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# DC in focus



# Key issues and challenges emerging from DC pension provision

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# Welcome

As the growth of defined contribution (DC) pension provision continues both in the UK and US as well as across Europe and beyond, the inherent issues and risks involved in running such schemes are increasingly being recognised. In the UK, specifically, we are beginning to see the emergence of a new, redefined and all round more effective DC pension plan.

Over the last year or so, there has been an almost unprecedented evolution and development of innovative thinking and best practice around the design and operation of DC plans – and it continues to evolve and develop. For anyone interested in running a DC plan, there is much to consider and keep abreast of.

In this publication, some of our leading DC associates consider and discuss the key issues and challenges emerging from DC pension provision – setting out latest thinking and identifying emerging best practice.

Most of these articles were exclusively written by Watson Wyatt for 'Pensions World', which is published by LexisNexis Butterworth. All articles have been reproduced by kind permission of their respective publishers.

I hope that you find these articles interesting, thought-provoking and valuable reading.

If you have any questions, or would like to discuss any of the areas covered in this publication then please do not hesitate to speak to your usual Watson Wyatt contact or, alternatively you can contact me on **+44 (0) 20 7222 8033** or email me at [gary.smith@watsonwyatt.com](mailto:gary.smith@watsonwyatt.com)

Thanking you and kind regards.

**Gary Smith**



## High five – a **strong fiduciary** can make all the difference

Adam Stevenson

In a recent survey conducted by Watson Wyatt in conjunction with the 'Financial Times', the biggest fear over the next 10 to 15 years was that DC pensions would under-deliver. In light of this concern, it is not surprising that an increasing number of employers and trustees believe that it is imperative that they give their DC arrangements a lot more attention in the future.

The Pensions Regulator has taken a proactive role in providing guidance on this matter, by highlighting five key areas of risk (administration, understanding, charges, investment and retirement options) faced by a DC member. These risks clearly have a direct impact on the level of retirement income available to a member following retirement from a DC arrangement and therefore must be addressed.

So, who is best placed to consider and deal with these risks? Whilst the State, employees and providers may be able to assist with some issues involved, it is accepted that they will not be able deal with all the matters that require consideration.

During one of our recent conferences, it was agreed that these risks could be easily addressed as part of a robust DC governance framework. It was also acknowledged that the emergence of a clearly defined fiduciary role would strengthen a scheme's DC governance process.

Within occupational arrangements it is clear that the trustee body are best placed to undertake the fiduciary role. The employer, however, should not be forgotten as it will need to provide support to the trustees where appropriate. Under contract-based arrangements it is likely that the employer will need to assume the lead role by undertaking the fiduciary functions.

It is anticipated that where a strong fiduciary role is performed it will add significant value for both members and the employer.

We estimate that the greatest opportunities for the fiduciary to add 'real' value will lie in improving member understanding, providing better investment solutions and establishing an efficient at-retirement process.

Historically, member communication has tended to focus on the provision of information which has typically resulted in a disengaged membership. If schemes are realistically going to improve understanding, it is likely that they will need to adopt a consumer driven approach which will motivate members into action. Despite better education, a large proportion of members will still not be equipped to deal with the complexities which underlie investment options. The fiduciary could successfully address this issue with the greater use of multi-investment opportunities which are packaged into efficient investment vehicles. These investment options should appear simple to the member whilst at the same time being underpinned by highly sophisticated and innovative investment solutions.

During recent months the Regulator has focused heavily on the at-retirement stage. It is accepted that with the introduction of an efficient decumulation process, members should have a

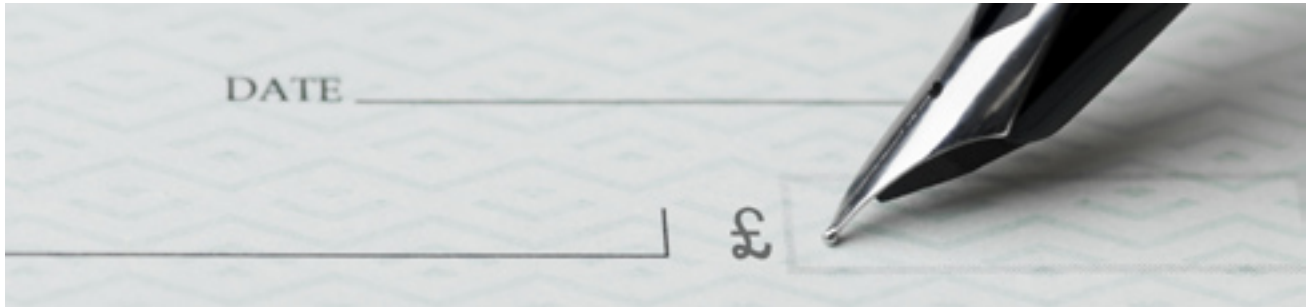
greater chance of making an informed choice at retirement whilst also obtaining the best rate (for example, retirement income) for their given choice. By implementing some fairly basic and easy steps, the fiduciary could make a very quick and significant difference to the level of a member's retirement income. This could involve the introduction of a targeted pre-retirement education programme, access to a specialist annuity broker or even access to financial advice.

