Headlines

Worldwide Pay and Benefits

Compiled and written by Towers Perrin in August 1999

Latin America

Coping with devaluation in Brazil

The economic slide in Brazil following the government's decision to float and effectively devalue the national currency, the 'real', is creating a number of challenges for multinational companies with operations in the country. Besides the obvious weakening of market conditions as a result of the recession, companies active in Brazil are being forced to reassess their employee compensation policies for all types of employees, ranging from ordinary hourly workers to highly-paid expatriates. Moreover, given the economic weakness that has taken hold in Venezuela and other areas of Latin America, some of the issues raised by the Brazilian experience may be applicable elsewhere, at least in a broad way — if not the specific details.

An appropriate response to the issues will be determined not only by political events and by the ultimate severity of the economic crisis, but also by an organisation's particular business objectives, resources and human resource requirements.

The key to managing compensation in Brazil under the floating currency conditions is to address the main issues that each type of employee. Companies operating in Brazil have six types of employees, all with their own compensation-related concerns:

- *Blue collar and clerical employees.* They will be more interested in maintaining employment and dealing with rising prices of basic goods and services. Possible compensation strategy — maintain competitive market levels of pay while following statutory and union agreements.
- *Local professional and middle management employees.* Their main concern will centre on maintaining their standard of living and seeking career opportunities. Possible compensation strategy — address 'hot skills' issues and reward performance to the extent possible while maintaining competitive market pay levels.
- *Key local nationals, ie, local executives, managers and professionals with scarce technical skills focused on Brazil operations.* Members of this group give equal weight to two concerns: how they are treated relative to their peers inside Brazil and the need to meet hard currency financial obligations, such as foreign tuition payments or loans. Possible compensation strategy — competitive local base pay with pay-for-performance merit increases and opportunity for short- and long-term incentives.
- *Local Brazilian executives who have regional or global responsibilities and/or corporate peer relationships outside Brazil.* Key concerns are equity with Brazilian and non-Brazilian peers. The stronger their non-Brazilian

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responsibilities and peer relationship, the greater the likelihood of hard currency financial obligations and spending patterns. Possible compensation strategy — competitive local base pay with pay-for-performance merit increases and significant short- and long-term incentive opportunities related to individual and Brazilian company performance with currency protection on incentives.

- *Foreigners on local pay packages.* Members of this group, which includes nonlocal employees without a designated home location or on assignment for an undetermined time period, will be so worried about their ability to meet financial obligations outside the country that they will ask themselves whether they want to remain in Brazil. Possible compensation strategy — manage local compensation relative to local peers, but for key executives help to protect income from currency exchange fluctuations.
- *Expatriates with currency protection.* Members of this group, which includes employees from a designated home country working in Brazil for a limited time period, will be concerned that the balance sheet approach used to determine their pay does not adjust to currency fluctuation on a timely basis. This worry will be more emotional than based in fact. Possible compensation strategy — address and communicate the currency fluctuation issues within the balance sheet approach on a more frequent basis.

When developing compensation practices for Brazil, companies should ask, and answer, three fundamental questions:

- Does the drop in Brazil's currency

indicate a significant financial crisis because of a long-term change in economic conditions or a mere correction caused by strains that will ease over the near term?

- What is the direct impact of the changing economics on company operations in Brazil?
- What is the impact on human resource practices?

Examining these questions will allow companies to assess the impact on compensation practices and help them to determine an appropriate overall compensation strategy.

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Belgium

New investment rules for Belgian pension funds published

The restriction to invest at least 15 per cent of Belgian pension fund assets in Belgian government bonds has been abolished by a Royal Decree that introduces new investment rules beginning 1st January, 1999. Moreover, pension funds now have to focus their investments on security, return, liquidity, diversification and spread. This means that companies need to reconsider the investment strategies of their pension funds.

The Royal Decree defines maximum investment levels taking the principles listed above into account. The maximum levels apply to assets covering the technical reserves disclosed by the pension fund to the Belgian control authorities (including the solvency margin).

Some of the maxima are listed in Table 1.

