

employee
benefits

MERGERS & ACQUISITIONS

SUPPLEMENT

TOTAL REWARD

Highlighting package value
can ease staff integration

SALARY LEVELS

Restructuring may be
needed to avoid conflicts

PENSIONS

How to handle DB and DC
schemes under a merger

Sponsored by

TOWERS WATSON



Reward teams help seal the deal



HR has an essential role to play in a deal's success, says
Steve Allan,
M&A practice leader for EMEA at Towers Watson

As the economic recovery continues, merger and acquisition (M&A) activity is a significant route to growth for many organisations. The *Towers Watson Quarterly Performance Deal Monitor*, in conjunction with Cass Business School, continues to show that buyers outperform their non-acquiring peers.

However, getting the HR issues right will be critical to any deal's success. An acquirer must understand the target company's workforce and the factors that will affect its integration. Care should be taken to uncover differences in how staff are motivated and rewarded, especially when their employer's strategic priorities change because of the deal. The HR and broader people issues of an M&A deal are commonly cited reasons why deals fail.

Our combined research and consulting experience across hundreds of deals shows that organisations where HR can present itself as a key business partner to the deal team and is involved early in the transaction demonstrate greater deal success.

Employee benefits and rewards are key. These are a central component to consider as part of the deal process, and are, of course, one of the most sensitive subjects for employees. Getting the reward issues right will also send powerful messages about what it means to work for this organisation.

These issues are complex, detailed and often financially significant – indeed, many deals have stumbled over reward. Defined benefit pensions and other long-term liabilities have long represented key challenges, as have matters such as talent retention programmes during the period of transformation.

For many organisations, a deal can offer an ideal opportunity to revisit their underlying reward approach and realign how employees are motivated and rewarded within the

organisation's business strategy. Reward programmes are a key driver of engagement and motivation, so a review and harmonisation exercise enables the employer to send a clear message about how employees are valued within the transaction, as well as reinforcing the desired behaviours and future workplace culture of the new company.

Within the deal process, the focus on employee rewards will flow across the four key stages of the deal cycle. First, M&A readiness preparation includes capability and capacity building as well as understanding the reward programmes and policies the buyer already has in place. This will form a baseline for benchmarking and integration planning.

Deep due diligence on the target company will facilitate deal negotiations as well as informing implementation planning. Important areas of interest include the liabilities and obligations to be acquired in the transaction; any issues triggered on change in control; the expected integration approach; and any anticipated transition costs and risks.

Implementation planning is built on the due diligence findings, to address the business and reward-related issues. In this implementation planning, the acquirer will also identify key metrics to measure and manage progress.

At the implementation phase, retention programmes are rolled out, compensation and reward programmes are communicated and harmonised and legacy liabilities in acquired pension plans are addressed, for example.

HR and reward teams that can navigate these challenges and opportunities are seen as strategic business partners at the highest level during what is inevitably a period of significant business change. Our studies show the deeper and earlier HR is involved in a deal, the greater the chance of achieving the deal's objectives.

EDITOR'S COMMENT



A merger or acquisition poses many challenges for employers. Alongside the logistical issues thrown up by the gargantuan task of bringing two businesses together is the need to do so while ensuring that employees remain motivated and engaged with the new organisation and the business direction it may take.

Reward and HR professionals therefore have a significant role to play in the merger and acquisition process. Even in the initial negotiation stages, reward issues such as defined benefit pension liabilities have the potential to scupper a deal, so it is vital that the relevant professionals are involved as early as possible. In some cases, it may even be prudent to examine reward issues before a potential deal is even on the table.

Once a deal has been agreed, reward professionals face a mammoth task in identifying how best to merge the two workforces. A key part of this will be decisions around harmonising employees' reward and benefits packages, looking at factors such as overall reward strategy, pay and salary levels, holiday entitlement, levels of benefits coverage and, of course, pensions. Getting this process right can be crucial to engaging employees with the new organisation, as well as a useful tool in communicating its combined objectives and business strategy.

This supplement aims to guide organisations that may be considering, or are going through, a merger or acquisition as they tackle this vital process.

Debbie Lovewell, deputy editor

CONTENTS

05 / Due diligence

Benefits provision is a major consideration in any potential acquisition target

06 / Total reward

As workforces merge, communicating the full package value is important

10 / Pay and salary levels

Pay rates may clash after a merger, so restructuring could be necessary

12 / DC pensions

Several courses of action are possible for defined contribution scheme members

14 / DB pensions

Defined benefit pension liabilities can complicate takeover negotiations

Sponsored by

TOWERS WATSON 

Editor Debi O'Donovan • **Deputy editor** Debbie Lovewell • **Contributors** Sam Barrett, Sarah Coles • **Art editor** Deborah George • **Sub editor** Bob Wells • **Commercial director** Suzanne Saunders • **Business development director** Hamish Scott • **Senior account manager** Peter York • **Group production manager** Wendy Goodbun • **Group publisher** Phil Hayne • **Publishing assistant** Alice Gerard-Pearse • **Photography** Jacko

This publication is published by *Employee Benefits*, Britain's leading magazine for benefits decision-makers. *Employee Benefits* is published by Centaur Media plc, the UK's premier independent business publisher. *Employee Benefits* accepts no responsibility for loss or damage to material submitted for publication. Copyright Centaur Media plc. All rights reserved. No part may be reproduced in any form without written permission of the publisher. ISSN 1743-081X.

