Central Staff Committee
Comité central du personnel
Zentraler Personalausschuss

Munich, 05.12.2019
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Working Group on Finances
Report on the third meeting on 3 December

The third meeting of the WG-Finances took place on 3 December (13.00 to 15.00 hrs). During the meeting discussion focussed entirely on the salary adjustment procedure.

Background and latest events

Following the publication of the financial study phases I and II, the President set up a Working Group to discuss the so-called financial levers (the 17 measures) for filling an alleged gap of €3.8bn. He claims that an additional buffer of €2bn should also be covered. The Staff Committee challenges the existence of a financial gap. The pensioners association sent a further contribution in which it questions both the scenario leading to the gap and the need to introduce measures penalizing pensioners for addressing a gap. They furthermore completely refute the basis for the additional buffer.

We submitted further input to the WG, explaining the correlation between the specific indicator and the Gross Domestic Product (GDP) over the last 42 years (**Annex 1**). This input was made in the framework of the discussion on the salary adjustment procedure (measure 1).

An additional proposal aims at reducing liabilities by reinstating the invalidity allowance, instead of the pension for health reasons, while preserving acquired rights of colleagues (**Annex 2**).

Report on the meeting

To quickly recapitulate, the salary adjustment procedure (SAP) reflects two principles:

1. equality of purchasing power using purchasing power parities; and
2. parallelism of evolution of EPO salaries with salaries in reference member states, using the so-called specific indicator (SI).

The SI represents the average evolution of the salaries of the national civil servants in the member states above or below their own inflation, thus the evolution of the purchasing power. In Annex 1 we compare the SI with the GDP growth in those member states which are used as reference countries in the SAP over the last 42 years. It shows a certain correlation between the SI and the GDP growth. This is intuitive since the member states are not likely to increase the salaries of their civil servants during an economic downturn for affordability and political reasons. The first graph in Annex 1 clearly shows that whenever growth of the GDP is weak let alone when a country faces a recession, the SI turns negative. We therefore challenged the modelling of the consultants which assumes no correlation at all between these two parameters and uses a constant and positive SI (+0.5%) over the whole period of the study, despite the stress scenario involving an economic shock with a very slow recovery.

We recalled that the main driver for the cost development is the evolution of the salaries. Thus, we would have expected the same attention when modelling the salary evolution as was applied for e.g. the incoming files. Indeed, these were modelled with great attention for different economic regions each of which has its own economic assumptions down to assumptions for research expenditures.

We never observed a scenario in the past that was anywhere near as drastic as the Base 2 scenario. Therefore, the past evolvement of the average salary increases cannot credibly be used to model the Base 2 scenario, as it would vastly overstate the salary evolution and thus the expenditure.

None of the parameters driving the income were extrapolated from the past to the future, precisely because the underlying assumption was the extremely pessimistic economic scenario. This is a serious flaw in the used methodology to be used by the President to cut staff's purchasing power purely because of the mere existence of this dubious simulation. The carelessness in modelling the salary evolution leaves us speechless.

We stressed that a moderation clause should apply only to the specific indicator (as in other comparable organisations like the EU and the Coordinated Organisations) and that an exception clause (also on the SI) should be triggered if and when an exceptional event occurs. There is no such event on the horizon. We reiterated our availability for discussing these parameters.

Management queried the duration of application of a newly conducted Procedure and expressed the President's wish to introduce some control over the adjustments. They referred to the concept of reversibility. Reversibility should not be confused with retroactivity. Should the stress scenario, for which money is supposed to be withheld, never actually materialise it is not the intention of management to give the money back to staff. Our proposal for putting the saved money into a newly created fund in the RFPSS, accessible by the President only with the consent of the Staff Representation, met with shaking heads and a polite smile from the management side.

We are clearly against a reversibility concept in which reversal is not foreseen as an automatically applied integral part of the Procedure, especially in view of the lack of trust prevailing. The duration of the application of the Procedure at the EPO is currently 6 years. At the EU the procedure was in force for 10 years and at the Coordinated Organisations the General Secretaries of the organisations were suggesting to extend their current procedure to 7 years. Management could accept a longer duration of the Procedure with an intermediate review after e.g. 3-4 years from implementation.

