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Executive pensions briefing May 2008

What impact has A-Day had?

We have previously highlighted that many companies are moving towards a ‘defined cost’ approach to pension provision for their senior executives.

This might be a defined contribution (DC) pension plan and/or a cash allowance. In this year's executive pension benefits seminar held in May we looked at recent market data and the experience of delegates to determine whether this has indeed proved to be the case. In addition, we also examined:

- the benefits of integrating share plans and pensions
- the need for financial education
- the complexities of retirement options under the new tax regime.

Headlines from the seminar

- newly appointed directors and senior managers are most typically being provided with a DC pension arrangement, just like other employees
- the level of contributions to DC plans and of cash allowances where these are paid in place of pension provision for executives, is converging on a range of 15–25 per cent of basic salary
- three-quarters of companies are either setting up or will consider setting up a Group SIPP
- one in two companies would support the provision of financial advice for executives either through generic material or one to one advice.

Watson Wyatt Worldwide

Figure 1 | Type of pension compensation offered to FTSE 350 executives

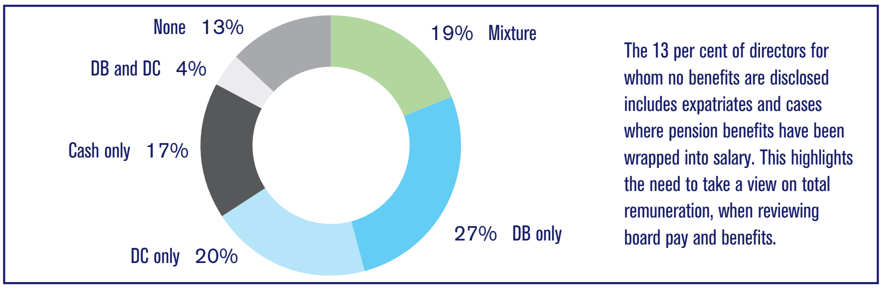


Figure 2 | Structure of pension arrangements offered to senior managers

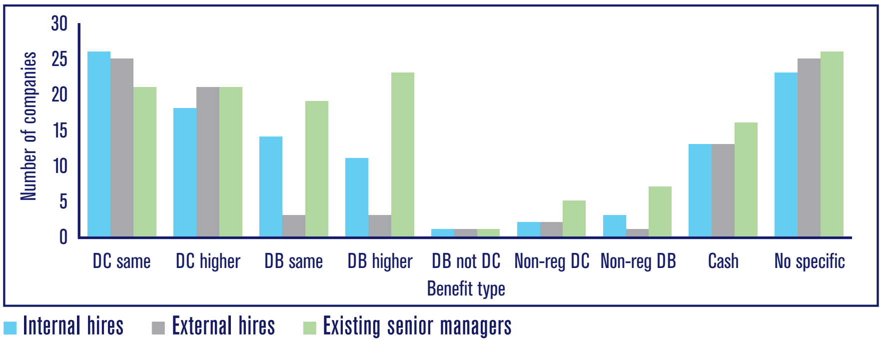


Figure 3 | Have you considered setting up a Group SIPP for your employees?

