

Creative Solutions to Cross-Border Pensions Challenges

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Foreword

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Governments and regulators around the world are preoccupied with major pensions issues - employee participation, security of assets and the adequacy of the savings pool. They are creating and implementing regulations that attempt to solve these challenges.

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Pensions have traditionally been governed at a local or country level. This makes each pension system (state, workplace and private) unique in each country. Corporate sponsors of multinationals' pensions operate within this complex environment. Often, where they look to create efficiencies and achieve value, they meet challenges in the form of regulation that may incur costs and local fiduciaries who wish to retain control.

This white paper¹ offers a European and ultimately a global perspective of these challenges drawing on insights from J.P. Morgan's third annual Multinational Pensions Forum which was held in Paris in September 2012. In April 2013, we will hold our first multinational pensions event in New York, where we will hear the U.S. perspective on multinational pensions challenges and opportunities. We hope you will find both interesting.

CONTENTS

- Foreword 1
- Introduction 2
- Creating a business case for a cross-border pension plan 2
- Buy-in of local fiduciaries to a cross-border solution 3
- Regulation impacting pensions 3-4
- Centralized clearing and collateral..... 4
- The business case for a cross-border IORP structure 4-5
- Education and engagement 5
- Managing asset and liability risks for the corporation 6
- Conclusions 7

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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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Introduction

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J.P. Morgan's third annual Multinational Pensions Forum in Paris brought together corporate sponsors and industry advisers to share best practice and bring unique thinking to cross-border pensions challenges.

These challenges sit within the context of regulatory change and economic uncertainty. They are far-reaching - from issues that typically concern Treasury and Finance, such as how best to measure and manage risk from the corporate center to minimise the impact on the balance sheet, through to implementing a communications program that engages and encourages employees to save adequately for their retirement - a responsibility that typically falls within the Human Resources and Benefits domain. During the Forum, several very nuanced case studies were presented to highlight some of the challenges involved in cross-border pensions provision.

This year's Forum included speakers from a number of multinational firms, including Danone, Nestlé, Shell, American Express, BP and Alcatel Lucent, as well as industry advisers such as Linklaters, Towers Watson, Aon Hewitt and Ortec Finance. Discussions recognized the different challenges faced by Defined Benefit and Defined Contribution plans.

In this paper we look to encapsulate the key themes of the day.

Creating a business case for a cross-border pension plan

A multinational corporation

By way of recap, this year's Multinational Pensions Forum revisited a central theme from last year's event, cross-border pensions - the rationale for and the keys to successful implementation.

A cross-border pensions approach involves increased collective decision-making and oversight by the corporate center along with greater standardisation of information from the different jurisdictions in which the pension plans are held. The benefits of successful implementation are economies of scale and enhanced decision making, with the ultimate objective of improved pensions provisions for employees.

There are numerous drivers to a cross-border approach. These fall broadly into the financial and operational drivers noted below:

FINANCIAL

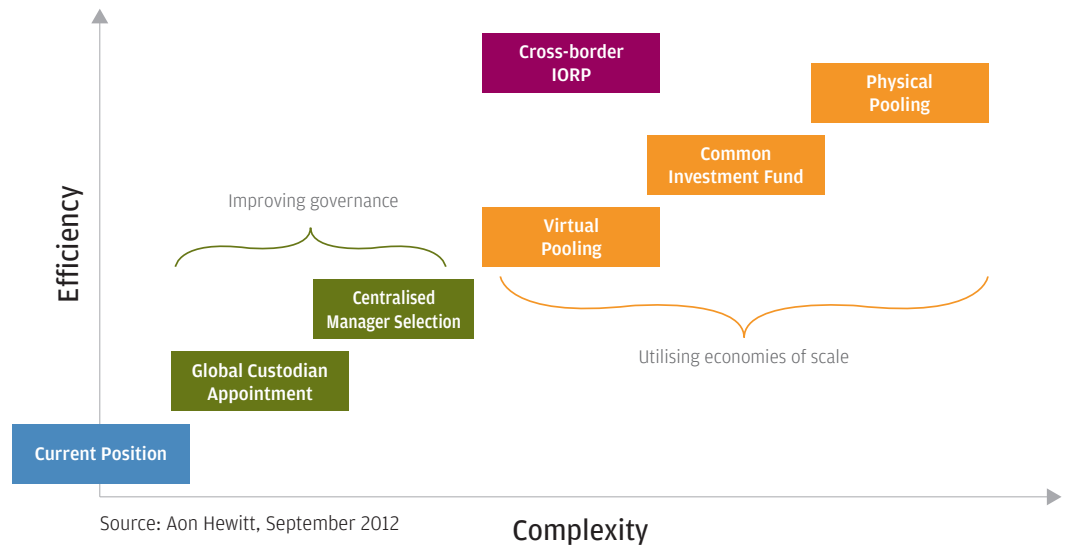
- Risk management of the multinational's balance sheet and income statement
- Cost reductions through economies of scale
- Access to risk-adjusted investment options
- Facilitation of multinational asset and liabilities pooling

