Wilson Group™

International Pensions for Key Local Nationals

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The Same Problem

Whether the company is a large multinational with just a handful of key local nationals in 35 or 55 countries, or a small company with an international sales force reaching around the world, the problem is the same. There are not enough of these key local employees, or even a locally registered company in some countries, to make it feasible to establish tax compliant pension plans. In some countries the concept or product does not even exist. The US headquarters may sponsor a pension plan or, more likely, it offers a 401(k) plan with elective deferrals, an employer match, a wide range of no or low load funds, and the ability to change investment selections frequently, not to mention take a loan from the account value. Moreover, headquarters knows the cost of the plan; it knows the benefits provided; it even knows how its plans stack up against those of its competitors. New accounting rules and pension legislation only throw headquarters for a short while, as it readjusts the parameters. Such is not the case when headquarters endeavors to provide “international pensions”, that is, a retirement plan for all (or most) of the international employees. The reasons for providing pensions are many – retaining key staff, providing for retirement savings, securing deferred compensation promises, offsetting declining social security benefits, compensating a global team, and delivering tax-efficient rewards. Indeed, it is natural for a modern company with performance driven compensation programs to think of a tax-deferred plan as part of the continuum. Perhaps headquarters has been covering some key local nationals in the US 401(k) plan, or in the company pension plan. Inevitably, the company is surprised when advisors suggest that the plan does not allow the participation of the international employees, that payouts to these employees may be subject to 30% withholding on earnings in the plan (as US source income), and that the deduction taken by headquarters for contributions on behalf of these employees may be questionable if they are not directly employed by the headquarters company. It may even strike headquarters as odd that the local authorities do not view the US plan as qualifying for tax relief. It has historically been easier to cover these few “international” employees in the headquarters pension plan. It is not so hard for headquarters to find a place for a handful of key employees in a final salary plan, or even simply carry their benefits on its books as an unfunded promise to pay. The shift worldwide to funded defined contribution plans makes that harder, in part because individual account balances are more visible, they are accounted for differently, and they raise a host of questions about the application of local tax and social charges.

STRATEGY FIRST

The company's first decision is a strategic one. What kind of company is it? How does it operate? Is this a company that is run from headquarters, or is it a company where major decisions are taken in the field and headquarters doesn't ask many questions unless the numbers don't add up or there are larger business reasons to do so? What international pension policy best suits the company's approach to compensating and rewarding its employees? Dependent on how the company operates, it may dictate plan design and funding options or it may leave such details to local discretion. Perhaps headquarters sponsors a defined benefit plan. It may also offer a supplemental savings plan for employees to save toward retirement, but the basic retirement promise is met via a pension plan. Further, the company may believe it should provide a basic retirement benefit to all of its employees, or a retirement income which is some respectable percentage of their average career salary, total final compensation or some other variant, including social security benefits. Admittedly, this kind of company is growing scarcer every day.

Alternatively (and this is by far the most prevalent philosophy today), this company could believe in running lean, paying employees competitively, and providing the opportunity for them to save for retirement, probably with a competitive company match and excellent investment choices, but beyond that, retirement provision is a matter of personal responsibility. Headquarters may provide not just the opportunity to save for retirement, but a way for key management to defer bonuses (or a percentage thereof) as well.

Obviously, there are many companies that historically offered a pension plan but now, whether because of new management or cost-cutting to remain competitive, offer only a contributory defined contribution plan.

NEXT STEPS

The next big decision facing this company as it moves to provide "international pensions" will be how to go about it. It is hard work, but headquarters must understand the basics of how in-country retirement plans work, the level and form of benefits provided, the extent to which employees contribute and the extent of the employer's liability. Many multinational companies cannot understand the need to consider an offshore solution until they go through the arduous task of trying to provide tax compliant in-country plans. Headquarters will find that, whatever its corporate benefit philosophy, its plan design may not be an option in some countries. Legislation and culture (though both could be changing) may dictate what is cost or tax effective, or even available in-country; and, in looking at what is typically provided in-country, the centralized company will be dismayed to realize the variance in cost and features available, not to mention the differences in social security benefits, which typically provide the floor for corporate pensions. If the company envisions spending something like the same amount to provide a retirement benefit for employees around the world, it will be sorely disappointed. Further, it will be shocked at what it costs to provide something like the same proportional (to total compensation) benefit to international employees.

