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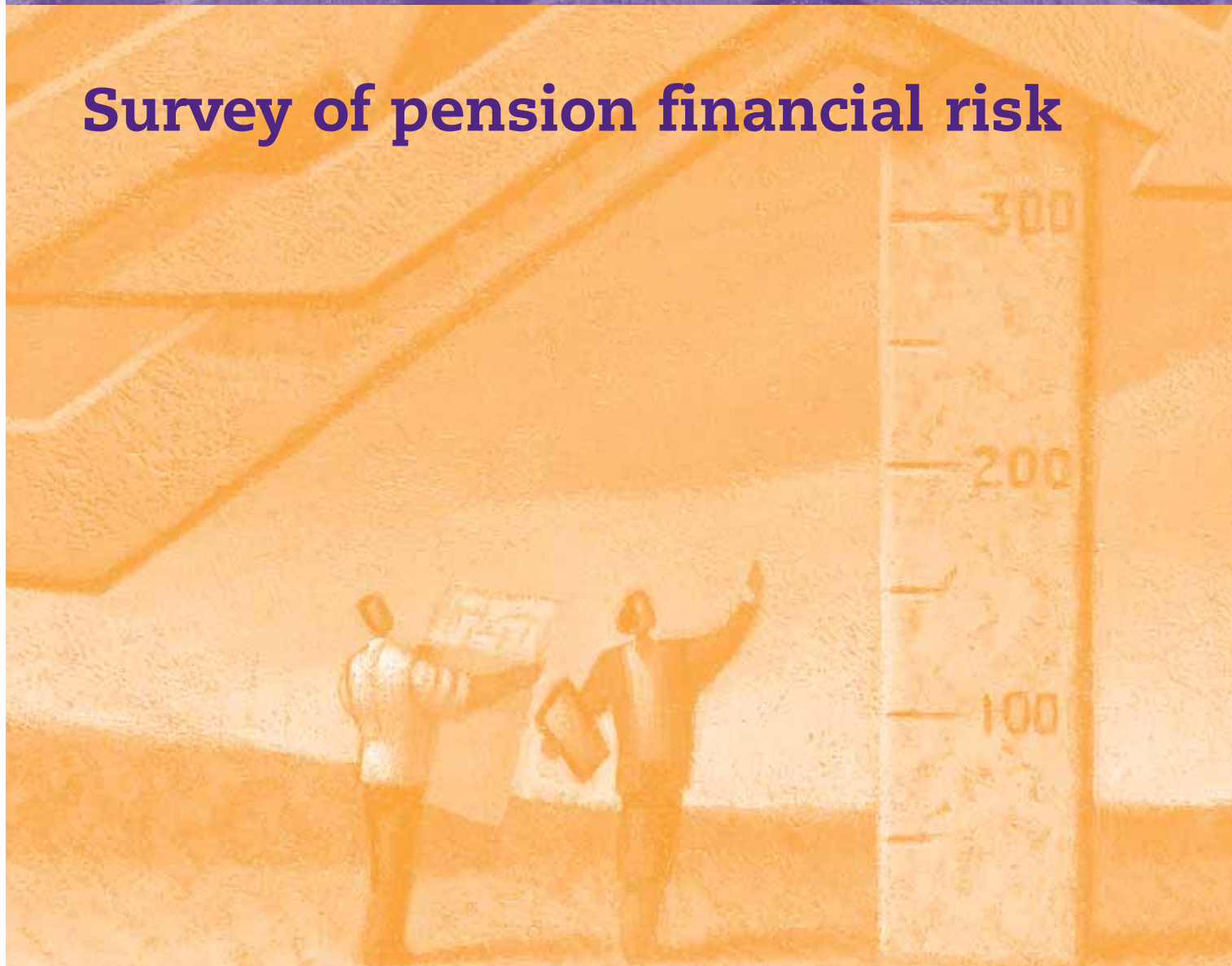
MERCER

