



Key issues and challenges emerging from DC pension provision

November 2006

Welcome

Defined contribution (DC) pension provision in the UK has grown significantly over recent years. Along with this substantial growth in DC provision, 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.



Inside

- 2 Pain management
- 3 Too much choice?
- 5 First class service
- 7 Automatic for the people
- 9 Try harder
- 10 Wake up call
- 11 Choices, choices
- 12 MI space
- 13 Control tower

For anyone involved in running a DC plan, there is much to consider and keep abreast of.

In this booklet, some of our leading DC associates briefly consider and discuss some of the key issues and challenges emerging from DC pension provision - setting out some latest thinking and identifying some emerging best practice in this increasingly important area.

The articles in this booklet were first published in a regular column, 'DC Debrief', exclusively written by Watson Wyatt for *Pensions World*, which is published by LexisNexis Butterworth.

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 discussed in this booklet 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

Thanking you and kind regards.

Gary Smith



PAIN
MANAGEMENT

It's time to reach for the aspirins again. You may have cured your DB pensions headache, but beware, the DC pain is only just beginning, says Gary Smith.

While defined benefit (DB) pension schemes feature highly on most companies' risk management agendas, defined contribution (DC) plans are often perceived as low risk. Their financing and investment options may be safer, but they can still induce endless headaches.

Prevention before cure

Pension provision continues to rise in profile and move further up employees' personal agendas. Concerns and blunders are hitting tabloid headlines while there is increased awareness of poor customer service delivery levels, particularly in the financial services arena. Customers are prepared to fight for compensation for personal loss or suffering.

In this environment, sound scheme governance is increasingly important and sought after. Indeed, the government and scheme regulators are focusing their attention on this and demanding higher levels of expertise, accountability and evidence of regulatory compliance.

Risk management is now an integral part of life, and pensions are no exception. A

DC scheme risk assessment exercise will identify a long list of vulnerabilities. Many risks can then be minimised on an ongoing basis by regular review and scheme monitoring. Issues can be promptly identified or anticipated and dealt with before they become major problems.

Know the risks

Inherent DC scheme risks are of four broad types:

- **management and financial risks:** Strategic objectives, management structure, competency and knowledge levels, decision making processes, compliance with legislation and regulation, and scheme design features (for example, contribution and eligibility rates)
- **investment risks:** Fund choice for members, selection of managers, delivery vehicles (for example, gateways or platforms) and agreements and performance
- **administration risks:** Administrator or pension provider services, those provided by companies' internal departments (for example, HR and

payroll), process design (including data and contribution flows), basic member record keeping, relevant contracts and service level agreements

- **communication risks:** Effectiveness of communications strategy, adequacy and accuracy of material given to members and the process behind their notification of choices.

These risks are not of the same importance to companies and trustees, nor are they equally likely to create a problem. So the next stage is scoring each one according to the likelihood of an event occurring and its possible impact. This will produce a significance rating, revealing where companies and trustees need to focus.

After identifying the key risks, companies must consider how to minimise and manage them on an ongoing basis. A crucial part of this is ensuring the scheme has a straightforward governance and risk management structure and process in place. This is a small price to pay for reducing the potential for significant damage or financial liability.



Too much choice?

Less can be best when offering scheme members a range of investment funds. **Duncan Hale**, unwraps some new ways of finding the sweetest opportunities.

The norm for defined contribution (DC) pension schemes is to offer members a diverse suite of passive funds, possibly supplemented by some single manager active options. Conventional wisdom has been that maximising investment opportunities is about broadening fund ranges and offering greater choice.

However, recent evidence shows that for most members, more choice does not mean better choice. They simply end up electing the default option. And despite recent improvements here, particularly with lifecycle strategies, the goal of all DC schemes must be to increase active participation thereby maximising investment opportunities. The two areas

where these can be most enhanced while increasing the ability to include members are asset allocation and manager selection/structure.