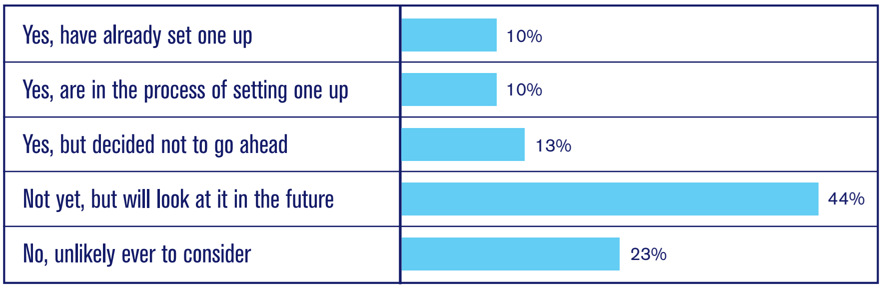


Figure 4 | Reasons for setting up a Group SIPP

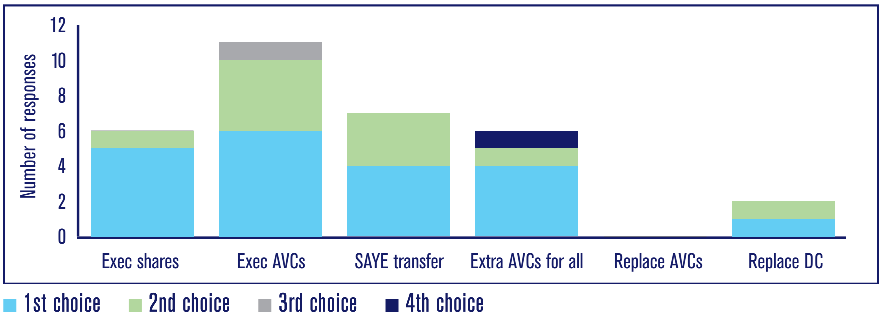
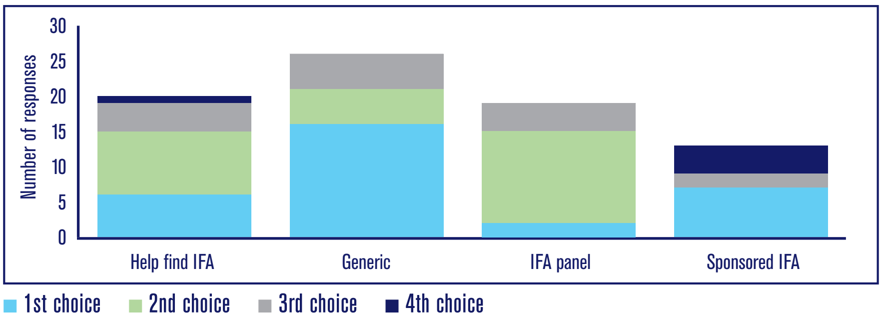


Figure 5 | How do you believe the company should facilitate financial advice?



Developing market practice for executive directors

Figure 1 shows an analysis of the pension element of benefit provision to directors, disclosed in the *2007 Remuneration Reports* for companies in the *FTSE 350*. It is interesting to see that only 27 per cent of directors are now entitled to pure defined benefit (DB) pension promises.

Our analysis also confirms that pension provision is diminishing in relative importance compared with other elements such as bonus. The 15–25 per cent typical pension contribution does not match the value of an old-style final salary pension, while incentive plans have grown in value, with the typical annual cash bonus for FTSE 100 executive directors disclosed in 2007 being 100–150 per cent of salary. This contribution range was also mirrored by the audience of the seminar, with only 5 per cent of companies represented providing a pension cash allowance in excess of 30 per cent of basic salary.

Senior manager benefits

One area of benefit provision that has historically been difficult to examine is the level of benefits provided to senior managers, that is those below the executive board, since this is not disclosed in any detail in a company's annual report. In our *Pension plan design survey 2008*, we asked companies to provide data on senior managers' pension benefits as compared to other staff, to see whether these benefits are also following the recent trends of employee benefits.

Figure 2 shows the responses to this survey. These highlight that the closure of DB schemes has also fed through to the senior manager population, with very few companies providing DB schemes for senior managers whilst providing a DC arrangement for other staff.

The impact of the Lifetime Allowance

Whilst it might be expected that most executive directors' pension benefits will be impacted by the Lifetime Allowance (LTA), the degree to which other employees' benefits may be affected does seem to vary greatly from company to company. The data from our *Pension plan design survey 2008* indicate that whilst a few companies expect more than 50 senior managers to be adversely affected by the LTA, the vast majority expect fewer than five employees, other than main board directors, to be affected. The seminar audience included a higher weight of larger companies than is reflected in the survey and therefore it was unsurprising to find that a higher level, 19 per cent of the attendees, indicated that they expect to have more than 50 employees affected. However, 30 per cent of the attendees indicated that they had fewer than five employees affected, in addition to the executive board.

The relatively small number of employees expected to be affected does therefore imply that a large number of employees will have some scope to top up their pension benefits within the LTA in addition to the standard employer-financed component.

