

FRONTIERS IN FINANCE SUPPLEMENT

November 2011

Operational excellence – in focus

KPMG

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Executive summary

Four years after the onset of the financial crisis its impact continues to affect the global pension fund industry. After a fleeting period of economic recovery, the renewed threat of double dip recession in various developed countries and slowing growth elsewhere has weakened already fragile investor and corporate confidence. Extreme volatility in many markets, fuelled by the sovereign debt crisis and its attendant uncertainties, is not only hitting funds' immediate investment returns, but is making it harder to invest to meet future liabilities.

Faced with these challenges, pension funds need to maximize value for their stakeholders. Implementing strategies to achieve operational excellence – and thereby provide maximum value to plan members by offering more targeted services and increasing net returns – is an important way of generating that enhanced value.

Attaining operational excellence is not a one-off exercise. Rather it requires an ethos of continual improvement. However, by learning from the experiences of other funds in other industries across the globe solutions can be found. The prize for those who succeed will be worth the effort.

What is Operational Excellence?

Operational excellence can broadly be defined as the ability of a pension fund to maximize its financial outputs (asset values and retirement benefits), minimize its operating costs, pay retirement benefits on time, and generally optimize the service provided to plan members.

Drivers of Operational Excellence

Almost every region in the world is pursuing pension system reform. The motivations vary, but for many the broad aim is to expand pension coverage, address the cost burden of their aging societies, and improve retirement benefits and the quality of service.

To meet these objectives, the pension fund industry is under

pressure from legislators, regulators, and existing and prospective members to reduce their operating costs, improve investment returns and enhance risk management.

How is Operational Excellence Achieved?

There is no one template for achieving operational excellence. Inevitably, different pension funds operating in different markets and with different member priorities will need to adopt strategies specific to their needs. That said, common methodologies include:

- Process optimization
- Cost optimization
- Lean customer-oriented approach
- Cross-fund collaboration and merger
- Asset pooling
- Outsourcing

Benefits of Operational Excellence

By implementing programs to achieve operational excellence, pension schemes can:

- Increase net investment returns.
- Reduce waste, helping lower costs and thus further boosting net returns.
- Provide more tailored services and enhanced product offerings to members.
- Improve competitive advantage and position, including improved retention of members.
- Foster confidence in the industry and encourage the provision of additional retirement savings.

Achieving operational excellence, therefore, is critical to pension funds' performance, and by extension to the future success of the industry.

Spotlight on Operations

Almost every region in the world is currently in the process of reforming its pension system. However, the motivations for reform and the particular avenues that it takes differ dramatically from one country to another:

- In much of Asia, pension reform debates are dominated by concerns about broadening coverage and improving benefits.
- In the economies in transition from socialism, the reforms are largely motivated by the need to adjust pension programs and administering institutions to a market economy.
- Many Latin American reforms are motivated in part by a desire to insulate the pension system from political interferences and to improve the quality of service to pension system participants.
- Reform debates in North America, Japan and Western Europe, on the other hand, have tended to focus on dealing with the costs of an ageing society.

Nevertheless, what is common in all countries is the need to maximize retirement benefits and reduce waste through operational excellence, whilst engaging with members in a way that engenders confidence within the industry and encourages the provision of additional retirement savings.

Drivers of excellence

Operational excellence means different things to different pension schemes, depending on both the macro- and microeconomic environment in which they operate. Broadly though, the overarching objectives are a desire to:

- Increase net investment returns and/or reduce costs, facilitating an enhanced dollar outcome to members. Whilst increasing investment returns is unpredictable and carries greater risk, it is the side of the equation that traditionally garners the most attention. On the other hand, reducing costs is predictable and can be directly controlled by the fund.
- Identify and refine value from the members' perspective.

By enhancing efficiency, pension funds are able to maximize their financial outputs (retirement benefits and asset values), reduce operating costs, pay retirement benefits on time and generally optimize gains to members.

Furthermore, recent media coverage of fund performances and practices is making legislators, governors, regulators and the public think about how pension systems are being run now and how they need to be run in the future. Increasingly, pension authorities are reviewing the performance of their pension system against international benchmarks and performance.

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Figure 1

Conceptual model for pension fund efficiency



International variations

One way to gauge the efficiency of pension systems is to examine the total operating expenses of a country's pension fund industry.

As Figure 2 demonstrates, there is large differential in pension funds' operating expenses as a share of total investments between different countries. A number of contributing factors are behind the cost variations. What the statistics reveal though is that countries with defined contribution systems and those with large numbers of small funds generally have higher operating costs than countries with only a few funds offering defined benefit, hybrid or collective defined contribution pension arrangements.

Scale inefficiencies

Meanwhile, Figure 3 illustrates the strong positive correlation between assets and operating expenses.

The Pearson correlation analysis between operating expenses and total AUM across geographies results in a coefficient of .92, signaling a positive correlation between both variables. This means that as total assets of the pension market increase, operational expenses increase too. This indicates that there is further scope to drive economies of scale as the marginal cost of increasing FUM is still relatively high.