Bake your own

Manager selection within asset classes is a paradox for DC trustees. They either offer only a passive option, or one active manager (a clear signal of endorsement), or more than one. But is it practical to expect members to differentiate successfully between managers when more than one is available? This has two obvious effects: it confuses members and increases default take up or encourages choice based on past performance, brand and fees.

A solution is for trustees to create their own individual asset class funds. They could construct a fund within global equities, for example, reflecting their beliefs on structural issues like the split between UK and overseas equities or active and passive opportunities, and whether small cap and emerging markets managers should be included. It could then be populated by best in class managers. Such funds would enable trustees to provide all the building blocks currently available, but structured in a more member friendly way and with a more concentrated range.

Furthermore, because members only select funds at an asset class level, it becomes easier for trustees to change managers – something they have previously found difficult and that has often resulted in the acceptance of substandard arrangements.

Ready mix ingredients

Historically, schemes involving implicit strategy advice were limited to with-profits and single manager multi-strategy funds. While both served their purpose in the past, the maturing of the DC market has seen their popularity rightly decline. The lifecycle approach has partially filled this gap. It has significant merit, being the only

generic approach to recognise and deal with a member's changing risk preferences over their working life.

However, while lifecycle as an asset switching concept must be cultivated, its implementation until now has been based at an asset class level. This usually means members either have to accept a predetermined equity mix or design their own asset allocations. Given that trustees hire professionals to advise them on the latter in a defined benefit context, is there any wonder that when faced with a similar task, the overwhelming majority of DC members opt for the default option! To boost member engagement trustees must offer pre-packaged asset options

designed to achieve risk and return metrics that are more meaningful to members. An example of this is the structure adopted in Australia where DC trustees offer a suite of multi-strategy options with a raft of inflation 'plus margin' return targets. Risk is then expressed as the chance of a negative return, described as how often this option is expected to have negative performance.

While similar to balanced funds, this solution is superior for allowing trustees to retain control of manager selection, asset allocation and objective setting. It also lets members make investment decisions based on their own financial position and attitude to risk.

Easy as apple pie

Moving to these approaches shifts some former member decisions to trustees. This transfer of responsibility may be controversial but the question is: do members see value in choice not backed up by the necessary expertise? This question is seemingly answered by the amount of people taking the default option. The aim is not to remove decision making from members completely, but to simplify it by giving them fewer but more fundamental choices for their long-term wealth.





First class service

The delivery of DC administration requires more consistency so that all schemes can proudly provide service with a smile, says **Claire Hall**.

Defined contribution (DC) administration is sometimes seen as a commodity: you expect it to work and provide you with value for money. But does 'you get what you pay for' ring true, and how do you know if you are getting a good service?

Go with the flow

Administration is not just about storing data, answering the phone and running a few calculations. It is no easy task. Administrators must satisfy members while supporting a host of HR

and payroll contacts, and organising the collection and investment of contributions to tight deadlines. The key to success lies in the dataflow model and reconciliation process. It is essential that the data, contributions and investments are merged during the update processes and promptly reflected in member accounts.

Bad administration leads to slow services, unreconciled accounts, member complaints and the inability

to communicate with them within reasonable timescales. Together with clients, members gauge whether they are receiving a good service based on their own perceptions of what it should provide and their previous experiences.

Customer satisfaction

From a trustee's perspective, good service is where members do not complain, data is up to date and accurately supported, member communications are sent on a regular basis, and the scheme does not breach any regulations.

From a company's perspective, the administration provider makes life easy by providing the link between the HR and payroll functions. It has extensive data validation routines in place to ensure the information cycle between the three areas is consistent and accurate. Everyday member queries are supported and costs are maintained within an agreed budget.

From the members' perspective, good service might include the phone being answered quickly, the option to go online for their latest account balances,

making changes to contributions, and seeing consistency with their individual company brands.