Human Resource Consulting

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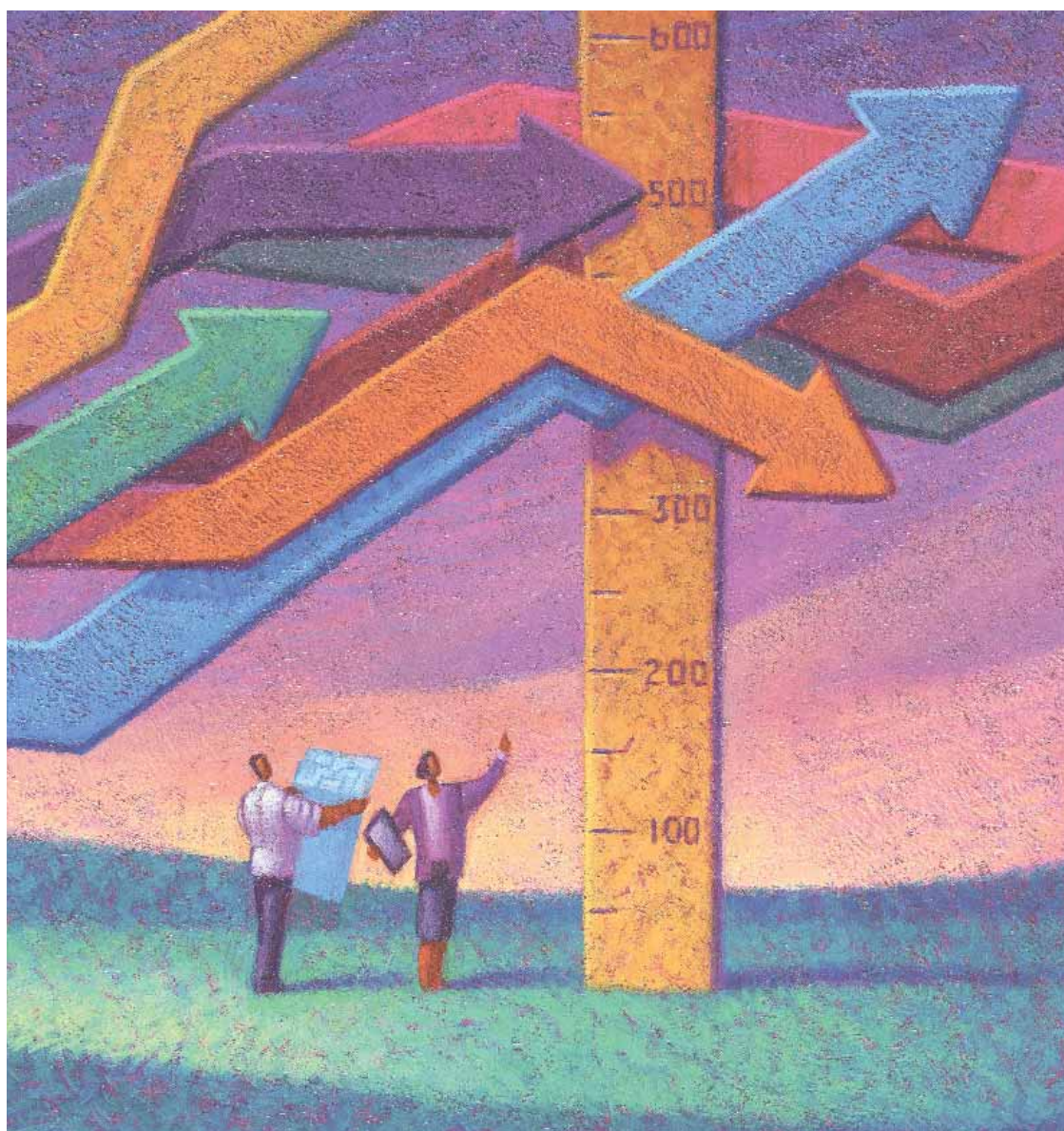
# Survey of pension financial risk







During April and May 2006, Mercer Human Resource Consulting and the Association of Corporate Treasurers approached the CFOs and treasurers of substantial companies in their second annual survey on managing pension financial risk. This survey sought to determine the extent to which respondents view pension schemes and their deficits as significant corporate risk issues, their perceptions of stakeholder attitudes towards such risks, and the prevalence of some specific and topical risk management actions. This report summarises the 102 responses received, mainly from FTSE 350 organisations.



