

Pension plan design survey 2006

Report

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Executive summary

Yet again, pension plan design is headline news as the twin pressures of cost and risk continue to bear down on defined benefit pension plans. The move to defined contribution plans is well-documented, but key questions about the trends in pension provision still remain:

- How many companies still offer defined benefits to new entrants and are they likely to continue?
- What are companies doing to control cost and risk for pension liabilities that have already built up?
- Is defined contribution provision the simple solution it originally appeared to be?
- Can the enhanced pensions offered to executives continue at their previous levels?

These are just some of the questions examined by Watson Wyatt's seventh pension plan design survey carried out in January 2006 and the results make fascinating reading. The survey is focused on larger organisations. Of the 159 respondents, 75 per cent had more than 1000 employees in the UK including 23 companies who are members of the FTSE 100. The key findings revealed by the survey are:

- Final salary plans now only account for one-third of plans offered to new employees.
- Companies are taking wide-ranging actions to manage final salary costs, with increases in member contribution rates and reductions in the value of benefits both very evident.
- Defined contribution plans have greatly increased the investment choices available to members but there is still a question as to whether current contribution rates will provide the level of benefit that members are expecting.
- Hybrid plans continue to provide a 'middle ground' for companies willing to bear some of the financial risk, rather than passing it all to the members.
- Reductions in the generosity of pension benefits to executives are apparent, mirroring the trends for the rest of the workforce (albeit from a higher starting point). A day has had a significant impact on the shape of benefits at a senior level.

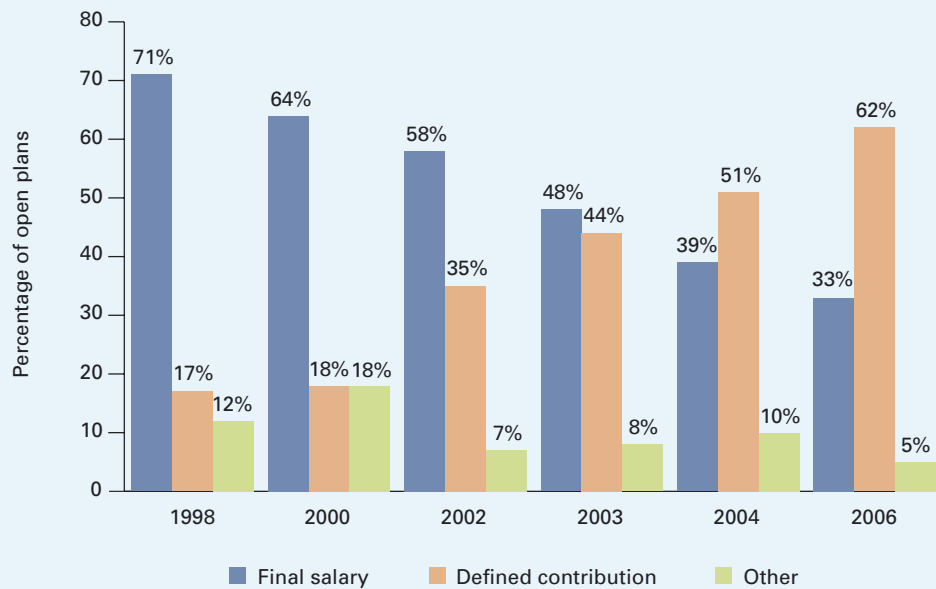
More information is contained in the following pages highlighting the key trends and aiming to address the current topical issues. If you would like further details or more analysis (such as breakdowns by industry sector) please contact your normal Watson Wyatt contact.

2 Final salary plans

Introduction

In previous surveys we have observed a rapid demise in the number of open final salary plans; this year's survey reveals that the trend has continued. As Figure 1 illustrates, only 33 per cent of open plans are final salary compared to 39 per cent two years ago. However, more detailed analysis of the survey reveals that the size of the decline varies markedly by industry.

Figure 1: Trends in pension provision



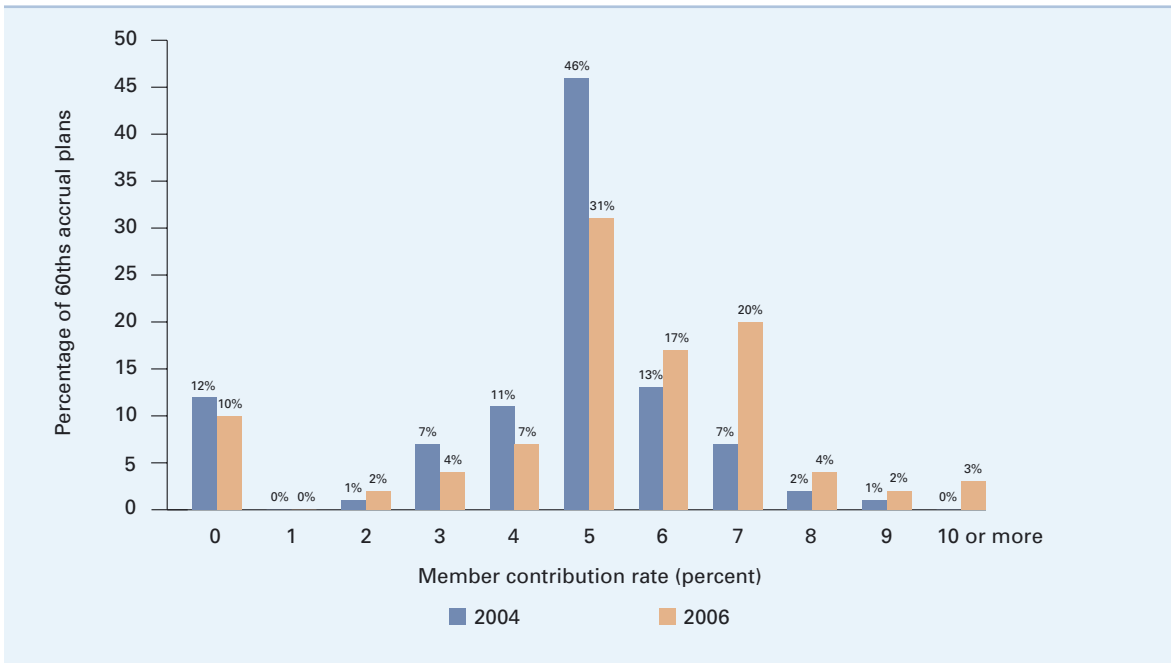
In addition to final salary plans closing to new members, there have recently been some well publicised cases of organisations going further and halting future accrual for existing members. Our survey reveals that such action has, to date, been extremely rare, although many respondents indicated that this option would be considered – particularly if costs, risks and the regulatory burden continue to increase or if their competitors decided to do so.

