Law on supplementary pension and minimum guaranteed return on contributions for defined contribution plans: what’s next?

Why is this change in the law so important?

On 28 April 2003, a new law on supplementary pensions (LPC – WAP) was introduced and has since become popular for its article 24. The article established a minimum guaranteed return on contributions made to a supplementary pension plan that’s also a defined contribution plan.

The annual rate was set at 3.25% for employer contributions and 3.75% for contributions made by employees. At the time, 10-year linear bonds (“OLO”) in Belgium were at 4.2%, so minimum guaranteed rates of return were very reasonable compared to market conditions; an investment with little risk could yield a return of one percent more than the guaranteed rate of return on employer premiums.

Employers in Belgium are obliged to finance pension plans through a third party and can do so in two ways: a group insurance contract or a pension fund vehicle (“OFP”). When the LPC – WAP law came into effect, most insurers in Belgium offered a rate of return of 3.25% on branch-21 contracts (contracts with a guaranteed rate), meaning it was possible for employers to meet the mandatory yield set by the law.

Since then, market conditions have changed significantly; rates have plummeted year on year since the end of 2011 and are today at less than one percent (0.9% end of October 2015). In these conditions, it’s clearly a real challenge for employers to meet the minimum guaranteed rates set in 2003 and for insurers to maintain their rates. Insurers lowered their rates in 2012 and have reduced them multiple times since. The rate guaranteed for new business in branch- 21 contracts is today about one percent or even lower according to insurers. Employers who use a group insurance contract as a financing vehicle find themselves in a situation whereby they have to make up the difference in rates (3.25%/3.75% against the tariff).
**Is the minimum rate to guarantee likely to change quickly?**

The average over 24 months of the 10-year OLO at 31/12/2015 will be very close to 1.32% (average of January 2014 through October 2015). The applicable percentage according to the rules of the transition period is 65%, which would lead to a guaranteed rate of 0.86%; since this rate is lower than the minimum rate of 1.75%, this minimum rate of 1.75% would be the minimum required rate to be met as of 2016. This rate will most likely remain applicable for several years unless the rates of the OLO increase significantly in the near future. In 2018, the average over 24 months of 10-year OLO will have to have reached 2.67% (at 1.32% today) for the minimum rate to be guaranteed to reach 2% (the resulting rate has to be rounded to the nearest 25 basis point). In 2020, this average would have to be 2.35% for the minimum applicable rate to be 2%. This means that for several years employers will likely be unable to find insurance contracts that allow them to completely meet the minimum legal rate they have to guarantee. The additional expense with respect to plan costs that this would result in would however be lower than it is currently.

**Is there any particular point that you would like to draw attention to?**

**People should keep two elements in mind:**

1. **Different treatment depending on the financing choice made.**

Discrepancies introduced with regards to future guaranteed return on prior accrued benefits between branch-21 and other financing means raise questions. Is it fair to participants? Two individuals, enrolled in the same pension plan, having had the same career and subject to the same legislation, but with one working for an employer that chose a pension fund vehicle while the other working for an employer with a branch-21 contract, would not be eligible to receive the same minimum amount of pension upon retirement. Imagine two 45-year-olds, each eligible for a minimum amount of 25,000 euros at 31/12/2015. If we assume the minimum rate set by law is 1.75% for the next 20 years, for that portion of their accrued benefits, the first (pension fund vehicle) will be entitled to a minimum of 35,369.45 euros when they reach 65, while the other will get 47,395.95 euros. If we assume a minimum legal average rate of 1.75% during the first 10 years and 2.25% for the next 10 years, the minimum amount the first individual is entitled to shifts from 35,369.45 euros to 37,146.45 euros, still a huge 10,000 euros (or 22%) less than in the second scenario!

2. **Verification of current pension plan rules to ensure no change is required.**

The benefit definition in some pension plan rules explicitly uses the minimum legal guaranteed return. According to how this guarantee works, employers might find themselves in 2016 compelled to provide a much higher guaranteed return than the one prescribed by law. To deal with this issue, pension plan rules will need to be updated, a process which can be lengthy and tedious depending on how the plan was originally set up.
What about impact with regards to reporting under IFRS (IAS 19)?

For firms reporting under IFRS, this change will either have a positive impact, a decrease in reporting requirements for balance sheets, or will have no impact on financial statements, only notes to financial statements would have to be adjusted to reflect the change in the law or minimum rate.

Under IFRS, pension plans must be reported based on IAS19 principles. They must be classified as defined contribution plans or defined benefit plans. Under IAS19, a pension plan is a defined contribution plan if the employer’s liability for a year is limited to making a contribution and thereafter no further liability can arise for that year of service that opened the right to the contribution payment. If a plan does not meet these criteria, it’s classified as a defined benefit plan. The standard requires an actuarial calculation and recognition of a provision on the balance sheet for defined benefit plans. No such provision is required for defined contribution plans.

