

## A Global Approach to Pension Governance

By John Por & J. Bradley Walsh

# A GLOBAL APPROACH TO PENSION GOVERNANCE

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In most of their operations, multinational organizations have adopted a global perspective, applying uniform management principles in all subsidiaries. However, the same rigour is not always applied to the governance of the pension arrangements of subsidiary companies. By investing in a global best-practices system of pension governance, pension managers can earn high returns for their organization and kudos for themselves.

As globalization evolves from concept to application, large multinational corporations and conglomerates have become more successful than ever at competing and manufacturing within any marketplace throughout the world. These organizations attribute their success to a well-defined global perspective. In maintaining this focus, they apply a consistent and uniform system of management to the entire organization, no matter where a particular operation may be located.

Yet for many multinationals, this global perspective does not extend to their pension arrangements. Instead, responsibility for employees' pensions is delegated to local managers, who may or may not have the necessary expertise to do the job effectively. Why does this happen, and how does it affect the corporation?

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## CULTURAL DIFFERENCES

Considering the cultural and professional differences between one country and another, it's not surprising that the pension arrangements of different subsidiaries of the same multinational hardly resemble each other, especially if they're governed independently of one another. Nor should it come as a surprise that all subsidiaries operate their pension arrangements differently than does headquarters. Without a global governance framework to coordinate their pension arrangements, multinationals are influenced by the practices of the local culture of each subsidiary.

The most common differences involve a number of key elements.

*Unique managerial cultures.* We know from experience that companies based in one country are managed differently than those in another and that these differences extend to the subsidiary's pension fund. However, like other functions in which local management culture is integrated with headquarters practices, the principles applied to governing a subsidiary's pension fund should be integrated with the organization's global best practices.

*Investment knowledge and experience.* In many countries, only a rudimentary framework may exist for establishing and maintaining a pension arrangement and the individuals who manage the pension plan may have only a basic understanding of the principles and objectives of sound pension governance. In a few countries, with more sophisticated and better-established pension environments, individuals receive a much more thorough grounding in the nuances of governing a pension arrangement..

## A Global Approach to Pension Governance

By John Por & J. Bradley Walsh

*Investment philosophies.* Pension managers located in different countries may interpret the same set of guidelines differently. The concept of prudent investing, for example, means one thing in the United States and quite another in the UK or The Netherlands. Common legal, accounting, investment and auditing terms may also have different meanings in different countries. Without a clear definition of terms, each subsidiary will take a different direction in governing its pension arrangements.

*Investment sophistication and strategies.* Pension arrangements have evolved at different rates across the world, as has the investment management of these arrangements. In countries with longer evolutionary periods, pension managers of local subsidiaries tend to be better trained and more experienced, operate within a more developed legal, investing, and accounting frameworks, and have better access to expert support. In contrast, pension managers of subsidiaries in countries that have not yet undergone a lengthy evolution, tend to manage the plan on a part time basis and therefore, tend to have less technical and strategic expertise. In addition, these managers tend to have less access to highly competent professional services in order to manage and optimize the operations of the pension arrangement.

*Available resources.* In countries with sophisticated pension arrangements, subsidiaries have little problem finding skilled employees, consultants and professionals to attend to the monitoring, reporting, auditing and legal aspects of governing a pension plan. In addition, because executives understand the importance and requirements of sound pension governance, they allocate resources to these functions accordingly. In other areas of the world, however, skilled professionals may be in short supply and pensions may be administered haphazardly by individuals who lack the time or resources to dedicate to the task.

*Relative significance of the pension arrangement.* In the United States and other industrialized countries, assets held in corporate pension arrangements have grown at a steady and impressive rate for the last two decades. In most mature US organizations, pension-related assets are now similar in size to the assets of the core business; and their impact on the bottom line is becoming more significant with each passing year. As a result, senior corporate managers have recognized the importance of sound pension administration and risk management; they have devoted the resources required to monitor and manage pension-related risk and to achieve consistently high performance in their pension portfolios. In other countries where pensions do not hold significant assets and therefore have less impact on the core business, they are given far less attention by senior management.

*The importance of market and investment risk within the pension arrangement under differing legislation.* With the trend toward defined contribution pension arrangements, in which individuals make their own investment decisions about their pensions, organizations are delegating investment risk to their employees. In return, however, these organizations incur two other types of risk:

*Market risk.* If capital markets don't perform according to employee expectations, large numbers of employees will not have adequate retirement incomes and will remain in the workforce.

*Legal risk.* If their retirement income is deemed inadequate, employees may launch legal challenges against their employers as they look for deep pockets to top up their pensions.

Subsidiaries in different countries operate within different regulatory frameworks, so each subsidiary will have to address the market and legal risks differently. Nevertheless, when a corporation introduces a global pension arrangement, these risks must be evaluated carefully. There are countries in Europe, for example, that take a very protective stance on employee rights. Accepted practices in the United States may not be acceptable in these countries. Corporations have to work closely with their local legal.