However, before we completely write off the future of final salary plans it is worth noting that 15 years after closing it to new entrants one company has recently announced it is to re-open its final salary plan (to workers that are aged over 40 and have worked for the firm for five years) after employees said they would rather have an improved pension plan than a pay rise – could this be the start of a new trend in pension provision?

Member contribution rates

One of the key features emerging from this year's survey is that those members remaining in final salary plans are being asked to pay more for the privilege. This is shown in Figure 2 for 60ths accrual plans.

Figure 2: Member contribution rates for 60ths accrual plans



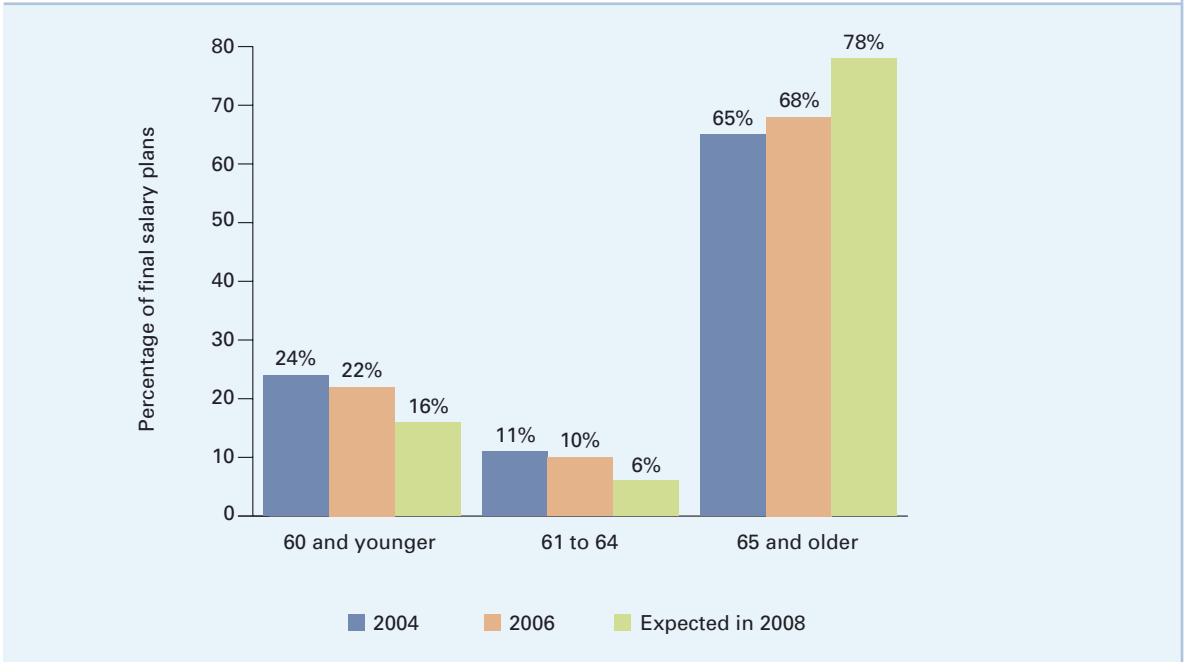
Over the last two years the average rate for such plans has increased from 4.6 per cent to 5.2 per cent, with nearly half of plans now having contribution rates in excess of 5 per cent compared to around a quarter just two years ago. Furthermore, the range of member contribution rates has significantly widened with rates of 10 per cent or higher being introduced over the last two years. Organisations expect that the upward trend in member contribution rates will continue over the next two years with the average rate forecast to increase to around 6 per cent, a further increase of almost 1 per cent.

Normal retirement age

Members are not only being asked to pay more into their final salary plans but they will also be asked to work longer in the future.

Figure 3 (overleaf) shows relatively stable normal retirement ages over the last two years but that this is expected to change in the foreseeable future. Over the next two years the proportion of plans with a normal retirement age of 65 is expected to reach almost 80 per cent, an increase from around two-thirds two years ago.

