

SUBJECT: Introduction of a funded system to finance the Healthcare Insurance Scheme

SUBMITTED BY: President of the European Patent Office

ADDRESSEES: 1. Administrative Council (for decision)
2. Budget and Finance Committee (for information)

SUMMARY

Following the Office proposals presented in CA/164/09 and the comments of the delegations, the President gave an internal mandate to the Office services (CA/191/09). It is proposed to introduce an actuarially funded system to finance the healthcare insurance scheme, to replace the current pay-as-you-go (Paygo) system.

This document presents further information on this subject, along with a proposal for an amendment to Article 83 of the Service Regulations for employees of the EPO to permit the President of the EPO to set the contribution rates to a funded system of healthcare insurance on the basis of an actuarial study.

The financial management of the scheme would be based on a reserve fund. The initial contribution rate to the new scheme would be established following a study to be carried out by the Actuarial Advisory Group.

It is proposed that the scheme enter into force on 1 January 2011.

The Administrative Council is invited to approve the draft decision in Part II of this document.

~~Note: This document is being published prior to the meeting of the General Advisory Committee (GAC). The President will inform the Budget and Finance Committee and the Council of the opinion of the GAC and of any action taken following this opinion.~~

This document replaces CA/66/10 dated 21.05.2010 and CA/66/10 Corr. 1 dated 28.05.2010. The amendments are indicated by grey hatching.

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PART I

I. **STRATEGIC/OPERATIONAL**

1. Strategic

II. **RECOMMENDATIONS**

2. It is recommended to fund the healthcare scheme of the EPO staff and that the President set the contribution rate for the funded system on the basis of an actuarial study. Article 83 of the Service Regulations should be amended to this effect.
3. The actuarial study would be carried out by the Actuarial Advisory Group, as is already the case for pensions and LTC contribution rates.
4. After the introduction of the scheme, any future annual increase/decrease in the rate of contribution would be limited to a maximum of 10% of the rate in force.
5. The rate paid by ~~the current and former staff~~ members would remain at 2.4% for the years 2011, 2012 and 2013. This transitional period is to allow time to better assess the early impact of cost containment measures. Thereafter, the staff contribution rate would be one third of the total contribution rate, but any annual increase/decrease would be subject to a limit of 10% of the rate in force. The goal is for the staff contribution rate to eventually reach one third of the total contribution rate.

III. **MAJORITY NEEDED**

6. Qualifying majority

IV. **CONTEXT**

7. Due to the projected increase in the proportion of scheme members who are retired, as well as the continuing increase in the costs of healthcare generally, the Office proposes to move from the current Paygo system to a system funded on an actuarial basis in order to stabilise the costs of the scheme and ensure its financial long term sustainability.

V. ARGUMENTS

A. INTRODUCTION

8. In the course of this review, the opportunity is taken to revise the name of the current provisions. Hence forward, "Sickness Insurance" will be referred to as "Healthcare Insurance".
9. During the discussions on healthcare insurance and its financing, the question of moving from the current Paygo system to a funded system was raised (cf. document CA/164/09, part V. G b) (i) and CA/191/09).
10. The UN has been facing a similar situation and has also come to the conclusion that a funded system is necessary. Proposals to this effect were presented to the General Assembly in October 2009 (document number A/64/366).
11. Other organisations are also reflecting on the future financing of their healthcare schemes and exploring the option of creating reserve funds for this purpose.
12. In this context, the Actuarial Advisory Group (AAG) was asked to reflect on an actuarial method to calculate the contribution rate necessary to finance the healthcare insurance scheme of the Office based on a funded system, for staff, pensioners and their dependents together. In their report (CA/182/09), they presented the Entry Age Normal Method, which they found to be the most suited to the needs of the Office.
13. The AAG also calculated the initial one-off contribution at the inception of the scheme, which amounted to 283 mEUR (subject to change as a result of the actuarial study). That amount is, in fact, the reserve that would have been present if the actuarial funding had started at the inception of the current insurance contract instead of in 2011. Any employees recruited after 2011 will not affect the value of that amount. The fund of 300 mEUR created under Council decision CA/D 14/09, together with an additional contribution from the Office if required, will be used to finance this required reserve.

