

Corporate Pensions Briefing

January 2008

Pensions issues have stayed high on the board's agenda following the significant changes of the last few years, the booming M&A market up until mid 2007 and the subsequent credit squeeze and market volatility.

Watson Wyatt's Corporate Consulting Group seminar held its latest Corporate Pensions Briefing on 12 December 2007, exploring the experiences of 2007 and considering what pension scheme sponsors can expect from 2008. The briefing was attended by 33 delegates, comprising senior finance, treasury and pensions executives from companies with defined benefit pension schemes. This factsheet summarises the headlines from the seminar and the survey voting results gathered during the seminar.

Headlines from the briefing

Scheme funding

- Increasing life expectancy, coupled with the move to scheme specific funding, is leading to increased employer contributions.
- Medium cohort improvements now suggest a rapid reduction in longevity improvements – see Figure 1.
- Sponsors are increasingly looking to use contingent assets to limit contribution increases.
- Increased contributions and/or market performance are being used by sponsors to reduce investment risk.



Pensions in corporate transactions

- Pensions remain a major factor in many deals, particularly leveraged buyouts.
- There are a wide variety of potential alternatives to cash, if security for a weakened covenant is required.

The changing face of the buyout market

- 2007 has seen a large number of buy out quotations but very few full buyouts. Instead, we have seen providers offering partial risk-transfer solutions as well as a few corporate transactions driven by a desire to get hold of pension liabilities.
- A market in longevity risk transfers is developing – this would provide the tools for sponsors to disaggregate and hedge longevity risk (without the need to hedge it with other risks).

These topics are covered in more detail in our publication *Boardroom briefing: Corporate pensions – issues for 2008*.

Key points from delegates' feedback

- **Views on the key development of last year were mixed** – 31 per cent of delegates saw 2007's key development as the emerging market in longevity solutions.
- **Dynamic de-risking is popular** – Two-thirds of delegates would look to use asset out-performance (compared with liabilities) to reduce the risk the pension scheme posed to the sponsor, while 22 per cent would look to use it to reduce employer contributions. Over a quarter of delegates also thought 'dynamic investment de-risking' would be a likely area of expansion in 2008.

- **Deal structure influences the perspective on pensions in M&A** – A higher level of funding is thought to be necessary if there was a leveraged buy out rather than a trade buyer, with nearly two-thirds of delegates believing a difference in excess of 20 per cent would be necessary. Such funding could be contingent, rather than in cash.
- **A significant proportion of sponsors are looking at transferring pensions risks** – 26 per cent of delegates have been in discussion with a buyout provider regarding either a full or partial buyout.

Key developments from 2007

Views on the key development of 2007 were varied, with 31 per cent of delegates seeing it as the developing market in longevity solutions, closely followed by the fundamental changes to corporate pension provision brought about by the introduction of Personal Accounts (28 per cent of delegates). IFRIC 14 and its implications for the amount of any pension surplus that can be recognised under pension accounting standard IAS 19 also concerned a significant proportion (25 per cent).

Figure 1 | Improvement in mortality rates amongst 65-69 year olds

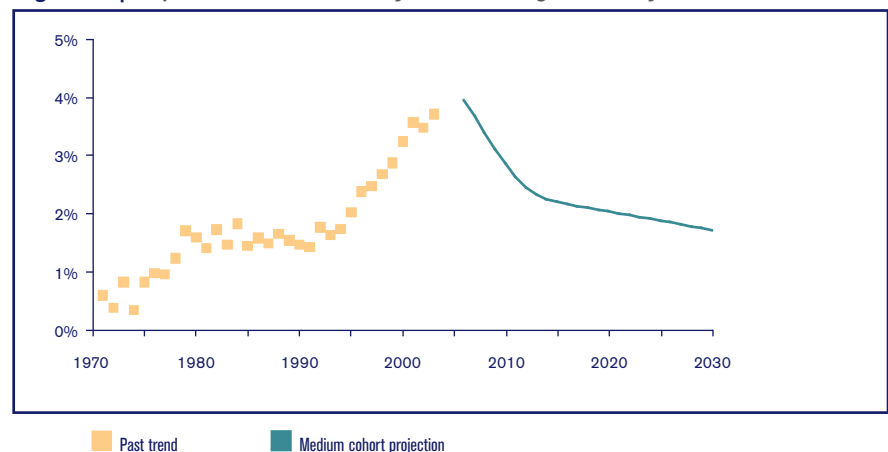
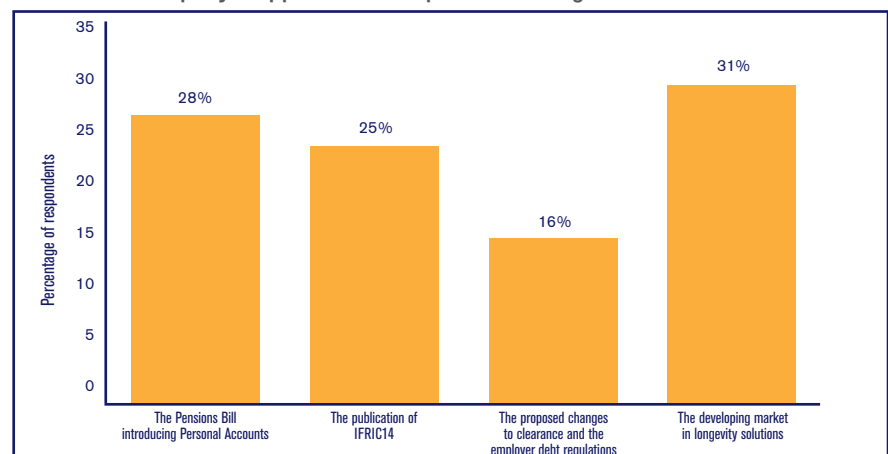