OPERATIONAL

- Focused and simplified governance structure and operation
- Reduction in internal management time as a result of consolidation of pensions services providers
- Consistent internal branding and employee experience

Cross-border pensions can take a variety of forms. As illustrated in the Asset Consolidation Spectrum, options centring on plan assets can range from a simple global custodian arrangement in which the pension plan's assets are custodied through a single provider, through to an arrangement in which pension plan assets are notionally amalgamated or even physically pooled.

ASSET CONSOLIDATION SPECTRUM



In general, more complex cross-border pension arrangements can achieve greater efficiencies and economies of scale, although these structures can be more difficult to implement. A company can choose to be anywhere on this Asset Consolidation Spectrum depending on their current pensions arrangements, their objectives, timescales and importantly, their corporate culture and their ability to implement change within their organisation.

Whichever structure is chosen, implementing a cross-border approach requires conviction and resource as well as operational changes with the pensions model and behavioural changes within the company. Successful implementation requires the support of all stakeholders.

Buy-in of local fiduciaries to a cross-border solution

A multinational corporation

A real case study was presented; a multinational outlined a conundrum where one of their defined benefit pension plans held assets greater than its liabilities in one country, while two defined benefit plans were underfunded in other countries. The corporate sponsor proposed paying a benefits increase to the better-funded plan, if the excess assets could be put to use for the underfunded plans with ring fencing in place. Effectively, this proposal would dramatically reduce the corporate center’s cost of funding the two underfunded plans. However, while national regulators in all three countries agreed to the proposal, the trustees of the overfunded plan did not. This presents an interesting case study about sponsor covenant and how the long-term benefit to the corporate sponsor, and arguably the plan members, can be blocked by some trustees.

Regulation impacting pensions

A multinational corporation

ONE SIZE DOES NOT FIT ALL

There is no shortage of regulation impacting pensions, so unsurprisingly this was a key topic of discussion at this year’s Forum. European regulators are questioning whether pensions regulation remains fit for purpose. As a result, Europe has new pensions initiatives which look at a wide range of issues – from whether pension plans need new measures of assets, liabilities and capital requirements to whether regulation recognizes the growing importance of defined contribution funds.

One speaker highlighted that future regulation is being designed to cover all pension plans, both Direct Benefit (DB) and Direct Contribution (DC) plans, regardless of their size or tradition. However, as the speaker noted, one size cannot fit all for a variety of reasons. As we know, the European pensions landscape is varied and diverse on account of country-level traditions (market and industry differences). In addition, 94% of all pension plans in Europe have fewer than 100 members whereas 90% of pension assets are held by the largest pension plans.¹ Increased regulation creates the potential of increasing the cost of running pension plans. For smaller plans, this may be particularly onerous. Another challenge for the policymakers is that 60% of Europeans have no funded pension provision at all.