14. This document presents further background information detailing the reasons why the ~~Administration of the EPO~~ President of the Office feels it necessary to move from a Paygo system to a funded system to finance the healthcare insurance scheme. It also proposes the necessary changes to the Service Regulations, allowing the President to set the contribution rate for the funded system on the basis of an actuarial study. Such a basis is already applied for the pension and long-term care (LTC) schemes.
15. The current ceiling for staff contributions of 2.4% of basic salaries and pensions was defined in the framework of a Paygo system. In a funded scheme, in order to ensure an ~~fair-effective~~ two-thirds, one third cost sharing between the Office and its staff, it could not be precluded that this 2.4% ceiling for staff contributions would be exceeded, after 2013.
16. Further, it is proposed that, once the system is in place, any future increase/decrease in total contribution rate, resulting from the actuarial study referred to in paragraph 14, should be limited to 10% of the rate applicable in the previous year. This provision is also included in the revision of Article 83. This ceiling on increase/decrease in contribution rate is similar to the ceiling on the pension contribution rate applied by the EU (c.f. ANNEX XII: Rules for implementing Article 83a of the Staff Regulations (96), Article 2(96) paragraph 1) *"Any adjustment shall not lead to a contribution being more than one percentage point above or below the valid rate of the previous year"*. Limiting the variation in contribution rate is also in the interests of the Office for budgetary planning purposes.
17. In parallel, the EPO is implementing a programme of cost containment measures. The effect of these measures on the rate of contribution to a funded scheme would have a positive impact which would filter through the regular actuarial studies.
18. In order to better consider the early impact of these cost containment measures, it is proposed that the ceiling for the staff contribution rate remain at 2.4% for the years 2011, 2012 and 2013. Throughout this period, ~~the total contribution rate would be actuarially calculated as described in paragraph 16, and the difference between this total contribution rate and the capped staff contribution rate of 2.4% would be payable by the Office.~~ a comparison would be made between the actuarially calculated total contribution rate and three times the employee's maximum contribution rate specified in Article 83 of the Service Regulations. Any shortfall would be funded by the Office, primarily by using the credit balance at Vanbreda in the accounts of the Organisation.