## Key findings

- The majority of participants considered all stakeholder groups as viewing pension funding and investment strategies to be of increasing importance, with only a minority believing that there had been no material change year on year. The level of increased importance was considered to be highest among board members and senior management, followed by employees and, then by shareholders and analysts.
- Almost 60 percent of participants had made “special” pension contributions during the period (that is, above-normal contributions to fund accruing benefits). By far the largest drivers for these were scheme-specific funding requirements (30 percent) and general risk mitigation (25 percent). Pension Protection Fund (PPF) levy and tax considerations exerted less significant influence. Fewer than 10 percent of companies undertook a specific financing to fund the contribution.
- The PPF is expected to consult on including an investment strategy element in the risk-based levy formula. Of those who intended to respond, a small majority favoured modifying the formula to reduce the levy for those adopting investment strategies with increased levels of asset/liability matching. If the PPF makes such a modification, there was again an almost equal division between those who would and would not increase the amount of matching and those who had not made up their minds.
- Derivatives remain very lightly used by pension schemes, with only around 5 percent of participants using them to hedge interest rates, a similar level using them for inflation, 10 percent using them for other purposes (mainly in connection with currency and equity hedging) and none using them for credit protection.
- Fifty-seven percent of participants disagreed with the statement by the Pension Regulator that the Pensions Act 2004 has had little impact on corporate activity (for example, M&A). However, only 31 percent felt that it had affected such activity in their own company.
- One-third of participants had significant pension funding and investment strategy issues outside of the UK. Of these, three-quarters felt that their importance had increased in the eyes of the board and senior management year on year.
- More than half of the participants had reviewed their mortality assumptions over the previous year. Of these, all had apparently tightened their assumptions, with a majority doing so in line with the medium cohort effect projections of the basic PA92 tables. Of those who had not yet reviewed their mortality assumptions, a majority intended to do so during 2006.

The increasing visibility of pension issues for schemes both within and outside the UK means that pension risk mitigation is not just a domestic issue for a significant number of companies. However, much remains to be achieved in the area of practical financial pension risk management.

Mercer has worked with many companies to benchmark their pension exposures, allowing them to explore alternative funding and investment strategies that better align the management of their pension risks with those of their business as a whole.

We expect interest in this approach to continue to grow.



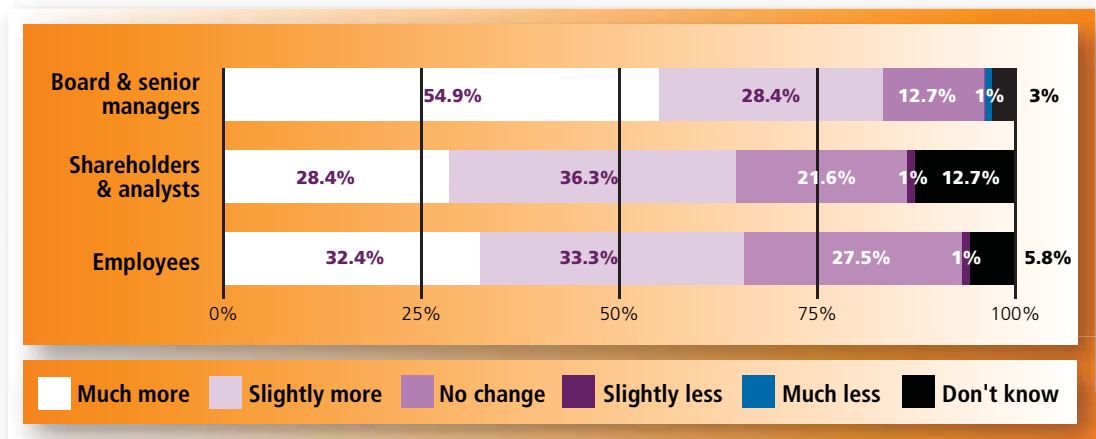


# Results in detail

## 1. Changing attitudes to pension risk

Participants were asked to give their perception of the change of importance in the eyes of various stakeholders of the funding level and investment strategy of their company’s pension schemes over the last year.

### Change in perceived importance



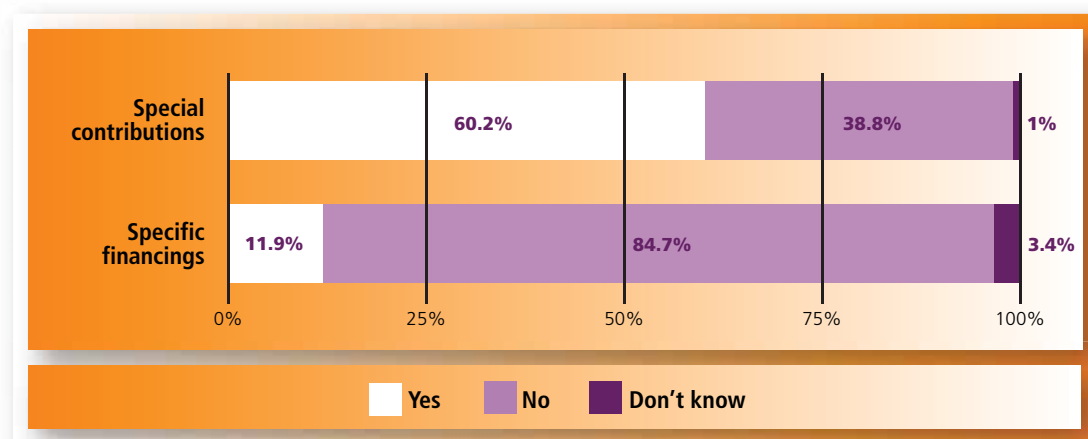
All three stakeholder groups were adjudged by a majority of participants to be attaching either slightly or much more importance to these strategies. In the “much more important” camp, the board and senior management led the way (over half), followed by employees (around a third) and shareholders/analysts (over a quarter). One interpretation of this result is that the latter two categories got there first and boards are now catching up.

