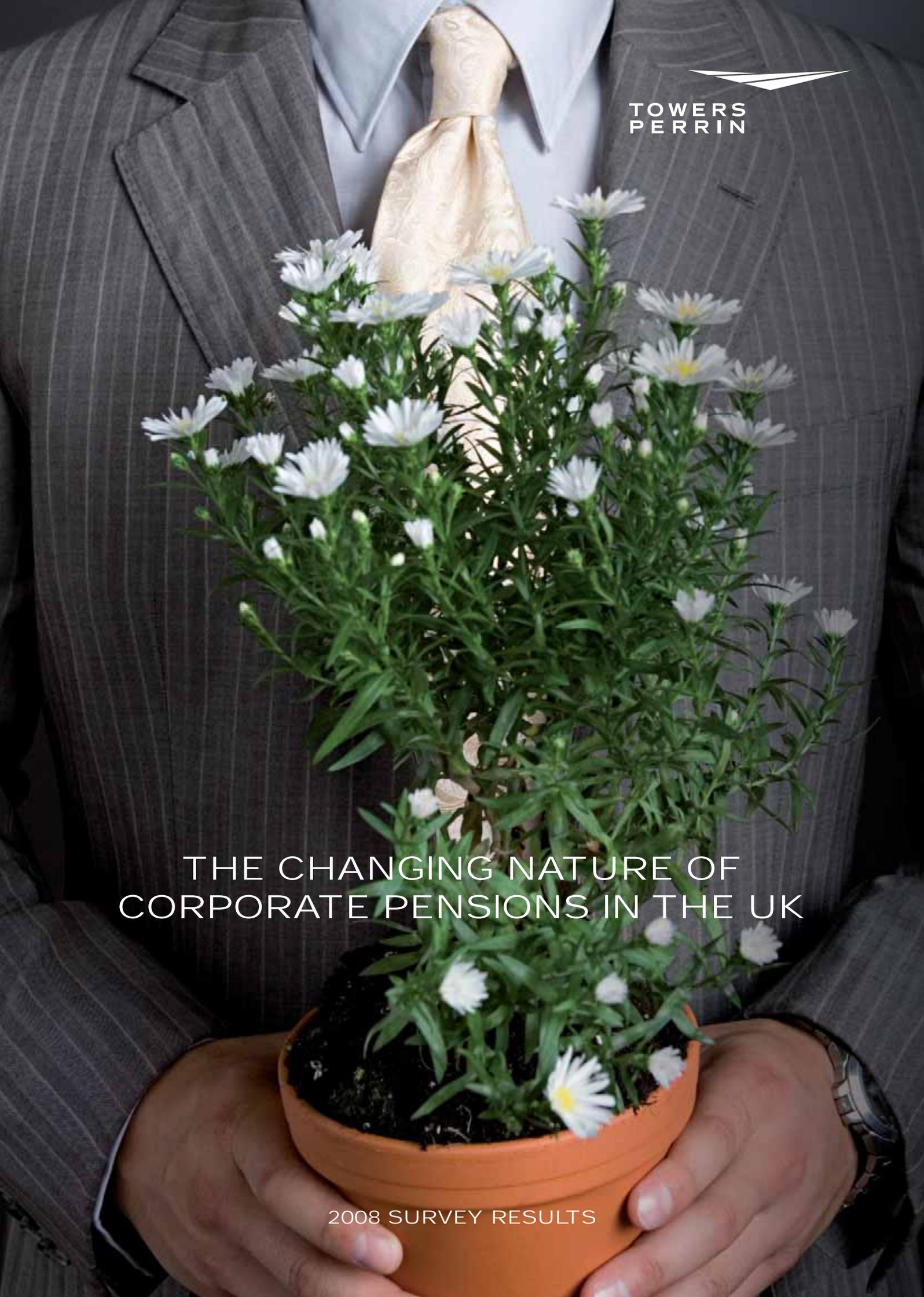




TOWERS  
PERRIN



THE CHANGING NATURE OF  
CORPORATE PENSIONS IN THE UK

2008 SURVEY RESULTS



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### **DECEMBER 2008**

Markets have been subject to unprecedented volatility since the research for this survey was conducted. To see our latest thinking, we include our update on 'UK Pensions – dealing with market turmoil', or visit [www.towersperrin.com](http://www.towersperrin.com) for further information and bulletins.

## KEY FINDINGS

This report is the fourth edition of Towers Perrin's biennial survey of company pension plans at large private-sector organisations in the UK.

The research into this report was carried out among UK pension schemes earlier in 2008, at a time when the credit crisis had started to emerge in the US, but prior to any major impact being felt within the UK and globally.

One hundred and eleven companies responded to the survey making this research one of the leading sources of information on trends in UK company pension provision.

The pace of change in company-sponsored pension provision continues unabated. A variety of themes recur – cost cutting, risk sharing, de-risking, employee choice and savings flexibility, to name a few.

This year's survey results provide insights into the latest developments on:

- the emerging role and profile of pensions in the employment deal (and how this compares to the deal for legacy employees);
  - the drivers behind further changes to pensions and the nature of changes now being contemplated;
  - trends in defined benefit costs and the de-risking actions being considered;
  - the challenges faced by members of defined contribution plans and the support being provided; and
  - the steps employers are taking as a consequence of personal accounts.
- The survey provides some revealing insights into the latest developments in UK private sector pension provision. The key highlights are:

### 1. The future of UK pension provision is defined contribution (DC)

The move away from traditional final salary schemes continues apace, with now only around one in ten private sector employers providing this form of benefit to new hires. The door is closing fast – of the 52% of respondents indicating they are considering making changes to their pension arrangements in the next two years, 17% expect to close their defined benefit (DB) plan to new entrants.