A maximum of 5 per cent may be

Table 1

Asset classes	Maxima
Currency restrictions:	
Currencies other than Euro on non-OECD currencies	10%
Nonconvertible currencies	Not admitted
Bonds issued outside the EU-approved A-zone*	10%
Equities not transacted on a regulated market	10%
Mutual funds not subject to EU regulations	10%
Derivatives for purposes other than hedging	5%
Real estate	10% per holding
Real estate certificates	5% per issuer
Non-guaranteed loans	5%
	1% per issuer

*The following countries are included in zone A: EU countries, Australia, Canada, Czech Republic, Hungary, Iceland, Japan, Mexico, New Zealand, Norway, Saudi Arabia, Switzerland, Turkey, United States

concentrated per issuer. Some exceptions are made, for example, for bonds issued by a European Union member state.

A maximum of 15 per cent of assets exceeding the technical reserves may be invested in securities issued by the sponsoring company. A pension fund's custodian has to be based in an EU country. Previously, assets needed to be located in Belgium.

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European union (EU)

Pan-European pensions resurrected

After the resignation en masse of the European Commissioners earlier this year, it was widely expected that legislative reform of the EU legal framework for supplementary pensions would go onto the back burner indefinitely. Indeed, plans to pursue a test case in the European Court of Justice were being dusted off again in anticipation of continued legislative gridlock in Brussels.

It was a pleasant surprise, then, when the European Commissioner for the single market and financial services published a communication, 'Towards a

single market in supplementary pensions,' on 11 May, 1999.

The communication (a communication is effectively a proposal by the Commission for new EU legislation) addresses reform in the following areas.

Prudential supervision

- The communication proposes some EU-wide basic requirements for pension plans, such as the separation of pension plan and employer assets and harmonised rules for the authorisation of pension plans by competent authorities.
- Pension plan investment is to be governed by the Anglo-Saxon 'prudent person' principle; national requirements that pension plans must invest in particular types of asset (such as bonds issued by the member state) are to be abolished, although quantitative limits on particular asset classes will continue to be permitted as long as they do not unduly restrict freedom of investment.
- Pension plans are to have the freedom to appoint authorised fund managers from anywhere in the EU.
- Common actuarial and solvency standards may be imposed.

Free movement of workers

There will be another directive covering a range of pensions-related barriers to freedom of movement. This will cover:

- vesting — it seems likely that excessively long vesting periods will eventually be out-lawed; this is likely to be a major issue for German employers whose pension plans typically have a ten-year vesting period
- harmonised standards for calculating transfer values
- barriers to cross-border membership.

The Commission is to create a pensions forum to coordinate the technical work required to implement changes in these areas.

Tax coordination

The greatest obstacle cross-border membership and truly pan-European pension plans is taxation. The communication does not include firm proposals to legislate against the discriminatory treatment by most EU tax authorities against pension plans that are tax-qualified in other member states.

Despite talking the language of tax 'coordination' rather than 'harmonisation', the degree of commitment hinted at in the communication on the part of both the Commission and member states does seem to indicate a genuine awareness of the problems caused by the current state of affairs and possibly a real political will to legislate about it early in the new millennium.

In the meantime, there is still much that pan-European employers can do to harmonise delivery of retirement benefits on a European-wide basis by implementing a pan-European pension strategy based on specific business, HR and benefit objectives and using

appropriate vehicles available locally.

Timetable for implementing legislation

- Draft directive on prudential supervision by late 1999/early 2000.
- Draft directive on cross-border membership/tax coordination by late 1999/early 2000.
- Prudential supervision directive to be adopted by 2002.

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Hong Kong

Review of payroll and benefit costs essential

As difficult economic conditions continue, companies will need to review critically all their payroll costs, particularly the components of base salary and bonuses, as well as benefit costs such as housing allowances and retirement plans.

Research from the Employers' Federation of Hong Kong, which represents the country's largest employers, has shown that almost three-quarters of employees have had their salaries frozen, 1 per cent have had their salaries reduced, and the remainder have received a salary increase averaging 1.3 per cent. This trend is expected to continue for at least the remainder of the year and probably into the year 2000. However, as the cost of living in Hong Kong — particularly housing costs — continues to fall (the Consumer Prices Index negative for the last two years), disposable income has actually increased for those employees whose salaries have been frozen.