And there are also third parties to satisfy. Accurate data needs to be supplied to actuaries for valuation purposes, to life assurance and permanent health insurance providers to maintain cover, and to schemes' auditors.

State of the art

While people's perceptions of good service vary widely, communication is the common link. Employees are becoming much more pensions aware and are keen to gain greater access to their personal data. This is provided through a variety of tools. The traditional paper benefit statement, while a regulatory requirement, is becoming redundant as members receive communications via the internet and text messaging as 3G technology allows personal data access from mobile phones.

To fulfil their governance objectives, trustees require access to member demographic information. By providing them with internet access to run reports

against live member data, they can monitor scheme activity and make investment vehicle and contribution level decisions. This use of technology can only be deployed if member data and contribution records are up to date and accurate. A good DC administrator will provide a highly automated service with assurance that member accounts are reconciled allowing the greatest use of state of the art technology.





Automatic for the people

Auto-enrolling employees into pre-programmed pension schemes is laden with technical glitches, says **Mark Green**.

But if given the right support, members need not shut down.

Automatic enrolment has been touted as the pensions crisis panacea. It will create a nation of savers funding their retirements with regular contributions from their salaries. But this view overlooks some potential problems.

Spend, spend, spend?

Auto-enrolment may result in people saving for retirement but failing to benefit from their efforts. This could affect those on lower incomes, perhaps working part time, who are likely to benefit from pension credits supplementing their

State capital allowances. Any potential savings will offset these benefits, proving to be a waste of money. Spending, not saving from the outset would be a better option. (This problem extends to defined benefit [DB] scheme members, many of whom have been auto-enrolled and face this issue without the warnings given in defined contribution [DC] schemes.)

The minimum income guarantee might not be payable when today's members reach retirement but it should not be ignored while it is in place.