Subscribe: 020 7292 3719 or online at <http://sales.centaur.co.uk> For information about Centaur's products, visit www.centaur.co.uk



Mergers and acquisitions

A clear perspective

A merger or acquisition can be a volatile time. That's why it's important to have a partner who can help smooth the way. Towers Watson consultants work in collaboration with clients. We listen to you, learn, challenge and discuss. Then, together with you, we identify the right approach and tactics to address each stage of a deal -- from organisational readiness, through due diligence and integration planning to execution.

Towers Watson has the experience, knowledge and expertise to help your organisation achieve its deal objectives. Let us work with you to address and manage all of the people-related challenges and opportunities that a deal creates.

Towers Watson. A global company with a singular focus on our clients.

Benefits
Risk and Financial Services
Talent and Rewards

towerswatson.com

Copyright © 2011 Towers Watson. All rights reserved.
TW-EU-2011-20570a. May 2011.

TOWERS WATSON 



Find out the FACTS

There is a lot to check out about a potential acquisition and the benefits package demands careful attention, says Sarah Coles

In any marriage, it pays to know everything important about your partner before it is too late to change your mind. In merger and acquisition (M&A) situations, the due diligence process enables the buyer to assess all the liabilities of its intended acquisition and assess whether the claims it has made are true. Compensation and benefits should be a prominent part of this.

Given the scale of liabilities, if there are large pension schemes, particularly defined benefit (DB) plans, it is vital to know where you stand. Raj Mody, partner and chief actuary at PricewaterhouseCoopers, says: "A decade ago, you agreed the deal, then

considered pension issues. Now that has been turned on its head and buyers do not do the deal until they have got to the bottom of pensions."

For a DB scheme, the full economic cost and risks must be assessed. Terry Simmons, partner and head of pensions at Ernst and Young, says three key questions must be asked: What is the impact on profit and loss? What contributions will trustees demand in future? What other risks are there?

In this third area lie many pitfalls. Mody says it is vital to understand the balance of power with trustees and whether they can constrain the actions of the sponsoring employer. There may also be legacy issues such as data problems and administration niggles. Also, will any transaction trigger a demand for full and immediate payment on a buyout basis? Robin Ellison, head of strategic development for pensions at law firm Pinsent Masons, says: "Defined contribution is much easier than DB because you only need to know whether contributions have been paid as they should have been and take a look at the accounts, the contract and the investment allocation."

Pay is another major consideration. The wage bill is one liability, but buyers also need to understand outstanding commitments, and whether, for example, any kind of uplift is promised within certain contracts. Likewise, bonuses must be considered, and other important questions include: Are any

bonuses contractual? What long-term bonuses remain outstanding? What liabilities will carry over?

Finally, there is administration within the payroll. For example, has it adhered to rules and legal requirements, and have all taxes and benefits been paid for as promised?