Employers have also recognised the

importance of communication and people management skills given that it will be several years before substantial economic growth resumes in Hong Kong. In the meantime, companies will need strictly to control all their costs, including labour costs, if Hong Kong is to regain its cost competitiveness with international markets.

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Italy

Pensions market booms

Italian compensation and benefit professionals who have typically had limited experience with supplementary pensions now have the opportunity to broaden their experience.

It has taken over ten years for various Italian governments to draft the legislation relating to supplementary pensions and five years to clarify and ratify it, but with the way ahead now clear, and with pensions high on union agendas, supplementary pensions are now finally growing fast. For example:

- Most national labour contracts are being modified to force companies to provide a minimum level of coverage. In parallel, individual sector unions are setting up nationwide arrangements to provide such coverage. These nationwide arrangements typically have low administration fees, no investment options and no design flexibility.
- However, there are a number of exceptions to the nationwide approach. Larger companies have always tended to provide their own arrangements, as have financial sector companies, where national union influence in terms of pensions has

historically been limited. In such cases, organisations are either setting up new defined contribution arrangements or converting their existing arrangements to defined contribution.

- Entities that do not fall in any of the above categories (eg, smaller financial institutions), or companies that want more flexibility than a nationwide arrangement offers, are potential buyers of off-the-shelf products — of which there is a vast array. Over 70 providers are offering a variety of investment vehicles. With no investment track records, competition is primarily in terms of charging structures, which are relatively low.

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Japan

Accounting rule changes have major balance sheet implications

New accounting rules to be adopted from Japan's next fiscal year (starting 1st April, 2000), in line with International Accounting Standard 19, will generally have major implications for the balance sheet and income statements of Japanese firms, and many foreign affiliates with Japan operations. This is part of Japan's financial reform and (among other things) includes changes to tax-effect accounting, consolidated accounting and market-value-related accounting.

Currently, Japan has no special accounting standards for retirement benefits, and there is no recognition of differences in accounting policy and funding policy. So for funded plans, the employer expense/charge to earnings is equal to the plan contributions. But plan contributions are driven by tax and other

considerations. And they can be very misleading in terms of the costs and liabilities associated with the plan because of statutory valuation methodology used and the unrealistic assumptions (eg, 5.5 per cent discount rate) often adopted. Furthermore, there is no specific methodology for accounting for book-reserved retirement plans, which are still very widespread instead of, or in combination with, funded plans.

The new accounting rules only cover defined benefit retirement plans whether they are funded and/or book reserved. Overseas subsidiaries that are subject to consolidated accounting as Japanese-controlled entities (essentially 50 per cent voting control) will also be covered.

The rules include:

- unifying the accounting standards for off-balance-sheet funded plans and balance-sheet reserved plans
- adopting accrual rather than cash-based accounting
- using a projected benefit obligation type liability measurement
- using a discount rate that reflects market rates (eg, long-term government bonds of at least AA rating in Japan)
- marking assets to market value
- reflecting unfunded liabilities on the balance sheet
- amortising all gains/losses over the expected future working lifetime of the employee group
- amortising the effect of the accounting change over a maximum period of 15 years
- disclosing the plan type, breakdown of expense and liabilities, and related actuarial assumptions adopted.

Although some foreign affiliates already use US GAAP or similar method for their consolidated reporting, the local books are different. The new rules will

provide the opportunity to unify their accounting on a realistic, best-estimate cost basis.

But confusion will continue because the statutory actuarial methods used to determine funded-plan contributions will be retained. This can lead to a significantly different budgeting pattern.

These changes may have a significant impact on company financial results. Employers should review their current plans, liability/cost basis, and determine what changes are necessary.

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The Netherlands

Rules governing compulsory participation in industry-wide pension funds changed

The grounds for exemption for companies from participating in industry-wide pension funds have been expanded recently under a 'dispensation guideline'.

In addition to the current exceptions, ie, the existence of an equivalent pension plan, and voluntary dispensation by the industry-wide fund, the guide line provides the following statutory grounds for exemption:

- *Dispensation in connection with the formation of a group of companies.* This applies where the group of companies has obtained dispensation for all affiliated companies in the group. This will be given only where the group complies with certain criteria relating to minimum numbers of employees and pension plan members.
- *Dispensation in connection with a collective labour agreement (CLA).* This

needs to be by agreement with representative unions.