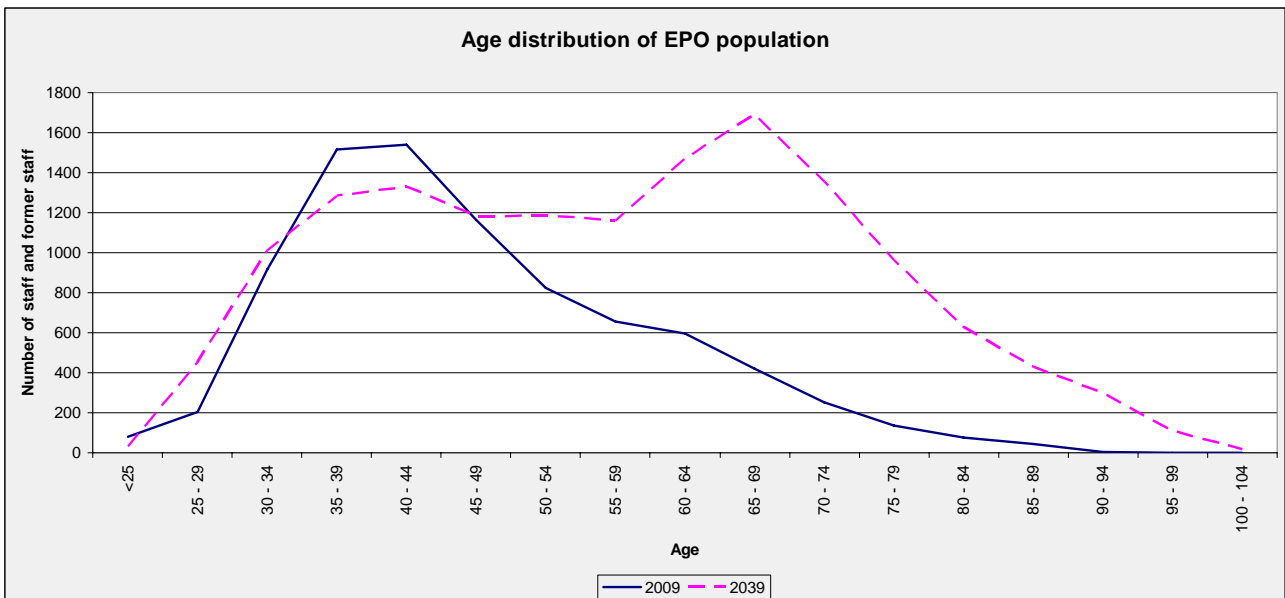
19. From 2014 onwards, the staff contribution rate would be set at one-third of the total contribution rate calculated as described in paragraph 16, subject to a limitation that any increase/decrease in the staff contribution rate would be limited to 10% of the rate in force in the previous year. The difference between the calculated total contribution rate and the staff contribution rate would be payable by the Office.
20. At the end of 2009, the insurers held reserves of 5.7 mEUR for the Office as a result of total contributions paid exceeding total payments made. This reserve, or credit balance, held by the insurers, will be used to reduce the contribution of the Office as calculated in paragraph 18 to its two-thirds share of the total contribution rate calculated as described in paragraph 16.

