure against most or all of the investment risks in order to have a plan that is, effectively, DC from the employer's perspective, even if a minimum level of benefit is guaranteed.

A typical "good" contribution oriented plan design is based on a contribution rate of 1.5% - 4% below the Social Security Ceiling and 6% - 15% above the Social Security Ceiling, although the higher rates may apply only for senior executives. Minimum investment returns are often guaranteed in line with the maximum guaranteed interest rate available on insured retirement contracts (currently 0.9% p.a.). Increasingly, longevity and investment risks are being managed by structuring plans to provide a target retirement lump sum with an option to convert into a pension at the rate prevailing at retirement.

The retirement age is usually linked to the point at which employees would begin to draw their Social Security pension.

Most plans provide a long term disability pension equal to either the accrued or the projected retirement pension.

Plans usually provide a spouse's pension of 50%-60% of the disability pension or, in case of a retiree, 50%-60% of the pension in payment. Orphan's pensions, where provided, are typically 10% to 15% of the member's accrued or actual pension.

Regulation

There is no legal requirement for a company to provide retirement benefits to its employees, although, if requested, the company must provide the facility for employees to sacrifice part of their salary into an external individual private pension plan (see Section 4.2.3 below).

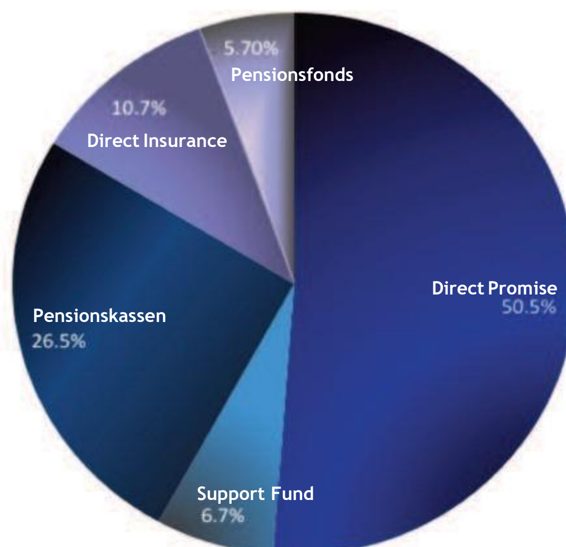
Where retirement benefits are provided, there are some restrictions applied under the German Pension Law, in particular:

- Accrued benefits (determined as a pro-rata portion of the retirement pension earned by potential service to retirement age) must fully vest after 5 years' plan membership (or from age 25, if later).
- Pensions in payment should be adjusted upwards every three years unless the employee has an individual insurance contract. The indexation measure can be general price inflation, or the average net salary inflation for the employee groups covered by the plan. In the event of poor company performance, it can be possible to pay a reduced or zero increase, although a proper process must be followed and documented in order for this to be legally sound and to avoid future claims from members. For pension promises granted on or after 1 January 1999, however, this indexation requirement does not apply to pension promises with a guaranteed increase rate of at least 1% per annum to pensions in payment.
- Retirement benefits below a materiality limit of, currently, EUR 29.75 per month (EUR 26.60 per month in the former East German states) may be commuted into a one-off cash sum without the employee's agreement; commutation of a benefit up to twice this amount is permitted with the employee's agreement. Also, direct promises for active members may be commuted without limit subject to there being no imminent expected end in the employment relationship. Less restrictive rules apply to certain former employees.

The regulatory environment depends upon the funding vehicle:

- Direct promises and support funds are not subject to specific regulatory supervision
- Pensionskassen, (Direct) Insurances and Pensionsfonds fall under the supervision of the supervisory authority for financial enterprises (BaFin, *Bundesanstalt für Finanzdienstleistungsaufsicht*).

Funding vehicles
There are five different types of pension vehicles that can be used to provide benefits under the second pillar one uses internal financing while the remaining four are financed externally. Whenever an external financing vehicle is used, however, should the provider prove unable to pay the vested benefits promised, the employees may potentially claim against the employer.



The chart above illustrates the estimated share of liabilities (for 2015 a total of EUR 575.0 bn.) financed by each of the five funding vehicles.

Direct promise (internal "book reserve" financing or Direktzusage)
A direct promise exists where the employer commits contractually to pay retirement benefits directly to an employee.

Some companies reinsure all or part of the benefit obligation with policies taken out in the name of the company. In some cases, these reinsurance contracts may be pledged to the individual members in the event of company insolvency in order to provide additional security (particularly for those plan members whose benefits are not covered by the statutory insolvency protection fund, see further below).

Similarly, many larger companies ring-fence company-owned assets using a CTA (Contractual Trust Arrangement) to pre-fund their obligations. If the use of the assets is limited to providing pension benefits, then the assets usually qualify as plan assets under IFRS or US GAAP accounting.

Support Fund (Unterstützungskasse)
A support fund is a separate legal entity from the employing company through which employee benefits are financed. The benefits are promised by the employer and not subject to any minimum funding requirement. However, support funds are often funded through reinsurance which can offer greater security to the employee and liability protection to the employer. Regardless, if the support fund is unable to pay the benefits promised, the employee can claim against the employer. There are limits set on the maximum pace of funding for tax deductibility of company contributions.

Direct Insurance (Direktversicherung)
A direct insurance is an endowment type of insurance contract between employee, employer and an insurance company. The employer is the policyholder, but the employee and dependents have a direct claim for the benefits promised against the insurance company. The employer pays the contributions, although all or part of this contribution may arise from a salary sacrifice arrangement.

Pensionskassen
Pensionskassen are a special type of insurance vehicle providing retirement benefits. They fall into two broad groups:
- Pensionskassen owned directly by an insurance company and independent Pensionskassen competing with such insurance company products, known as "deregulated" Pensionskassen.
- Company-owned Pensionskassen or multi-employer Pensionskassen, which are "regulated".

In regulated *Pensionskassen*, should the funding level fall below minimum required levels, benefits may be reduced or additional premiums charged in respect of accrued benefits. This may also apply to some deregulated *Pensionskassen*

Pensionsfonds

Pensionsfonds are separate legal entities, originally established with the intention of encouraging external pre-funding of pension obligations.

The key advantages of Pensionsfonds are:

- Past-service (accrued) obligations in respect of direct promises into a Pensionsfonds can be insured by a single premium payment in excess of the normal tax allowable provision and can be treated as a tax deductible expense amortized over 10 years.
- The PSV levy (the contribution to the statutory pension insolvency protection fund) is reduced by 80%.
- The restrictions on investment strategy are more relaxed than those applicable to Pensionskassen.

Pensionsfonds can now pay up to 30% of accrued pension benefits as a lump sum upon retirement. For so called "insured *Pensionsfonds*", after retirement, all annuities provided have to be guaranteed by the *Pensionsfonds*, so that insurance premium rates are used. Since 2007, there is an option for the employer to take some of the risk, which then opens the opportunity to transfer the liabilities with a single premium at a level closer to an IAS 19 obligation. The employer would then retain some of the inflation, investment and longevity risks.

Due to the administrative complexity of establishing and running a Pensionsfonds, only a small number of the largest companies have their own Pensionsfonds. Most companies contribute to Pensionsfonds established and operated by an insurance company or other financial services provider offered as an open-market product.

Insolvency protection

As a result of the prevalence of direct promises and support funds with limited or no external funding, a statutory pension insolvency protection fund was established called the Pensions-Sicherungs-Verein A.G. (PSV). The PSV secures vested benefits promised by employers should any become insolvent and unable to meet those obligations. The PSV does not insure benefits accrued by individuals whilst they are an owner or majority shareholder of the company (note that family shareholdings are also taken into account), nor does it cover the amount of any individual's pension benefits in excess of EUR 99,540 p.a. (2014).

Each year, the cost of securing the benefits promised by companies is charged to all companies with Direct Promises (including CTAs), Support Funds (including those which are reinsured) and Pensionsfonds as a flat percentage rate of the value of the liabilities; these are calculated on a defined actuarial basis similar to that used to calculate the tax balance sheet provision. For liabilities insured within a Pensionsfonds, the PSV charge is reduced by 80% to reflect the external funding requirements of such plans.

Liabilities insured by Direct Insurance or reinsurance contracts are covered under the industry-wide insurance protection scheme (Protektor); some Pensionskassen also participate in this insolvency protection scheme.

Accounting and Actuarial Issues

There are no minimum funding requirements for company-operated pension plans (i.e. direct promises and/or support fund); therefore, no funding valuations are required for this purpose. Companies with their own Pensionskasse or Pensionsfonds need to comply with the requirements imposed by the financial institution regulator, BaFin.

All EU listed companies have to produce financial statements under IFRS, in which case the normal rules apply.

Annual valuations are required under the local accounting standards (Handelsgesetzbuch, HGB). The treatment of pension obligations under HGB depends upon the type of pension vehicle used and when the promise was given:

- Direct pension promises entered into after 31 December 1986. The value of these obligations must be recognized on the balance sheet
- Direct pension promises entered into up to 31 December 1986 and "indirect" pension commitments (via support fund, Pensionskassen, Pensionsfonds or direct insurance contracts). These benefits may be recognised on the balance sheet, or the obligations may be accounted for as a cash expense, as and when contributions or benefit payments are made. The value of any such pension liabilities that are not recognized on the balance sheet should still be disclosed in the notes of the financial statements.

Up to 2009, a wide variety of actuarial methods and assumptions could be used to calculate the value of the liabilities under HGB, with the statutory tax provision as a minimum. It was common practice, historically, for many companies to simply use the statutory tax provisions in their HGB accounts. From 2010, the balance sheet modernisation law (BilMoG) mandates a valuation approach more similar to IFRS. In January 2016, the government made some changes to the legislature of 2009 so that now:

- the discount rate is linked to a 10-year average of swap rates of a duration equal to the liabilities, or 15 years as a default
- there is no prescribed valuation methodology (both projected unit credit and entry age normal methods are common) and
- there is the option to use the 10-year average retrospectively for the 2015 balance sheet.

The change represented a significant increase in the disclosed value of the liabilities for many companies: the one-off impact may be amortized over 15 years.

Assets held for the sole purpose of providing retirement benefits may be treated as plan assets in a similar way to IFRS, subject to certain restrictions.

For direct promises, the statutory tax balance sheet provision is calculated using the entry age normal method with an entry age of 27 or, if later, the actual entry date and a discount rate of 6% per annum. Only guaranteed benefits are valued. No allowance is made for any future variable increases (e.g. due to future salary increases or pension indexation linked to inflation). The mortality tables used must be approved by the tax authorities (current standard tables: RT Heubeck 2005G).

Support funds which hold assets other than re-insurance contracts need to perform annual valuations in order to determine the maximum tax-free company contribution to assets. These valuations are performed using a prescribed age-based annuity factor table.

Taxation

The tax environment in Germany in respect of contributions to funded plans and benefits received is very complex and the summary below is far from a complete picture.

Contributions: The taxation treatment of the contributions depends on the funding vehicle.

- Contributions (employee or employer) to direct insurance contracts, *Pensionskassen* and *Pensionsfonds* are generally taxable income of the employee, although up to 4% of the Social Security Contribution Ceiling (2016: EUR74,400) plus an additional tax-free contribution of EUR 1,800 for new schemes since 1 January 2005 can be paid in each year tax free.
- Contributions to some legacy direct insurance contracts implemented before 1 January 2005 are taxable at a flat rate of 21.5% up to a prescribed limit; where applicable the benefit payment would remain tax free correspondingly.

- Contributions to a *Pensionskasse*, Direct Insurance contracts and to Pensionsfonds, as well as the increase of the statutory tax balance sheet provision for direct promises and allocations to support funds (within the tax limits) are generally tax deductible expenses to the employer.
- Allocations to book reserve plans and contributions towards re-insured support funds are not taxed to the employee when made.
- Single premium payments to a *Pensionsfonds* made in order to transfer the past service liabilities arising from a direct promise or a support fund are not taxable income of the employee if the employer spreads its tax deduction over a ten year period.

Benefits: Generally, benefits are taxable income of the former employee, if the contributions/allocations during the service period were tax free. For certain types of pension, a proportion of the benefit is not taxed in some cases, depending upon the year of birth of the employee.

Market Practice and Trends

There has been a significant move away from occupational pension provision, particularly for small- to medium-sized employers. Given the difficulty in reducing benefits for existing employees, typically, plans have been closed to new entrants with active plan members continuing to accrue benefits.

Where plans have remained open to new entrants, benefits have often been amended such that fewer risks remain with the company. Often reinsurance contracts are used to protect against investment and longevity risks, and open final pay plans are no longer common. External funding has become more prevalent.

4.2.3 Pillar III

The third pillar of pension benefits consists of private retirement savings arrangements. These include the following:

Riester-Rente

The term "Riester-Rente" comes from the Labour Minister Walter Riester who originally proposed this approach in 2001. Employees can enter into a private contract with a bank, insurance company or other provider of a Riester pension product. Employees make contributions to the Riester arrangement out of their net (after tax) salary. The State provides additional "top-up" contributions to the arrangement, based on the number of children the individual has. Thus, for persons with large families, this can be an attractive way of saving for retirement. Monies that have been saved in a Riester contract can, in some circumstances, also be used to finance the purchase of a house or apartment.

Basisrente or "Rürup-Rente"

The Basisrente was introduced in 2005. The Basisrente was originally referred to as the "Rürup-Rente" after the economist Bert Rürup who originally suggested the programme. This arrangement is similar to the Riester- Rente, except that no top-up payments are paid by the State. Instead, contributions to a Rürup-Rente are partially tax-deductible for the individual, with full tax-deductibility being phased in by 2025.

Eichel-Rente

This is another term for "salary sacrifice" arrangements, whereby employees can forgo a portion of their cash compensation in respect of additional pension and risk coverage from their employer. Amounts converted into pension and risk benefits in this manner are not taxed until paid. Companies are required to offer this option to their employees in one form or another. Any of the second pillar financing vehicles discussed earlier can be used for this purpose, provided that these are made available by the employer.