- *Dispensation in connection with investment policy and investment performance.* This is possible only if the company proves that the investment policy of the industry-wide fund is poorly substantiated, and/or that the investment performance is inadequate. If dispensation is granted on these grounds, the dispensation only relates to the implementation of the pension plan, and not to the pension plan itself.

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New Zealand

Super 2000 task force appointed

The debate on the future provision of retirement benefits to New Zealanders continues with the announcement by the government of a new task force. One of its major objectives is to continue the work of the task force, which reported in 1997. While this task force undertook a comprehensive review, the implementation of its recommendations was undoubtedly adversely affected by the referendum in 1997 on whether or not New Zealand should introduce a compulsory plan (in which 92 per cent of voters said no).

The task force is broad based, with representatives from employers, unions, academia, the savings industry, minority groups and a journalist. It will look to raise further awareness of the public on retirement matters, look for integration of public and private provision, seek a suitable taxation regime and pursue all other relevant matters.

Although there is scepticism over yet another review, it is encouraging that

retirement remains a high-profile issue and that parties are prepared to debate the issue to find durable solutions.

Move to master trusts accelerates

The move to master trusts has, if anything, accelerated in the last six months. This involves not just plans with less than \$5m in assets and less than 20 members, but now \$20m-plus plans with 100-plus members. The driver is the overwhelming need by employers to simplify the administration of their plans, to reduce compliance costs and reduce executive managers' time.

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South Africa

Discrimination — is it permissible and, if so, in what circumstances?

The 1997 amendments to the Pension Funds Act brought into effect the office of the Pension Funds Adjudicator, Professor John Murphy. The decisions made by the Adjudicator have contributed significantly to certain areas of pension plan practice. One such area has been discrimination, an untried question in pension plans to date.

In one of the recent cases put forward to the Adjudicator, he held that all members of a fund do not necessarily have to be treated equally (*Low v. BP, Southern Africa Pension Fund*). The duty of the trustees is to act impartially towards beneficiaries. This does not mean that all beneficiaries must receive equal benefits. Trustees, he says, are entitled to exclude some beneficiaries from a particular benefit and to prefer others as long as the exclusion does not amount to unfair discrimination in terms of the constitution. In *Low*, a pensioner

of the fund complained to the Adjudicator that the decision by the trustees to increase benefits for active members, but not for pensioners, was unfairly discriminatory and unjustifiable. The Adjudicator dismissed the complaint on the grounds that the discrimination was not unfair and that it served a legitimate objective, ie, to make the employer more competitive in the workplace. Professor Murphy believes that the employer is a participant in the fund and that trustees are duty bound to consider its interests. Not every rule that differentiates will amount to discrimination. 'Firstly, the differentiation must amount to discrimination. Secondly, such discrimination must be unfair. Thirdly, there should be no justification for the unfair discrimination.'

Unfair discrimination also came under the spotlight in the matter of *Clarence v. The Independent Schools Pension Fund*. The Adjudicator narrowed the question to be decided down to the following: '... whether the actuary was justified in discriminating between married members and divorced members in calculating withdrawal benefits and transfer values'.

The fund justified the distinction in the calculation of transfer benefits upon withdrawal between married and unmarried members on the basis that provision has to be made for a spouse's pension in respect of married members.

The Adjudicator found that this rationale is unreasonable in our society as many people are divorced or have relationships with persons who are dependent on them, even if they are not legally married (common-law marriages, same-sex relationships, etc). He said that based on this reasoning, granting preferential rights to married members rather than to unmarried members, more often than not, will be discriminatory and unfair.

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United Kingdom

Divorce pension sharing rules relaxed

Under the government's proposed pension-sharing (on divorce) rules, a divorcee whose benefits are the subject of a pension-sharing order is regarded, for Inland Revenue limits purposes, as still being entitled to benefits that have been transferred to his or her ex-spouse. This has provoked considerable criticism on the grounds that divorced members could be prevented by Revenue limits from building up sufficient replacement pension.

