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Pensions across Europe: A work in progress

by Tim Burggraaf

Multinational corporations are finally finding their way towards pan-European pension solutions. As a result of some recent European Court rulings and the passing of the 2003 Pensions Directive, which facilitated cross-border pension arrangements, multinationals are progressing toward a pan-European pension strategy. The potential cost savings and more efficient governance structures have also fueled the move. Mercer expects more positive developments in 2007. The most movement will be seen for executive plans and for companies with a wide spread of operations. While pan-European solutions are not a panacea, they will surely be a key subject for discussion and planning over the next few years.

Finding and implementing a solution

Finding a pan-European pension solution involves thinking across borders while using various resources to achieve the best possible scheme for participating countries. Various options already exist, but some are more robust than others. For example, risk pooling is a well-tested strategy, and we know it is sustainable. However, the lack of political agreement in Europe on the specifics of true pan-European funds (such as the role of regulators and the shift in power between them) could derail the development of that option.

Finding the best possible solution depends on a number of factors, including the company's European reach, how diversified and large its subsidiaries are, and the level of corporate decentralization, among others. Some of the biggest hurdles faced by multinationals have been discriminatory tax treatments in EU member states, but these barriers have begun to break down. Others include complying with the social and labor laws of each country.

This Issue

6 Implementing a governance framework: From theory to reality

11 The Southeast Asian tigers: Retirement coverage in ASEAN

16 Pension Protection Act of 2006: The dust is settling

"Pan-European schemes make it easier for employees to work in different locations without jeopardizing their benefits."

That said, the economic advantages of a pan-European scheme may well outweigh any difficulties involved. Pooling scheme assets across countries could result in lower investment management fees, reduced transaction costs and tighter risk control. Also, larger asset portfolios and greater access to leading global investment managers mean that a pan-European arrangement could lead to enhanced investment returns. In addition, investment returns are also enhanced by avoiding the use of less efficient vehicles in some countries (for example, life assurance products). Plus, pan-European schemes make it easier for employees to work in different locations without jeopardizing their benefits.

The most obvious driver for change is the real and difficult problem posed by mobile employees – any solution will help. After that, organizations are looking for operational savings. Administrative and professional costs need to be contained, and multiple plans, particularly smaller ones, can multiply these costs alarmingly.

Pan-European pension solutions involve different kinds of pension scheme strategies across Europe. Some solutions may seem to be a little premature, but others are achievable now, and may not even be all that new. Two examples of existing solutions that could promote a pan-European strategy are asset pooling and multinational risk pooling. However, creating a full scale pan-European pension fund (as envisaged in the EU directive) still appears to be a work in progress. Judging from articles on the subject, several multinational companies as well as financial providers in the European market have expressed considerable interest in this type of fund. Finally, pension outsourcing can also be regarded as a useful pan-European strategy as well.

The following table provides a framework for adopting a pan-European strategy. The table displays the building blocks for four common pan-European strategies: risk pooling, asset pooling, a pan-European fund and outsourcing.

Pooling of	Administration	Assets	Risks	Liabilities
Risk pooling			X	
Asset pooling		X		
Pan-EU fund	X	X	X	X
Outsourcing	(X)	(X)	(X)	(X)

Outsourcing refers to the transfer of pension- related activities (mostly processes) from the organization to a third party. Depending on the need of the organization, one strategy or all could be outsourced, and some strategies could be combined.

A pan-European strategy needs to be tailored to provide the best fit to a specific organization, and the best solution built from the available building blocks, whether stand-alone or combined together. Sometimes, the pooling of assets alone might provide the best possible solution. In other situations, risk pooling as well as asset pooling could offer a more profitable framework. So various strategies need not necessarily be implemented in the same way. For example, risk pooling can either be implemented through a European network of insurers (most likely in a risk pooling only scenario) or through the pan-European vehicle itself (most likely in a pan-European fund scenario).

Strategies and how they work

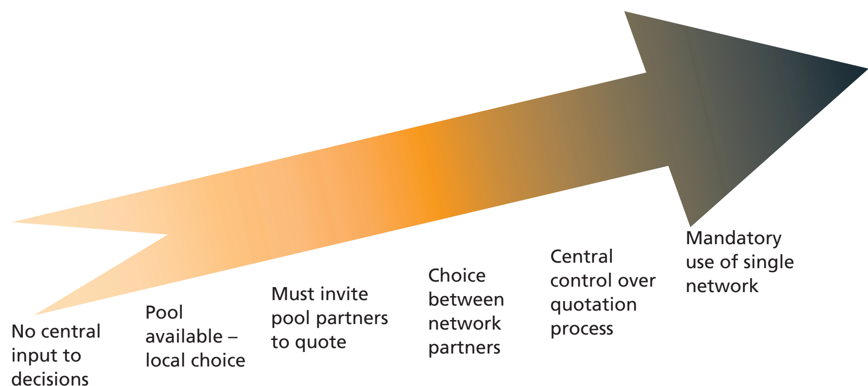
Risk pooling

Multinational risk pooling is a way for multinational companies to achieve global economies of scale in the purchase of pension insurance in Europe. What is interesting about this concept is that it will develop as the insurance markets themselves develop. For example, as more emphasis is put on longevity risk insurance, the pooling process can be used for that also.