43 MEDICAL AND OTHER BENEFITS

Germany has a compulsory system of medical benefits for employees and their dependents (*Gesetzliche Krankenversicherung*, GKV). Those earnings under EUR 57,600 must be insured in the State system (Krankenkassen) although individuals do have a choice of provider. Those earning above this limit may instead elect for private health coverage.

For 2017, the contribution is generally 7.3% from each of employer and employee on earnings up to EUR 52,200. Supplementary coverage (private rooms in hospitals, access to the senior surgeon, enhanced dental benefits etc.) is available privately at additional cost.

Companies rarely provide employees with medical benefits in excess of the statutory company contribution to the compulsory medical system, and when they do this it is often limited to senior management. Companies must also pay into a compulsory insurance (*Berufsgenossenschaft / Gesetzliche Unfallversicherung,* GUV) to cover the medical expenses of employees injured whilst at, or on their way to/from work (amongst other occupational accident and disease benefits).

Altersteilzeit or “ATZ” (Old-age part-time) programs are common and are used to facilitate restructuring. However, ATZ plans have become less common as some State subsidies for these programs have expired in 2010 (for example, the Chemical Industry in Germany has meanwhile closed collective bargaining agreements relating to these kinds of plans; long term saving accounts are used instead). There are two forms of the ATZ plan. The most common one, called the “block model” is for employees to continue to work for a period and then have the same length of time off work. At the end of the second period the employee moves into actual retirement. Employees typically receive a reduced salary (typically between 70% and 90% of pre-ATZ net salary) throughout the whole ATZ period, a lump-sum at the end of the ‘time-off ’ period, and Social Security contribution payments on 90%-95% of the equivalent full time salary. Under the “block model”, liabilities need to be established in the company accounts in respect of salary earned but not paid, additional “top-up” payments made to employees to bring them up to 70% - 90% of net salary, and any additional benefits payable as a result of the ATZ arrangement.

Long service awards are commonly provided to employees after 10, 25 and 40 years’ service, but are gradually becoming less common.

Other benefits typically provided include company cars or allowances for senior employees, subsidized canteens or meal tickets.

Flexible benefits are still not very common in Germany.

Share Plans do exist but are not widespread. Generally, the employee is taxed in full on the value of the benefit as it vests, except for stock options plans which are taxed as income when option is exercised

Summary

This Chapter begun with a brief economic overview and then outlined the scope and nature of pension benefit arrangements. It also mentioned briefly medical and other benefits provided.

Self Test Questions

- What State retirement benefits are available?
- What type and level of private retirement benefits are offered?
- What medical benefits are provided?

INTRODUCTION

For US employers, the major benefits issue is more often healthcare than retirement savings. Healthcare plans for employees are common. The healthcare system—provision through a profusion of government, charitable and privately-own facilities— is highly advanced and complex, and yet inefficient and subject to significant claims inflation; it is currently undergoing major reform with respect to access to medical insurance by most of the population. On the retirement side, a career-average defined benefit Federal pension is supplemented by employer-funded supplementary plans in most companies, most commonly (in terms of the number of people covered by such plans) in the form of a 401(k) or similar defined contribution (DC) savings plan. Death and disability benefits are also typical for employees.

5.1 ECONOMIC AND EMPLOYMENT OVERVIEW

The US economy is the largest in the world with a mix of large and small employers operating in a wide range of industries. The services sector is the largest component of the US economy, with a leading presence in telecommunications, financial services and information technology. While the economy has expanded fairly steadily since the end of the last recession in June 2009—and continues to out-pace Europe, the lagging effects of the real estate and financial market crises of 2008/09, has resulted in more tepid growth, with real GDP averaging slightly less than 2% per annum from 2009 to 2014 but has been improving over last 3 years with 3.10% growth recorded in June 2017. Adding to the drag are the large number of workers who have dropped out of the labour force – the labour force participation rate has declined from 66% to 63% during this time — and a still recovering housing market.

The unemployment rate is broadly following a downward trend since reaching 9.8% in November 2010, dropping to 4.2% by September 2017. However, the size of the labour force over that time is essentially unchanged at approximately 155 million since 2010, due to declining labour force participation. Some large employers have collectively bargained agreements with employee representatives which set salary and employee benefits. Only 10.7% of wage and salary workers were members of unions in 2017. In the private sector, only 6.4% of employees are union members.

5.2 PENSION AND RISK BENEFIT PROVISION

Overview: Employee pensions derive from three sources, or three pillars, government, employers, and individual savings. The three pillars are a defined benefit career-average pay Social Security benefit, employer-sponsored second pillar benefits (DC and/or defined benefit (DB)) and voluntary, individually-focused third pillar savings vehicles, such as Individual Retirement Accounts (IRAs).

5.2.1 Pillar I: Federal Social Security

The first pillar consists of a 'pay-as-you-go' Federal provision (Old-Age, Survivors and Disability Insurance, OASDI).The full retirement age (FRA) for both men and women is 66 years for those born in 1943 to 1954. It will continue to increase annually until it reaches age 67 in 2027. Retirement on reduced benefits is available from age 62.

Benefits

Benefit entitlement is based on earning credits, with up to four credits earned each year. In 2017, one credit will be earned for USD 1,300 in covered wages in a quarter. Four credits are earned for USD 5,200 in a year. Forty credits are required for any retirement benefits, i.e. vesting (fewer are required for persons becoming disabled or dying before age 62).

Benefit amounts are related to indexed annual earnings up to the Social Security ceiling over the 'best' 35 years of the career (if necessary, including years where there were no earnings at 0).The total adjusted earnings is then divided by 420 [35 x 12] to determine the Average Indexed Monthly Salary (AIME). AIME is then multiplied by the benefit percentage applicable to earnings in each of three earnings brackets (often called 'bend points') to determine the Primary Insurance Amount (PIA) for benefit payment. For those taking retirement in 2017:

AIME Earnings bracket (USD)	Benefit percentage multiplier
1 – 885	90%
885 – 5,336	32%
>5,336	15%

The benefits formula is weighted to favour career low-level earners.

The maximum state pension is USD 2,687 per month (2017) at full retirement age (FRA). Since 1975, pensions are normally increased annually on 1 January to account for increases in the cost of living. However, if official cost-of-living data does not indicate that living costs have increased, no increase is granted; this is rare, however, happening only twice since 1975, in 2010 and 2011.

An eligible spouse (including divorced spouse with 10 or more years of marriage) may claim the higher of a pension based on own record or a spouse's supplement of 50% of the retiree's pension.

From age 60 (age 50, if disabled), a surviving spouse can begin receiving Social Security survivor benefits. The proportion of the deceased worker's pension is set at date of death: 71.5% for a surviving spouse aged 60, increasing to 100% if the surviving spouse is over FRA at the date of death. A pension may also be paid to a divorced spouse if married to the deceased for at least ten years. A benefit amount equal to 75% of the deceased worker's pension is paid to eligible children.

Disability benefits are payable at any age before FRA to those persons whose disability prevents them from participating in "substantial" gainful employment, and whose disability is expected to last for at least one year or result in death. Generally, earnings of USD 12,000 or more per annum are considered "substantial". Disability benefits commence after a five-month waiting period.

Financing

In order to finance Social Security, which covers retirement, survivors' and disability benefits, employee and employer currently both contribute 6.2% of covered earnings, up to a salary ceiling (Social Security Wage base) of USD 127,000 per annum in 2017.

Taxation

Employee Social Security taxes (generally, known as FICA) are withheld from an employee's pay; they are not tax deductible Employer contributions are treated as a business expense. Benefits are treated as taxable income when paid out.

Trends

While continuing to increase the normal retirement age has been put forward, and consideration given in the past to moving to a DC for part or all of the benefits, current political considerations indicate there will be no major reforms possible. The current system is unlikely to experience financial difficulties in the short- to medium-term.

5.2.2 Pillar II Employer

Practically all employers provide some form of second pillar retirement provision, which may be DB, DC – for most newer plans) or hybrid DB/DC. Benefits payable on death or disability are typically insured separately.

Regulation

Employer-provided retirement plans are broadly divided between 'qualified' and 'non-qualified' plans. A 'qualified' plan offers certain tax advantages to members and their employer. To be qualified, plans must meet certain standards on plan design and administration which includes minimum levels of plan participation by ordinary employees (as participation is normally voluntary) and non-discrimination requirements. Non-discrimination refers to rules which prohibit plans from favouring so-called 'highly compensated employees'—broadly, those with earnings of USD 120,000 (2017)or more—over ordinary employees. Plans must undergo periodic testing to verify that they meet established standards to maintain tax-favoured status. The cap on annual compensation for qualified plans is annually indexed and is currently USD 270,000 in 2017.
Because the rules on qualified retirement plans limit covered compensation for benefits, employers often provide non-qualified retirement plans for more highly paid employees.

Non-qualified plans:

- do not have the tax advantages of qualified plans
- in most cases, are limited to a select group of management or highly compensated employees
- can be flexibly designed as DB or DC
- in many cases, make up for benefits in underlying qualified plans that are limited by statutory maxima
- have complex tax rules for benefit payment timing and options, with significant penalties for violations.

Benefits and Financing

Defined Benefit

The majority of workers eligible for company-provided retirement benefits are in some form of DC plan. Only about one-third of workers, mainly in large corporations, are covered by DB plans; however, in terms of total assets, DB plans account for almost two-thirds of total retirement savings in the US (OECD data).Together with Social Security, qualified DB supplemental retirement plans aim to replace between 60% and 80% of final average salary for a low-wage earner, and 45% to 60% for a high-wage earner who work for the same employer for their entire career. Benefits are typically based on a percentage of average pay (accrual rate) in the final three to five years for each year of service. Hybrid and other more recent DB designs accrue a benefit based on pay earned during each year of service.

Benefits are paid as an annuity, although some plans offer a lump-sum option. Benefits from DB and DC plans must be provided as a qualified joint and survivor annuity (QJSA), unless the plan member and spouse (if any) explicitly choose an alternate form of payment. Employees are sometimes allowed to opt for payment of their entire DB pension in the form of an actuarially determined lump sum. These may be rolled over into an IRA (see below, Section 5.2.3) or another employer's qualified plan to avoid immediate taxation and possible penalties for early withdrawal. If offered, minimum lump sums must be determined using a statutory conversion basis. The ability to make lump-sum payments may be restricted if the plan's funding ratio falls below 80% or the employer is in bankruptcy.

Qualified employer-sponsored retirement plans are required, on death in service, to provide survivor pensions to spouses equal to at least 50% of the employee's vested pension. Plan sponsors are permitted to reduce the employee's benefit to pay for the cost of providing survivor benefits; because of the administrative complexities involved in these reductions, and the relatively small cost savings they achieve for the plan, these reductions are not common. Lump-sum benefits in lieu of survivor annuities are sometimes available, with the same conversion rules described above.

Participants usually elect the form of payment at retirement from a standard set of options. Spousal consent is required to elect any form of payment that does not provide a death benefit to a surviving spouse.

Hybrid plan designs (which are DB plans with DC-like features)—such as cash balance and retirement shares—have gained popularity. Cash balance plans use an account-based plan formula, with a 'guaranteed' investment return; they generally offer lump-sum pay-outs.

Retirement benefits are commonly vested after five years of service, but hybrid plans such as cash balance plans must vest after three years of service.

Employee contributions to DB plans are rare as no income tax deduction is available; the cost of DB retirement plans is typically borne fully by the employer.

Defined Contribution
Almost all medium to large employers provide some form of DC arrangement, whether a profit sharing plan or, more typically, a 401(k) plan. Technically, these latter may be considered savings plans (see Part 2 Chapter 5) rather than retirement plans, since they allow for employees to defer a portion of their pay on a pre-tax basis; their prevalence is such that many features are commonly considered prototypes for the design of DC retirement plans in other countries.

Profit sharing DC plans will typically have an employer contribution formula with the rate set by the employer. As employee contributions are not tax deductible, the plan is unlikely to have any provision. Vesting will typically be over a period of two to six years. Flat, service-weighted, or age and service-weighted percentage of pay contributions are present in some DC arrangements. Age and service weighted contributions are frequently used as a means to transition from a DB plan to a DC plan.

The 401(k) plan structure is often considered more flexible and attractive to employees. An employer establishing such a plan is not required to make any contribution although many provide for such on the basis of a flat-rate or profit-sharing type formula. Most popular, however, are plans which provide company matching contributions to those of the employee.

Typical employee contributions are between 1% and 6% of pay. Plans may also permit additional salary deferral from the employee, whether on a pre-tax basis or a post-tax basis or both. Company matching contributions in 401(k) plans are typically 50–100% of employee contributions up to 6% of pay, with lower limits sometimes applied.

Vesting of employer contributions is typically either immediate or graded over two to six years. Employer-paid matching contributions in 401(k) "safe harbour" plans must be fully vested immediately; however, 401(k) "safe harbour" plans that also include automatic increases in participant contributions to certain thresholds (a "Qualified Automatic Contribution Arrangement" or QACA) require full vesting after two years of service. An employee's own contributions are always 100% vested. Accumulated contributions with investment earnings are paid as a lump sum at retirement, employees bear the investment risk.

Risk benefits
Due in part to tax favourable treatment, the provision of group life insurance benefits for employees, their spouses and dependent children is very common. The benefit is typically provided as a basic policy of one or two times annual salary which the employee can supplement by paying additional premiums. In addition, the provision may include supplemental lump sum benefits (insured as a rider) payable on death from accidental causes or due to dismemberment or disablement.

Two-thirds of employers provide benefits on long-term disability (LTD) and around 90% of all large employers also provide short-term disability (STD). LTD benefits may provide income continuation on the level of 50% to 66.67% of income protection inclusive of Social Security payments. STD benefits are usually based on a fixed percentage of around 60% of normal earnings for up to six months.

Basic risk benefits are invariably fully employer-paid, except AD&D benefits, which are sometimes contributory for employees or set up as a voluntary benefit (which may be known as personal accident insurance). Companies sometimes offer optional benefits through a flex plan.