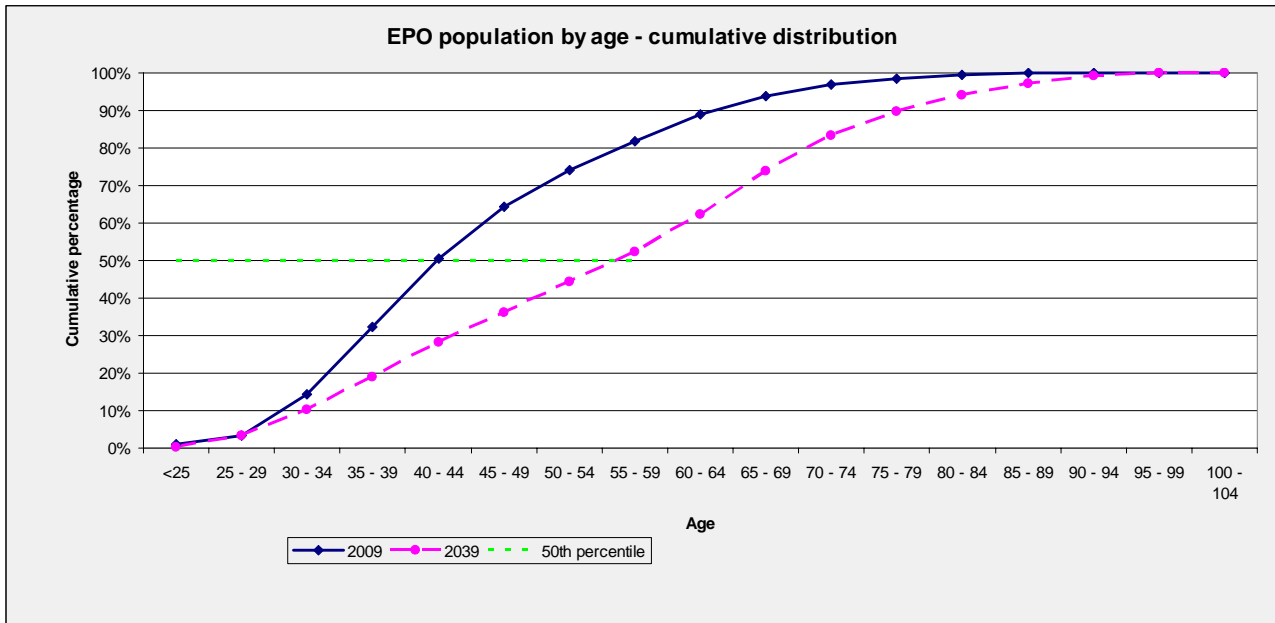
B. AT THE PAY-AS-YOU-GO FINANCING VERSUS ACTUARIAL FUNDING

21. Paygo is a term used to describe a method of financing in which health insurance benefits are funded in the year in which the benefits are used by the employee or former employee, rather than building reserves to stabilise the premium. In other words, only costs for the current year are considered and no reserve, or fund, is accumulated against any future costs.
22. The idea of using a fund for the financing of the healthcare insurance scheme is to create a reserve during a saving period for each employee (i.e. a period in the life of the individual when healthcare costs are low) that could then be used to contribute to the costs of the spending period, which is the time when healthcare costs increase, usually in later life and after active service. The costs of life-long healthcare are thus spread over the whole period of insurance.
23. The one advantage of Paygo financing of healthcare benefits is that it is typically less costly in the short term. However, over time, as more and more staff retire and live longer and as medical inflation continues to increase at rates considerably higher than general inflation, the costs associated with the scheme will increase significantly, putting ever more pressure on the budget of the EPO.
24. In addition, in the longer term, funding the benefits by establishing reserves is more economical because investment earnings serve to reduce budgetary requirements. Each year of funding in the saving period correspondingly reduces the cost during the spending period, and, with active investment, the returns ultimately pay for a significant portion of later life healthcare costs. This is because

the investment income becomes another funding source for the benefits, replacing contributions that would otherwise be required.

25. Regular actuarial valuations of the fund would be necessary to ensure that the equilibrium of the fund, i.e. the balance between the current reserves and premiums and future liabilities is maintained. These valuations could be conducted together with the actuarial valuation of the other funds of the RFPSS. The fund would also be administered in the same way as the RFPSS, with an asset allocation which is appropriate for the cash flow pattern of the funded healthcare insurance scheme, as determined by the regular actuarial studies.
26. As the EPO is a young organisation, the number of retirees in proportion to the whole population insured is still relatively small and the ratio of pensioners to active staff has not yet reached a stable state.
27. The expected demographic development of the EPO population is illustrated below:





28. The first graph clearly indicates the shift to the right as the result of an aging population. It also shows the increase in contributing scheme members (the area under the dotted curve is significantly greater). The second graph shows the distribution of the age classes cumulatively. It can be seen that 50% of the current members are younger than 45 whereas in 2039 this percentage of staff is only reached when including members up to 55-59 age group.
29. Combining the two elements (aging population and the medical expenditure profile, by age (cf. CA/182/09)) will lead to a significant increase in cost per employee of around 19%. When the effect of medical inflation, which tends to increase at a higher rate than price inflation, is also taken into consideration, the costs will increase further.
30. The EPO has been using the Paygo approach since introducing the healthcare insurance programme. Thus far, the cost of healthcare has been a relatively small proportion of EPO annual budgetary expenditure, and so the costs of the Paygo funding strategy, borne entirely by the regular budget, have been manageable. However, the expected demographic development of the population covered by health insurance will lead to significant increases in healthcare costs in the years ahead, as all other things being equal, older people require, on average, more healthcare than younger people. Combining this impact with recent observations of significant increases in healthcare costs and in life expectancy, which are expected to continue to increase in the years ahead, results in further escalation of costs. The ongoing viability of this financing approach is therefore questionable.