Due to the minimum guaranteed return set by law, defined contribution pension plans in Belgium don’t meet the criteria required to be considered as defined contribution plans under IAS19. Instead, they have to be considered as defined benefit plans. The strict application of the standard involves the application of the actuarial method prescribed for that type of plan and the recognition of a provision on the balance sheet. This requires an estimation of the amount of projected benefits at normal retirement age and recognition of the accrued amount based on the years of rendered service at the time of reporting. The projected amount is calculated taking into account future contributions and the future rates of return, determined using assumptions. If the legal minimum guaranteed rate decreases, the estimated amount of the pension benefit will also decrease, as will the provision on the balance sheet.

Finally, defined contribution plans in Belgium are in reality hybrid plans as they exhibit the characteristics of both plans: the benefit is determined as the sum of accumulated contributions with return (like defined contributions (DC)) but cannot be less than a pre-determined amount (characteristic of a defined benefit plan). The standard does not foresee any specific guidance for these types of plans. Numerous discussions have taken place within IASB to try to complete the standard with specific guidance, but this hasn’t materialised.

Some believe that as long as the standard doesn’t encompass specific guidance for these sorts of plans (DC plans with guaranteed returns), it’s preferable not to recognise a provision unless there’s underfunding compared to the legal minimum; the impact and risks associated with these pension plans must nevertheless be clearly specified in the notes to the financial statements. Employers who chose to adopt this approach need to modify their notes.

This alternative method is commonly called the intrinsic method. PwC believes that, based on IAS19 principles and the additional technical analysis made by IASB staff to resolve technical questions on this subject, there’s sufficient guidance to suggest that for the measurement of the obligation, the approach to follow is that of defined benefit plans, provided that related amounts are assessed as significant.

Due to the diversity that’s arisen, the Belgian regulator (FSMA) has also studied the topic and issued a separate report (Study 44- January 2015) that concludes that minimum disclosures should be improved to cover a description of the plan and its risks for employers, a clear description of and justification for accounting policies adopted to measure the obligation to be recognised and the related plan assets, a description of relevant assumptions and estimates used to calculate the obligation, quantitative disclosures on the measurement of the obligation and information about the amount, timing and uncertainty of future cash flows.
How and when the impact (decrease in liability) of this change in legislation needs to be recognised in the accounts?

As to how this should be tackled depends on knowing if it would be considered a change in assumption or plan. The first option means recognition through Other Comprehensive Income (OCI), whereas the second through recognition on the income statement.

We believe that a change in assumption best suits the current situation (the former assumption being that there would be no change in legislation with regards to supplementary pension). In fact, this change doesn't meet the definition of a plan change according to §8 of IAS19 (introduction or termination or changes made to a defined benefit plan). In addition, §87 indicates the assumptions to consider in determining the liability related to a defined benefit plan and infers that these assumptions should be made concerning relevant changes in legislation influencing the benefits.

More particularly, ‘Estimated future changes in the level of any state benefits that affect the benefits payable under a defined benefit plan, if, and only if, either (i) those changes were enacted before the end of the reporting period; or (ii) historical data, or other reliable evidence, indicate that those state benefits will change in some predictable manner, for example, in line with future changes in general price levels or general salary levels’ should be taken into account.

When does this change have to be recognised in financial statements? Paragraph 87, mentioned here above, can help answer this question. If the change in legislation is voted in before 31/12/2015, it will have to be taken into account for reporting at 31/12/2015. If the law is not voted in, but there's enough tangible evidence that the change will take place, it will also have to be taken into consideration.

At the moment, however, with no official publication, even in draft form, we doubt that these potential changes are described precisely enough to be factored into projections and estimations. Let’s hope that we’ll hear more about this bill in a concise and precise way in the next few weeks so that the required transparency to report at 31/12/2015 exists. In the meanwhile, the best and most pragmatic approach would be for entities to require a sensitivity analysis on guaranteed returns to their actuary. Both options would then be available at year end, enabling them to be ready.

How can PwC help entities face these changes?

We can make a quick scan of pension plan rules to make sure that there’s no need for adjustment. If changes are required, we can support the company throughout the entire process with the adaptation of legal documents. We can also help employers explain the consequences of the law change to employees.

And we can quantify the impact: in terms of benefits for employees or costs for the employer, as well as the impact on their financial accounts.

Finally, more specifically for insurance companies, we can help them make sure that they’re compliant with the new rules and check if the calculation of the pension accrued rights of affiliates is correctly implemented.

Contact

Monique Mariamé
Director Actuarial Services
Tel: +32 2 710 71 15
monique.mariame@be.pwc.com