In conclusion, it is clear to see that the fiduciary has an extremely important role to play if the concern that DC pensions will under-deliver is to be successfully tackled. If the fiduciary functions are taken seriously and performed strongly there is a great opportunity to significantly improve the level of a member income in retirement, whilst at the same time generally increasing the member's appreciation of their employer sponsored DC pension arrangements.

In a nutshell:

- a clearly defined fiduciary role should strengthen the DC governance framework
- by addressing the five key areas highlighted by the Regulator, the fiduciary could make a significant difference to a member's income in retirement
- investment options need to be apparently simple to members, whilst at the same time being highly sophisticated and innovative underneath
- enhanced education programmes are needed if members are to be motivated into action.

“ ... the greatest opportunities for the fiduciary to add 'real' value will lie in improving member understanding ... ”



# Everyone's **salary sacrifice** can be a safe bet for both employers and employees

Julie Vile

Pension salary sacrifice allows both employees and employers to pay less National Insurance (NI) with no reduction in the employee's pension benefits. More and more employers are looking for ways to make their pension schemes more attractive to employees, and as financially efficient as possible.

Employers planning to implement a pension salary sacrifice structure need to focus on the compliance and employment requirements to ensure an effective salary sacrifice from launch and on an ongoing basis.

Salary sacrifice involves making a change to employees' contractual terms and conditions of employment, it is necessary to obtain their consent to the change. This can be a positive consent, asking all members to sign a form indicating their agreement to join the pension salary sacrifice arrangement, or a negative (or implied) consent, introducing the changes and only asking employees to inform the company if they do not wish to join the salary sacrifice arrangement (that is, they wish to 'opt out').

The positive consent route can be administratively burdensome due to the need to obtain positive agreement in writing from each employee and this may also impact on the take-up rate.

The negative consent route means that all employees will be deemed to participate in the change unless they formally elect to opt out within a specified period. Employee's consent is implied by employees continuing to work under the revised terms and conditions. There is, however, a risk that employees may claim they did not consent, although this is considered to be low because salary sacrifice arrangements are designed so that employees are not financially disadvantaged.

## Employment law

Pension salary sacrifice is a mechanism to restructure employee pension contributions without incurring NI on them. Pension salary sacrifice applies to all types of pension plan and to bonus and salary payments. It should be structured so that employees are not adversely affected. The HM Revenue & Customs (HMRC) recognises pension salary sacrifice as an acceptable process and acknowledges that it is an employment law rather than a tax issue. In particular, while it results in a NI saving, it is derived from a change in the employment contract and rules of the pension plan.

NI is not payable on employer pension contributions, but it is on employee contributions. Employees therefore stop making regular or single pension contributions in a pension salary sacrifice structure. They agree to waive the right to receive a bonus (the 'bonus sacrifice') or reduce their contractual gross pay (the 'salary sacrifice'). The employer pays increased contributions into the pension plan equal to the payment(s) no longer made by employees. This will create an efficient financial structure where savings are achieved.

Pension salary sacrifice is effective only when the contractual right to pay has been reduced. To be successful the pay must be given up before treated as earned and the true construction of the revised contractual arrangement

## “ Pension salary sacrifice is effective only when the contractual right to pay has been reduced. ”

between employer and employee must be that the employee is entitled to lower pay and a benefit.

### Communication process

Implementing salary sacrifice involves making a choice between a positive or negative consent route. Whichever option is selected, it is essential that a clear communication process is followed.

The communication period should be for sufficient time to allow an informed decision by employees. In addition, for pension salary sacrifice, the sacrifice must be made before the right to receive the payment accrues. Therefore the timing of the communication period and the date by which employees must opt out (if they do not wish to participate) are critical.