Share plans

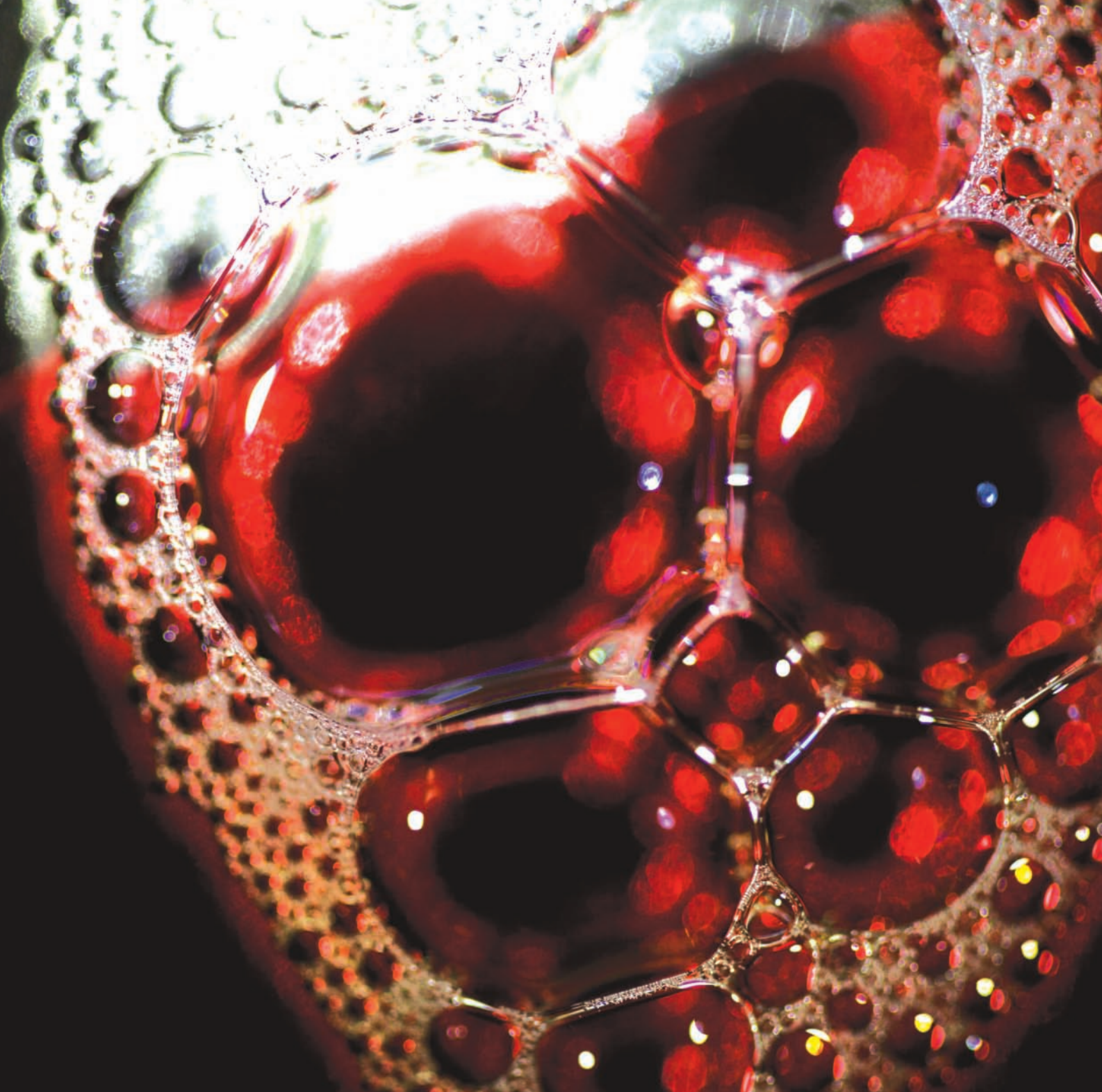
The other major area worth visiting in depth is executive stock or share plans. Mody says: "You need to understand any legal commitments and whether M&A crystallises these. Some plans may get accelerated, so you will face an earlier bill. Also beware of any new rules around executive reward. Issues can be created here if you are in the middle of an M&A process and legislation is changing at a frenetic pace."

Other matters range from sick leave and pay entitlements to working time and time off. What must be carried over, and what can be left behind? What is contractual, and what is custom and practice and can be argued to be contractual? Mody concludes: "A classic danger to watch out for is exceptions to the rules, such as side letters and personal deals with senior individuals. A key question is: 'Do you have arrangements that do not conform to the standard rules?'"

"There are significant reward and pensions issues in any M&A activity, and it makes sense to involve reward professionals early in the process." ■

IF YOU READ NOTHING ELSE, READ THIS...

- De-risk the pension scheme(s) – the less risk and lower liabilities, the better.
- Check contracts. Are there any difficult commitments lurking?
- Check the rules on benefits – will the sale trigger any difficult payments, such as stock option payouts?
- Communicate. Employees need to know you are preparing for a merger.
- Check your administration – have you done everything you should have?
- Clean data, ensure you are up to date.



Common **FACTORS**

*Highlighting the total reward package for new and existing employees can smooth the integration process during a merger, says **Sam Barrett***

Reward strategy plays a key part in any organisation, especially one that is experiencing the upheaval of a merger or acquisition (M&A). Highlighting how staff will be rewarded and the benefits the employer is prepared to offer can help to bring the new organisation together.

Ashley Norman, partner at law firm Cobbetts, says: "Harmonising pay and benefits is usually a key objective after any M&A activity. Co-ordinating all internal HR procedures not only streamlines the process, it also improves staff morale and creates a sense of unity."

But this is often a complex process. The first stage of harmonisation should be a reward audit, says Tim Johnson, managing director of employee benefits consultancy Gallagher Risk and Reward. "Go through both the new employees' and your existing benefit package with a fine-tooth comb," he says. "You will be surprised how many employers do not know what they offer."