The core principle of multinational risk pooling is that subsidiaries buy their risk insurance from one network of insurers. In addition to the financial savings when claims experience is positive, multinational risk pooling also provides other benefits, such as improved underwriting and terms, annual financial reporting globally, and more influence over local insurance companies. This is why multinational risk pooling fits well into a pan-European pension strategy, offering a stronger corporate grip on pensions in Europe.

The way multinational pooling is introduced throughout an organization will depend on its management and operating style. While best results can be expected in a very centralized organization, positive results can also be looked for in decentralized organizations. To determine the best approach, a feasibility study might be an appropriate first step.

Increased centralization



Obviously, the concept of risk pooling is not limited to Europe and is very often implemented on a global basis. Furthermore, the concept is not usually limited to pensions but is commonly applied to other employee benefits (such as life insurance, disability, medical and accident insurances).

Asset pooling

Cross-border pooling is the commingling of assets from multiple investors, domiciled in different countries, into one vehicle. This asset pooling offers an enhanced governance structure to monitor consistent investment returns and achieve better risk management. Lower asset management costs can be achieved through aggregating assets, which increases the purchasing power with investment managers. Another advantage is the crossing of unit trades. Rather than buying funds for one mandate and selling the same or comparable funds for another, a computerized tracking

“It seems logical that pan-European plans will focus on DC schemes instead of DB plans…”

system allows trades to be made without entering the open market. Obviously, the corporate asset pooling vehicle could have significant impact on the local plans, so it is crucial to keep local plan fiduciaries informed during all stages of the international asset pool implementation. An asset pooling framework will offer mandate consistency and a higher quality of risk management. Although a list of preferred provider networks could serve the same purpose, asset pooling vehicles offer additional advantages such as reduced transaction costs, enhanced control over selection and monitoring of managers and custodians, and reduced custodian fees. But to have a strong cost/benefit proposition, there needs to be sufficient poolable assets.

Finally, depending on the actual situation of the company, VAT tax advantages can be obtained. Assuming an asset management fee of 1 percent and an average VAT tariff of 20 percent, this could translate into tax advantages of 20 basis points annually. As far as location of pooling vehicles, at the moment Ireland (offering the so-called Common Contractual Fund) and Luxemburg *(Fonds Commun de Placement)* are the most common choices. The UK and the Netherlands are also good alternatives, depending on the specific situation of the corporation at hand. It is interesting to note that the difficulties associated with setting up a truly pan-European pension plan have led some multinational companies (including Unilever, Nestle and IBM) to establish pooled vehicles to at least benefit from economies of scale in investment management, custody and governance-related areas (asset pooling).

Pan-European fund (IORP)

In 2003, the EU Parliament and Council formally agreed on the wording for the Pensions Directive, otherwise known as the European Directive on the Activities of Institutions for Occupational Retirement Provision (IORP). Despite best efforts during the development of this directive, discussions around appropriate funding levels as well as intra-European tax issues, such as differing tax treatments in member states, will make it more difficult to operate a pan-European defined benefit (DB) plan. In contrast, defined contribution (DC) plans seem ideal.

Taking these funding and security issues into account, DB plans are not ideal candidates for pan European plans because setting up these pooling vehicles is too time-consuming and expensive, and thus any cost savings and efficiencies that would accrue would be undermined. Therefore, it seems logical that pan-European plans will focus on DC schemes instead of DB plans, except perhaps in a small handful of cases such as regional executive plans.

Establishing pan-European pension plans has the potential to provide significant benefits to multinational companies, including cost savings, operational efficiency, risk control and employee mobility.

But managing pension plans on a pan-European basis is not the same as implementing the same retirement plan in every country around Europe (which, in practice, would not be feasible because of differences in tax treatment). Effective management of pension plans on a pan-European basis means having a well-defined strategy with centralized implementation through single or combined legal and operational frameworks.

"Organizations that have small subsidiaries in a reasonable number of European countries would probably benefit from a full pan-European DC strategy. "

In 2007 we expect to see more realistic pan-European plans for defined contribution benefits building on the asset pooling concepts and administrative and regulatory solutions available.

