

Executive pensions in the post A day environment

Three perspectives: the employer, the Remuneration Committee and the individual

Deciding what pension provision to offer senior executives used to be easy. Initial appointment discussions would have covered salary and incentives and even the company car and then, only once these were agreed, would the executive pension plan have been explained. In large companies this normally provided two-thirds of final salary after 20 years' service, with compensation for the earnings cap.

Companies had surpluses in their pension schemes and shareholders had little interest in the cost of pension schemes. Then all this changed: the cost of final salary pension schemes increased just as new disclosure rules meant that shareholders started to see the values of pension provision to individual directors.

Companies now face a much more complex picture when managing their pension schemes and remuneration strategy. Similarly, executives are likely to need to be much more active in monitoring their own financial affairs to plan for a comfortable retirement.

We held a seminar on 1 May 2007 to look at this area. It was attended by 50 senior representatives from major companies. We asked delegates a number of questions about how they are handling the issues involved. Their answers, together with responses from a further 15 companies, are summarised in this document. The total responses include replies from 20 FTSE 100 companies.



Headlines from the seminar:

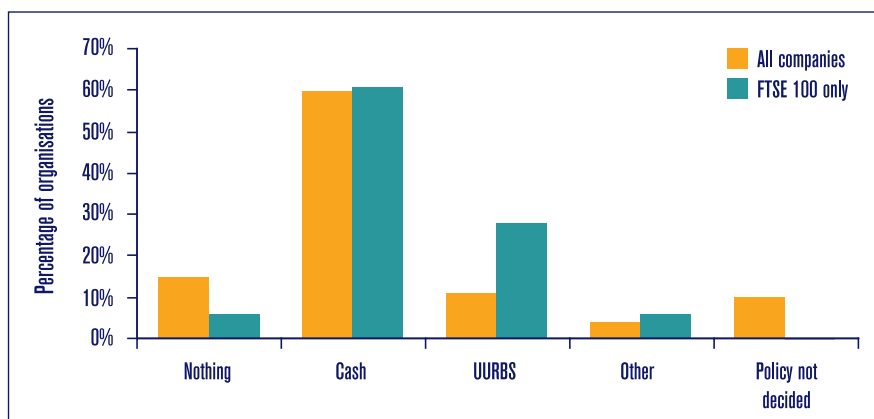
- employers increasingly provide retirement benefits to executives under fixed cost arrangements (defined contribution pension plans or cash allowances)
- the logic of carefully constructed remuneration packages can disappear once pension values are included in total remuneration figures because of the differences in pension values
- market data on executive salaries is becoming distorted as some companies increase salaries to compensate for a fall in pension benefits on change of employment
- personal financial planning decisions faced by executives have become increasingly complex and carry significant risk
- executives would benefit from impartial financial advice on an annual basis.

Is cash the new pension?

The introduction of the Lifetime Allowance (LTA) limits the level of tax-efficient benefits that an executive may accumulate within a registered (formerly known as 'approved') pension scheme. Many executives may therefore look for the pension element of their package to be paid in a different form to avoid accruing benefits that may be subject to a 55 per cent tax charge (see **Figures 1 and 2**).

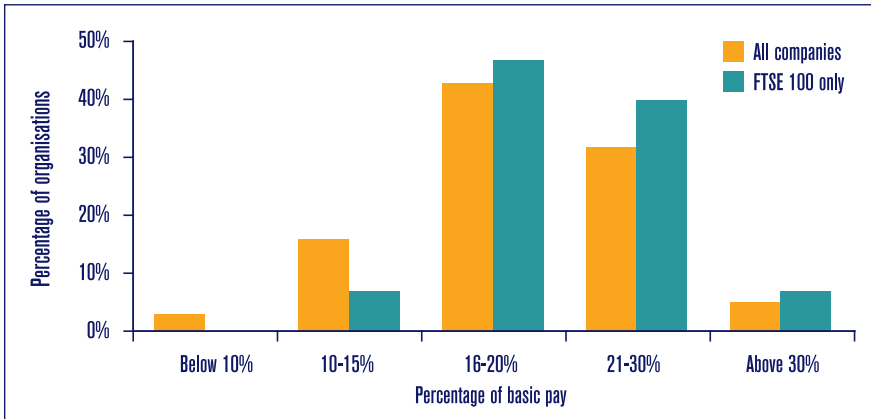
“ **Executives and shareholders expect internal and external equity.** ”