Other expectations

As well as taking pay, incentives and employee benefits into account, it is also essential to consider any other expectations the new employees may have. Nich Crowson, reward consultant at HR consultancy Independent, says: "Sometimes when employees are transferred, especially when they move from the public to the private sector, they will have an expectation of something that cannot always be offered in the new organisation."

For example, public-sector staff may fear redundancy less than private-sector peers.

As well as comparing the two reward structures, it is worth getting a reality check on what is being offered in the open market. This will ensure an employer remains competitive, which can be important at a time when staff may feel unsettled.

This exercise should also take into account what the organisation wants to achieve. Leslie Moss, practice leader for human capital consulting at Aon Hewitt, says: "Think about factors such as how you

QUICK FIXES

- Harmonisation can take time, but some steps can be taken quickly.
- These help to kick the process off, signalling intentions to employees and helping to streamline administration.
- Where benefits are the same, it is sensible to move everything to one provider. It is easier to deal with one provider and an employer might also get a deal because of the increased size of the organisation.
- Among the benefits of being larger are lower costs on benefits such as pensions; enhanced terms such as improved underwriting for private medical insurance; and more opportunities for tailoring cover.
- Quick fixes can be made to areas such as when the holiday year starts and the terms relating to sick pay, especially as operating different systems across the same organisation can add administration.
- These changes are normally fairly straightforward. Although they are referred to in the employment contract, the finer details are contained in the staff handbook, which can be changed more easily.

want to be perceived as an employer and how difficult it is to recruit and retain employees. This can be reflected in the reward package you offer."

Cost is also a major consideration. Johnson says: "I have never come across an organisation that had unlimited budget and was able to harmonise reward upwards. Sometimes they have to leave some staff on these benefits rather than harmonise."

On top of this, some benefits are more valued than others. For instance, Gary Luck, director of consulting services at Towers Watson, says decisions around providing a company car can be very emotive. "Staff can attach a lot of value to their company car, so it is essential to tackle this area carefully."

But although there may be sticking points, many areas of the reward package can be brought into line. Ben Wells, senior consultant at Buck Consultants, says: "Many organisations adopt a long-term approach, making some changes such as switching benefit providers quite quickly, but looking to harmonise over three to five years."

A flexible benefits scheme can be a good

way to do this. Moss says he has seen employers introduce a flex scheme in response to a merger or acquisition. "It allows employees to replicate the benefits they had in the old organisation, making it much easier to deal with any number of different starting points," he says.

IF YOU READ NOTHING ELSE, READ THIS...

- Highlighting employees' pay and benefits package can help to bring a new organisation together.
- A reward audit should be the first stage of the harmonisation process.
- A flexible benefits scheme can help to harmonise provision, but replicating previous packages may still be tricky.
- A total reward strategy can be a particularly powerful tool.
- Employers must give fair warning if benefits are to change.

CASE STUDY

Integration no problem at Informa

Having grown significantly through acquisitions over the past 13 years and being the result of a merger itself, Informa has seen its HR and reward department play a key role in integrating businesses into its benefits package.

A vital part of the acquisition process is communicating with new staff. This is led by the chief executive of the division acquiring the business, with support from

HR and the reward team. Thomas Humphris, UK reward director at Informa, says: "With a larger acquisition, we will run a reward show to tell new employees about our benefits. With smaller groups of staff, there will be a general presentation, followed by a one-to-one with the reward team. We have an incredibly comprehensive benefit package, so we usually find they are quite excited about

what we offer."

Some elements of reward are harmonised quickly, including the pension, where the previous scheme is closed and staff transferred to Informa's pension on the same terms. Bonuses and commission are also brought into line quickly, so employees feel they are all working towards the same goal.



But because Informa operates as a series of independent business units, it is not necessary to move everyone onto identical terms. "There is plenty of variation across the business, for instance holidays can range from 25 to 30 days," says Humphris. "But it does not cause any issues. Our package is flexible enough to allow for variation."

This can also help to remove issues around holiday entitlement. For instance, if new staff have a lower holiday entitlement, a flex scheme could enable them to increase this by purchasing additional days.

Also, where the new employees have come from a smaller organisation, the choice available through flex can help them feel positive about their new employer.

But even with a flex scheme, replicating some benefits can be tricky. For instance, if an employer buys part of a larger company, it might be hard to obtain the same terms for perks such as private medical insurance.

In such cases, it may be easier to take a

financial hit. Mark Thompson, associate director at the Hay Group, says: "If someone has a particularly generous benefit, perhaps PMI or a final salary pension that could increase significantly in cost in the future, it may be easier to buy them out."

However benefits are harmonised, a well-thought-out communication strategy can make or break a deal. Aon Hewitt's Moss says: "The earlier [employers] communicate, the better, as it will help show they respect and value staff. Even if, under Tupe [Transfer of Undertakings (Protection of Employment)], employers cannot make any changes for 18 months, from day one

employees will want to know what they are going to do in 18 months and a day's time."