Figure 3: Normal retirement age

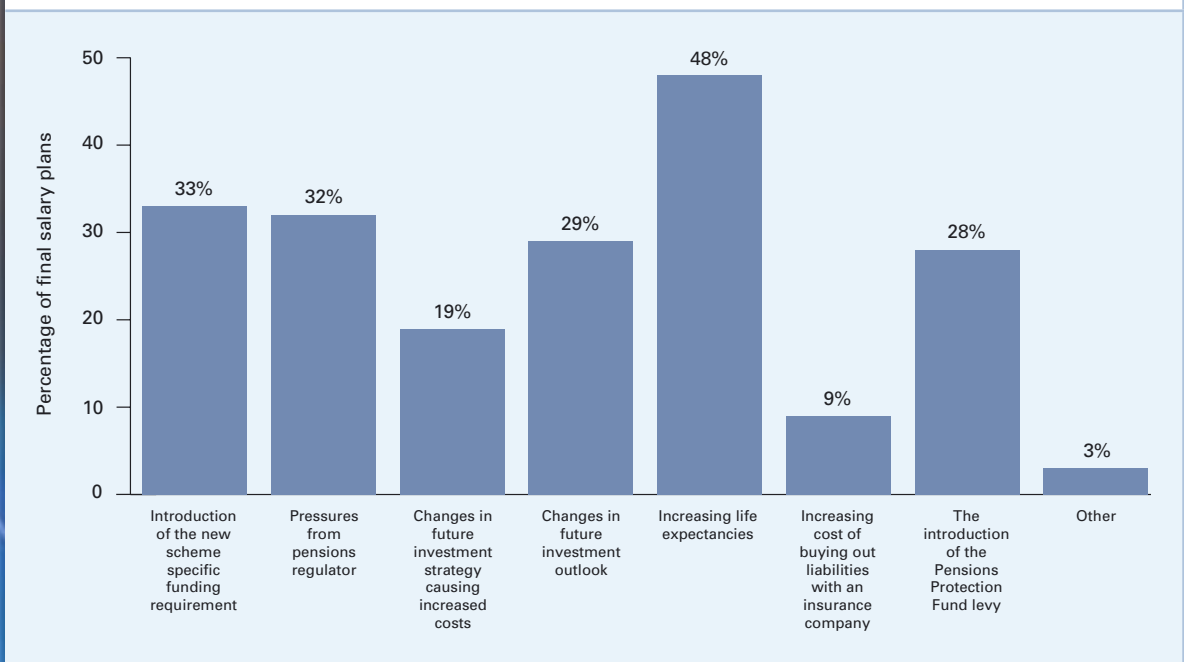


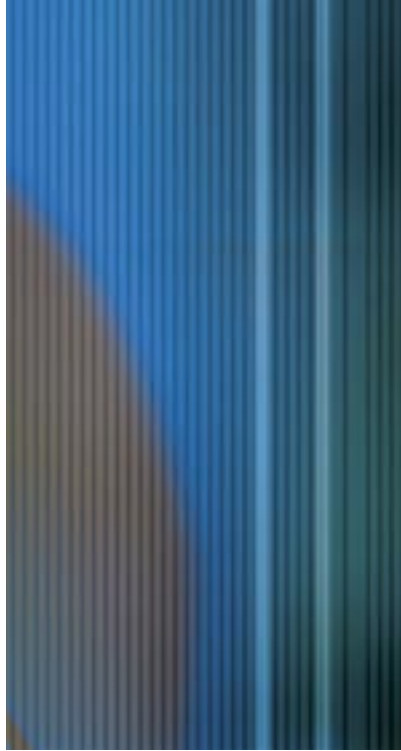
Key cost pressures

Figure 4 shows key cost pressures that may lead organisations to review either the status of a plan or the benefits that it offers.

Nearly half of all respondents said that increasing life expectancies was a key concern – this is consistent with the expected increase in normal retirement ages and shows that some organisations are addressing their concern directly.

Figure 4: Key cost pressures on final salary plans





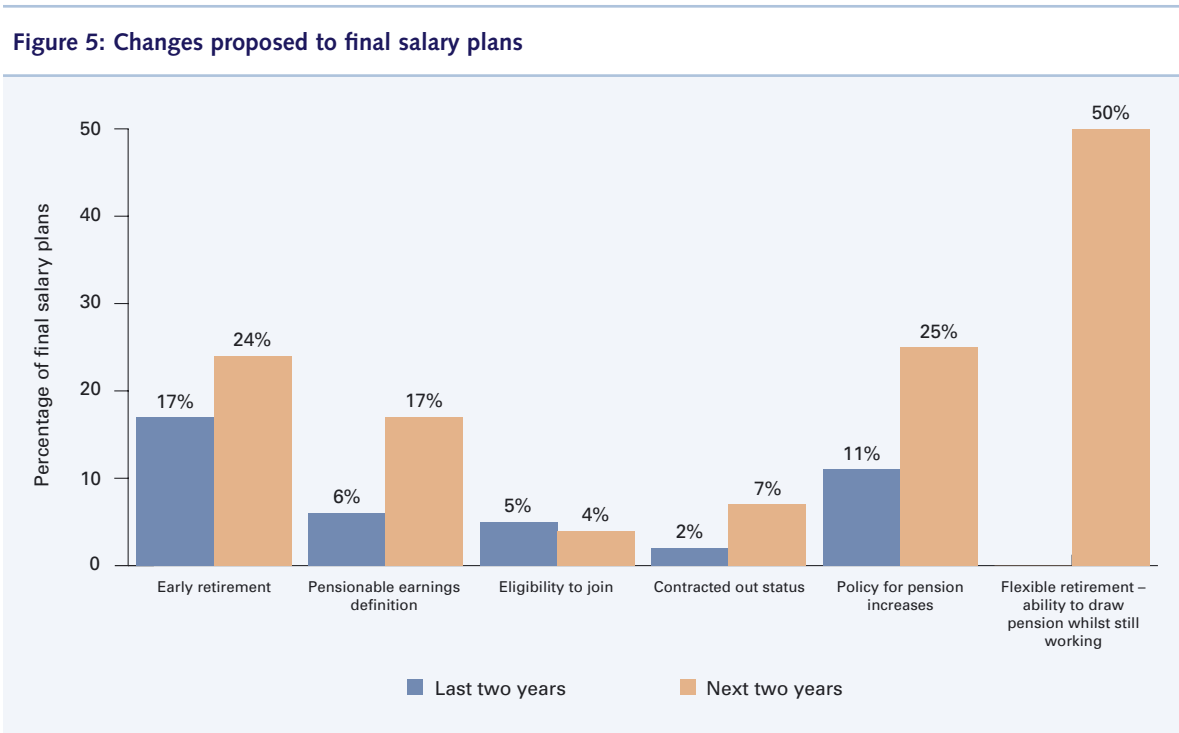
Many organisations expressed concern about the potential increase in cost resulting from the raft of new legislation. Key pressures were seen to arise from the pensions regulator, the new scheme specific funding requirements and the Pension Protection Fund levy.