31. The Paygo approach also results in a distortion of cost distribution. For each employee, the demographic structure of the organisation dictates the level of the premium, regardless of the age of the individual. A funded scheme, however, results in a much fairer cost distribution as the cost of the whole group is spread over the entire lifetime of each employee and is less sensitive to the overall demographic development.

C. IFRS

32. Currently, net (unfunded) liabilities, which are a result of employees earning the right to after-service healthcare during the course of their careers at the EPO, continue to accrue. According to IFRS, these liabilities must be accounted for.
33. However, IFRS does not dictate the method by which healthcare insurance schemes must be financed and allows an organisation to decide on the financing method from a broad scope of possibilities.

D. CONCLUSIONS

34. As noted above, funding healthcare benefits would be beneficial to the Office and its staff for a number of reasons:
- a) The alignment of costs and contribution of the beneficiary would be enhanced so that the costs of the benefits, including both active and retirement periods, are spread over the whole life of the employee;
 - b) Projected future increases in the cost of healthcare would be addressed;
 - c) Long-term contribution requirements by the EPO and its staff would be reduced as investment earnings begin to supplement budgets to fund a growing and ultimately significant portion of annual benefits;
 - d) The burden on the EPO budget would be smoothed over time, which would have a positive effect on the management of this budget;
 - e) regular updates of the actuarial valuation would ensure that the long term financial sustainability is regularly examined and that contribution rates are adjusted to keep the funds balanced.

35. The Office asked the Actuarial Advisory Group for its opinion on the Office proposals and the expected positive effect on the Office finances. The Actuaries share the Office views and their opinion is shown in the Annex to this document.
36. The current funding of 300 mEUR (CA/55/09) is likely to cover the past service-related liability, or "alte Last" (CA/182/09) and further financing efforts can be avoided.
37. Should this funding system be adopted, amendments would have to be made to the fund created by Council decision CA/D 14/09 or a dedicated fund to be managed by the RFPSS be established.

E. CREATION OF THE HEALTHCARE INSURANCE ADVISORY COMMITTEE

38. It is proposed that a specific joint committee, appointed by the President, be created to deal with issues relating to healthcare insurance. Deferring to the GAC in addition to another committee would create unnecessary delays while specific healthcare matters sometimes need reactions at short notice. Also, pensioners, as stakeholders, would need to be represented and they are not permitted to sit on the GAC.
39. The Healthcare Insurance Advisory Committee would be given sole responsibility to deliver recommendations and give reasoned opinion on any proposal to amend or extend the healthcare insurance scheme and its regulation, replacing the usual GAC consultation for healthcare issues.
40. The Office will submit proposals on the necessary statutory changes to the Administrative Council at a later meeting.

F. AMENDMENT OF ARTICLE 83

41. Article 83 of the Service Regulations would need to be amended to accommodate the changes outlined above
42. The opportunity is used to harmonise the three language versions of Article 83 paragraph 2(c). In the German version of Article 83, which details the possibility for people leaving the Office with entitlement to a deferred pension to remain insured under Vanbreda, "Resign" was translated as "in den Ruhestand treten" ("to go into pension"). The Article needs to be amended to ensure agreement between all three language versions and to avoid erroneous interpretation of the Article.