By contrast, the decentralized company may find that it has great difficulty in even identifying the benefits its subsidiaries or acquired companies have already or are putting in place at operations around the world. Headquarters may not even know what questions to ask, or what to make of the answers it gets back. In addition, there is the nightmare of ongoing compliance in-country to

changes in legal and funding requirements, and headquarters staff's attesting to that compliance. This is particularly so when there is no local staff to mind these plans.

Accounting for the cost of these various plans is difficult because the benefits and their costs do not easily equate, even when accurate information is forthcoming. The reality is that it isn't just local tax, custom, or pension legislation, and international and local accounting rules but also the competitiveness of the local market for pension products that drives the variance.

Additionally, the world has always been divided into places where trustees and investment committees are prevalent and those where insurance companies typically provide the wrapper in which benefits are provided. It remains so today and is yet another variant in any analysis. The difference between those two approaches makes the benefit cost analysis significantly more challenging.

In any case, the company's choices come down to in country solutions (where possible), offshore solutions, cash or some combination of the other two options.

TOWARD A SOLUTION

The HR Director at this headquarters company may well have been asked to survey the marketplace and make a presentation to the Board on the best way to provide retirement benefits for all of the company's international employees and to comment on the trends in this important aspect of benefit provision. Of course, if the company has many international employees concentrated in a few countries, local law and competitive forces will drive most of its choices. The company may find it has many local options, if not easier decisions. The costs of those options and the decisions are an increasing part of the cost of doing business in these countries.

Such is not the case if the international employees are scattered around the world, where the company will find its choices more constrained. The HR Director could approach local providers in each country, but it will be more productive to approach one or more of the international benefit networks for a quote. Success will be dependent on where the company's employees are located, and which networks are approached. In the simplest terms, the goal is to find a reasonable match between where the network has approved carriers (and suitable products) in-country and where the company has operations. The more countries the company has operations in, the less likely it is that there will be a perfect match.

Once a compatible network, or even a handful of local quotes, is found, those quotes need to be pulled into a coherent presentation to the Board. This is not an easy task, as the quotes are all over the place, providing different basic benefits and different ancillary benefits – and the costs vary greatly. The HR Director will grow old trying to compare administrative expense factors, investment returns, or the actual benefit delivered for corporate dollar expended. If the company has few enough employees in some countries, he/she will be forced to consider individual policies (if available) and the negotiations with key employees that this may entail.

Moreover, try as one might there is no practical way to provide a pension in many countries for a handful of employees without an operating company registered in that country. It is still a typical organizational model for a US company to have a multinational sales force report directly to the

USA or to a holding company in the EU. Additionally, in some countries there is no, or inadequate, pension legislation and no suitable pension provider.

All of these difficulties may lead the HR Director to look for an offshore solution, eschewing local tax efficiency for simplicity. A number of good providers can be found, but if there are few or no assets to be transferred or significant contributions anticipated, he/she may discover they have little interest, or that the expense factors are very high. Some providers' charges (at least in part) are based on the annual contribution level, so that the smaller the international employee population, the higher the cost. The company may or may not be able to increase the annual contribution level by adding employees or improving contribution levels in the years to come. If the company decides on the offshore solution (and the reasons are many – flexibility in contributions and payouts, and tax-advantaged accumulations in a secure offshore environment with good pensions regulation), there are a number of other decisions to make besides the selection of a provider. The choice of a good lawyer is important, as numerous international and local issues will arise, not to mention a good international consultant!

One of those decisions is situs. Should the offshore plan be in Luxembourg, Isle of Man, Guernsey, Bermuda, or the Cayman Islands? Where the plan is located is a choice of law (trust, foundation, etc.) and regulation (security and asset protection), availability of qualified workers and professional services, 21st century banking operations and IT sophistication, name recognition and familiarity (for the employer and employee), or it may simply be the situs the offshore plan provider has selected for many of the same reasons. Not to be underestimated is access from headquarters and a comfortable working relationship with the service providers and their staff (you will be turned over to staff once the "sales" process ends) and one needs to enquire about staff turnover.