Outsourcing

Although outsourcing is another pan-European pension strategy, it is completely at the other end of the spectrum from pan-European pension fund management. An outsourcing strategy ideally fits organizations that would not consider managing pension assets and/or risks a desirable part of their business. Pension outsourcing generally is part of a larger process of HR business outsourcing and calls for different solutions in different markets. The outsourcing market is rapidly gaining ground, and Mercer along with other providers will be offering versions of a pan-European pension outsourcing solution for DC schemes.

What's on the horizon?

As we've seen, pan-European solutions already exist in several forms (such as risk pooling and asset pooling), and others are being investigated (such as pan-European funds and outsourcing). The pan-European pension market will continue to evolve in the upcoming years. Depending on the pan-European readiness as well as the profile of an organization, certain strategies will work, while others may not right now. It seems safe to assume that organizations that have small subsidiaries in a reasonable number of European countries would probably benefit from a full pan-European DC strategy. If those organizations are looking for an outsourced solution as well, they might be wise to await relevant market developments in 2007. On the other hand, organizations that mainly have large subsidiaries might benefit more from implementing asset pooling as well as risk pooling vehicles now.

What's important to stress is that to achieve a successful pan-European pension arrangement, an organization must first determine its needs and then choose a solution(s) that best aligns with its overall business goals.

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In Mercer's 2006 global governance of retirement plans survey, ***Meeting the Challenge of Implementation in Europe***, we found that 80 percent of companies take a risk-based approach to managing pensions.

Implementing a governance framework: From theory to reality

by Elizabeth Renshaw-Ames and Rosanne Corbett

Managing pension risk effectively is a challenge that dominates many companies' agendas. The first article in our governance series, **The buck stops – where?**, set out our view that corporate boards should make informed and confident decisions on retirement plan issues. In this article, we examine the steps companies need to take to overcome the internal and external challenges that may inhibit their ability to build effective governance frameworks.

A lot rides on the management of pension plans. A company's reputation, financial results, employee productivity and industrial relations are all affected by risks associated with operating employee pension plans. If providing these benefits is a material expense or represents a significant risk, or if there is uncertainty as to whether an exposure exists, then improving governance and risk management in this area should be a corporate imperative. Yet despite the incorporation of risk management principles into the decision-making processes of many corporate functions, the same governance principles have not generally been applied to the pension arena. Pension liabilities are often so huge that pensions can seem to be the "tail wagging the corporate dog" (*Financial Times,* 2005). Organisations with retirement plans have a responsibility to their shareholders to see that the costs of providing these plans yield business benefits.

Very often, external change through a merger or acquisition can be a trigger for implementing governance structures or strengthening current processes. After all, having a clear picture of risk and cost is fundamental in an M&A situation, as either can make or break a deal. An increasing number of companies are concerned about the lack of governance over benefit plans – both at the company they are buying and within their own company. This is particularly evident when the acquirer is expanding rapidly and assuming a large amount of pension debt, potentially in countries in which it previously has had no presence.

The reality: external challenges

In virtually all jurisdictions, retirement plans are subject to considerable external and regulatory scrutiny. Changes in legislation can lead to a modification in pension plan management and have a profound long-term impact on the way companies view their pension obligations.

“There has been a steady and growing call in the market for stronger and more effective plan governance practices.”

Legislation in the UK, the US and the Netherlands, for example, has brought about significant change in the pensions industry in those countries.

- In the UK, the Pensions Act 2004 requires a more stringent funding target than the minimum funding requirement previously in place. The act shifts the responsibility of determining funding strategy, assumptions and contribution rates to the trustees (fiduciaries) of company-sponsored pension schemes and stipulates explicit governance requirements for both the sponsor and the trustees.

- In the US, legislators and regulators have honed in on retirement plan governance following widely publicised corporate scandals in the past few years and the fallout effect those corporate events have had on employer-sponsored pension plans. The Sarbanes-Oxley Act of 2002, which introduced major changes to the regulation of corporate financial practice and governance, was an attempt to strengthen governance at the organisational level. The US Department of Labor and the Securities and Exchange Commission followed up with guidance designed to help fiduciaries address plan governance issues, particularly with respect to fiduciaries making informed decisions on investment options.

  The recently passed US Pension Protection Act of 2006 (PPA) clarifies or expands fiduciary protections for issues such as default investment options, fund mapping (whereby the employer or other fiduciary replaces an investment option with one of the same type but with a different investment adviser), and the provision of investment advice to plan participants. The PPA also completely overhauls pension funding rules starting in 2008 and expands 401(k) stock diversification rights.

- In the Netherlands, the *Financieel Toetsingskader* (FTK), effective 1 January 2007, is a new financial assessment framework intended to place insurers and pension funds on the same consistent, transparent platform for funding purposes. The FTK introduces a minimum required solvency level along with other solvency tests that require underfunded plans to top up assets to prescribed levels. The FTK has already affected the investment policy of pension plans, and we expect companies to begin to address the design of their pension plans.

