

Finland: The Changing Benefits Market

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There have been many developments in pensions and other benefits in Finland during the last few years. The changes that have taken place can be grouped into four basic areas: pensions, taxation, accounting standards and intermediaries.

PENSIONS

On 1 January 2005 the Employees' Pension Act setting up the *TEL** was heavily amended. Originally passed in 1962, the Law laid down the provisions for a scheme with the following features:

- a retirement age of 65 (for men and women),
- compulsory enrolment for all employees,
- employer sponsorship,
- immediate vesting,
- no income ceiling,
- disability, survivors' and children's pensions in addition to the old-age pension,
- administration by private (mutual) insurance companies,
- a free choice for employers,
- a pension target of 60% after 40 years' employment (accruing 1.5% per year), i.e. defined benefit,
- a final salary scheme (the last four years indexed to the date of retirement and the two middle years' earnings used as the calculation basis),
- all income included (bonuses, share programmes, fringe benefits, etc.), and
- indexing of pensions in payment.

Changes have been made over the years, usually in the direction of providing more generous benefits, though this has not been the case lately.

Employees became obliged for the first time in 1993 (temporarily) to make personal *TEL* contributions, which became a permanent feature in 1994. In addition, the definition of final salary was changed that year to

the longer averaging period of the last 10 indexed calendar years and early retirement options were abolished. An option that existed earlier permitted the early retirement of World War II veterans – obviously no longer necessary. As a footnote, Finnish employees are still not given the option of choosing the underlying investments or a carrier for their own contributions.

Politics has always played a part in occupational pensions, as our Parliament, labour unions and employer federations actively participate in formulating pensions policy.

As in many other Western countries, the problem in Finland is demography. We have an old saying: "What was the second thing Finnish men did when they returned from the war? Took off their skis!" This has led to a situation where we now have a large generation born in the 1940s nearing retirement. It recently became clear that changes in pensions legislation were necessary.

A working group, called the 'Puro-Group', was led by the CEO of one of the largest pension insurers in Finland and named after him. Its aim was to cut costs emanating from the reform of the Act and, perhaps most importantly, to keep people working longer. Although officially the retirement age is 65, Finns tend to start drawing a pension around the age of 59.5 years. This might sound dramatic, but one has to remember that in this average figure there is the influence of those professions that have a lower retirement age: ballerinas (42), pilots (52) and so on. I suppose the idea of having a 64-year-old ballerina performing *Swan Lake* would not be very appealing.

In proposing the changes that have now been implemented, the Puro-Group had to make many compromises with the terms of the old scheme (see TABLE 1 overleaf). The most significant changes can be identified as:

- the move from final salary to career average,
- the introduction of a longevity factor, and
- the change in pension accrual rates.

The unions were basically happy with this, although those representing academics were sceptical, which is

* *Työntekijäin eläkelaki*

TABLE 1

A Comparison of Old TEL and New TEL

Features	Old TEL	New TEL
Normal retirement age	65	63-68
Early retirement	60	62
Pensionable salary	Average of final 10 years	Career average
Accruals on pensionable salary	Age 23-59: 1.5% p.a. 60-65: 2.5% p.a.	Age 18-52: 1.5% p.a. 53-62: 1.9% p.a. 63-68: 4.5% p.a.
Maximum pension	60%	n/a
Employee premiums (deducted from pensionable salary as from 1996)	Age 23-65: 4.6% p.a.	Age 18-52: 4.6% p.a. 53-68: 5.8% p.a.
Unemployment pension	From 60	Unemployment allowance (for those born after 1 January 1950)
Longevity factor	No	Yes
Calculation of disability pension	Final salary projected to age 65	Based on last 5 years of earnings
Children's pensions	18-21 possible	Age 18

understandable as their members usually start earning 'big bucks' at a later stage in their careers. Their chances of earning a reasonable pension are therefore slimmer in percentage terms, though not in monetary terms.

The longevity factor has received little publicity. It is a factor that can be applied, without any changes in legislation being required, by decision of the Ministry of Social Affairs and Health. This means that, if people continue to live longer, the factor can be applied to reduce their pension. According to the calculation rules, a pension of €1,000* per month would attract a longevity factor of 0.90, i.e. the pension would be reduced to €900 per month.

The benefit of accelerated accrual of pension after age 53 (1.9%) and after 63 (4.5%) is partly lost because contributions paid by individuals are deducted from pensionable salary, so the higher the contributions at later ages, the lower the pensionable salary. The individual contributions mentioned in TABLE 1 are those for 2005; they have been temporarily reduced for 2006 and are now 4.3% for employees below age 53 and 5.4% for older employees.

The result of these changes is obvious: executives, in particular, will have a shortfall in their pensions, which will represent only 30-40% of final salary. Thus, the need for supplementary pensions has increased significantly. Additional risk covers are also needed as the calculation bases for disability, survivors' and children's benefits have taken a turn for the worse.

TAXATION

Pension taxation was changed in 2004 with different effects for groups and individuals. Premium payments made by the employer to a pension insurance plan for

a group of employees are now deductible for the employer but are tax exempt for employees. A court ruling from 1994 had made it possible to form an "objective group" consisting of one person (for example, the CEO). The underlying condition was that successive CEOs had to receive the same benefits; otherwise the arrangement would be considered to be an individual policy where premiums above €8,500 p.a. would be taxable income. A new court ruling in 2004 made this impossible, so all schemes with only one participant had to be paid up. This has created a market for good advice, especially for CEOs who still need to be catered for. IAS 19† doesn't make life any easier. As a result, defined contribution plans are starting to be popular (most plans having previously been on a defined benefit basis).