As a partial response to this criticism, the Revenue has indicated that it will drop this requirement, but only for individuals earning less than £22,650 at the time of the divorce. For people in this position, the pension given up can be ignored for Inland Revenue maximum limit purposes. At this stage, no further details of the Revenue's proposals are available. It is not known, for example, whether the figure of £22,650, which is a quarter of the current earnings cap, will be indexed in the same way as the earnings cap.

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Data Protection Act calls for action

The Data Protection Act 1998 became law last year, and is expected to come into force at the end of June 1999 when all the necessary regulations have been made. It will affect procedures for the administration of pension plans and communications with members as follows:

- Trustees need to check existing registrations under the Data Protection Act 1984. If these are not up to date (or if the trustees have not registered), the trustees will need to notify the Data Protection Commissioner that they are processing data.
- Plan members need to be told that personal data about them is held by or on behalf of the trustees for the purpose of administering the plan. If this is not already covered in company literature, a suitable paragraph should be included in the plan booklet.
- Plan members should be asked to consent to processing of data about themselves. Unless covered satisfactorily in other company literature, a suitable provision should be included in the plan application form that should also authorise the passing of information to third parties.
- Where the data include information about the member's physical or mental health, the consent form must explicitly state that the members agree to this data being processed.
- Trustees using another party, such as an administrator (third-party or in-house), to process data on their behalf should enter into a written contract with the other party that requires it to comply with the data protection principles.

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United States

FASB issue proposal for stock issued to employees

The Financial Accounting Standards Board (FASB) has issued its proposed Interpretation of Accounting Principles

Board Opinion No. 25 (APB 25) to provide guidance under US accounting requirements for company stock issued to employees.

While intended to clarify certain accounting issues, the proposal appears to raise some troublesome implications for many employers. Notably, it applies the common-law definition of employee, which means that awards to outside directors, leased employees and independent contractors ('nonemployees') fall outside the scope of APB 25.

Moreover, where the exercise price of a stock option is lowered in response to a market decline, such 'repriced' options would be accounted for as a variable plan, requiring mark-to-market accounting from the date an option is repriced until it is exercised.

The board's proposal also covers such key issues as the accounting for plan modifications, plans with a put or call option, stock purchase plans with a look-back option, shares withheld for tax purposes, awards exchanged or granted in a business combination, and cash bonus arrangements linked to vesting or exercise of stock options.

The proposed interpretation would be effective upon issuance (expected to be later this year) and would be applied prospectively. But it would cover certain events occurring after 15 December, 1998 — most significantly, grants to nonemployees and option repricings. A copy of the proposed interpretation is available at www.fasb.org. Public comments are due 30th June, 1999.

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Rising drug costs prompt action by employers

As many employers and benefit managers are now painfully aware, rapidly rising

prescription drug costs are claiming a growing share of human resource budgets and forcing companies to reevaluate — in whole or in part — the delivery of an increasingly popular benefit.

This year, employers are reporting prescription drug cost increases of 15 per cent and higher despite the use of pharmacy benefit managers (PBMs), higher co-payments for employees, and other widely accepted practices common to soundly administered healthcare plans. Some companies report prescription drug benefit programmes creeping toward 20 per cent of total healthcare expenses.

Given all that is going on, it is no wonder employers are asking themselves some tough questions about what they can do better to manage their prescription drug benefits, while preserving the confidence of employees who have come to rely on the protection that these programmes deliver. Keep in mind that reducing prescription drug costs takes time and that whatever measures are adopted are most effective when made part of an integrated health care strategy. Towers Perrin recommends employers look for or develop the following components in a managed pharmacy programme:

- Evaluate or benchmark your current pharmacy benefits contract.
- Evaluate alternative retail pharmacy networks.
- Consider covering certain over-the-counter (OTC) drugs that are alternatives to expensive prescription medications.

- Establish education and communication programmes that help give patients a role in managing their disease.
- Perform return-on-investment analysis for any disease management and patient education programmes that your organisation sponsors.
- Select the right preferred drug list, keeping in mind the impact these programmes may have on employee satisfaction.
- Insist your pharmacy benefits administrator provide effective physician communication and education programmes to counter aggressive industry marketing and patient demand, as well as a toll-free pharmacy helpline staffed with knowledgeable clinicians available to answer patient and physician concerns.

Employers can successfully use these methods as part of a comprehensive programme to control costs.

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