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Title

International Pension Plans, their role in multinational benefit planning

Authors

Stephen Ainsworth MA FIA ASA FPMI FCII TEP FRSA
Abelica Global
sainsworth@bwcigroup.com

Carl Hansen BSc FSA MAAA EA Dip.IEB
Abelica Global
chansen@bwcigroup.com

Abstract

There is an increasing interest in international pension plans (IPPs) for expatriates as a consequence of the trend towards globalisation of businesses and the increasing challenges of retaining globally mobile employees in domestic pension plans. They are typically established in international finance centres such as the Channel Islands, the Isle of Man or Bermuda in order to benefit from a benign fiscal and regulatory regime and may either be serviced by locally based actuaries or by the international teams of domestic actuarial consultants. IPPs pose unusual challenges to employee benefit actuaries and consultants in balancing the conflicting demands of parity with domestic employees on the one hand having regard to the differing fiscal and social insurance arrangements at home and overseas, with a need on the other hand for flexibility and proportionality where relatively small numbers of globally mobile employees are involved.

This paper traces the development of IPPs over the past three decades, how they typically operate at present and how they might continue to develop in the future. It comments upon the trend from defined benefit to defined contribution pension provision, the general interaction with other aspects of the employee benefit package, the relative merits of funded and unfunded arrangements and the relative attractions of "bundled" and "unbundled" investment and benefit administration approaches.

There have been very few papers on this subject presented to previous ICA conferences and this paper seeks to fill a gap in this specialist field. The authors present the paper from both a British and an American perspective, drawing upon their personal experiences in advising upon IPP issues and in managing IPPs in practice.

1. Introduction

International pension plans have received little attention at past Congresses, although a paper was presented to the International Association of Consulting Actuaries in 2002 (reference 1). This paper seeks to remedy this and to indicate why interest in international pension plans continues to increase, as indicated in an article for the Society of Actuaries in 2012 (reference 2).

The paper is written from the perspective of practitioners currently working in Guernsey, Channel Islands, where a large number of international pension plans are based. However, the concepts should be of application more generally to international pension plans, wherever they may be based.

The paper concentrates on plans established to provide retirement benefits. It does not consider the use of other employee benefit plans or trusts (established for example to deliver share options or awards). Neither does it consider the use of employee benefit captives for the delivery of risk benefits. Both structures are also encountered internationally and merit consideration, but will need to await a further paper.

2. Some Definitions

In order to set the scene it is useful to start with some definitions. While the terminology is not universal, the following definitions would probably be generally accepted:

- An **international** (or offshore**) pension plan** may be described as a pension plan established in an international finance centre, which is the home country of neither the employer nor the employees, to provide benefits for the international staff of a multinational group. Thus, a UK multinational company might establish an international pension plan in Guernsey to provide retirement benefits for its international staff working, for example, in Africa or Asia. The plan can sometimes also be used to encompass locally recruited staff in overseas locations where, by reason of economies of scale or because of the lack of local pensions vehicles, it is efficient to arrange their pension provision through a global pension plan.

- **International staff** might be career expatriates, or may be secondees or permanent transferees from one country to another, while remaining within the multinational's group of companies. This group may also be referred to as mobile employees.

- A **career expatriate** is an employee recruited for international service (probably in a number of countries in the course of a career) or an employee transferred into this category in the course of their service within the multinational group.

- A **secondee** is an employee recruited in one country and seconded from there to another country for a specific (usually shorter term) period, or to carry out a specific project, with the intention that he or she will return to the original country when the period of secondment is over.

- A **permanent transferee** is an employee recruited in one country and then subsequently transferred permanently to another country.

- International staff are sometimes referred to as **third country nationals** (TCNs) although strictly a **third country national** is a citizen of one country, working in another country for the local subsidiary of a parent company that has its headquarters in yet a third country (for example a Dutchman working in France for the French subsidiary of a UK parent company).

In practice, the distinctions between these categories may become blurred at times, and employees may move from one category to another as their careers progress.

3. Reasons for Establishment

Why set up an international pension plan? This is usually because the alternatives have been considered and found unsuitable.

It is not generally practical for a multinational group to retain all its global employees in a single pension plan established in its home country. Some countries may allow mobile employees to remain in a home country plan for only a limited period of time.