Regarding individual pension insurance, before the change individuals were able to take out their own policies and deduct premiums up to a maximum of €8,500 p.a. from taxable income. Particularly in the case of executives, with marginal tax rates close to 60%, this was a way of arranging supplementary pension cover for their spouses. However, in reality, most of the policyholders were definitely middle income and the premiums were closer to €1,000 p.a. than the maximum.

Earlier, the lowest possible retirement age for a qualified plan was 55, though this had risen to 60. In 2004 this age was again increased, to 62 (the earliest possible age to retire under TEL). Furthermore, the maximum deductible premium fell to €5,000 p.a. and this deduction can only be made from capital gains. As the capital gains tax rate

* £1 = €1.45; US\$1 = €0.79 as at 14 July 2006

† International Accounting Standard No. 19

is 28%, the deduction is no longer significant and, as the benefit eventually is taxed at the same rate, the tax on a small pension will be higher than if calculated as income tax. (The average pension is only around €1,000 per month on which income tax would be lower than 28%: tax progression on income is steep in Finland.)

As a period of grace was allowed, premiums could still be paid according to the old system until 31 December 2005. Between 2006 and 2008 individuals can still pay into their old scheme even if the retirement age is lower than 62 but can deduct from pensionable salary only in accordance with the new rules. If premiums continue to be paid, part of the pension is taxed as income and part as capital gains – not a good idea!

It is predicted that, for larger groups of employees, group pensions will be popular as they still allow a retirement age as low as 55 and the premiums are always deductible for the employer and not taxed as income for the employee (no maximum limit on the size of the premium).

INTERNATIONAL FINANCIAL REPORTING STANDARDS

The statutory pension scheme (*TEL*) had a system whereby disability premiums for large employers were rated according to workforce size and claims experience. Disability claims had an impact on the premiums and the liability for claims expenses progressively increased when there were over 50 employees until the full 100% was reached at more than 800 employees. Good claims experience meant paying less than the average premium and vice versa. Good working conditions can therefore pay off. For less than 50 employees, the average premium was paid and claims experience had no impact on the premiums. This had to be taken into consideration under IFRS rules.

From the beginning of this year, a change has been made. Employers are now divided into 11 different groups (group 4 being the average premium level) based on their claims experience during the two previous years (in this case 2003 and 2004), the worst experience demanding the highest premiums.

According to IFRS rules, since claims are now incorporated in premium assessments, provision for disability liabilities need no longer be recognized.

THE BROKER LAW

As all these changes were occurring, a new broker Law* was implemented, updating a 1994 law. When the Ministry of Social Affairs and Health started working on it, opinions were invited from the labour unions and employer federations. Interestingly, the Ministry tried to push through the Law in record time. What is also interesting is that not one employer was interviewed. The change was initiated by the insurers and, according to them, the aim was transparency – to make it illegal for brokers to accept commissions from insurers. The principle was to make clients pay for the services of brokers – basically a sound system, which would call for premium rebates when using a broker, i.e. 'net premiums' (commission loadings having been removed). Some, but not all, insurers have promised to offer net pricing.

The Law was not passed as fast as the sponsors wished but it was implemented on 1 September 2005, with a

period of grace until 1 September 2008. The most important changes in the broker Law (the old one was also quite strict) are that:

- from 1 September 2008 brokers cannot accept commissions from insurers;
- brokers have to pass a specific, written examination (and have sufficient education and experience) to qualify for registration (the demand for education and experience already existed and was supported by an insurance exam);
- agents, who do not need the above nor liability insurance as they represent the insurers, are favoured;
- clients who use the services of a broker will be required to pay direct fees; and
- during the period of grace (and beyond) the broker has to disclose to the client the amount of commission payable without being asked (previously, this was only disclosed at the request of the client).

This has, of course, made life tough for many brokerages and it appears paradoxical that broker activities, only permitted in Finland in 1994, have now been discouraged by the very insurance companies that originally encouraged their recognition.

Before brokers evolved in the early 1990s, Finland was very much a country where companies dealt directly with specific insurers, with selection influenced in part by the large insurers holding significant shares in quoted companies and with the insurance company executives continuing to sit on the boards of those companies. Real competition does not exist between retirement pension insurers in Finland because accumulated reserves cannot be transferred, nor does any foreign competition exist.

Foreign *TEL* insurers are permitted only if based in Finland and fulfilling all the same requirements as Finnish *TEL* companies. In addition, several Finnish life insurers have demutualized and in becoming stock companies are pursuing increased dividends for shareholders which has cast a shadow. Group risk insurance is therefore often placed with an international insurer whose rates and retentions are very competitive compared with domestic offers. The *Danner* case has had no impact on the Finnish voluntary pension market. The local conditions that have to be met to qualify for taxes might not make the relatively small Finnish market attractive to large international insurers.

CONCLUSION

Against this background of tax and pension laws that have recently been implemented and are affecting market practices, it is understandable that companies might find it difficult to make their way, so a definite need for brokers and consultants remains in Finland.

Choosing a group insurer in Finland can be like buying a dog – not just for Christmas but for life: a life in which low bonuses and poor service can prove to be a disappointing experience. Ω

* *Laki vakuutusenvälittäjistä A1645/1993*