Pace of change

In the past, operational excellence was not considered to be as critical, in part because pensions operate in a compulsory industry.

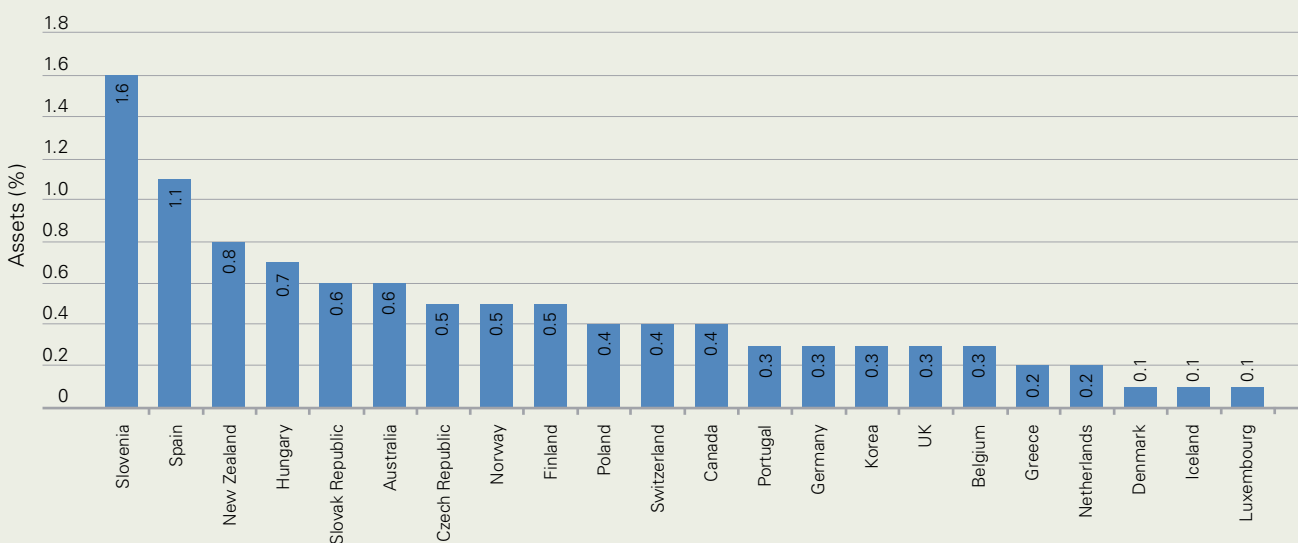
As a result, funds do not have to compete as hard for business. Relatively high barriers to entry also reduced competition, decreasing focus on improving operations and efficiency.

In addition, the pensions industry in many jurisdictions is highly fragmented, with a proliferation of providers. For example, the Australian market has around 400 funds. The largest of these is US\$40 billion against a total market size of approximately US\$1.4 trillion, representing 2.8% of the market. Consolidation within the pension industry is gathering pace as providers attempt to generate greater economies of scale.

And while organizations have started focusing on efficiency in the last few years, the recent financial crisis, greater volatility in investments and growing dependence on pension

Figure 2

Pension funds' operating expenses as a share of total assets in selected OECD countries, 2009 (%)



Source: OECD Global Pension Statistics

products have upped the stakes. Furthermore, under IFRS 19 the funding level of defined benefit schemes is reflected within an organization's balance sheet. Therefore improved performance and efficiency can improve the balance sheet of the corporate entity.

Achieving operational excellence

The most commonly used techniques and methodologies are:

Process optimization whereby business and organizational processes are reviewed to identify whether the business is achieving its stated objectives, and determine whether each activity is adding maximum value to the organization. Through this process inefficient or non-value adding processes can be identified and rectified.

Cost optimization aims to reduce costs without destroying the value in the process. The cost drivers are analyzed to remove the inefficient ones and replace them with cost effective/high value drivers.

Lean is a customer oriented approach aimed at increasing performance through customer service, quality, cost reduction, productivity, and process efficiency. It focuses efforts on getting the right things to the right place at the right time in the right quantity, whilst minimizing waste, being flexible and able to change. Lean never trades-off customer to reduce costs.

Mergers/Collaboration have helped companies achieve economies of scale. However, many pension funds may wish to retain their brand and member awareness, and consequently are not willing