We fully expect the next phase of change within DB schemes to be their closure to future accrual, an issue supported in the Economist Intelligence Unit's 2008 report *A way through the maze: The challenges of managing*

*UK pension schemes*. Nineteen per cent of respondents to this survey confirmed they had already taken this action, with an additional 31% anticipating doing so in the next three years.

Although there has been talk within the pensions industry about the potential role for risk-sharing pension arrangements, there is little evidence to suggest this potential will be realised. Our survey records a small increase in the number of open career average revalued earnings (CAREs), an early prototype for plans that might be deemed to better share risk. However, this (and any future government encouragement) is now too little too late for risk-sharing plans to gain meaningful employee coverage.

In Australia, DB plans were killed off by the introduction of superannuation. In the UK they are already in fast decline. However, the introduction of personal accounts and auto-enrolment in 2012 could be the final nail in the coffin.

For many employers, DB is now viewed as a legacy arrangement with finance taking a much more active role in their running. The term 'DB endgame strategy' has become common parlance. With these mindsets, it is little surprise that de-risking interventions have become so prevalent.

### 2. If left unchecked, overall spend on pensions could continue to increase

We have undertaken analysis based on the results of our survey to assess the future pattern of pension costs for a typical UK employer. We have assumed that this employer has a closed DB scheme and an open DC scheme (both providing average levels of benefits) and its defined benefit costs were last measured around 12 months ago (current benchmark). We have ignored the effect of personal accounts (but see later).

Our analysis indicates that, in the absence of any intervention by employers or changes in financial markets, overall costs of pension accrual could remain above current benchmarks for the next five to ten years. It is only then that the effect of the migration of staff to a lower cost DC arrangement would start to bring costs down below the current benchmark.

This analysis provides a stark warning to employers hoping that the introduction of a DC arrangement will help manage cost pressures. The effect of staff turnover may not be sufficient in itself to achieve the desired result in the short to medium term.

### 3. During the transition DB will continue to be pared back

Where DB pensions are being provided to employees, this is now largely as a run-off vehicle for legacy employees. Our survey indicates that the cost to the employer of providing this benefit could be well in excess of 10% of salary higher than the typical new hire DC benefit.

Not surprisingly, indications are that the value of this benefit will continue to be pared back. One-quarter of respondents cite the different legacy and new recruit pension structures as an aspect of material concern.

Around 17% of respondents indicate they might increase employee contributions to DB. A similar proportion indicate that they might take other steps to reduce the value of DB commitments.

### 4. Personal accounts could lead to a large increase in costs

This survey indicates that, for many employers, levels of non-participation in existing pension arrangements are sufficiently high that the introduction of personal accounts could have a material impact on costs. On average, around 30% of the workforce is not currently participating in a pension plan (there are wide deviations around this average). The intention of the introduction of personal accounts is to change this.

We have undertaken analysis based on the results of this survey to assess the potential impact on costs of the introduction of personal accounts. To gauge the maximum potential cost we have assumed that rather than be auto-enrolled in personal accounts, current non-plan members choose to join the corporate pension arrangement for which they are eligible (as this generally offers much better value). Based on what we know of the 'average' respondent to our survey, we estimate that overall pension costs could increase by 10% if these non-members chose to join the company's DC arrangement. If they have access to a DB plan then the increase in costs could be in excess of 20%.

The actual impact on costs will vary substantially by employer. However, it is likely that many employers will be taking action before 2012 to manage their exposure to these additional costs.

### 5. Lack of employee awareness and engagement remains a major challenge

Politicians are showing a clear preference for employing non-intrusive persuasion (known as nudges by behavioural economists) to influence behaviours, rather than to rely on free markets or direct regulation. Within the pensions arena these nudges take the form of default funds or auto-enrolment into workplace pensions from 2012, with the option to opt-out. The dominance of the herding effect should not be underestimated – very few will move away from the default position.

Although these nudges could be highly effective at helping meet government objectives (eg, reduce the reliance on state benefits), it is questionable that an approach of herding into one-size-fits-all solutions gives the optimal result from the individual's perspective when retirement savings are concerned. Many employers are recognising the scale of the potential problem – their single highest concern in relation to pensions being getting employees more aware of and engaged in decisions about pension saving (59% of respondents). This even outweighs employer concerns over cost-certainty.

Despite employer concerns about the lack of employee awareness and engagement with pensions, there does not appear to be any concrete evidence to suggest they see it as their role to help bridge this gap. If anything, the evidence is to the contrary. In a greenfield situation, two-thirds of employers would choose to establish their DC arrangement on a contract basis – presumably with the intention of distancing themselves from the running of the plan.

With the increasing importance that DC is playing in the income of future retirees, this position may change. Some employers may conclude that taking an active role in helping employee awareness and engagement in pensions could become a major employment differentiator.

