Headlines

Worldwide Pay and Benefits

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International

Corporate reform law raises governance and financial issues for global companies

The new corporate reform law signed into law earlier this year by President Bush makes important changes that will impact governance and financial management practices at global companies operating in the USA.

Moreover, the law's enhanced disclosure requirements and its set of tougher criminal penalties for fraud put companies on notice that they will be more closely scrutinised than ever in the way they manage their business around the world.

The Sarbanes-Oxley Act of 2002 applies to all companies that register with the Securities and Exchange Commission. As such, many non-US corporations fall within its ambit.

The new law, along with the increased attention being paid to pensions by financial analysts, the press, Standard & Poor's and investors, may encourage companies to 'raise their game' in managing pensions and other employee benefit programmes, even if they are not directly affected.

Emphasis on corporate responsibility

Among other things, the law enhances corporate responsibility by requiring the Chief Executive Officer (CEO) to certify the integrity of the company's financial statements. Companies that do not

comply will be de-listed, and the signing officers will face significant penalties and prosecution. If financial statements are restated due to material non-compliance with financial reporting requirements, the CEO and Chief Finance Officer (CFO) must pay back any bonus, incentive pay and stock-based compensation received in the 12-month period after the original, flawed financial statements were issued.

The law's new requirements highlight the value of sound financial management practices, including those for company benefit programmes. For example, many organisations are taking a fresh look at the policies and assumptions they use to determine financial statement entries and disclosures related to pension and post-retirement welfare plans.

Meanwhile, CFOs and CEOs are looking for education on post-retirement accounting, and they are developing communication strategies for the financial reports on these programmes that are delivered to regulators and analysts. In some cases, companies are looking for an independent review of the financial reporting for post-retirement programmes to meet particular concerns.

Increased scrutiny needed

The law reinforces the need for increased scrutiny and governance of worldwide pensions and other post-retirement benefits — both in relation to day-to-day activities and the financial reporting cycle. Large multinational

organisations may wish to consider any or all of the following:

- a global accounting review (an independent assessment reviewing plan assumptions, accounting methodology and calculation processes)
- a global governance review (reviewing a range of opportunities and risks in worldwide decision making)
- ensuring global consistency in actuarial valuations (eg through the use of a global actuary)
- financial management reviews of specific plans or countries on a globally consistent basis
- programmes to monitor emerging financial developments and provide early warnings of potential problems.

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Belgium

Employers facing new law for private pension plans

Employers doing business in Belgium are getting ready to comply with a sweeping new law for company-sponsored pension plans that was approved by lawmakers earlier this year after months of delays and public debate. The law, known as WAP or Law Vandenbroucke, will take effect from 1st January, 2003.

The new law is likely to have a major impact on benefit plan arrangements of large employers, as well as on their financing method, employee communication programme and daily plan management activities. As a result, it will also influence company remuneration packages and overall HR strategy.

The new provisions include:

- **Creation of a broad framework for industry-wide pension plans.** An industry-wide plan can be set up through a collective labour agreement and is then compulsory for employers and employees. The agreement can allow companies to opt out if they guarantee to provide benefits at least as good as those available in the industry-wide plan.
- **Introduction of a new type of 'social' plan.** These are similar to pension plans, but must also provide certain social benefits (eg waiver of premiums for employees who fall sick, become disabled, are made redundant or lose their job through employer insolvency.) One advantage of a plan that qualifies as a 'social' plan is that both employer and employee contributions will be exempt from the standard 4.4 per cent tax.
- **A minimum investment return requirement for defined contribution (DC) plans and cash balance plans.** The minimum average annual return that must be achieved is 3.25 per cent for employers and 3.75 per cent for employees up to the time benefits are paid. It applies only to contributions paid after the Law Vandenbroucke becomes effective. In view of the guaranteed nature of the investment return, these plans will need to be valued according to defined benefit accounting requirements.
- **New restrictions on early benefit payments.** Benefit payments will no longer be allowed before age 60. However, until the end of 2009, early payments before age 60 for existing plans will be allowed.
- **Restrictions on promises before retirement to pay individual pension benefits.** These are still

allowed, but they must be made at least three years before retirement, and there must be a company plan for all employees. Other restrictions apply, and the promises will be subject to the same pension legislation as other pension plans (eg vesting of benefits).

