

Reducing Risk and Costs

Global Management of Pension Plans

After above-average returns and low costs in the 1990s, corporate pension plans were hit hard by an unusual combination of declining equity markets and low interest rates. The former reduced pension asset values and the latter increased the present value of their liabilities. Corporations accustomed to pension surpluses and funding “holidays” found themselves making substantial cash contributions to underfunded pension plans. At the end of 2003, Standard & Poor’s estimated that pension underfunding among the S&P 500 had grown to a record \$259 billion.

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Dealing with these pension cost issues is particularly challenging for multinational corporations. Most multinationals leave bottom-line business responsibility to local operations, yet the impulse to fund pensions at the absolute legal minimum – whether it occurs at corporate headquarters or in geographically distant business units – can expose a multinational to cash-flow volatility.

Seeking to control costs and reduce risk, an increasing number of multinational corporations are taking a global approach to managing their pension plans. In 2000, 50 percent of multinationals surveyed by Mercer Investment Consulting had some form of centralized global process. By 2002 that proportion had risen to 84 percent.

Global management of pension plans does not mean one worldwide plan or a single plan design. Instead, multinationals have developed policies and procedures that seek to align global financial objectives with a local company's ability to provide competitive benefits. Managing pension plans globally poses a number of challenges, including the authority vested in local trustee boards rather than the employer; differing terminology and different meanings for the same phrase (e.g., "cash balance" plans); and the role of unions, work councils, and other employee groups. Successfully managing retirement plans on a global basis requires local market knowledge, broad global resources, and good communication between local and head offices.

Multinational corporations have been paying particular attention to four key aspects of global management of pension plans: strategy, governance, cost reduction, and risk management.

Strategy. More and more multinationals are setting global pension guidelines – for example, a preference for defined contribution plans instead of defined benefit plans. Many companies have a global policy preference for defined contribution plans to provide the company with the greatest control over costs and liabilities. Other companies have set a policy of conforming to the local competitive practice in each country in which they operate, without specifying a particular kind of plan to be used worldwide.

Another element of global pension strategy is the degree of integration of company retirement plans with local social security programs. Many companies have moved their plans away from direct integration with public pension systems because of unsustainable benefit levels in many “pay as you go” state programs. If private plans are designed to offset state pensions, shrinking public contributions will automatically drive up the cost of company plans.

Increasing numbers of multinational corporations are setting and monitoring investment objectives – for example, outperforming customized benchmarks or controlling risk relative to liabilities. Yet even with greater emphasis on global management of pension plans, hiring investment managers is often a local decision.

Governance. The increasing salience of transparency and accountability in today's business environment has prompted multinational executives to pay close attention to the way fiduciaries make decisions on behalf of plan members. Key governance issues include setting clear guidelines around the role and authority of fiduciaries, plan trustees, and management bodies. Many multinationals have become very specific in terms of best practice guidelines, documentation of decision-making, and communication responsibilities.

Some corporations have a centralized internal group that monitors local compliance with global policies. Some use third parties for analysis, monitoring, and reporting, and others have global corporate representatives serving on local trustee boards.

Cost reduction. This is one of the main drivers of global management of pension plans. For example, using a global custodian as a source of consistent, easily accessed information for monitoring plans can reduce pension costs. Looking at investments more broadly across countries can avoid some transaction costs, and actuarial fees can be reduced through global programs.

Key Steps in Developing a Global Program

- Identify your retirement plans. Some multinationals have more than 100.
- Collect asset and liability data.
- Conduct a coordinated review of local plan assets and liabilities to identify opportunities to eliminate costs and build synergies between plans.
- Define guidelines for plan management and approval protocols for any changes.
- Develop a consistent global approach for decision-making.
- Develop regular local plan compliance reviews, either formally or informally.
- Review local plans to assess aggregate risk profiles, funding status, and potential cash flows.
- Identify opportunities for streamlining management responsibilities and reducing costs through consolidation of service providers – for example, a global custodian.
- Develop an informal process to identify emerging issues and provide a foundation for constructing more formal policies.
- Centralize liability monitoring and reporting to ensure valuation consistency.

Risk Management. Linked to governance is the issue of managing investment, interest rate, and other risks to pension plans. The recent volatility in pension plans will be exacerbated by the global movement toward “mark to market” valuation of assets and liabilities and full, current recognition of plan changes, income, and expenses. Despite the long-term nature of pension liabilities, short-term market fluctuations will have a significant impact on reported pension costs.

Mercer's process for managing pension plan risk and controlling costs is called Retirement Financial Management, which analyzes the interaction of benefit, accounting, investment, and funding policies. These policies are interdependent, and changing one can affect another. Consider a company that adopts an accounting policy that uses "smoothing" techniques to minimize fluctuations in asset returns. If that same company's investment policy calls for investing heavily in long-term bonds to hedge interest rate fluctuations, the asset-smoothing accounting policy will distort the hedging strategy by reflecting the bond portfolio's "smoothed" value.

Conclusion

CEOs and CFOs today are seeking to ensure that their company pension plans are meeting fiduciary responsibilities, reporting liabilities appropriately, and avoiding unpleasant financial surprises. Senior executives are also trying to get better control over the volatile costs of pension plans. For multinational corporations, the global management of pensions that judiciously balances global resources and local knowledge can help reduce risks and control costs.

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