As a result of all these developments, there has been a steady and growing call in the market for stronger and more effective plan governance practices. Addressing these demands can be resource-intensive and is made more challenging when the requirements of multiple countries must be met.

The reality: internal challenges

Retirement plans are technically complex, involving layers of operations and responsibilities within an organisation – from the corporate board and the benefit committees it sanctions to local management and perhaps separate trustee boards. The number of stakeholders in a pension plan has also increased in recent years, and often these stakeholders are playing “catch up” with respect to learning about the fundamental risks a pension plan may have on the business and also how to manage these risks.

"A strategic and flexible approach is required to manage the wide range of risks inherent in retirement plan sponsorship."

Stakeholders are diverse and have varying levels of interest and differing roles and objectives. This diversity can crystallise into conflicts of interest. Identifying key risks and controls can also be problematic when there are many parties involved, both on an internal and external basis. The personality and preferences of stakeholders, executive sponsors and those doing the work either can detract from or contribute enormously to successful implementation.

Often, where diverse stakeholder groups are involved, no single group takes ownership. In this case, it is unlikely that effective risk management will occur. Companies will want to think about how well their finance and HR teams currently work together, and they should work to strengthen these relationships where necessary.

Without conscious attention to pension plan governance, there is likely to be a lack of resources at corporate headquarters and a lack of expertise in the regions and locally.

Moving from theory to reality

Designing a governance framework

A strategic and flexible approach is required to manage the wide range of risks inherent in retirement plan sponsorship. The framework depicted below has been designed to build an integrated and resilient governance infrastructure. Five principles, each independent and interdependent, are derived from governance best practice underpinned by a corporate risk management foundation and prevailing legal standards.

This structure delivers clarity around accountability and decision making and, as a matter of best practice, requires a global retirement committee responsible for pensions risk management. Such a committee would be responsible for a number of areas, including the agreed-upon strategy, a wide-ranging due diligence exercise to identify risks that may hamper achieving the strategy, adoption of policies, and an accountability structure, plus an ongoing monitoring process – all of which must be communicated and informed by a steady and meaningful flow of written reports.

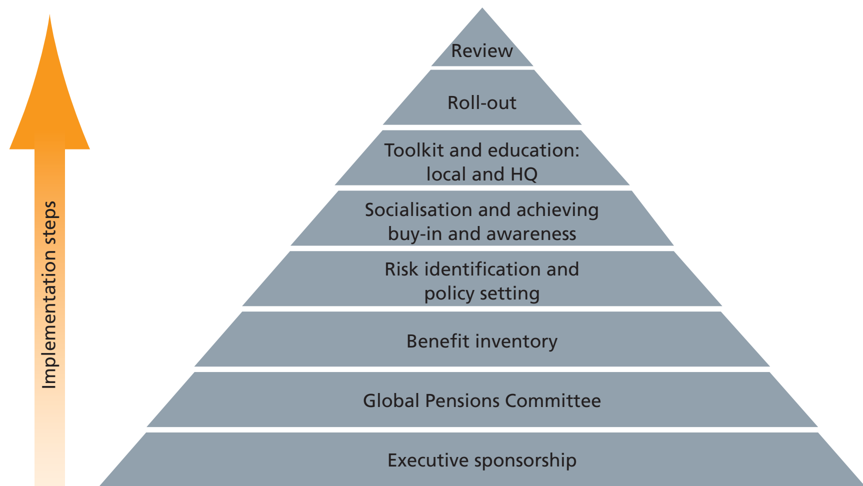
Implementation

The creation of such a structure and its accompanying processes is clearly not going to happen by accident and can only result from deliberate and careful thinking, planning and disciplined implementation.

"An effective framework can only be built if the organisation is of the right mind and has the right commitment."

At the implementation stage, it is essential that the architecture of the structure is carefully considered. Understanding the issues and challenges around decision making, roles and responsibilities, risk, and relationships will ensure the structure is built on a firm foundation that encapsulates how to move from the current situation to the desired state, taking into account the risks involved.

The model below depicts the key steps to successful implementation and ongoing success.



In our experience, an effective framework can only be built if the organisation is of the right mind and has the right commitment.

The will

Governance structures tend to develop piecemeal in response to particular issues unless an influential person or group in the organisation sponsors and coordinates the implementation. Executive sponsorship gives weight to the project, and a global committee is best positioned to oversee and manage both the implementation and the ongoing maintenance of the framework.

It is possible to develop a pragmatic solution built on the premise that, as resources are limited, a governance framework should be established specifically to mitigate the significant financial risk a pension plan poses. But this approach must be supported by sufficient due diligence to ensure that a small plan does not turn into a large corporate problem.