The financial study distorts facts in several places. It states that the "coverage gap" in 2038 is €3.8bn[1]. It, however, conveniently neglects to mention the future national renewal fees the EPO can collect for patents already in force in 2038. When a patent is validated in a Member State, the applicant pays fees to that Member State. 50% is transferred to the EPO to supplement the procedural fees which on their own do not cover the cost. The national renewal fees are one of the pillars on which our finances rely. As explained in the IFRS accounts, merely on legal grounds, the EPO cannot recognise the income from the future national renewal fees as an asset to match the "coverage gap". For that reason they are stated as a footnote instead of an asset in all IFRS accounts. By the end of 2018, the value of these future national renewal fees was €4.7bn[2]. Since the financial study assumes an increase of the patents in force, this figure will likely be higher. It would more than completely offset the alleged "coverage gap" of €3.8bn. PD finance eventually reluctantly agreed to disclose the value of the future national renewal fees in 2038.

We queried how trust could be re-established on such a basis. While the applied level of prudence

[1] CA/83/19 page 4

[2] IFRS accounts, footnote 4 on page 42

is a matter of perspective, substantial methodological flaws, all to the detriment of staff, like

- the neglecting of income certain to happen,
- no guarantees that the exercise will just be repeated any time soon with even more "prudent" assumptions, and
- the reluctance to guarantee that the saved money isn't eventually just spent elsewhere,

will not contribute to restoring trust.

Different views could be freely expressed during the meeting. This did, however, not yet culminate in defining a possible control mechanism for the Procedure.

Unfortunately, none of the other measures we have suggested were discussed due to lack of time. Management was also not in a position to provide the figures for simulating a transitional measure from the Old Career System to the New Career System as requested earlier and as promised by the President.

Report on further discussions with the President

The salary adjustment procedure was also on the agenda of a second meeting, between the CSC and the President, which was held right after the above meeting.

A lively and controversial debate ensued on the existence and value of any financial gap. It was the common view, though, that there is no financial problem for the time being. The President put forward that there would be some logic in adjusting salaries with inflation if fees are adjusted with inflation. With this general statement we are still far from converging, but at least a bit closer, so we thank the President for that.

In this second meeting the President confirmed that he would consult the Administrative Council on the financial "gap" next week[3]. He also confirmed that the intended time framework for discussions within this working group would be until February and that consultation of other stakeholders in other fora would follow, including the GCC and the BFC for a decision in the June 2020 Council.

Next WG meeting

The WG will reconvene on 12 December, directly after the Council meeting.

Your Central Staff Committee

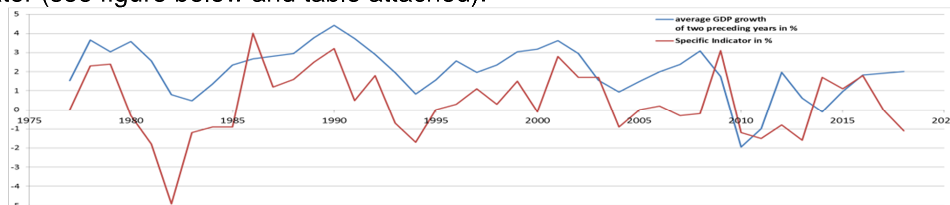
<u>Annexes</u>:

- Annex 1: Proposal for refining the model
- Annex 2: Proposal for converting the pension for health reasons into an invalidity allowance

