Headlines

Worldwide Pay and Benefits

Compiled and written by Towers Perrin in June 2002

International

International accounting standards taking hold

New international accounting standards (IAS) that will impact large multinational employers and their employee benefit plans in a number of countries are on the way — or already in place.

In the European Union, listed companies will be required to apply international accounting standards when preparing financial statements. The aim of the new rule, adopted by the European Council in June and to take effect in 2005, is to improve the comparability of company financial statements and to help make the EU financial markets more efficient.

All listed companies in the EU will be required to apply IAS 19 when accounting for employee benefits such as termination and other deferred compensation; post-retirement benefits; health and life insurance; long-term disability, and equity compensation.

However, the big change for many companies will be in accounting for post-retirement benefits. The basic requirement of IAS 19 is that the cost of providing these benefits should be accounted for in the year of accrual, rather than the year of payment. Because it can take a long time to gather the data required to understand post-retirement benefits in different countries, and to establish an annual valuation process,

companies listed in the EU are advised to begin developing implementation strategies for IAS 19 as soon as possible.

In response to the adoption of IAS by the EU, the UK Accounting Standards Board (ASB) has signalled that it will postpone full implementation of FRS 17, the new pension accounting standard that was scheduled to take effect for accounting periods ending on or after 22nd June, 2003. Instead, companies need only to continue to disclose FRS 17 results in the Notes to the Accounts, although they still have the option to adopt FRS 17 early.

The primary reason for delaying full implementation is to avoid requiring companies to implement FRS 17 and then within a short space of time, another standard in 2005. The ASB believes that FRS 17 is a superior standard to other pensions accounting standards.

It is not only the EU that is moving to the international accounting standard:

- The Financial Reporting Council of Australia has announced that it is adopting international accounting standards for Australian companies in 2005
- In Brazil, companies listed on the stock exchanges are following new standards to account for costs and liabilities of employee benefits, NPC-26. The accounting rules, which use IAS 19 as a benchmark,

were issued by the Brazilian Accounting Institute and became effective on year-end 2001 balance sheets. Auditors are extending the application of the new accounting rules, as a best practice, to other companies such as the limited partnership enterprises

- Companies doing business in Hong Kong are now subject to a new Statement of Standard Accounting Practice 34 (SSAP 34) that was issued in December 2001 by the Hong Kong Society of Accountants. The standard is closely modelled after IAS 19 and has many similarities with the accounting standards of the large industrial nations
- In South Africa, a revised accounting standard AC116 has been issued that is copied verbatim from IAS 19 and applies to all South African employers' financial statements beginning 1st January, 2001. The new standard will particularly affect employers who sponsor defined benefit retirement funds, making a clear distinction between the funding of retirement benefits and the allocation of this cost in the accounting treatment. In turn, the revised standard may lead to changes in the delivery of benefits to retirement fund members, as employers weigh the financial implications of benefit changes. Unfortunately, AC116 does not deal with recent surplus legislation in South Africa, and this is likely to create a number of practical difficulties until a further amendment is made
- In Japan, new accounting requirements similar to IAS 19 have been in force since 1st April, 2000 (see article on Japan).

Subsidiaries or branches of foreign multinational companies should seek

guidance from their parent companies if their benefit accounting standard is different from the one used by their parent company on consolidated financial statements.

Further information: Christine Farmer, London, farmerc@towers.com, tel. 44-207-170-3747.

Austria

New funding of termination indemnities

Employers in Austria will need to examine the financial implications of the new requirements for funded severance pay.

The new legislation, establishing funded severance pay accounts for employees took effect 1st July, 2002, replaces the current system of termination indemnities for all new hires beginning 1st January, 2003. Under the current system, entitlements to indemnity payments are financed by book reserves, backed 50 per cent by government bonds. Generally, employees are entitled to an indemnity payment on termination by the company or on retirement age. The level of benefit ranges from twice monthly salary after three years of service to 12 times monthly salary for 25 years of service.

The new law will switch from the book reserves system of financing the benefit to a defined contribution type of system. Each employer will be required to become a member of one of the employee provision funds ('Mitarbeiter-Vorsorgekassen') that will be set up over the next few months, probably by insurance companies and banks. The employer will be required to pay 1.53 per cent of the employee's monthly earnings into the fund selected. Employer contributions will begin immediately after the first month of employment. A different contribution

rate may be negotiated in collective bargaining agreements.