Equally, the pension arrangements (if any) of the local overseas subsidiary company are unlikely to be suitable for international staff posted there for a limited period. Such local arrangements will have been designed in the local currency to meet the needs of the local staff, having regard to the available local social security benefits, local expectations and the local cost of living, and may well not meet the requirements of any international staff working in that location. In particular, international staff may not work in any location long enough to build up a full social security contribution record, and may not qualify under any local vesting requirements for occupational benefits either. Moreover, few international staff retire in the country of their assignment and those career expatriates with a series of overseas postings would not wish to accumulate a number of small deferred benefits denominated in a variety of currencies en route (even if the vesting conditions had been satisfied) and overseas transfer payments are not usually available. Additionally, international staff are unlikely to appreciate retirement benefits denominated in the currencies of certain emerging market economies, or payable from some developing countries.

In recent years, there has been some development of pan–European pension plans with just over 80 now in existence based on recent information (reference 3) from the European Insurance and Occupational Pensions Authority (EIOPA). In theory, a pan-European plan can provide a single pension plan for all of an employer's European employees. However, the legal, taxation, and social insurance difficulties have made them costly for all but larger employers to operate. Also, solvency requirements leave little flexibility for funding. An analysis of EIOPA's report suggests that pan-European

plans have had a very limited appeal so far. The report shows that about half of the existing plans cover only employees in the United Kingdom and Ireland, with only about 15% of the plans covering more than two countries. Even if pan-European plans continue to develop, they will not provide a complete solution for most multinational groups, as their activities will extend beyond the EU boundaries. International pension plans and pan-European plans can complement each other in a well designed benefits programme.

An additional reason for establishing an international pension plan (and increasingly for extending the scope of a plan already created for career expatriates) can be to provide pensions (or other leaving service benefits) for local staff where there are no suitable local investment vehicles for pension provision, or in order to gain from greater economies of scale when investing the assets. These workers may be excluded from participating in local retirement plans due to their expatriate status, or they could be local workers with limited options for retirement provision. Typical employers are large international oil or mineral extraction operations as some countries rich in mineral or other natural resources may not have a well developed pension structure.

In an increasingly global economy, smaller “emerging” multinationals are now facing some of the benefits issues once only affecting the very largest employers. There are many fast growing companies with only informal or less uniform pension promises in place for internationally mobile workers. This often takes the form of a verbal or written promise that the mobile employee will be no worse off than if they had stayed in the home country benefit plans. Such promises are often not clear (especially when they must be interpreted a number of years later at retirement by those unfamiliar with the original situation) and it may be uncertain which group operating company should be meeting the cost of the promise made many years previously. They can also vary by individual, and they may lead to unintended inconsistent treatment of similarly situated employees. An international pension plan allows the employer to bring together all current and future promises in one structured arrangement. This also makes it much easier for various company departments to share information and to collaborate on funding, accounting, or risk benefit issues.

4. Possible Locations

When selecting a location, a number of features will need to be considered.

- The location should have political and economic stability, and a good reputation as an international finance centre.
- There should be no exchange controls to restrict the flow of income or outgo.
- Regardless of whether the location itself is tax-free, there should be legislation that exempts international pension plans from local taxation, both on investment income, and on the benefit payments, whether in pension or lump sum form.
- The regulatory authorities should have a helpful approach and be prepared to respond rapidly.

- There should be minimal restrictions on benefit levels, and the ability to take benefits wholly in lump sum form can often be important.
- Assuming that the pension plan is to be established under trust, the location should recognise the concept of a trust and have its own trust law.
- There should be appropriate (but not excessive) regulation of pension trusts and trustees.
- There should be a range of support services to enable the international pension plan to be managed effectively.
- There should be good communication links with the home country of the parent company, and ideally convenient air links so that corporate executives can visit the location easily.
- There should be a sound business infrastructure, ensuring adequate provision of legal services, banking services, communications media, and information technology.
- Communications are also assisted if the location is in a similar time zone as the parent company and if it shares a common language.

Having regard to these features, there are three types of location generally considered for international pension plans.

Firstly, there is the home territory of the parent company. For UK multinationals for example, and perhaps surprisingly, the UK could itself be considered to be an "offshore" location for this purpose, through the facility to set up such funds under the provisions of Section 615(6) of the UK Income and Corporation Taxes Act 1988. This has the advantage that the pension plan could be controlled and managed in the UK alongside the domestic UK pension plan.