Does the company want an insured plan or a trusteed plan with a pension administrator/record keeper, or perhaps an insured plan where the insurance contract is held in trust? This is perhaps one of the most confusing aspects of the selection process. While the insured or trusteed options can appear very similar in their presentation today, they are basically different in their underlying premise and are regulated differently. Most importantly the service/product providers are compensated differently, and, as in all else, you need to follow the money – who gets paid for what? "Transparency" is now a term used by both, so it is easier, though by no means easy, to tell what amount is being charged and for what services.

If the company wants to sponsor a funded defined contribution plan, does it want a "guaranteed fund" or an annuity option? Typically these have been products, but the mutual fund providers may offer a "defensive value fund" or a money market fund that has never lost value. The insurance company will have an annuity option in the contract, but at what rates? If the option is not in the contract, the participant's account value can be used to purchase an annuity, but again at what rates? Is the insurer (or a partner) an admitted carrier in that country? The uninsured plan also offers the option of taking periodic payments from the account value. If the company is funding for a defined benefit liability and wishes to completely transfer the risk, it might opt for an insurance contract, or it may establish an irrevocable trust offshore to fund those liabilities.

WHY NOT A PAN-EUROPEAN PENSION?
If most of the international employees are in Western Europe, headquarters may ask whether they can all be covered in a single EU plan. Isn't that part of the promise of a unified economy? Despite the Pensions Directive and ECJ* judgments, the ability to deduct a pension contribution in-country, or to have the contributions (employee as well as employer) escape current taxation and social charges, seems a long way off. In some instances, and in some countries, it can be achieved, but not easily, and certainly not across the entire international employee population, leading to inequitable benefit results. Many providers offer the simplicity of an offshore solution while positioning themselves in local markets for a pan-European pension solution when it becomes a realistic possibility. A few providers continue to believe they can structure a product, say in Luxembourg, which will be able to obtain tax relief in some countries while positioning the plan toward the eventual goal of EU-wide tax favorability. International accounting rules and global investment management and asset pooling are leading the way toward pan-European pensions. Unfortunately, local tax law and local regulation of investment and insurance still stand in the way!

Beyond Europe there are other intractable issues, even a few countries with currency exchange controls, which can make any payment out of the country very difficult. However, for the purposes of this section of the Report, the EU is tough enough!

THE PRODUCTS AVAILABLE
So what are the products that are available for the newly international company (or, at least, one that is newly focused on the problem)? There are two basic options:– investment through an insurance based program, or– direct fund investments using a trust arrangement with a pension administrator or record keeper.

The first option is usually a more seamless product (fewer moving parts – the insurance carrier does much of the work behind the scene and presents the product pretty much as a package). The second option is similar to the 401(k) plans sponsored by most US multinationals (with a trust, an administrator, and investments all, more or less, separately selected and compensated). In both cases, the costs are much higher than they are for similar products in the USA. Most companies opt to use a trust arrangement to hold insurance contracts (third party ownership offers significant creditor protection and accounting advantages versus direct ownership of the assets); so the distinction is less than clear cut. What follows is a brief survey of some of the providers I found in a recent, very unscientific exercise. There are other providers worth noting, but here I only cover Fidelity International, AIG, AEGON, and Zurich International Life (ZIL). Since each case is different, and pricing is based on many factors including negotiation, my comments are general in nature.

I found a wide choice of providers and funding options available, and while many providers may target high minimum asset cases, either available for transfer or as projected annual contributions, some are willing to make a case-by-case assessment of a potential offshore plan. Perhaps they welcome more customers/assets, perhaps a potential client is an attractive name, or it provides entry into a new industry. Perhaps there is a provider relationship/partner in the headquarters

country that both the client and the provider wish to maintain offshore. Whatever the reason, it is worthwhile for both parties to explore the possibilities.