The knowledge

A significant challenge to coordinating global pension plans lies in developing a full understanding of the plans to be managed and the associated risks of sponsoring them. This knowledge can be acquired by assembling a benefits inventory and a register of associated risks. From this, objectives can be set and global policies developed.

The moment of truth

While local operations **might** be involved in the "will building" and knowledge-gathering stages of implementation, they **must** be engaged at the moment of truth – when the rhetoric hits the road. Buy-in to the governance structure is imperative for implementation to be meaningful. Local socialisation strategies include training and education and the development of toolkits to enable participation in the global process. The implementers must be able to explain clearly and specifically:

- Why governance is important
- What it means for the business
- What it means for the individual and groups of stakeholders
- How it will be implemented
- What ongoing support is required

This is best demonstrated by finance and HR working effectively together. Only then is full rollout and implementation of the framework possible.

The result

The amount of effort expended in building a governance structure needs to be supported by an effective maintenance programme. Once established, the framework should be adaptable to meet the challenges of business evolution, because markets and organisations will change, develop and grow.

"If the facts don't fit the theory, change the facts."
– Albert Einstein

Albert Einstein said, "if the facts don't fit the theory, change the facts." Extrapolating from this, we have concluded that if your current governance reality does not fit the theory, you should fix the current status. Therefore, if your governance structure is not aligned to objectives of the business, it is unlikely to be effective. Reviewing and improving the structure will be a requirement if objectives are to be achieved.

Ongoing monitoring and review by all those with oversight responsibility will ensure that the framework is fit to address the risks posed by pension plan sponsorship in the light of ever-changing circumstances. The final article in our governance series will deal with the features of a plan-specific governance framework, examining best practice plan governance – the final piece of the governance puzzle.

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The Southeast Asian tigers: Retirement coverage in ASEAN

by Marc Duguay

World attention has been on the market giants of China and India for a while. As labour costs in places like Shanghai and Mumbai increase as fast (or faster) than their GDP, business leaders have started looking for alternatives in the region. Will the forgotten Southeast Asian tigers put pressure on the Chinese dragon and Indian elephant? In this article, Mercer explores the retirement systems, legislative updates and market trends of Southeast Asian countries.

What's ASEAN?

The Association of Southeast Asian Nations or ASEAN was established on 8 August 1967 in Bangkok by the five original Member Countries, namely, Indonesia, Malaysia, Philippines, Singapore and Thailand. Brunei Darussalam joined in 1984, Vietnam in 1995, Lao PDR and Myanmar in 1997, and Cambodia in 1999.

The ASEAN region has a population of more than 500 million, a total area of 4.5 million square kilometres, a combined gross domestic product of almost US$ 700 billion, and a total trade of about US$ 850 billion.

The bloc cannot quite be likened to the European Union, but it is working towards greater integration. It has been busy enhancing relations and cooperation within its own member nations and with the world economic powerhouses.

"Today, ASEAN is not only a well-functioning, indispensable reality in the region. It is a real force to be reckoned with far beyond the region."
– Kofi Annan,
ex-Secretary-General of the United Nations

Quick facts

The table below shows some key demographic and economic information:

	Population[a] (millions)	Salary Growth[b]	GDP Growth[a]		
Country	**2006**	**2006**	**2006**	**2007**	**2008**
Indonesia	245.5	11.4%	5.3%	6.0%	6.5%
Malaysia	26.6	5.8%	5.6%	5.5%	5.2%
Philippines	89.5	8.6%	5.3%	5.0%	5.2%
Singapore	4.4	3.8%	7.3%	4.6%	4.4%
Thailand	66.0	6.3%	4.2%	4.8%	4.9%
Vietnam	84.2	8.0%	7.8%	7.3%	7.5%
China	1,315.2	7.7%	10.7%	9.8%	9.3%
India	1,110.0	12.3%	7.6%	7.4%	7.2%

[a] Economist Intelligence Unit
[b] Mercer forecast

Retirement System Summary

The table below summarises the key components of company-sponsored retirement benefits:

	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
Mandatory Retirement Plan	No	EPF	No	CPF	No	No
Mandatory Retirement Indemnities	Yes	No	Yes	No	Yes	Yes
Supplementary Retirement Plan[a]	62%	70%	90%	5%	55%	1%
DB vs DC[a]	DB: 36% DC: 64%	DB: 40% DC: 60%	DB: 95% DC: 5%	DB: 40% DC: 60%	DB: 5% DC: 95%	DB: 100% DC: 0%
Recent Legislative Updates	None	Restructuring of EPF balances	None	CPF reduction	New mandarory plan from 2008	Social Insurance Law reduction in 2007

[a] Prevalence of supplementary retirement plans based on various Mercer surveys

Indonesia: Emerald of the equator

The Social Security system JAMSOSTEK was implemented in 1993. It covers personal accident, life, health, and old-age security benefits. Normal retirement age is age 55 but can be extended to age 60.