VI. ALTERNATIVES

43. To retain the Paygo system.

VII. FINANCIAL IMPLICATIONS

44. Based on first estimates of the Actuarial Advisory Group, the global contribution rate is expected to be around 9%, which would lead, in the short term, to a higher budget cost than the Paygo system. However, this would be used to build a reserve that would ease the burden on the budget of the EPO in future years.
45. Using the budgetary figures published in CA/D 01/09, the theoretical yearly cost to the Office in 2010, with a fair one third, two third cost sharing between staff and the Office, would be approximately 53 mEUR, should the 9% be confirmed.
46. If the 2.4% ceiling were to be retained, the Office share of the 9% increases to approximately 58 mEUR for 2010.
47. The budgetary costs of the current Paygo system for 2010, estimated in CA/D 1/09, amount to around 50 mEUR.
48. The cost to the EPO of retaining the ceiling of 2.4% for the period 2011-2013 is calculated to be 12.8 mEUR. However, in the long term, the Office contribution in excess of its two thirds share will be gradually reduced and will bring, over the next 30 years, savings estimated between 150 and 168 mEUR.
49. According to the Financial Statements 2008 (CA/60/09), the credit balance held by the insurers and referred to in paragraph 18 amounted to 5.6 mEUR (5.7 mEUR at the end of 2009). This will be used to reduce the excess contribution of the Office to its two thirds share of the total contribution.
50. However, as the demographic structure of the EPO develops, the relative cost applying the current Paygo system will continue to increase, as will the percentage of the costs covered by the Office. The advantage of an actuarial system is that the costs to the Office of financing the healthcare scheme would be better spread over time.

VIII. LEGAL BASIS

Article 83 of the Service Regulations

IX. DOCUMENTS CITED

CA/D 14/09, CA/D 1/09

CA/164/09, CA/182/09, CA/191/09

CA/60/09

UN document A/64/366

EU Staff Regulations (96)

PART II

Draft

DECISION OF THE ADMINISTRATIVE COUNCIL
of [date of decision]
amending Article 83 of the Service Regulations for permanent
employees of the European Patent Office

THE ADMINISTRATIVE COUNCIL OF THE EUROPEAN PATENT ORGANISATION,

Having regard to the European Patent Convention and in particular Article 33(2)(b) thereof,

Having regard to the Service Regulations for permanent employees of the European Patent Office (hereinafter referred to as "the Service Regulations") and in particular Article 83 thereof,

Having regard to the Implementing Rules for Articles 83 and 84 of the Service Regulations,

Having regard to the Collective Medical Insurance Contract as approved by the Administrative Council at its inaugural meeting (CI/Final/19/77 and CA/PV 1) and the subsequent amendments made thereto,

Having regard to the opinion of the Budget and Finance Committee,

On a proposal from the President of the European Patent Office, submitted after consulting the General Advisory Committee,

HAS DECIDED AS FOLLOWS:

Article 1

The title of Article 83 and Article 83 paragraph 1 of the Service Regulations for permanent employees of the EPO shall be amended as follows:

"Article 83 Healthcare insurance

- (1) a) unchanged
- b) The total contribution required to meet reimbursements under such insurance, calculated by reference to the basic salary, shall be set by the President of the Office, on the basis of an actuarial study. One third of such contribution shall be charged to the employee.
- c) unchanged
- d) Should the President of the Office deem it necessary to have an evaluation of the cost of the present scheme made by one or more actuaries and should this show that the total contribution set pursuant to paragraph b) above no longer corresponds to the contribution necessary to finance the benefits payable under these Regulations, the President shall establish what changes, if any, are to be made to the rates of contribution.
- e) Any adjustment in the total contribution rate pursuant to paragraph b) above as a result of recommendations of the actuaries referred to in paragraph d) above shall be limited to 10% per year of the contribution rate in force."

Article 2

The German version of Article 83, paragraph 2, letter c, of the Service Regulations for permanent employees of the EPO shall be replaced by the following:

- "c) Ein Beamter, der Anspruch auf ein zurückgestelltes Ruhegehalt hat und nach Vollendung des 50. Lebensjahres auf Antrag entlassen worden ist oder insgesamt mindestens 25 ruhegehaltfähige Dienstjahre abgeleistet hat, kann auf Antrag weiter nach Absatz 1 versichert werden. Nach einem Zeitraum, der 10 % der ruhegehaltfähigen Dienstjahre überschreitet, hat der Beamte jedoch den gesamten Beitrag zu tragen. Der Berechnung des Beitrags wird

das letzte Grundgehalt der Besoldungsgruppe und der Dienstaltersstufe des Beamten zugrunde gelegt.