This can also be a legal requirement, says Cobbetts' Norman. "An employer is required to inform and consult with staff throughout the process."

The consultation process should also include any union representatives.

Communications strategy

As part of the communications strategy, a total reward approach can be particularly powerful. Gallagher's Johnson recommends using total reward both before and after harmonising benefits. "By adding up the value of everything in the package, staff can see what they had in the old organisation and that, although there might have been changes, they are no worse off," he says.

Employees should also be given fair warning if benefits are to change. For instance, if an employer is moving to different terms on maternity benefits, it is prudent to give at least 12 months' notice.

But it is not always necessary to harmonise packages, says Johnson. "If it is a hardcore M&A business, offering a uniform benefits package is not that important. Everyone knows they are on something different. Running various [schemes] can cause administration issues, but does not cause problems from a staff perspective." ■

RETAINING KEY TALENT

There are usually key people who have a significant influence over how smoothly any integration goes, so it is important to have a strategy to retain these individuals, at least until the integration has taken place and knowledge has passed to the new organisation.

Ben Wells, senior consultant at Buck Consultants, says: "Identify who is key early on, ideally before the deal takes place. This makes them feel part of the new organisation. If they are ambitious, feeling valued by their new employer can be incredibly positive."

Incentives, such as bonuses, are often used to encourage key staff to stick around. Gary Luck, director consulting services at Towers Watson, says: "It can often boil down to cash. A deferred incentive will help to tie these people in."

Share options can help to lock key staff in for a few years. Tim Johnson, managing director of Gallagher Risk and Reward, says: "They are tax-efficient and the value of share options means the employee has a direct interest in looking after the company."



Employee Benefits:

M&A critical

A clear perspective

Employee benefit programmes can be among the most expensive, and misunderstood, liabilities in a merger or acquisition. Correctly valuing them is a business-critical requirement. Benefits are also an emotional issue for employees, and any changes must be handled carefully.

Companies around the world rely on Towers Watson's expertise and broad perspective to help them identify and value pension and long-term benefit plans and manage them through the transition process. We also work closely with clients to consider the strategic available options - from settlement to trustee negotiation.

Allow us to collaborate with you to harmonise your benefit strategy. With the right programmes at the right cost, the new organisation can drive employee attraction, retention and engagement and ensure compliance at global, regional and local levels.

Towers Watson. A global company with a singular focus on our clients.

Benefits
Risk and Financial Services
Talent and Rewards

towerswatson.com

Copyright © 2011 Towers Watson. All rights reserved.
TW-EU-2011-20570b. May 2011.

TOWERS WATSON 



Scale MODELS

*Harmonising pay scales between merged organisations may call for some restructuring to avoid conflicts, says **Sam Barrett***

Inheriting another organisation's pay bands and salary levels can throw up a number of challenges. Paying different rates can affect morale and cause recruitment and retention problems, and could also land employers in hot water legally. Gary Luck, director of consulting services at Towers Watson, says: "The key to getting pay right is to go right back to the beginning and understand the logic behind the merger. This will determine the degree and speed of any changes."

For example, if an organisation has bought a company to gain a new product or

enter a new market, it might not need to worry about integrating and reviewing pay structures. Mark Thompson, associate director at the Hay Group, says: "A good example is Unilever. It has taken over lots of companies but because they are different, they can be left to run independently."

But if an organisation is combining two similar businesses where staff have similar roles, such as when consultancies Towers Perrin and Watson Wyatt merged last year to form Towers Watson, harmonising pay bands and salary levels will be important to engage staff and achieve common goals.

Where harmonisation is required, the first thing to do is determine some form of pay scale to apply to all jobs. "The starting point is establishing relative job size," says Luck. "Employers need a mechanism to understand the relative weight of each job and map them onto the scale."

A grading system can help, says Ben Wells, senior consultant at Buck Consultants, and many organisations operate one. "The easiest scenario is where they both operate the same structure, but this does not happen often. We see situations where one company operates a grading system and the other does not. If this happens, we would look to adopt the grading system across the organisation. The worst scenario is where there are two different systems in place."

If two different pay scales exist, it may mean starting afresh, creating new job titles and descriptions and transferring staff onto these. Such change can require considerable thought and consultation with employees.

But even if the two organisations operate similar pay scales, it is not always simple.

IF YOU READ NOTHING ELSE, READ THIS...

- Inheriting another organisation's pay and salary levels can throw up a number of challenges for employers.
- Employee benefits must also be taken into account, because these may skew the balance of what is offered.
- Where two different pay scales exist, employers may need to start from scratch, creating new job titles and descriptions.
- If an organisation plans to leave an acquisition to run independently, it may not need to worry about aligning pay structures.