Funding Vehicles and Typical Investment Profile

Defined Benefit
Advance funding of nearly all tax-qualified retirement plans is required by federal law. Pensions are funded through trust instruments (most common) or insurance contracts. Insurance companies, banks and investment firms are all active in asset management of pension funds. Asset management has become highly sophisticated and asset managers are continuously measured and monitored, with large companies frequently using two or more asset managers. Record keeping is handled by institutional trustees which have custodial, disbursement and sometimes investment responsibilities. Some smaller plans use insurance companies, but this is not common. In some instances, unfunded book reserve methods are used to finance deferred compensation arrangements, but these are not tax-qualified and are customarily confined to top executives.

Defined Contribution
Plans place their money with an institutional trustee. The trustees have custodial, disbursement and sometimes investment responsibilities. Employees typically have control over how their vested DC accounts are invested. The typical investment profile of pension funds therefore varies widely. According to 2016 data reported by the Profit Sharing/401(k) Council of America, plan assets are most commonly invested in the following types of funds:

Investment Category	Percentage of assets
Actively-managed domestic equities	21.4%
Indexed-domestic equity funds	12.4%
Target retirement date funds	19.8%*
Stable value funds	8.10%
Balance funds	6.5%

Source: 55th Annual Survey of Profit Sharing and 401(k) Plans
* The average allocation to target-date funds (19.8 percent of assets), which are offered by 63.2 percent of plans, is up from only 4.1 percent ten years ago.

Risk Benefits
Risk benefits will typically be insured externally, although larger employers may self-insure, particularly long term disability benefits.

Statutory Funding and Accounting Requirements for DB Pension Plans
DB plans require annual funding valuations to be performed by an actuary, who advises on current funding level and required contribution rates. There are significant restrictions on funding, particularly, with respect to the minimum level. The maximum contributions are generally so great that, in practice, few employers are restricted from funding because of this limitation. The Pension Protection Act (PPA) of 2006 required organizations to fully fund their pension liabilities over a rolling seven year period, beginning in 2008. In response to the extremely poor market performance in 2008, companies were given temporary statutory and regulatory relief to ease the transition into the full requirements of PPA.

In addition, annual valuations are required for accounting purposes under the US accounting standard ASC 715. The method used for measuring the benefit obligation is the Projected Unit Credit method.

DC plans have no such requirements.

Taxation

Contributions: Employer contributions are fully tax deductible up to complex limits. Employee contributions (salary deferrals) to 401(k) plans are tax deductible up to USD 18,000 (2017) but again, complex alternate limits may apply. Employer contributions are not treated as taxable income for the member subject to certain limits. The maximum employer and employee pre-tax contributions is USD 54,000 per annum in 2017.

Retirement benefits are taxed as ordinary income upon distribution. Distributions received prior to age 59 and a half may be subject to an additional 10% penalty tax unless the taxpayer qualifies for a specific exception based on the reasons for early withdrawal.

A notable feature of profit sharing and 401(k) plans is that distributions may be ‘rolled over’ into a successor employer’s qualified plan (if permitted under that plan’s rules) or into an IRA with the income tax deferred until actual receipt of benefits. This is particularly useful for an employee leaving service who wants or is required to take a benefit out of the plan prior to retirement.

Market Practice and Trends

Active employees may participate in both a DB plan and a DC plan, but many companies offer only a DC plan to new hires, retaining the legacy DB plan for existing employees and retirees. Seventy percent of companies in the Fortune 100 sponsor only DC plans. That being said, DB plans are not disappearing quite yet. Approximately 40% of survey respondents in for-profit and not-for-profit organisations offer a DB plan to new hires.

The trend toward greater employee cost-sharing of retirement benefits continues with the popularity of 401(k) plans. The majority of DC plans are 401(k) plans, but other plan types include (in order of prevalence): profit sharing plans; tax-sheltered annuities, or 403(b) plans, for educational and not-for-profit organizations; deferred compensation plans (457 plans) for public-sector employers; discount stock purchase plans; and employee stock ownership plans.

Mark-to-market funding and accounting rules combined with financial market volatility have increased interest in topics such as total retirement risk management, pension asset allocation, and (for frozen plans) “end game” planning and strategies for eventual windup of the DB plan.

523 Pillar III Individual

The third pillar represents individual savings.

A voluntary individually-focused retirement arrangement to supplement provision from Pillars I and II is known as an Individual Retirement Account (IRA). IRA varieties include both the traditional IRA and the Roth IRA. While the traditional IRA was targeted as a retirement supplement, the Roth IRA variant was intended for wider long-term savings,especially, assisting parents to pre-finance university education for children.

Tax benefits for traditional IRAs are taken at the time of investment, while Roth IRA account withdrawals are tax - and penalty - free if a variety of conditions, including such factors as age and disability status, are met. Individuals age 50 and above can contribute more to IRAs than younger investors (USD 6,500 versus basic limit of USD 5,500 in 2017), but basic contributions may be limited based on the taxpayer’s total income or contributions to a qualified employer plan.

5.3 MEDICAL BENEFITS AND OTHER BENEFITS

Social Security medical benefits (Medicare) are provided only to individuals aged 65 and older and to the disabled. Medicaid, a joint Federal and State government program, provides medical benefits to low-income individuals and families, the elderly, and people with disabilities. The majority of the population are, therefore, reliant on private healthcare provision.

Since his election, President Trump has been trying to repeal "Obamacare" bill which introduced Medicare and Medicaid. We can expect further developments on this topic in 2017/18.

Companies typically provide healthcare coverage for employees (and possibly dependents), although coverage is reducing due to high costs; all companies are looking for cost control mechanisms.

Medicare: a national insurance program primarily for those age 65 and older. It consists of four Parts:
- Part A: Hospitalisation insurance
- Part B: Medical insurance
- Part C: Medicare Advantage plans
- Part D: Prescription drug plans

Eligibility: 5 years legal residence plus 10 years contributions by individual or spouse
Contributions: 1.45% of all earnings from each of employee and employer, plus employee pays 0.9% on earnings above USD 200,00 [employer only contribute towards Part A]

Benefits
Medical: Most company medical plans cover a broad range of services for employees and dependents:
- Outpatient services
- Hospitalisation
- Dental
- Vision
- Laboratory fees and X-rays
- Prescription drugs
- Preventive and acute care services

Employers generally cover 68–80% of health insurance premiums of employees and their families. "Managed care" networks are common, whereby an employer enters into a contract with a specified group or network of healthcare providers, but enrolment in certain types of networks is slowing down because so many employers have already shifted to this type of arrangement. Employers generally receive discounts from these providers and design their programmes to pay a higher share of health costs for employees who use a practitioner/facility within the network.

Federal legislation requires employer-sponsored medical benefits plans to provide access to continued coverage – referred to as COBRA – to employees, their spouses and their children for 18 months upon termination of employment and for 36 months upon the employee's death, divorce or legal separation, or a child's coming of age. This applies in all cases of termination, including voluntary termination/resignation. Some forms of involuntary termination, such as theft, can preclude the candidate from continuation coverage. However, employers can charge up to 102% of the cost of continuing coverage to the employee, making the option of continuing coverage fairly expensive for the former employee.

Some large companies have historically provided coverage also for retirees, though such arrangements are largely closed (see Part 2, Chapter 3).

Dental: Dental plans generally come in two varieties: basic plans covering preventative and basic dental care, and comprehensive plans which cover the basics as well as major restorative care. Many plans are also open to dependents and include orthodontics. Dental plans contain several cost containment provisions, such as deductibles and maximums, which exist in order to limit the risk associated with the elective nature of dental benefits.

Financing

Financing varies, with larger companies (500+ employees) being self-insured (often incorporating some type of reinsurance or stop-loss arrangement to limit catastrophic risk exposure), while smaller employers typically use some form of insurance to finance their plans. The method and level of any advance funding varies depending on the size and risk tolerance of the employer. Many US employers have adopted flexible benefit or cafeteria programs which includes medical/dental care options.

Costs are increasingly shared with employees. Co-payments by beneficiaries usually range from USD 10 to USD 50, e.g. for prescription drug services. The new US healthcare reform law eliminated co-payments for certain preventive services beginning in 2010.

The trend of employees contributing more towards the cost of their benefit plans continues, though this varies widely by employer. Typical employee contributions, as a percentage of premiums, range from 20% to 24% for individual coverage and from 28% to 32% for family coverage. Larger employers (500+ employees) typically contribute a greater percentage of premiums towards cover than do smaller employers.

Contributions for dependent coverage vary by employer, with most employers requiring employees to pay for some of or the entire dependent premium. Most employers require the employee, spouse or child to pay the entire premium for COBRA coverage, plus a small administrative surcharge allowed by law. Depending on the nature of termination, employers may subsidize the cost of COBRA coverage for a limited period of time after the end of employment.

For dental coverage the average employee contribution as a percent of premium for individual coverage is 41% and for family coverage 45%.

Other techniques used in an attempt to control costs include:

- Plans with high deductibles (over USD 1,300 per person) combined with employer- and/or employee-funded, pre-tax health savings accounts (HSAs), commonly referred to as “consumer-driven health plans” (CDHPs), are being established
- Dental benefits subject to an annual maximum, usually USD 1,500 – 2,000.The typical orthodontic benefit is 50% of costs, limited to a lifetime maximum of USD 1,500- 2,000.

Accounting and Actuarial Issues

Liabilities for plans providing post-retirement medical benefits must be reported on annual financial statements under US accounting standard ASC 715-60.

Taxation

Contributions: Employer contributions are deductible and, most importantly, are not considered taxable income to the employee for income tax or Social Security purposes. The health care reform law now requires employers to report the cost of coverage on employee tax statements (Form W-2) for informational purposes to help individuals understand the full cost of their health care coverage. Employee contributions are made from pre-tax earnings.

Benefits: Benefits are not taxed.

Market Practice and Trends

Sharp and continuing rises in prescription drug spending has resulted in many employers moving away from two-tiered prescription drug co-payments in their health plans (generic/non-generic) in favour of three-tiered co-payments (generic/formulary/non-formulary) systems or moving to increased co-insurance percentages.

Many employers have also begun eliminating coverage for high cost compound drugs in favour of lower cost specialty drug alternatives. Regardless of the depth and breadth of an employer's benefit offer, medical and retirement benefits are still the primary drivers of employee satisfaction with their benefits. They are also, by far, the costliest benefits, both to the employer and employee, health care in particular. According to a recent annual report on employer health benefits by the Kaiser Family Foundation and Health Research and Educational Trust (KFF/HRET), the average annual health insurance premium for single coverage was USD 6,435 in 2014; for family coverage, it was USD 18,142.

The 2010 health care reform law (the Patient Protection and Affordable Care Act) will impact all aspects of the private and public systems including individuals, employers, health insurers, the pharmaceutical industry and health care providers. Due to the sweeping nature of the changes, the bulk of the law was implemented in stages from January 2010 to January 2015. Most importantly, beginning in 2014, employers with 50 or more full-time employees are required to offer health insurance to their employees. From 2014, uninsured persons who fail to purchase health insurance are subject to a tax penalty unless he or she can demonstrate that no affordable coverage option exists in their location. Various states and the federal government have set up Health Insurance Exchanges (HIEs) where consumers can purchase coverage.

Other Benefits

Flexible benefits plans are offered by 42% of employers, focused on medical, dental, paid leave and life insurance benefit options, rather than offering a wide range of additional benefits.

Other benefits commonly provided by larger companies include employee assistance plans, pre-tax healthcare and dependent care "spending accounts", free or subsidized parking, reimbursement of employee educational expenses, wellness programs and discounted company products.

Executives would typically receive company cars or, more commonly, car allowances, and participation in deferred compensation plans, stock option arrangements and 'non-qualified' supplemental retirement benefits.

Summary

This Chapter begun with a brief economic overview and then outlined the scope and nature of retirement benefit arrangements. It also mentioned briefly medical and other benefits provided.

Self Test Questions

- What State retirement benefits are available?
- What type and level of private retirement benefits are offered?
- What medical benefits are provided?

INTRODUCTION

A fixed-rate State pension is supplemented by a mandatory employer-focused funded supplementary system. High levels of required minimum pension provision means benefits provided are relatively high. Medical benefits are provided for the individuals through a system of compulsory private insurers and employers play a minimal role. Death and disability benefits are high but flex benefits are relatively rare.

6.1 ECONOMIC AND EMPLOYMENT OVERVIEW

Switzerland has an open economy with both strong export performance and sustained growth through internal consumption. The country was less impacted than its neighbours by the recession of 2008-10.The country has focused on high-value-added service and manufacturing industries and employees are typically well-qualified. Although Switzerland is not in the European Union, it has signed many bilateral agreements, meaning that its legislation follows closely that of the EU. It has generally subscribed to the 'free movement of labour' principles, with work permits freely issued, but the 2014 referendum result triggered a need to re-negotiate with the EU to reduce access.

In 2015 the Swiss National Bank removed the peg of the Swiss Franc to the euro. As a consequence, the Swiss Franc increased in value significantly, resulting in a challenging market situation, in particular for the Swiss export sector. Tax rates vary from low to moderately high by European standards, depending on Canton of residence; Social Security contribution rates are moderate but applicable to all employment income.

Employment is in practice governed by written contracts (although there is no legal requirement).There is a highly-flexible labour market with relatively short notice periods ranging from 1 month to 3 months. Other key employment legislation includes a minimum annual holiday of 4 weeks per year, maximum working hours and compulsory workplace insurances. Several large employers have collective agreements with employee representatives/unions which set salary and employee benefit conditions. There are rarely labour disputes and few strikes.

6.2 PENSION AND RISK BENEFIT PROVISION

Overview: Pension consists of three pillars. The first two pillars aim to provide a pension at retirement of 60% of final salary on a combined basis, whereas the third pillar aims to provide supplementary benefits on top of the first two pillars. The three pillars are a fixed-rate Social Security pension, an employer-sponsored second pillar with a compulsory element and optional supplement, and a voluntary individually-focused third pillar. Given the number of guarantees applying to benefits accruing within a nominal defined contribution (DC) pension plan, for international accounting standards, these are considered as defined benefit (DB).