Figure 1 | Alternative benefits on opting out for LTA reasons



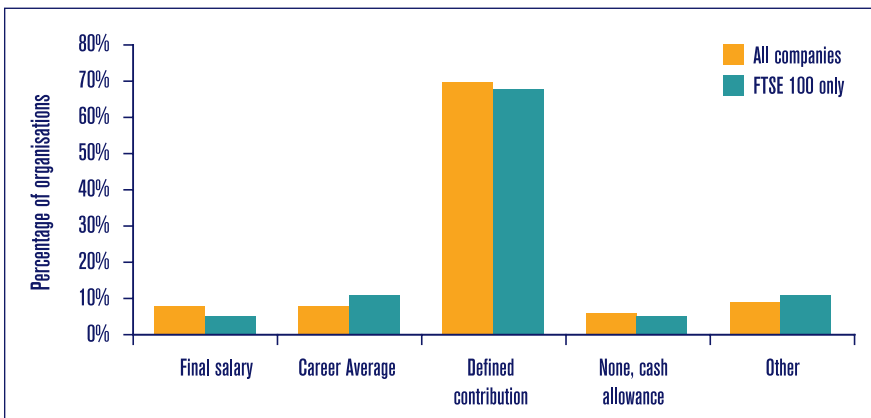
“ **Executives also need to consider contingent benefits such as those paid on death and ill-health when choosing whether to take a cash allowance as these can be difficult for the executive to arrange by themselves.** ”

Figure 2 | Level of cash allowance payable on opting out



“ **The cash allowances now being paid are unlikely to generate anywhere near the traditional 1/30th accrual benefit executives have historically received.** ”

Figure 3 | Pension arrangements offered to new senior hires



By far the most popular alternative being offered is a cash allowance, at over 60 per cent of all companies. This practice will further diminish the number of executives who continue to receive a defined benefit promise. However, a higher proportion of FTSE 100 companies than companies generally continue to seek to provide a defined benefit promise through an unfunded arrangement.

Has the general move to defined contribution arrangements also affected executives?

With many defined benefit pension schemes now closed to new entrants, executives are increasingly being offered defined contribution arrangements on joining a new employer (see **Figure 3**). The resulting challenge is to determine how the contribution rates to these arrangements should be set, given

- the level of contribution rates paid for other employees
- the level of cash allowance paid where an executive opts out of a defined benefit arrangement for LTA reasons and
- any implicit allowance for retirement benefits made through the payment of a higher salary.

The varying approaches taken have led to a distortion of base salary data in some cases and any analysis of remuneration and benefits survey data should consider this effect.

It is increasingly important that companies use data sources that include pension values (see

Figure 4).

Legacy remuneration issues

So how do companies review the different elements of pay?

The developing structure of pension benefits over the last 20 years may result in an executive team having a combination of different benefit structures, just some of which are listed below

- defined benefit on full salary, continuing accrual
- defined benefit on full salary, with part above cap or above LTA provided through an unfunded promise
- defined benefit on full salary, ceased accrual but still linked to future salary increases, plus a cash allowance for future service
- defined benefit on full salary, ceased accrual and not salary linked, cash allowance for future service
- defined benefit on capped salary, cash allowance on balance
- defined contribution on full salary
- cash allowance only.



Managing pensions within a total compensation framework needs to come out of the ‘too hard box’.



Figure 4 | Benefits elements reviewed when setting remuneration

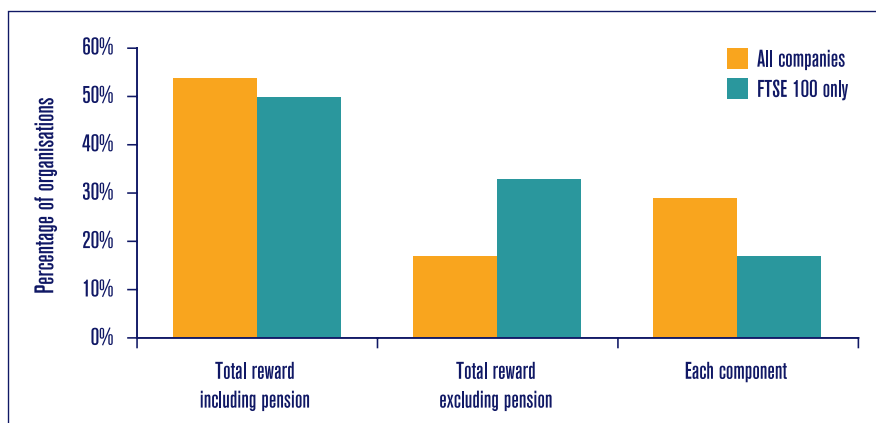


Figure 5 | How frequently are pensions valued individually when considering internal relativities of reward elements for executive directors?

