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New challenges. New solutions

The Changing Landscape For Multinational Pensions: a cross-market dialogue on achieving global consistency, operational efficiency, and strong cross-plan governance

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Introduction

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Today's politically complex and financially uncertain times are creating a riskier investment environment and retirement future for everyone. We are also on the cusp of new financial and pensions regulation that may either help or hinder pension strategies.

Multinational companies create employment for thousands of individuals globally and facilitate the retirement of hundreds of thousands more. These firms are looking to ensure employee pension provision at a time when they face numerous pension challenges including volatile financial markets, and increased longevity.

At the same time, the global nature of their pension plans continues to expand as they enter new markets and position their firms for growth. This environment is creating an even greater drive to achieve consistency, operational efficiency and strong governance across pension plans globally, to ensure effective decision-making, whether these decisions impact the long-term liability and risk management of a Defined Benefit (DB) scheme or the design of a new Defined Contribution (DC) plan.

In September 2011, J.P. Morgan held its second annual forum for Multinational pension funds. The forum seeks both to stimulate debate around the challenges and opportunities faced by corporate sponsors of multinational pension plans and to create a platform for multinationals to hear what their industry peers and service providers are doing. Participants included speakers from multinational corporate sponsors and their global advisers. This white paper[1] captures some of the key themes of the day. We hope you find it thought-provoking.

1. Some of the views expressed in this paper are J.P. Morgan's own and not solely those of the participants

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Foreword by the Moderator

A year ago, when J.P. Morgan first gathered several multinational corporations together to discuss managing pensions across borders, the debate focused largely on the merits of taking a multinational approach.

The key discussion points focused on improving governance, integrating risk management, increasing longevity, changing accounting rules, and containing costs. While these issues remain the primary focus of most corporate sponsors, a lot has changed since the last colloquium. Continued adverse economic conditions have highlighted to many multinationals that even smaller, seemingly remote pension issues can add up across borders to become a global problem. Laws, products and tools have developed and evolved enough to give corporate sponsors more options in managing local plans in a cross-border environment. A strong shift to implementing DC plans, has highlighted to employers that they should still worry about the adequacy of employees' savings and whether their pension plans are aligned with employees' long-term needs.

An awakening to the idea that pension issues will be significant considerations for sponsors regardless of the plan type set the stage for this year's discussion. Understanding how pensions aligned to local operations, risk correlations between plans, and potential aggregate financial impact of plans factored into this dialogue. Finally, the evolution of multi-country tools and product solutions underscored the broader agreement that multinational corporate sponsors are moving toward more centralized governance and management frameworks. So, while the core issues and challenges have not changed significantly over the past year, their impact and the options for managing them have, which set the stage for an engaging and lively debate.

The Multinational Pensions Journey — the route to consistency

"There are potential opportunities for multinationals to consolidate some of their pension arrangements. We talk about multinationals taking steps in a journey." Dinkar Jetley, Head of Worldwide Securities Services, J.P. Morgan

Numerous multinational plan sponsors have started their 'journey' toward consolidation and centralization of their pension plans. This centralization occurs to varying degrees and can mean anything from the creation of central guidelines or statements of intent through to corporate boards that have a high degree of control over the day-to-day management of pension plans. For many, this journey typically commences with the corporate centre recognizing that there are distinct advantages in placing their plans under some level of centralized control or oversight, particularly if looking to manage pension risks and maximize transparency. In general, the corporate centre initially focuses on examining its pension structures and exposures across countries for its DB plans, supported by a centralized and consolidated information reporting framework.

Whatever the level of centralized governance, there are two key points to consider. Firstly, strong elements of localization will need to remain in place given that legislation, regulation and the responsibility of local fiduciaries differs country-to-country. Secondly, the degree of centralization should fit with the structure of the corporate.