## **A Global Approach to Pension Governance**

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departments in defining an acceptable legal framework for pension governance, and the risks have to be managed and monitored closely.

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### **MISSED OPPORTUNITIES**

Multinational organizations understand that subsidiaries in different countries operate under different accounting, legal, actuarial and professional practices and standards. In managing other parts of the business, these organizations try to minimize the impact of such differences by developing and following consistent principles. However, we have found that, when it comes to pension governance, they often abandon this consistency. Instead, pension plans are governed according to the demands of the subsidiary's particular location, and the potential efficiencies of a global approach to pension governance are ignored. In the process, multinational organizations are missing a significant opportunity to achieve the best performance possible from their subsidiaries' pension plans.

The implications of this missed opportunity become apparent in answering two questions:

- ❖ Would there be any advantages to establishing a global governance framework?
- ❖ What would this process look like?

We will now consider each of these questions in turn.

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### **ADVANTAGES**

A global framework for pension governance leads to enhanced performance, primarily because best practices are identified and applied throughout the organization. It has been shown, for example, that good pension governance can contribute an additional 50 to 100 basis points to investment performance in countries with well-developed capital markets. We believe the impact of good pension governance is even higher for pension assets managed in other countries.

On a less tangible but equally significant level, a global framework for pension governance ultimately develops skills and competencies throughout the organization and raises the level of investment sophistication among finance and HR executives and pension managers, no matter where they are located.

Because each subsidiary becomes better equipped to govern its pension arrangement under a set of universal and consistent guidelines, multinational organizations mitigate their pension-related legal liability. In the process, organizations make better use of their resources.

Likewise, in introducing a global framework where subsidiaries operate according to the same general principles, they are much less reluctant to share information about pension issues and are no longer intimidated by cultural differences. They understand clearly the governance principles involved in managing their pension arrangements, and they know that information that contributes to their own.

## **A Global Approach to Pension Governance**

By John Por & J. Bradley Walsh

management performance will do the same in another part of the organization. In the process, increased communication enhances understanding and enriches the skills of managers and executives throughout the company.

As pension managers enhance their skills in administering pension arrangements within a clearly defined global framework, they become much more mobile. By sharing a wealth of common pension-related knowledge, pension managers, for example, could more readily move from one subsidiary to another when necessary.

Meanwhile, most human resources professionals currently face the task of overseeing and reporting to top management on their pension arrangements. If each pension plan within an organization operates within its own framework this presents a difficult challenge. As organizations adopt global governance systems, HR professionals can apply similar global strategies to pension governance, simplifying their own jobs and earning well-deserved attention from top management.

Finally, each local pension arrangement operating under global governance will have access to a greater base of knowledge and be exposed to a greater level of scrutiny than it would without a global governance framework. It will, therefore, operate with considerably less fiduciary risk than it would otherwise.

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### **HOW TO DEVELOP A GLOBAL ARRANGEMENT**

Organizations can follow several steps in developing a global approach to pension governance. Senior management must first define the pension arrangement itself. Do they want to structure the system to provide the greatest degree of flexibility to local managers while operating within an established framework that can be easily monitored, measured and updated? Or is there a preference towards customization?

In either case, the framework must be specific enough to mitigate the risk of misinterpretation, and be flexible enough to allow finance executives and pension managers in different countries the ability to oversee their plans in accordance with local regulations and customs. Actuarial principles must be spelled out clearly, for example, so that pension staff throughout the organization operate according to the same fundamental framework. The organization also has to develop a global standard for measuring results and articulating allowable subsidiary deviations from the overall framework.

Before establishing the framework, senior management must clearly define the roles and responsibilities of individuals who will administer and monitor their plans by addressing the following questions:

Who will participate at the local level in managing the pension plan?

How will local pension staff interact with headquarters to maintain the integrity of the pension arrangement?

How will they reach decisions, and how will they execute them?

Who will monitor compliance with the global governance framework and also with the local pension laws and regulations?.

## **A Global Approach to Pension Governance**

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The more clearly these roles and responsibilities are defined, the less chance for misinterpretation.

In developing a global governance arrangement, headquarters staff may have the critical and detailed knowledge required, but they have no monopoly on good ideas. For example, we worked recently with a large multinational corporation, whose US headquarters adopted best practices first developed at its U.K. and Canadian subsidiaries. As this company realized, the success of a global pension arrangement requires the application of best practices, wherever those practices are found.

Senior management also have to develop a risk-management framework, especially in case of a defined contribution arrangement. They must identify the key risks inherent to the pension plan, establish a global approach to measuring and quantifying these risks, and set limits on allowable risk exposures. In the process, senior management also have to determine who will have authority within the organization for managing risk. Otherwise, without appropriate guidelines as to risk, it will be difficult for pension staff to design and implement an investment program that corresponds to the level of risk-taking desired by pension managers. For example, the decision to include or not include actively managed investment alternatives will have a dramatic effect on the DC investment program's risk profile.