Secondly, there are other “onshore” locations such as Belgium, Ireland, Luxembourg and Switzerland that may be considered, although most of these locations are focused more on pan-European plans for employees in European Union member states rather than for international staff generally. For example, Belgium has introduced a new legal entity appropriate for pan-European plans, known as an OFP (Organisation for Financing of Pensions).

In practice, most international pension plans are established in one of the world’s international finance centres in order to provide greater flexibility. The choice of location may depend in part upon the location and time zone of the parent company. For this reason, US multinationals have historically favoured Bermuda or the Cayman Islands. So far as UK multinationals are concerned, the obvious choices are Guernsey, Jersey or the Isle of Man, both because of their respected reputation and financial infrastructure, and also because of ease of communications (having a common time zone with the UK and convenient air links). Guernsey and Jersey both have a minimum of regulatory requirements, while the Isle of Man has a comprehensive regulatory regime (modelled on parts of the UK Pensions Acts).

5. The Development of IPPs Over the Years

Historically, many international pension plans were set up on a defined benefits basis, to reflect the benefit design of the multinational's home pension plan. Minor adjustments might be made to reflect the overseas service. For example, benefits might be based upon a notional home country salary or adjustments made for differences in social insurance accruals. As a variation, a "base country" approach has sometimes been adopted, whereby a base country would be determined for each of the international staff and benefits provided on the same basis as local staff working in that base country, regardless of where the international staff are posted from time to time. A further variation has been to determine a special benefit structure for all international staff, perhaps with a higher accrual rate or a lower pension age than for comparable staff in the multinational's home pension plan.

However, defined benefit structures are often too inflexible to provide for all the variations encountered in the employment conditions for international staff and one can end up with as many variations from the standard benefit package as there are members in the international pension plan. In addition, defined benefit structures can be complex in practice to administer. While it may be equitable to allow for the effect of differing social insurance accruals for each member, it can prove exceedingly difficult in practice to determine just what those accruals may be in some countries. This can be a problem for funding calculations, but a major concern for benefit calculation purposes, where benefits are to be brought into payment (or a transfer payment made) before the social insurance benefits fall due.

Thus, a defined contribution structure is particularly suitable for international staff, since it is easier to design a defined contribution arrangement, with contribution rates determined to fund a target level of benefits (where this is desired), than to have a rigid defined benefit structure. Such an approach also streamlines the documentation required, since there is no longer any need to draft detailed schedules of benefit rules. Instead, standard defined contribution documentation can be adopted, supplemented by individual member letters setting out any target benefits to be provided on a case by case basis.

Accordingly, in common with worldwide trends, most new international pension plans are set up on a defined contribution basis. Some employers may have established defined benefit international pension plans many years ago, only to be discouraged by some of the general financial and administrative frustrations that have developed over the years with defined benefit plans. Those employers are now re-evaluating the international pension plan from a defined contribution or hybrid plan perspective in search of more flexibility and easier administration, without the same volatility in funding requirements. A defined contribution or hybrid international pension plan can supplement or replace an existing defined benefit international pension plan on a more cost effective basis.

Another trend is to establish international pension plans on a "master trust" approach, so that a number of different plans (with different benefit designs, or perhaps funded by different companies within the multinational group) can be provided within a single trust. This can prove more cost effective than setting up separate trusts. It can also provide a

central investment vehicle for local pension plans operated by subsidiaries within the group who do not have suitable investment vehicles in their particular locations.

Flexibility of plan provisions should be aimed for wherever possible, in order to cope with the unexpected. This can often be more readily achieved with a pension plan in an offshore location than in heavily regulated onshore locations, for example to permit the payment of retirement benefits in lump sum form when required, and to permit the accumulation of unallocated (surplus) reserves and/or for their return to the employing companies as agreed from time to time.

6. The Unfunded Alternative

Tax issues in some countries – most notably, the US – can cause difficulty for international pension plan design and administration. US tax rules typically defer taxation on assets saved for retirement in one of only a few US tax qualified arrangements. Also, US taxpayers are taxed on worldwide income regardless of where they live. As a result, contributions to an international pension plan (both employer and employee) on behalf of a US taxpayer member are generally taxable income when they are made.