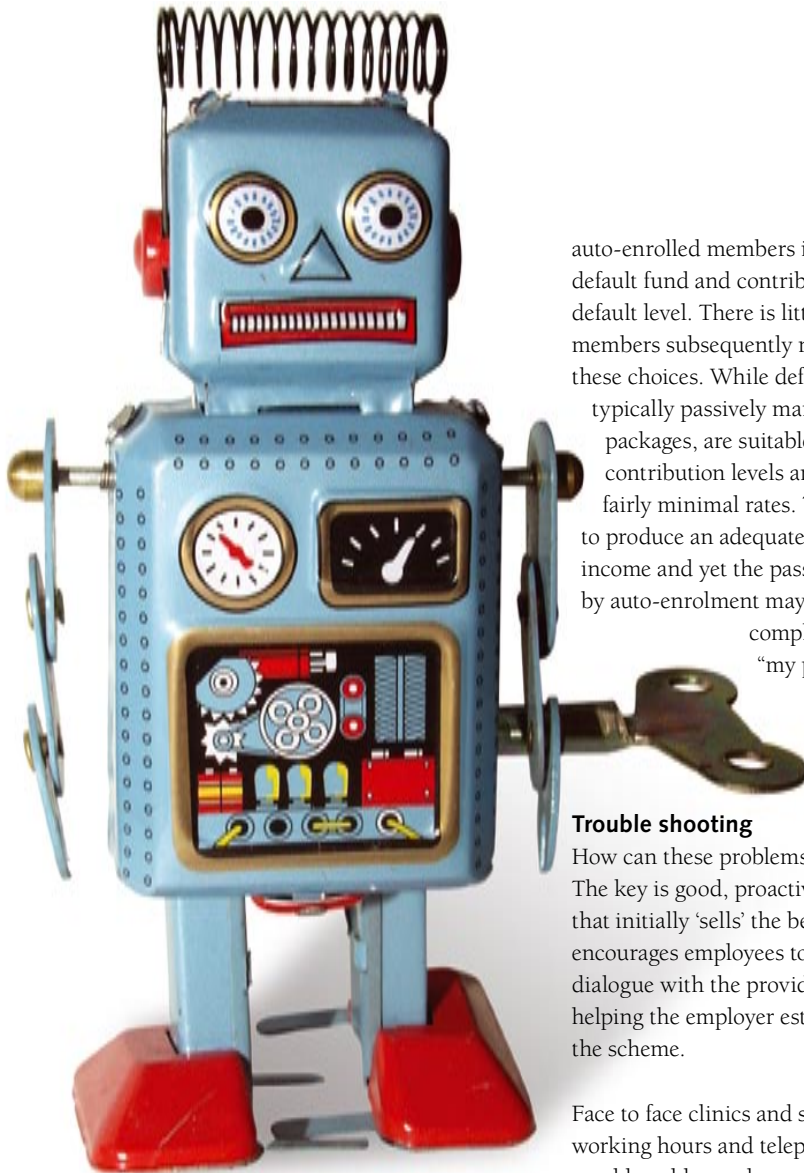
Bugs in the system

Another danger is that despite warnings about the potential communications risk issued during the enrolment process, it is unlikely that those affected will have the financial literacy or access to specialist advice to identify whether or not they will fall into this trap.

Auto-enrolment may also be perceived by members not so much as an employment benefit as another tax. Compulsory saving, even if it does not result in inadvertent mis-selling, may not be in employees' best interests. Individuals finding themselves forced to save may resent this. They may have other priorities such as debt repayment. While any auto-enrolment process has an opt out facility, there is a difficult balance to strike between making it easy for those opting out for the right reasons and minimising it for those who would benefit from the discipline of compulsory saving.

Cruising on auto-pilot

Thirdly, auto-enrolment does not encourage scheme engagement. Instead, it tends to result in a passive mentality. Evidence suggests that over 75 per cent of



auto-enrolled members invest in the default fund and contribute at the default level. There is little evidence that members subsequently review either of these choices. While default fund options, typically passively managed lifecycle packages, are suitable for most, default contribution levels are usually set at fairly minimal rates. This is unlikely to produce an adequate retirement income and yet the passivity encouraged by auto-enrolment may lead to the complacent belief that “my pension is sorted”.

Trouble shooting

How can these problems be addressed? The key is good, proactive communication that initially ‘sells’ the benefits and encourages employees to enter into dialogue with the provider/adviser, helping the employer establish and run the scheme.

Face to face clinics and seminars during working hours and telephone helplines would enable employees to see how

schemes could work for them and provide a further opportunity to ask questions. Online modelling tools would also allow them to experiment with adjusting contributions to see the effect on their retirement incomes. Onsite training should accompany the introduction of any technology.

Most importantly, the communication should not be a one off exercise when the scheme is established or when members join. It must be a continuous dialogue throughout their careers. It should be made as personal and relevant as possible.

Is auto-enrolment a wolf in sheep’s clothing? Not if it is done well, in which case it has the potential to be, if not the panacea some hope for, at least a significant step forward in addressing the pensions crisis.

Try harder

Tackling DC planning and communications requires a strong team. Companies must keep trying to convert ideas into action, says **David Wareing**.

Looking at how to improve DC schemes is rather like asking what makes a rugby team better? There is no single answer or quick fix solution but it starts with strong, determined management and a blend of good confident players. You start with a clear business plan, created and implemented by a focused and confident management team. The players are the membership and they are absolutely crucial to making DC better.

Strategic scrum

The business plan sets out the objectives and key performance measures for the scheme. It addresses why the arrangement was set up in the first place (a point critical to its long term success) and considers the risks that could prevent it achieving its goals.

This is a very simple summary of a very comprehensive document. In an ideal situation, preparation of this plan will see human resources and finance working collaboratively. They should review the strategy regularly to assess



how the scheme is performing against its performance measures. The membership will feel their employer is taking the scheme seriously if it monitors, measures and reviews processes.