For contracted-in arrangements a small number of employees may see a reduction in State Second Pension (S2P) benefits that negates their NI saving. It is essential to ensure that potentially affected employees are identified and receive appropriate communication about how and to what extent they are impacted.

The contractual change occurs through the communications issued for existing employees so there is no need to issue new contracts of employment. For new employees pension salary sacrifice would be the default position.

### Low earners

A key objective of pension salary sacrifice is to ensure that employees are not adversely impacted. Individuals earning close to the lower earnings limit could be affected if they participate in a pension salary sacrifice arrangement, for example, through a reduction in state benefits.

Employees earning on or near the National Minimum Wage (NMW) should not participate, as an employee cannot agree to a sacrifice that reduces their income below NMW. Therefore, employers need to put in place checks and controls that would automatically exclude these employees from participating in a salary sacrifice arrangement.

To ensure that pay and benefits are protected the concept of a 'reference salary' is introduced. This is an employee's basic salary before the

salary sacrifice. The reference salary is used as the basis for calculating all salary related pay and benefits to ensure no loss (for example bonus, overtime, life cover).

### **Systems and documentation changes**

Pension salary sacrifice will require a number of changes to the payroll system to ensure the correct payments are made and the correct reporting is provided, following the introduction of pension salary sacrifice. This includes changes to employee's payslips. Changes will also be required for the pension administration system including, for example, the setting up of a new contribution type and possible changes to the member's benefit statement.

A number of changes are usually required to the trust deed and rules of the pension scheme. These will cover areas such as future employee contributions and refunds on leaving. In addition, the current schedule of contributions will need to be revised and signed off to reflect the new contribution arrangements. These will both require trustee consent.

### **HMRC notification**

Pension salary sacrifice is readily accepted by the HMRC but as good practice, an employer should contact their local HMRC contact notifying them in advance that a pension salary sacrifice arrangement is being implemented. Confirmation that the salary sacrifice arrangement is in place should be sent once the arrangement has 'gone live'.

An increasing number of large and well known organisations are or have introduced pension salary sacrifice arrangements, including those in the public sector. Due to this, the fact it is readily accepted by the HMRC and in light of the current economic climate it is likely that this trend will continue. Although there is a cost to the employer associated with the introduction of a pension salary sacrifice arrangement, it is a win win situation for both the employer and employee.

**“ An increasing number of large and well known organisations are or have introduced pension salary sacrifice arrangements. ”**





## Back up – members **approaching retirement** need help to get where they want

Gary Smith

Trustees and employers are investing a significant amount of time and money into the provision of retirement income for their employees through DC pension arrangements. Unfortunately, to date, one of the areas which has received little attention is the issue of converting

the members DC pension account into an income, for example, the decumulation process.

Many would perhaps defend this by pointing at the relatively small number of members who have retired from DC plans to date, but this is changing and there is now increasing focus on this, until now, largely overlooked area.

Members nearing retirement face an increasingly complex array of retirement income options. These choices include conventional annuities, enhanced annuities, unit-linked annuities, variable annuities and income drawdown.

As the decisions made at retirement can have a significant effect on the level of retirement income an individual will receive, it is vitally important that the numerous features of these products are both understood and considered in the context of the members' overall financial circumstances and objectives.

It is acknowledged that most employees are not financial experts and they are going to need help if they are going to successfully navigate the retirement options market. As a result, slowly but surely, it is being accepted that members of both trust and contract-based DC plans will need to be provided with better pre-retirement education and support.

If this objective is going to be realistically achieved, trustees and employers will need to undertake a thorough review of their current decumulation practices, including considering whether their members actually understand what they need to do and, most importantly, how critical the decisions are that they make during this stage.

The likely conclusion of this assessment is that the pre-retirement and decumulation process will require a major overhaul. When faced with this outcome, trustees and employers should not shy away from investing resources into this stage of the retirement process, as it is recognised that timely advice and guidance could not only boost the value of a members retirement income, but it could also do much to enhance both the brand value of the pension arrangement and the sponsoring employer.

Watson Wyatt believes that there are three stages to a suitable support framework.

Stage one is the provision of high-level awareness and education, starting perhaps five years or so prior to retirement. Stage two then kicks in about a year to 18 months before retirement and should provide more detailed assistance to members, including access to planning tools and even perhaps advice. The support in both stages could be provided via a

number of different media including online, paper and face-to-face communications. The third stage, assuming the first two are effective, is the simple execution stage (for example, purchasing the annuity).

