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The Euro Crisis and Political Risks Affecting Retirement Income Programs

By Norman Dreger

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INTRODUCTION

Many of us have watched the developing euro crisis with trepidation. What started as a banking crisis has now turned into a government debt crisis, in particular on the European periphery.

One issue that has not been in the spotlight as much as one might expect, is the implications of the euro crisis on retirement income programs.

As countries suffer economically, so too will their social security programs. Such programs are typically provided on a pay-as-you-go basis, and many of these programs were subject to structural problems long before the European sovereign debt crisis came around. Possible negative implications are not restricted to government pension programs though. As company pension benefits are highly regulated, these benefits are also subject to political risks to a greater extent than many other employee benefits might be.

In the past, we have seen changes to regulations which have been perceived to negatively impact pensions. However, during the euro crisis, we have seen governments undertake austerity measures which dramatically reduce pension benefits in a way never seen before in Europe, at times even going as far as to confiscate pension assets in order to fill government coffers.

This article examines such developments in four European countries.

HUNGARY: CONFISCATION OF SECOND PILLAR PENSION ASSETS

After the transition to a market based economy, the pension system in Hungary consisted of three pillars:

- Pillar 1: A pay-as-you-go social security system
- Pillar 2: A funded system of mandatory individual accounts
- Pillar 3: Company pension benefits

At the end of 2010, the second pillar pension system had over 3m members and around 10 billion euro in assets.

Near the end of 2010, the Hungarian state was in dire need of capital. Desperate times call for desperate measures, and the government came up with the creative solution of asking people to "voluntarily" give up their second pillar savings in order to help the government deal with its short-term liquidity concerns.

You may wonder why anybody in their right mind would agree to "voluntarily" give up their hard earned pension savings. The answer is simple: The payment of the account balances to the government was made voluntary, however, anybody who was not willing to make such a "donation" would not receive any additional future benefits from the first pillar social security system, although they would be required to continue to contribute to the system in future. In what basically comes down to a form of blackmail, some 97 percent of members sacrificed their second pillar accounts, handing the government a one-off 10 billion euro windfall.

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The question some pundits are asking is whether the government will stop at the second pillar. Many doubt the government will. The third pillar currently has about 3 billion euro in assets. Will people be asked in future to "voluntarily" give up this money as well? Watch this space!

IRELAND: "TEMPORARY" TAX ON PENSION ASSETS

Ireland has traditionally been a relatively poor country. However, Ireland is also a country with a long tradition of funded corporate pension benefits and as a result, while the government coffers have often been quite empty, there has traditionally been (relatively speaking) a lot of money in Irish pension funds.

The economic situation in Ireland improved dramatically in the late 1990s. This trend continued through to 2007/2008, and the start of the global banking crisis. And then everything started to go really wrong, really fast.

In September 2008, the Irish government announced that the country had entered into a recession, the first state in the Eurozone to do so since the introduction of the euro.

Ireland received assistance from the EU and the IMF in 2010, and in return was required to meet very challenging deficit reduction targets. The government was on the lookout for creative solutions to try and solve what seemed to be an impossible problem.

In May 2011, the government dropped a bombshell announcement: A "temporary tax" on pension schemes and personal pension plans of 0.6 percent per year of the value of the pension assets would be levied. The levy is to last for four years, and is intended to raise about half a billion euro in each of these years.

Whether this will actually be a temporary measure remains to be seen. After all, income tax was also introduced as a temporary measure many years ago, and we still are living with it today. This move may also be the death of the Irish hosted pan-European pension plan. Can you imagine a company wanting to transfer all of its European assets to Ireland, only to have these taxed at a rate of 0.6 percent per year?

PORTUGAL: ASSUMPTION OF LONG-TERM PENSION LIABILITIES TO SATISFY SHORT-TERM BUDGET CONSOLIDATION TARGETS

Portugal is one of the countries suffering the most as a result of the Eurozone crisis. Similar to Ireland, Portugal received massive financial assistance from the EU and the IMF in 2010, and in turn committed itself to drastically reduce its budget deficit over a short period of time.

Presented with limited options, the Portuguese government also needed to seek creative solutions in order to meet its short-term budget consolidation targets.

Such a creative solution was found in 2010. It was agreed that the state would assume approximately 3 billion euro in pension assets and liabilities from Portugal Telecom. The three billion in assets would provide Portugal with desperately needed funds to help it deal with its short-term spending requirements, while reducing its budget deficit as required by the EU and the IMF. Unfortunately, by taking on the assets, the Portuguese government also took on the liabilities associated with the pension commitments. And while the assets which were assumed were used up almost immediately, the liabilities remain with the state on an unfunded basis. The Portuguese state will need to pay for these benefits through future increases in productivity, or through future increased savings.
Because the state is not required to prepare a balance sheet in the same manner as a publicly listed company, these liabilities will not

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be recorded or disclosed in a transparent way. However, this fact does not make the future obligations of the Portuguese government and the corresponding financial burden any less real. In fact, this lack of transparency might ultimately prove to be an additional burden, as obligations that are not accounted for properly are perhaps less in focus and thus more difficult to manage.