A minority believed that there had been no material change year on year. It is quite possible that these organisations may have already taken pension strategy issues very seriously or have schemes not material to the business.

## 2. Contributions

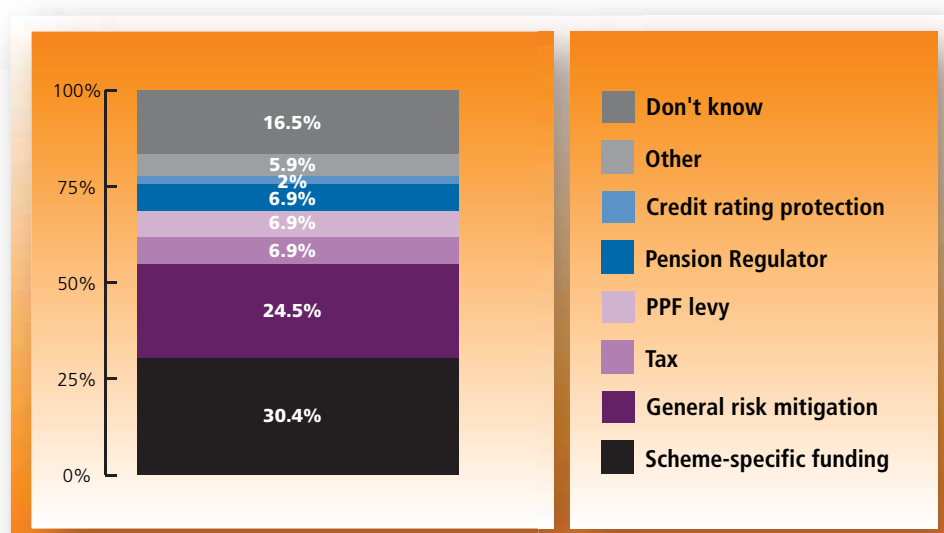
Participants were asked whether they had made any “special contributions” (that is, above normal or statutory contributions) to company pension schemes in the UK or abroad within the last year. Those that had done so were asked to state the principal drivers and whether they had undertaken a specific financing in connection with the special contributions.


### Contributions and their financing



The fact that over 60 percent of participants had made special contributions is not surprising, given the number of schemes in deficit. What is more interesting is that only a little over 10 percent of participants that had made such contributions had raised funds to fund the contribution, the implication being that there was sufficient capacity within other funding activities or cash generation from the business to cover the deficit payment without resorting to a specific capital fund-raising project. Anecdotal evidence suggests that the use of large single payments to clear the bulk of a deficit, which might be expected to be associated with a specific financing, remains the exception rather than the rule.