"The alignment of multiple plans needs to be treated in the context of the corporate culture. A decentralized pensions strategy in a culture of corporate centralization has less chance of success — and vice versa."
Andrew Tunningley, Aon Hewitt

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Ultimately the multinational sponsor is seeking consistency across all of its plans, both DB and DC. This means a consistent approach to investments, asset allocation and risk strategy, and a consistent approach to appointing and negotiating with vendors, including asset managers, custodians, or advisers. This consistency and coordination across plans enhances information flows and importantly improves the quality of information, which can be used to drive operational efficiencies. The journey can even extend to more complex cross-border asset and risk pooling and pension plan consolidation — both of which are addressed in greater detail in this paper.

Above all, a pension strategy needs to support the business strategy, particularly as companies position themselves for growth, enter new markets and recruit new talent at a local, regional and international level. Danone, a food-products multinational, is at an early stage of its multinational pension journey. Their emphasis is on creating a 'culture of pensions', supported by the centre's Finance and Human Resource functions, that provides a unified approach to designing pension plans in new countries and engaging employees in their own retirement planning.

The Governance Framework

Governance is a key tool in moving towards a more centralized approach. Numerous multinationals advocate strong pensions governance led by the corporate centre. This will generally consist of a governance framework that keeps key stakeholders informed, and achieves consistency and best practice.

This framework will be supported by two key business areas that share complimentary goals; the Finance Department (or Treasury) which wants to ensure operational efficiency and effective risk management; and Human Resources which wants to ensure that pension outcomes support talent and reward strategies, given their increasingly important part of the total benefits package.

"It's absolutely clear that the people that you partner with on pensions are incredibly important, and as a company we spend a lot of time ensuring that we have the right advisers and that our internal processes are solid." Barbara Whent, Global Practice Leader, Benefits, Rio Tinto

The key to effective pensions governance for many multinationals, is to set a framework and standards from the centre, while allowing regional solutions and local flexibility. Rio Tinto, for example, created a specialist stream — the Global Benefits Practice — to ensure best practice and risk reduction across their individual country pension plans. This unit centralizes a team of experienced senior subject matter experts that provide consultancy services at both the global and local level on global benefits information, regulations and policy. Unilever, for its part, combines the expertise of its Global Pensions Team with individuals from the Univest Company, Unilever's internal asset management and servicing company. Together this team produces key policies that cover global investments, funding, and standardized vendor contracts.

The Shift from Defined Benefits to Defined Contributions

There is a huge and continuing shift from DB to DC pensions provision, which is generally country-specific i.e. the shift started some time ago in certain countries and more recently in others. The United States, the UK and Australia are examples of more mature DC pensions markets, while other countries including Argentina, Brazil, and South Korea, inter alia, are at earlier stages of DC pensions development. However, DB still has a major role to play for many companies, as a large part of a multinational's pensions 'resource' is spent managing these substantial long-term liabilities. Hence, DB is an area where the corporate sponsor continues to take a keen interest.

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The trend for many multinationals is to move exclusively to offering DC schemes for the future accrual of benefits, even if the historic accrual has been DB. For the corporate sponsor, this shift transfers the management of risk and liabilities from the corporate to the individual. This places the onus on the employee to make their own informed investment decisions. However, the corporate sponsor remains responsible for ensuring that members are engaged and provided with the right information and tools to achieve better retirement outcomes. This requires strong employee communications, which often fall within the remit of Human Resources, supported by external retirement solutions providers and pension platform providers.

"From the point of view of our current employees, we're going to have to look very much around the phased retirement, flexible retirement, portfolio careers, and those sorts of things to allow people to continue to work longer and save the money that they need for their extended retirement."

Barbara Whent, Global Practice Leader, Benefits, Rio Tinto

Many corporate sponsors and advisers are thinking about the adequacy of DC pension provision, and use the more mature DC markets as models to provision in other countries. Unless the corporate wishes to increase pension contributions, one of the most effective way to improve DC retirement outcomes is to improve operational efficiency and thereby drive down costs, as has been a focus in the US. Another key approach is to improve member decision-making through communication. Australia was cited as an example of a country where pension funds are looking to increase engagement with their members, so participants take a more active role in reviewing their own pension needs. Another focus of the US DC market is to reduce risk and create greater certainty of outcomes for the individual. For this reason there is a drive for stronger default options that include Target Date Funds. However, some HR departments may themselves need further education on lifestyle or Target Date Funds, and this is where investment advisers play an important role.