Some staff may be paid significantly more, or less, than their colleagues, making it difficult to map them onto the scale. Luck says this can indicate a more basic problem. "If an employer finds someone is way out on the pay scale, it is usually because they are not doing the job their title suggests. The employer may need to promote them or manage them into a different role."

Skew the balance

As well as pay levels, employee benefits must also be considered, because the value of these can skew the balance. For example, if one organisation pays generous salaries but has little in the way of benefits while the other offers generous benefits but a lower salary, this would need to be taken into consideration when harmonising pay.

"This can be tricky, especially if an employer is bringing in highly-paid staff," says Hay Group's Thompson. "Use total reward to demonstrate the value of each employee's package. As pay is contractual, it might need to do a deal, either collectively or individually, to reduce pay in return for enhanced benefits."

Thompson suggests using flexible benefits to enable staff to trade some of their pay for perks. "If the packages are roughly equal, this can work well," he says.

Another factor to take into account when setting pay levels is how the employer wants to be perceived. A review of market rates will help gauge where it sits compared with

CASE STUDY

Santander accounts for many changes

Mergers and acquisitions are not uncommon in the banking sector and 2008 was a busy year on this front. Ian Cuning, senior reward manager, human resources at Santander, says: "Towards the end of the year we acquired Alliance and Leicester, the retail deposit arm of Bradford and Bingley and the card division of GE Money. This almost doubled our headcount, taking us from 16,000 staff to 26,000. It was an interesting time."

Given the scale of these acquisitions, harmonising pay and benefits took time. "Initially, we had to establish key principles and objectives," says Cuning. "These included simplicity, cost-effectiveness, fit for purpose and to be competitive in the market."

One of the first areas to be tackled was pay and salary grades. "We were relatively lucky as similar scales operated across the



companies," says Cuning. "Also, because we were moving from Abbey to

Santander, we were able to introduce a new system across the board. We implemented one structure to ensure equal pay, but also to enable employees to understand where they were in career development. On top of this, local changes were brought in to take account of shift allowances, overtime, and so on."

its peers, but it must also consider whether these rates are affected by the merger. For instance, if a merger makes an organisation a market leader, it may find it does not need to be so generous with pay to attract staff.

Matthew Howse, partner in the labour and employment team at Morgan Lewis, says: "You do see organisations that are prepared to risk tribunals over constructive dismissal when they adjust pay, but this is unusual. Most prefer to take it slowly, harmonising pay levels over many years."

Taking time allows more gradual changes

to be made. For instance, someone at the top of their pay band could be given smaller pay rises than someone at the bottom of the band to bring them more into line.

A good communications strategy is essential, says Howse. "Even if an employer is only changing the structure and staff pay will not be affected, it still needs to show that no one will be any worse off."

Buck's Wells says using all available channels for communications, including trade unions, staff councils and one-to-one meetings, will help to win approval ■

LEGAL ISSUES

■ In a merger, it is important to consider legal implications if undertaking a wholesale review of employee reward.

■ The Transfer of Undertakings (Protection of Employment) (Tupe) Regulations apply in most mergers involving

employees. A Tupe transfer protects employees' contractual agreements.

■ This does not rule out a harmonised approach, but the employer has to show an economic or organisational reason to change reward.

■ The Equality Act 2010 also comes into play when assessing pay structures. It requires employers to pay the same amount to men and women doing equal work.

■ Although it is important to bear the Equality Act in mind,

it is rarely a problem. This is typically more of an issue for the public sector, where many people carry out the same role, but it can cause problems if an employer has a critical mass of people performing the same function.

Multiple CHOICE

Employers have several options on DC pensions after a merger, says Sarah Coles

There is no single right answer when it comes to deciding what to do with pensions after a merger. Some employers find the best solution is to do nothing at all, keeping all the schemes going. Others have a policy of continuous acquisition and simply roll each new employee into one existing pension. And some take the opportunity to start afresh and build a brand new pension scheme for all staff.

Tony Pugh, UK head of Mercer's defined contribution (DC) consulting business, says doing nothing is a powerful option. "I know of one company with 91 pension funds," he says. "Some conglomerates with active acquisition strategies have an approach of leaving well alone. If the acquired company is a distinct part of the business, then they

may not need to harmonise the schemes."

But for many, the aim is to bring pensions together. Roger Mattingley, head of client relationship management at JLT Benefit Solutions, says: "There is a real corporate desire in most organisations to harmonise and get some consistency. The utopian position for [employers] is to offer the same core benefits for everyone."

By far the most common option is to run a DC pension scheme – either offering an existing plan to the rest of the M&A parties, or starting a new one.