[3] See item 11.6 on the agenda of the December meeting CA/94/19

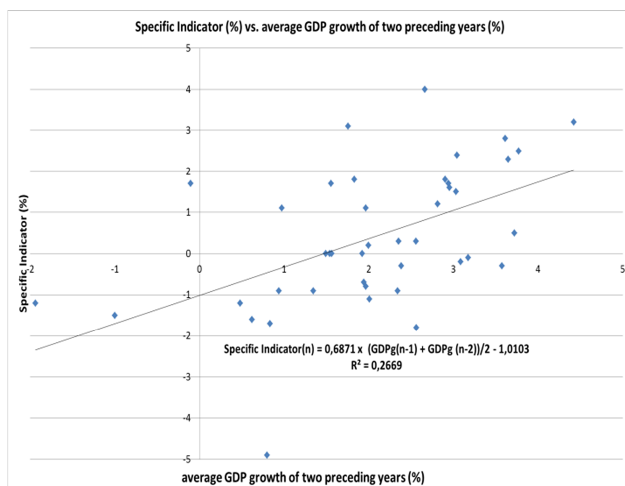
Proposal for refining the model

The Base 2 scenario of the financial study uses an economic stress scenario following the European Systemic Risk Board. It thus assumes a global economic recession starting in 2020, which normalises only from 2025 onwards. Still, the salary growth is set to 0.5%[1] over inflation which corresponds approximately to the specific indicator of 0.38%[2] observed in the past 42 years. Although this is in line with the approach by the AAG[3] it must be emphasised that in the reference countries, during the last decades, we didn't observe a period with an economic crisis even remotely as severe as assumed in the financial study[4]. **The past 42 years are thus not representative for the Base 2 scenario**. We could, however, observe some much shorter economic crisis and we could observe their impact on the specific indicator (see figure below and table attached).



It reveals that already in times of lower growth let alone in an economic crisis, the specific indicator turns negative. It must be recalled that the specific indicator is the weighted average of the real salary evolution (thus above or below inflation) of civil servants in representative member states.

The Base 2 scenario thus assumes nothing else than a salary increase for the national civil servants in excess of inflation even though the economy is in a severe crisis. This is neither realistic nor politically justifiable and cannot be consolidated with past observations. It is an oversimplification. Such an oversimplified model for the specific indicator is also **inconsistent with the modelling granularity of other drivers for the Office's finances**. Indeed, the financial study modelled the filings and equity returns in great detail, depending on economic area, year and economic situation[5] **precisely because it doesn't assume that the past is a valid predictor for the future.**



We, therefore, kindly ask that also the specific indicator is modelled with the same attention. A model could be based on a linear regression as shown in the graph. This can be obtained by drawing the specific indicator vs. the SI-weighted average GDP growth of the two preceding years.[6]

We propose a re-assessment where the specific indicator for the year n is set to

Specific Indicator (n) = 0,6871 x (GDPg(n-1)+GDPg(n-2))/2 – 1,0103

This formula yields even a slightly higher adjustment over the past 42 years than the observed adjustment (see attached table). Since the GDP of the countries contained in the weightings of the SI cover most of the EU-GDP, we agree to take the EU-GDP as a proxy.

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[1] CA/83/19 page 123; Baseline

[2] CA/56/19 para. 66

[3] CA/56/19 para. 67

[4] source: https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=EU

[5] CA/46/19 pages 48-53

[6] The GDP growth is weighted according to the weightings of the Specific Indicator tabled in para 15 of CA/160/07, which is currently still in force. The specific indicator is correlated with the average of the GDP growth of the two preceding years because of the delays of the adjustment procedure.

