International Pension Plans – Dispelling The Myths

In previous articles I have looked at many of the challenges faced by HR when providing pensions and risk benefits for globally mobile employees and expatriates. These often concluded that a combination of approaches provides the most appropriate solution and this will commonly include an International Pension Plan (IPP). However, many HR professionals ignore the IPP for a number of reasons. In this article I'll address the main objections to IPPs with a view to dispelling some of the myths that still prevail.

"IPP's Are Not Really Pensions At All – They Don't Have Any Tax Advantages."

What is a pension? The word usually implies some form of tax-incentivised savings plan with restrictions around when and how the accumulated benefits can be taken. For many it conjures up an image of a complex web of tax rules, regulations, lack of access and control and possibly, in some countries, a political football and unacceptable selling methods. To me, a pension is a source of income upon which an individual will survive once employment ceases, however that source of income is structured and derived. For some people it will result from the sale of a business, for some a combination of investments such as property and shares, while others will rely on a combination of state- and employer-sponsored pension plans. All of these are perfectly valid sources of income in retirement but not all attract any tax advantages and each may suffer various forms of taxation at different times, such as income tax, capital gains tax and inheritance tax. Yet that doesn't faze those following their particular path to a more secure future as they believe in the investment, first and foremost. Of course, if a tax-efficient option is available it makes sense to take this path, but if, and only if, the tax advantages are not out-weighed by other factors that impact upon the likely returns or add unacceptable levels of risk.

Internationally mobile employees face a number of additional challenges when it comes to establishing a worthwhile pension. Local pensions vary greatly from country to country in terms of the tax position, some giving relief on contributions but taxing income, others with no relief but providing a tax-free income in retirement. Importantly, though, the tax advantages are often partly or wholly negated by other factors, such as currency volatility, investment restrictions and economic and political instability. Given a choice between a local plan offering tax relief of 15% in a volatile currency, or an IPP with no relief but a strong currency, the latter can easily be seen as the least risky option.

While it's very important to avoid decisions based solely on tax advantages, it's also worth stressing that for some people the IPP can be a very tax-efficient way to save. If benefits are accumulating during periods of work in low-tax countries, such as the Middle and Far East, tax relief up front will be of limited importance. The IPP then offers tax-free growth, often referred to as gross roll-up as there is no tax levied by the local tax office, and with careful timing of the withdrawal of benefits any income tax liability on benefits can also be minimised. So while the IPP may not be tax advantaged, for some people, depending on their circumstances, it will be tax efficient.

"We Only Have A Few Mobile Employees, It'll Be Too Expensive To Set Up For A Small Group."

Many employers recognise the potential benefits and flexibility of IPPs for their expatriates and globally mobile employees, but the cost of establishing a plan is often seen as prohibitive, particularly for small numbers of employees. It is true that IPPs have historically been more expensive to set up and administer than domestic plans in large developed markets, mainly due to the IPP market being much smaller and specialist and therefore lacking the economy of scale of domestic markets.

It is also true, though, that in recent years the costs associated with IPPs have fallen greatly and, while they are still more expensive than domestic plans, the difference has narrowed. This is due to a number of factors, including improved automation of administration and investment, greater use of low-cost passive funds, the emergence of multi-employer master trust solutions that cater for smaller numbers, and general competition in the market to drive down costs. It is also important to be aware that employer-sponsored corporate savings plans will almost always be a better deal for the expatriate employee than plans available in the local retail savings market.

"We Don't Need An IPP. We Use Home And Host Plans Or Extra Cash."

Perhaps the most frequent reason I am told that a company doesn't need an IPP is that there are better options available, such as retention in home plans. The reality is that these alternatives will be the right solution for certain employees, depending on the nature and length of their assignment, but will be wrong for others. Consequently, this should not be a blanket approach for all mobile employees. Retention in home plans carries a number of risks and challenges, such as the possible creation of a cross-border scheme, regulatory time restrictions and providers' inability or lack of appetite to include overseas workers (for example, in group personal plans in the UK). Host country plans face a number of concerns that can add significant risk, such as currency volatility and the factors already mentioned above when looking at tax breaks.

