Cross-border hold-up for UK

Cross-border provisions, which require the funding gap to be met, are delaying the UK government's publication of pensions directive regulations, says **Tim Sharples**

In the UK, implementation of the provisions of the EU pension directive is proving to be more complicated than expected. As a result, the UK government is missing deadlines on the publication of final regulations.

The problems centre on the new funding requirements required under the directive and the fact that a relatively large proportion of existing UK schemes will be treated as cross-border schemes.

Historically, the UK funding requirement (the MFR) has been much less onerous than those in many other countries. The introduction of the new legislation should mean that pension schemes improve their funding position to something like full funding over a period of five to 10 years.

However, cross-border schemes (as defined by the legislation), will have to achieve full funding by September 2007.

As an illustration of the figures involved, if we estimate that the deficits under the new funding requirements will average out at close to the deficits disclosed on the international accounting basis, the funding deficits for the UK FTSE 100 schemes total some £37bn (€54bn). To meet this deficit over 10 years requires contributions of some £4bn (including interest).

If all these schemes are treated as cross-border, (and as explained below, this is not a bad assumption) the funding requirement becomes £19bn. There must be a question about the capacity of some companies to provide such a high level of contributions and, if they do, what the effect on the level of corporation tax collected by the UK authorities will be.

There is potential for most UK schemes to be treated as cross-border because the UK tax authorities have always allowed UK employers to include employees in the UK pension scheme, even when they have seconded them overseas for a period of up to five and more recently 10 years. Given the international nature of many UK businesses, this is a frequently used provision. Also, until recently, it was simple to include both Irish and UK employees in the same pension scheme and many such schemes still exist.

The draft regulations issued by the government in August for consultation make any scheme with a member seconded to another EU country a cross-border scheme, even where the employees remain, to all intents and purposes, employed and paid by the UK employer. This means that in a 10,000-member scheme, having one member overseas for more than one year makes the whole scheme cross-border and subject to the requirement to have full funding at all times.

Our firm has responded to the UK government on the impracticality of these regulations, making suggestions as to how they might be changed.

The main problem with the regulations is that they go much further than the directive and so solutions involve returning closer to what the directive says. In particular, the definition of seconded employee should be changed to bring it into line with the definitions applied in the mobile worker directive (1998/49/EC) which is what we believe is the intention of the pensions directive.

The directive defines cross-border activity as occurring when a pension scheme in one member state accepts contributions from a sponsoring employer located in another member state. The circumstances where an employee is seconded to another member state but remains under a UK contract, with the UK employer remaining responsible for paying contributions to the pension scheme in respect of the employee, do not seem to fall within this definition of cross-border activity.

The directive distinguishes between the home member state of the pension scheme and the host member state, which is the state whose social and labour laws in the field of occupational pensions apply to the employment contract between the employer and the employee. In the case of a seconded employee, the position depends on the particular countries involved.

However, the general principle as outlined in the mobile workers directive is that the home country laws apply for 12 months. If the assignment is longer than 12 months, then the employer and employee can extend the period to two years. There is also a provision under article 17 of the mobile workers directive for the employer and employee to agree that the home country contract should continue to apply for a longer period.

All these provisions lead to the conclusion that permitting the UK employer and employee to continue on the basis that the employee is an ordinary UK employee without the cross-border provisions applying is a reasonable approach.

Another possible solution would be to segment the UK pension scheme into UK and cross-border sections, with the intention that all seconded employees would move into the cross-border section when they take up a post in another member state. The cross-border section would be fully funded at all times, but as it would be only a small proportion of the whole fund, this would not be difficult.

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This solution might be unpopular with some sets of trustees, as it would discriminate between different members of the same plan by increasing the security of some members' benefits. However, we would argue that the trustees should be pleased that sectionalisation is improving the funding position of the scheme as a whole, even if the improvement is unequal.

One might think that employers could simply set up a separate cross-border scheme into which to place seconded employees and others. However, typically, the seconded employee will leave a deferred pension within the main UK scheme. If this scheme is under-funded, then the company will make deficit contributions to the scheme, part of which will be to meet the under funding on the member's deferred pension.

Under the regulations, the employer will have contributed to the pension scheme on behalf of a seconded employee and so the scheme is cross-border, even though the seconded employee is no longer earning benefits within the scheme. Therefore, the full funding requirements will bite.

One option might be to ensure that the seconded employee transfers his deferred pension rights to the cross-border scheme, when he moves employment. However, without the member's co-operation, this will be impractical, within the timescales required. Given that other issues involved with the move will be much more important in the employee's mind, this solution will not work.

Again the solution depends on the government redefining contributions from a UK employer into a UK scheme so as not to make such contributions cause the scheme to become cross-border.

Current funding levels of pension schemes in the UK are too low and the new funding requirements are to be welcomed. However, unthinking application of the regulations, which means that a large number of pension schemes become affected by the cross-border regulations, will remove the flexibility which UK companies require to rectify their current low levels of funding. This will severely damage UK companies and their pension schemes.

It is no surprise that the government has delayed these regulations. We wait to see whether moderation will prevail when they finally appear.

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