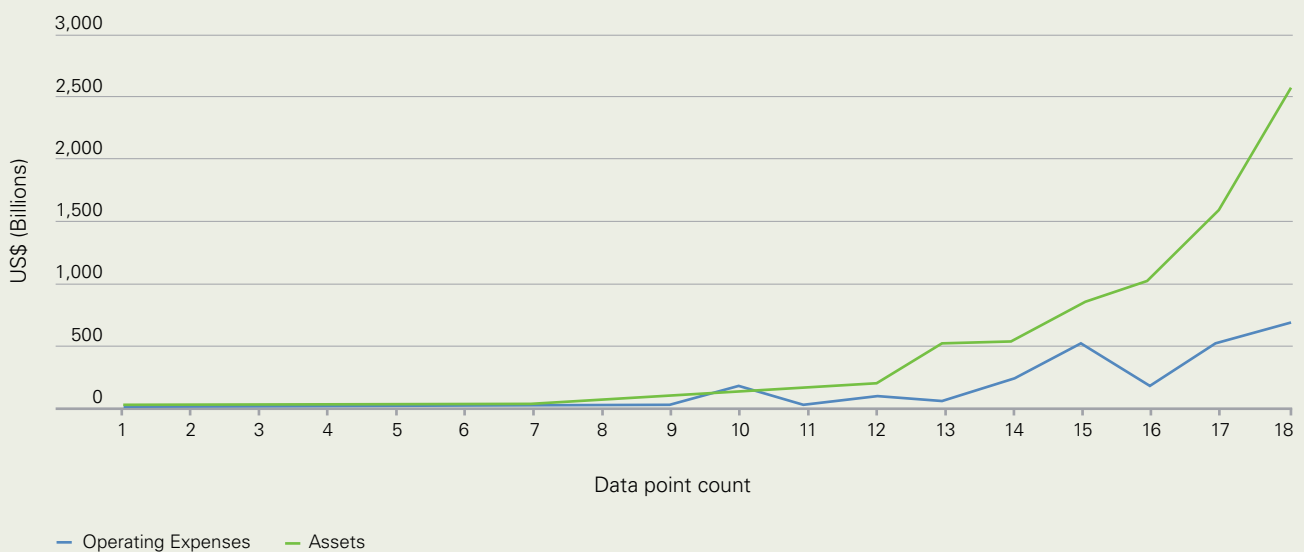
to undergo a merger. In such circumstances funds need to examine other methods of achieving economies of scale such as the use of collaboration. The Australian market is a good example. Where mergers are not always seen as the preferable option due to other strategic reasons, there has been increased focus on the utilization of shared services and resource pooling to achieve similar outcomes.

Asset pooling helps multinational companies improve their pension governance, control financial risk and reduce costs. At the same time, asset pooling can help companies increase their operational efficiency and provide their pension funds with better investment solutions.

In the manufacturing sector, there are many reported instances where implementation of the above processes have resulted in benefits

Figure 3

Correlation between assets and operating expenses



*Pension assets plotted in tens of millions for clearer representation

Source: "Global Pension Assets Study 2011," Tower Watson, February 2011, OECD Global Pension Statistics; KPMG analysis

to organizations. The challenge is to ensure that these benefits are ongoing through continuous improvement.

Following best practices

Examining practices in global corporations that have implemented highly successful operational excellence programs, such as Toyota, is invaluable for pension funds, whatever their industry.

Key amongst these best practices is the need to achieve a cultural change within organizations when implementing and maintaining continuous improvement. The pursuit of operational excellence should not be seen as a one-off project. Rather, it is a journey of continual improvement, where staff are empowered to challenge the methodologies by which services are currently provided.

Specific tasks which funds have sought to embed to achieve the desired outcomes, include:

- Activity Based Costing – to help pension scheme trustees understand and identify cost and value drivers within the fund. It can also be utilized to accurately price products and services to maintain and grow competitive advantage and market share.
- Process mapping – to identify inefficient and redundant processes that are hindering the achievement of greater efficiencies.

- Benchmarking and diagnostic testing – increasingly the focus is not just on the scheme as a whole but on individual components and services, to ensure the delivery of highly valued services to members.
- Analysis of team performance and dynamics.
- Assessment of existing information technology infrastructure capabilities and the manner in which these can be leveraged to achieve greater efficiency.
- Data cleansing and data mining, resulting in a more personalized service to scheme members.
- Reviewing procurement processes and ongoing issues of supplier and contract management. Rigorous debate continues, for example, on the effectiveness of penalty clauses traditionally contained within service provider contracts versus the provision of incentives to work with the scheme to achieve efficiencies, whereby both parties are able to benefit from the outcomes.

The application of any of the above methods must be viewed in light of the member's experience. To this end, we are often seeing the above analyses being overlaid with customer surveys regarding what services they value the most.

The preferred approach for each scheme must be considered in light of the political, social and environmental barriers faced in the various geographies. But

whatever the techniques employed, implementing and achieving operational excellence will enable pension schemes to add greater value to members through increased net returns, and the provision of more tailored services to members.

Action is imperative

There is a growing need for policy makers and the regulatory community, as well as private sector participants, to compare program developments and experiences with those of other countries and other industries. Increasingly, the relative success of the pension industry from a social policy and sustainability perspective is being questioned. This is, in part, being driven by debate around the:

- Adequacy of retirement incomes and longevity;
- Impact on sovereign debt;
- Impact of company finances; and
- Increased levels of personal indebtedness on a per capita basis.

For these reasons it is important that pension schemes consider the manner in which they can maximize value to members via the adoption of methods such as those described in this document. Unless the global pension industry continues to challenge itself in this regard it runs the risk of failing to engender the confidence of the members it seeks to serve. There is a danger that could result in social, political and economic dislocation.

The pursuit of operational excellence should not be seen as a one-off project. Rather, it is a journey of continual improvement, where staff are empowered to challenge the methodologies by which services are currently provided.

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