6.2.1 Pillar I: Social Security

The first pillar (known as AHV in German or AVS in French) consists of a 'pay-as-you-go' State provision. Retirement age is 65 for men and 64 for women.

Benefits

Pension at retirement depends on the contribution record with a maximum pension of CHF 28,200 per annum (around 40% of average earnings) based on a career of 44 years for men and 43 for women. The pension itself is made up of a flat-rate component and an earnings-related component. The maximum combined amount for married couples is 50% higher. Pensions in retirement are indexed.

A widow(er)'s pension is payable and amounts to 80% of the old age pension in payment or projected payment. Disability benefits equal to the projected old age pension are also provided under the IV/AI system, reduced proportionately for partial disability.

Financing

Social Security contribution rates amount to 5.125% on unlimited salaries for both employees and employers. These contributions include 4.2% from both employer and employee towards retirement and survivors benefits, and 0.7% each for disability coverage (the remaining 0.225% provides financing for military and maternity leave).

Taxation

Employee contributions are tax deductible. Employer contributions are treated as a business expense. Benefits in payment are treated as taxable income.

Trends

The predominant activity is a comprehensive reform of both first and second pillar pension systems ("reform 2020"). The main objective is to ensure long-term financial sustainability of both pillars, while not reducing the current level of benefits. With regard to the first pillar, the reform harmonizes the normal retirement age of men and women (age 65) and provides for more flexibility in terms of retirement age (between 62 and 70). It reduces minimum conversion rates in the mandatory part of the second pillar to 6.0%, and most controversial, increases future pensions from the first pillar.

The first pillar will face a substantial funding gap due to changing demographics, which will be addressed with additional funding through an increase in VAT.

The Swiss Federal Council submitted the reform 2020 to parliament in November 2014, and the proposals are subject to a referendum on 24 September 2017. (Even if it is rejected, the main changes in benefits are likely to be part of the next reforms.)

6.2.2 Pillar II: Employer-sponsored

The second pillar is a compulsory employer focused system, known as the BVG (in German) or the LPP (in French). Companies must provide a DC arrangement for their employees and the government sets down minimum levels of benefit. All employees from age 25 earning more than CHF 21,150 per annum are covered (for those between age 17 and 24, only risk benefits need to be provided). Employers are permitted to provide an alternative DB plan for their employees provided the benefits are at least equal to those mandated under the BVG/LPP.

Regulation

Pension funds must be set up in the form of a foundation, cooperative or mutual society or established under public law. The system is closely regulated. One of the most important areas where authorities are involved is in prescribing minimum benefits that pension funds must provide. These cover:

- Minimum age-related contribution rates for DC Plans or level of benefits for DB Plans (see Table 1 below)
- Minimum rates of return to be declared on members' accounts (for a long period at 4%, since 2003 this has varied between 1.25% and 3.25% and is currently at the all-time low of 1.25%)
- Conversion rate of accumulated funds at retirement to a pension income (minimum conversion rate of 6.8%)

The conversion rate, the minimum rate of return and the definition of obligatory covered salary are fundamental parts of the system. In respect of the minimum conversion rate of 6.8%, if the individual has an account balance of CHF 100,000 on reaching retirement age of 65 for men or 64 for women, this means that their pension is calculated as CHF 6,800 per annum. However, this rate applies only to the minimum account balance (based on the minimum contributions and covered salary described below.) If the individual's actual account balance exceeds this level, the pension fund can convert to pension at the rate they see fit, as long as the resulting pension is not smaller.

These requirements – the minimum rate of return and conversion rate – only apply to contributions paid on a defined minimum legal pensionable salary amount (salary between 75% and 300% of the maximum Social Security pension, currently, CHF 21,150 and CHF 84,600 respectively).

For earnings above this level, employers have more freedom over determination of the benefits to be provided. In practice, however, many employers:

- Maintain contribution rates at the same level as applicable on the compulsory part (even if the employer has set the contribution rate on the compulsory part at a level above the minimum)
- Maintain the split between employer and employee contributions on the compulsory part (even if the employer has set the split about the minimum 50 :50 required on the compulsory part)
- Apply the minimum rate of return to the 'excess salary' part of benefits as well
- However, apply a conversion rate to the 'excess salary' at a lower level

The maximum level of pensionable salary that can be taken into account in pension funds currently amounts to CHF 846,000 per annum.

Benefits and Financing

For the relatively few remaining DB plans, benefits tend to be indirectly integrated with Social Security provision (often through offsets to pensionable salary). A target replacement ratio in the proper sense does not exist. The aim of both pillars (I and II) is to maintain the standard of living during old age.

For DC plans, the Government sets down minimum age-related contribution rates (see Table 1) which tend to act as a basis for plan design. These contribution rates, or credits, only apply to the minimum legal salary for BVG/LPP (also known as the 'compulsory part').The employer must pay at least 50% of the total cost of savings and risk benefits within the plan.

Table 1

Age	Minimum Savings Contribution Rate
25-34	7%
35-44	10%
45-54	15%
55- 64/65	18%

Risk Benefit contributions amount to around 1% - 3 % of salary in addition but can vary from 0% to 6%.The cost is sometimes borne in total by the employer. Plan administration costs can further increase plan financing cost by 1% to 2% of salaries; again, this may sometimes be borne wholly by the employer.

Early retirement is possible as from age 58. On retirement, the accumulated fund is converted into a pension at a set rate – subject to the minimum legal requirements, currently 6.8% at age 65/64. Note that many funds allow members to take all the benefit in lump sum form; legislation requires employers to allow at least 25% of the accumulated amount to be taken in this form.

On leaving service, benefits are vested but have to be transferred to the new employer's pension fund, or, alternatively, to an individual pension account if the individual does not take up another employment or becomes self-employed. There is a State default fund available for transfers where no action is taken by the former member. This means that pension funds do not have deferred pensions.

Other benefits provided include disability (typically calculated as a percentage of insured pay), spouses' pension on death in service or retirement and children's pensions. Again, there are minimum benefits that need to be provided under Swiss law, as follows:

- Disability Benefit: 100% of projected retirement pension assuming no interest credited on the member's account.
- Death Benefits: 60% of the Disability pension for Death in Service and 60% of the pension in payment for the Death in Retirement pension.
- Orphan's Pension: 20% of the old age pension for death in retirement and as a percentage of the disability pension for death in service.

As for the benefit minimum requirement, many companies provide levels in excess of the minimum legal requirements.

Funding Vehicles and Typical Investment Profile

For pension savings benefits, companies have the choice of running their own foundation (known as an autonomous pension fund) or joining a multi-employer (collective) foundation offered by one of many providers. In any case, these vehicles must be a separate legal entity independent from the company. The latter can (but need not) be reinsured with an insurance company so that pension funds are guaranteed to meet the minimum return requirements and can never become underfunded. Larger companies tend to have their own pension foundation; smaller companies tend to go for the collective approach.

A key constraint on investment is the minimum rate of return that must be credited to members' accounts. Although insured funds do offer products guaranteeing the minimum rate of return, this also limits the 'upside' resulting in relatively modest returns. Employers with their own autonomous pension fund will need to set up reserves, calculated by the actuary, for this purpose. Table 2 sets out the average return of pension funds and the minimum rates of return over the last several years. It should be noted that, for most pension funds, there is no employee choice; DC Plan investment policy is decided by the pension fund itself.

Table 2

Year	Minimum Rate of Return	Average Pension Fund Return
2001	4%*	-4.15%
2002	4%*	-7.98%
2003	3.25%	9.25%
2004	2.25%	4.49%
2005	2.25%	12.62%
2006	2.25%	6.58%
2007	2.5%	2.04%
2008	2.75%	-13.25%
2009	2%	10.86%
2010	2%	3.01%
2011	2%	-0.56%
2012	1.5%	7.21%
2013	1.5%	5.76%
2014	1.75%	7.73%
2015	1.75%	0.95%
2016	1.25%	3.87%
2017	1.00%	3.94% (YTD Q2)

* The rate of 4% applied from 1985 to 2002 inclusive.

The typical investment profile of pension funds, therefore, varies widely depending on whether the fund is autonomous or insured. However, the implications of meeting the guarantee every year means that the profile does not vary widely between mature plans and plans with a relatively young member profile. The table below details the average asset allocation as at 31 December 2015 according to the Credit Suisse Swiss Pension Fund Index Survey

Investment Category	Asset allocation
Swiss Equities	14%
Foreign Equities	17%
Swiss Fixed Interest	25%
Foreign Fixed Interest	8%
Property	22%
Cash	5%
Other (mortgages/alternatives)	2%/7%

"1e" Plans for higher earners

Since 1 January 2017, pension benefits provided in respect of salary above CHF 126,900 p.a. may be in the form of plans with member-directed asset choices without the compulsory interest guarantees, allowing for true DC plans under IAS 19.

Accounting and Actuarial Issues

- DB plans require funding valuations which are performed by the scheme actuary who advises on current funding level and required contribution rates.
- DC Plans also require the involvement of the actuary who will determine the reserves required in order to meet the minimum account return required as well as meeting the commitment of the conversion of accumulated lump sum to pension at the minimum rate as required under Swiss law. Due to the guaranteed investment return and the minimum mandated conversion rate to pension, DC plans are considered as DB in nature for the purposes of International Accounting Standards.
- Pension funds are required to publish annual statutory financial statements in accordance with the Swiss accounting standard FER26/RPC26. In contrast with IAS 19, where the Projected Unit Credit method applies, the method used for local accounting under FER26/RPC26 is an accrued benefit basis with additional reserves for future risks and fluctuations.

Taxation

Contributions: Both employer and employee contributions are fully tax-deductible. Employees can buy back 'lost' past service on a tax-efficient basis within the statutory limits.

Benefits: Pensions are taxed as income; lump sums are taxed at special rates. Tax rates and methodology applied to the lump sum depend on the Canton of residence.

Market Practice and Trends

There has been a gradual, but significant, move from DB to DC provision. The plans are converted to cash balance plans that are to be considered as DB plans for accounting purposes. In the last three years the investment returns were high due to impressive returns in equities and corporate bonds. However, the yield on corporate bonds which is the basis for the determination of the discount rate is in a range of -0.7% to 0.5%. It can already be observed in the markets that some pension funds have reduced the discount rates in their valuations resulting in higher liabilities, so increasing financing needs. As at 31 March 2016, the average statutory funding levels stood at 99% for public funds and 109% for private pension funds.

Moreover, a further reduction in the number of autonomous pension funds towards a concentration on insurance solutions is expected.

6.2.3 Pillar III: Voluntary Individual

The third pillar is a voluntary individually-focused pension arrangement with a relatively wide range of investment options. Individuals choose the fund and can contribute up to CHF 6,768 per annum (indexed each year) to supplement the provision from pillars I and II. Within this framework, contributions are tax-deductible and earnings are tax-deferred. Lump sum payments out of the third pillar are also taxed at special rates when taken.

63 MEDICAL AND OTHER BENEFITS

Switzerland has a compulsory system of medical benefits. All residents are required to have private medical insurance with minimum medical coverage ('Standard Cover'). The choice of provider is made annually. Supplementary coverage (private rooms in hospitals, complementary medicine, etc.) is optional and insurers may demand a health questionnaire before acceptance. Providers are not allowed to negotiate terms for the standard cover element, but can negotiate rates for the supplementary coverage. While most employers are not involved in their employees' insurance choice, some companies subsidise part of the cost. This can vary from CHF 120 to CHF 400 per month (around CHF 50 to CHF 60 per month for children) depending on the insurer, canton and deductible chosen.

Other benefits typically provided include subsidies for public transport, subsidised canteens or meal tickets, subsidised education, extended leaves (e.g. for maternity) and free parking.

Flex benefits are not popular in Switzerland due to the high level of minimum coverage and relatively conservative demands of employees.

Share Plans do exist and their structure depends on the company. Tax treatment may vary by Canton, despite Federal guidance provided.

Summary

This Chapter begun with a brief economic overview and then outlined the scope and nature of pension benefit arrangements. It also mentioned briefly medical and other benefits provided.

Self Test Questions

- What State retirement benefits are available?
- What type and level of private retirement benefits are offered?
- What medical benefits are provided?

INTRODUCTION

A fixed-rate State pension is typically supplemented by a voluntary employer-sponsored pension plan. Compared to many other countries, the typical pension provision is relatively high, and mostly in the form of defined benefit (DB) provision, although it should be noted that there is a trend towards offering defined contribution (DC) plans. Medical benefits are provided through a system of compulsory private insurers in which employers play a limited role.

7.1 ECONOMIC AND EMPLOYMENT OVERVIEW

Within the EU, the Netherlands is a country with a very strong history of stable industrial relations resulting in low unemployment and stable inflation. The Dutch economy is largely focused on global trade, transport and added value industrial activity with highly skilled employees. The country is attracting significant foreign investment.

The Dutch economy was hit very hard by the financial crisis which began in 2008, as a result of which the GDP contracted by 3.9% in 2009, while exports declined nearly 25% due to a sharp contraction in world demand. The economy saw a small resurgence, but declined again in 2012, after which recovery started. GDP growth is projected to remain at or just over 2% in 217-18. The Dutch financial sector, with some of the largest players in the world, has also suffered significantly from the financial crisis. The stakes in financial institutions that the Dutch government acquired in the aftermath of the 2008 financial crises are now (in 2017) almost all sold to private investors or partly relaunched on the Amsterdam stock exchange.

The Dutch economy and employment policy is based on broad consensus between employer, employee and Government, which is referred to as the "poldermodel"[1]. To a large extent, employment is organised through national and industry-wide collective labour agreements which are based on the full support of all stakeholders. The result is a very stable economy with little employee unrest which created an environment that supported continuous economic growth for more than 25 years. The downside, however, is a rather immobile and inflexible employment market. In the first half of 2014, Dutch Parliament passed legislation facilitating more mobility of employees, which came into effect in July 2015.