### Key drivers for funding



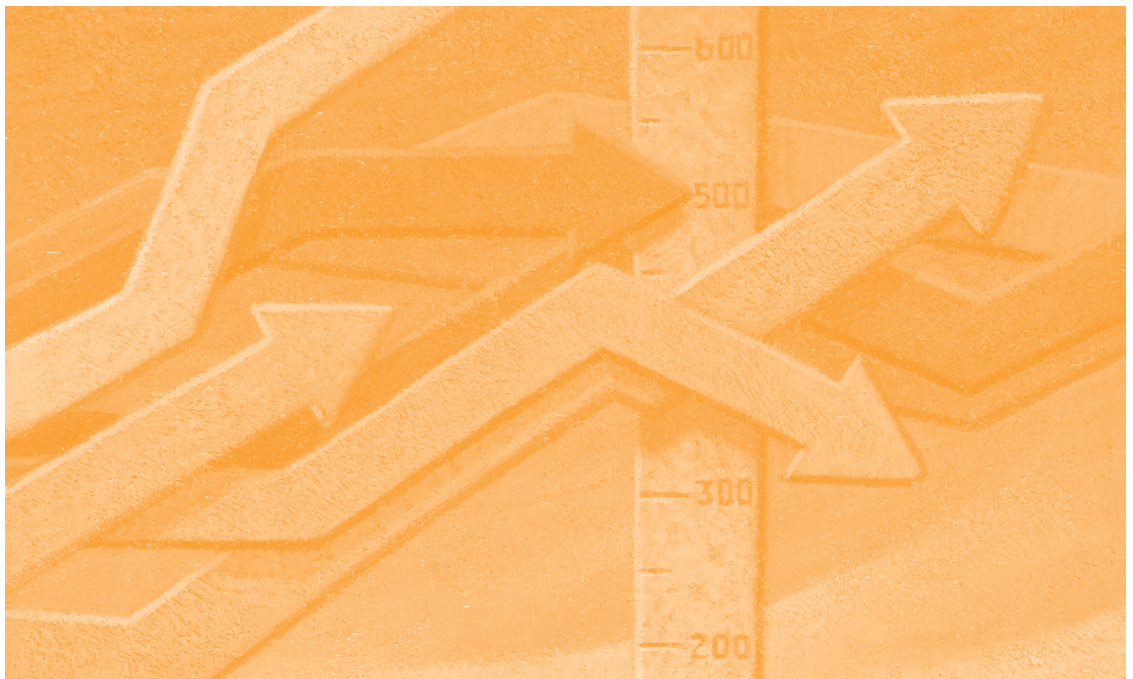


The citing of scheme-specific funding requirements as the major driver for special contributions last year may be considered surprising, given that the relevant legislation is only now taking practical effect. However, its arrival had been widely anticipated in negotiations between trustees and sponsors. It will be interesting to watch whether this proportion increases.

The other major driver was general risk mitigation. This certainly supports anecdotal evidence of more treasurers and CFOs applying quantitative risk management assessments to business risks in general and pensions risks in particular.

Interestingly, minimising the PPF levy or tax was less often quoted – these may produce additional benefits from increased funding, but they are evidently not seen as major drivers.

In addition to the drivers mentioned in the question, a few participants cited other, usually highly company-specific, reasons for special contributions, such as the facilitation of corporate transactions.



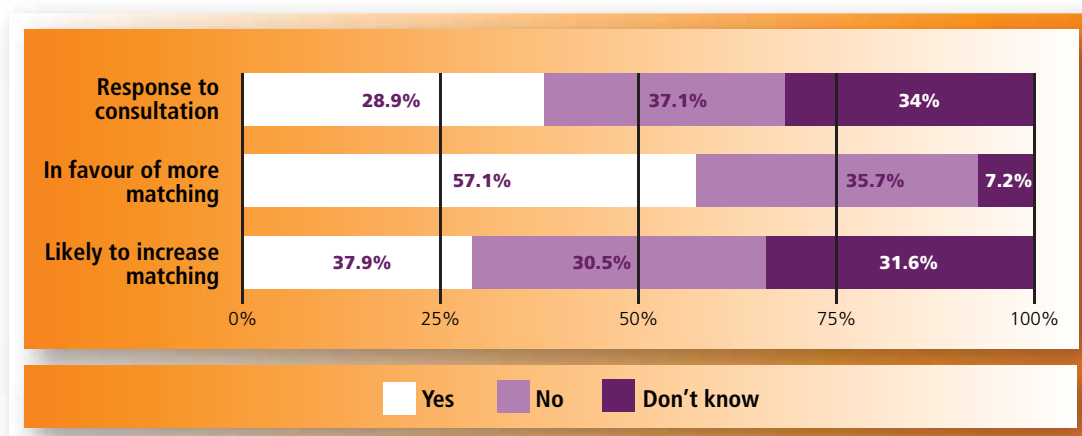
### 3. Investment strategy and the PPF risk-based levy

The PPF Board has stated that it will consult on a possible modification of the risk-based levy formula to take account of the investment risk taken by schemes, which may be interpreted as the degree of mismatching between assets and liabilities. This approach lies at the heart of the nFTK (new financial assessment framework) pension regulations that are being put in place in the Netherlands.

Participants were asked whether they intended to respond to the PPF Board's proposed consultation on introducing an asset/liability matching element into the risk-based levy formula. Those that said they intended to do so were asked whether they favoured the risk-based levy being lower for those schemes with more closely matched assets and liabilities, all other things being equal.

Participants were also asked whether they were more likely to seek to increase the amount of asset/liability matching in their scheme in the event that the PPF Board did modify the risk-based levy formula to take asset/liability matching into account.

#### PPF risk-based levy



Only a little over a quarter indicated that they intended to respond to the PPF Board. This figure is probably consistent with the proportion of companies responding to other consultations undertaken by the PPF Board.