Team talk

Scheme communications are also key to making DC better. It is not just about when but what to say to members and this will be down to the type of workforce and employer. There is clear evidence that face to face communication is the most effective way of engaging with members but resources may not permit this level of attention. There is a place for internet or intranet based solutions but there is still no substitute for paper. A combination of the two may be the answer. The sponsor should remember that workforces have diverse needs so there may be a case for highlighting specific topics for different member groups.

We live in an information friendly world and should embrace this as part of our communication strategies. If a source exists that explains a subject effectively, why seek to reinvent it?

Trophy winning tips

- establish a sound cross party committee to manage the scheme
- produce a sound business plan that seeks to establish the sponsor's needs and objectives
- create a risk assessment document to help the employer maximise outlay and minimise risk
- have a DC plan that meets employee expectations thereby fostering a spirit of engagement
- communication is critical to success. When and what to communicate is clearly important but do not forget the need to understand the differing characteristics of your membership
- look to the support of a specialist adviser who understands and shares the same values as the sponsor.

Wake up call

Apathy could mean DC scheme members are sleep walking into pensions pitfalls. It is time to sound the alarm, says **Helen Dowsey**.



Defined contribution (DC) members are making poor pensions decisions and it is time to take action to save money later. For a variety of reasons employees are not joining DC schemes. Recent Watson Wyatt research found that DC take up is around 66 per cent on average meaning around a third of eligible employees are not joining. In addition, members are generally paying inadequate contributions and are not making appropriate investment decisions. Around half of DC members do not know whether their pension is currently invested appropriately for their needs. Furthermore, over half have never changed their investment choices and nearly a third have not reviewed them in the last three years.

Apathetic showing

Members make poor decisions due to a mixture of apathy and ignorance. The danger is that employees will reach retirement and suddenly realise they cannot afford to give up work. They will look for someone to blame and it is likely they will turn to their employer, expecting a significant financial contribution to their pension pot or the employer will be forced to allow a later retirement age. With age discrimination legislation making it harder to force workers to retire once they reach a certain age, the problem of not being

able to afford to stop working will cause significant HR issues.

Auto-enrolment is the simplest way of addressing apathy and experience shows scheme take up can increase dramatically. Traditionally members receive an annual communication in the form of a benefit statement but this is not enough for most people. A worrying 47 per cent of members spend less than 10 minutes reviewing their statements and over 80 per cent take no subsequent action. Some schemes have introduced programmes where members sign up to an automatically increasing scale of personal contributions. This can form part of an auto-enrolment process or a simple box ticking exercise on an application form.

Opportunity knocks

In *Watson Wyatt's 2005 FTSE 100 DC Survey*, 57 per cent of schemes had the employer offering some form of additional matching contribution on top of core payments. This partnership approach can help to plug the pensions gap. In the 2004 Survey, the figure was 42 per cent, indicating that matching structures are increasing in popularity. Not all employees take advantage of these facilities and this is not always because they cannot afford to,

sometimes they just do not understand the value of the additional contribution. We use wonderful phrases like 'reckless conservatism' but essentially most employees do not have a clue when it comes to selecting funds. We often see schemes (especially additional voluntary contribution (AVC) arrangements) with a high proportion of assets in cash funds. In our research, 62 per cent choose the default option.

You may be able to tick all the boxes:

- automatic enrolment is in place
- 'pay more later' processes are in place
- there is a default lifestyle investment option
- online projections and stochastic modelling tools are freely available.

But have you really thought it through?

Passive aggressive

Default options are not a panacea. There is a tendency for members who have been defaulted into a scheme to remain passive (not necessarily in an investment sense although this may also be the case) and they will need to be continuously cajoled into reviewing their contributions and investment options. A wide ranging, customised and ongoing education programme will address these issues. A structured process of monitoring and reviewing member behaviour and decision making as part of a wider governance structure will ensure you stay on top of them.

Choices, choices

Choosing investment funds can be like picking chocolates, it is as easy to pick a bitter coffee centre as it is a sweet surprise.

