A New Perspective On End Of Service Gratuities

"You're gonna need a bigger boat"
Chief Brody (Roy Scheider) - Jaws 1975

For your employees, doing more than simply staying afloat through retirement means making financial preparations during their working life. However, UAE employers' ambivalence towards addressing the need for retirement savings means employees will have to fend for themselves, assisted to some extent by the End of Service Gratuity. So, in the absence of employer-facilitated savings, will they sink, swim or get eaten alive by the increasing cost of living in retirement?

For the majority of expatriate workers in the UAE, the occupational retirement plans found in western countries do not exist. Instead, employers are obliged to make a lump-sum payment known as the End of Service Gratuity.

But what is the value of this gratuity payment in the context of adequate retirement provision? Let's start by looking at some figures.

The amount of the gratuity payment depends on the employee's salary at the time they leave service and how long they have been with their employer – it is, therefore, a 'defined benefit' (DB) payment.

The rate at which this benefit accrues during their working life is 21 days' salary for each year of service in the first five years and 30 days' salary for each year of service after that.

The maximum an employee could potentially receive through this benefit, within the UAE, is two times their basic annual salary – or to put it another way 730 days' salary.

To accrue this amount, the employee would have to work for the same employer for just short of 26 years! If they left and joined another employer, the lower accrual rate (during the first five years) would come into play again. This means an employee working for three employers during their working life would take about 30 years to earn the maximum entitlement.

However, this doesn't take account of another important factor – that if an employee leaves during the first five years of employment, the gratuity entitlement would be reduced by one third or two thirds. For our purposes here we'll keep it simple and assume that our hypothetical employee stays with each of their three employers for at least five years.

So if an employee retired today on a final basic salary of USD 20,000, having worked for three employers during their 30-year working life, they would be entitled to a USD 40,000 lump sum.

(Incidentally, I'm aware that in practice an entitlement would have been paid by each employer on leaving, but please bear with me – the important thing is the USD 40,000 total.)

Now let's put this benefit into perspective.

In other developed economies, a company-sponsored retirement savings plan comes as an accepted part of an employment package. In Europe and North America workplace savings are facilitated by the employer in recognition of the fact that employees place a great deal of value on being helped to secure their financial future.

A fairly average DB plan in the UK for example, may be an 80ths plan. This means that the employee would accrue 1/80th of final salary as a pension for each year of service completed.

So, an employee with 30 years' service would have built an entitlement to 30/80ths of final salary at retirement. If the final salary is USD 20,000, (as above) then this would equate to a pension of USD 7,500 a year for life.

We now need to calculate a cash equivalent amount to enable direct comparison to the lump sum payable under the gratuity model.

This is not an exact science, but bearing in mind the average DB plan would include a spouse's pension on the death of the retiree and there would be some indexation to the pension in payment, the accepted multiple to use is 25 times. This means the cash equivalent amount of the annual pension would be USD 187,500.

An important point to consider in addition, however, is that the final salary definition would be greater than just basic salary. Pensionable pay would include other elements of remuneration that are not taken into account in the gratuity calculation.

It is safe to say, therefore, that the average DB plan in the UK is about five times more generous than the gratuity benefit.

"But," you might say, "a lot of defined benefit plans are closing."

And you would be making a fair point – so let's make a defined contribution (DC) comparison.

To build up a benefit of USD 40,000 today over a 30-year period would require a 4% contribution rate, assuming 3% annual salary inflation and annual investment returns of 6%, on a final salary of USD 20,000. How does that compare with other DC plans?

A survey by Towers Watson (a leading global professional services company) in May 2013, found that FTSE 100 companies with DC plans were prepared to pay an average of 10% of pensionable salary – and don't forget, pensionable salary is likely to be higher than basic salary!

It also found that many employers offered to match employee contributions in order to encourage workplace savings, thus producing a more generous overall contribution rate.

In many developed economies, employees would also be accruing an entitlement to a state pension. The DC plan benefits would be in addition to this foundation level.

Whichever way you look at it, the gratuity entitlement is simply not enough in terms of delivering the desired sum to fund retirement and is a very poor substitute for a properly structured savings plan. A recent survey by Zurich showed that the vast majority of employees in the UAE (83%) believe that the gratuity is an inadequate method of saving for their retirement years.

To add to an employee's lack of security, the vast majority of employers don't set assets aside in relation to their growing gratuity liabilities. A survey, again by Towers Watson in December 2015, shows that 83% of companies settle employees' benefits as they become due from company assets. A company facing a downturn or efficiency pressures, which lead to it making redundancies, may then have to find the cash to make gratuity payments to a large number of employees. The timing could not be worse. The implication here is that the employees' 'assets' may be at risk if their employer faces financial problems and cannot make the payment - not very comforting to supposedly valued employees. This could tarnish the employer's reputation and affect their ability to recruit in the future.

Therefore, isn't it about time that responsible employers faced up to the fact that in order for their employees to cruise comfortably through retirement, they're going to need a bigger boat?

Those companies that provide a retirement savings solution for their employees will find that they will become an employer of choice with significantly improved recruitment and retention results. The same survey by Zurich found that nearly two thirds of respondents (58%) said that they would be more inclined to stay with their current employer or join another company if they were provided with a corporate retirement plan.

Evidence shows that individuals are not saving enough for their later life - a problem compounded by the fact that they will be living longer than previous generations. They will face a difficult choice of either saving more or working longer.

To encourage a savings culture, companies should set up a corporate savings plan for their employees that moves beyond making a simple promise to pay a gratuity to providing a true employee benefit. It can incorporate the existing gratuity obligation and do so within a more structured savings vehicle that acts as a retirement fund and very effective employee retention tool.

Either put the power of corporate savings plans to work or find that your employees are financially out of their depth – and running the risk of falling into the jaws of an unfulfilled retirement life.

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