



Case study: Managing the retirement program to facilitate global expansion

Situation

A large US-based global chemical company wanted to expand its presence into Asia Pacific and Eastern Europe to generate profitable growth. Some of this expansion would involve adding capacity to existing product lines, but much of it would be focused on developing new product lines, representing a horizontal integration strategy for the company. To accomplish this, considerable local country hiring would be needed, but the company also wanted to transfer mid-career US and UK engineers and key managers. Financially, the expansion would require considerable borrowing, and because the company's pension plans were considerably underfunded, the company was worried about what any new debt would do to its credit rating. So it turned to Mercer for help.

Challenge

To facilitate the necessary employee transfers, the company would first have to address some retirement plan issues. The company had maintained a final pay pension plan in the US and the UK throughout its history, and many engineering and management employees were reluctant to take global assignments without full pension replacement – a complex and costly proposition that the company wanted to avoid. Further, because the plans' aggregate unfunded liability was approaching 50 percent of the company's shareholder equity, any new debt incurred for the expansion could trigger a credit downgrading in the future. To address these critical issues, the company decided that it needed to redesign its retirement program, shifting from a defined benefit (DB) to a defined contribution (DC) plan in both the US and the UK. It also determined that it should accelerate the full funding of the plans and lower the risk of large unexpected contributions in the future since this could easily trigger a credit downgrade. So the company needed to look at three key pension policies in combination: design, funding and investment allocation to fully manage the retirement programs costs and risk.

Action

Mercer conducted a thorough competitor and employee analysis to assess the impact, both externally and internally, of freezing the current retirement plans and of moving to DC plans. Our research revealed that longer-service employees were counting on the retirement program and would feel disenfranchised and bitter against the company if their plans were terminated. In contrast, mid-career employees valued the program, but could accept a new program that was viewed as fair and equitable. At the same time, extensive financial analysis was completed to determine the ultimate cost impact of fully funding the current unfunded liability and changing to a "liability driven" investment strategy, which would have the desired result of maintaining full funding and avoiding unexpected contributions in the future. This analysis showed that the operating cost of the new DC program would be somewhat lower than that of the DB plan; that past service cost of the DB programs would be slightly increased as a result of lower expected investment return; and that the risk of significant fluctuations in funded status, and therefore contributions, would be largely eliminated.

Results

To move forward with the expansion, the company decided to freeze future benefit accruals for all current employees in both countries (except for those with at least ten years of service and within five years of early retirement eligibility) and close pension plans to future employees. The DC programs in both countries were enhanced to guarantee annual contributions equal to a fixed percentage of pay, depending on service. This retention of DB benefits would address the potential morale issue with older employees, and the replacement of DB with DC plans removed the requirement of pension replacement for mid-career employees to accept the much-needed global transfers. The company set its contribution policy to increase funding status from 82 percent to 100 percent of past service liability in two years. And it dramatically altered its pension investment policy to substantially reduce equity exposure and to hedge 100 percent of its interest rate and inflation risks through an increase in long-term fixed-income assets in conjunction with a notional swap overlay. The net result of the changes in design, contribution and investment policies was cost neutrality for the new program, but with an overall lower enterprise risk level, which was viewed as favorable for shareholders and beneficial for the company's global workforce strategy.

Investment advisory services provided by Mercer Investment Consulting, Inc.