- **Minimum disclosure requirements.** These will apply for annual benefit statements, including those for deferred vested members.
- **Equal tax treatment, to a large extent, of pension and lump sum benefits.** Currently, lump sum payments receive a favourable tax treatment.

Given the extent of the changes in the law, companies are advised, if they have not already done so, to assess the impact on their own organisation immediately and to draw up an action plan. A few examples of activities that might help are given below.

Review of plan design

The introduction of a minimum return for defined contribution plans may result in a change in the investment portfolio. In that case, an asset/liability study could help to obtain an optimal balance between return on assets and investment risk (including the risk of a shortfall in the upcoming minimum return). Moreover, for DC plans with individual investment choice, companies may wish to consider changing the investment options or eliminating individual investment choice altogether.

Other approaches that might help include setting up a contingency fund or switching to a cash balance fund.

Impact on communication and daily management

The content of the annual benefit statements has to be extended (eg all

plan variables should be mentioned on the benefit statement) and an annual statement must now also be sent to deferred vested members. Historical information since 1996 also has to be provided on request, and thus stored.

Given the mandatory option of annuity payments in addition to lump-sum payments and the improved tax status, annuity payments will become more popular than they are today. These aspects will involve set-up work, IT involvement and make the daily plan management more complex.

Impact on HR strategy

The fact that early retirement benefits payable before age 60 will disappear will affect workforce strategy and planning. More broadly, it is clear that the many changes in Belgium's new pension law will have a major impact on company-sponsored retirement plans. Companies should look upon this as an opportunity to align their benefit plan more closely with HR strategy consistent with a suitable financial management approach.

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Brazil

New funding regulations for private plans

New rules approved by the Council of Complementary Pension Management may have a significant impact on contributions required to be paid to company-sponsored retirement plans in Brazil. The rules, which focus on trust-based private pension plans, require adherence to new funding levels calculated on prescribed assumptions.

Full details of the rules, which were adopted in August, have yet to emerge, but initial indications are that effective

from year-end 2002, private pension plans will be required to fund their liabilities up to 100 per cent. This compares with the 70 per cent funding level required by the old private pensions law. Underfunded plans will need to draw up and present plans to the regulators indicating how they intend to eliminate their deficits; this may extend to signing a debt contract that would be registered in the plan sponsor's books.

Wide impact seen

The new rules are expected to have a significant impact on many companies, forcing them to increase their current contributions to their retirement plans. The changes will affect defined contribution-type plans that still retain a defined benefit liability with their promise to pay a lifetime annuity. They will also impact plans that have recognised employees' service prior to the plan implementation date (past service) and have decided to amortise the corresponding liability over future periods.

Although full details are not yet available, employers operating in Brazil are advised to take early action to investigate cash-flow scenarios, budgeting and accounting implications.

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Government clarifies new pension portability rules

The Brazilian government has provided some clarification on the new vesting and portability rules for pensions. Although portability became mandatory for private pensions beginning 31st May, 2001, companies were unable to implement the new law because the regulations detailing the new requirements had not been issued.

Now there is some guidance for

employers doing business in Brazil. Resolution No. 9, issued in July 2002 by the government, 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 in the plan. A ten-year membership period applies under existing plans. In the past, common practice was to provide benefits for terminating employees over the age of 40 with at least ten years' service.

Companies are still awaiting the regulations setting out how to calculate the amount to be transferred, particularly for defined benefit plans, and to allow time for companies to take account of the possible increase in future costs and liabilities. Plans have until 31st July, 2003 to implement the new law.