Centralized clearing and collateral

Eileen Herlihy, Executive Director, OTC Clearing Sales and Marketing,
J.P. Morgan Investment Bank

Amongst the forthcoming regulatory changes, any entity that uses over-the-counter (OTC) derivatives must prepare to comply with new regulation on centralized clearing and the concomitant collateral requirements. This regulation concerns not only OTC derivatives subject to mandatory clearing but, in addition, risk mitigation procedures for non-cleared or bilateral trades.

Under Dodd-Frank² in the U.S., centralized clearing commences in 2013 in a phased approach according to the type of market participant and there is no exemption for pensions. In contrast, pension plans in Europe have been granted a temporary exemption under EMIR³ for hedging contracts which is scheduled to last until August 2015, whilst CCPs find a way to take non-cash collateral as variation margin. For pension plans and their corporate sponsors, there will be clear regional differences in the regulatory regimes and considerable implications for liquidity, execution and collateral management.

One multinational attendee highlighted that European plans that choose to opt out of centralized clearing under the exemption could experience higher capital charges associated with their derivatives positions. With hedging strategies becoming more expensive, it therefore makes sense for the corporate center to consider how they can standardize, centralize or create a best practice policy to most efficiently employ their collateral. Yet it's unclear what approach the corporate sponsor should take.

Even the use of a centralized clearing broker is arguably impractical. In the first instance, local plans will have their own banking relationships which they may wish to continue. Furthermore, few clearing brokers will have strong execution relationships across Europe, which means few will be able to access all of the markets required. And, to diversify counterparty risk, some pension plans may prefer to make use of multiple clearing brokers.

The business case for a cross-border IORP structure

A multinational corporation

Another important regulation impacting pensions is the new Institutions for Occupational Retirement Provision Directive ('IORP II'). The European Commission is revisiting the first IORP Directive (also known as the Pensions Directive), looking at three pillars: funding, governance and communications. Whilst the detail of the Directive is yet to be written, it aims to facilitate better cross-border pension provision and strengthen protection for scheme members.

1. Survey on the implementation of the small IORPs exemption, EIOPA, 2012

2. The Dodd-Frank Wall Street Reform and Consumer Protection Act

3. Regulation (EU) No 648/2012 on OTC Derivatives, CCPs and Trade Repositories (EMIR) contains the EU requirements in respect of central clearing of standardized OTC derivatives

The European Commission is seeking to incorporate some of the fundamentals of the Solvency II regime for insurers into IORP II. However, the application of insurance language surrounding sources of capital, solvency and regulation which has traditionally been applied to insurance companies, is proving challenging for the pensions industry. Notwithstanding its revision, IORPs has already proved an effective approach to pan-European cross-border pensions.

One multinational described their use of an IORP structure. As always, the key to success lies in collaboration. Rather than trying to force pension plans to join the IORPs cross-border arrangement, the multinational focused on creating a robust business case to win over local plans. Numerous benefits were cited.

- Funding flexibility: avoiding trapped surpluses otherwise dictated by regulation in some locations at a country level by using a stabilization fund as required
- Central expertise, products and practices
- Uniform practice and enhanced administration service to members
- Defined Benefit (DB) investment consolidation
- Defined Contribution (DC) investment flexibility, enhanced member choice, significantly reduced and transparent charges
- Economies of scale

To gain the support of all the stakeholders involved, it was essential to communicate these benefits effectively. Also in this example, the IORPs were developed in two phases, commencing with DB plans and culminating with the inclusion of DC plans (currently underway). In this staged approach – as opposed to big bang – there's a greater likelihood of success.

Education and engagement

EDUCATING AND ENGAGING EMPLOYEES

One aspect of the new IORP II Directive aims to produce greater transparency and consistency of disclosure within communications. This is already a requirement for mutual funds in Europe, where UCITS are required to produce a pre-contractual Key Investor Information Document (KIID). Whether or not this should be applied to pensions, remains under discussion.

This is particularly relevant for DC plans, which are designed for employees who may have less understanding about how to invest and often find too much choice is an obstacle rather than an opportunity. Some also find the topic of pensions overwhelming and therefore ignore or delay decision making. For these reasons, the most effective communications are simple. Rather than adopting a standardized approach, different communication channels and materials need to be based on local country-level culture and attitudes to savings.