Employers can choose whether or not to move to the new system for current employees, although employee agreement would be needed. Employers would first need to consider the implications, particularly in terms of the level of benefit and funding.

Further information: Klaus Georg, Frankfurt, georgk@towers.com or Ira Guttenberg, Frankfurt, gutteni@towers.com, tel. 49-69-1505-5206.

Brazil

New rules on pension investments create challenges

The new investment rules for pension funds have proved difficult to implement and monitor on an ongoing basis. The investment managers will usually provide some, but not all, of the required services to ensure compliance, and there is likely to be a great deal of complexity in reporting given the fact that employers commonly use several investment managers for each pension fund.

The new rules require pension funds to:

- establish risk control systems and credit control systems (either internally or using a credit risk agency such as Standard and Poor's)
- consolidate all portfolios and report risk, return and value of shares. Most funds in Brazil have more than one asset manager, which creates operational problems. Custodial responsibilities also need to be centralised
- submit annual investment policy guidelines to the regulatory agencies, subject to quarterly review by the

pension fund. The results should be communicated to participants. Pension fund trustees may be subject to civil and criminal liability for the assets.

Towers Perrin has set up an 'investment club' in Brazil to create a value-added package that not only delivers the required reports in accordance with the new regulation, but also assists clients to manage effectively their pension investments. A number of companies have joined the club and are benefiting from the professional management of their funds and the increased information/analysis at their disposal.

Further information: Eder Carvalhaes, Sao Paulo, carvale@towers.com Sao Paulo, tel. 55-11-3706-3471.

Tax success for government as employers drop lawsuits

Brazilian pension fund investments are now subject to taxation. However, plan sponsors were granted a concession on the tax rate provided they withdrew lawsuits being contested in court as far back as 1983. The deadline for dropping the lawsuits expired on 28th February, 2002.

A brief survey conducted earlier this year by the Brazilian National Association of Closed Entity Funds indicated that 86 per cent of respondents among 111 closed-entity funds (company-sponsored plans) elected to drop their lawsuits. According to the Private Pensions Secretary, the 20 largest funds, with the exception of the largest, Previ (Banco do Brasil employees), started to pay taxes for the first time in history. Considering that in Brazil there currently are around 360 closed entity funds, the result indicates major support for the government proposal.

In a November 2001 decision, the Brazilian Supreme Court confirmed that

private pension funds were subject to taxation of investment returns. However, the court left an open window by exempting from taxation the investment returns of funds financed only by the sponsoring company, ie, without any employee contributions.

While the exemption was granted only to the closed entity fund sponsored by Shell in Brazil, which claimed taxation immunity in court, the market is doubtful about its broader application to other similar funds. Consequently, many companies are debating whether to look to similar relief in court before amending their plan designs.

The government expects to collect about 6bn reals (around US\$2.5bn) in back taxes from companies participating in the programme.

Further information: Eder Carvalhaes (carvale@towers.com), Sao Paulo, tel. 55-11-3706-3471.

New rules make portability of benefits mandatory

Plan sponsors in Brazil will need to assess the cost of implementing a new law that makes the vesting and portability of benefits — notably employer contributions — mandatory. To allow time for companies to take account of the possible increase in future costs and liabilities, the new law will not take effect until 31st July, 2003.

In the past there were no minimum required vesting rules for employees who leave before retirement, although common practice was to provide benefits for terminating employees over age 40 with at least ten years' service. The law requires new plans started after 31st May, 2001 to provide vested benefits and allow the benefits to be transferred after five years of an employee's membership of the plan, while a ten-year membership period applies under existing plans.

Companies are still awaiting the regulations setting out how to calculate the amount to be transferred, particularly for defined benefit plans.

Further information: Eder Carvalhaes, Sao Paulo, carvale@towers.com Sao Paulo, tel. 55-11-3706-3471.

Europe

Pensions directive gets the go-ahead

After 18 months of debate, European ministers have reached agreement on a pension funds directive that sets standards for prudential supervision of pension plans in the EU. Subject to final approval by the European parliament in the autumn, the directive could be implemented by member states by the end of 2004.