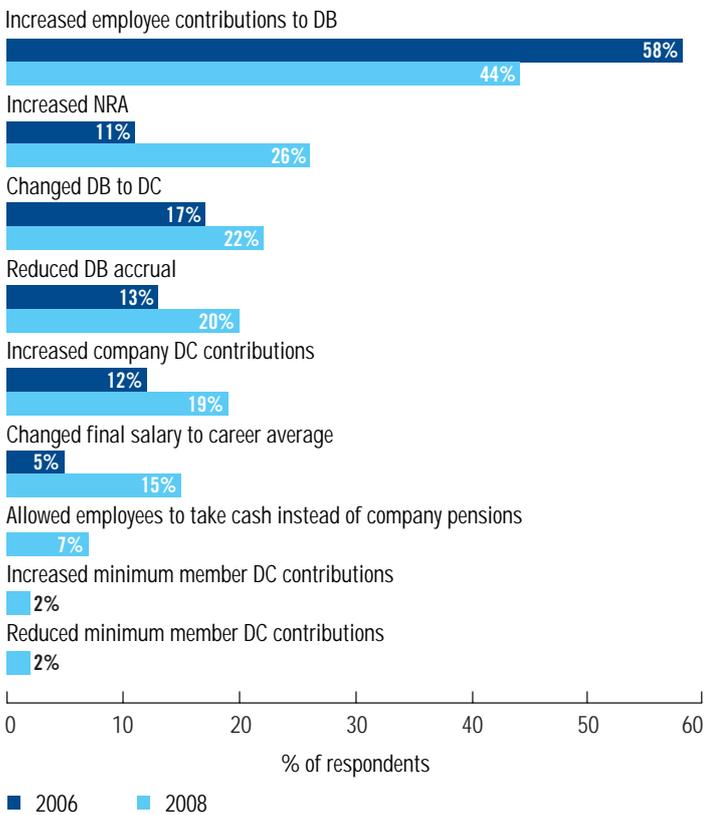
**We would like to thank all the participants in the survey for their dedicated support.**

## THE EMERGING ROLE OF PENSIONS

### DEVELOPMENTS

Since our last corporate pension survey in 2006, many pension schemes have made design changes. Figure 1 shows changes made as a result of legislative, regulatory and financial developments.

**FIGURE 1**  
Changes in pension provision for existing employees: made in last two years



Forty-four per cent of schemes have increased employee contributions to their DB scheme (58% in 2006), 26% increasing normal retirement age (11% in 2006), 22% have moved from a DB to DC scheme (17% in 2006) and 20% have reduced accrual under the DB arrangement (13% in 2006). This has meant increased cost and/or reduced benefits for many pension scheme members.

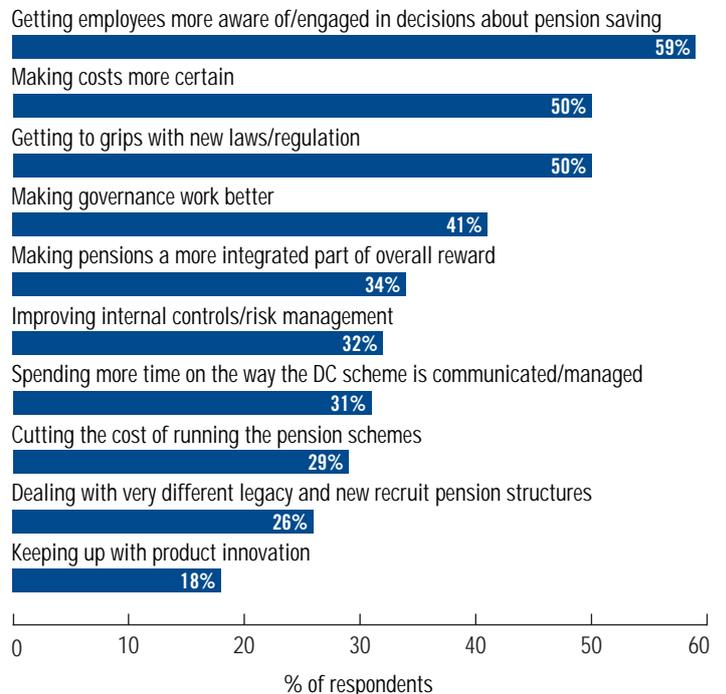
When making these changes, a sizeable proportion of 42% of schemes, offer choice to their pension scheme members.

### ISSUES FOR CONCERN

The ongoing challenge of stimulating employee interest in pension saving is recognised as the main concern of respondents, as shown in Figure 2. Two other employer concerns closely follow this – getting to grips with new laws and regulations, and trying to make the cost of pension provision more certain.

Despite the aspirations of employers to make employees more aware and engaged, in a greenfield situation, two-thirds of employers would put a new contract-based scheme in place for delivering DC pensions. This arguably places more of the emphasis on awareness and engagement of employees with the contract-based scheme provider than with the employer.

**FIGURE 2**  
Aspects of managing pension arrangements of material concern



The fourth-highest ranking issue for concern: making governance work better, was also reflected in the findings of Towers Perrin research commissioned with the Economist Intelligence Unit earlier in 2008. This found organisations taking steps to manage their pension risk through better decision-making arising from improved governance practices; as well as increasing corporate officers' and trustees' knowledge and understanding of pension issues.

Just over one-quarter of respondents view the anomalies between legacy and new hire pension arrangements as of material concern. Many employers are concerned that some of their retiring DB scheme members may be relatively pension rich, with other DC scheme members pension poor by comparison – as differing arrangements have the potential to provide markedly differing benefit levels.

Many respondents are considering or have considered different strategies for managing the financial risks associated with their legacy defined benefit pension arrangements. Some common themes include utilising a deferred member transfer exercise and a full or partial buy out (or buy in) of liabilities.

Thirty-seven per cent of respondents confirm they have considered a deferred member transfer exercise, 31% a partial buy out of liabilities and 11% a full buy out.

Practice is changing fast in this area. Even in the short period since the data was collected we would now expect to see higher levels of activity being recorded in relation to de-risking strategies.