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Europe

European court rules on tax discrimination

The European Court of Justice has given its decision in the Danner case. The Court agreed with the Advocate General's opinion given earlier this year and ruled that member states cannot discriminate between the tax treatment of pension contributions to foreign and domestic institutions. This means that a state that gives tax relief on contributions to locally approved pension plans cannot deny this relief to similar plans established elsewhere in the EU.

The full impact of this ruling may take some time to become clear, in part because of the understandable reluctance of EU member states to contemplate the loss of tax revenue. It is unlikely that there will be much clarity until the PEPGO-sponsored AMS case is heard by the European Court of Justice. PEPGO

(the Pan-European Pension Group of 20 multinational companies) is backing a case in which a UK company (AMS Management Systems Ltd) is seeking permission to grant the same tax privileges as would be given if the employee joined the UK plan. This has yet to be heard in the UK courts.

However, the Danner case has created significant interest and pressure to speed up the movement to true pan-European pensions.

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Germany

Change in law makes *pensionsfonds* more attractive

In response to criticism, the government has made some important changes in pension law to make Germany's new *pensionsfonds* more attractive savings vehicles for employees.

The two main changes, which took effect from 1st July, 2002, are:

- Up to 20 per cent of the employee's savings can now be taken as a cash sum at retirement. The original legislation requires all of an employee's savings to be turned into an annuity. The change will give *pensionsfonds* parity with the four other employer-sponsored pension vehicles and will make it easier for employees to switch funds.
- The employer, rather than the *pensionsfonds* itself, can now shoulder the responsibility to provide the guarantee of a return of the contributions invested. The argument was that companies can do this because they are required to join the Pensions Sicherungs Verein (PSV), a collective group offering insurance to cover employers in the event of

insolvency. The change will allow the *pensionsfonds* greater freedom of investment.

Despite these changes, German employers are reluctant to use this new financing vehicle for a number of reasons:

- They have little or no experience with it.
- The *pensionskasse*, a traditional German financing method, is going through something of a renaissance and is offering strong competition to the *pensionsfonds*. *Pensionskassen* are essentially captive insurance companies set up by employers (particularly in the chemical industry) to fund their pension promises. Many of these captive insurance companies have now been opened to the market as group captive insurers and are offering greater investment freedom with unit-linked products than was traditionally the case. This, combined with favourable tax treatment, makes the *pensionskasse* an attractive option for employers.
- A record number of insolvencies are pushing up PSV premiums by 60 per cent, with the increase being back-dated to the beginning of 2002 to cover claims already made. Since employers are required to pay PSV premiums for *pensionsfonds*, but not for *pensionskassen*, *pensionsfonds* appear to be more expensive.

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The Netherlands

Dutch pensions supervisor mandates tougher funding requirements

Companies may be required to increase contributions to their Dutch pension fund because of tougher new funding

rules laid down by the Netherlands' pension supervisory authority, the Pension & Insurance Chamber (PIC). The PIC acted in the wake of the erosion of pension fund reserves due to the fall in equity markets.

In a letter issued to the country's 1,000 pension funds in October, the PIC has laid down tougher solvency requirements that must be met over the next two to eight years. In addition, it has given the estimated 300 funds whose solvency levels have fallen below 100 per cent one year to restore the 100 per cent level and warned that it may intervene if the deadline is not met. Following is a summary of some key requirements.

Buffers for investment risks

Under current requirements, Dutch pension funds are required to hold a buffer to cover approximately a 35 per cent fall in their equity portfolio. Under the new buffer requirements, a pension fund must be able to cover:

- a 40 per cent fall in its equity portfolio relative to the highest level of the past 48 months, with a minimum of a 10 per cent fall in the equity portfolio in the previous 12 months
- a general reserve of 5 per cent above the value of the pension liabilities
- up to a 10 per cent decline in the value of its bond portfolio. This is based on a market interest rate of 4 per cent. At a 5 per cent market rate, the buffer requirement is reduced to 5 per cent, and no buffer is required if the market rate rises to 6 per cent or above.