7.2 PENSION AND RISK BENEFIT PROVISION

Overview: The first pillar benefit is flat-rate, related to residence and is provided to all residents. Second pillar pension plans are widespread; almost every employee participates in a company pension plan. Furthermore, voluntary third pillar savings are becoming more popular. Traditionally, the rule of thumb replacement ratio of 70% gross salary was targeted from the three pillars. In the last few years, more realistic goals have been to achieve anywhere from 55% to a maximum of 70% (with an average of 60%). In 2013 and 2014, fiscal limits have been made tighter, allowing for less tax-facilitated accrual of pension benefits. The fiscal limits are aimed at 75% of average pay in a 40 year career. As of 2015, the pensionable salary (on behalf of tax-facilitated pension accrual) cannot exceed EUR 103,317 (in 2017). For salaries above this cap, there is a possibility to save for a net pension. These net savings are to be done from net income and employees can opt out of such a net plan in case it is set up collectively.

7.2.1 Pillar I: Social Security Benefit

State retirement pensions (AOW) are flat-rate and related to residence, not to employment. They are financed on a pay-as-you- go basis out of income taxes. In 2018, the State retirement age is 66 years, 4 months for men and women. The State retirement age will increase by small increments to age 67 by 2021, and will be linked to remaining lifetime expectancies beyond that. This will assist the Government to deal with increasing longevity of the beneficiaries and the rising cost of provision. Starting in 2022, every five years, the Dutch Parliament will determine the State retirement age.

1 A "polder" is land that was drained from the sea. About 20% of the Netherlands consists of drained land, which is characterised by a flat, even and equal landscape.

The pension at retirement based on a full accrual period of 50 years is EUR 9,613per person for couples and EUR 13,940 for a single person (July 2017).

Spouse pensions and orphan's pensions (ANW) will have a limited future existence. Spouses are eligible to an ANW spouse pension if they were born before 1950; the spouse pension will stop when the beneficiary starts receiving AOW. In addition, the benefits are means tested. The spouse and orphan pensions are flat-rate. If the spouse has a child or children, the spouse pension is increased. A full spouse benefit (without child) is EUR 14,275 p.a. (July 2017).

Benefits are subject to income tax.

Social Security contributions are part of the income tax collection and integrated into the initial tax rate. Contributions for the retirement pension amount to 17.90% of annual income up to EUR 33,790 (2017); contributions for spouse pension amount to 0.60% of annual income up to EUR 33,790 (2017). There is no employer contribution.

7.2.2 Pillar II: Company Benefits

Contrary to many other countries where the second pillar has shifted heavily to DC plans, a lot of Dutch company plan remain to have DB characteristics but are often executed as Collective DC (CDC) plans (see below). The company pension plans that still are DB plans have almost all shifted towards career average plans, with a revaluation of past entitlements which are conditional on sufficient funding in the pension plan, instead of the former practice to offer final pay plans.

Since 2002, some companies started introducing DC plans for their new employees while existing employees remained in their DB plans. Other companies have transferred the risk of their DB plans to the plan members by installing a so-called Collective DC plan (CDC). In such plans, the formula is still DB but the employer agrees with the members a fixed contribution into the plan. As a result of the recent, and on-going financial crisis, there is even more pressure to transfer pension risk to the plan members. Although DC is becoming more prevalent, the consensus approach may also lead to pension structures which still include solidarity between different groups of employees and which balance risk between employee and employer. As of 2015, a new solvency regime has been introduced which, inter alia, sets stricter rules with regard to recovery plans, introduces an indexation rule (indexation only allowed if the funded status on Dutch pension fund GAAP is above 110%), and aims to limit volatility in pension contributions.

Funding of Company Benefits

The four funding options for a Dutch pension plan are direct insurance, a company pension fund, an industry-wide pension fund, and a PPI. The Dutch National Bank (DNB) supervises insurance companies, PPIs and pension funds. Legislation has been enacted to introduce a new type of pension provider (APF – General Pension Fund—is discussed below).

Direct Insurance

Funding has to occur according to pre-defined arrangements through the purchase of annuities from an insurance company. Insurance companies are free to determine their own premium rates, subject to the oversight and agreement of the DNB. Dutch insurance companies offer group annuity contracts in which deferred annuities are purchased by (most commonly) level annual premiums, although single premium plans are also an option. Premium rates are guaranteed for a period of years and subject to a volume discount varying according to the size of the total premium. Insurance companies can offer a number of different approaches to bonus or profit-sharing within the policy being taken out.

To meet the needs of small groups of employees, the major Dutch insurance companies have developed a number of so-called standardised pension plans. These plans combine the advantages of group insurance rates, computerised administration, and attractive premium discounts; the principle disadvantage is relatively inflexibility as to the design of benefit structures.

There are no explicit statutory restrictions on the investments of life insurance companies. Therefore, the DNB exercises exclusive supervision over all aspects of insurance company operations. Dutch insurers need of course to follow Solvency II.

PPI

Premium Pension Institutions (PPIs) are a type of DC provider. The PPI often offers a wider choice of investment providers compared with those offering a bundled product. This has increased the competition in the DC market.

Pension funds

The Pension Act sets down the general conditions applicable to employer-sponsored pension funds which include:

- The primary purpose must be to provide retirement, survivors' and disability pensions;
- Plan rules must be clear, definitive and must not discriminate between employees in the same defined category. Variations between defined categories are allowed;
- To qualify for favourable tax treatment, plan benefits must stay within applicable limits, taking into account the employee's service period and salary. A target replacement level of up to 70% to 75% of (average) gross salary after 40 years of service has traditionally been widely applied and continues to be generally acceptable. The maximum accrual rates per annum reflect retirement age 67 for pension accrual in 2014 and onwards, whereas it was retirement age 65 for pre-2014 accrual;
- Plans must be funded according to pre-defined agreements through an approved and supervised pension foundation;
- Pension plans that provide for post-retirement pension increases must provide the same increases to the retirement pensions of the deferred pensioners. Once the payment of a pension commences, survivor pensions must be treated in the same way as the primary pension would have been;
- Pension rights can be transferred from one pension fund or insurance company to another. In general, such transfers are subject to member approval. In case of collective transfers, DNB approval is needed as well;
- In case of the purchase of the employer through an asset transaction, the rights and obligations in the pension scheme will transfer to the buyer unless the buyer opts for the application of its own pension scheme, or the buyer participates in a compulsory industry-wide pension scheme in which scope for the transferred employees fall, or, in case a different decision is made, a resolution by collective bargaining agreement.

The pension fund governance structure is fairly complex. A pension fund is managed by the pension fund board, on which it is mandatory to have retiree participation. In most cases, the employer can nominate one-half of the board members. There are additional requirements in respect of internal financial controls and administrative accountability.

A compulsory code of conduct for pension funds is applicable to board members, fund managers and all other individuals working for the pension fund as well as their immediate families/direct relatives. The code stipulates the promotion of professional conduct and transparency in all aspects of fund management; other business and personal activities must be kept strictly separate. The exact content of the code of conduct is left to the discretion of pension funds, but it must meet certain minimum legal requirements.

The Pensions Act, and its financial framework, states that the assets and future contributions must be sufficient to cover pension liabilities on a quasi buy-out basis at any point in time. Apart from this, there is full freedom as to the financing system adopted by the plan. DNB must receive a report each year, to be externally audited and signed off as to the adequacy of the pension provision under the 'prudent person' rule by a qualified actuary. This is intended to provide a full picture of the financial position of the fund.

Investments must be prudent. DNB is the final arbiter of whether a balanced risk approach is being used. No more than 5% of assets can be invested with the sponsoring company. If a company belongs to a holding company, no more than 10% of assets can be invested in one of the other companies belonging to that holding company.

Subject to the agreement of DNB, the restriction relating to self-investment can be waived in situations where the employer has taken on new financial obligations due to an increase in pension benefits relating to years of past service.

Industry Wide Pension Plans

As noted previously, industry-wide, multi-employer pension schemes are common (and may also apply to more than one branch of industry). By collective agreement or ministerial extension, participation in such plans is often compulsory. This means that, if there is a collective labour agreement ratified by the Ministry of Social Affairs, then the employees must join the scheme. An exemption from compulsory affiliation by 'contracting-out' is permissible only under certain specific circumstances as governed by the Pensions Act and the Act for Compulsory Industrial Pension Funds. The Minister of Social Affairs is empowered to make participation compulsory at the request of a group of employers and employees which are deemed sufficiently representative of the branch of industry, subject to certain conditions. In addition, all employers in a particular industry may be required by the Ministry of Social Affairs to provide pensions for their employees. This requirement is normally implemented by bringing all employers in the sector together into an appropriate industry pension fund.

Many of the rules on single employer pension plans such as the content of articles of association and rules, the composition of fund boards, codes of conduct applicable to board members, and investment restrictions, apply equally to multi-employer plans.

Funding for industry-wide plans tends to be based on average, flat-rate premiums applied uniformly to all members, irrespective of age or years of service, with fund profits generally used to increase benefits. Industry-wide plans may also offer individuals the possibility to join a top-hat plan.

APF

An APF (Algemeen (General) Pension Fund) is a pension fund in which multiple employers can participate. The legislation regarding APFs has recently been finalised and the first APF did receive its license to operate in June 2016.

An APF can administer and execute multiple pension plans with separate funding per employer/plan(s) (ring fencing).Within the ring, however, principles of collectivity and solidarity will apply.

An APF can be set up by employers, insurers, administrative organisations, asset managers and possibly industry-wide pension funds (under certain conditions).

Foreign pension plans can also be managed by an APF, but that this has not materialised in practice.

Taxation

Both employee and employer contributions are tax deductible. Pensions are taxed as income. Lump sum payments from second pillar pension plans are not allowed.

Market Practice and Trends

Due to the economic circumstances and decreasing interest rates, many pension funds continue to be in deficit. Most of these funds have not fully recovered from the last economic downturn in 2008-2009.The funding ratios of these funds were below the minimum required level of roughly 105%.This has led to benefit reductions being imposed by many pension funds thereafter.

Because of the introduction of the new Financial Assessment Framework (see hereafter), no reductions have been required in 2015. However, the low interest rates in the first half year of 2016 have moved the financial position of a number of pension funds into the "danger zone", leading to the expectation that benefit cuts might be due starting 2017 or 2018.

Pension funds that are unable to fully recover naturally or through additional measures - increasing contributions, lump sum payments or increasing investments returns - are required to reduce pensions.

Since the introduction of the current (new) Financial Assessment Framework (FTK, incorporated in the Pension Act), the Government and the DNB have been working on a solvency regime that was first laid down by social partners in 2010 (National Pensions Deal). The main characteristics of the new pension structure, which was introduced in 2015, are:

- Sudden, significant benefit reductions must be avoided as much as possible; the impact of windfalls and setbacks should be spread over time. However, every effort must be made to avoid postponing corrective measures.
- No distinction to be made between long-term and short-term recovery plan. A pension fund is obligated to set up a recovery plan as soon as the funding ratio falls below the required level. Each year, the recovery plan should be revisited and, possibly, revised in light of new circumstances.
- Annual increases to pensions are not allowed when the funding ratio is below 110%.When the funding ratio is above 110%, annual increases can be granted based on what the pension fund can afford. This implies that awarding full annual increases (according to ambition) will take place only when the funding ratio is above the so-called 'indexation funding ratio', which is determined by the pension fund.
- The FTK must not increase the volatility in the contribution; the requirement that the contribution must contribute to recovery has been dropped.
- The statutory security criterion of 97.5% requires a higher buffer to be set.

In addition, stricter solvency requirements and reduced smoothing mechanisms are increasing the cost of pension promises, which are unable to be adjusted, and provide a clear incentive for change.
For employers with directly-insured or re-insured pension arrangements, the framework contained in the new National Pensions Deal is less clear. Insurance companies, by their nature, provide security through guaranteeing pension benefits. While some insurers are currently lobbying legislators to offer new products aligned with the new system, it is unclear how the insurance system will fit into the Dutch pension structure moving forward.

7.2.3 Pillar III: Individual Pension Provisions

In addition to the first two pillars and, even more, in the rare case when an employer does not provide an occupational pension benefit, individuals have the option to insure a pension themselves. The tax facilitated possibilities for this are:

- A policy with an insurance company
- A savings plan with a bank
- If offered by the employer's pension plan, increasing pension benefits through an additional module

7.2.4 Net Pensions

As of 2015, pension accrual based on income exceeding EUR 103,317 (2017) can be realized by means of net pension. The full implications of this new retirement structure are still being considered. In essence, contributions into the plan will come from post-tax income and benefits from the plan are expected to be tax-free. The accrued account value is the plan is exempt from taxation on capital.

Net pensions can only be offered as a DC scheme. It is expected that the providers can be insurers, PPIs, or pension funds.

7.2.5 Disability Benefits

Many pension plans offer disability benefits. The most common disability benefit within a pension plan is a waiver of contribution with regard to pension accrual.

Although many pension plans also offer a disability pension (payable until retirement age), employers that offer pension plans without a disability pension often offer a separate insured disability pension benefit.

7.2.6 Death Benefits

Employers do not usually offer lump sum death benefits due to adverse tax consequences. Basically, all pension plans provide spouse's pensions.

Within the Dutch market, it has been common for individuals to procure their own life insurance, particularly in the form of funeral insurance. This has lessened any employee demand for such a benefit.

Given the tighter fiscally-facilitated pensions as of 2015, imposing effective limits on spouse's pensions, it can be expected that the demand for death benefits will increase.

7.3 MEDICAL BENEFITS

Under the health care system established in 2006, all residents are required to have health insurance to a minimum standard. The majority of the employee population arranges their medical care plan individually instead of being covered under an employer-sponsored group medical care plan. There is a range of supplementary insurances available to individuals to provide enhanced or additional provision; these are linked to the compulsory basic insurance provided by the insurance companies.