### EMPLOYER ATTITUDES

The 2008 survey sought employers' attitudes about the ability of employees to make saving decisions, whether pension contributions should be available as cash, and whether employees could be trusted to make their own investment decisions. There was no firm consensus of opinion on these issues.

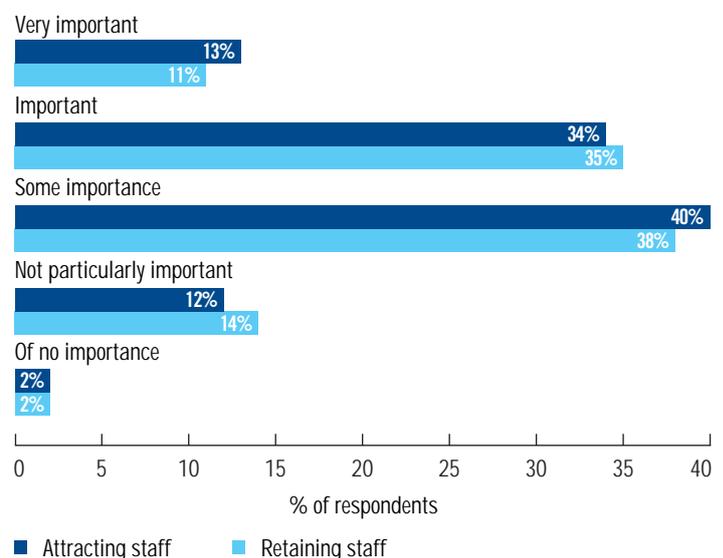
Half of respondents agree or strongly agree that employees are able to make their own saving decisions, with one-third remaining uncommitted. However around half (54%) disagree or strongly disagree that employees should be permitted to take their pension contributions as cash. Respondents are evenly divided

when asked if employees could be trusted to make their own investment decisions.

Employers were also asked how they viewed their pension arrangements in relation to attracting and retaining key staff, Figure 3. The majority of respondents acknowledge their pension arrangements are of some importance, with just over a third confirming the pension on offer is an important element of both attraction and retention.

The importance of a pension scheme as an attraction element within the remuneration package was also highlighted in the *Towers Perrin 2007 Global Workforce Study*. In a study of 88,600 respondents in 18 countries, territories and regions, competitive retirement benefits were among the top ten attraction drivers.

**FIGURE 3**  
**Importance of company's pension arrangements for new employees**  
For attracting and retaining key staff



Employer attitudes alter somewhat when asked to focus solely on any legacy pension arrangement on offer (typically a DB arrangement). Respondents view these schemes as being an influencing factor in keeping employees, with 76% confirming these are either important or very important. This response is not surprising given that this survey shows that typical legacy DB arrangements can be worth in excess of 10% of salary more than typical new hire DC arrangements.

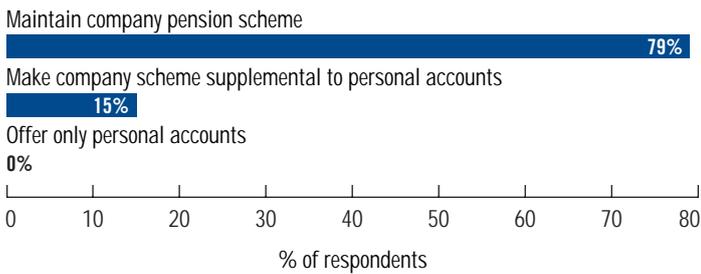
## THE CONSEQUENCES OF PERSONAL ACCOUNTS

Personal accounts are proposed for introduction in 2012. The 2008 survey explores whether employers have considered their implications to date.

Personal accounts are likely to alter employee perception of pensions at a fundamental level. Scheme membership will become compulsory, subject to an opt-out clause that has yet to be finalised, a compromise known as soft compulsion. The resulting association of pensions with compulsion will inevitably have a knock-on impact on attitudes towards the defined contribution pension schemes that companies decide to continue to administer themselves.

Forty-eight per cent of employers have considered how personal accounts would change their pension provision. As Figure 4 shows, 79% expect to maintain their company pension scheme, with 15% making the company pension scheme supplemental to personal accounts. No employer surveyed yet anticipates offering a stand-alone personal account.

**FIGURE 4**  
**Approach to be adopted following the introduction of personal accounts**



Forty-four per cent of employers do not anticipate changing their employer contribution as a result of personal accounts, with 41% undecided as to whether the employer contribution would alter.

Those investing in personal accounts will have a choice of funds into which their money will be paid. For those not making a specific choice, there will be a default fund, into which the pensions of an estimated five to ten million people will be channelled. Inevitably, because of public interest, there will be constant media spotlight on its performance.

This survey indicates that around 30% of the workforce is not currently participating in a pension plan. The introduction of compulsory savings could therefore have a major impact on employer costs.

To gauge the maximum potential cost we have assumed that, rather than being auto-enrolled in personal accounts, current non-members choose to join the corporate pension arrangement for which they are eligible (as this route generally offers much better value). Based on what the average respondent to our survey says, we estimate that, if current non-members choose to join the company's DC arrangement this could increase overall pension costs by 10%. If they have access to a DB plan the increase in costs could be in excess of 20%.