Other changes

Organisations are still looking to reduce the costs and risks associated with final salary plans. Figure 5 shows the areas where organisations have either made amendments to their plan design in the past two years or where they expect to do so in the future.

In particular:

- Many organisations have reviewed or are looking to review their plan’s early retirement terms, again consistent with concerns over life expectancy. Typically, terms are worsened (from the member’s perspective) by removing consent to early retirement or by applying reductions from older ages.
- There is also a growing interest in reviewing the pensionable earnings definition, with some employers looking to remove variable elements of pay such as overtime and shift pay and others going further by limiting the future increases in pensionable earnings.
- Generally, those organisations looking to review their pension increase policy are taking advantage of the Pensions Act 2004 relaxation on pension increase requirements, namely that pensions accrued after 5 April 2005 need only to be increased each year by RPI up to 2.5 per cent rather than 5 per cent.



3

Defined contribution plans

Introduction

Defined contribution plans continue to increase in popularity. 62 per cent of all plans open to new employees are defined contribution in nature, with the majority (73 per cent) created since the turn of the century.

Our findings show a number of developments and trends in defined contribution plan design. These trends are particularly important for those organisations setting up a new plan; but they are also very relevant for those organisations that introduced defined contribution arrangements some time ago, as the design may no longer be best suited to the organisation's objectives.

Contribution rates

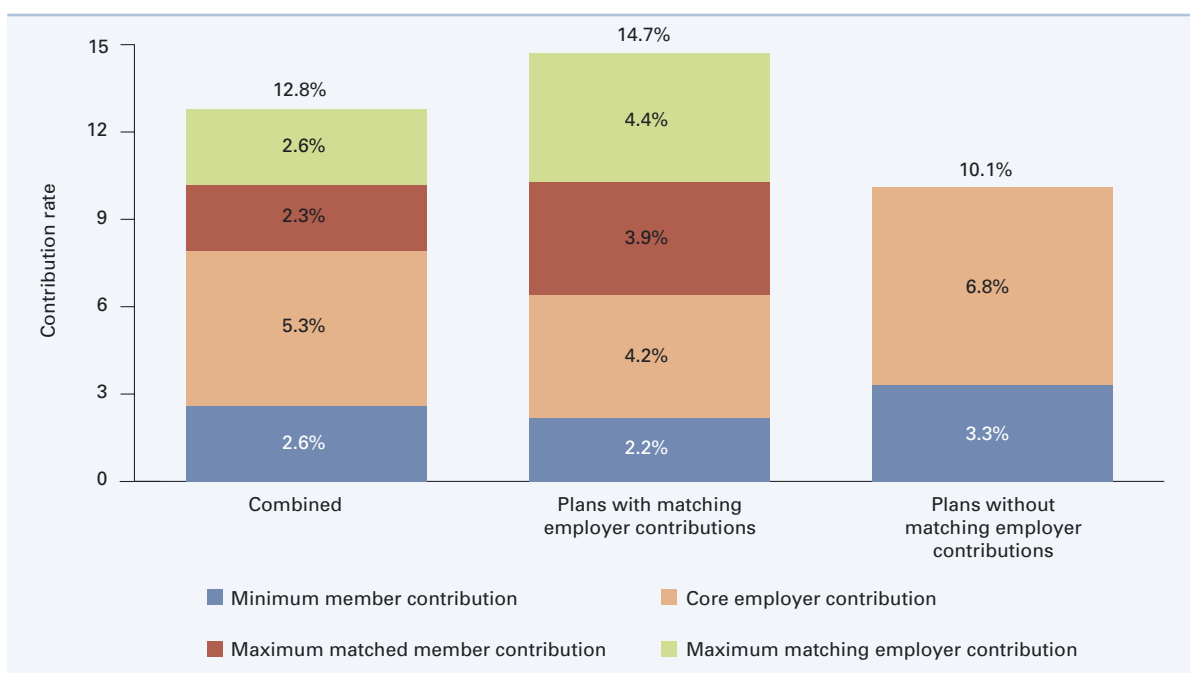
This year's survey shows little overall change in the contribution structure of defined contribution plans compared to two years ago. The majority of plans (57 per cent) continue to use a flat-rate contribution structure, whilst a significant number (35 per cent) have contributions that vary with age (the remainder have service-related contribution rates.) However, the survey did show that newer plans tend to favour flat rates, with 80 per cent of plans set up since 2004 adopting this structure.