In 2003, the new Labour Law 13/2003 was implemented, which features a severance package that includes a severance payment, a service payment and other compensation. Its introduction has been unpopular with companies, and is still hotly debated. The key reason is the additional costs for companies and the balance sheet liability associated with the severance package.

Why can't the HR director chill out in Bali?

He probably can. But he should keep an eye on market practice and evolving legislation.

How can the finance director relax in Lombok?

The Labour Law 12/2003 is basically a mandatory termination indemnity plan. Defined benefit in nature, the plan represents an unfunded balance sheet liability. More and more companies are implementing defined contribution plans, which can be used to offset the termination indemnity, hence partially funding the termination indemnity and reducing the balance sheet liability.

Malaysia: Waterway to the world

The Social Security SOCSO Act revised in July 1992 applies to all companies employing a minimum of one employee. The Act provides certain benefits to employees in case of invalidity and employment injury, including occupational diseases. There is no statutory retirement age, but 55 is the norm in the private sector.

Virtually all private sector employees in Malaysia are covered under the Employee's Provident Fund (EPF). Although this is primarily a retirement fund, savings in the EPF may also be used for housing, education and medical expenses.

Why can't the HR director peacefully climb Mount Kinabalu?
Most multinational companies provide supplementary retirement benefits. Retirement benefits can be a key factor in attracting and retaining talent, so an HR director should make sure the benefits are aligned with his or her company's overall HR strategy and business objectives.

How can the finance director have a quiet drink in Penang?
Perhaps she can. Most multinational companies would prefer to supplement the EPF using a defined contribution arrangement. However, defined benefit plans are still relatively common and having such a plan may affect the balance sheet and require appropriate governance measures.

Philippines: Pearl of the Orient seas

On 1 September 1957, the Social Security Act, now known as the Social Security Law, was implemented, marking a significant milestone in the Social Security programme. Social Security provides replacement income for workers in times of death, disability, sickness, maternity and old age. Under the Labour Code, an employee who reaches age 60 and has completed at least five years of service may retire.

In addition to social security benefits, mandatory termination indemnities are payable under the provisions of the labour code.

Why can't the HR director go diving in Cebu?
The majority of multinational companies sponsor final salary defined benefit plans. Retirement benefits can be used to offset the mandatory termination indemnities. In addition to making sure that benefits are competitive, the HR Director will likely be involved in the administration of the plan and will be providing information for actuarial valuations. At this point in time, there seems to be no noticeable trend towards defined contribution plans, which makes the Philippines rather unique.

How can the finance director enjoy the white beaches in Davao?
As for other final salary plans around the world, appropriate investment strategies and strong governance processes are critical to the plan's cost and efficient operation. In the Philippines, many companies adopt a very passive approach and leave such decisions to their trustee; this may not always be an effective arrangement. A trend towards defined contribution has yet to emerge, but the situation should continue to be monitored.

Singapore: The lion city

The Central Provident Fund (CPF) was set up in 1955 to provide financial security for workers in their retirement or when they are no longer able to work. Over the years, it has evolved into a comprehensive Social Security scheme, which aims not only at providing for a member's retirement, but also at taking into account home-ownership and health care needs.

In line with the government's long-term objective of raising the retirement age to 67, the statutory minimum retirement age was raised from 60 to 62 with effect from 1 January 1999. Further extensions of the retirement age will depend on the prevailing economic conditions and the experience gained from this extension.

All Singapore citizens and permanent residents who are employees must be included in the CPF. Foreigners are excluded.

Why can't the HR director just go shopping on Orchard Road?
There are two main reasons. CPF contributions have been reduced over recent years putting more pressure on companies to step in (see Legislative Update). This might cool off following the New Year's speech by the Prime Minister hinting at a contribution raise in 2007. The other reason is that foreigners are not covered by the CPF, so retirement coverage for these individuals is a big issue for many companies.

How can the finance director go play golf in Sentosa?
Well, she can. She probably has a good handicap actually! Supplementary retirement plans are very rare and hence the payment of CPF contributions is normally the extent of the company's responsibility.