## TRENDS IN DEFINED BENEFIT COSTS AND DE-RISKING

### THE CONTINUED DEMISE OF DB SCHEMES

We considered the current state of play with regards to the defined benefit (DB) and defined contribution (DC) pension landscape. Figure 5 confirms the continued decline of DB since previous surveys – reducing from 67% of new employees being able to join a traditional DB arrangement in 2002, to just 11% in 2008. The complimentary growth in occupational DC arrangements is also confirmed, although this peaked around 2004, when 65% of respondents provided these.

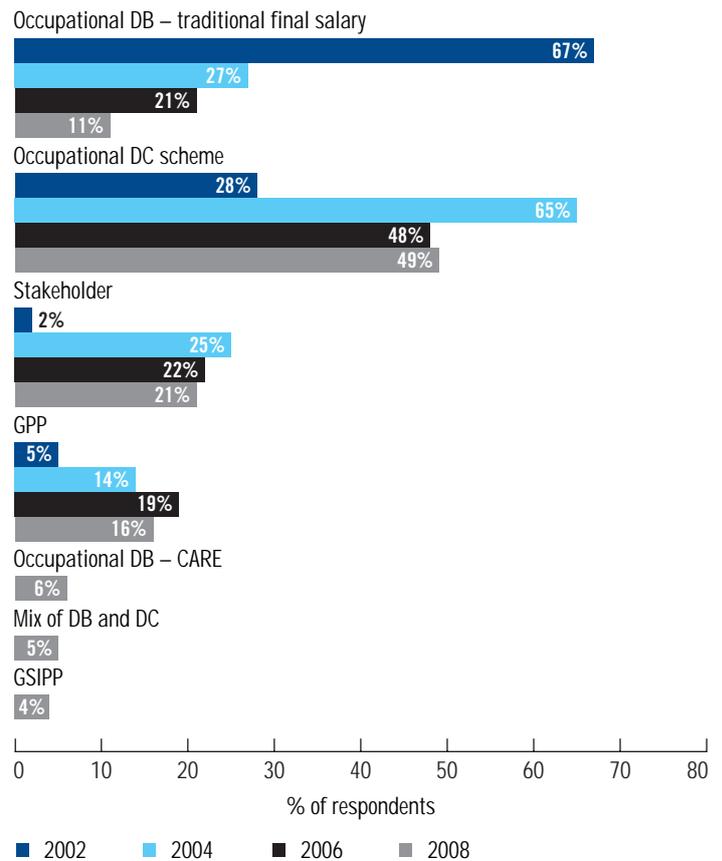
A point to note is the emergence of alternative arrangements, including occupational DB career average revalued earnings (CARE) arrangements, hybrid DB/DC arrangements and the development of group self invested personal pensions (GSIPPs), which offer individuals much greater investment flexibility than do group personal pensions. We expect to see more of this latter type of arrangement, as, when asked to consider future pension arrangements, 27% of respondents confirm that they have introduced, or are considering introducing a GSIPP.

Although there has been talk within the pensions industry about the potential role for risk-sharing pension arrangements, there is little evidence to suggest this potential will be realised. Our survey records a small increase in the number of open CAREs, early prototypes for plans that might be deemed to better share risks. However, this talk (and any future government encouragement) is now too little too late for risk-sharing plans to gain meaningful employee coverage.

The structuring of member contributions through salary sacrifice has increased since our 2006 survey and is now being used by 41% of respondents, an increase from 25%. Employers retain the employer NI saving from such an arrangement in 75% of instances, with the employee benefiting 23% of the time.

FIGURE 5

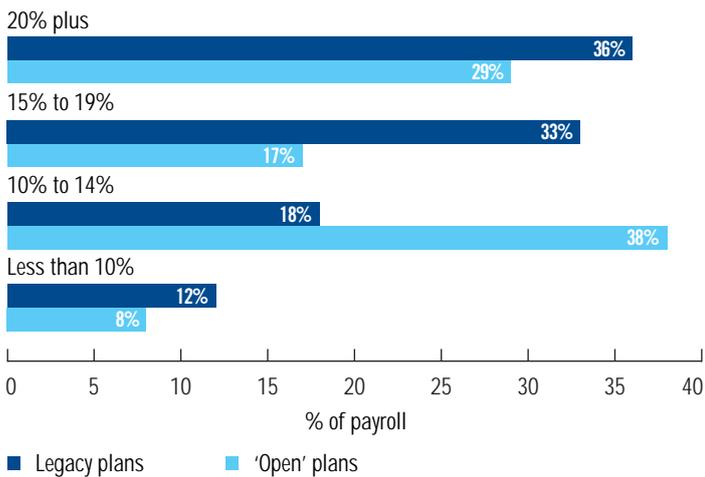
### Pension plans for new employees (main staff plans)



### SCHEME COST

The approximate cost to employers of DB plans is shown in Figure 6. Thirty-six per cent of legacy DB schemes cost their sponsoring employer in excess of 20% of payroll a year, with 33% costing between 15% and 19%. The amount being paid into open DB plans is generally lower, with 38% of respondents paying between 10% and 14% of payroll.