This assistance should start early enough to enable members the opportunity to really consider both their current personal and financial circumstances as well as their future requirements. Only then will they be in a position to start formulating a view on which at-retirement product(s) will be most suitable for them, potentially enabling the member to make an informed decision.

In conclusion, it is clear that if members are going to be able to make an informed decision during the decumulation process, they are going to need a lot more help. If the time and money invested into this stage are going to be effective, the education and support framework must ensure that members understand where they are now, where they want to be and ultimately understand the choices that are available to them. Once this is achieved, members should be better equipped to make the right decisions, maximising the level of their retirement income and enhancing the member experience.

In a nutshell:

- the decumulation phase has generally received very little focus to date
- most employees are going to need help to successfully navigate the retirement options market
- trustees and employers need to undertake a thorough review of their current decumulation process
- a suitable pre-retirement support framework could have three stages:

- 1 high-level awareness and education
- 2 more detailed fact-finding and planning assistance
- 3 execution.

Stage one should start perhaps five years before retirement, moving to stage two about 18 months before and stage three at the point of retirement itself.



## Chalk and talk – **professional financial education** is worth the cost for both employers and employees

Mick Calvert

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In the current economic climate, well informed financial education has never been more valuable. By providing employees with professional and crucially, impartial financial education, an employer can be assured that individual employees can begin to

really appreciate the value of their overall benefits package.

Equally importantly, they are better placed to optimise their choices in the context of their personal circumstances and objectives and properly address any concerns they may have. The value of this to the employees is obvious. To the employer, the value is perhaps less clear but can manifest itself in a number of ways. Greater employee engagement leading to lower turnover of staff, savings in HR time spent answering or trying to answer employees' questions on benefit related issues, avoidance of risk in terms of pensions and/or HR professionals straying into areas of regulated advice, and certainty that the level of benefits spend is being used to its full potential. There is no point in employers spending significant sums on benefits only for some of this to be wasted by employees taking poor quality and/or potentially biased financial advice.

If employees are likely to waste some of their benefit value in this way, then the employer may as well reduce the benefit spend accordingly and redirect some or all of the savings towards an appropriate financial education programme to deliver the same net benefit to the individuals.

If we accept that there is a significant potential value to be had by all here from a financial education programme, the



**... employers need to realise that retaining advisers on a time based fee structure is the most appropriate way forward.**



value and cost relationship will be fundamentally driven by how this is structured and who provides it. There are many providers in the 'financial education' space, ranging from life insurance companies/banks, through the independent financial adviser (IFA) market, specialist employee benefit consultancies and accountancy/legal practices. Similarly, the range in 'costs' to the employer and, importantly, the employee, is potentially vast.

Most of the potential providers will offer financial education services on a no cost or a 'peppercorn' charge to the employer. This may sound good, but the reality is however, somewhat different. Typically, services offered on this basis represent something of a 'loss leader' to the provider, with their main return coming through individual advice given to participants in the programme. Such return is likely to be derived in initial commissions generated by sales of products, for example, investment/pension arrangements and

protection policies and/or 'trail' or annual charges/commissions generated from monies which the individuals have been persuaded to place under management with the provider.

Clearly then, the structure of adviser remuneration will influence the costs to both employer and employee and, indeed, whether the employer or the employee ultimately picks up the tab. On the basis above, the employee will bear the burden of most, if not all, the costs which may be acceptable to the employer, although probably not if the actual costs are understood or result in the sale of inappropriate products.

In order to guarantee a professional and impartial approach to financial education services, employers need to realise that retaining advisers on a time based fee structure is the most appropriate way forward. Although there will be an explicit cost, value is guaranteed. In order to reduce their own costs, employers can consider

sharing those with employees, particularly given that per capita charges are relatively small because services are delivered typically by way of group session.

There is a strong argument that financial education is so valuable to employees that they may even be prepared to accept a re-structured benefits package, in order to be assured that impartial professional guidance will be available when most needed. In summary, unless financial education is provided on a professional and impartial basis there is danger that the services may add no value, whilst adding cost to either the employer or the employee. A professional approach will guarantee value, but at some cost. The trick is to ensure that appropriate filter processes are included within the service specification to optimise time spent and therefore costs incurred and that, where the employer feels it appropriate, such costs are shared with the employee on an equitable basis.



