Pension alliances: deal breakers for deal makers

Paul Boerboom explains what lessons can be learnt from the Netherlands

The pension world has been subject to a high level of change. Mergers, pension buy-outs, fiduciary alliances, out-sourcing and in-sourcing are becoming common aspects of the organisational design of pension funds.

There is a risk however that most alliances with external parties will fail to yield the desired results. The most common obstacles in building (fiduciary) alliances can however be avoided.

The trend towards consolidation

In his recent book, *Pension Revolution*, cutting-edge pension thinker Keith P. Ambachtsheer concluded that the Dutch are leading the way in "Winning the Pension Revolution".[1] He mentions three main drivers: the Dutch culture, which is geared towards getting a better pension system, the country's compactness, which facilitates these efforts, regulatory leadership and innovative research into the economics of pension contracting.

Ambachtsheer identified one important remaining challenge, which is "solving the organisation design puzzle" and invited other countries to keep up with the Dutch as they tackle the challenge of building more effective pensions organisations.

The pension system in the Netherlands is the outcome of a century long historic development. Despite its relative old age, according to today's standards, the present system looks at first glance remarkably modern. The Dutch pension system is a three-pillar system and is partly based on pay-as-you-go and is partly capital funded. Therefore, it meets the standards propagated by the IMF, the World Bank and the EU. After 35-40 years of paid work, workers are in general eligible for a pension covering 70% of the last earned income. Dutch pension funds have assets of approximately €650bn under management, representing over 120% of GDP (highest rate in OECD region).

Contrary to many OECD countries, the Netherlands until very recently didn't feel any need to reform its pension system. The reigning idea has been that the Dutch pension system was one of the best in the world, mainly because of its relative well-developed first and second pillars.

The relative political tranquility around the pension theme has been broken in the aftermath of September 11, 2001. One of the consequences of September 11 was a hampering of the world economy, also causing severe losses on the international stock markets and increasing inflation. Both developments caused direct financial strains on pensions.

> "The question is whether the smaller and medium sized funds continue to get sufficient attention within a strategic alliance, where they become the "little bird riding on the shoulders of the elephant"

These events resulted in a series of stricter regulatory measures regarding minimum required funding ratios, compliance standards and risk control of pension funds, pension governance and external stakeholder communication. Furthermore the accounting standards regarding pensions changed (IFRS, IAS 19).

The combination of market volatility, scarce professional knowl-edge, stricter regulatory standards and increased demands on proactive and transparent communi-cation to stakeholders have resulted in the fact that pension directors and trustees are increasingly re-thinking the effectiveness of their pension plans, organisations and investment portfolios.

This re-thinking of pension organisations has led to a remarkable decrease in the number of pension funds with almost 25%, from 1038 in 1998 to 792 in 2006, as is illustrated in the table on the right..

Industry experts expect this trend of consolidation to continue over the coming years, with an increasing number of DC schemes, pension buy-outs, pension mergers and strategic alliances with fiduciary managers.

In working with our clients we have found various reasons why pension trustees and directors are re-thinking their organisations and consider further consolidation and alliances with external parties:

- To benefit from economies of scale (buying power, asset pooling)
- Organisational continuity.
- Access to talent and knowledge
- Access to scarce investment strategies around the globe.
- Innovative power.
- Improve the quality of the advisory role to the fund's board.
- Manage the investment portfolio on a more continuous and pro-active basis.
- Improve performance by including diverse sources of return
- Improve the quality of reporting and risk management
- Continue to fulfil requirements from the regulatory bodies.

A recent survey by KPMG suggested that 70% of the pension funds which participated in the survey have outsourced part of their investment activities.

Table 1: Dutch pension market

	Total	Company	Industry wide Compulsory	Industry wide Optional	Professional	Other
1998	1,038	934	68	17	11	8
1999	1020	916	67	19	11	7
2000	988	881	71	18	11	7
2001	963	856	70	19	11	7
2002	939	822	76	22	11	8
2003	921	799	80	23	11	8
2004	860	738	80	23	11	8
2005	831	707	83	20	12	9
2006[3]	792	669	81	22	12	8

Source: Registers DNB en Pensioenmonitor

Organisational re-design and strategic alliances: towards a high performance culture

With the further adaptation to new market circumstances, the Dutch market is undergoing a further wave to increase professionalism, however, as Ambachtsheer recalls, "the vast majority of pension funds have not consciously set out to build a high-performance culture"[1]. He mentions that "the governance and organisations design structures that implement most "pension deals" are ineffective, if not downright dysfunctional. Simply put, without significant scale economies, pension plans cannot deliver "value for dollars" to its shareholders:

1. The unit costs of the plan's investment and pension administration "businesses" will be too high to be "competitive".
2. The plan cannot afford to assemble the necessary nucleus of internal expertise to effectively manage the investment and pension administration "business". "Such internal expertise is needed even in cases which operational investment and administration outsourcing strategies are employed".[1]

In order to find a high performing organisation which is set to fulfil the long term goals vis-à-vis all stakeholders, an important challenge is to find the optimal balance between standardisation and cost effectiveness (operational excellence) on the one hand versus customisation and flexibility (customer intimacy) on the other. Whereas some processes, like administration, can and should be standardised, other processes, like investment and risk management, require a more tailored approach.