Indexation

Pension funds must also be clear about the nature of their commitment to index linking of pensions. A commitment that is linked to the financial condition of the

pension fund must be clearly disclosed, and if the commitment is unconditional, it must be backed by reserves held explicitly for that purpose.

If it is not clear that the commitment is conditional, pension funds should hold a special reserve earmarked for commitments arising in a transition period from unconditional to conditional indexation.

Transfer values

If a pension fund's funding level falls short of the PIC's requirements, the agency can limit the payment on transfer values. It is also required to inform new members clearly about potential negative consequences in connection with their right to take a transfer value.

Period allowed to restore funding

Pension funds whose funding level falls below 105 per cent must take immediate steps to remedy the situation within a year. Longer deadlines of between two to eight years apply for restoring buffer levels, with progress being made transparent from year to year. The rate at which a pension fund must restore its buffer levels rises in proportion to the rate at which its funding ratio deteriorates as its buffer shrinks and risk levels increase.

In light of the new requirements, the pension fund's board of management in conjunction with the sponsoring company will need to review their funding policies and the fund's investment strategy.

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Government protects pensions on takeover

New legislation will significantly affect the way that companies involved in mergers and acquisitions deal with

pension benefits. In future, the purchasing company will have to maintain the existing pension arrangements and take on existing pension liabilities.

In April 2002, the Dutch parliament passed legislation to protect employees' pension rights in business acquisitions. The new requirements go further than European legislation mandates and came into force on 1st July, 2002.

Under Dutch law, the general rule is that in a business takeover, the rights and obligations arising from employment agreements transfer unchanged from the selling employer to the buying employer. This does not currently apply to pension benefits, so that the buyer is not obliged to continue existing pension arrangements.

However, with the new requirements, the rights and obligations arising from pension plans will transfer automatically to the buying company. As this includes past service liabilities and other obligations (such as unpaid contributions), the buyer will need to ensure full due diligence is carried out before completion of the purchase. If there are any external pension assets, such as insurance policies, the buyer will need to check the conditions of transfer of ownership.

As the buyer will have to maintain the transferring employees' pension benefits, it will have to adopt one of the following:

- continue the seller's pension plan
- if it has a pension plan of its own, apply its own pension plan to the transferring employees
- continue participating in an industry-wide fund if it is obligated to do so, or if the transferring employees were in one prior to the sale.

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United Kingdom

Defined benefit plans face transfer value dilemma

Trustees of UK defined benefit plans are facing the dilemma of increasing transfer values at a time when pension fund asset values have taken heavy falls.

In the UK, plans have to comply with a minimum funding standard (MFR). After leaving pensionable employment, members of pension plans have a legal right to transfer the value of their retirement benefits to another pension arrangement. While general practice has been to calculate the transfer values with reference to MFR, the Institute of Actuaries has recently advised all plan actuaries that it considers the unmodified use of MFR to be almost untenable for the calculation of individual members' transfer values.

It is now widely accepted that the MFR materially understates an objective calculation of the expected cost of providing members' benefits in current economic conditions.

This situation has arisen following the recent falls in equity market values. The MFR basis implicitly assumes that the markets will rise again and that future investment returns will exceed the long-term average. In line with this logic, MFR liability values have fallen in line with the equity market. The logic may be correct, or it may be optimistic. In any event, the actuarial professional guidance warns against an overly optimistic approach.

There is, therefore, an urgent need for trustees to reconsider how transfer values should be calculated, and trustees should be talking to their actuary at the earliest opportunity.

Longer term, the government intends to replace MFR, and actuaries are hoping details will be contained in a consultation paper due out shortly.