In 60 per cent of plans employers will pay additional contributions if employee contributions are made

above a minimum level (referred to below as 'matching contributions'). This represents a slight increase from two years ago. For plans set up in the last two years the vast majority (85 per cent) offer these additional contributions.

Figure 6 shows the average contribution rates for all defined contribution plans (left hand bar), those plans with employer matching (middle bar) and those plans without employer matching (right hand bar). For plans with matching, the rates shown assume employees pay contributions at the highest rate that attracts extra employer contributions.

Figure 6: Overall average contribution rates



Compared to two years ago this shows an increase in the total average contribution rates of around 1 per cent for plans without matching and 1.5 per cent for plans with matching. However, much of the increase is accounted for by changes in the profile of respondents and does not indicate that organisations have amended their contribution rates to any material degree.

However, our survey reveals that newer plans tend to be more generous than more established plans, with the average combined rate for plans set up in the last two years being 14.2 per cent.

Changes to plans

Figure 7 shows areas that organisations have reviewed, or are looking to review. In line with comments already made about contribution rates this shows that relatively few organisations have reviewed their contribution structures to date. However, over the next couple of years a significant number of organisations will be looking to see if their contribution arrangements remain appropriate.

Investment

The range of investment funds made available to members of defined contribution plans

continues to grow. In our 2000 survey only 25 per cent of plans offered more than five investment options. As Figure 8 (overleaf) shows, 80 per cent of plans now offer more than five options. In fact, 20 per cent of plans now offer more than 20 options. Furthermore, this seems set to continue into the future with one in five organisations saying they are looking to review investment options in the next two years.

The drift from trust to contract-based

We have observed an increase in the proportion of defined contribution plans which are now

Figure 7: Changes proposed to defined contribution plans

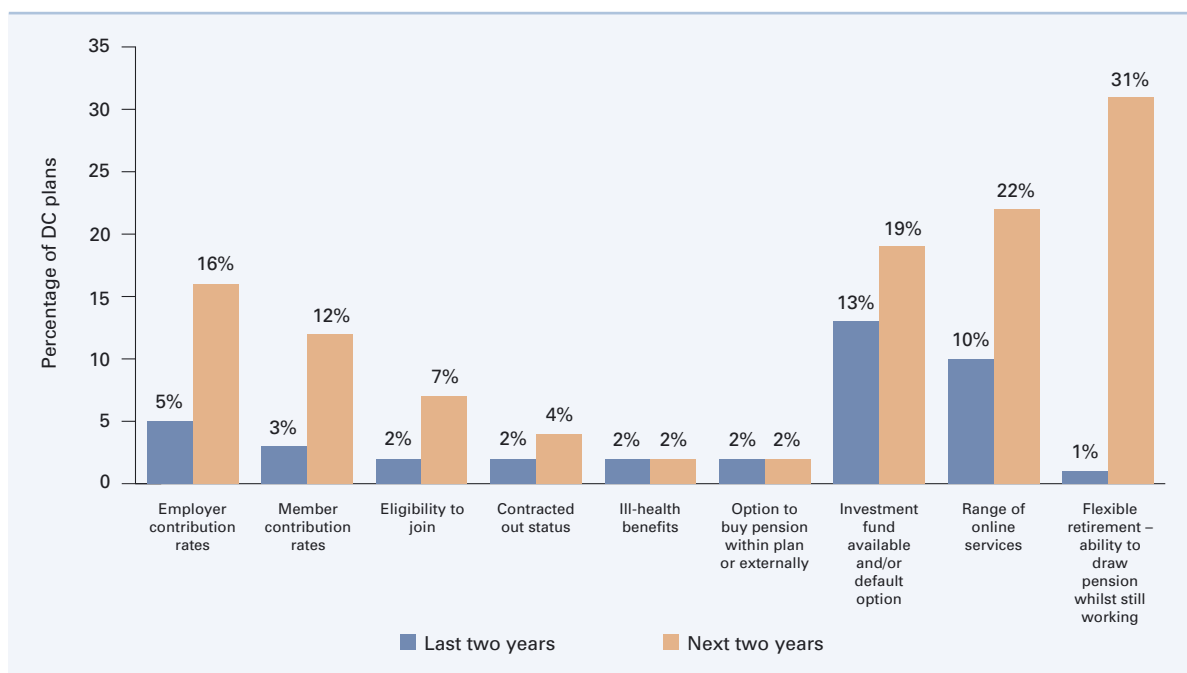
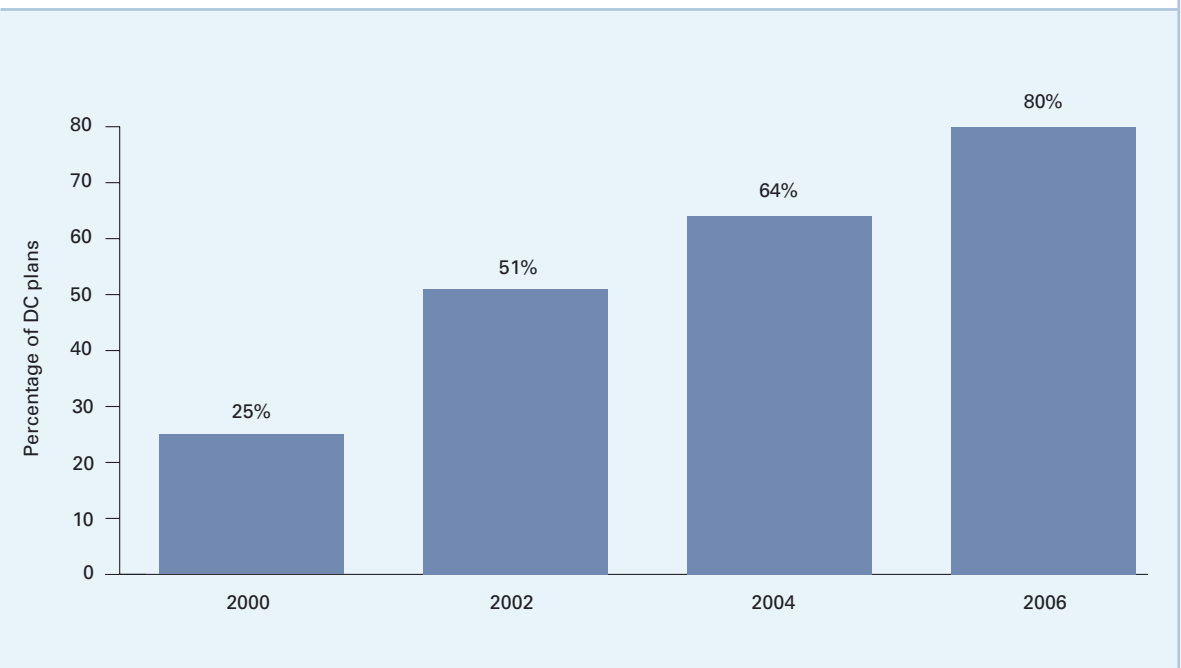