Of those who did intend to respond, more than half thought that there should be a reduction in the risk-based levy for those schemes that adopted a lower risk-investment strategy. Presumably, the others felt that they should be free to allow riskier strategies to contribute to deficit reduction over time without penalty.

The fact that around one-third of respondents would modify their investment strategy to take advantage of any risk-based levy reductions that might become available is not surprising. However, nearly a third would not do so – one explanation might be that these respondents expect to be paying a low rate of levy because they are close to being fully funded on a PPF basis. The final third – those who do not know – naturally will wait to see what the level of incentive is for a change in policy. We will explore this further in future surveys.

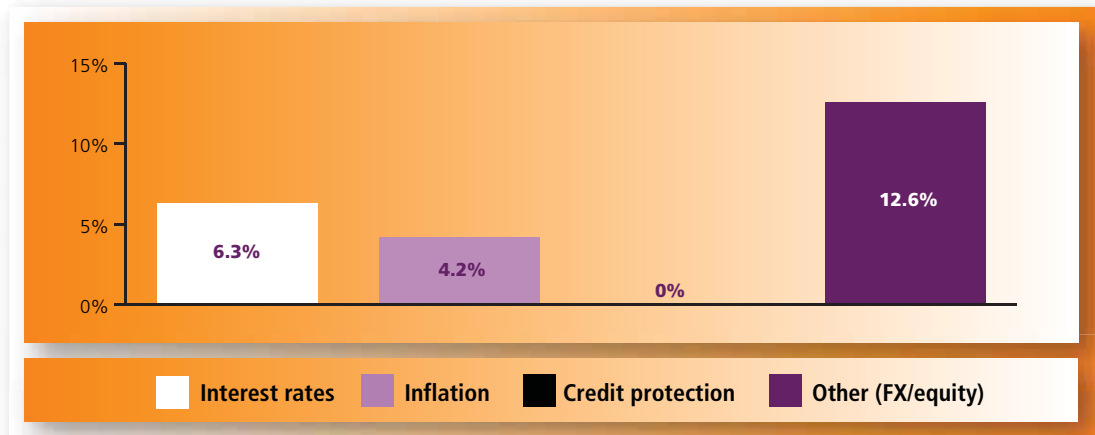


#### 4. Use of derivatives

Investment risk minimisation strategies, in general, require the use of derivatives, given the scarcity and illiquidity of assets that naturally hedge liabilities. There are also other risk areas (for example, the sponsor covenant and overseas investment) where derivatives might be expected to be able to contribute.

Participants were asked whether they had used derivatives for a variety of the purposes in their pension schemes in the UK or abroad in the last year.

##### Use of derivatives



The very low percentages answering yes to the use of the first two derivatives categories, interest rate and inflation hedging instruments, bears out anecdotal evidence that trustees have been reluctant both to (a) accept the use of such derivatives and, even if they do so in principle, (b) actually proceed to implementation. The fact that no participant had used credit derivatives may, in part, be due to the PPF's lack of acceptance of such instruments in assessing the risk-based levy.

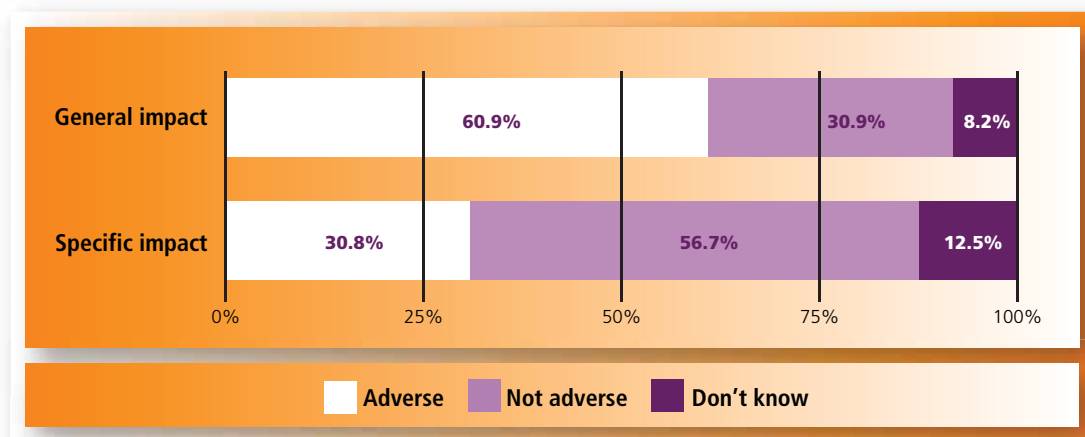
However, more than 12 percent of participants had used different types of derivatives not listed in the question. These were divided principally between (a) currency derivatives used to hedge non-UK bond and equity portfolios and (b) various types of equity derivatives. We may speculate that in some cases these instruments were actually entered into by investment managers, thus obviating the need for trustees to enter into documentation often perceived as "difficult." Again, future surveys will investigate these areas in more detail.



