

Corporate Pensions Bulletin

Impact of the new pension scheme funding regime

January 2006

The new pension scheme funding regime is likely to have a very significant impact on companies' cashflows and there are some important new factors for the corporate sponsors of defined benefit pension plans to consider. These issues will hit the Boardroom agenda very soon. Here are a few of the headlines ...

The potential threat to cashflow

The Pensions Regulator has set out how it intends to police the funding of UK schemes, and indicated that FRS 17/IAS 19 is likely to be considered a reasonable funding target. To 'fly under the radar' companies may need to pay significant amounts of free cash flow into their pension schemes. Analysis undertaken for the Regulator suggests that over a third of companies, were they to adopt an FRS 17 funding target, would be required to pay over 25% of free cash flow into their schemes. *Further details are set out in the enclosed 'Pensions News Flash'.*

Avoiding the Regulator's attention

In order to determine an indication of what might be an appropriate level of cash contribution under the new funding regime, companies will need to undertake a proper investigation – especially given the continued fall in corporate bond yields over 2005. As a very rough first step, however, annual cash contributions can be estimated as:

$$\frac{[\text{UK FRS 17 or IAS 19 deficit}]^* + \text{service cost}}{8}$$

** most recently calculated accounting deficit.*

The potential for over-funding

Past service funding based on an FRS 17/IAS 19 measure effectively assumes future investment returns will be at the level of corporate bond yields. These currently stand at under 5% and it might be hoped that there is a real possibility of greater pension scheme returns over the medium to long term. If schemes become over-funded, getting money back out may be very difficult and subject to penal tax rates. How might this use of money be viewed by shareholders?

Improving security without extra cash

There are a number of ways to give security to the pension scheme other than by paying extra cash. These include the use of letters of credit, escrow accounts, special purpose subsidiaries, intra-group guarantees and insolvency insurance.

However, before entering into any such arrangement, companies will need to consider aspects such as the cost and duration together with any effect on borrowing plans and existing covenants.

Taking action to reduce the risk-related PPF levy

From April 2006 the calculation of the levies payable to the Pension Protection Fund will relate to the level of a pension scheme's underfunding and the risk of a sponsoring company's insolvency. There is now a very limited time-frame in which to take action so as to reduce the PPF levy – either through extra funding or by putting in place some form of contingent funding. *Further details are set out in the enclosed 'Pensions News Flash'*

How can we help?

We would be very happy to share our experiences with you and explore your particular circumstances. Please contact your Watson Wyatt consultant, or call Steven Dicker on 0161 839 1600 or Andrew Reid 020 7222 8033.

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