Figure 8: Plans offering a choice of more than five investment funds



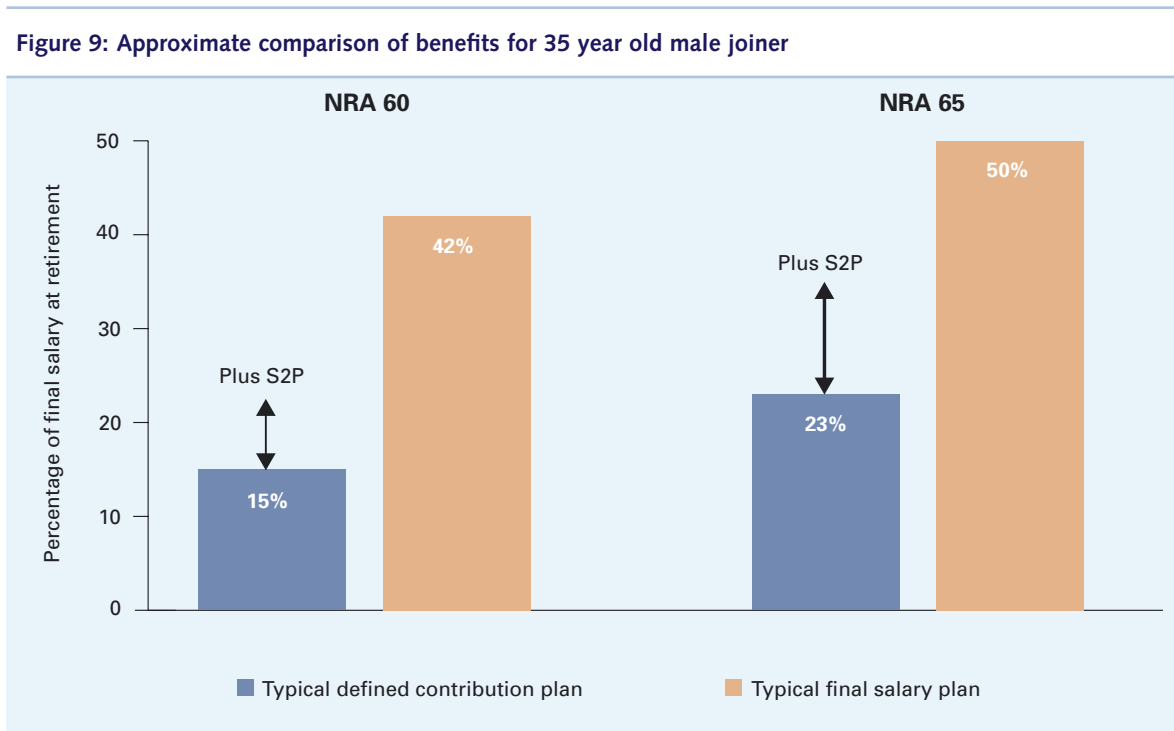
operated as individual contracts with insurance companies as Group Personal Pensions or stakeholder plans, rather than operated under a trust. Around a third of defined contribution plans surveyed are contract-based, an increase from around a quarter two years ago. Interestingly, whilst very few plans have moved from trust-based to contract-based in the last two years, 24 per cent indicated that the trust-based status is likely to be reviewed in the next two years. In addition, nearly three quarters of plans that have opened since 2004 are contract-based.

