

PODCAST
PRESENTATION

**CROSS-BORDER PENSION POOLING HELPS MULTINATIONALS
MEET THE CHALLENGE OF GLOBALIZATION**

HOST: The trend toward worldwide integration of markets for goods, services and capital is transforming the global economy. Multinational corporations, key contributors to the forces shaping globalization, are expanding their global reach, as opportunities in emerging markets justify a presence, representative offices gain traction and become branch offices, and branches and subsidiaries evolve into regional headquarters. This expansion increases the complexity of managing pension plans across multiple regulatory regimes. Multinationals and investment managers who have interest in meeting the challenges of globalization will be interested in how Northern Trust has developed an innovative approach to cross-border pension pooling, offering clients a unique solution to their needs.

As multinational companies grow in size and breadth, pension managers need to establish effective governance and risk management processes for substantial and growing assets across an increasing number of countries that differ in legal structure, regulation and market practice. To meet this challenge, innovative corporations are building global pension platforms that enable them to execute global strategies and rapidly adapt to changing circumstances. They use cross-border pension pooling to aggregate the assets, in order to gain efficient oversight and economies of scale. In this podcast, Kathy Dugan, senior vice president and product manager within Northern Trust's Global Institutional Product Group, examines the challenges, solutions and future trends of cross-border pension pooling.

Kathy, begin by telling us about the challenges that multinational corporations have faced in the past in managing their pension plans?

KATHY: In the past, decisions on pension plan structure, asset allocation, investment mandates and investment manager choice were all made at the local level. This structure is costly, risky and inefficient. Consider, for example, a "typical" multinational with funded pension plans in 25 different countries. Each plan will need a trustee board to evaluate asset/liability strategy, determine asset allocation, design mandates, select managers and conduct regular due diligence reviews. Smaller plans frequently lack trained pension professionals to provide pension asset oversight, so multinationals increasingly have appointed dedicated staff, charged with global pension oversight, who advise on best practices, set global standards, consult on decisions and serve on local boards. While this practice helps headquarters gain better understanding and control over pension assets and



liabilities worldwide, it does not address the inherent inefficiencies of the process. While many of these decisions (asset allocation, for example) need to remain local, others (such as investment manager selection and monitoring) can benefit from centralization.

For example, all subsidiaries in the previously mentioned plan will likely need global equity exposure. If all decisions are made at the local level, then the company will undertake 25 different investment manager selection processes. Moreover, most of the smaller plans will have insufficient scale to diversify across managers and will pay higher fees.

HOST: And how have Northern Trust and multinationals tried to address these issues?

KATHY: Multinationals have tried to address these issues by negotiating global relationships with large investment manager firms. Headquarters selects investment managers with broad global distribution who agree to provide relationship pricing (reduced fees to small plans, in recognition of sizeable mandates under management for larger affiliated plans). Subsidiaries then select from among the list of recommended investment managers. While this practice ensures that headquarters is comfortable with the due diligence process for manager selection and addresses some of the cost issues, it substantially restricts the investment manager candidate pool. High-performing boutique investment managers often lack global distribution capabilities. Other managers have proven unwilling to negotiate substantial cost reductions because they retain the costs of managing separate client relationships and potentially separate accounts for each of the subsidiary plans. Moreover, a decision to terminate a manager will still be difficult and time-consuming to implement as a separate process needs to be followed in every subsidiary country.

HOST: What is perceived to be the ideal solution?

KATHY: Ideally, multinationals want to create a global investment platform, pooling assets from subsidiary plans worldwide. By centralizing the decision-making process, they can concentrate investment expertise across the organization on defining investment mandates, selecting managers and monitoring risk and performance. They can effectively execute on investment strategies, quickly adapting to changing circumstances. Consolidating assets achieves real economies of scale, reducing transaction costs and manager fees. Small plans gain access to best-in-class managers, manager diversification and exposure to alternative asset classes.

HOST: What steps have been taken thus far to initiate global investment platforms?

KATHY: As early as 2002, two leading multinationals took the first steps toward creating global investment platforms for worldwide plans. Initially, growth was slow because withholding tax issues limited the asset classes that the platform could accommodate. New investment vehicles and new techniques in fund administration emerged to address these issues. These programs “took off” in 2005, reaching substantial scale as the initial innovators expanded their existing programs and other “early adopters” launched global investment platforms. Northern Trust currently supports \$20 billion in assets in cross-border pooling platforms.

HOST: What is the key to a successful global strategy for pensions management?