Steht der Ehegatte eines Beamten, der Anspruch auf ein zurückgestelltes Ruhegehalt hat, im aktiven Dienst des Amtes, so ist diese Option obligatorisch, sofern der Beamte nicht in einem anderen Krankenversicherungssystem erstversichert ist."

Article 3

In the years 2011 to 2013, a comparison shall be made between the actuarially calculated total contribution rate and three times the employee's maximum contribution rate specified in Article 83 of the Service Regulations. Any shortfall shall be funded by the Office, primarily by using the difference between the total contributions paid and the total payments to staff of medical expenses, referred to as "credit balance at Vanbreda" in the budget accounts of the Organisation.

Article 4

During the years 2011, 2012 and 2013, the contributions to be paid by staff shall be kept at 2.4% of their basic salaries.

Article 4 Article 5

This decision shall enter into force on 1 January 2011. By exception, Article 1 shall apply as from 1 January 2014. In all rules and regulations applicable to current and former staff members and those entitled under them, references to "sickness insurance" shall forthwith be replaced by "healthcare insurance".

Article 5 Article 6

This decision shall enter into force on 1 January 2011. In all regulations, references to "sickness insurance" shall forthwith be replaced by "healthcare insurance".

Done at Munich, [date of decision]

For the Administrative Council
The Chairman



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Date: 10.03.2010

Funding Healthcare Insurance

Dear Messrs Leblond, Rhiel and Reay,

As you are aware, the EPO has been reflecting in recent months on the future financing of its healthcare insurance scheme and has submitted some proposals to its Finance and Budget Committee and its Administrative Council.

The Office has concerns that, as healthcare costs increase, the current pay-as-you-go (Paygo) system will become an ever increasing burden on the Office budget. It is felt that pre-emptive action taken at this point is the most prudent approach for the EPO management. In particular, the demographic structure of the insured population will change considerably over the next 30 years, and the EPO will find itself with an aging population.

The Office is preparing a document to be submitted to the Administrative Council and proposing statutory changes to move from a Paygo system to a funded scheme. May I now ask you to consider the issues raised by the Office in CA/66/10 and ask for your opinion of the views expressed in this document?

I thank you in advance.

Yours sincerely,

Christian Archambeau,
Principal Director Human Resources

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ANNEX 2 LETTER FROM THE ACTUARIES

The Actuarial Advisory Group:
Richard Leblond
Raimund Rhiel
Timothy Reay

Mr C. Archambeau,
Principal Director, Human Resources,
European Patent Office,

12 March 2010

re: Funding Healthcare Insurance

Dear Mr Archambeau,

In response to your letter of 10 March, the Actuarial Advisory Group would like to make the following observations.

The structure of the insured population at the EPO is still far from a steady state and its expected demographic development will result in a large increase in the proportion of older insured persons (staff members and family members) covered by the healthcare insurance scheme. The healthcare costs of an aging population are inevitably higher than those of a younger population. It is therefore fair to assume that the costs of the EPO healthcare insurance scheme will rise considerably over the coming years.

The current Paygo system does not make any provision for these future increases in costs.

On the other hand, if a fund were created at this point, reserves could be set aside whilst the population is relatively young, for future use. Also, the income from the investments owned by the fund would become another source of income for the fund, along with the regular contributions. This should serve to reduce the overall contribution rate.

The funding method we recommend is the Entry Age Normal Method (c.f. CA/182/09) as we find this method best suited to funding life-long healthcare for EPO employees.

In our view, moving from a Paygo system to a funded system to finance the EPO healthcare insurance scheme would be advantageous to the Office at this point as it would spread cost over time more evenly. We therefore endorse and support the Office's conclusions, as presented in CA/66/10. The Office should be aware that the funded approach means some financial effort in the short term to build the reserves that can be used later on to support the Office budget.

Yours sincerely,

R. Leblond

R.Rhiel

T. Reay