Employers typically agree favourable terms with a health insurer for their employees. Larger companies often have some supplementary insurances tailored to their type of business, to make sure that the insurance cover is in line with wellness activities the employer offers, e.g. treatment (like a physiotherapist) at the workplace, with an eye on reducing absenteeism and reducing disability cost.

For medical care that is not covered by the individual medical care plans (i.e. long term medical care requirements), a State benefit, the so-called AWBZ, was previously available. From 2015, this has been parceled out among the basic coverage of health insurers, the local Government administrations, and the new Long-term Care Act (Wlz). The costs of the Wlz are financed through income tax collection. Contributions for the Wlz amount to 9.65% of annual income up to EUR 33, 715 (2017).

Summary

This Chapter begun with a brief economic overview and then outlined the scope and nature of pension benefit arrangements. It also mentioned briefly medical and other benefits provided.

Self Test Questions

- What State retirement benefits are available?
- What type and level of private retirement benefits are offered?
- What medical benefits are provided?

INTRODUCTION

A State pension that combines fixed-rate and salary-related elements is supplemented by an employer-sponsored funded supplementary system. Comprehensive medical benefits are also provided through a State system, typically supplemented by employer plans. Death and disability benefits are also supplemented by employer plans.

8.1 ECONOMIC AND EMPLOYMENT OVERVIEW

Japan has an open economy experiencing both strong export performance but decreasing growth for internal consumption due in part to the impact of deflation. The country, although on the way to recovery from a severe recession for almost two decades after the economic bubble burst, is still struggling with decreasing consumer confidence, reduction in tax revenue, as well as worsening levels of national debt. In addition to the lack of confidence impacting on economic growth, significant demographic changes are becoming a major Social issue. With the highest life expectancy in the world, and a relatively low birth rate, Japan has one of the world's most rapidly aging populations. This is putting severe pressure on the sustainability of the current State pension system, which is financed primarily on a Pay-As-You-Go basis, as well as the increasing cost impact of a State-run post-retirement medical system.

The unemployment rate increased in the recession, but the rate is gradually decreasing with 2.8% in 2017.The labour market is relatively inflexible, reflecting traditional values of "life-long employment" which, although diminishing, are still prevalent. As companies generally target only new graduates for recruitment, lack of opportunity in the labour market is creating a generation of young part-timers, who switch between jobs after a short period or work on short-term contracts.

For those on permanent full-time contracts, labour conditions are protected by the work rules of the company. Any changes to work rules require an opinion in writing (which is almost in line with consent) from an employee representative, covering more than half of the entire company workforce. Redundancies are very rare in Japan, as the employer needs to satisfy tough conditions before lawfully terminating any employment contract. Instead, companies often provide a preferential early retirement package to encourage voluntary early retirement.

8.2 PENSION AND RISK BENEFIT PROVISION

Overview: Pension consists of two pillars: a Social Security plan with both fixed and salary-related elements, and a corporate defined benefit (DB) or defined contribution (DC) second pillar.

8.2.1 Pillar I Social Security (NP and EPI)

The first pillar consists of two elements:

- The National Pension (NP) which covers residents between the ages of 20 and 59 (voluntary extension to age 64) with a normal retirement age of 65
- The Employees Pension Insurance (EPI) which covers employees in industry and commerce under the age of 70. EPI currently has a normal retirement age of 60 but this is being increased to 65, for men by 2025 and for women by 2030.

Benefits

Pension at retirement depends on the contribution record, and requires a minimum of 10 years' contributions. Pensions in payment in retirement are indexed following changes in cost of living and earnings.

The NP provides a fixed rate benefit. The maximum annual pension is JPY 780,100 based on a contribution record of 40 years. A spouse's pension is payable under the NP equal to the old age pension in payment or projected payment, but only if the widow has a dependent child under 18. Supplementary amounts are payable for second and third children.

The EPI provides an earnings-related pension based on pre- and post-2003 service. For service through March 2003, average monthly salary was allocated to one of 30 Average Monthly Standard Remuneration levels. The AMSR is then indexed to current value and the accrual rate applied for each month of contributions credited. For service from April 2003, an adjustment has been made for bonus to be included - now called Average Standard Remuneration (ASR) - and the accrual rate has been reduced by approximately 23%.

Example : simplified determination of **Annual EPI Pension**

Service period	**Earnings**	**Accrual Rate (may vary by DoB)**		**Service credit in Service Period**
Until March 2003	AMSR X	7.125/1000	X	Months of contributions
PLUS				
From April 2003	ASR X	5.481/1000	X	Months of contributions

Additional amounts are paid for eligible dependents. For retirees under age 65, a fixed rate 'bridging' pension may be paid until the NP becomes payable. There is an EPI survivor's benefit equal to 75% of the earnings-related old-age pension formula in the case of participation in EPI for 300 months or more. If the period of participation is less than 300 months, it is considered as 300 months.

Disability benefits also equal the projected old age pensions from the NP and EPI, with a 25% uplift for "first-grade" disability [total disability with need for care attendance].

Financing

The contribution to EPI is 9.091% (2017) on capped salaries (Standard Monthly Remuneration and Standard Bonus) for both employees and employers.

For participants in the EPI, there is no direct contribution towards NP; others pay a monthly flat-rate contribution of JPY 16,490 (2017).

Taxation

Employee contributions are tax deductible. Employer contributions are treated as a business expense.

Benefits in payment are treated as taxable income, although a very favourable tax deduction applies to those opting to take their benefit entitlement as cash lump sum at retirement rather than as pension.

Trends

It is likely that the pension commencement age for the State pension will be increased in future although this will need to be approved by the parliament.

822 Pillar II

Second pillar retirement benefit is provided through employer-sponsored plans. Supplemental retirement plans have been part of the corporate culture in Japan for decades and employees expect that their employer will offer such a plan. To remain competitive, most companies find it necessary to offer a supplemental retirement plan. These have operated with a retirement age of 60, but employers are required to offer employment to those over 60 up to age 65 who wish to continue working. It is common for such employers to terminate eligibility to retirement plan at age 60 in order to encourage leaving service.

There is a trend towards DC provision, and many large companies have converted a part of their DB plans to a DC basis. However, there is a relatively low contribution cap on DC, forcing employers to supplement their DC plans with an alternative package. Therefore, hybrid plans are very common, and it is rare for an employer to have just a DC plan.

Regulation

DB plans can take different forms including:

1 Retirement allowance plan, or RAP (unfunded DB)
2 Defined benefit corporate pension plan, or DBCPP (funded under DB law)
3 Employee pension fund (EPF) – Funded DB plan (usually a multi-employer arrangement) that provides a portion of the Government pension benefits ("substitutional part") contracted out from the Employees' Pension Insurance (EPI) programme (Social Security), in addition to the EPF's supplemental retirement benefits . Legislation which promotes dissolution of EPFs has been in effect from April 1, 2014. No new EPFs are allowed to be established.

Benefits and Financing

Defined Benefit

DB plan structures include the following:

- Final salary plan: Pensionable earnings ? benefit rate.
  "Pensionable earnings" may be last month's salary, or similar.
  "Benefit rate" is typically based on years of service and the reason for termination (rates typically differ depending on whether an in-service termination is involuntary - redundancy - or voluntary - resignation - or at retirement).
- Points plan: Accumulated total points ? unit value of one point (typically, JPY 10,000). Points can be based on factors such as job grade, years of service, performance, etc..
- Cash balance plan: Benefit is equal to the balance of each participant's notional account, which is made up of accumulated pay credits and interest credits up to normal retirement or termination. Large companies that have introduced new DB plans tend to use the cash balance design rather than a traditional final pay-linked formula

Unfunded plans (RAP) typically pay lump sum benefits only at retirement, whereas funded plans provide pensions guaranteed for 5 – 20 years. Life annuities are unusual.

Death and disability benefits are typically covered separately (see below).

Employee contributions are possible but unusual – costs are typically fully paid by the employer.

Employers often apply a voluntary termination ("vesting") schedule to reduce the benefit if an employee leaves for voluntary reasons. After meeting a minimum service requirement (for example, 20 years), or upon leaving involuntarily, the benefit would no longer be reduced.

Defined Contribution

For DC plans, monthly employer contributions are restricted to JPY 55,000 per employee (maximum contribution and tax deductible limit) if there is no concurrent funded plan, or JPY 27,500 per employee if there is a concurrent funded plan.

Corporate DC law was amended in 2011 to allow employee contributions from January 2012. Employee contributions must satisfy the following conditions:

- Employee contributions must be equal to or less than the employer contribution
- Sum of the employee and employer contributions must be equal to or less than the statutory monthly contribution limit

On retirement the accumulated fund is typically paid as a lump sum, but may also be converted into a pension.

Death and disability benefits are typically covered separately (see below), though there may be a return of accumulated funds.

Benefits must vest 100% after completion of three years' service.

Funding Vehicles and Typical Investment Profile

DB plans may be financed internally as book reserves (internal financing), or externally through tax-qualified pension plans (DBCPP) or Employees' Pension Funds (EPF), or a combination of these. Typically, there is a single plan per company, but industry plans also exist.

DC plans are financed in tax-qualified defined contribution plans governed by the DC Law and managed by DC service providers. Employees must invest the contributions by choosing among the investment products that the DC plan offers. The employer must offer a minimum of three investment options which have different risk- return profiles.

The average asset allocation of pension funds (DBCPP and EPF) as at end of March 2016 was as follows:

Investment Category	Insured Vehicle
Domestic Equities	12%
Foreign Equities	13%
Domestic Bonds	26%
Foreign Bonds	14%
Insurance (General Account)	16%
Cash	7%
Other	12%

Accounting and Actuarial Issues

- Funding tests must be carried out each year on DB plans. Also, every three to five years a comprehensive funding status review is required.
- The local accounting standard is ASBJ Statement No.26(Japan GAAP).

The method used is the Projected Unit Credit method.

Taxation

Contributions: Employer contributions paid to any funded plan are tax deductible. In a RAP plan, there are no contributions as the plan is unfunded, but the employer does receive a tax deduction when the benefit is paid.

Benefits: Employees receive advantageous tax treatment on cash lump sums.

Market Practice and Trends

Companies are looking to take advantage of the availability of cash balance and DC vehicles, following the 2002 DB Law and the 2001 DC Law. However, DC plans are still not understood by employees, which present communication challenges. Due to the current low contribution limits, DC-only is usually not a viable option because it will not deliver a competitive benefit. The investment fees, particularly on actively managed equity investments (paid by the employee in a DC plan), are also prohibitively high.

Funding levels in DB plans continue to remain low by international standards. As the Japanese population ages, this will put severe pressure on companies' cash flow to fund and pay benefits.

Due to a legislative change, companies which have set the normal retirement age (NRA) at 60 will need to offer renewed employment contracts for those wishing to continue working beyond 60.

823 Pillar III

Unlike many other countries, there are very few third pillar voluntary individually-focused pension arrangements in Japan.

Risk Benefits

Group term life insurance (GTL) is offered by the majority of employers, with accidental death & dismemberment insurance (AD&D) also offered by some multinational and local leading companies. Premium cost is met fully by the employer.

On death by accidental/natural causes or total permanent disability, a lump sum of two times annual salary is typical under GTL.

For AD&D, death by accidental causes would lead to a lump sum of, typically, JPY 10 million or two times annual salary, with a scale for dismemberment as a percentage of the death amount.

Some companies also offer long-term disability insurance (LTD), with a smaller proportion also covering supplementary short-term disability (STD) through simple continuation of payroll.

LTD would provide income continuation of 30% to 60% of last drawn annual income, commencing after a 90-to-180-day waiting period. Payment would continue until company retirement age.

For STD large companies provide paid disability leave that varies by years of service. The benefit typically ranges from 1 to 12 months at 100% salary continuation.

The supplementary LTD and STD benefits are both integrated with mandatory benefits (i.e. State benefits are offset from the overall amount). STD would be self-funded, with LTD covered through a wholly employer-paid private insurance policy.

83 MEDICAL AND OTHER BENEFITS

As part of the universal health care scheme, Employees' Health Insurance (EHI) provides universal and comprehensive cover for medical, dental, vision, drugs, injections, surgery, hospitalization and nursing for all employees. Employees may opt for family coverage (which includes spouse, children, parents, grandchildren, grandparents, siblings). Social contributions of around 5% (4.955% in Tokyo(2017)) of Standard Remuneration are payable for employee and employer (actual percentage depending on prefecture)

However, it is common to opt out of the EHI scheme and create or join a single-/multi-employer Health Insurance Association (HIA) alternative. HIA provides the same benefits as EHI except with typically higher medical reimbursement levels, additional lump-sum benefits and a multitude of wellness programmes. Premiums are often lower as well. The premium cost is split between employer and employee, often with the employer paying more then fifty per cent. Premiums paid by an employer are tax deductible and do not count towards the employee's taxable income; premiums paid by the employee are tax deductible.

Private insurance cover for supplemental medical cover is not typically provided by the employer. Less than one-third of multinational and local leading companies report providing hospitalisation supplementary to compulsory benefits (EHI/HIA).

Typically, companies provide for 100% of employee commuting costs. Some companies, however, limit the amount provided to the tax-deductible limit of JPY 150,000 per month.

Other benefits typically provided include housing assistance for relocated employee (e.g. cash allowance, company leased housing, etc.), education allowances (e.g. to learn English or computer skills), savings plan (based on the "Zaikei" law), long service awards, and allowances for condolence on death, marriage and disaster (e.g. house fire).

There has been relatively little interest in Flex benefits given the comprehensive statutory benefits system and insurance products for supplemental cover do not allow for flexible coverage. Some companies provide free access to various discount programmes through "Cafeteria plans", and a small minority among them provide a flexible point credit system for the use of discount programmes to employees. (In many cases, companies provide "Cafeteria plans" without giving any point credits to employees)

Summary

This Chapter begun with a brief economic overview and then outlined the scope and nature of pension benefit arrangements. It also mentioned briefly medical and other benefits provided.

Self Test Questions

- What State retirement benefits are available?
- What type and level of private retirement benefits are offered?
- What medical benefits are provided?