Some employers have taken the position of excluding US taxpayers from international pension plans in order to avoid adverse tax consequences. Some service providers will also exclude US taxpayers to avoid administrative difficulties, and future reporting requirements under the Foreign Account Tax Compliance Act (FATCA) may well accelerate that trend. Other employers have decided to not fund international pension plans that include any US taxpayers.

While an unfunded approach may have tax benefits for a limited number of members, it leaves all members in the plan with no security in the event of employer insolvency. Also, a lack of plan assets will probably deter some service providers with asset based fees or less transparent charging structures.

An alternative to an unfunded approach is to fund for all members except US taxpayers and any other members with adverse tax issues. Administration systems should now be sufficiently sophisticated to handle separate classes of members.

7. Funding

Conventional defined benefit international pension plans would typically be funded using the Attained Age or Projected Unit methods of valuation and using similar assumptions as for the equivalent onshore pension plans of the parent company. The Attained Age

method may be more often used, in view of the relatively small numbers of members usually found in international pension plans, and hence the greater variability of the experience. Equally, the size of membership would not normally enable scheme specific actuarial assumptions to be adopted.

The general absence of complex solvency requirements for defined benefit international pension plans gives welcome flexibility for the employer, but can result in some concerns about security of benefits, particularly in small plans.

Accounting standards on pension costs are unlikely to be a factor in determining the funding plan, as international pension plans are typically not material to the reporting entity, so that the cash contributions made during the reporting period would then be used for accounting purposes.

Where the international pension plan has been established on a defined contribution basis, but with a target level of benefits, then a Current Unit method of calculation may be more appropriate. Thus the funding objective would be to provide for the leaving service benefits at any time, but no more, in order to prevent surplus arising in the event of leaving service. This would be expected to lead to an increasing funding requirement with age and service.

Indeed, provided that the sponsoring employer understands the increasing funding commitment over time, there is an argument that a Current Unit valuation method would be appropriate for conventional defined benefit international pension plans with only a handful of members, to avoid the need to dispose of any potential surplus in the event of the members leaving service.

8. Trusteeship and Administration

Central to the establishment and operation of a successful international plan is the appointment of a suitable trustee and administrator. The trustee should be based in the chosen international finance centre, in order to demonstrate control and management there (and thus not, for example, in the home country of the multinational) to avoid taxation or regulatory problems in the home territory. Several international finance centres specialise in the provision of trustee services, although most trustee services are geared to the provision of private discretionary trusts for high net worth individuals, and the number of trustees with meaningful experience of pension trusts remains limited. The better regulated international finance centres have not only introduced their own trust law but have also introduced legislation to regulate professional trustees. Thus, a check should be made to ensure that the intended trustee is fully licensed in the chosen territory.

Some multinationals will have a natural wish to retain more control of the trustee function than is possible with the appointment of an independent professional trustee. In such cases, a suitable solution can be to form a separate trustee company in the international finance centre as a subsidiary of the multinational which would act as a single purpose vehicle for the trusteeship of the international pension plan. Management of the trustee company can then be delegated to a suitable independent fiduciary based in the same location as the plan.

While the trusteeship should be performed in the international finance centre, it is still possible to delegate some administrative functions back to the multinational's benefits or HR department in the home territory. For example, the accounting functions might be performed in the international finance centre, but the membership administration (being the more technically complex part of the operations) could be delegated back, though an appropriate administration agreement should be put in place to demonstrate that ultimate control remains with the trustee.

Similarly, investment management need not be carried out in the plan location. It is increasingly common for international pension plans to invest in the pooled funds of major financial institutions. In the case of defined benefit plans this is because most such plans are of a size that direct investment into securities is at best only of marginal advantage relative to pooled fund investment. In the case of defined contribution plans this is to simplify the unit allocation process between plan members.

9. Establishment and Operation

The international pension plan would typically be established by means of a trust deed and rules, which would normally be reviewed by a lawyer in the chosen territory to ensure compliance with local laws. The documentation should be submitted for approval (or confirmation of exemption from local taxation, as applicable) to the income tax office where the plan is being established and any other relevant regulatory body there, and the usual procedure would be to submit a draft for clearance before execution if the provisions are at all non-standard.