Fidelity offers an offshore plan that is very close to the US 401(k) model. If Fidelity's trust services (in the Cayman Islands) are used, the plan and trust set-up fees are quite reasonable. If the pension committee (and the company auditor) prefers to have an independent trustee, trust companies in Bermuda or the Channel Islands are happy to oblige, for more substantial fees (and considerably more services).

Fidelity's fee schedule for ongoing recordkeeping costs of the plan discourages smaller plans. The annual administrative fees are based on assets under management and can be zero with US$5 million of transferable/anticipated assets. Fidelity's quoted minimum is US$1 million in investable assets. (Some others quote a minimum as high as US$6 million, so this is a difficult ballpark for the small company or the large multinational with only a few international employees, unless the plan also provides benefits for a substantial number of expatriates and foreign nationals, which would increase both the contributions and assets available.) Investment management fees (for Fidelity's own extensive funds) are clearly stated. There are no Market Level Adjustments, no exit penalties and no initial or up-front charges.

Fidelity offers 24/7 internet access for participants, daily valuations, and a host of other things many US 401(k) sponsors take for granted, including its "Plan Viewer", roughly the equivalent of "Net Benefits", its US version. Many of Fidelity's offshore funds boast returns well in excess of their benchmarks. Performance is reported net of fees, a standard in the USA.

I cannot speak to client satisfaction, but it is always a good idea to both request and follow up on references. In order to ensure client expectations are met, Fidelity appoints a dedicated relationship manager to each case to coordinate all services.

When AIG relocated its Global Retirement Plus (GRP) to the Isle of Man in 2002 a number of enhancements were built into the product, including the ability to choose investment funds from a large investment universe and the disclosure of underlying fund charges to the client. Many offshore providers use what is known as "mirror funds". Essentially, a mirror fund is a fund created in order to buy another fund house's fund and offer it as one of their own. AIG believes that holding mirror funds in its GRP would contradict its philosophy of total transparency because they can be modeled to allow for hidden charges. Instead, AIG buys funds for GRP directly from other fund houses and negotiates an entry fee (often zero) and an annual fee. A rebate fee, typically 0.50%, is paid to AIG from the fund's annual investment management fee. The annual investment fund fee is not "loaded" by the fund house to accommodate the rebate. Given this approach, AIG can hold virtually any fund and has negotiated entry and annual fees with most of the fund houses. The GRP platform can also host third party investment managers for a fund-of-funds approach. All of AIG's investment fees are clearly stated. Other fees are explicit as well (an introducer's fee may be added to the installation fee, or an advisor fee, capped at 0.25%, may be added to the annual fund fees). Portfolio performance on all funds is reported net of management fees.

AIG's GRP offers monthly switches and it has no exit fees. The client has the option to hold the contract directly (a less expensive option) or through AIG's independent trust in the Isle of Man. The client may also, with AIG's approval, use another trustee/location.

AIG requires a minimum corporate deposit of US$25,000 p.a. or US$1,000 per month which makes GRP accessible by a smaller company. Individual continuation is allowed with a US$50,000 minimum initial deposit and a US$1,000 minimum monthly contribution.

In addition to AIG, AEGON and ZIL, just a few of the other insurance providers in this marketplace offer investment into funds of other well-known managers for a wider range of investment options. It is also possible to select a fund where a well-known investment research firm monitors fund performance and selects the best performers for a fund-of-funds approach. It is important, however, to recognize that there is a cost for such variety. Each layer in these wrapped (or mirror) funds can add to the cost. While the management fees of the basic funds may be reasonable, the additional fees paid to market those name brand funds or to pay the investment research firm increase the number of dollars that are not invested in a participant's account. (A few of the providers will cap the total investment management fee.) If the small multinational company has a sophisticated international employee population, and the performance to be expected of the underlying fund managers is extraordinary, the additional fees might be justified.

Almost universally the providers think that expectation of an EU-wide pension in the near-term is unrealistic and that contributions to an offshore plan would be taxable and subject to social charges. However, an offshore solution should be able to offer earnings accumulation (and exceptional fund selections) within a trust arrangement in a tax free environment, such as the Isle of Man. Many multinational companies deal with these additional tax and social charges by simply making higher contributions for the international employees, perhaps 6% might become 12%, or even 15%.