The European ministers (with the exception of Belgium, which abstained) accepted the compromise position on investment rules drawn up by the Spanish presidency. This waters down the 'prudent person' principle by allowing member states to impose quantitative restrictions within certain limits on their domestic plans and more relaxed limits on cross-border plans.

The directive introduces baseline actuarial and funding standards. One major concern was the rate of interest used to value the benefit liabilities. Two alternative approaches will now be allowed, one based on future investment returns and the other determined by reference to market yields of high quality or governments bonds.

The directive also covers the mechanism and requirements for managing cross-border pension plans (plans established in one member state for employees in another member state). The scope of the directive does not extend to book reserve and pay-as-you-go plans.

It is still some way off before a genuine pan-European pension plan can be implemented. In particular the directive does not address tax harmonization. Although initiatives are being taken to address this issue (see below). In the meantime, much can still be done to develop an effective pan-European strategy to optimise the allocation of resources on a Europe-wide basis.

Further information: Karen Klietz, Newbury, England, klietzk@towers.com, tel. 44-1635-525645.

Legal opinion backs tax harmonisation for pensions

Last year, the European Commission issued a communication stating that discriminatory tax treatment of cross-border pension plans was in breach of existing EU law.

An opinion from the advocate general of the European Court of Justice (ECJ) has been published for the first case following the EC communication. The advocate general said that member states may not discriminate in taxing pension insurance contributions to foreign and domestic institutions. The ECJ's ruling is expected later in the year, but the court normally follows the advocate general's opinion.

The case involves a German doctor who moved to Finland and continued to pay pension insurance contributions to two German institutions. The Finnish tax authorities refused to give him full tax relief on his contributions to the German arrangements. The doctor claimed that this was contrary to European law, because he would be allowed the tax relief if the contributions had been made to a Finnish arrangement. The Finnish authorities referred the matter to the ECJ for a preliminary ruling.

A further case can be expected in due

course. PEPGO (the Pan-European Pension Group of 20 multinational companies) is backing a case whereby a UK company (AMS) is seeking permission from the UK Inland Revenue to place a UK employee in a Dutch plan. If, as expected, officials refuse to grant the same tax privileges as would be given if the employee joined the UK plan, AMS will have a test case in the UK courts and then, if necessary, in the European courts.

Further information: Karen Klietz, London, klietzk@towers.com, tel. 44-1635-525645.

Ireland

More protection for pension plan members

By now employers in Ireland should be adapting their pension plans to comply with the Pensions (Amendment) Act 2002. This became law in April and gives significant additional protections to members of company-sponsored pension plans. The major changes are:

- *early leavers*: employees now have the right to a vested benefit after two years' (rather than 5 years') pensionable service and the benefit will relate to all their pensionable service (not just service after 1990) — this applies to all members leaving after 1st June, 2002.
- *transfers*: regulations will provide more flexibility in the type of plans to which early leavers can transfer their entitlement — this will include overseas plans. However, transfers to the new PRSA (see below) will be allowed only for those with no more than 15 years' pensionable service (or on the winding up of a plan).
- *complaints*: a pensions ombudsman will be appointed to hear complaints from

plan members, and plans will be required to have their own internal dispute resolution procedure.

- *funding*: the plan actuary will need to confirm once a year whether or not the plan is fully funded, and, if not, what corrective action is being taken.
- *plan amendments*: plan amendments will be held invalid if they unfairly favour the sponsoring employer over members or unfairly favour one group of members over another, and if they are made less than 12 months before or six months after a significant event, such as a sale of business, a change from a defined benefit to a defined contribution or bulk transfer to another plan.

Further information: Michael Parker, St Albans, parkerm@towers.com, tel. 44-1727-815037.

New defined contribution plan available

Employers will soon be required by law to offer membership in a pension plan to all employees. For those employees not eligible to join the company-sponsored plan within six months of hire, the employer must offer one of the newly available Personal Retirement Savings Accounts (PRSAs) and operate a salary deduction facility for contributing employees. The employer is not required to contribute to the PRSA.

