

Scheme Specific Funding

Achieving the corporate objectives

February 2007

Many companies will be facing their first new style ‘scheme specific valuation’ in 2007. Those companies that are used to the trustees and the scheme actuary taking the lead on valuations need a change of corporate mindset if they are to meet their goals and manage the process effectively.

Background – why companies should be preparing now

The new funding regime has handed increased powers to the trustees and, under pressure from the Regulator, there is a trend towards increased contributions as a result of higher funding targets and shorter deficit repayment periods.

To allow companies the best chance of achieving their objectives relating to the valuation - be they minimising costs and/or reducing risk - we recommend that they engage proactively with trustees as early as possible into the process. This has the advantages of:

- Ensuring early engagement of all parties;
- Flushing out any potential issues early at an early stage; and
- Avoiding either party developing an entrenched position.

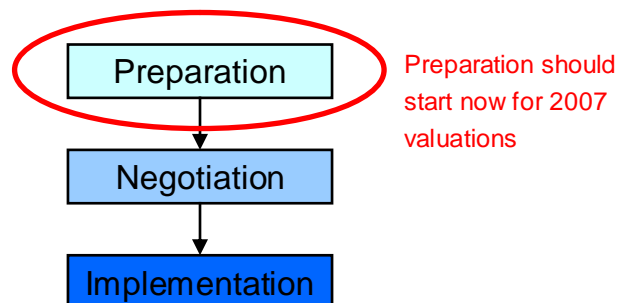


Figure 1: The corporate valuation process

The first key step for a company is to develop its objectives for funding the pension scheme, taking into account its attitude towards cost and risk and the views of internal (eg employees) and external (eg shareholder, credit rating companies) stakeholders. By considering its position well in advance, it will be able to develop a strategy for working with the trustees to ensure that these objectives are met.

The information in this document is based on UK legislation and practice. The Watson Wyatt commentary in this document is not intended to be comprehensive, nor to provide professional advice. It should not be treated as a substitute for professional advice on individual circumstances.

What options are available?

The strategy to meet the company's objectives could entail a number of different elements, for example

- ***Proactively communicate the strength of the company covenant with the trustees:*** the information provided to the trustees could include business plans, forecasts or credit rating agency reviews. A balance needs to be achieved between demonstrating strength, but not the ability to pay very substantial contributions.
- ***Use of contingent assets:*** a number of different vehicles are available (such as escrow accounts, charges over fixed assets, parental guarantees and so on) as a means of providing extra security. These can be instrumental to agreeing longer deficit repayment periods or avoiding the likelihood of trapped surplus.
- ***Take independent advice on the choice of assumptions:*** by taking separate advice on the key actuarial issues, the company can form a corporate perspective and engage with the scheme actuary at an early stage to ensure that the assumptions are not unduly conservative.
- ***Examine investment strategy:*** investment strategy is a key driver affecting scheme finances and is closely linked to the funding approach and assumptions. The dramatically increased focus on investment strategies with additional scope to improve the risk/reward trade-off by diversification, hedging techniques and identifying reliable sources of active management, offers the potential to change the balance between future contributions and investment return.
- ***Reduce future service benefits:*** particularly if costs would otherwise escalate to an unacceptable level. From a strategic perspective, any intended changes to benefits (eg to align benefits across the workforce) would be best considered in conjunction with the funding discussions.

The solution for each company is likely to be different - the benefits of taking a proactive approach can be best illustrated by way of a real example:

In advising a major UK plc with a significant pension scheme, we were instrumental in designing an innovative mechanism that reduced future ongoing and deficit contributions by assuming an asset return in excess of the discount rate for the Recovery Period.

The pension scheme was given protection because the company agreed to pay additional contributions if this required return did not occur while the company shared in any performance in excess of the required return by a further reduction in contributions.

This approach reduced the company contribution requirement by over £100m during the period to the next valuation and subject to good asset performance has the ability to reduce future contributions by the same amount again.

How can we help?

Trustees can often feel under pressure from the Regulator to treat a deficit as a bank or unsecured creditor would when dealing with the company. However, we believe that a fully briefed company should still be able to achieve many of its objectives, often in partnership with the trustees.

Watson Wyatt is the trusted corporate adviser for many of the world's leading organisations. Our tools and extensive client base means we are uniquely well placed to help companies develop solutions to their funding and investment strategies. Furthermore, our associates include some of the most highly respected experts in the industry.

We would be delighted to discuss any of the issues raised in this bulletin. Please call <....> on <.....>.