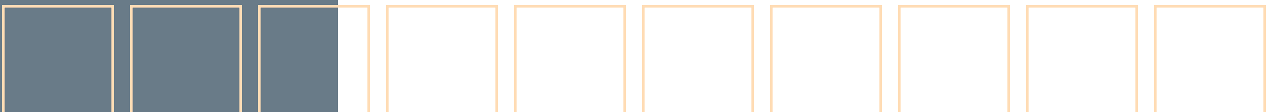
Thailand: Land of smiles

From 1 April 2002, a company employing more than one person is subject to the regulations of the Social Security Act and must contribute to the Social Security Fund. There is no mandatory retirement age in Thailand, although most companies in the private sector consider normal retirement age as 55 or 60.

Under the Provident Fund Act of 1987, companies can set up voluntary provident funds which have significant tax advantages. There are also mandatory termination indemnities whereby an employee retiring with more than 10 years of service is entitled to a lump sum payment of 300 days' salary.

Why can't the HR director take cooking lessons in Chiang Mai?
The government is planning to introduce a mandatory retirement plan in 2008 (see News Flash from the previous edition). The new legislation was supposed to take effect in 2007 but has recently been postponed. The recent political events might cast additional doubt on the effective date.

How can the finance director go play golf in Phuket?
Well, she can. She probably practices with her Singapore counterpart. The majority of supplementary retirement plans are defined contribution. She should not forget to book the liability for termination indemnities on the balance sheet though.



Vietnam: Home of the mighty Mekong

The Vietnamese economy is growing rapidly, and this development raises several HR issues. One key issue at the present time is the attraction and retention of talent in the fast-moving growth environment. The entry of Vietnam into the World Trade Organization (WTO) will likely exacerbate the problem. Intel, for example, has already announced foreign direct investment of US$1 billion and plans to hire 4,000 people.

In addition to social security benefits, mandatory termination indemnities are payable at a rate of about 2-weeks' pay per year of service.

Why can't the HR director concentrate when driving his scooter in Hanoi?

A new Social Insurance Law is slated to become effective from 1 January 2007 (see Legislative Update). Under the new law, contributions to the social insurance system for employees with salaries above a certain ceiling (currently VND 9.0 million) will be reduced. The new law will also affect other areas of social insurance such as maternity benefits.

Companies should review the impact of the changes on their business objectives in Vietnam and within the framework of their global remuneration philosophy.

How can the finance director go snorkelling in Nha Trang?

She probably can. Supplementary retirement plans are virtually non-existent at the moment. She should not forget to book the liability for termination indemnities on the balance sheet.

Find your zen

Despite the extraordinary growth in China and India, Southeast Asian countries continue to attract significant foreign investment. As we have seen in this article, the region is very diverse, with different retirement frameworks and practices as well as rapidly changing legislation. With the exception of the Philippines, one common factor is the clear trend towards defined contribution plans. Before the HR and finance directors can quietly crash on a white sandy beach of Southeast Asia, there are still plenty of issues to consider.

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Pension Protection Act of 2006: The dust is settling

by Bruce R. Nordstrom, ASA, EA, MAAA

With last October's passage of the Pension Protection Act of 2006, long-anticipated pension reform finally became a reality. Echoes of this reality have caused a great deal of consternation for pension plan sponsors across the US and a serious review of their retirement program options. The new pension funding laws, combined with changes to pension accounting under Statement of Financial Accounting Standards # 158 (SFAS 158) have sent pension thinkers back to the drawing board to determine the best ways to manage their pension plans. This article will address where plan sponsors find themselves now, how they got there and where they may be going.

"The most visible effect of the new funding rules will be on the sponsor's cash contribution requirements…"

The first step in absorbing these changes is to understand their impact on plan provisions, plan sponsors, employees and other interested parties. The most visible effect of the new funding rules will be on the sponsor's cash contribution requirements, but the legislation will also affect how benefits may be provided to participants in poorly funded plans and to certain executives of organizations sponsoring those plans. Sponsors entering into collective bargaining will also have to take the new rules into account, because the funding requirements, cost recognition and other implications for benefit improvements have changed.

With this in mind, most plan sponsors and their actuaries are conducting stochastic and scenario-based projections to determine changes to funding requirements and accounting entries. Many pension plan sponsors are also reviewing their funding and accounting policies, as well as their investment and benefit policies, looking for the most effective financial management of their plans.

"The new rules replace the prior pension funding rules, which were more complicated than directing the London Symphony Orchestra by telegram…"

One of the biggest effects of both the new funding law and the new accounting rules is that the inherent volatility of pension plan costs is being unmasked as the laws and standards move into an era of unprecedented transparency. Before the recent changes, pension plan sponsors could legally defer pension plan contributions for years while the plans' funded status deteriorated. The legislation eliminates many of the smoothing mechanisms that concealed pension plan reporting and the techniques that allowed long-term deferral of plan funding. The new rules replace the prior pension funding rules, which were more complicated than directing the London Symphony Orchestra by telegram, with a single set of relatively simple funding rules. Likewise, under prior financial accounting rules, sponsors could maintain unrecognized gains and losses (mostly caused by experience that did not meet expectations) in off-balance sheet arrangements, thus protecting their balance sheet from full recognition of these liabilities. This technique has also been eliminated, and the smart money expects annual expense to undergo a similar transformation in which changes in a plan's funded status would be immediately recognized as expense for the plan.