As highlighted by Aon Hewitt, there is realistic scope for multinational pensions sponsors to use a DC platform that provides a 360 degree connection with the employee to deliver the 'nuts and bolts' of what is required through communications and investment administration. Multinationals are beginning to look at this option, as a way to drive operational efficiency, which in turn will improve pension provision for DC members.

The Era of Pooling?

As pensions become more centralized, so the prospect of extending the journey to cross-border pooling becomes more viable.

Many multinationals are exploring pooling opportunities to more closely manage costs, performance and risk, with the support of global vendors such as global custodians, fund managers and advisers. Multinationals with significant DB pensions are typically more interested in cross-border solutions, for both their DB and DC plans.

Although the pooling of pension assets is not a new concept, there are different views on how this can be achieved. Two types of pooling structures are being explored; 'virtual' and 'physical'.

VIRTUAL POOLING

In a virtual pool, assets are pooled at the accounting level. The assets remain legally and physically segregated, in the ownership of each participating plan, with no requirement to establish a single 'physical' investment vehicle.

The corporate sponsor appoints fund managers and a custodian at a global level. Local plans place their investment orders via the custodian, which uses its end-to-end technology to process orders and provide consolidated information reporting to the corporate sponsor.

Aon Hewitt argues that 'virtual pooling' can be a more cost effective and less complex alternative to physical pooling, given that it overcomes some of the local taxation and regulatory challenges, offers a broader appeal beyond European pension assets (potentially allowing multinationals to pool their plans globally), and can be used equally in a DC and DB environment. It may also offer a more flexible solution for DC assets, including support for both target date funds and lifestyle strategies.

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"I'd like to think that the industry is going to have some great examples, maybe in the next twelve months, of clients having gone for a virtual pooling solution, where they're able to pool their riskier assets with non-riskier assets, defined contribution plans with defined benefit plans, where they'll be able to experience total control of their pension assets around the world and drive improved economies that come from consolidation."
Andrew Tunningley, Aon Hewitt

PHYSICAL POOLING

With physical pooling, as the name suggests, assets are 'physically' commingled in a centrally managed legal entity. Pooling occurs at the investment or asset level, with liabilities generally remaining separately managed at the local or national level. However, in the case of IORP,[1] liabilities may be pooled. Each local pension holds units or shares in a range of pooled vehicles and retains beneficial ownership of the underlying assets.

For DB plans, cross-border pooling offers the possibility of enhanced governance, increased transparency and efficiency benefits. However, these structures can be complex to implement due to the disparate tax treatments and regulations that apply to each country. Indeed, if not done properly they may create tax inefficiencies. Physical asset pools may also create challenges for the corporate sponsor, as local country schemes may be unwilling to enter the pool due to the need to satisfy different investor requirements or retain local fiduciary responsibility.

In spite of these hurdles there are solutions to these challenges and examples of multinationals using physical pooling. Unilever is a case in point. Its pooled vehicles include both DB and DC assets from 19 investing countries. Through the successful implementation of its physical pooling strategy, Unilever has been able to fulfil one of its key pension 'aspirations' – achieving maximum leverage of scale of its assets and resources.

So how exactly are some of the challenges of physical pooling being overcome? Within the European Economic Area (EEA) there is legislation in the form of the IORP Directive which permits cross-border pooling of European assets without fiscal complexity. Commonly used vehicles that facilitate pooling include FCPs (Fonds Commun de Placement) in Luxembourg, CCFs (Common Contractual Fund) in Ireland, and FGRs (Fonds voor Gemene Rekening) in the Netherlands, as well as options under Liechtenstein law. In terms of practical implementation considerations, local plan participation and support, corporate sponsors may choose to take a staged approach, by initially pooling specific asset classes that are consistent across local plans.