'Smart Saving' is a global employee financial wellness program at American Express which focuses on pension as well as wider personal finances. For example, as part of the Smart Saving launch in the UK in 2012, one of the programs, 'Smart Spending', focused on helping employees save on regular day-to-day purchases and generated awareness of what could be done with those savings such as making contributions into a pension plan. The American Express example demonstrates how the corporate sponsor can better engage employees by focusing holistically on their overall savings and personal finances rather than just their pensions. Although the program is global in nature, it has been adapted to be locally relevant and engaging when introduced to employees in several markets, for example, the Smart Saving for Children program in Hong Kong and the U.S., making it a truly multinational approach to promoting a wide savings culture within the workplace.

Managing asset and liability risks for the corporation

Paul Sweeting, Managing Director, European Head, Strategy Group,
J.P. Morgan Asset Management

In today's global political economy, financial markets continue to be volatile which means we are likely to experience further market shocks affecting the value of assets of all types of pension plans. Furthermore, the pattern with which interest rates will normalize from their current low levels, will have a significant impact on the multinational's balance sheet. For this reason, we need to consider the fundamental inter-relationship between the pension plan investments and corporate sponsor. Given the plan's financial reliance on the sponsoring company, this can present a significant risk as both the corporate sponsor and the pension plan assets are affected by common economic factors.

Whilst global economies are linked, they are not perfectly correlated. Therefore, to some extent, multinationals can benefit from geographic diversification. However, since many multinational firms operate in the same global sectors as the plan's assets are invested in, e.g. oil, telecommunications, banking and insurance, this means they will be impacted by specific sector risks on a global basis, e.g. resource-based input costs. The ability of the sponsor to address any additional funding requirement for the plan might then be restricted precisely when the need for such a requirement might be heightened.

To protect against joint and simultaneous plan and sponsor stress, one presenter suggested measuring the resilience of the pension plan portfolios to extreme adverse moves in an identified key variable, i.e. the element causing the shortfall in the plan's assets. Based on this analysis, a revised (tilted) asset allocation framework could be applied to mitigate or reduce the impact of this variable, with the aim of improving the performance of the plan's assets.

Additional speakers highlighted solutions that are emerging which allow the corporate center to quantify the effects of single country decisions on its consolidated balance sheet and income statement. These provide the basis for risk management solutions that not only account for the impact on the corporation but also a level of analysis to understand regulatory implications, thereby allowing for greater transparency and more effective decision making.

Conclusions

IN SUMMARY –

This year's Multinational Pensions Forum saw a continuation of the key themes affecting cross-border pensions:

- Cross-border and IORP pension approaches offer clear benefits
- To leverage these benefits, increased centralization, standardization and transparency are required
- Creative pension solutions need to accommodate regulatory and market changes
- Reconciling the interests of the different pensions constituents will take time and determination
- Effective implementation requires the support of all key pension stakeholders
- The pension plan's unique liabilities and profile are the starting point for all decisions and potential cross-border solutions
- Further consideration by participants of the formation of a region-wide lobby group to support relevant change

ADDITIONALLY,

- Multinational firms are as challenged as ever by heightened regulation and fiduciary/local governance
- Pension constituents can learn the most from being amongst their peers and hearing best practice
- Multinational firms also need an effective voice to be heard by the regulator and fiduciaries

For these reasons, the consensus was that there has never been a more important time than now for input into the pensions political and regulatory debate. Indeed, industry and trade organisations are lobbying to demonstrate how proposed regulation could impact the balance sheet and financial health and resilience of corporate sponsors as well as threatening continuing provision.

J.P. Morgan's Corporate & Investment Bank operates a Global Consultant Relations program. To learn more about this and our thought leadership program, contact Kate Spencer, Vice President and EMEA Consultant Relations Executive, Investor Services, J.P. Morgan at: kate.c.spencer@jpmorgan.com

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