The transfer of assets and liabilities from Portugal Telecom was intended to be a one-time arrangement to help Portugal out of a difficult situation. However, just one year later, Portugal again found that it was struggling to meet its budget deficit reduction targets. In order to again meet these targets, another "pension solution" was found, this time with 18 Portuguese banks. It was agreed to transfer approximately six billion euro in assets and liabilities from the banks to the state. And again, while this gave the government badly needed access to funds; it also meant that the long-term liabilities were assumed by the state on an unfunded basis.

The Portuguese government will need to meet ambitious deficit reduction targets in 2013 and in future years. One has to wonder how long Portugal can strip pension plans of their assets and assume the pension obligations on an unfunded basis as a type of additional sovereign debt, before there are no pension plans left to raid and the country finds itself with its back against the wall.

U.K.: DECREASE IN TAX EFFECTIVE PENSIONS SAVINGS LIMIT

The United Kingdom has also suffered greatly as a result of the current crisis. The government has introduced a number of extreme austerity measures in the last several years to try and get the country back on track. Effective April 2011, there was a dramatic change in the amount of pension an individual can earn in a given year on a tax sheltered basis. This amount was reduced by over 80 percent from 255k GBP to 50k GBP per annum.

For the purposes of determining the value of pension benefits earned in a given year, different approaches are required for defined contribution and defined benefit pension plans. For a defined contribution plan, the value of the pension benefits earned in a given year is simply the total contribution made. For a defined benefit pension plan, the value is based on a formula, essentially the increase in pension entitlement over the year times a factor of 16.

While much smaller than before, 50k GBP may still seem like quite a large amount of tax sheltering for pension benefits. For instance, for a defined contribution pension plan paying a contribution of 10 percent of salary, only employees earning over 500k GBP would be affected by this change.

However, for defined benefit pension plans, especially plans which are based on final salary, the threshold is now low enough that people in middle management or other professionals could be affected.

Take for instance a typical middle management employee. Let's call her Elizabeth in honour of the 2012 diamond jubilee. Elizabeth earns 110k GBP a year, a decent salary all things considered, but no CEO-salary by any means. Elizabeth participates in a defined benefit pension plan which pays 2 percent of final pay per year of service, and has 25 years of credited service.

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Elizabeth had a very successful year in 2010. However, as her employer had a very challenging year in 2010, it was decided globally that there would be no salary adjustments at the start of 2011. Elizabeth was disappointed, but she was promised that the company would make it up to her in 2012.

Elizabeth's notional pension earnings in 2011 are:

110k GBP x 2 percent x (factor of 16) = approximately 35k GBP

Since this amount is less than the tax effective savings limit of 50k GBP, Elizabeth would pay no tax as a result of the pension entitlements she earned in 2011. After paying about 40k GBP in taxes on her regular salary, and 30k GBP in mortgage payments, this leaves Elizabeth with 40k GBP to spend.

Lets jump ahead now to 2012. This year Elizabeth received the salary increase she was waiting for, a 13.6 percent increase from 110k GBP to 125k GBP. She was delighted when she heard the news: however, her celebratory mood came to an abrupt end when she received her tax bill for 2012.

Here's why: Elizabeth's notional pension earnings are significantly higher than in the prior year, leading to additional tax payments. Her annual pension entitlement at the end of 2011 was:

25 years of service x 2 percent x 110k GBP = 55k GBP per year

At the end of 2012, her pension entitlement was:

26 years of service x 2 percent x 125k GBP = 65k GBP per year, an increase of 10k GBP.

This means that Elizabeth has notional pensions earnings in 2012 of

10k GBP x (factor of 16) = 160k GBP

which is significantly higher than the 50k GBP maximum tax effective amount. Even if Elizabeth can transfer 15k GBP of unused tax effective pensions savings from the prior three years (which is permitted under the new rules), this means that she will have to pay an additional tax on notional pension earnings of:

160k GBP – 50k GBP – 3x15k GBP = 65k GBP.

The additional "pensions tax bill" on this 65k GBP of notional earnings is expected to be around 30k GBP. Thus assuming she has 45k GBP of regular tax, an additional "pensions tax" of 30k GBP and 30k GBP of mortgage payments, this leaves Elizabeth with only 20k GBP to spend in 2012, half the amount she had in the prior year.

This admittedly overly simplified example (U.K. actuaries: please forgive me for cutting some corners here) demonstrates how even ordinary employees can be hugely impacted by this change in legislation. Companies that have open defined benefit pension plans in the United Kingdom will need to do some hard thinking about how they would like to address this problem.

CONCLUSIONS

The euro crisis has resulted in negative implications for retirement income programs in a number of European countries. Unless we experience a dramatic turn of events, this trend may be expected to continue, and even to spread to other countries. However, in spite of the risks, I believe corporate pensions will remain a key attraction and retention tool for employers; the risks associated with pensions can be managed, but it is important that companies say abreast of developments in order to minimise the impact of surprises, in particular in such volatile and uncertain times. ☐