WHICH PATH TO TAKE?

There is no right or wrong answer to pooling that applies to all multinationals. Virtual and physical pooling both have their proponents. It is vital for the multinational to work with their advisers to determine which one, or combination of options, is most appropriate to help meet their strategic plan objectives. Whichever route is taken, the multinational needs to partner with the right providers and take incremental steps; for example considering in advance whether to appoint a single global custodian.

For those multinationals with pension plans provision in the EEA, cross-border IORPs remain an important consideration, either as a stand alone solution for EEA or coupled with a physical or virtual pool in the rest of the world. Used correctly, and cutting through much of their perceived complexity and shortcomings, IORPs can provide a valuable means for multinationals to consolidate the operational and governance functions of their EEA pension provision. It remains that any pooling solution should be considered within the wider context of the multinational's global governance objectives and should be seen as a means to achieve greater operational efficiency, greater visibility and increased control over asset and liability risks globally.

"Tax transparent pooling is gaining ground. Some of the major multinationals have broken down the barriers and proved that the pooling approach really works and it's now opportune for others to follow."
Tim Reucroft, Thomas Murray

1. Institutions for Occupational Retirement Provision. The name IORP comes from a specific EU directive (IORPs, Dir 2003/41/EC). The IORP Directive allows pension funds in one European country to manage the pensions of a company operating within another European member state and also enables companies to create a single pension fund for all their operations in Europe.

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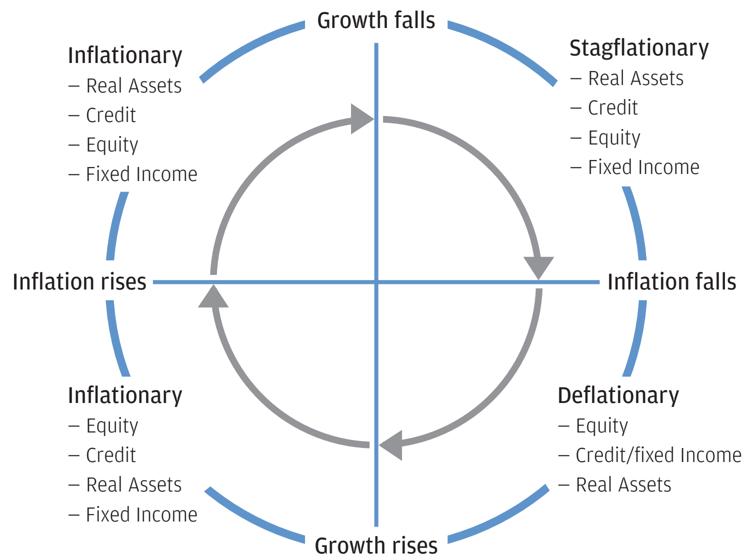
Further Considerations: Asset Management, Risk Management and Regulation

ASSET MANAGEMENT

Another way plan sponsors have been trying to manage the trade-off between risk and return in their portfolios is to create a framework that incorporates intermediate and/or opportunistic investment ideas – ones which may take the plan's asset allocation substantially away from its long term asset allocation. Adopting this type of framework requires plan sponsors to develop an investment process that can identify return generating opportunities (or hire a manager or advisor with such a process), and also, very importantly, ensure that the plan's governance structure has the flexibility to allow such investments.

With regard to an investment methodology to identify medium term (18-36 months) opportunistic investment ideas, one suggestion presented was a process which systematically evaluates the market environment, assesses opportunities, and repositions the portfolio throughout an investment cycle. Economic growth and inflation data can be used to indicate the phases of the economic cycle. An analysis of historical return and volatility data can indicate probable asset class performance within a given stage, while a forward-looking macro view on the economic stage can give sponsors and managers a guide to which asset classes should outperform – or, perhaps more importantly, which might underperform. Finally, integrating the macro economic data with an assessment of current valuations and the liquidity environment will help determine the timing and size of portfolio shifts, allowing plan sponsors and investors the opportunity to add or reduce risk, or to reposition their overall asset allocation.