By contrast, AEGON, one of the insurance providers in this very unscientific survey, says that while its product provides for gross contributions, with the expertise of its local pension providers it feels it can work with the multinational client (and its advisors) to optimize the tax situation in each country where feasible. The product, offered through La Mondiale Europartner, part of the AEGON Pension Network, is a European compliant product offered by a Luxembourg based insurer. It allows for subscription by the parent company on behalf of its subsidiaries or by each of the subsidiaries directly. As far as I can see, this approach provides no relief when the multinational company operates on a worldwide basis from an EU holding company with no in-country company registration. It may, however, succeed with more traditional company structures, at least in a few countries. The model provides a multinational company contract and an in-country adoption, and features pooled investment management and administrative services. The product appears to be quite flexible, allowing different investment portfolio options for different countries, including managed funds and lifestyle funds and a long list of mirror funds, and even the flexibility for a terminating employee to transfer to an individual product.

The fees charged will be AEGON's own fees plus the commissions charged by the intermediary (agent / consultant), both on contributions and assets. Such commissions will vary from case to case, dependent on the intermediary used and negotiation. The underlying funds that the client selects have their own management charges to which will be added wrap fees if the fund is a

mirror fund. The proposed charges might be acceptable, particularly if the funds can, in fact, obtain in-country tax relief. I was unable to identify the charges for the underlying funds or obtain performance net of fees. (Insurance products have often been referred to as black boxes, because it is so difficult to tell how they are priced.)

Currently, AEGON offers weekly valuations and it does not allow online investment switches. Fidelity and AIG have useful, easily navigable websites, while the AEGON / La Mondiale Europartner website is clumsy and some companies will be put off by much of the French only content. It is my understanding that the website is currently being redesigned.

The ZIL (Magnus product) basic and managed funds, with BlackRock Merrill Lynch and Threadneedle as submanagers, have investment management fees roughly comparable to Fidelity or AIG, and if the client extends the choices by using mirror funds the investment management fees are additive. The existence of the mirror funds allows the scheme to choose from up to 100 funds. The plan members, however, will be limited to the 10 funds chosen by the plan trustees (employer). At the end of the day, after taking investment fees and commissions into account, roughly 93% of the contribution is invested in a participant's account. There are annual minimum contributions of US$1,500 per member and US$35,000 per scheme. ZIL is replacing its normal CD demo, which is cumbersome and must be ordered, with an online demo.

Many of the record keepers contacted in this mini-survey operate in the Isle of Man. One of them, ECS, offers straightforward trustee and pension administration services. It charges a start-up fee and there would be an ongoing administrative charge for each active and retained member, per quarter. ECS can accommodate any fund choice but, for illustrative purposes, ZIL was used in this survey as the investment platform. It should be noted that the ZIL insurance contracts can be held by the company directly or, as most advisors would recommend, in trust through Zurich International Trust or an independent trustee like ECS.

SOME CONCLUSIONS

What the headquarters company offers at home it usually seeks to extend to its international operations. This is less true in a decentralized company, which tends to accept what those "with boots on the ground" say is necessary in-country.

The international pension analysis will need to cover many of the points raised in this section of the Report. Many services and plan options are worth additional cost, but the HR Director should be able to make a cost/benefit judgment when the analysis is completed. That cost / benefit analysis should include the cost of consulting and legal advice as well. However, in choosing an established and capable retirement plan provider as a partner, real value can be added to a global benefits strategy. Finally, this is a fluid situation. It will require ongoing re-evaluation. Whether the company chooses the more traditional (for Europe, at least) insurance approach, or the US 401(k) funding model, with explicit fees (which even some insurers, like AIG, have adopted), the company will need to analyze and respond to changes in local legislation and regulation and future EU directives as well as a host of other issues impinging on total compensation and retirement planning in the21st century. □

Biography –Ruth Ryals:

Ruth A. Ryals

CLU, ChFC, CEEBS, NASD

Ruth is a compensation and benefits consultant with a broad range of compensation and benefit experience, having consulted to large and small companies, industry associations, and non-profit organizations on both domestic and international HR issues for nearly 30 years. She is experienced in working collaboratively with client management and other professionals/consultants around the world to achieve the client's strategic goals.