Group Self Invested Personal Pension Policies (Group SIPPs)

Whilst the typical routes an employee may take to utilise this scope within the LTA may be additional contributions, say to an Additional Voluntary Contribution (AVC) arrangement or a personally established SIPP, a growing number of employers are now considering offering access to a Group SIPP to:

- facilitate share transfers from company share plans
- assist executives to meet company shareholding requirements
- offer a wider investment choice than might be available within the all-employee pension arrangement.

At the seminar we asked the audience whether they had considered setting up a Group SIPP for their employees. The responses are shown in Figure 3.

The most popular reasons for considering establishing a Group SIPP are those shown in Figure 4. Very few attendees saw a Group SIPP as a potential replacement for an all employee DC or AVC arrangement. There also appears to be limited appetite currently for employers to redirect core pension contributions to a personal SIPP if requested, with only 8 per cent of attendees being currently prepared to do this and only a further 27 per cent considering doing so.

It is clear that the potential for enhancing the perception of a company's overall benefit arrangements, by highlighting the merits of linking share plans to pension arrangements through the use of a Group SIPP, will see them become an increasingly popular addition to benefit offerings over the coming years.

Financial education

The advent of additional opportunities under the new tax regime for pension schemes, such as concurrent membership of a Group SIPP, has brought with it a need for a much greater degree of ownership of pension planning by the individual.

Many companies offered a form of guidance near to A-Day to their senior employees on the impact of the new regime. Whilst this addressed the immediate issues of the introduction of the new regime, in many cases there remains a need for the individual to review regularly their arrangements to ensure any scope within the LTA is optimised, say through bonus waiver, and to avoid exceeding the LTA unexpectedly and suffering a LTA charge on retirement.

It was interesting to see that 34 per cent of the attendees do now facilitate financial planning advice for senior employees to assist with these considerations, whilst a further 22 per cent are currently considering doing so.

The format of this advice can vary greatly and Figure 5 shows how the audience felt a company should best provide this advice, with the most popular choice being to arrange for the provision of generic advice through the provision of seminars and/or written material.

In addition to the planning issues highlighted above, it is clear that the choices taken at retirement can also have a significant impact on a member's benefits. It therefore appears likely that senior employees will demand much greater assistance from their employer in making these choices. Given that a wrong decision can result in a significant tax liability arising that might have been avoided, even by something as simple as deferring retirement by just one week, it will become increasingly important to ensure that senior employees are receiving the correct level of regulated authorised advice at this key time of their life.

Is this simplification?

In summary, it appears that the pensions' tax simplification legislation and general ongoing trend towards DC arrangements will ultimately result in the provision of a much simplified level of core benefits to executives, which may well include cash allowance arrangements.

However, allied to this will be the greater degree of choice surrounding the new additional funding opportunities, such as Group SIPPs, and the complexity of decisions facing the individual, both throughout their employment and on leaving service, to ensure maximum tax-efficiency is derived from the options available to them.

It is therefore likely that, having established and implemented policies in respect of the level of benefits in the period since A-Day, companies will now spend the next few years refining these and exploring the additional flexibilities and the need for executives to have financial guidance.

Note on survey data

During the seminar 34 delegates provided feedback by electronic voting. This note draws on this data source 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.

Our analysis of the *2007 FTSE 350 Remuneration Reports* disclosures currently covers 87 FTSE 100 and 179 FTSE 250 companies and a total of 1039 executives of which 748 remained in service throughout the period covered by the relevant report.

The data quoted from our *Pension plan design survey 2008,* covers 120 companies.

Watson Wyatt executive benefit services

The need to consider benefit provision to executives from various perspectives has never been greater. We offer advice to clients that addresses issues from the employer's, the shareholder's and the employee's perspectives in order to develop a robust, coherent and cost-efficient solution for each party, including:

- Remuneration committee guidance
  - reward design
  - benchmarking
  - corporate governance compliance
  - long-term incentive design and valuation.
- Benefit policy
  - plan design and implementation
  - funding assessments
  - benefit communication.
- Impartial financial planning advice
  - one to one advice
  - group workshops
  - financial education
  - new hire/severance support.

Further information

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

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Ref: 2008-EU-0313