OVERVIEW

This Part provides an overview of the European Union. Both through direct legal and regulatory influences, such as the Pensions Directive, and through indirect impacts of the free market, such as the free movement of labour and the Euro, the European Union increasingly influences employee benefit design and financing in Europe.

This Part consists of a single chapter

1.1 BACKGROUND AND STRUCTURE

The Treaty of Rome, signed in 1957 by the six founder members of what was then the European Economic Community, formed the underlying foundations of what we now refer to as the European Union (EU). What began as little more than as a loose trade association amongst just a few countries has now developed into one where an ever-increasing number of elements of sovereignty are being pooled. Economic, fiscal and political unity are partly on the way to being achieved or being discussed and sought after (to a varying extent) by the individual Member States.

The Treaty of Rome was followed by a series of amendments and new treaties. Key milestones include:
- the Schengen Agreement (signed in 1985, implemented in 1995, and leading to the opening of most intra-EU borders in 1997),
- the Single European Act (signed in 1986, leading to the launch of the Single Market in 1993),
- the Maastricht Treaty (signed in 1992, coming into force in 1993, creating the European Union and paving the way for the introduction of the single European currency), and
- the Treaty of Lisbon (signed in 2007 and coming into force in 2009, consolidating and streamlining some of the decision-making processes).

The countries of the EU now have a combined population of over 500 million and a GDP of over a quarter of the world's total.

The EU now includes the following 28 European countries as Member States. All are in the Schengen Area and the Eurozone except where indicated:

1 Austria
2 Belgium
3 Bulgaria (s, e)
4 Croatia (s, e)
5 Cyprus (s)
6 Czech Republic (e)
7 Denmark (e)
8 Estonia
9 Finland
10 France
11 Germany
12 Greece
13 Hungary (e)
14 Ireland (s)
15 Italy
16 Latvia
17 Lithuania (e)
18 Luxembourg
19 Malta
20 Netherlands
21 Poland (e)
22 Portugal
23 Romania (s, e)
24 Slovakia
25 Slovenia
26 Spain
27 Sweden (e)
28 UK (s, e, b)

Notes:
(s) –Not in the Schengen Area. A request from Bulgaria and Romania to join in March 2011 was put on hold and eventually vetoed in September 2011. In order to join, countries must pass an evaluation process and be approved by all current members.
(e) – Not in the Eurozone. The UK and Denmark have secured an opt-out from the Eurozone and are not obliged to join even if they meet the entry criteria; Sweden has a de facto opt-out. The others, and any future new EU members, will join automatically once the entry criteria are met.
(b) - In June 2016, the UK held a referendum and voted to leave the EU. The precise timing and mechanics of such an exit have yet to be negotiated.

In addition, four other European countries are worthy of mention in this Chapter:

- Iceland, Norway and Liechtenstein, which are neither in the EU nor in the Eurozone, but form part of the European Economic Area (EEA, consisting of the EU plus those three countries).The EEA is an extension of the EU Single Market and the Four Freedoms; in exchange, these three States have agreed to adopt all related EU legislation with the exception of agriculture and fishing. All three are in the Schengen Area.

- Switzerland, which is neither in the EU nor in the Eurozone nor in the EEA is in the Schengen Area. It has concluded an agreement with the EU to apply many of its treaties and provisions, including those that relate to employment and pensions. However, application of these is not automatic. Initially the regulation was not fully agreed by Switzerland and so the old Regulation 1408/71 (which was agreed) continued to apply. From April 2012 the new Regulation 883/2004 was adopted for certain categories of members, although we understand there is a proposal this regulation may be amended.

The Four Freedoms and the Single Market

One of the key achievements of the EU has been the Single Market and customs union between all the Member States, ensuring the Four Freedoms (see box), and a common external customs tariff on all goods entering the EU.

The Four Freedoms of the EU

Freedom of movement within the European Union of:

a) Goods
b) Services
c) Capital
d) People

Income and Expenditure

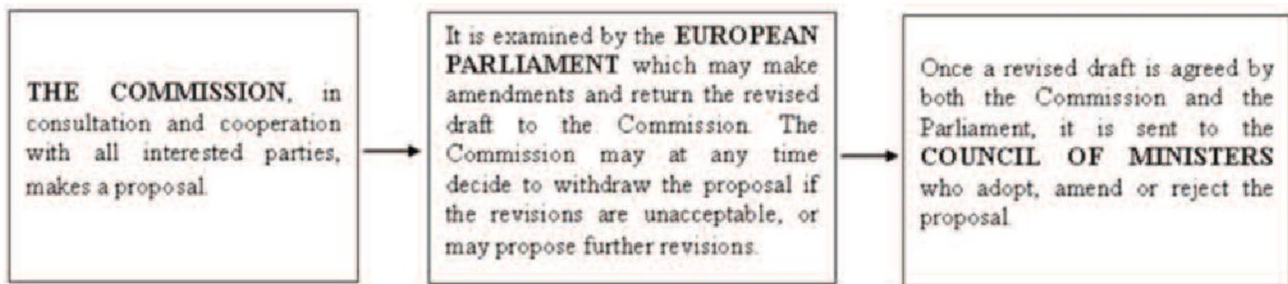
The EU does not levy direct taxes on the population or on the companies in its Member States, but receives payments from each Member-State (broadly, based on a proportion of VAT receipts). Of its budget of a little over 1% of the total Gross National Income (GNI) of the EU Member States, around 40% is spent on natural resources (mainly agriculture), and about 45% on sustainable growth.

1.2 THE LEGISLATIVE PROCESS

There are three key bodies involved in the legislative process.

- **The European Commission (EC)** can be regarded as the Civil Service of the EU. It has exclusive power to initiate EU legislation and is responsible for the day-to-day running of the EU. The governments of the Member States appoint the Commissioners.
- **The European Parliament (EP)** has powers to review and recommend amendments to proposed EU legislation as well as on the implementation of Treaties between the EU and other countries. The EP must approve the budget of the EU and can dismiss the Commission (but not individual Commissioners) by a two-thirds majority in a vote of censure. Members of the EP (MEPs) are directly elected by the population of the EU Member States.
- **The European Council (or Council of Ministers)** is the body that must approve and adopt Directives and Regulations in order for them to come into force. It consists of appropriate Ministers from the Government of each Member-State. For example, matters connected with Social policy will be dealt with by the Social Affairs Council comprised of the Ministers of Social Affairs for each Member State. (This should not be confused with the Council of Europe, which is an international organisation unrelated to and independent from the EU.)

The legislative process, although typically quite lengthy and politically fraught given the difficulties of dealing with the sensitivities of 28 often quite different Member States is, in theory, quite simple:



The Council of Ministers makes decisions on a "qualified majority" basis, but in certain areas, including, in particular, any issues relating to tax and certain issues relating to social and employment affairs, decisions must be unanimous; every Member-State has a right of veto.

Three other bodies are worthy of note:

- The **Directorates General (DG)** are the equivalent of government departments and are responsible for specific areas of policy within the Commission. The most important DGs with respect to employment (and employment benefit) matters are the Employment, Social Affairs & Inclusion Directorate, the Internal Market, Industry, Entrepreneurship and SMEs Directorate and the Financial Stability, Financial Services and Capital Markets Union Directorate. The Taxation and Customs Union Directorate and Justice and Consumers Directorate also have an important impact in some areas.
- The **Court of Justice of the European Union (CJ of EU)** decides matters which depend on an interpretation of European Community law. For example, national courts of Member States are able to refer questions of EU law to the ECJ which will give answers to the specific questions.
- Finally, the **European Insurance and Occupational Pensions Authority (EIOPA)** is a supranational regulator responsible for supervising insurers and occupational pension funds across the EU with an aim of achieving supervisory convergence into a 'single rule book'.

Forms of Legislation

EU legislation may take the following forms:

- **Directive** - the main form in which laws emanate from the Commission. It is, in effect, an instrument by which the EU "directs" each Member-State to enact certain laws. A Directive itself does not have the force of law in a particular country until it is implemented by the national government. However, where a provision of a Directive is clear and unambiguous, it does grant EU citizens certain rights, which they can activate through the ECJ even if their own national government has failed to implement the terms of the Directive.
- **Regulation** - based on Articles of the Treaty, these are another frequently used form of legislative instrument. However, unlike Directives, Regulations immediately become part of each country's local laws without the need for separate implementation.
- **Recommendations** - are proposed by the Commission and adopted by the EU Council of Ministers. They recommend courses of action for Member States. It is important to recognise, however, that Recommendations do not have the power of binding law on any Member-State - they are simply recommendations.
- **Communications/Notices** - are published by the Commission in the Official Journal (the official daily publication of the EU in which proposed and final legislation is set out and announcements are made).They do not have legal effect but, in practice, can be influential in the formulation of future legislation.

1.3 ECONOMIC AND MONETARY UNION (EMU) AND THE EURO

The framework for Economic and Monetary Union (EMU) was laid down in the Maastricht Treaty of 1992 and broadened by Regulations agreed subsequently by the Member States. Denmark and the UK secured a permanent opt-out and Sweden reserved the right to choose whether or not to join when eligible; all have so far chosen to remain outside EMU. For the other Member States, the criteria for automatic qualification for participation in EMU are summarised below:

- inflation and long-term interest rates should not be significantly higher than those of the best performing Member States
- budget deficit should not be excessive (as decided by the Council)
- national debt should not exceed 60% of annual national income
- stable exchange rate
- compatibility of national legislation, including the statute of its central bank

The Treaty incorporates a degree of flexibility and the conditions were interpreted broadly in the case of some of the initial group of Member States (the Belgian and Italian debt being significantly in excess of the limit - "but moving in the right direction"). Twelve Member States (i.e. the 15 members at the time, less the three above who had secured an opt-out) transferred to the single currency, known as the Euro:

- From 1 January 1999, when the exchange rates between the Euro and the then national currencies of the partners were irrevocably fixed, the European Central Bank became responsible for monetary policy, and, therefore, the setting of interest rates, within the Eurozone
- From 1 January 2002, Euro bank notes and coins entered into circulation alongside national currencies which were withdrawn six months later.

The other Member States that joined the EU after the Euro was introduced also undertook to participate in EMU once they meet the above criteria for qualification. So far, the following Member States have joined:

Slovenia (1 January 2007)
Cyprus and Malta (1 January 2008)
Slovakia (1 January 2009)
Estonia (1 January 2011)
Latvia (1 January 2014)

Impact of EMU on Pension Plans

EMU had an impact in all EU countries where segregated assets are held to finance pensions. This is irrespective of whether a particular country participates in the single currency, because most pension funds (both self- administered and insured) will have some investments in Euro-denominated assets.

For EMU members, however, there were a number of direct and immediate matters which needed attention as well as more indirect and long term implications to be considered.

- Direct and immediate factors included conversion of all currency amounts to Euros, with associated communication requirements and costs; some aspects of benefit design (e.g. increases in line with a consumer price or earnings index) had to be reviewed.
- Indirect and long-term factors included the reduction in interest rates and inflation in the EU leading to a real cost increase for defined benefit (DB) plans, accelerating the trend to defined contribution (DC) designs. Also, continued compliance with the EMU criteria has increased pressure on Social Security systems, leading to greater encouragement of voluntary provision by employers and individuals.
- The fact that there is now no currency risk for a Eurozone plan to invest in other Eurozone countries has significantly reduced (but by no means eliminated) the "domestic bias" in Eurozone plans, i.e. the tendency for pension plans to invest disproportionate amounts of their assets in the home market.

1.4 SOCIAL AND EMPLOYMENT POLICY

The role of the EU in formulating social and employment policy has its base in a number of Articles of the Treaty of Rome – now encapsulated in the Treaty establishing the European Community setting out objectives for the EU.

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- Article 140 provides for the promotion of close co-operation between Member States in employment security, vocational training, health and safety, right of association and collective bargaining between employers and workers.
- Article 141 stipulates equal pay for equal work.

Effect is being given to these objectives by means of EU legislation, mainly in the form of Directives, supplemented by ECJ judgments. The most developed areas to date are:

- equal pay for equal work, and equal treatment
- protection of workers' rights in mergers, acquisitions and insolvencies
- working conditions (especially health and safety)
- employee involvement
- freedom of movement of workers within the EU

Notable features of employment legislation already adopted across the EU are:

- Acquired rights directive / TUPE Transfers
- written proof of an employment relationship
- minimum parental protection (amount of leave, amount of benefit and protection against dismissal)
- limits on the organization and length of working time
- consultation and worker participation through European-wide Works Councils
- authority for a Member State to impose its labour laws on employees employed in another Member State and posted to work in its territory
- protection of Social Security rights of migrant workers within the EU

1.5 PENSIONS AND INSURANCE ISSUES

It is important to consider insurance when addressing employee benefits in the EU, as retirement pensions, as well as death and disability benefits, are often provided through insurance policies.

Although this Chapter is not intended to provide the student with a comprehensive description of all relevant parts of the EU body of law that have an effect on employee benefits, some key ones are indicated below.

Key Cases at the Court of Justice of the European Union

Mr Barber sued his employer in the English Courts on the grounds that the company's retirement plan discriminated against men with respect to certain retirement conditions and allowances. The case was subsequently referred to the CJ of EU which held, on 17 May 1990 (unfortunately, after Mr Barber's death), that, under Article 141 of the Treaty establishing the European Community (formerly article119 of the Treaty of Rome), retirement and redundancy benefits under occupational benefit plans constitute deferred pay and must be equal for men and women.

The principal message from the **Barber** judgment in 1990 was that it was no longer permissible under EU law for retirement plans to exhibit features that had the effect of discriminating between men and women such as:

- unequal retirement ages
- different levels of employee contributions
- different benefit levels

This is a good example of a case referred to the CJ of the EU by just one Member-State but with a result that has had far reaching implications for all other Member States.