**FIGURE 6**  
Cost to employer of DB plan for new employees and legacy arrangements for existing employees

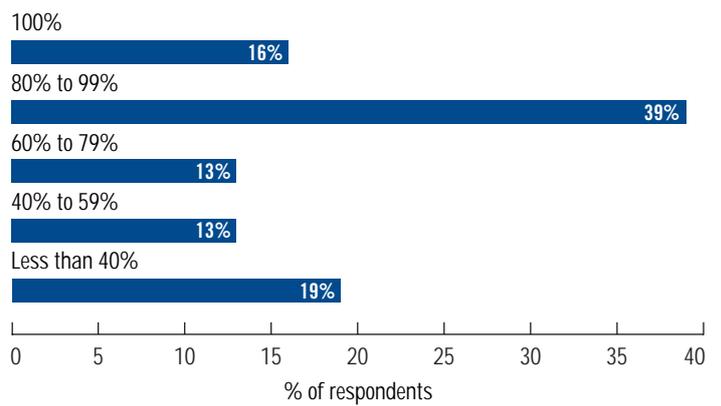


Since these benchmarks for cost were last assessed the underlying costs may have risen. We estimate that, in the absence of any intervention by employers or changes in financial markets, overall costs of pension accrual could remain above these benchmarks for the next five to ten years. Only then might the effect of migration of staff to a lower cost DC arrangement start to bring costs down below the current benchmark.

### TAKE UP RATES

Take up rates for DB schemes are shown in Figure 7. The most prevalent range is between 80% and 99% membership, with 39% of DB schemes falling within this. It is worth noting that even for DB arrangements, take up rates are less than 80% for almost half of the plans.

**FIGURE 7**  
Current take up rates for DB pension schemes



### DE-RISKING STRATEGIES

At the time of writing this report in the autumn of 2008, many UK businesses are facing a period when their profits will be squeezed, credit is tight and pension deficits are emerging or getting bigger.

UK employers are acutely aware of the risks posed to them by their legacy DB arrangements. This mindset, coupled with a more competitive and flexible market for third-party risk transfer, has led to a dramatic increase in the level of de-risking being undertaken.

By means of an example, 37% of respondents confirm that they have considered a deferred member transfer exercise, with 42% considering a full or partial buy out of liabilities. In the time since this data was collected it is feasible to assume that interest in this type of option has increased further.

Things for the company to do now are:

- Look at projections of where the year end accounting numbers might be and consider the options to help mitigate the bad news;
- Prepare now for ways in which the pension trustees might respond and think through the implications of any funding agreements in place. It might be necessary to make a case for paying in less than the trustees expect;
- If it is decided to protect the company going forwards, work out what de-risking can be afforded now and what further de-risking might be implemented, if and when the pension plan's finances improve.

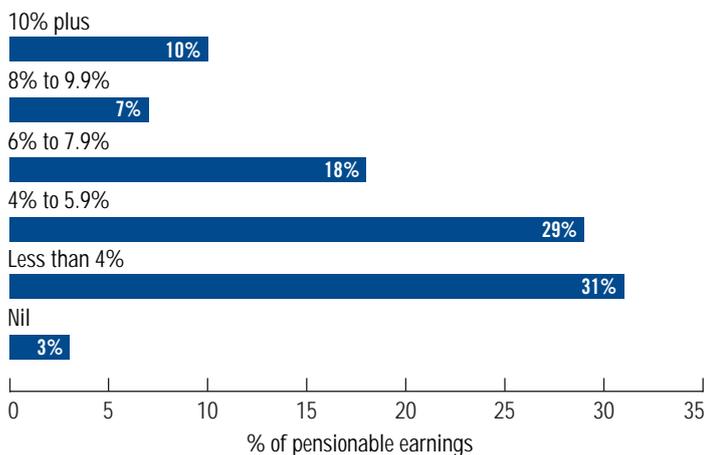
## THE OUTLOOK FOR DC PLANS

### CONTRIBUTIONS

Figure 8 shows that minimum employer contributions are generally less than 6%, with 31% being less than 4% of pensionable earnings, and 29% between 4% and 5.9%. Ten per cent of employers make minimum DC contributions of 10% of pensionable earnings or more. Average minimum employer contributions are 5.13% of pensionable earnings.

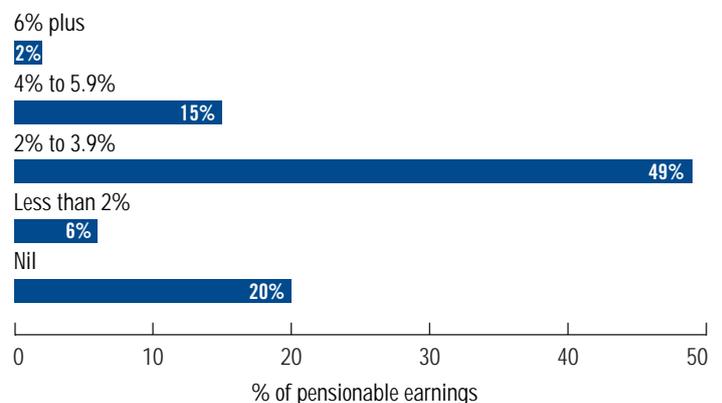
As many employers seek further ways of targeting their spend towards employees who appreciate it the most, the proportion of schemes offering matching of contributions has risen substantially from 2006. Sixty-six per cent of respondents now say they offer this facility, compared to 44% in 2006. In a scheme where the matching of contributions is available, the typical additional employer contribution is approximately 6%, with the corresponding additional employee contribution just over 4.5%.

**FIGURE 8**  
Minimum level of employer DC contribution



Sixty-nine per cent of schemes require the employee to contribute (84% in 2006), with the most common minimum employee contribution being in the range 2% to 3.9% (49%), see Figure 9. Average minimum employee contributions are 2.36% of pensionable earnings.

**FIGURE 9**  
Minimum level of employee DC contribution



The maximum 'matched' employer contributions is greater than 10% for 22% of companies.

The total average minimum contributions, involving any 'matching', equates to 11.13% from the employer (5.13% plus 6%), and 6.86% from the employee (4.5% plus 2.36%).