Employers may also wish to assess how this new type of defined contribution plan could form part of their retirement benefit strategy. A PRSA can accept contributions from both individuals and employers, and for some employers a PRSA may be suitable as the main funding vehicle for a retirement programme. Contributions are fully tax deductible and are limited in total to a percentage of earnings up to an earnings limit of €254,000, based on age.

Employees who are members of the company-sponsored pension plan can also choose to make contributions to a PRSA, with contributions aggregated within PRSA limits for tax relief. (Unlike the UK, there is no earnings limit on those who can have a PRSA as well as membership in a company-sponsored plan.)

Any taxpayer is entitled to tax relief on a contribution of €1,525 even if this exceeds the normal income-based limit.

The limit on employee contributions to company-sponsored pension plans has been changed to reflect the new PRSA limits. The Irish Finance Act 2002 amended the limit from a flat 15 per cent of earnings to the PRSA age-related scale. However, the percentage limits at each age band are 5 per cent lower, but again there is no cap on earnings.

Employers may therefore wish to offer a PRSA as an alternative to the existing investment vehicles available through the pension plan for employees' voluntary contributions.

Further information: Michael Parker, St Albans, parkerm@towers.com, tel. 44-1727-815037.

Israel

Easing investment rules on pension funds

Managers of pension funds and provident (employee saving) funds have an opportunity to consider new investment strategies thanks to less restrictive pension fund investment rules that will take effect in October.

The Minister of Finance signed new investment and management regulations on 10th April, saying the changes are in line with the government's policy of streamlining the capital market and encouraging competition among institutional investors. The changes are

also intended to give pension funds greater flexibility to participate in the market.

The following are some of the new rules:

- All investments are allowed, with very few exceptions
- Most quantitative restrictions are repealed, including the maximum investment in shares and the requirement to invest at least 50 per cent of capital in government bonds, deposits, and highly rated corporate bonds. Each fund can now choose the composition of its investments.
- The quantitative restrictions on overseas investments and the limits on types of overseas assets are repealed.
- The quantitative restriction on real estate investments, particularly in income-producing properties, is repealed.
- The rules for preserving the funds' stability are expanded.

In Israel, the investment strategy of pension and provident funds is determined by the funds' internal investment committees, although employers who represent a major part of the insured employees are entitled to have a representative on the committees. Employers should consider periodic reviews of the performance of the funds in which they participate, bearing in mind the new investment opportunities.

Further information: Jeffrey Schwartz, New York, schwaje@towers.com, tel. 1-212-309-3537.

Japan

Changing environment for retirement plans

Given the sweeping legislative, demographic and financial changes

underway in Japan, companies with operations there should be closely examining how they manage their retirement plans — and considering new approaches. Here are some of the major developments affecting the management of company pension programs in Japan.

New accounting requirements

There are new regulations for financial years starting on or after 1st April, 2000 that are similar to IAS 19 and require reporting of unfunded plan liabilities. The change highlights the critical underfunded plan situation that was often overlooked in the past by management.

Pension reform

- *New defined contribution plans:* Effective 1st October, 2001 employers can set up defined contribution (DC) plans for new hires and/or existing employees.
- *New defined benefit requirements:* Effective 1st April, 2002 (a) company employee pension funds (EPFs) can surrender the contracted-out benefits back to the government by switching to a new defined benefit (DB) plan, (b) new complex minimum solvency standards apply for the new DB plans and require plan sponsors to make up asset shortfalls in the short-term, and (c) cash balance-type plans are introduced. These changes increase a plan sponsor's benefit design options while enhancing the protection of accrued employee benefits and setting new disclosure requirements. For existing qualified pension plans — there is a ten-year transition period to switch to the new rules.

Breakdown of lifetime employment model

Many major Japanese companies are beginning to offer open window programs to reduce staff. Traditional

retirement programmes that encourage employees to stay until normal retirement do not match with current employer needs.

Critical state of defined benefit pension plans and Japanese life insurers

Although many plan sponsors have recently increased contributions, many pension plans (particularly industry-wide EPFs) still are significantly underfunded with Japanese government bond yields at near historical lows and poor investment returns over the last couple of years. In addition, several life insurance companies have been taken over or forced to reorganise in recent years and plan sponsors often do not realise that plan assets invested with Japanese life insurers are held in the life insurer's name, not the pension plan's. Therefore, exposure to life insurers involves a level of solvency risk, particularly with the weaker life insurers.