KATHY: Great question; the key to a successful global strategy for pensions management is the right balance between centralization and local control. Each subsidiary faces unique liability and funding challenges; pension regulations and market practices are country-specific. For these reasons, asset allocation decisions usually remain in the hands of local trustee boards who decide whether to invest in the multinational investment platform, which asset classes to select and in what proportion. Research suggests that asset allocation determines 90 percent of performance, so it makes sense for subsidiaries to focus their attention there.

HOST: And Kathy, what can you tell us about the advantages of a global investment platform?

KATHY: A global investment platform, sponsored by the multinational on behalf of its subsidiaries, promotes administrative efficiencies, reduces overall costs and ensures professional implementation of strategic asset allocation decisions. Headquarters establishes an investment committee to decide which mandates to offer within the platform, determines the vehicle structure, sets investment policies, selects managers and monitors risk and performance. The platform supports those mandates of interest to multiple subsidiary plans: global equity, global bonds and funds-of-hedge-funds, for example, or more specific mandates based on the needs of the subsidiary plans. Local subsidiaries make arrangements for exclusively local mandates. A Swiss plan, for example, may hold a portfolio of Swiss bonds. The global investment committee may include members from subsidiary plans, giving them a voice in the decision-making process and ensuring effective worldwide communication.

HOST: Why is pooling critical for growing multinationals?

KATHY: Those who continue to manage investments at the local level will face increasing challenges in the face of geographic expansion, growing asset sizes and increasing complexity in investment strategies. For a growing multinational, cross-border pension pooling offers a tool that provides significant benefits in risk management and administrative efficiencies.

HOST: Kathy, what can you tell us about what you call tax-transparent pooling?

KATHY: A tax-transparent pooling vehicle is a key component of a robust global investment platform. In fact, until recently, the withholding tax consequences of pooling presented the chief barrier to cross-border pension pooling. In many countries (the U.K., the Netherlands, Switzerland and Canada, for example), pension plans that invest directly in U.S. equities pay no withholding tax, based on double-taxation treaties with the U.S. Those same plans will pay 15 percent to 30 percent tax on dividends, if they invest through most pooling vehicles. Pension plans were understandably unwilling to invest in any vehicle that required them to pay an extra 30 basis points in taxes. Cross-border pooling wouldn't work for global equities until this issue was resolved.

In 2001, Northern Trust joined two multinational companies, Mercer Investment Consulting and Goldman Sachs Asset Management in a client-led consortium to tackle the problem. The work of the consortium suggested that two tax-transparent vehicles, the Luxembourg FCP (Fonds Commun de Placement) and the Irish CCF (Common Contractual Fund) promised to preserve investors' tax treaty benefits. Implementing these vehicles in practice, however, required substantial additional work.

HOST: And why is that?

KATHY: Multinationals require a vehicle that can accommodate investors from a broad range of countries (our research began with 12) and support investments in a wide range of countries (our research began with 34.) Before a client could implement a robust solution, tax authorities in a number of different countries needed to provide formal confirmation of tax transparency.

These vehicles also require new methods for custody and fund administration. In other types of pooled vehicles, all investors in a pooled vehicle pay the same rate of withholding tax. Multinationals need a tax-transparent vehicle that will apply different rates of withholding tax to different investors. Moreover, a vehicle that is tax transparent for withholding tax purposes is also tax transparent with respect to capital gains. Accurate calculation of capital gains at the investor level is particularly important in those countries where pension plans pay capital gains tax. Some countries (Germany, for example) have stringent regulatory reporting requirements that require detailed tax reporting at the investor level. Securities lending for tax-

transparent vehicles requires a special methodology. Taking all these different demands into account, Northern Trust needed to create a global platform that would satisfy a broad range of local requirements. We created a proprietary system and methodology that is uniquely suited to the administration of tax-transparent vehicles. The key is to record detailed information at the investor level that can then be used as required to meet the demands of local tax and regulatory authorities. Recognizing the innovative nature of our tax transparent pooling solution, Northern Trust applied for a patent to protect our investment in this technology.

HOST: What is the goal of tax-transparent vehicles?

KATHY: Tax-transparent vehicles have attracted a lot of attention in industry conferences and publications because their new features offer promising new functionality for multinationals and fund managers. They provide, however, only one component of a multinational investment platform. A multinational will normally put some assets (global bonds, for example) in a non-tax-transparent vehicle and other assets (for example, global equity) in a tax-transparent vehicle. While they may prefer to support their equity investments in a UCITS vehicle, they will need a non-UCITS vehicle for hedge funds. In some cases, they may choose to launch feeder funds. The goal for a multinational is not tax transparency, or even the launching of investment vehicles, but rather the ability to effectively plan and implement investment strategies. The entire investment platform is a means to achieve that end.