Often, organisations with at least one trust-based DC scheme will expand it to the wider business. For example, when Lucent and Alcatel merged in 2008, Lucent's stakeholder pension scheme was closed to

new members and Alcatel's trust-based DC plan was opened to all staff. With trust-based schemes, it is more usual to extend one scheme than to close both and start afresh. Pugh says: "If employers can reduce the number of staff affected by the change, that may well prove the easiest option."

If employers have two DC contract-based schemes, they can still extend an existing plan to new staff. With a contract-based scheme, employees must choose to transfer into it themselves. In 2010, for example, Computershare Investor Services opened its group personal pension (GPP) to staff who joined the business after it acquired HBOS Employee Equity Solutions. The legacy DC and DB schemes were closed and staff were invited to enrol in Computershare's GPP.

CASE STUDY

E.On empowered by national pension scheme

E.On is a diverse business with a long history of mergers and acquisitions. In the UK, most staff belong to one of three pension plans: career average and final salary arrangements that are closed to new staff, and an open defined contribution (DC) plan.

Ant Donaldson, senior specialist, employee benefits at

E.On, says harmonising pensions was helped by the fact that the whole industry is part of the national Electricity Supply Pension Scheme (ESPS), a final salary scheme. "Whenever there is a merger or acquisition involving ESPS members, they are generally moved from one section of the ESPS to

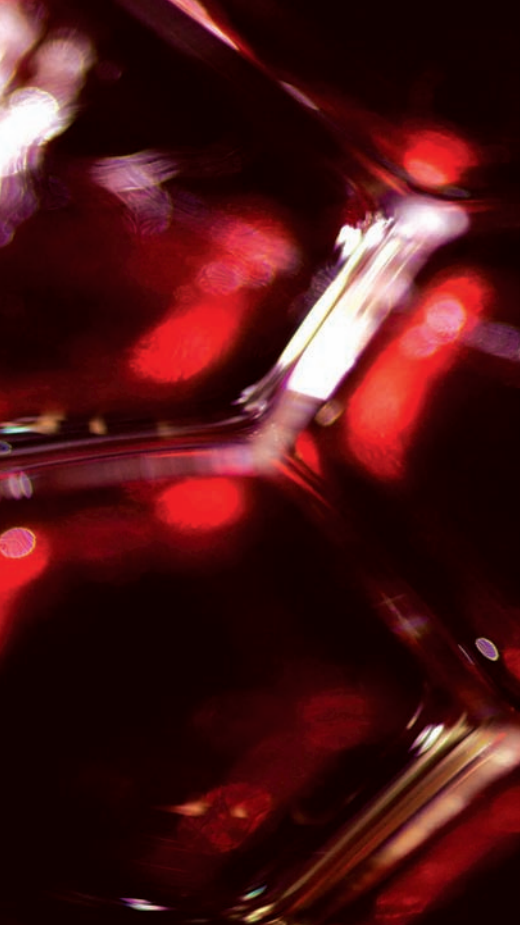
another," he says.

Eight years ago, E.On closed membership of ESPS to new joiners and set up its own career average pension scheme. This was subsequently closed to new members two years ago, when E.On launched a contract-based DC scheme.

There have been some



acquisitions that fell outside ESPS. "We have allowed schemes to run on where we felt this was the most sensible course of action," says Donaldson. "Where appropriate, we have offered members of those schemes the choice to move to whichever of our main three plans was open at the time."



Employers with contract-based DC plans have an easier job than those with trust-based DC plans if they want to start a new scheme for the whole business. Philip Baker, senior consultant at Towers Watson, says: "Employers may be in a greenfield situation where what they consider to be right for the workforce is not already on offer at any of the merger parties. This is an opportunity to refresh the benefits strategy."

Transfer benefits

If employers set up a new DC scheme, they need to enable employees to transfer their existing pension benefits and need to wind up the old schemes. Then it is just a question of establishing the right governance, contribution levels and communications.

Robin Ellison, head of strategic development for pensions at law firm Pinsent Masons, says: "The Pensions Regulator is issuing streams of advice and regulations that make running DC almost as complicated as DB, so a governance system is increasingly worth considering."

Employers also need to look at contribution levels, particularly if merging staff received different contributions in their previous schemes. Employers may have to choose between levelling up or down. When Live Nation Entertainment merged with Ticketmaster in 2007, it levelled up, and some staff saw their contributions rise. JLT's Mattingley says: "When harmonising

benefits, it is easier to sell to staff if employers level them up, but the overriding commercial desire is to keep costs neutral."

But there are risks in increasing benefits to the highest level of the old schemes. Baker says: "Levelling up is expensive and it increases expectations for all aspects of reward, so most businesses try to keep changes to remuneration cost-neutral."