## 5. Impact on corporate activity

Participants were asked whether they agreed with the statement of the Pensions Regulator that there has been little impact on corporate activity (for example, mergers and acquisitions) in general as a result of the Pensions Act 2004. They were also asked whether they felt their own companies had been adversely impacted.

### Adverse impact of legislation on deal activity



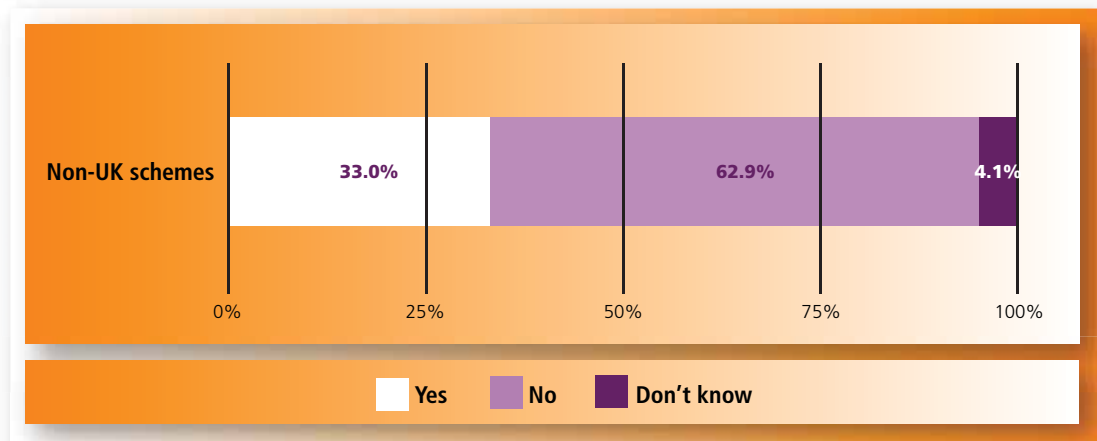
The majority of participants disagreed with the Pensions Regulator about activity levels in general being unaffected, which again supports anecdotal evidence that a number of private equity deals in particular have been adversely hit.

However, only about a third felt that the activities of their own company had been adversely hit.

## 6. Pension issues outside the UK

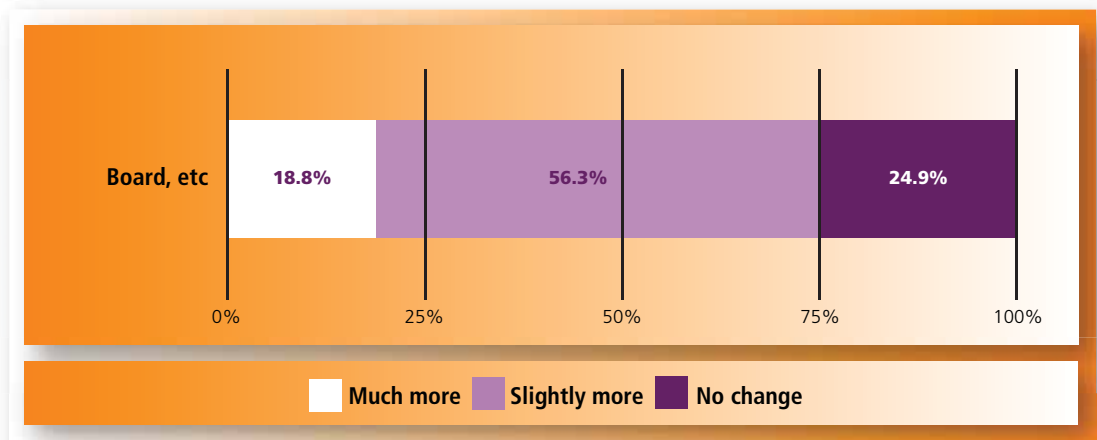
Participants were asked whether they had significant pension funding and investment strategy issues outside the UK and, if so, how the perceived importance by the board and senior management had changed over the year.

### Existence of non-UK schemes



Almost a third of participants had significant pension strategy issues outside the UK.