Whilst the arguments behind the trend of consolidation and outsourcing, with the creation of alliances, are clearly valuable, the question emerges whether Big is Beautiful" in all cases? To what extent can the sole argument of scale be associated to a high performance culture? Recently various mega-alliances were formed in the Dutch marketplace (like ABP and Cordares, and the industry pension funds for metal workers). The question is whether the argument of increasing economies of scale still applies when one turns an "elephant" into a "mammoth".

The creation of large "elephants" or even "mammoths" with low unit costs, high levels of operational efficiency, high negotiating and buying power in various markets and access to scarce investment resources and opportunities is an appealing perspective. The question is whether the smaller and medium sized funds continue to get sufficient attention within a strategic alliance, where they become the "little bird riding on the shoulders of the elephant".

Warnings from the world of M&A and strategic alliances

More and more external parties are offering a wide range of asset management, investment and risk management solutions and ancillary solutions. The pension trustees have to find their way in this labyrinth and decide on the most appropriate organisation design and possible alliances with external parties given their specific objectives and preferences.

Decision-making processes in building strategic alliances tend to have a momentum of their own. Growing participant commitment, euphoria and overconfidence of decision-makers often lead to incomplete analyses of potential candidates or overestimation of the potential benefits.

Is this what we have been witnessing in the Dutch pension arena over the past years? Some pensions funds start various forms of external partnering like fiduciary management, without overseeing all consequences. Most participants have a professional background in the industry, such as portfolio managers, investment consultants, and actuaries, but don't have the experience to manage the change process into a strategic alliance.

A few years ago McKinsey has shown in a study that 67% of alliances have serious problems in first two years, due to cultural conflicts, changes in the environment, bad organisational and cultural fit between partners, bad strategic fit, lack of trust, lack of alignment and bad management of interfaces, lack of stakeholder support, lack of consistency with the "larger whole".

Research shows that decision-makers and their consultants tend to give disproportionate attention to 'hard' measurable issues (i.e. to strategic and financial data). In the pension arena still traditional ways for selecting external managers are applied to designed strategic partnerships. Organisational issues tend to be postponed to the implementation phase in the belief that these can be solved after the contractual phase. This is exacerbated in cross-border deals and deals between large and small companies, with parties coming from different cultural and business environments.

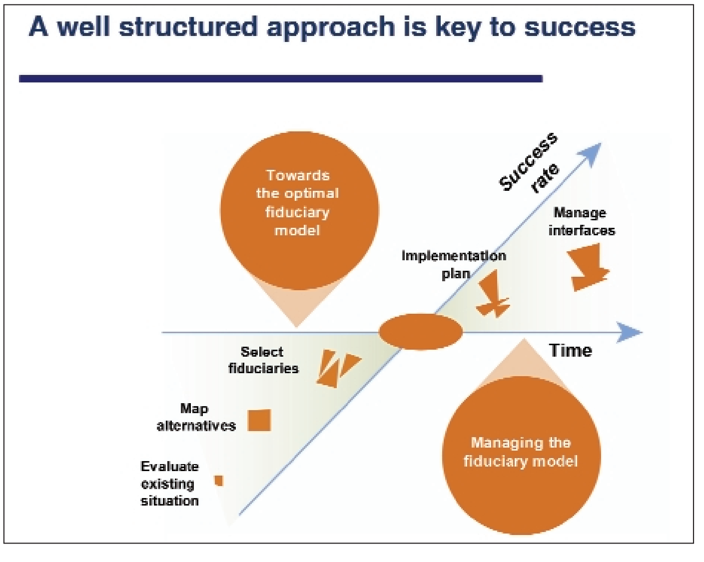
This is particularly relevant in case of fiduciary alliances with foreign players and alliances between small pension funds and big conglomerates. Smaller funds risk losing control over their own destiny if they don't keep a critical nucleus of internal local competencies. Wharton University of Pennsylvania's research on effectiveness of alliances shows that success can be explained by "Relational capital" in mutual respect, trust and knowledge of each other's businesses.[2]

In summary three elements are key to any successful deal making process: the strategic fit, the organisational and cultural fit and the implementation plan .

The high performance culture, as mentioned in the excellent book by Ambachtsheer, is certainly not an utopia. In the search for the optimal organisation, with the appropriate balance between internal resources complemented with well designed external partnerships, we invite pension trustees and directors to take into account the a few lessons which can be learnt from managers and directors who have faced similar challenges:

- The board of trustees stays responsible. Key questions are: can we explain the model to our stakeholders? Do we understand all risks involved? Do we keep sufficient knowledge in-house with sound checks & balances; Is the implementation properly planned?
- Build in sufficient flexibility to be able to manage the organisation in a dynamic way and verify the robustness of the organisational set-up under different scenarios which might unfold. What if regulatory environment changes? What if the pension deal changes?

A survey of MIT Sloan (200 businesses with 1572 alliances) has shown that the success rate of an alliance with an external party increases after 2 years from 40% to 75% if a specialist role in building and implementing alliances is used, with a structured approach, as per the diagram on the left.



[1] *Pension Revolution, A solution to the Pension Crisis. Keith P. Ambachtsheer*

[2] *Source: Prof. Harbir Singh Wharton University of Pennsylvania 2003, Managing Strategic Alliances to Achieve Competitive Advantage*

WRITTEN BY
PAUL BOERBOOM, MANAGING PARTNER OF AVIDA INTERNATIONAL