In this environment, companies with operations in Japan should be examining their management of retirement liabilities closely, reviewing their investment and funding strategy, and perhaps reviewing their plan design in light of the new types of plan available.

Further information: Mark O'Brien, Tokyo, obriem@towers.com, or Bill Branch, Tokyo, branchw@towers.com, tel. 81-3-3581-6430.

Turkey

New regulations allow private pensions

Regulations published in March have opened the door to the creation of private pension funds under legislation passed by the Turkish government last year.

Up to now, the government has been the main source of retirement income for employees. Under the new system,

which is voluntary, employers and employees may participate in defined contribution funds for retirement. There are tax incentives to participate in the new system, but these are largely thought to be inadequate. Contributions will be paid to a choice of newly created pension companies that are authorised and regulated under the legislation. The pension company must offer at least three investment funds, each with different kinds of investment portfolios.

Fund withdrawals are allowed at retirement beginning at age 56, provided the employee has participated for at least ten years. The employee may choose to draw the funds in whole or in part and either take a cash sum or use the funds to buy an annuity. There is also the option to transfer to another pension company after one year's contributions have been made.

There are as yet no pension companies in the market, although seven insurance companies were authorised to offer these plans.

Once the market becomes established, many employers are expected to decide to make contributions to the system.

Further information: Jeffrey Schwartz, New York, schwaje@towers.com, tel. 1-212-309-3537.

United Kingdom

Relaxation of minimum funding standard helps employers

The government has announced interim changes to the minimum funding requirements (MFR) that apply to company-sponsored defined benefit plans. These requirements were introduced in 1997 in an attempt to ensure that UK pension plans maintained an acceptable level of funding to protect the benefits promised to plan members.

The changes follow continuing

criticism that the rules led to short-term volatility in company contributions and distorted investment decisions. The downturn in capital markets over the last two years has caused many plans to fall into an MFR deficit.

The government has announced that the rules eventually will be abolished, probably beginning in 2004, and replaced by a plan-specific funding approach. In the meantime, some requirements have been relaxed effective March 2002, as follows:

- more time to remove any MFR funding deficit. The period has been extended from one year to three years to bring the funding level back to 90 per cent and from five years to ten years to reach 100 per cent funding
- a change to the financial assumptions to calculate benefit liabilities, reducing the funding liability for non-pensioner members
- removal of the annual check on the funding level for plans that were 100 per cent funded on an MFR basis at the last triennial valuation.

The government has also acted to strengthen the requirements for plans that are terminated, ie 'wind up.' Currently, the sponsoring employer is required to meet any MFR deficit when a plan winds up. The changes mean that if a company winds up its plan voluntarily, the deficit will include the full cost of securing pensions already in payment, plus wind-up expenses.

These changes will now allow plan sponsors to evaluate appropriate long-term strategies for their UK pension plans (eg contribution policy, asset strategy, design issues) without having to worry unduly about short-term MFR issues.

Further information: Mike Hammer, London, hammerm@towers.com, tel.

44-20-7170-3586 or Charles Young, London, youngc@towers.com, tel. 44-20-7170-3410.

Government delays rule change on trustee boards

The UK government has postponed its plans to force the trustee boards of employer-sponsored pension plans to include trustees nominated by plan members. The move is in response to the ongoing review of simplifying current pension law.

Since 1997, plans have been required to have one-third of the trustee board nominated by members, but employers could opt out of this requirement if they obtained approval from members for alternative arrangements. Many employers did so, and these arrangements, which last for six years, are now coming up for renewal. This renewal process must start in the window between a year and six months before the end of the six-year period. If employers fail to start the renewal process in this window, member representation will become mandatory.

To help employers avoid having to renew at this time of uncertainty, the government has proposed legislation — now expected to come into force in August 2002 — to extend the life of current arrangements by three years. However, some employers may prefer to renew their existing arrangements — or indeed put forward different ones — and they still have the opportunity to do so before the legislation comes into force, provided they are in the six-month window. If members accept the new proposals, then, based on the current draft legislation, the lifetime of the new arrangements will include the three-year extension and, therefore, will last for a further nine years.

