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Cross-Border Pension Alternatives

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In recent years many column inches in the European pensions press have been devoted to cross-border pension schemes (and, by extension, to pan-European pension schemes). This article considers whether the enthusiasm has been premature and identifies an alternative pension vehicle available to EU employers seeking to provide pension provision for their employees.

IN CONTEXT

According to the United Nations Conference on Trade and Development in its 2001 analysis of transnational corporations (TNCs) – see BOX 1 opposite for a definition – and foreign affiliates:

“Developed countries, specifically in the European Union, still host the largest number of transnational corporations.”

FIGURE 1, also opposite, shows the world's top 10 non-financial TNCs, with the number of their employees ranging between 67,000 and 382,000. All have significant representation in and outside Europe. Cross-border employment, and cross-border pensions, are clearly big business.

HISTORY

The European Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision (IORPs), officially 'Directive 2003/41/EC' and commonly known as the IORP Directive, was published in the EU's *Official Journal* on 23 September 2003. EU member states were given two years to implement the Directive.

From 12 April 2007, the IORP Directive came into force in all European Economic Area countries – this means that it now covers Norway, Iceland and Liechtenstein in addition to the EU member states.

One of the main objectives of the IORP Directive was to establish regulatory mechanisms to support the operation of cross-border occupational pension schemes. Some saw it as the long-awaited first step towards the establishment of pan-European pension schemes and the creation of one market for occupational retirement provision. However, it should be noted that the Directive only applies to funded occupational pension schemes; it does not apply to State schemes or personal pensions.

THE DIRECTIVE'S PRINCIPLES AND APPLICATION

The main principles of the Directive are to:

- enable an occupational pension scheme established in one EU member state to accept contributions from employers located in other member states, thus enabling pension schemes to operate across borders; and
- allow an employer located in one EU member state to sponsor an occupational pension scheme established in another, where the member state in which the scheme is established is the *home* member state and the member states of the other participating employers are *host* member states.

The Directive does not define the characteristics of a pension scheme or the benefits it offers, so member states have been left free to determine the structure of their pension systems.

The whole cross-border scheme is regulated under the relevant pension legislation for the home member state *but*, importantly, the scheme has to comply with the social and labour legislation of every host member state in which there are scheme members. Each host state is responsible for the application of its social and labour

BOX 1 Definition of a Transnational Corporation

A transnational corporation is an enterprise that controls assets of other entities in economies other than its home economy, usually by owning a certain equity capital stake. An equity capital stake of 10% or more of the ordinary shares or voting power for an incorporated enterprise, or the equivalent for an unincorporated enterprise, is normally considered a threshold for the control of assets.

laws, with any detected breaches being dealt with by the relevant authorities there, in conjunction with those of the scheme's home state.

Schemes must be 'fully funded' at all times; this is intended to ensure a high level of protection for members and beneficiaries but leads to increased scheme expenses due to the need for schemes to produce annual valuations.

The Directive states that the assets are to be invested in the best (or, in the case of a potential conflict, the sole) interest of members. Although schemes have the freedom to determine their own asset allocation, there is a prohibition on borrowing (except on a temporary basis, when authorized for liquidity purposes) or when acting as guarantor on behalf of third parties. This could prevent schemes from underwriting new share issues. Furthermore, a host member state may require tighter investment rules in respect of assets relating to activities carried out in that member state.

POSSIBLE DRAWBACKS

In theory, there are undoubted benefits to pension schemes operating cross border, most notably the anticipated cost savings resulting from economies of scale in relation to:

- documentation,
- trustees,
- administration, and
- investment.

In reality, how likely is it that these economies of scale will materialize?

The basic documentation of a scheme must obtain approval from each host member state, as well as the home member state. This could lead to delays, and increased costs, in establishing the scheme cross border, depending on the number of host states that the scheme covers and the experience of the legal advisers drawing up the documentation. If a company has only a small number of employees in a large number of EU states, the costs could mount quickly and become disproportionate compared with the size of membership in the home state.

Similar caveats regarding experience are also likely to apply to the quality of trusteeship and administrators. As a minimum, trustees are likely to require more training to ensure that they understand the implication of any decision they make, given the need to meet individual host states' social and labour legislation. As the IORP Directive has only been in existence for a few

years, it is unlikely that a great deal of experience is yet available regarding cross-border pension schemes.

Cross-border schemes may not offer the investment freedom desirable for many large schemes. In addition to the prohibition on borrowing or acting as guarantor (mentioned above), there is a provision for ring-fencing part of a scheme's assets if this is required to meet the stricter investment requirements of the host state or to meet the reserving requirements applicable in the home state.

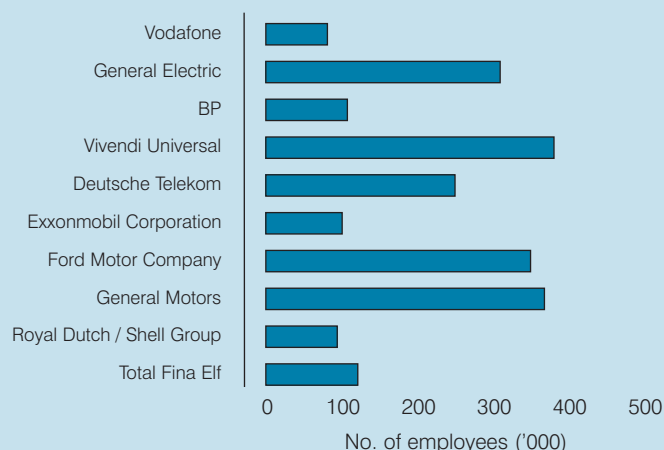
One major barrier to pension schemes operating across borders has been the discriminatory tax treatment applied by a member state to IORPs established in other member states. The IORP Directive does not directly address this important issue. Separately, however, these barriers are slowly being removed as a result of action taken in the European Court of Justice and pressure from the European Commission.