## Hitting the target – setting one’s sights on the right level of **retirement income**

Paul Macro

In years gone by, targeting an acceptable level of retirement income for members of employers’ pension schemes was relatively simple. This is because they were in final salary schemes, which normally provided them with an income of 66 per cent of their salary close to retirement after 40 years’ service – thus the ‘two-thirds rule’ was born. But is

two-thirds the right level and how in this brave new DC world can an individual both know what the right target should be and how to achieve it?

The first task is to define what the ‘target’ actually means. The right targeted income is probably one which enables an individual to continue their lifestyle pre-retirement into their retirement, without a significant drop in living standards.

There are a number of reasons why ‘two-thirds’ of pre-retirement salary is probably not the right target level for a DC scheme. The obvious reason is that the majority of 1/60ths final salary schemes from which ‘two-thirds’ was derived, were contracted out of SERPS/S2P, whereas the majority of DC schemes are contracted-in. The State will generally provide a larger level of benefit for DC members than defined benefit (DB) members and so DC schemes can provide lower levels of benefit than many DB schemes. However, simply deducting a flat percentage of salary from the target to take account of this does not work well, as SERPS/S2P is based on a banded definition of salary and the rules/level from this scheme(s) has a history of being changed by governments (indeed, S2P looks likely to become a flat-rate benefit for all going forward).

Even if we can take this into account, does everybody need the same level of income (relative to final salary) in retirement from their employer's pension arrangement? There is clear evidence that this is not the case for two reasons.

First, the level of state basic pension an individual receives is not linked to their salary. Therefore for low earners, a smaller proportion of their total income in retirement needs to come from their employer's arrangement than for a higher earner, where state benefits are proportionately much lower.

In addition to this, needs in retirement also generally differ by income level. For lower income levels, much of their income both before and after retirement is spent on simply getting by and surviving. This group do not have much leeway to see their income levels drop dramatically and will need a post retirement income which is high proportion of their pre-retirement income.

On the other hand, high earners often spend a proportion of their income on items which are linked to working and raising a family, like commuting costs, school fees, university sponsorship, mortgage and so on, many of which will not be needed in retirement. Thus, higher earners are likely to need (though may not want) a lower proportion of their pre-retirement

income as a scheme pension in order to maintain their standard of living. Therefore, a single 'universal' target level of benefit from a DC scheme is not sensible.

Income in retirement needs are much more complicated than simply saying 'two-thirds' but how can we help individuals decide their own required target?

One approach is to provide members with a budget planning tool, allowing them to think about what they currently spend their money on and what they will actually need in retirement. At its simplest level, this type of tool can remind people that there will be items which they will not require to spend on in retirement for example, child care and loans. It can also be used to remind them that their tax status may change, meaning that their gross pension need not be as high as they might have expected.

At their most complicated, they may even allow consideration of variable income needs in retirement, such as long-term healthcare, which in practice might have to be met from outside pension income. These types of tools are now available and so far have been under-used.

Determining the required level of income in retirement is only the first step however. Many DC scheme

members are unaware of what their retirement income is likely to be. This is partly due to apathy and partly because they do not understand the nature of DC. Members need help now. A first step towards this is helping them calculate how much they need to save in order to achieve their target and how this should be invested. The former can be achieved with many schemes' or providers' modelling tools; the latter is a subject for another article.

A universal target level of benefit does not reflect what different individuals require, and there is a need to determine a specific target level of benefit, recognising individual consumption requirements in retirement.

In a nutshell:

- two-thirds of final salary is not necessarily the right target level of retirement income for everyone
- needs in retirement generally differ by income level pre-retirement
- budget planning tools enable members to determine a specific level of benefit tailored to their requirements.



## Technical wizardry – creating **innovative solutions** that deliver true benefits to members

Richard Tuff

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Technology has been moving on at a very quick pace over the past few years. We have seen great leaps forward in software, hardware and production technologies. Generally this sort of advancement is positive and useful. However, with such a fast moving environment it is often easy to

confuse what is possible with what is innovative. For example, it is possible to put a radio in my torch, but such a thing is not an innovation. Can you recall the last time you stood in the dark thinking how useful it would be to have a radio?

Similarly, in the DC pensions world we need to be careful that there are clear member needs driving what we do and build. Just because something can work in a new environment, or one database can talk with another, does not mean they should. Innovation comes from finding the need and then delivering a solution.