Once the current legislative review is over, it is possible the government may cut short the three-year extension. It is unclear whether the government will continue with its plans to make member representation mandatory.

Further information: Simon Cann, London, canns@towers.com, tel. 44-207-170-3514.

New law prohibits discrimination against fixed-term employees

Employers who employ contract staff will need to ensure that their employment terms for contract workers are at least as favorable as those for permanent employees. This is as a result of the UK government implementing the EU fixed-term workers' directive beginning 1st October. The new regulations prohibit employers from discriminating against employees engaged on fixed-term contracts. It is expected that the UK law will go farther than the EU directive requires because it will apply to pay and pensions, as well as other employment terms. However, employers are advised to refrain from simply opening membership in pension and flexible benefit plans as a knee-jerk reaction. Solutions some employers are considering include:

- encouraging fixed-term employees to accept an alternative form of remuneration in return for giving up benefits that are impractical to provide (such as some benefits typically provided through flexible benefit programmes)
- excluding certain benefits where the cost of providing the benefit is wholly out of proportion with the cost of the benefit itself
- employing fixed-term employees through a separate company in a group that does not employ any

permanent employees or permanent employees doing the same work.

The UK government has also published a consultation document on how to outlaw discrimination at work on the grounds of sexual orientation, religion, age and race. 'Towards Equality and Diversity' outlines the government's proposals to implement new anti-discrimination laws and amend current disability and race legislation. The consultation process — allowing review by lawmakers — ended last month.

Further information: Simon Cann, London, canns@towers.com, tel. 44-207-1703514.

United States

Temporary funding relief provided for DB plans

Legislation signed into law in March by President Bush provides temporary relief on funding requirements for DB pension plans.

Minimum funding requirements applicable to US DB plans are based, in part, on unfunded current liability. Current liability is the present value of benefits earned to the date of the actuarial valuation and is determined using an interest rate based on yields on 30-year Treasury bonds that are published monthly. Previously, the rate could be selected from within a range of 90 per cent to 105 per cent of a four-year weighted average of 30-year bond yields. The new law raises the top end of the permissible range to 120 per cent for plan years beginning in 2002 and 2003 — effectively allowing plan sponsors to lower their current liabilities from what they would be otherwise.

The increase in the acceptable range of current liability interest rates relieves a great deal of pressure on pension plan

funding over the next two years. Towers Perrin estimates that plan sponsors will see reductions of 8 per cent to 12 per cent in their current liabilities.

However, this relief may only prove temporary. While employers will be hoping for better capital markets that improve plan funding ratios, a review of funding and contribution strategies now could lead to decisions that help protect against plan volatility and expense in the future.

Further information: Michael Archer, Parsippany, archerm@towers.com, tel. 1-973-331-3562.

Focus on pension reform legislation shifts to Senate

The focus on pension plan reform in Congress is shifting to the Senate following the April passage by the House of its version of the legislation (the Pension Security Act, H.R. 3762). The House bill extends to 2001 the temporary relief on minimum funding requirements currently available for defined benefit (DB) plans in 2002 and 2003. Key provisions aimed at 401(k) and other types of defined contribution plans:

- require at least three investment options (other than company stock) and allow participants to change investment options at least quarterly

- set specific rights to diversify account balances
- require employers to provide participants quarterly benefit statements, including a description of investment allocation restrictions and an investment education statement
- require 30 days' advance notice of a blackout period (an administrative freeze on transactions)
- prohibit insider sales of employer stock during blackout periods
- allow employees to purchase retirement planning services using pre-tax dollars deducted from their paychecks.

The Senate has begun work on alternative proposals, and any bill approved by the Senate would have to be reconciled with the House-passed measure before going to President Bush.

While it is unclear what will happen, it does appear that any legislation that becomes law would bring a number of changes to the way employers structure qualified defined contribution arrangements. Plan administration and employee communication programs would also be affected.

Further information: Michael Archer, Parsippany, archerm@towers.com, tel. 1-973-331-3562.

© Towers Perrin