Forty-eight per cent make higher DC contributions for executives. Just over one-third of respondents offer differing contributions to employees, depending on criteria such as age (55%), length of service (21%) and job grade (36%).

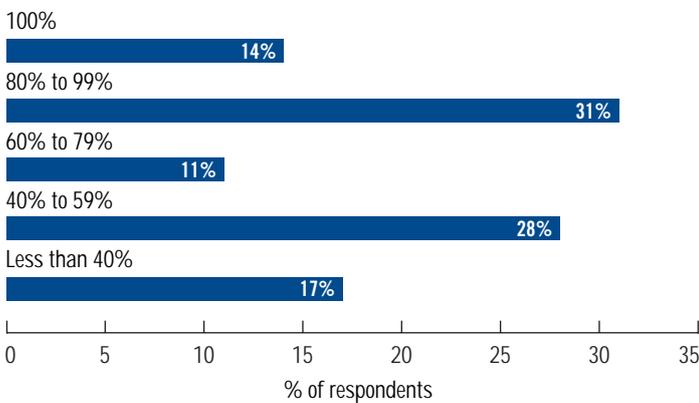
For a pension scheme to be exempt from personal accounts from 2012, employers will need to offer arrangements equivalent to, or providing more generous benefits. Expected contribution levels of 'qualifying earnings', are 5% from the employee, including around 1% tax relief, plus 3% from the employer so many employers will need to review their minimum contribution levels if they intend to rely on this exemption.

### TAKE UP RATES

For DC schemes, the most common band for take up is between 80% and 99%, with 31% of schemes reporting this level of membership, Figure 10.

FIGURE 10

#### Take up rates (of those with a DC scheme)



With the proposed introduction of personal accounts we would expect enrolment levels in company schemes to increase with the introduction of soft compulsion – see section *The consequences of personal accounts*.

### INVESTMENT

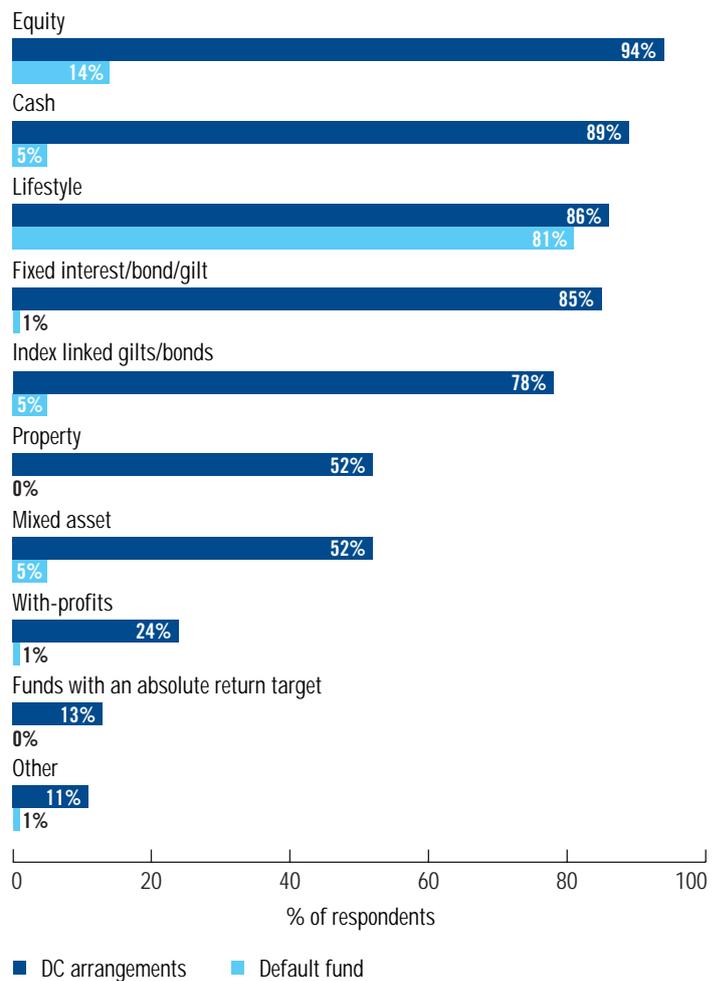
Equity, bond and cash funds dominate investment options, with lifestyle funds representing the majority of default funds. Fourteen per cent of respondents use a static equity default option, with 5% either offering cash, index-linked bond or mixed asset default investments.

An option not seen in our 2006 survey was funds with an absolute target return, which are now present in 13% of respondents' plans. These aim to provide a positive return irrespective of market conditions. A selection of the 'other' investment funds available includes shariah-compliant, ethical and socially responsible funds.

Sixty-eight per cent of respondents confirm that in excess of 70% of their scheme membership uses the default fund.

FIGURE 11

#### Options offered to members as part of their company's DC arrangements (of those with a DC scheme)



When employees retire, 87% of respondents convert pension savings to an annuity externally, with only 6% having the option to convert internally.

As in 2006, the administration of pension schemes is outsourced to a third party in the majority of instances. One growing trend is that combined in-house and external administration has increased from 6% of respondents in 2006 to 15% in 2008.