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### **TRAINING AND SKILLS**

The success of a global pension arrangement depends, to a large extent, on the quality of the individuals who manage it. Therefore, it is paramount that the corporation, as a whole, trains and maintains a skilled staff of pension managers. A potential role of Headquarters could be to facilitate the development of a such a skilled staff. Headquarters usually has the resources and personnel to run such a program and is usually in the optimum position to determine best practices and apply them to all subsidiaries. Such best practices must be documented, discussed, and disseminated throughout the entire company, so that the managers of subsidiary pension arrangements can follow them, no matter where they may be located. With a consistent level of skill in pension fundamentals, local personnel can execute more precisely the day-to-day decisions involved in running their pension plan.

A multinational organization has to build a system to monitor compliance with the policies and practices it has put in place, and a reporting mechanism to allow relevant information to flow throughout the organization. A consistent approach to reporting and communicating information will help enhance the exchange of critical pension-related information throughout the organization.

If the organization does not adopt a consistent reporting and communication mechanism, the life of headquarters staff responsible for reporting on these issues becomes intolerable. With one or two dozen pension arrangements around the world operating with no common framework, it becomes very difficult to report on their condition in a meaningful way.

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## **A Global Approach to Pension Governance**

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### **LEADERSHIP FROM HEADQUARTERS**

For a number of reasons, Headquarters must take responsibility for initiating and developing a global pension arrangement. In the first place, headquarters staff usually have a broad perspective on the organization and the detailed pension-related knowledge required to establish an effective system. At the same time, subsidiaries often wish to maintain their independence without realizing the associated direct and indirect costs.

Usually, Headquarters also adheres to the most demanding standards of performance and execution. After all, it is directly accountable to the parent board and other stakeholders in the organization and has the greatest incentive to develop effective global systems.

By the same token, personnel at headquarters have direct access to and influence on senior management and the board of directors. Headquarters staff can ensure the active participation and support of the board and senior management in establishing a global pension arrangement and can obtain the requisite resources for such initiatives.

Since policy development is usually a headquarters responsibility, its staff have experience with these tasks and more resources than other parts of the organization to devote to establishing a global pension arrangement.

Because it often monitors and assesses other global management policies followed throughout the organization, headquarters may also understand and appreciate the validity and potential rewards of a global pension arrangement to the organization and its stakeholders.

A clearly defined pension framework ensures productive communication between subsidiaries and headquarters. Ultimately, of course, the organization's parent board of directors has overall responsibility for its governance arrangements. Directors should understand that a global pension framework contributes not only to better pension results, but to more effective corporate governance, as well.

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### **CASE STUDY**

We conclude with a case study. During a recent review of the pension governance practices of a multinational company, we discovered a number of inconsistencies that affected the performance of the pension plans of its subsidiary, as follows:

Each subsidiary adhered to a distinctly different decision structure. For example, in some cases, staff members selected investment managers and a custodian, while in other cases these decisions were made by the board.

The composition of the pension committee, hence the available knowledge and experience, varied from one subsidiary to another. In some cases, executives were responsible for overseeing their own performance or approving their own recommendations in pension-related matters.

Subsidiaries applied a different set of fiduciary education and orientation practices than the others. These practices ranged from comprehensive and formal to non-existent. As a result, the sophistication of each subsidiary's investment program also varied greatly.

## A Global Approach to Pension Governance

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Without a common philosophy among subsidiaries, the development of pension-related policies varied from one to another. The rigour with which these policies were developed and applied was also not consistent, resulting in poor performance and significant finance staff turnover.

When pension managers reported to the board and to their Pension Committees, they prepared vastly different types of reports. Some prepared detailed and comprehensive written reports; others presented their reports verbally. Due to these inconsistencies, remedial actions were late to follow.

There were differences in the operating practices of the Pension Committees of subsidiaries. Some met monthly; others, quarterly. Some prepared the minutes of each meeting; others didn't.

Having conducted the review, we then set out to determine why such differences existed. Could they be explained by different regulatory environments or by the scale of the pension plans involved; or was there some other factor? We discovered that these factors certainly played a role, but the main reason for the discrepancies in pension governance here lay primarily with the organizational culture of the subsidiaries. Adhering to the management style of the particular country, some subsidiaries were simply far more rigorous than others in managing and overseeing their pension arrangements. As it turned out, the subsidiaries that applied the least amount of rigour were those with the greatest amount of assets under management.

Company headquarters undertook the initiative to develop some consistency in approach to pension governance. They developed a governance manual that provides guidelines and principles for implementing a global approach to governance. The manual also includes a detailed mechanism for pension monitoring. The manual contained 'best practices' from at least three subsidiaries.

The guidelines have now been distributed to all subsidiaries, which are expected to adapt them to their legal and market environments according to their size and available resources. Headquarters will provide pension staff training and will monitor compliance and demand required adjustments. All subsidiaries, however, will now be implementing the same pension governance framework, using the same level of rigour.

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