The cross-border risk should not be underestimated. Occupational pension plans established in one European country and with members localised in another European country must satisfy the cross-border regulations. This includes creating different country sections and meeting the local social and labour laws of each country, which may mean member materials in different languages, meeting local disclosure regulations and so on. For defined benefit plans it means ensuring the plan is fully funded at all times.

Recognising these issues leads many employers to resort to paying extra cash in lieu of a pension. A quick examination of the reasons why pensions are offered in the first place would seem to demonstrate that this isn't a good option – the use of benefits to attract and retain skilled employees, good social responsibility, centralised approaches to benefits for senior employees and supporting employees to plan for their departure from the company are just a few examples.

"We Don't Want The Responsibility And Risk Of A Trust-Based Plan For A Small Group Of Employees."

While it's not the only option available, the most common approach to setting up an IPP is under a trust – typically one established in a tax-neutral location such as the Isle Man or the Channel Islands. For some employers, particularly in mainland Europe, trusts are viewed with much apprehension. There is a perception that trusts are expensive to set up and run, and that individuals must be appointed as trustees who then personally shoulder the burden of selecting an appropriate range of investments, with the risk that employees may in the future seek recourse for funds that fail to deliver on expectations. Where alternative structures to a trust are preferred, the investment risk point still prevails, resulting in many employers opting for guaranteed funds that promise no risk at all – a concept that I challenge further below.

The reality is that trusts serve a number of very important purposes that arguably justify the costs involved. In addition to separating the plan funds from the assets of the company, and so securing them for the benefit of the plan members, trusts add an important layer of governance and assist in plan administration, especially if things go wrong. The trustees are responsible for ensuring that the funds made available are suitable for the members, but this responsibility need not fall on individuals, as the majority of IPPs are set up with professional firms of trustees, not individual employees or the sponsoring employer.

For smaller numbers of employees the cost of setting up a trust may still seem disproportionate, but the growth in master trust solutions is starting to overcome this. Yes, master trusts lack some of the flexibility of stand-alone trusts, but they do offer a low-cost way for employers to provide an IPP for small numbers of mobile employees.

I mentioned guaranteed funds earlier and these are perhaps one of the greatest myths in the pension world, especially for IPPs. Many employers, especially on the European continent, will only offer one fund to members, one that has no risk of downside and offers an annual return that is then also guaranteed. The problem with these funds is that they hide a number of issues and are widely misunderstood. The first problem lies in understanding what the true cost of the guarantee actually is, as these funds rarely provide any information on the underlying assets and charges. Second, returns on these funds are at an all-time low and are being eroded in real terms by inflation. Third, in order to offer these funds, the insurer must match the liability of the guarantees with low-risk assets such as bonds, which in turn create a drag on performance, particularly over the longer-term. And finally, providing a guarantee adds significant liability to the insurer's balance sheet, creating a third-party risk to the plan – any guarantee is only as good as the company that promises it.

So, is there a better approach for the employer and trustee to adopt to minimise the risk to themselves and the employee? In the US the trend is strongly in favour of target date funds. These funds seek to take the appropriate level of investment risk at the right time, reducing the level of risk as the target date approaches. Generally unavailable in the international market, a similar effect can be achieved with lifestyle or lifecycle funds, which also reduce the risk profile as retirement, or some other target date, approaches. These funds are normally the default fund, but where the member wants to be more involved in the process of selecting funds, trustees and employers can assist through the use of risk assessment tools and risk-rated fund options that maintain a particular risk profile on an ongoing basis. By demonstrating this level of support, the likelihood of future complaints is much reduced.

The IPP is developing at some pace and the advent of master trusts, sophisticated blended and lifestyle funds and greater flexibility over when and how benefits are withdrawn, means that IPPs are becoming a solution available to all. As a result, HR professionals who have avoided setting up a plan due to costs and numbers of mobile employees may have options available that they have previously passed by.

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