HOST: Kathy, what can you tell us about the role of the custodian or fund administrator?

KATHY: Cross-border pooling requires a close partnership between the multinational client and the custodian/fund administrator. Generally speaking, in creating a pooling vehicle, the sponsor must issue a prospectus for each mandate, report fund NAVs, and conform to the regulatory requirements of the vehicle's jurisdiction. An investment manager who launches a pooled vehicle to attract a broad range of investors normally establishes a Management Company to provide legal oversight and control over the vehicle. A multinational, who establishes the vehicle exclusively to support investments from affiliated pension plans, may ask the custodian/fund administrator to provide Management Company services as well. In each case, either the Management Company or the investment vehicle itself will typically contract with a fund administrator to provide accounting and financial reporting, strike the NAVs, and track each investor's ownership in the fund.

HOST: And what about any additional services required to support these vehicles? What is necessary and how do they factor into the cost?

KATHY: The additional services required to support cross-border pooling vehicles factor into the multinationals' cost/benefit analysis. Economies of scale gained from reduced investment manager fees, transaction costs, and tax drag combined with increased use of commission management and securities lending will counterbalance the additional fund accounting costs.

Multinationals preparing to launch tax-transparent vehicles can benefit from the support of an experienced custodian with specialist withholding tax expertise. A sponsor may need to apply to tax authorities in investor countries for confirmation of tax transparency. A custodian who has obtained such rulings on behalf of other clients can share experience to help streamline the process.

HOST: How does this new, innovative ownership structure affect traditional processes involving securities lending, custody and fund accounting?

KATHY: The unique ownership structure of tax-transparent vehicles requires an innovative approach to securities lending. A borrower who borrows a security from an individual investor or from a non-tax-transparent

vehicle normally pays the investor a manufactured dividend rate equal to the dividend less the withholding tax. When lending from a tax-transparent vehicle the loan is transacted from a legal perspective at the subfund level of the vehicle and you need to recognize the different rates of withholding tax that the investors would pay. Because each investor has a percentage ownership interest in every share of stock, the applicable dividend rate the borrower must pay is a blended rate, taking into account the different rates paid by all the different investors. Moreover, these rates can change as investors contribute or withdraw funds and our process takes these changes into account. Northern Trust has supported securities lending for tax-transparent vehicles at blended rates since January 2005, using a proprietary system.

Tax-transparent vehicles represent a significant market innovation, and they require new approaches to both custody and fund accounting. It is comparatively easy to support such vehicles if all investors have a single tax rate (for example, a single country of investor and a single country of investment). A multinational company, however, needs a broad solution that satisfies the requirements of multiple countries of investor and multiple countries of investment. A multinational seeking to launch these types of vehicles can benefit from the expert assistance of a consultant, tax advisor and custodian who have experience with these new vehicles.

HOST: So what lies ahead in the future for cross-border pooling programs?

KATHY: The success of multinational cross-border pooling programs has attracted considerable attention across the industry and new initiatives are underway to broaden their use.

The Dutch FGR (Fund for Joint Account) is gaining traction as a tax-transparent alternative to the Luxembourg FCP and the Irish CCF. The vehicle is commonly used by Dutch investors only, but some Dutch multinationals, aided by the Dutch Ministry of Finance, are hoping to gain confirmation of tax transparency from tax authorities in other countries. Broad acceptance of the FGR as a cross-border tax-transparent vehicle would enable multinationals to use it to pool assets from subsidiaries across the globe. Northern Trust is working with clients on the launch of FGRs.

Many smaller and mid-sized multinationals want the benefits of a global pooling platform, but they lack the scale to establish their own. Existing vehicles offered by investment managers offer a limited solution, because multinationals are seeking independence in investment manager choice. We can expect to see the emergence of manager-of-manager programs, offering a broad array of asset classes and investment managers, to meet the needs of the smaller multinationals.

Multinationals who have launched successful global investment platforms initially concentrated on offering traditional asset classes – bonds and equities – to defined benefit plans. Northern Trust is now working with clients to expand their programs to accommodate alternative asset classes such as hedge funds and to open the pooling vehicles to investment by defined contribution plans. Clients are planning to add liability driven investments and currency overlay programs in the context of global pooling platforms.

HOST: In closing, it is clear that multinational companies are looking for ways to compete effectively in a changing environment characterized by increased global collaboration as well as competition. Cross-border asset pooling provides a new tool for global cooperation, delivering added value to subsidiaries by leveraging advances in investment management practices and technology.

For more information on cross-border pension pooling, please visit northerntrust.com/Europe.

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Q15070 (04/07)