Figure 2 | Which development from 2007 will most affect your company's approach to its pension arrangements?



Scheme funding

Two-thirds of delegates would look to use good asset performance (relative to liability movements) to reduce the risk the pension scheme posed to the sponsor, either by reducing the allocation to return seeking assets (45 per cent) or by strengthening assumptions or allowing an additional funding reserve to build up (22 per cent).

Twenty-two per cent of delegates would look to reduce employer contributions, with 11 per cent considering provision of a contingent asset to reduce the risk of 'trapped' surplus.

Pensions in corporate transactions

The Pensions Regulator has stated that trustees should consider seeking materially enhanced mitigation over IAS 19 if there is a significant weakening of the sponsor's covenant, for example as a result of a leveraged buy out (LBO). This view was recognised by delegates, all of whom thought a higher level of funding would be targeted if there was a LBO rather than trade buyer – nearly two-thirds (61 per cent) thought a figure in excess of 20 per cent would be necessary in such circumstances.

The changing face of the buyout market

2007 has seen significant marketing by buyout providers with more than half of delegates (58 per cent) having been contacted by a provider, and slightly over a quarter (26 per cent) having had further discussions about either a partial or full risk transfer.

Figure 3 | If 2008 saw good performance by your scheme's assets you would:

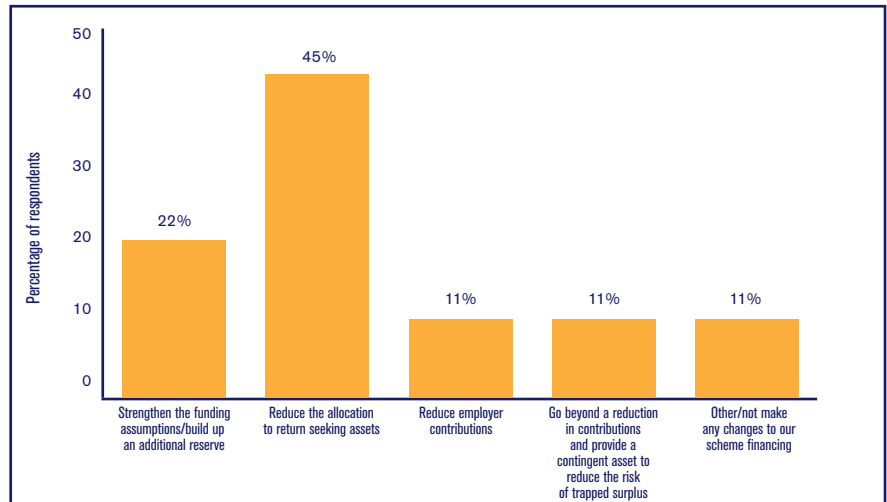


Figure 4 | How different would you expect the level of the funding target to be if negotiations focused on a leveraged buy out rather than an investment grade trade purchaser?

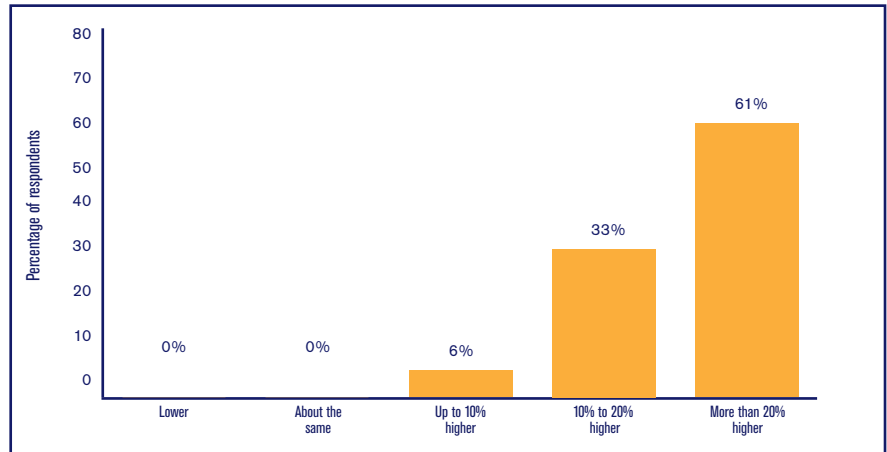


Figure 5 | Have you been in contact with one of the players in the buyout market?