### Changing importance of non-UK schemes



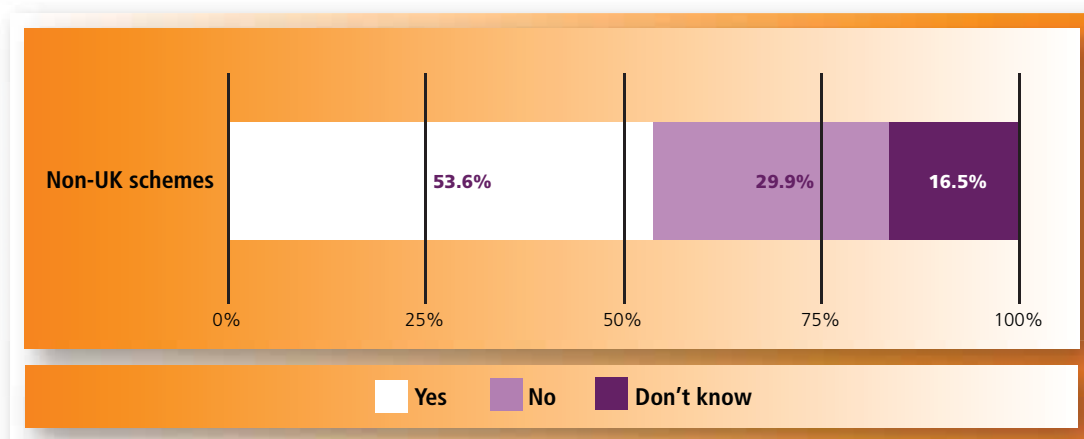
Of these, three-quarters believed that there had been at least some increase in the perceived importance of such issues over the last year, with almost 20 percent believing that they were now much more important. Future surveys will examine which overseas countries are giving rise to such concerns.

## 7. Mortality assumptions

Trends in improving expected longevity are much debated. While actuarial tables have included allowance for some improvement for some time, additional variants of the basic “PA92” tables – the short, medium and long cohort projections – have been published, which suggest more rapid improvements are likely. The last of these gives rise to the highest levels of expected longevity improvements and thus to the greatest increase in liabilities compared to other tables. As an example, for a typical scheme, the adoption of the medium cohort projection rather than the base projection can add 20 percent to its liabilities.

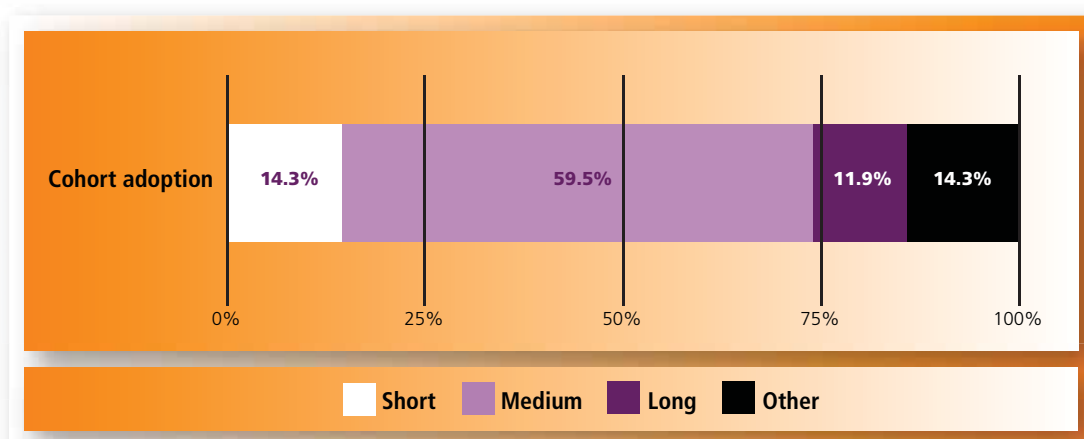
Participants were asked whether they had reviewed their mortality assumptions over the last year and, if so, whether they had strengthened them in line with the so-called “cohort effect.”

### Review of mortality assumptions



More than half of participants had reviewed the tables used in their schemes over the last year, which should not be surprising, given the relatively high profile now being granted to mortality assumptions. Of those that had not yet done so, around half intended to do so in 2006.

### Cohort adjustment adopted



Anecdotally, it has been clear for some time that the medium cohort effect projections are becoming increasingly favoured, and this is borne out by the responses that show that almost 60 percent of those reviewing their assumptions adopted this basis. It is common to make further adjustments to the published tables to reflect the nature of the scheme membership. Future surveys will explore the adoption of the PA00 series of tables that are expected to become available during 2006.



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