The student should also be aware that a wide variety of other cases involving potential discrimination of many different kinds have been, and continue to be, considered by the CJ or the EU. Notable examples from the 1990s include the **Danner** and **Skandia** cases, which confirmed that Member States could not treat contributions to domestic and foreign pension plans differently for tax purposes solely on the basis of where they are situated (rather than on any other factor such as plan design), and paved the way for the European Commission's "Tax Communication" (see below). More recently, the Test Achats case led to the requirement for annuity rates to be determined on a unisex basis.

The Life Insurance and Solvency II Directives

Until the passage of the various Life Directives, insurers resident in one Member State could only effectively do business in another Member State by setting up a local office and obtaining local approvals and registration. This is usually an onerous undertaking. However, the EU spent much effort and many years developing an approach to easing the transaction of cross-border insurance business using the "single passport" mutual recognition principle. In essence, this says that, if an insurance company is properly licensed to do business in any one Member State, all other Member States shall allow the insurer to transact business in their States without the need to obtain additional licences. (This principle has also been used successfully with non-life insurance companies and in banking).

The Life Directives established all the important basic features for cross-border insurance business, including the ability for insurers to actively solicit for business in other Member States rather than merely function as "passive acceptors" of business. The final (Third) Life Directive became effective from July 1994, allowing multinational companies with subsidiaries in more than one European country to use a single insurer to cover the insurance aspects of their employee benefit plans.

However, for many years, tax obstacles were a considerable hindrance to the spread of such arrangements, and, until 2007, many countries did not grant a corporation tax deduction to companies that pay premiums to insurance companies whose principal business is not in that State.

From 1 January 2016, the Solvency II Directive came fully into effect. This harmonised still further the supervision of insurers across the EU. The Directive covers three pillars – capital adequacy, governance and disclosure – the last of these concerning information provision to policyholders and supervisors.

The Pensions Directive

An initial draft Directive on cross-border pension fund investment and administration was proposed and discussed in the early 1990s, but proved unacceptable to some Member States and was withdrawn. Subsequent discussion eventually led to the Directive on the activities and supervision of Institutions for Occupational Retirement Provision (IORPs), or the "Pensions Directive", which was adopted on 23 September 2003. The stated objectives of the Directive were to:

- ensure a high level of protection for beneficiaries
- enable funds to take advantage of the Single Market and the Euro in order to improve their investment strategies
- guarantee a "level playing field" between all providers of occupational pension services, and
- allow for the mutual recognition of prudential regimes between Member States and pave the way towards forms of cross-border pension provision

The Directive applied to all "Institutions for Occupational Retirement Provision" (IORPs), except for:

- pension plans with less than 100 members, if the given Member State so decides – except that the prudent person principles still apply in cases where membership exceeds 15 and all the Directive applies if an IORP operates across borders
- Social Security systems (as defined in then applicable the EU Social Security regulation 1408/71 as subsequently amended; in particular, this includes the ARRCO/AGIRC "complementary" schemes in France)
- The occupational retirement provision business of life insurance companies, although individual Member States can choose to apply certain provisions instead of those under Solvency II
- unfunded pension arrangements (this is the dominant method of occupational pension provision in Germany)
- in Germany, "*Unterstützungskassen*" (support funds)

One effect of the Directive was to separate supervisory and regulatory (or prudential) law from social and labour law. What constitutes "social and labour law" has been a matter for debate, and EIOPA invited all Member States to identify which pieces of their pension-related legislation constitute prudential law and which constitute social and labour law.

The **Home Member-State** is where the IORP as a legal entity is based

The **Host Member-State** for each member of the IORP is (broadly speaking) where the member is employed

Supervisory and regulatory (prudential) issues are a matter for the Home Member-State

The **Host Member-State** cannot impose any requirements relating to supervisory and regulatory issues (e.g. funding and reporting requirements)

Social and labour law issues are a matter for the Host Member-State

The **Host Member-State** may impose restrictions if it considers that they constitute Social and labour law (e.g. benefit design, vesting of benefits, etc.)

In summary, the Directive set out a number of requirements to be followed by Member States. The most significant of which were.

1. All IORPs must conform to a minimum series of standards, including

- legal separation of the sponsor and the IORP
- the requirement for annual reporting and various disclosures to members and to national supervisors
- that the IORP have sufficient assets to cover the actuarial liabilities, with an approved recovery plan to achieve this if the assets temporarily fall below the liabilities; in the case of cross-border activity, there is a stronger requirement to be "fully funded at all times"
- investment according to the "prudent person" approach

2. All IORPs must be allowed to

a) invest assets of up to at least 70% of the plan's actuarial liabilities, or the whole portfolio in the case of a plan in which the members bear the investment risks, in shares
b) invest assets of up to at least 30% of the plan's actuarial liabilities in assets denominated in non-matching currencies
c) use investment managers and custodians established anywhere in the EU

3. All IORPs must be permitted to operate across borders within the EU while only being regulated (for prudential law matters) by the regulator in the Home Member State.This is subject to each Host Member State being allowed to impose its own social and labour law on the operation of the IORP in relation to members based in the Host State, and subject to certain information being passed between the Home and Host Member States' regulators.

In practice, the IORP Directive (as with other Directives) has been interpreted differently by each Member State. The funding requirements for DB plans as prescribed in each have led, in many cases, to multinational employers comparing these as well as the applicable regulatory regimes in deciding where to base their IORPs. Some employers, for example, have decided to base their pension plans for their Dutch employees in Belgium because of the more benign nature of the Belgian regulatory regime.

In 2008, the European Commission initiated a review of the Directive. In December 2016 final text of a revised Directive was published to the official journal. Member States have until January 2019 to implement its requirements. A stated objective for the new Directive is to facilitate the development of occupational retirement savings, and to reinforce the role of IORPs as institutional investors in the EU's economy. However, it also evidences the desire for supervisory convergence with much of its content being based on the Solvency II Directive for insurers. One aspect that was originally proposed, but dropped in 2013, was for the IORP Directive to include capital adequacy measures based on those for Solvency II.

The proposal has four specific objectives:
- Remove remaining barriers for cross-border IORPs
- Ensure good governance and risk management
- Provide clear and relevant information to members and beneficiaries
- Ensure that supervisors/ regulatory bodies have the necessary tools to effectively supervise IORPs

The main points covered in the proposal are:
- The system of governance can be proportionate to the nature, scale and complexity of the activities of the IORP
- IORPs will need to carry out regular, but proportionate, risk evaluations known as 'Own Risk Assessments' which should drive management decisions
- IORPs must have in place specified key functions (such as an internal auditor and risk management function), filled by fit and proper persons
- IORPs must put in place and disclose a remuneration policy for the key people that run the IORP and hold key functions
- Plan members must receive an annual 'pension benefit statement'. This must contain certain specified information although Member States have flexibility around additional content
- Cross-border plans shall continue to be required to be fully funded at all times although the EP introduced a recital that Member States should take into consideration the funding requirements for both domestic and cross-border IORPs, which is intended to try to promote further harmonisation of their treatment and could be considered to be an amelioration. Under-funded cross-border schemes would be subject to intervention from the competent authorities of the Home Member-State
- New rules introduced to make it easier to transfer assets and liabilities between IORPs in different countries

The Tax Communication

Directives that include tax provisions are unlikely to be approved as they require unanimity among Member States, some of which may not approve of the directive itself, and others of which may jealously guard their right to maintain control at national level over tax matters.

However, in 2001, the Commission concluded that the existing body of EU legislation already prohibited "tax discrimination", i.e. the practice where Member States treat domestic pension plans differently from other EU pension plans for tax purposes. For example, a Member State may have granted income tax relief on contributions to pension plans in that State, but not in relation to those made to plans in other Member States.

Accordingly, the Commission issued a Communication (the "Tax Communication") in 2001, asserting that such discrimination was contrary to existing EU legislation and would be vigorously pursued in the European Court of Justice, effectively inviting employers and individuals to bring cases against Member States. Subsequent cases at the European Court of Justice (notably Danner and Skandia, addressing personal income tax and corporate tax respectively) backed the Commission's stance. Emboldened by these successes, the Commission vigorously pursued the Member States that were refusing to change their legislation accordingly, and, to date, has won every case that it brought.

1.6 INTERNATIONALLY-MOBILE EMPLOYEES

Employees who move between different member States in the pursuit of employment (either with the same employer or with different ones) will encounter a bewildering array of problems connected with retirement and other issues. The action of the EU in this field covers both Social Security rights and other cross border measures. (NB. This topic will be covered in more detail in International 2, Part 6)

Social Security

Regulation 1408/71 and its successors, on Social Security provision for mobile employees within the EU and EEA, have operated effectively for almost 40 years. The latest revised Regulation is 883/2004 and enables migrant workers (i.e. employees who move between Member States) to be protected by the three fundamental principles:

- non-discrimination between nationals and legal residents of EU Member States on moving to another Member-State (Denmark has an opt-out on residents)
- guarantee of portability of Social Security benefits between Member States; in practice, this means access to payment in respect of a benefit to which entitled
- aggregation of periods of coverage in each Member State for the purposes of determining eligibility for benefit

The general rule is that employees are covered by the Social Security of the EU country in which they are working. Exceptions to this cover temporary assignments (also known as postings or secondments):

- **"Article 14"** (technically now Art 12, Reg 883/2004): An employee sent by the employer, under the same contract, to work in another EU country for a period not expected to last more than twenty-four months (previously twelve months), remains covered by the legislation of the country from which sent and, therefore, continues to contribute to the Social Security system there rather than in the country where working. This provision does require that the transferring employee is not replacing another employee who has completed a term of posting. Unlike 1408/71, if the posting unexpectedly exceeds the twenty-four month period, there is no provision for an extension to be granted (previously, application for up to a further twelve months could be made).
- "**Article 17"** (technically, now Art 16, Reg 883/2004):Where the posting involves the specific needs of the Home country employer or specialist job skills, or where it will be in the best interests of the employee, the two EU countries (with the consent of the employee) can agree that Home country coverage is maintained for the entire duration of the assignment. In practice, many EU countries impose a limit on the period of exclusion from their Social Security system, typically, five years; Article 17 allowed each Member State freedom to decide whether to grant such continued coverage, although the Commission has issued a Communication to Member States encouraging them to harmonise their requirements. The replacement Article 16 does not clarify the position with respect to the length of assignment but explicitly does not mention any five year limit.

The principle of aggregation of periods of coverage is that, when assessing eligibility for Social Security benefits in any given Member State, periods of contributions in all other Member States are counted. Of course, the benefit must then be "pro-rated" as an employee who spent, for example, half his career in France and the other half in Germany cannot expect a full pension from each. Each country carries out separately an assessment of the benefit to which the individual is entitled. The result of this "pro-rata" calculation is then compared to the calculation based on in-country contributions alone, and the employee is entitled a benefit equal to the higher of the two.

The following example of a Social Security calculation for a mobile employee is intended only as an illustration of the workings of Regulation 883/2004. The figures are not to be taken as a reflection of current levels of income or State pensions.

> An employee who has worked for 5 years in Luxembourg and 30 years in other EU countries would calculate the Luxembourg pension as follows. The first calculation is simple: five years alone is not enough to earn an entitlement to a Luxembourg pension, so his entitlement on a Luxembourg-only basis is zero. For the second calculation, we first consider what the employee would have earned if his 35 EU years of service had all been carried out in Luxembourg. Suppose the answer to this is □19,000.Then the pension on an aggregated basis is 5 / 35 x □19,000 = □2,714 which he would receive from the Luxembourg authorities when he reaches the Luxembourg State pension age, to add to the pensions he will receive from the other EU countries in which he has worked, calculated in an analogous way in each.

It is important to note that each element of pension remains paid by and in the currency of the country in which it arises (although most EU Member States have the same currency) and is subject to subsequent increases granted in that country. The employee can either claim the pensions directly from each EU country, or through the agency of the last EU country in which he or she worked prior to retirement, which will liaise with the others as to the claim.

Occupational Pensions

Local pension laws and other impediments in countries can impose severe restrictions on the ability of employed persons to manage their pension affairs appropriately. In some cases, employees moving abroad are prevented from staying in their original home country plan for ongoing accrual, even though many of them would prefer to do this because they intend to return home at retirement. In other cases, employees who would like to transfer their pension entitlement to a new country of residence often cannot do so. Moreover, regardless of the outcome of these matters, there are often tax complications that are difficult, if not impossible, to resolve.

A Directive on Occupational Pensions Mobility (98/49/EC) was adopted in July 1998 for implementation in Member States by June 2000, requiring preservation of acquired occupational pension rights of plan members who move to work for another employer in another Member State; it also requires employees posted temporarily to another Member State to be allowed to continue to contribute to their employer's occupational pension plan if they are also retained in the home country Social Security system. The Directive was, in practice, almost completely without effect, as the original proposal to oblige the host country to give the same tax relief on contributions to a home country plan as would apply to an approved plan established in the host country, was removed at the last minute in order for the Directive to be approved by qualified majority vote rather than needing a unanimous vote of the Member States.

However, further to the 2001 Tax Communication (see Chapter 5) and subsequent cases at the ECJ, "tax discrimination" (i.e. the practice where Member States treat domestic pension plans more favourably than other EU pension plans for tax purposes) is now clearly prohibited. This effectively re-introduced the tax provisions deleted from the Directive, rendering the cross-border provisions more useful to employees and employers.

In addition, the provisions of the Pensions Directive have encouraged many employers to start to build cross-border pension plans aimed specifically at their internationally-mobile employees. The key issue for these employers is the design of this international plan benefit is as coherent as possible taking into account the various permutations of Social Security and occupational plan participation both prior to becoming an internationally mobile employee and while holding that status. As a simple example, an employee earning benefits in both Italian Social Security and a UK occupational pension plan is likely to be being over-provided, whereas someone in the opposite situation would be likely to be accruing an insufficient total retirement benefit.

Summary

This Chapter has provided an overview of the European Union and its impact on employee benefit provision. It began with a summary of the structure of the EU and its members. It included an outline of the pensions and insurance issues.

Self Test Questions

- How many countries are in the EU and the Schengen area?
- Which countries are not in the Eurozone?
- What was the pensions directive?