Ruth is a principal in IBCG, a consulting firm formed in 1992 to develop products and define tax strategies for senior executives and principals of international companies whose pension/insurance arrangements were not tax effective across the borders of multiple countries. They currently have a personal pension product approved in the UK. As a principal of IBCG, Ruth works closely with George Beram & Co. to provide international pension and insurance expertise for their mutual clients.

In the course of her career, Ruth has worked for the international human resources consulting firm, Watson Wyatt; the actuarial firm, with it's international affiliates EURACS and IBN, George Beram & Co.; the international insurance brokerage firm, Coroon & Black/Willis Coroon; and the international accounting firm, Arthur Young/Ernst & Young.

At Watson Wyatt, Ruth was consultant to many of the firm's clients on domestic executive compensation and benefit issues, including providing competitive information on total compensation and HR issues. Her primary role, however, as part of Watson Wyatt's international practice, was to consult with clients on international compensation and benefit issues, working to establish and administer global HR strategies.

She managed client projects involving numerous consultants and other professionals with differing expertise in multi-national locations to achieve the client's strategic compensation and benefits goals, including the handling of all employment, compensation and pension issues in various international acquisitions

Ruth represented the firm at NFTC (National Foreign Trade Council) meetings and authored an article on global healthcare strategy. She represented the firm in Sao Paulo, Brazil in a project to examine the feasibility of a managed healthcare consortium of major international and local companies.

Some of Ruth's clients included Ingersoll Rand, Welch's, Ocean Spray, Wellington, Applied Extrusion Technology (AET), Pluess-Staufer Industries, Liberty Mutual, Biogen, State Street Global Advisors, and numerous local high tech companies with international operations.

While at George Beram & Co. Ruth managed all consulting services for several of the company's major clients, being responsible for both domestic and international work. She specialized in cross-border executive tax, compensation and benefit issues.

She represented the company at NORACS (North American Actuarial Consultants) and EURACS (European Actuarial Consultants) meetings. R Watson & Sons was one of the EURACS partners, later to become part of Watson Wyatt Worldwide.

Ruth managed several significant mergers/acquisitions and consolidations of US compensation/benefits programs and HR systems. This included the combination of numerous defined benefit and 401(k) plans and the selection of new funds/money managers/administrators, as well as the consolidation of numerous health and insurance programs into a multi-tiered cafeteria plan to accommodate subsidiaries of different size and profitability.

Some of the clients Ruth worked with while at George Beram & Company included American Saw, Harrisons & Crosfield (H& C(A) Inc.), IPSCO and Gallatin Steel, GLAXO Welcome, Fisons, Hawker Sidley (BTR), Bank of Ireland and Allied Irish Bank.

Early in her career, Ruth was hired to continue the US ERISA practice of a retiring partner in Arthur Young's Pittsburgh office. While there she drafted and terminated qualified and non-qualified plans and reviewed pension and welfare plans for tax signoffs on audits. While there she became known as one of the firms' resources on insurance. She was called upon frequently to consult on supplemental executive benefit programs funded with insurance, for major clients of the firm such as Southwestern Bell and Textron.

She was moved to the firm's New York office, as Tax Principal, to establish and co-direct the compensation and benefits consulting practice based in AY's (soon to become Ernst & Young) headquarters. While there she worked with many of the firm's major clients, including as lead consultant on a study for the American Bar Retirement Association of the organization's master (qualified) plans offered to the thousands of ABA member firms. She also worked on a major study for the American Medical Association of the insurance products offered to the AMA members, saving the AMA several million dollars a year in administration of the plans and reserves.

Ruth also led an insurance and management audit of a major western-US utility's self-insurance of all of the company's welfare and workers' compensation benefits, via fraternal insurance companies it controlled, at the request of state regulators.