SI weight		up to 2007	23,60%	19,10%	16,10%	14,20%	10,20%	9,60%	7,20%	0,00%		Spec. Ind.
		as of 2008	19,8%	16,3%	16,6%	15,0%	8,2%	7,0%	5,2%	11,9%		acc. to
		cumul.	GDP Growth									Trendline
Year	SI %	SI	DE %	FR %	UK %	IT %	NL %	BE %	LU %	ESP %	SI weighted	(cumul.)
1975			-0,87	-0,96	-1,48	-2,09	0,00	-1,97	-6,57	0,54	-1,58	
1976			4,95	4,36	2,91	7,13	4,46	5,65	2,53	3,30	4,66	
1977	0	1,000	3,35	3,46	2,44	2,56	2,52	0,63	1,57	2,84	2,64	1,000
1978	2,3	1,023	3,01	3,98	4,20	3,24	2,70	2,84	4,07	1,46	3,45	1,015
1979	2,4	1,048	4,15	3,55	3,74	5,96	2,01	2,34	2,35	0,04	3,71	1,026
1980	-0,3	1,044	1,41	1,58	-2,03	3,43	1,34	4,44	0,84	2,21	1,42	1,041
1981	-1,8	1,026	0,53	1,07	-0,77	0,84	-0,78	-0,28	-0,55	-0,13	0,18	1,049
1982	-4,9	0,975	-0,39	2,51	2,01	0,41	-1,24	0,59	1,13	1,25	0,78	1,044
1983	-1,2	0,964	1,57	1,24	4,22	1,17	2,07	0,31	2,99	1,77	1,91	1,037
1984	-0,9	0,955	2,82	1,51	2,28	3,23	3,06	2,47	6,19	1,78	2,77	1,036
1985	-0,9	0,946	2,33	1,62	4,20	2,80	2,58	1,65	2,79	2,32	2,55	1,042
1986	4	0,984	2,29	2,34	3,14	2,86	2,79	1,82	9,98	3,25	3,08	1,051
1987	1,2	0,996	1,40	2,56	5,30	3,19	1,93	2,31	3,95	5,55	2,83	1,061
1988	1,6	1,012	3,71	4,74	5,76	4,19	3,44	4,72	8,46	5,09	4,72	1,072
1989	2,5	1,037	3,90	4,34	2,57	3,39	4,42	3,47	9,80	4,83	4,13	1,088
1990	3,2	1,070	5,26	2,92	0,74	1,99	4,18	3,14	5,32	3,78	3,31	1,111
1991	0,5	1,076	5,11	1,05	-1,09	1,54	2,44	1,83	8,64	2,55	2,50	1,128
1992	1,8	1,095	1,92	1,60	0,37	0,83	1,71	1,53	1,82	0,93	1,39	1,139
1993	-0,7	1,088	-0,96	-0,63	2,53	-0,85	1,26	-0,96	4,20	-1,03	0,28	1,143
1994	-1,7	1,069	2,46	2,36	3,89	2,15	2,96	3,23	3,82	2,38	2,85	1,138
1995	0	1,069	1,74	2,11	2,46	2,89	3,12	2,38	1,43	2,76	2,27	1,138
1996	0,3	1,072	0,82	1,41	2,54	1,29	3,50	1,59	1,39	2,67	1,66	1,147
1997	1,1	1,084	1,85	2,34	4,29	1,84	4,33	3,71	5,71	3,69	3,04	1,151
1998	0,3	1,087	1,98	3,59	3,34	1,62	4,66	1,98	6,04	4,31	3,02	1,158
1999	1,5	1,104	1,99	3,42	3,21	1,56	5,03	3,56	8,48	4,48	3,33	1,170
2000	-0,1	1,103	2,96	3,92	3,45	3,71	4,20	3,63	8,24	5,29	3,90	1,184
2001	2,8	1,133	1,70	1,98	2,84	1,77	2,33	0,81	2,53	4,00	1,99	1,201
2002	1,7	1,153	0,00	1,14	2,50	0,25	0,22	1,78	3,82	2,88	1,12	1,213
2003	1,7	1,172	-0,71	0,82	3,34	0,15	0,16	0,77	1,63	3,19	0,76	1,214
2004	-0,9	1,162	1,17	2,83	2,35	1,58	1,98	3,63	3,61	3,17	2,23	1,210
2005	0	1,162	0,71	1,66	3,15	0,95	2,05	2,09	3,17	3,72	1,76	1,210
2006	0,2	1,164	3,70	2,45	2,55	2,01	3,46	2,51	5,18	4,17	3,00	1,214
2007	-0,3	1,161	3,26	2,42	2,55	1,47	3,77	3,45	8,35	3,77	3,17	1,222
2008	-0,2	1,158	1,08	0,25	-0,35	-1,05	2,17	0,78	-1,28	1,12	0,34	1,235
2009	3,1	1,194	-5,62	-2,87	-4,25	-5,48	-3,67	-2,25	-4,36	-3,57	-4,22	1,238
2010	-1,2	1,180	4,08	1,95	1,71	1,69	1,34	2,74	4,86	0,01	2,22	1,209
2011	-1,5	1,162	3,66	2,19	1,64	0,58	1,55	1,80	2,54	-1,00	1,71	1,188
2012	-0,8	1,153	0,49	0,31	1,45	-2,82	-1,03	0,23	-0,35	-2,93	-0,47	1,192
2013	-1,6	1,134	0,49	0,58	2,05	-1,73	-0,13	0,20	3,65	-1,71	0,26	1,185
2014	1,7	1,154	2,18	0,96	2,95	0,11	1,42	1,25	4,30	1,38	1,69	1,173
2015	1,1	1,166	1,74	1,11	2,35	0,92	1,96	1,74	3,92	3,64	1,97	1,169
2016	1,8	1,187	2,24	1,10	1,79	1,12	2,19	1,45	2,41	3,17	1,87	1,171
2017	0	1,187	2,16	2,26	1,82	1,68	2,91	1,73	1,55	2,98	2,15	1,175
2018	-1,1	**1,174**	1,43	1,72	1,40	0,86	2,60	1,44	2,60	2,58	1,68	**1,179**

https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=EU

The Hague, 2 December 2019

Proposal by Staff representatives to the WG Finances for converting the pension for health reasons into an invalidity allowance