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United Kingdom/United States

Slow progress on tax treaty

It is now unlikely that the long-awaited new tax agreement between the UK and the USA will come into force this year.

After three years of negotiation, the UK and USA finance ministers agreed on a new treaty convention in July 2001. A protocol was signed in Washington on 19th July, 2002, and the UK government has published draft regulations to implement the new convention.

However, the agreement needs to be ratified by both governments before it comes into force. The UK regulations were passed in November, but will not take effect until the agreement has been passed by the US Senate. It is not expected that the agreement will be put to the US Senate until next year.

The new treaty, once in force, will allow employees moving between the USA and the UK to remain in their home country pension plan without the current adverse tax consequences. The main points of the new agreement are:

- There will be no withholding tax on dividend payments made by a US company to a UK-approved pension plan (and vice versa).
- There will be no USA tax liability for contributions or accrued benefits of USA residents who continue to participate in a UK-approved pension plan that they participated in prior to moving to the USA, subject to a few other conditions (and vice versa).
- There will be no US tax liability for a US citizen who is resident in the UK on contributions to or benefits accrued under a UK-approved

pension plan up to the limits available for relief on corresponding plans in the USA.

The treaty also clarifies tax treatment of benefits once they fall due (generally taxed in the country of residence, except for lump sums). The document includes guidance on taxation of income from stock options held by employees who move from one country to the other between the time the options are granted and the date they are exercised.

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United States

New corporate reform law targets executive compensation programmes

The corporate reforms contained in the Sarbanes-Oxley Act of 2002 have broad implications and some new requirements for executive compensation programmes of companies, both US and foreign, with shares traded in the USA.

While the new law focuses on changes relating to corporate governance and accounting, it also contains a number of provisions that will impact the design and administration of executive compensation programmes. Companies will have to begin moving quickly to comply with the new restrictions by making the appropriate plan design and administration changes and communicating the changes to their employees.

In particular, the new law:

- *Prohibits company loans to directors and executive officers.* It is a broad prohibition that outlaws both direct and indirect loans, including loans to purchase company stock and loans to

cover income taxes that come due when executives vest in restricted stock or performance shares.

- *Accelerates disclosure of transactions in company stock by insiders.* Directors, executive officers and shareholders who own more than 10 per cent of the company will be required to report their transactions in company stock to the Securities and Exchange Commission within two days, as opposed to the monthly and, in some cases, annual reports due under prior rules. These rules generally do not apply to non-US companies.
- *Bans directors and executive officers from purchasing or selling certain company stock during blackout periods (when participants in a company's 401(k) plan are temporarily suspended from engaging in transactions in company stock).* In addition, they are not allowed to exercise stock options or stock appreciation rights. The ban on trading takes effect on 26th January, 2003.
- *Causes forfeiture of profits realised from sale of company stock and certain incentive compensation of CEOs and CFOs in the event that the company must restate its financial reports as a result of material non-compliance with accounting requirements due to misconduct.*

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Employer health costs surge for 2003 plans

For the fourth consecutive year, US employers once again find themselves facing double-digit increases in their healthcare costs. The increases, at a time when most companies remain under pressure to improve bottom line performance in a struggling climate, are prompting many to shift more of their healthcare costs to employees.

These are among the findings of Towers Perrin's just-completed '2003 Health Care Cost Survey', which collected responses from 358 employers, and found that the average cost of employers' health benefit plans will increase by 16 per cent in 2003 — the biggest one-year percentage increase since Towers Perrin began conducting this survey 14 years ago. Overall, the average reported cost per employee for all types of health plans combined in 2003 climbed \$833 to \$6,384.

Employee contribution levels also increased. On average, employees will contribute an average of \$576 per year (\$48 a month) for employee-only coverage, up from \$456 a year (\$38 per month) in 2002. Employee contributions for family coverage will average \$1,956 per year (\$163 per month), up from \$1,608 per year (\$134 per month) in 2002.

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