It is now almost obligatory for DC schemes to offer members a website. However, all too often pension schemes are seeing this as the end of the process. To be clear, members do not need a website, it is simply a convenient tool. What members actually need is to know their current fund value, make choices about their portfolio structure or contribution levels, assess their projected retirement income and perhaps change their beneficiary nomination details or run some education tutorials. A website only becomes an innovative solution if it meets these needs. If it displays static data, month old fund

values and a series of PDF forms to print off and post then you could even argue the website is getting in the way of the solution, by making members do more for less.

Equally, members now rarely think of pensions in isolation. Increasingly employers are asking employees to think of their whole reward package. This in turn has led to an increase in the development of solutions for things like total reward statements, flexible benefit packages, flexible retirement working patterns and wealth management. Such solutions look impressive or even innovative in isolation but is this really the member experience? Perhaps the member is having to remember five different log-on ids and passwords, print off the results from one planner to compare it with a different application's projections and then maybe logging onto a third system to effect the changes the member wants to make.

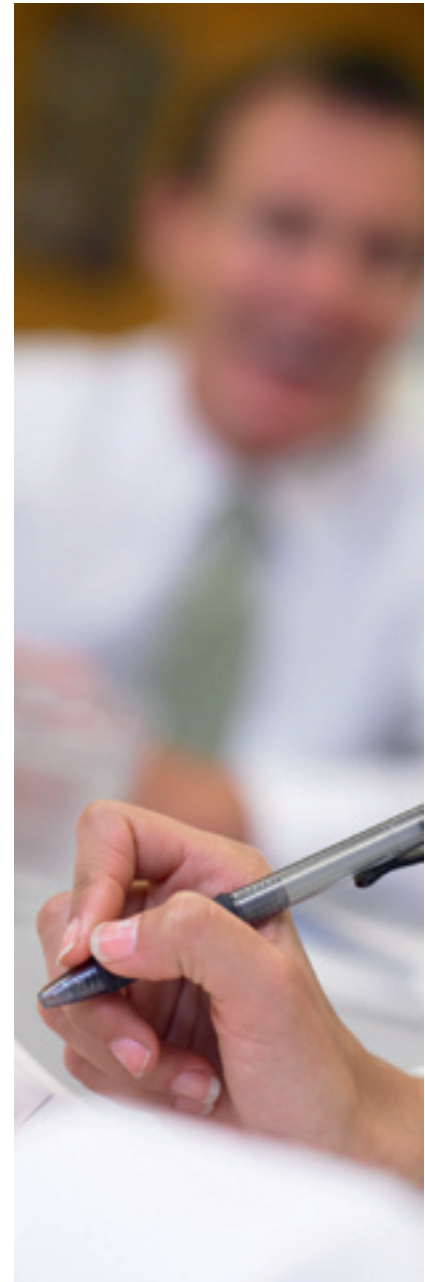
Those looking after DC pension schemes need to be thinking from the member's point of view to deliver true innovation. In the above case, once an employee is securely logged onto their

company's intranet site, they want be able to seamlessly move from one system to another without the need to log on multiple times. They want to be able to view all their benefits at a glance, perhaps use a modelling tool to help them decide to join the DC pension scheme and then, using that same session, capture their wish to enrol plus their contribution, fund choices and their death beneficiary nominations.

The recent development of solutions that enable secure, automatic and real time integration between employer and administration databases is a major pensions innovation, delivering true benefits to members.

Likewise the ability to present messages to members in a language that they will understand and via a medium they will use is another innovation deserving of attention. Administrators are still heavily reliant on postal mailings as their principal means of communicating with members, but DC schemes have young memberships. These younger members have little time for 'snailmail', they are looking for email

“ ... members now rarely think of pensions in isolation. ”



and website access as a minimum, but would prefer to obtain their information from text messaging services or webcasts. Administrators need to be looking at ways of offering these solutions.

Finally, administrators need to be aware of innovations in other areas, like investment, and deliver innovative solutions to cater for these ideas. For example, the sophisticated DC member is increasingly being offered a broad fund range in multiple currencies; they will need systems that can handle these currencies. Whereas the less sophisticated DC member is after a simpler fund choice with perhaps a 'wizard' to help them understand their options and make decisions.

As technology moves on and new solutions are possible, we should not forget members in our drive to improve. Solutions based on member needs are the innovations that will stand the test of time and become next year's standard.

In a nutshell:

- technological advances are offering administrators the ability to create new and exciting solutions
- we need to be careful however, that new solutions are not simply built because they are now possible
- administrators should always look to member needs when considering their next innovative project.



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