INVESTMENT CLOCK – ASSESSING THE INVESTMENT CYCLE



In order for plan sponsors to effectively implement such shifts, a plan's governance structure must permit two key things. First, the plan must allow for a certain level of departure from its long-term asset allocation policy – in a size, say, 10–15%, that will generate a meaningful contribution to portfolio results. Secondly, the plan's investment policy must reflect an ability to add strategies with a limited performance track record; many opportunities which present themselves may be offered in vehicles with a short (or non-existent) track record, even if the manager would ideally have demonstrated the ability to add value in similar strategies over time. Finally, the plan's staff must have the skill and flexibility to identify opportunities and managers in a timely way – and the investment committee must be able to act on those recommendations quickly. Several models were discussed which involved partnerships between asset managers and plan sponsors where the parameters of the relationships were defined by volatility and liquidity constraints, rather than traditional asset allocation models.

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RISK MANAGEMENT

Corporate sponsors are also reviewing how they think about risk management given all of the issues they need to consider; volatility in the financial markets, low interest rates, increased correlations, and longevity. Ultimately, the objective is to provide a secure retirement income for their employees.

To this end, Forum participants were urged to think about the importance of managing tail risk events[1] in their investment portfolios. Recent tail-risk events have been accompanied by a rise in volatility and correlations. The key message for the corporate sponsor is that asset class correlations have increased, and diversification alone is no longer the answer to mitigating investment risk; rather the corporate sponsor should consider how to hedge the tail risk with a solution that incorporates a long position in correlation and volatility.

REGULATION

The current regulatory environment looks almost Kafkaesque. The economies in Europe and the United States are struggling and political impasses over the sovereign debt issues have resulted in periods of extreme market volatility. There is a considerable lack of confidence in the banking sector — banks still face heavy criticism for their role in the financial crisis and there is uncertainty over adequate capitalization.

There is a vast regulatory change agenda underway, which has been influenced by the political landscape, including Dodd-Frank in the United States and EMIR, MiFID 2 and IORP 2 in Europe.[2] The key question is whether the outcomes of regulatory reform will deal with the underlying causes of the crisis and prevent future crises.

Companies may need to make a conscious decision to engage in the debate, to prioritize pensions issues and to continuously review the status of these changes and the impact on pensions provisions. Companies should make effective use of local and regional industry and trade bodies, ensure management discuss the issues, and are aware of potential repercussions, including additional costs.

Conclusion

Key takeaways for the Multinational Corporate Sponsor:

- There is no one-size-fits-all solution to centralizing pension provision. Decisions are right or wrong at the individual company level.
- The wider context includes asset management, global governance objectives, business strategy and corporate culture. For this reason, each multinational's pension journey will be unique.
- Virtual and physical pooling both have their proponents. Multinationals must work with their advisers to determine which one (or combination) suits them best and create the business case.
- Vendors and advisers are increasingly looking to provide innovative and flexible solutions to support multinationals on their journey.

J.P. Morgan would like to thank all the speakers and participants at the Multinational Pensions Forum. We will be exploring the themes raised in this paper throughout 2012, and look forward to sharing further insight and discussion in the coming months.

For further information on how J.P. Morgan can help multinational pension plans, please contact: Benjie Fraser, Global Pensions Segment Executive Investor Services, benjie.h.fraser@jpmorgan.com
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1. The working definition posited by the presenter was a 2-standard deviation weekly drop in the S&P. 2011 has been rich in tail-risk events where four such periods were seen to occur. August 11 2011 was a 5-sigma event, the magnitude of which the market had not witnessed since the 2008 financial crisis.
2. MiFID 2: Markets in Financial Instruments Directive. IORP 2: Institutions for Occupational Retirement Provision.

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