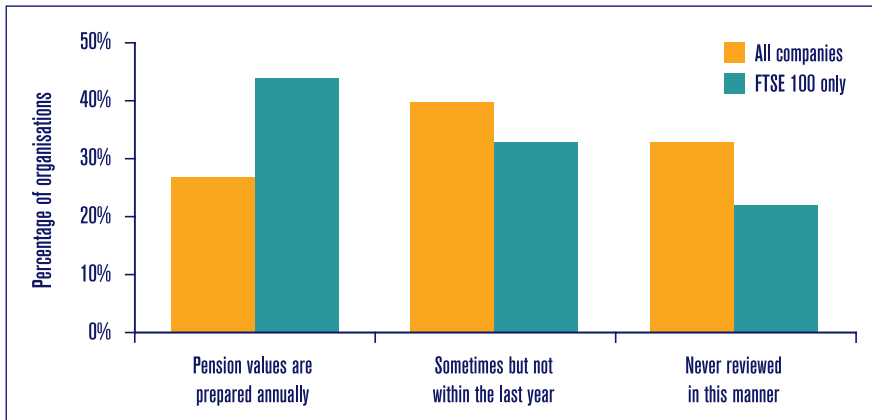
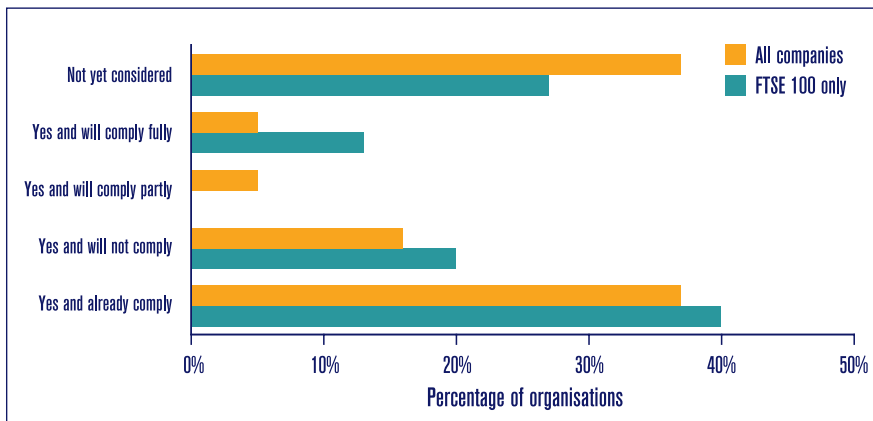


Figure 6 | Have you reviewed your approach to severance benefits in line with 2006 ABI guidelines?



*2006 ABI Guidelines: 'pension entitlement on severance can represent a large element of cost to shareholders. Remuneration Committees should identify, review and disclose in their report any arrangements that guarantee pensions with limited or no abatement on severance or early retirement. These would not be regarded as acceptable if included in new contracts. Remuneration Committees should demonstrate that the route taken on severance represents the lowest overall cost to the company.'

“ In some cases it may be more expensive to try to buy-out benefits to comply with the guidelines than to allow an existing contract to run its course. ”

Not only does this result in a high degree of complexity to be managed, but the differentials in the value of the pension benefits between executives may counterbalance any salary differential intended to reflect a difference in roles. It is increasingly clear that, in order to maintain internal relativities, an analysis of total remuneration including pension values should be completed on a regular basis. It is encouraging to note that over 28 per cent of companies are already completing such an analysis (see **Figure 5**).

It may also be appropriate at this point to conduct an audit of legacy 'unapproved' pension arrangements, to determine whether these may be converted to other benefit options in order to reduce the future overheads of maintaining these arrangements.

Shareholder requirements

The ABI, as a leading institutional shareholding body, continues to examine very closely the potential costs of providing enhanced pension benefits to executives. The latest evidence of this is the ABI's 2006 guidelines* on severance terms for executives. It is clear from our poll that many listed companies have still to consider whether they satisfy these guidelines (see **Figure 6**). Of those that have looked at it, even some of the FTSE 100 have no plans to change their benefits policy to completely satisfy these guidelines.