Take-up

With only 60 per cent of eligible employees actually joining the plan, take-up of defined contribution plans continues to be behind both final salary (91 per cent) and career average/cash balance (78 per cent). Perhaps the fact that only 22 per cent of defined contribution plans operate automatic enrolment plays a part in this differential, particularly given the more complex choices faced by a member when joining a defined contribution arrangement. There is a very wide range of take-up rates with rates as low as 25 per cent not being uncommon. If organisations respond to the proposal of the recent government White Paper by auto-enrolling employees in their plans, they will see a substantial increase in their pension costs unless they cut back on the level of contributions provided.

Retirement benefits

The overall average contribution rate to defined contribution plans including matching contributions is around 13 per cent of salaries, but what does this mean in practice for members of those plans? In Figure 9 we have estimated what retirement income a male joining the plan at age 35 might get on retirement from a typical 60ths accrual final salary plan and a defined contribution plan with 13 per cent contributions. The assumptions used are those currently prescribed for Statutory Money Purchase Illustrations but with increases in earnings assumed to exceed price inflation by 2 per cent per annum.



It can be seen that the pension payable from an average defined contribution plan is expected to fall significantly short of the amount payable from a typical final salary plan, assuming that members do not pay additional voluntary contributions. Despite this difference, the average member contribution rates to both defined contribution and final salary plans are similar at around 5 per cent per annum, assuming maximum matching contributions are paid. It should be noted that these projections do not allow for any state benefits. It may be that a defined contribution plan member would receive additional S2P/SERP benefits in exchange for paying higher National Insurance contributions.

4

Career average and cash balance plans

Organisations looking for an alternative to the conventional 'final salary vs. defined contribution' debate continue to seriously consider career average and cash balance plans. These 'risk-sharing' plans allow some risk to be passed to the employee, whilst some is retained by their employer.

Career Average

Career average plans provide pension at retirement based on the average salary over a member's career rather than just their final salary. 3 per cent of open plans surveyed are career average, representing 9 per cent of open defined benefit plans – a not insignificant proportion.

A wide variety of designs were observed, but a typical career plan might have:

- 60ths accrual
- 5-6 per cent member contributions
- guaranteed revaluation of LPI or RPI
- no intention to grant significant discretionary resolution.

The above features are similar to a typical final salary plan. However, members of career average plans will generally receive less generous benefits than they would have received in a corresponding final salary plan, owing to the averaging of their pensionable salary over the whole working life.

Interestingly, some recent high-profile employers have chosen to adopt a 'halfway house' between final salary and true career average, for example by limiting growth in pensionable salaries.

Cash Balance

Members of cash balance plans are allocated a cash sum payable at retirement which is usually expressed as a percentage of current salary for each year of service. Some form of increase to the cash sum would usually be made in the period prior to retirement. 2 per cent of open plans surveyed are cash balance (representing 6 per cent of open defined benefit plans). In view of the small number of such plans, no clear 'typical structure' was evident.

Executive benefits

Summary

The findings on executive benefits bring home two factors. The first is the complexity involved in pension plan design for executives, as demonstrated by the fact that we need ten different categories to illustrate the approaches (see Figure 10). The second is that the old 'gold standard' of a defined benefit plan for all, with the executives having a higher accrual rate is now much reduced for new recruits, being offered by only 19 per cent of participating organisations.

The main reasons for these two trends are, however, the same and are well known. They could be summarised as tax and accounting changes and the recognition of the cost and risks involved in defined benefit plans.

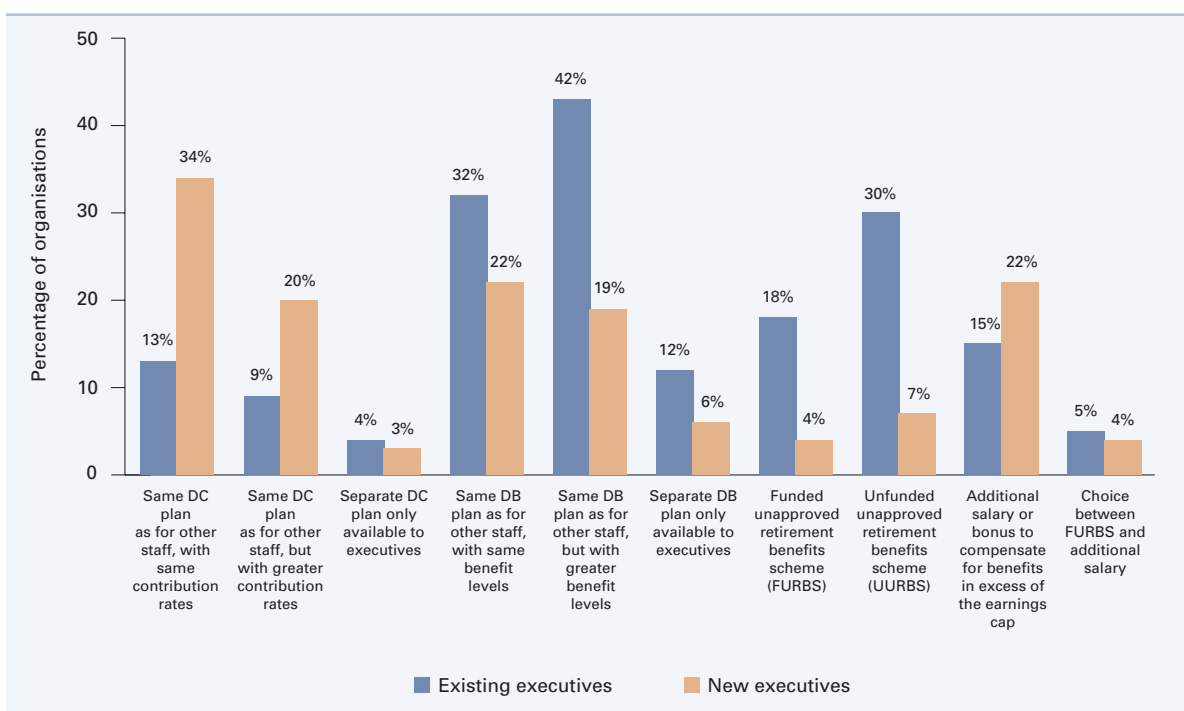
The outcome is that organisations face a real challenge in knowing what the 'market' is for executive pensions. Especially since A day executives will want their packages tailored to suit their own retirement plans or, as a minimum, to have a choice between pension and an alternative such as a cash allowance