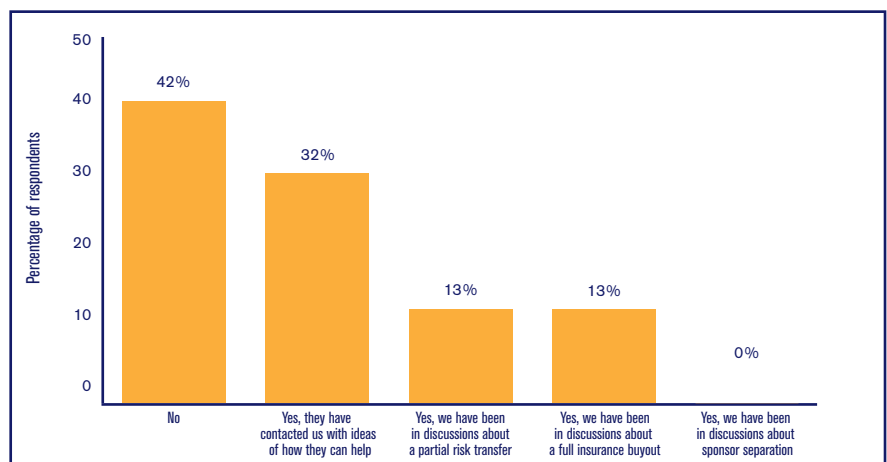
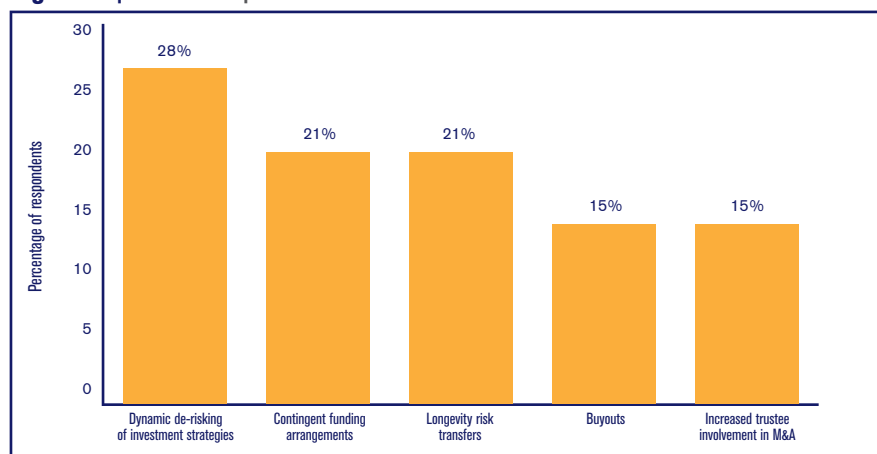


Figure 6 | I would expect 2008 to be notable for an increase in:



What to expect from 2008

2008 is expected to show an increase in the number of funds putting in place strategies to dynamically de-risk their investment portfolios, with 28 per cent of delegates selecting this as a likely notable area of expansion in 2008. Increases in contingent funding arrangements and longevity risk-transfers were also expected by 21 per cent of delegates each.

Watson Wyatt's Corporate Consulting Group

Watson Wyatt's Corporate Consulting Group helps companies optimise the risk and reward management of their pension and employee benefit arrangements, on an ongoing basis and in M&A situations.

Companies are faced with increasing costs and risks, decreasing control over their obligations, with full settlement of the problem often (at least in the short term) unaffordable. The issues that need to be addressed lie on a spectrum between managing the legacy (dealing with past obligations efficiently and effectively) and strategy for future business (implementing solutions to drive the business forward).

We offer practical, business-focused advice to clients across this spectrum of issues.

For further information please contact your Watson Wyatt consultant or

Andrew Reid

Head of corporate consulting
andrew.reid@watsonwyatt.com
+44 (0) 20 7222 8033

Steven Dicker

Senior corporate consultant
steven.dicker@watsonwyatt.com
+44 (0) 7808 176397

watsonwyatt.com

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