Perhaps the biggest constraint to pension schemes operating across borders is the requirement for (non-money purchase) cross-border pension schemes to be 'fully funded' at all times. This requirement applies to all sections of a sectionalized scheme and is not limited to those sections involved in cross-border activities. Where the home member state does not otherwise require pension schemes to be 'fully funded' (for example, in the United Kingdom) the implications of this can be quite severe and costly. This is especially true if the number of employees working cross border is small relative to the scheme as a whole. Indeed, in the United Kingdom this has resulted in some UK pension schemes removing all European Union employees from their membership – contrary to the primary aim of the Directive!

AN ALTERNATIVE IS AVAILABLE

Having highlighted some of the barriers to cross-border provision, there is a pension vehicle which a company employing staff across several EU states may use to provide them with pension provision while avoiding some of the drawbacks discussed above: an International Pension Plan (IPP) – see TABLE 1 above for a comparison of an EU cross-border plan and an IPP.

FIGURE 1 Employees of Transnational Corporations (top 10 non-financial TNCs by value of foreign assets)



Source: 'World Investment Report 2003', UNCTAD

TABLE 1

Comparison of an EU Cross-border Plan and an International Pension Plan

	<i>EU cross-border plan</i>	<i>International Pension Plan</i>
Freedom from 'fully-funded' requirement	No	Yes
Fewer investment restrictions	No	Yes
Tax relief on employer contributions	Yes	Yes*
Tax relief on employee contributions	Yes*	No
Tax relief on investment returns	Yes	Yes
Can operate without host states' approval	No	Yes
Freedom from host states' rules on benefit structure	No	Yes
Regulation and infrastructure available	Yes	Yes

* though with qualifications as explained in the text

An IPP is a pension scheme established in an offshore location, which is the home country of neither the employer nor any of the employees. The term 'offshore' is a slight misnomer, given that there are now many mainland and/or landlocked 'offshore' centres, such as Luxembourg and Dublin, and others like Singapore. Although some IPPs for European multinationals have been established in Bermuda and the Cayman Islands, the more obvious choices are Guernsey, Jersey or the Isle of Man. These islands have a respected reputation and financial infrastructure and communications are also relatively easy as they have a common time zone with the UK (and only one or two hours' difference from mainland Europe) and convenient air links. Guernsey and Jersey both have minimal regulatory requirements, while the Isle of Man has a more comprehensive regulatory regime.

In contrast to cross-border arrangements, IPPs have been in existence for many years (often for expatriate staff). They can easily be amended to provide pensions (or other leaving-service benefits) for all European staff.

An IPP will normally be established under trust, often via a 'master trust' approach. In this way, a number of different plans (possibly with different benefit designs that can encompass both defined benefits and defined contributions, or perhaps funded by different companies within the group) can be provided within a single trust. This may be similar to a cross-border arrangement. However, in contrast to a cross-border scheme, the IPP's documentation does not need to be approved by any employees' member states, nor need it take account of social and labour laws (although this will probably be done at a company level). Furthermore, an IPP could be extended beyond Europe to provide a central funding vehicle for all subsidiaries within the group, giving complete group coverage.

In order to demonstrate control and management, the trustee should be based in the chosen offshore location, thus avoiding taxation or regulatory problems in the employer's home territory. The better-regulated offshore locations have introduced their own trust law and legislation to regulate professional trustees (or are planning to do so). An employer should therefore expect to be able to recruit experienced trustees from a wide

skill pool. If pan-European employers want to retain more control of the trustee function, a separate trustee company could be formed in the offshore territory, as a subsidiary of the employer. This would act as a single-purpose vehicle for the trusteeship of the offshore pension plan; and the administration of that trustee company could be delegated to a third-party provider based in the offshore territory. Although it is generally advisable for accounting functions to be performed in the offshore territory, the membership administration could be delegated back to an (existing) pensions department of the employer (as would be the intention under a cross-border arrangement).

An IPP would be established in a neutral territory so that no local tax would be due on either its investment returns or its benefit payments. However, tax advice should always be taken on the tax deductibility of employer and employee contributions in the host states where the employers and the employees are based to ensure that any problems may be identified in advance.

An IPP has significant investment freedom. Unlike some cross-border pension schemes, there are generally very few regulatory restrictions on the use of the IPP's assets, so benefits from economies of scale, facilitated by the investment of pooled assets, can be realized. The investment management of the IPP's assets need not be carried out in the offshore territory.

Finally, due to the lighter regulation prevalent in offshore jurisdictions, an IPP readily allows flexibility in plan provisions. Most importantly, there is no legal requirement for an IPP to be 'fully funded' at all times. This removes one of the most significant barriers for a UK-based company operating a cross-border pension scheme. Another advantage is the freedom of choice in the retirement benefits offered; for example, the payment of retirement benefits can be in lump-sum form if required. In addition, it may be permissible for unallocated (surplus) reserves to be accumulated and/or returned to the employing companies.

While the IPP solution may not be the best one in all circumstances, it does have some real advantages compared with the cross-border alternative within the European Union. Ω