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Pension plans have a growing impact on a sponsor's books, so they must be managed more thoroughly.

Managing a defined benefit pension fund nowadays is about more than setting, implementing and managing investment policy. Corporate sponsors are increasingly being forced to regard their pension plans as though they were operating subsidiaries. In many cases, the pension plan is now larger than some active business units and has more of an impact on the bottom line. Even in situations where the pension plan assets are small relative to the plan sponsor, variability of contributions or pension expense can be one of the larger swing items in the sponsor's books.

This means management needs income statement, free cash flow and balance sheet measures that integrate the pension plan into the corporate financial structure, plus more sophisticated tools to keep the plan's contribution and expense volatility within acceptable limits.

The first step in constructing an appropriate financial framework is to understand the metrics used by external stakeholders to assess the company's performance and assess whether the pension plan could compromise the performance commitments provided to these groups. This includes understanding how a parent company assesses performance of subsidiaries and the consequences of failing to meet those targets. Next comes strategic and financial goal setting, short and long-term. It is necessary to explore the key factors that drive each goal and which of those factors can be controlled or mitigated through conscious action. In addition, you need to understand the company's targets for operating profit and free cash flow generation as well as how capital expenditures are planned and their importance to the future of the company. This provides a clear context for managing the pension plan within the corporate framework.

The third step is focused on the debt structure of the balance sheet. Financial analysts and rating agencies have already been consolidating pension debt with

other long-term debts of the corporation to assess interest coverage and financial leverage. Impending changes to accounting rules will make this even more obvious. However, the corporate debt structure could provide a natural hedge for pension plan interest rate risk if corporate debt is primarily variable rate debt.

In the fourth step, the plan's financials are consolidated with the company's operating statements. How material is the pension plan? To what extent might it swing free cash flow, operating profit and employee costs? For example, a test of the impact of a 10% fall in assets or rise in liabilities on nine large public sector plans revealed the impact on annual payroll costs (assuming 15-year amortization of the experience loss) varied between 3% and 12% of annual payroll cost. Expect the impact on mature corporate plans to be similar.

Step five is to integrate the pension plan into the company as a financial subsidiary, identifying and understanding the economic factors that drive pension costs and linking those factors back to the impact they have (if any) on the company's operating results. These could include interest rates, price inflation, the economic cycle and often currency exchange rates. To the extent that the corporation's business is sensitive to one of these factors it is much more important to carefully manage the pension plan exposure to that factor. This brings us to the sixth and, arguably, the most important step, determining where, if pension expense or contributions were to increase, the money would come from.

These six steps provide the understanding and data required to develop limits for the acceptable level and variability of pension contributions and expense as well as the balance sheet impact. With these limits in mind, we can then allocate pension fund assets between those that match liabilities and those that offer the added return needed to keep the plan sustainable. We can also consider ways to optimize the return on each asset category and to improve the pattern of returns from financially risky assets. ■