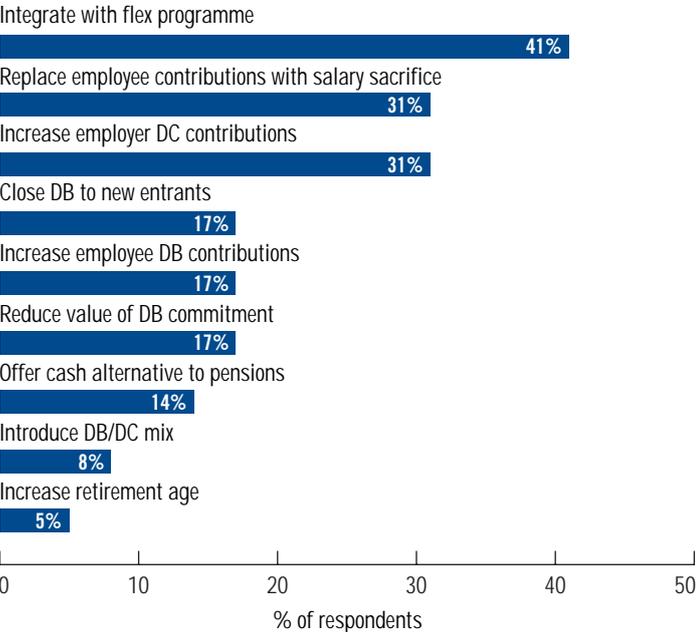
# DRIVERS BEHIND FURTHER CHANGES

We expect to see continued changes to the UK pension landscape over the next few years, with continued pro-active management of legacy pension arrangements as employers and pension schemes try to manage the risks they pose.

Forty-five per cent of respondents expect to make changes to their pension arrangements in the next five years, in relation to new and existing employees, with 40% anticipating no changes. Figure 12 shows the changes being considered.

Forty-one per cent are considering integrating pensions into their flex programme (21% in 2006), 31% replacing employee contributions with salary sacrifice (31% in 2006), and the same proportion proposing to increase the employer's DC contribution (20% in 2006).

**FIGURE 12**  
**Expected changes to pension arrangements in next five years**



Respondents also indicate that they are considering other changes. These include reviewing investment funds, introducing group SIPPs, looking at methods of reducing risk and/or shrinking the liabilities, introducing salary sacrifice, considering risk sharing alternatives, merging existing DB schemes into one, and dealing with changes as a result of personal account legislation due in 2012.

### SALARY SACRIFICE

Our survey notes a marked increase in the number of employers utilising a salary sacrifice facility – 41% now against 25% in 2006. This trend looks set to continue as 31% of respondents state their desire to replace employee contributions with salary sacrifice over the next five years.

### CONTINUED DC DEVELOPMENT

The prevalence of DC continues unabated, with 29% of respondents expecting to see in excess of 95% of employers in the private sector offering this type of arrangement to new employees. Given the opportunity to start afresh with a new DC plan, 66% state they would install any new DC plan such as a GPP or SIPP on a contract basis.

## PARTICIPANTS

We would like to thank the following participants who completed this year's survey, and agreed to be named.

AstraZeneca plc	Electrocomponents Plc	Nationwide Building Society
3M United Kingdom Plc	Eli Lilly and Company	NCH
ABN Amro	Experian	NEC Ltd
Aegon UK	First Group Plc	Nokia UK Ltd
Akzo Nobel Ltd	Firth Rixson (Trustees) Ltd	Norcros Plc
Alliance & Leicester Plc	Franklin Templeton Investments	Northern Trust
Allianz Insurance Plc	Fujitsu Services	Orange PCS
American Express	GKN Plc	Paragon Group of Companies Plc
Apple Europe Ltd	Global Crossing (UK) Telecommunications Ltd	Philips
AS Watson Group (Europe)	GSK	PSA Peugeot Citroën
Atkins Ltd	Hiscox	Punch Taverns
Aviva Plc	Honda of the UK Manufacturing Ltd	Reckitt Benckiser Group Plc
BG Group	Howarth Timber Group Ltd	Rentokil Initial Plc
Bristol-Myers Squibb	Huntsman	Rexam Plc
British American Tobacco	Ifineum UK Ltd	Royal & Sun Alliance
British Energy Group Plc	InterContinental Hotels Group	Skandia UK
British Standards Institution	Intertek Group Plc	Somerfield Stores Ltd
Britvic Soft Drinks Ltd	ITN	Stagecoach Group Pension Scheme
BUPA	J Sainsbury	Standard Life
Calor Gas Ltd	John Laing Plc	Stora Enso International Ltd
Chubb Ltd	John Lewis Partnership Pensions Trust Ltd	Syngenta Ltd
Ciba UK Plc	Johnson Diversey UK Ltd	TD Waterhouse Investor Services
Cobham Plc	Kellogg Brown & Root	The Bank of Tokyo-Mitsubishi UFJ Ltd
Compass Group Plc	Kellogg Co (Great Britain) Ltd	The Linde Group (BOC Pension Schemes)
Control Techniques Dynamics	Kingfisher Plc	The Walt Disney Company Ltd
Co-operative Group Ltd	Kraft Foods UK Ltd	Thus Group Plc
Croda International Plc	Lloyds TSB	Time Warner
CSC Computer Sciences Ltd	Logica UK Ltd	T-mobile (UK) Ltd
Dairy Crest	Mastercard UK Inc	Tyco Electronics UK Ltd
Debenhams	McGraw – Hill International (UK) Ltd	Unilever
Deutsche Bank	Meggitt Plc	United Business Media PLC
Development Securities Plc	Mitchells & Butlers Plc	United Technologies Corp
Devonport Royal Dockyard Ltd	Mitsubishi UFJ Securities International	VT Group Plc
Diligenta Ltd	Mothercare Plc	Wolseley Plc
Du Pont (UK) Ltd	Motorola Ltd	Xerox Ltd

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