EXECUTIVE SUMMARY

Outline of the proposal and its main financial benefits

It is proposed to convert the pension for health reasons (PfHR) introduced with CA/D 2/15 into an invalidity allowance (IA) as defined with CA/D 17/08, on the basis of the existing scheme at the EU, and CA/D 32/08, adding invalidity allowance to the list of emoluments subject to internal tax.

Acquired rights of colleagues currently benefiting from a pension for health reasons should be respected. The proposal would entail further advantages, not only financial, as developed in the **Annex**.

Reduction of liabilities

Instead of the EPO paying the tax adjustment for all the PfHR, the invalidity allowance would be submitted to internal tax. It would result in additional funding of the Pension Reserve Fund (PRF), since the invalidity allowance would be subject to contributions to the pension, except for invalidity granted for occupational reasons. This would lead to a reduction of the available cash every year.

Request for information and simulations

The President of the EPO is respectfully requested to give both the appropriate consideration to this proposal and the necessary instructions to provide the WG with:

- the numbers of beneficiaries of a pension for health reasons,
- an estimation of the number of colleagues currently incapacitated who would qualify for an invalidity allowance, but not yet being beneficiaries of a pension for health reasons due to the provisions of Article 14, Pens.Regs introduced with CA/D 2/15.
- an estimation of the savings for the tax adjustment if replacing the PfHR conditions with an invalidity allowance.
- a (anonymised) list of the cases filed against CA/D 2/15

The Staff representatives in the WG Finances

Annex

ANNEX

On top of providing financial savings the proposal entails several advantages. This proposal aims at correcting the most severe deficiencies of CA/D 2/15 with as results

- an acceptable policy for the weakest population of the EPO,
- a reduction in litigation and as a further (not negligible) side effect
- a reduction of the liabilities.

Historical background

After the Administrative Council decided in 2007 to suppress the tax adjustment for newcomers entering the EPO from 1 January 2009 and to put the burden of the tax adjustment onto the EPO, the EPO decided to transform the invalidity pensions into an invalidity allowance on the model of the allowance existing in the European Union. Under this status an internal tax was introduced on the invalidity allowance. This somewhat released the burden of the tax adjustment for the EPO for the period from when an employee starts to benefit from an invalidity allowance until (s)he turns 65.

Additional HR benefits

CA/D 2/15 contains several major flaws. The most striking one is that under the incapacity regime, staff members are forced to stay in their host country. This blatantly violates their right to freedom of movement and additionally makes their life more difficult, deteriorating the chances of recovery or of being able to live a life adapted to their condition. This is especially true for expatriate staff having no family in their host country. In doing so the EPO badly neglects its duty of care. When revisiting CA/D 2/15, the EPO could address further flaws of this regulation, like forbidding activities listed in the Regulation.

Reducing litigation

Dubious provisions introduced with CA/D 2/15 are currently being challenged, e.g. Article 15 on gainful activities or employment, or on the freedom of movement under the incapacity status. Modifying CA/D 2/15 would be an opportunity to address and to solve these problems.

Legal assessment

When the invalidity allowance was introduced in 2008, most countries accepted its status as an emolument subject to internal taxation. Only a few tax offices (DE, NL, BE, LU) challenged this status and tried to submit it to national taxation. All tax offices lost their challenge either in first or second instance (e.g. in DE or in NL). Unfortunately the EPO, after having helped the colleagues with their appeal, decided to reverse the invalidity allowance shortly after Mr Battistelli’s re-election and before the Bundesfinanzhof had a chance to judge it.

In view of the above it seems rather safe to assume that reintroducing the invalidity allowance would not present any legal risk.