Crispin Lace looks at how schemes can sugar the DC pill.

An innovative scheme design, catering for individual risk appetites, is a prerequisite in the development of ideal investment solutions for staff. Critically, they should address the questions of real asset diversity, emerging investment opportunities, investment efficiency and cost.



Soft centres

In the past, investment arrangements were set up with two factors in mind. First, assets should facilitate daily valuations and second, the limited availability of other asset classes precluded offering any choice beyond equities and bonds. The industry has evolved, now the foremost challenge is to provide a few simple choices that deliver cost effective sophisticated investment solutions.

To achieve this it is helpful to establish a framework that enables opportunities to be defined as different investment types; either *safety*, *growth* or *protection*. This makes it easier to mix and match them according to members' individual profiles and risk tolerances. *Safety* includes low risk assets, such as cash and government bonds. *Growth* means liquid and illiquid risky assets including

alternatives. *Protection* looks to limit the loss of capital either in the short or long term or any reduction in a member's projected retirement income.

This approach caters for the full range of individual circumstances so that every risk tolerance can be satisfied with an appropriate allocation between these broad investment types as well a mix of exposures within each.

Selection boxes

75 per cent of FTSE 100 companies offer a choice of more than five investment options in their defined contribution (DC) pension plans, an increase of 11 per cent on the previous year, according to Watson Wyatt research. While there is a noticeable trend towards increasing choice, it is striking

that research into levels of investment knowledge and engagement shows around half of DC members do not know whether their account is invested appropriately. Over half of typical DC scheme members have never changed their fund choices and nearly a third have not reviewed them for three years.

A key feature of a DC proposition should be to move against this expensive trend and reduce the number of funds. However those on offer must be more sophisticated, packaged solutions. This enables members to arrive at an investment strategy suited to their circumstances and risk preferences with fewer, simpler choices. To deliver this it is necessary to use real asset diversity, an approach that can reduce the probability of a negative return by around 26 per cent relative to a typical diversified DC strategy. The most efficient way of accessing this diversity is through an administrative friendly platform: the investment gateway.

This approach to solving the investment puzzle provides a complex but efficient back end packaged into simple but smart front end solutions, making it easy for risk profiled members to gravitate towards their ideal investment portfolio; an essential element to encouraging life-long saving.

Definition: Real asset diversity

Real asset diversity includes such asset classes as small companies, commodities, private equity, fund of hedge funds, high yield and emerging market debt and equities.

MI space

Management information is becoming an important element of the DC worldview. Without it providers could find that clients take off, says **Andy Parker**.

The significant financial expenditure on pensions by plan sponsors and employees, leads to a consideration of how best to maximise scheme returns while at the same time minimising operational risks.

Historically, the management of the defined contribution (DC) provider in a trust based scheme was ten minutes under 'any other business' at the end of a primarily defined benefit related trustee meeting. The position for contract based arrangements (group personal or stakeholder pensions) is often significantly worse with many employers hiding behind the fact that the legal relationship is between member and provider, suggesting that there is little or no role for the plan sponsor. Now DC schemes are the main pension planning vehicle for many employers, this position is gradually changing and active scheme management is being embraced.

Employers (and their advisers) are now more demanding. Some providers have introduced 'menu pricing' where they outline the range of services they can offer with an associated cost given to each part of the proposition or an overall price for the parts the employer requires. The days of paying for all services, irrespective of use, should be long gone.

MI way

A further service line is the one which enables trustees or a pensions governance body to manage the ongoing overview of a DC provider – the provision of management information (MI). Without MI, it is difficult to assess whether the scheme is meeting the stakeholders' objectives and the provider's service standards. To get the right MI, it is essential that the scheme has clear objectives and has identified the key issues.

MI assists in two main areas – ensuring that the DC provider's service proposition can be robustly analysed and understanding employee behaviour to determine what operational or design changes might be appropriate for the scheme. What information can be obtained and how easy is it to obtain?