to give them flexibility to meet their needs. Increasingly this is leading to organisations incorporating the value of pension provision within a total reward approach.

Registered benefits

In all, 47 per cent of organisations offer new executives defined benefit plans compared to 57 per cent that offer a DC plan (with some organisations offering both). This compares to 38 per cent of organisations having an open defined benefit plan for non-executive staff.

Figure 10: Types of arrangement included in current benefit policy



Non-registered benefits

Looking at the unapproved benefits for capped executives, it is clear that unfunded plans ('UURBS') are dwindling in popularity as a solution for the 1989 cap, with 30 per cent of organisations using them for existing executives but only 7 per cent offering them to new recruits. However, the A day changes have caused a renewal of interest in using UURBS. Other Watson Wyatt surveys have found that around one-third of FTSE 100 companies expected to offer UURBS to at least some of their most senior executives to allow uncapped defined benefits to continue to accrue post A day.

The use of cash allowances has been growing and, even prior to A day, 22 per cent of new recruits would have been offered cash in lieu of pension above the cap whereas only 15 per cent of existing executives have a cash allowance.

Alternatives to pension after A day

64 per cent of organisations told us that they expected to provide an alternative to continued pension for members above the Lifetime Allowance who wished to opt out of the registered plan. Of those, cash was to be offered in 79 per cent of cases and UURBS in 22 per cent. All other options fell below 5 per cent.

The rates of cash stated by the small sample (34 respondents) who answered the question varied from 10 per cent to 30 per cent of salary, with just two offering more than 30 per cent. No respondents planned to offer less than 10 per cent.

Some 13 per cent of respondents were expecting to offer more than one choice apart from continued membership of the registered plan.

Accrual rates and retirement ages

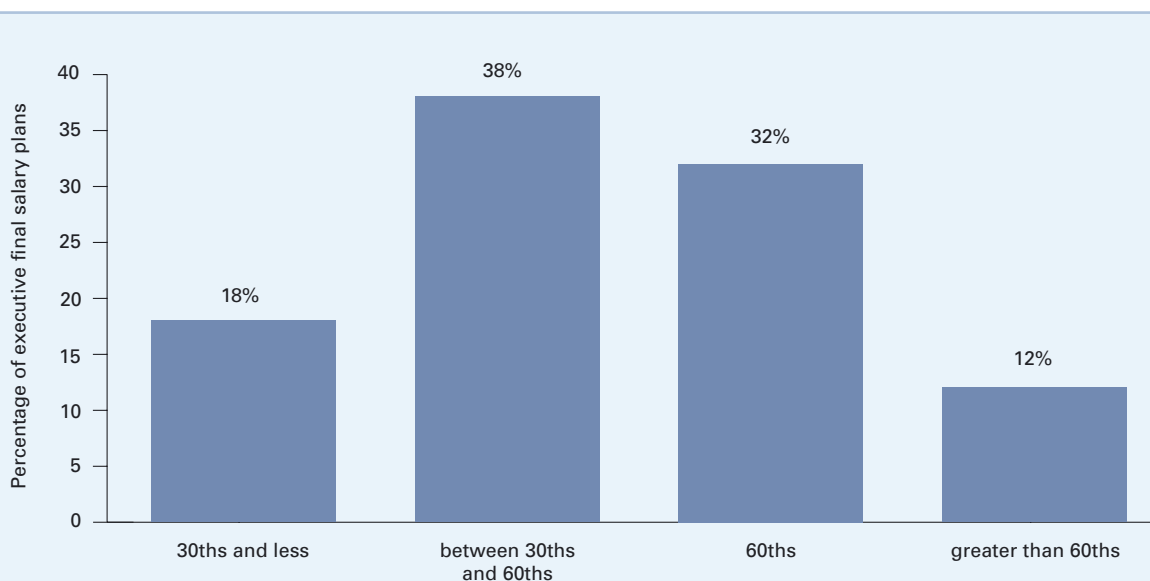
Figure 11 shows the range of accrual rates offered to new executives in final salary plans.

Notwithstanding the greater benefits provided to executives compared with other staff, the vast

majority (89 per cent) pay the same or lower contribution rates.

For new executives the earliest age at which members are able to take their pension without an early retirement reduction is 60 or less for around half of all respondents.

Figure 11: Accrual rates for executive benefits



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