Before proceeding, it would also be advisable to check out the taxation and regulatory position for the international pension plan in each of the locations where the intended members are based. Employer contributions to international pension plans are typically effectively tax deductible for the employer as an employment expense. However, some countries (for example, the US as mentioned previously) will view employer contributions as taxable income to employees when made. Employee contributions to an international pension plan are not usually tax deductible, but it may be possible to make them tax effective depending on individual circumstances. If employer contributions would be taxable on the employee as a benefit in kind then it may be necessary for such tax to be recompensed by the employer.

International pension plans will often include life assurance benefits that will require reinsurance, because of the level of cover required for the generally senior nature of the membership or the relatively small number of members involved. This can prove to be a practical problem if cover is needed in excess of the available free cover limits, as it can prove difficult to persuade hard pressed international staff to attend for medical examination. In such circumstances a degree of self insurance, or limitation of cover, may be needed unless the problem can be avoided entirely by including such international staff in the group life policy of the multinational parent company. Disability and medical benefits are not usually included in an international pension plan.

The new generation of defined contribution international pension plans are very flexible to meet the needs of a variety of employer types and sizes. Employer contributions can be uniform or vary according to home country, host country, age, service, or a variety of other criteria. Members can choose from a wide range of investment funds in various currencies to fit their own circumstances. Most plans provide some sort of a "lifestyle" fund or strategy as a default option for those employees wanting less involvement in the selection of their investments.

Member communication is important to the success of any pension plan, and is particularly important for international pension plans, where the members are physically remote both from head office and from the trustees and administrators. Most plans now centralise communications via a dedicated plan website with secure access to benefit and membership information, possibly in more than one language. Websites for defined contribution plans typically handle investment changes and enable retirement modelling. Some plans still provide printed member statements and plan booklets. Telephone helplines can sometimes be useful, though time zone differences or language barriers may make them impractical. A more common substitute nowadays is an email helpline to the administrator's offices.

10. Plans established under Contract

Many international insurance companies and investment fund providers now also provide services to international pension plans. These companies will arrange a contract with the employer to provide services to the plan in exchange for holding and managing the plan's funds.

Contract based arrangements are intended to be a cost-effective approach for an employer to set up and operate an international pension plan, especially for a small number of members. Providers are often able to offer tools or ancillary services originally developed for larger local retirement plan markets such as the US and the UK. However, there may be some less transparent costs involved in the form of asset based

fees taken from the investment returns. In a defined contribution arrangement, this can mean significantly lower retirement balances for members over the course of their career.

Plans established under contracts are generally less flexible than those set up using a trust. The permitted plan provisions tend to be limited to fit within the terms of the provider's standard contract. For example, an employer wishing to include some unique plan provisions, company branding for communications, or investment funds other than those offered under the contract may well be better served by a more flexible arrangement. If the provider is an insurer, there may be restrictions on including employees in countries where the insurance company is not licensed to operate.

While a trust is a separate entity from the employer and any provider, a contract based arrangement remains the property of the employer and the asset is the provider's policy. The plan members therefore have employment and retirement benefit provision risk concentrated in their employer, and there is also some risk of loss of capital on the insolvency of the provider.

11. Summary

It is hoped that this paper has provided a useful introduction to this specialist field, and will encourage other actuaries to explore international pension plan opportunities with their clients.

In the view of the authors, international pension plans are an increasingly important part of the armory of the human resources director in meeting the employment needs of a globally mobile workforce. They remain an elegant and tax efficient way to provide retirement benefits for employees who might otherwise have little or no formal pension provision due to their working location or their mobile lifestyle. While the initiatives of the European Union in encouraging cross border and pan-European pension provision are to be commended, the practical complications in establishing such plans have resulted in a relatively small number of such plans being established. Additionally, most multinational companies do not confine their operations to European Union countries, and so the availability of pan-European plans does not negate the need for international pension plans. In fact, the demand for such plans is expected to continue to increase, as companies increasingly find the need to conduct their businesses internationally.

Finally, while responsibility for the contents of this paper remains with the authors and gives their personal views of the development of international pension plans, the authors are grateful for the helpful comments given by a number of practitioners, in particular Gary Hibbard from BP, Stéphane Bonin from Total and Mark Colton from the BWCI Group in Guernsey.

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