MI might consist of a scheme level overview of:

- the provider's administrative and investment performance
- financial information such as cashflow and fund holdings
- membership behaviour (age profile, contribution levels, investment choices and so on).

Research shows that only around two-thirds of the major providers offer MI. It is a 'work in progress' for a further 10 per cent. This means some providers are not offering access to such information at all.

This is the reported position for new schemes established on today's state of the art administration platforms. If you have an older scheme on a legacy administration platform, the chances of obtaining meaningful data are significantly reduced. The format in which information is provided should also be carefully considered.

To facilitate successful scheme management, trustees and plan sponsors need to work with their provider to agree the provision of appropriate scheme specific information. Trustees and plan sponsors should have agreed objectives for the scheme and have identified the key issues and areas of focus – this will ensure that trustees and plan sponsors know what MI they want and need. Providers should provide the information clients want not just what they want to give! In today's low cost DC pensions environment, any provider who does not step up to the challenge should expect to see clients voting with their feet.

Control tower

The Pensions Regulator (TPR) is tracking DC management's take-off.

Sam Pickford Watson Wyatt suggests a flight path to follow.

The focus on appropriate and effective defined contribution (DC) pension scheme management continues to increase. Most recently, TPR identified the management of 'risks to members of work based DC pension schemes' as one of its three key objectives in its medium term strategy. TPR also recognises the role of contract based schemes (like stakeholder and group personal pensions) in providing work based DC pensions and as a result, states its intention to focus on their management as well as that of occupational, trust based plans.

The DC community has welcomed TPR's position, not least for its forward thinking approach to management. All too often schemes are getting too little, if any, management focus. The risks associated with running a DC arrangement are too often not recognised or are overlooked. TPR highlights DC administration as an area of particular concern along with member awareness and investment.

Driven by risk

TPR says its long-term objective is to ensure DC trustees and others involved in running DC schemes mitigate the risks to members. For this to happen, it believes that those responsible for running DC schemes must understand the key risks and have

a clear appreciation of how to mitigate them. Over the last year in particular, rising concerns about DC risks have inspired many trustees and employers to undertake a risk assessment and implement a scheme management (or governance) structure.



Good practice in DC scheme management is fast developing but there are essentially three key stages:

- agreeing a well defined management structure and a documented governance plan. This should detail the scheme objectives, illustrating what 'success' looks like operationally (and, if required, strategically)
- producing a year planner highlighting the key events, not just mandatory ones like producing accounts or issuing benefit statements but those things that trustees or employers would like to do to grow and develop the scheme
- establishing a comprehensive review framework including relevant and pertinent management information. This is driven by the key risks and objectives identified in the management or governance plan.

Grasping the wheel

Risk management profiles will increase as assets grow and more members begin to reach retirement. The importance of implementing a strategy at an early stage, together with regular monitoring, will allow risks to be identified before they

escalate. A risk management approach could therefore be a major factor in the scheme's success.

TPR has stated that its regulatory scope includes contract based group personal pensions and stakeholder as well as occupational, trust based DC and additional voluntary contribution (AVC) arrangements. Over the last few years, more employers have set up some form of committee to oversee and manage contract based DC arrangements.

The first hurdle for many trustees and employers will be to go back to basics by revisiting (or in many cases defining) suitable scheme objectives and success criteria. These will vary considerably between organisations. These basic objectives and key performance indicators can build an effective scheme management structure and an ongoing review and monitoring framework that can bring real and material commercial advantages.

Trustees and employers need not worry about the greater focus by TPR on their scheme – so long as they have effective

and appropriate management structures and processes in place. For many, it will simply mean not continuing to put it off until tomorrow but firmly grasping this DC nettle today and firmly taking management control.

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W W W . W A T S O N W Y A T T . C O M

21 Tothill Street, Westminster, London, SW1H 9LL UK
Telephone +44 (0) 20 7222 8033 Fax +44 (0) 20 7222 9182

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