Executives will need to take greater control of their own financial planning

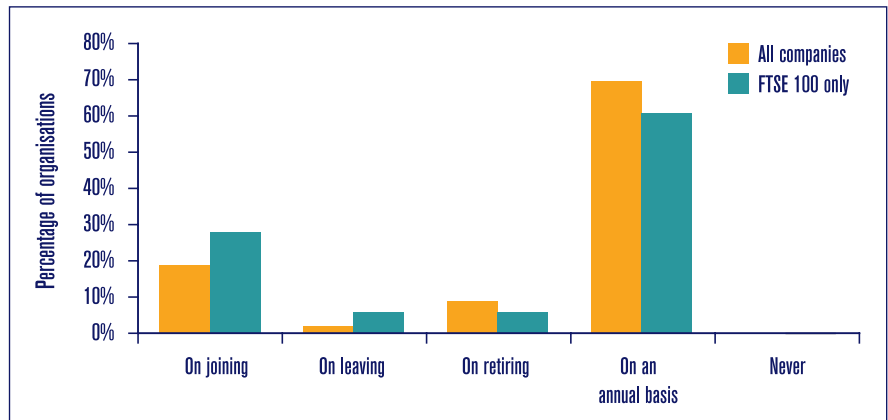
With the potential impact of the LTA and/or the need to manage personal investments to fund a required level of retirement income, the days of an executive relying on two-thirds of salary retirement benefit arranged, without their input, by their employer, appear to be long gone.

Whilst any change to their status of employment will be a clear trigger point for an executive to complete a personal financial review, there is a danger that deferring a review to such an event could result in several lost opportunities for the executive. As a result, a regular annual financial healthcheck should become a regular event in the executive's calendar (see **Figure 7**).

As might be expected, companies do not yet have a uniform view on how any advice pertaining to such a review should be paid for. One in three organisations believe there should be some form of employer funding either through a one-to-one advice service with an appointed independent financial adviser or through workshops (see **Figure 8**).

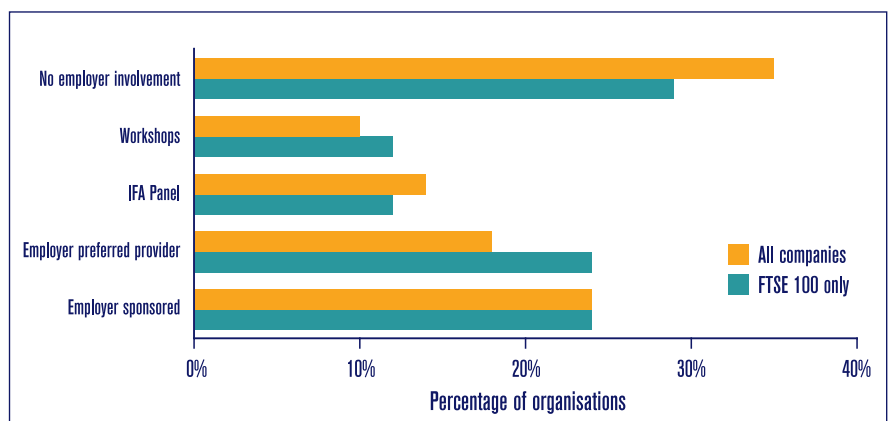
Counterbalancing this, one in three organisations believe there should be no employer involvement, with the executive arranging any review themselves at their own cost.

Figure 7 | When do you believe executives will most benefit from impartial financial advice?



Regular professional advice or guidance will help an executive avoid mistakes. A key danger for the executive is funding too much too soon. Personal funding could potentially remove the scope for an employer to provide future pension benefits within the LTA.

Figure 8 | How should access to this advice be achieved?



Summary

In summary, although we are now over a year on from A day, there are still many issues to address in respect of executive benefits, both by the employer and by the executive themselves. The realignment and harmonisation of executive benefits to reflect the new tax-regime for pension schemes and market practice for these benefits is likely to continue for several years to come.

Note on feedback: during the seminar 50 delegates provided feedback by electronic voting. A further 15 organisations provided similar feedback by the use of an online survey. This note draws on both data sources and therefore represents the views of this 'self-selected' group – it does not represent the views of Watson Wyatt or any individuals. The delegates were mainly compensation and benefits directors and heads of pension functions.

Watson Wyatt executive benefit services

The need to consider benefit provision to executives from each of these perspectives has never been greater. We offer advice to clients that addresses issues from each perspective in order to develop a robust, coherent and cost-efficient solution for each party, including

Remuneration committee guidance

- reward design
- benchmarking total remuneration
- corporate governance compliance
- long-term incentive design and valuation

Benefit policy

- plan design and implementation
- funding assessments
- benefit communication

Impartial financial planning advice to executives

- one-to-one advice
- group workshops
- financial education
- new hire/severance support

Further information

For further information on this subject please contact your usual Watson Wyatt consultant or:

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