In Conversation...about End of Service Gratuity

Having developed business throughout the GCC over the past 4 years, I increasingly find the topic of End of Service Gratuities ("EoSGs") on the agenda of employers, employees and their financial advisers. Conversations have now developed into serious discussions about methods of implementation with mandatory funding requirements on the horizon plus employers looking to gain an edge in incentivising and retaining key staff.

I caught up with Paul Soares of LGT Vestra in Jersey who is very familiar with the EoSG concept and its potential market. As this is an area where we at Optimus have undertaken our own recent product development, I took the opportunity to discuss with Paul where he feels EosG provision is heading over the next couple of years and how LGT Vestra's wealth management services can combine with professional fiduciary services to meet the market need.

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Essentially, EoSG is a form of severance pay prevalent across most Middle Eastern countries and which is mandatory in many. There is no standard formula across all countries for calculating the EOSG liability but generally, according to Paul, the central plank for the calculation is length of service: *"Under the UAE Labour Law, for example, the gratuity is payable where an employee has accrued at least 12 months continuous service with their UAE employer. This law sets out statutory formulae for calculating gratuities; the most common is 21 days' pay per year of service for the first five years of services and 30 days' pay per year of service thereafter, with the total gratuity not exceeding two years' remuneration. There are variants of this calculation which depend on, for example, the type of employment contract and the circumstances under which an employee leaves the company, plus of course each country will have its own twist according to its laws."*

> *"Failing to keep pace with the funding liability in line with earnings inflation could have a serious impact on the financial health of a business"*

What I often find incredible is that a specific funding provision for EoSGs isn't yet mandatory in all GCC countries. Most companies don't set anything aside for the liability instead funding the EoSG from cashflow as and when employees leave, effectively using liabilities to their employees as working capital. Paul explained how staff pay rises can quickly compound the liability given that the benefit is generally calculated on a final salary basis; *"Somebody who starts on Dh120K per annum and gets a pay increase of 5% each year for 10 years before they leave will end up on a final salary of approximately Dh186K, a difference of Dh66K. Multiply this by potentially hundreds of employees and the year-on-year liability increases can be quite staggering. Failing to keep pace with the funding liability in line with earnings inflation could have a serious impact on the financial health of a business".*

So surely, I suggested, even though it isn't mandatory, implementing some form of off-balance sheet mechanism would be lower risk for the business but also more attractive for staff knowing that when they do leave, what they are owed has already been put aside and it accessible. Paul agreed:

"Exactly and that is what we are speaking to people about; by introducing a type of defined benefit scheme, similar to yours, employers can demonstrate to their employees that there is a separate fund, under the control of independent trustees, set aside for the primary purpose of paying EoSG benefits. Importantly, the benefits paid from that fund should not be affected by the balance sheet strength of the company at the point when benefits are due."

Our view is that well-invested funds in such a scheme can offer the employer some flexibility further down the line, even though the funds are held off-balance sheet and Paul's view is that this ties in perfectly with LGT Vestra's offering; *"We are able to offer low risk, conservative portfolios from just 0.25% AMC - security not growth is the main driver here but any growth can potentially generate a surplus in the EoSG fund which might, for example, enable the employer to reduce or temporarily cease payments for a period. The historical net returns of 3% generated by our Defensive offshore investment strategy would fit within this scenario".* I added that we have been in discussions across the region about an additional, similar scenario where funds have been set aside for an employee who subsequently becomes ineligible and that a surplus can be generated here too. A carefully worded trust would enable an employer to use this surplus for other employment incentives, not just EoSG, provided the EoSG liability was covered.

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Paul's view is that the market wants efficiency above all else: *"What is key, as you and I have discussed, is cost and the ability to be able to handle volume; we've both seen over the past year a number of arrangements that can't cope with the large volume and the low cost needed to deliver value. That comes from the operational capacity of the both the trust provider and the investment manager."*

So with Expo2020 and Qatar World Cup on the horizon plus the thousands of new companies registering across the gulf annually, maybe now is the time to look more closely at EoSG funding. This is not only because it could soon be mandatory but also because it is good business practice, affordable and a key way to retain and enhance your workforce.

If you would like to continue the conversation regarding EoSG with either myself or Paul, please do not hesitate to contact me and we can arrange a call to discuss further.

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