The new funding rules are characterized by a long phase-in, while most of the new accounting rules for balance sheet entries are effective almost immediately. The new accounting rules for determining annual expense will probably be hammered out over the next few years before they become final. But one thing is clear: by sometime around 2010 or 2012, we can expect to have a great deal more transparency in the way pension plans are funded and in the way the accounting expense and balance sheet entries for pension plans are determined.

Plan sponsor financial reactions to the changes thus far fall across a continuum, which can be segregated into four broad schools of thought.

- Plan sponsors who have (temporarily, we hope) decided not to change their asset allocation or other aspects of their retirement financial management to accommodate the changes in the world around them. But this view is losing currency, and most plan sponsors are moving towards a view that the equity exposure in their pension plans must be reevaluated. The prevailing wisdom is that the new funding laws and expense rules will tend to punish, or at least no longer reward, plan sponsors who take on high equity risks in their pension plans.

- A moderate number of plan sponsors are going further and are taking steps to minimize interest rate risk through hedging techniques such as swaps and derivatives.

- A small number of plan sponsors are adopting a strategy to implement a full cash flow-matched investment portfolio. This can be accomplished by investing in a series of no risk or low risk bonds, either corporate or Treasury bonds, realizing a cash flow stream from these bonds that duplicates the cash flows expected from the pension plan. This will eliminate a large portion of the risk that is inherent in the pension plan.

- Many plan sponsors are considering closing their defined benefit pension plans, either prohibiting new participants or eliminating benefit accruals altogether, with the intention to terminate these plans when financially feasible. Generally, this change includes adoption of or enhancements to a defined contribution plan. This response to the increased scrutiny of pension plans on balance sheets and the increased pressure from the financial markets to generate stable earnings is unfortunate, in that the cost of providing a dollar of retirement income increases, but it is also unsurprising. Defined contribution plans offer predictable costs and have a growing appeal among plan sponsors. Interestingly enough, the scenario testing and stochastic analysis that many plan sponsors are performing to understand and predict what the new rules will spawn do not necessarily indicate that contributions are going to be more volatile, or that freezing the plan will lead to an immediate increase in stability.

While contributions will likely be higher, and funding requirements are likely to continue further into the future before plans becomes fully funded, the volatility in those contributions is generally not more significant than

under the old rules. But there are cases in which the contribution volatility does tend to increase, especially for plans that are severely underfunded or for those that in prior years targeted their funding to avoid certain penalties, such as additional other comprehensive income, or PBGC premiums.

The next step in absorbing these changes is to address the new rules strategically in light of overall business goals. If they have not already been completed, stochastic and deterministic projections of funding and expense results under the new rules are the first step. An analysis of these results including whether plans will be classified as underfunded ("at risk") under the new law and the effects of this classification should be next.

After reviewing the four pension policies (funding, accounting, investment and benefit) of financial management, plan sponsors must then be prepared to alter them to produce optimal results for their pension plans.

Responses to the new rules may vary widely, based on each plan's funded status, the sponsor's attitude towards retirement benefits, and the financial position of the plan sponsor. Such changes may include varying the plan's benefits structure, including freezing participation or benefit accruals, adopting more appropriate or more dynamic investment policies, varying funding contributions beyond the required minimum to produce smoother contribution requirements, and changing accounting policies with the intention of having similar effects.

The end result of these changes should make the true cost of benefits more visible and therefore easier to understand and manage.

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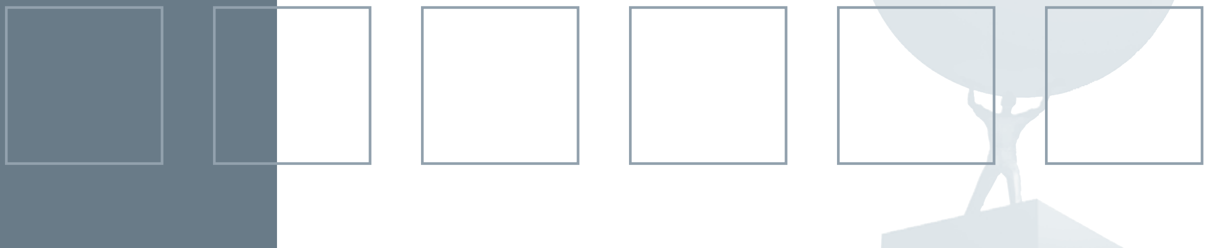

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