So there will be winners and losers, which makes it hard to satisfy all staff. Rather than trying to hide any negative effects of the changes, the key is communication. Take employees along, so they know this is not brutal cost-cutting, but is done for solid reasons and the good of the workforce.

Baker adds: "At the outset, employers may not be able to communicate what the new deal looks like, so they may need to tell staff about the principles they will employ, such as keeping overall benefit costs the same, to help manage expectations. If [employers] run a consultation process, they need to support it with communications. If decisions need to be made, staff need to understand the options available."

A third option is to offer a pension through a flexible benefits plan. "This helps harmonise benefits without encouraging

IF YOU READ NOTHING ELSE, READ THIS...

- There is no single right answer on what to do about DC pensions provision following a merger or acquisition.
- Some employers will launch a brand new scheme for all staff, others will extend an existing plan and others will do nothing.
- Employers must consider factors such as contribution levels and governance.

cherry-picking," says Baker.

When accountancy firm Grant Thornton merged with Robson Rhodes in 2007, it was faced with two very different DC pension schemes: one offering a contribution of 6% for staff who contributed 4%, and the other offering age-based contributions. Its new stakeholder scheme, launched in 2008 through a flex plan, offered to match staff contributions between 3% and 8%.

So, although there is no right answer in terms of how pensions are harmonised, the solution will need to combine careful analysis and open communications ■

AUTO-ENROLMENT CONSIDERATIONS

The impact of auto-enrolment must be considered in any harmonisation process. One element is cost: if a scheme is being introduced or rolled out more widely, employers must consider not just the cost of providing benefits to current pension members, but the potential overall cost if every single eligible employee is automatically enrolled.

Robin Ellison, head of strategic development for pensions at Pinsent Masons, says: "DC [provision] is going to get more complex because of Nest [the national employment savings trust] coming online. Employers have to consider whether the scheme they are intending to roll out to employees meets the new rules, because there is no point changing everything now and then changing again a year down the line."

Auto-enrolment poses additional challenges in an already complex process, but it also offers an opportunity. Tony Pugh, UK head of Mercer's DC consulting business, says: "With auto-enrolment, the removal of the default retirement age and the change in the state pension age, the landscape is completely changing. So much change gives employers an added rationale for entering a harmonisation process, which will leave them with a scheme suitable for a modern workforce and the current environment."

Paying the PRICE

Defined benefit pension liabilities can play a big part in merger talks, says Sarah Coles

In December 2008, a potential merger between Qantas and British Airways collapsed, with BA's £1.7 billion defined benefit (DB) pension liability cited as a major reason. This was perhaps unsurprising, given that BA's pension liabilities were more than twice the market value of its business.

But a pension does not have to be that huge to affect merger plans. The key is for both parties to understand the liabilities, for the price to reflect them accurately, and to devise a strategy for the pension and its liabilities both pre- and post-merger.

The first step is to understand the liabilities. Philip Baker, senior consultant at Towers Watson, says: "The buyer is taking on responsibility for existing pension promises to current members, deferred members and pensioners. It needs to understand the cost of these promises."

Scheme valuations tend to be carried out every three years, so a buyer may need to get an up-to-date actuarial valuation, which may inform the ratios of the merged group.

But a typical actuarial valuation under the rules of accounting standards FRS17/IAS19 is only one approach, and is likely to produce the lowest valuation of liabilities. Baker adds: "The buyer is also interested in the cash funding measure – how much cash goes into the plan and how much it may have to put in in future. Or there is the buy-out measure, the cost of securing all the liabilities with an insurance company. This is often the largest number a buyer looks at."

The valuation measure does not have to be agreed between the two parties. The buyer simply considers the figures during the valuation, and uses the different valuations in negotiations over price.

The price also needs to take into account any unpaid contributions and any regulatory concerns. The Pensions Regulator can intervene if it believes it is less likely that pension liabilities will be paid in full after the merger. It is common practice for buyers to seek approval from the regulator in advance to avoid potential problems. For the seller,

TRUSTEES' ROLE

The role of the trustees is to protect members' interests. The crucial issue is the employer covenant. Philip Baker, senior consultant at Towers Watson, says: "Trustees need to appreciate how strong the employer covenant is before the transaction and after."

If the covenant is weakened, trustees may require steps to be taken, such as cash payments, letters of credit, fixed or floating charges, or improving trustees' powers.

If they do not have sufficient financial understanding to assess the covenant, the regulator expects them to seek advice. The selling employer can help by ensuring all relevant information is supplied to trustees in a clear format. Baker says: "Employers will want dialogue with trustees to explain the rationale for the business."

this may mean the regulator insists on a payment into the scheme, which is usually deducted from the sale price. The regulator could also put the brakes on the merger.

There are various options for getting transaction-ready. Terry Simmons, partner and head of pensions at Ernst and Young, says: "Employers can close a DB scheme to new members and future accruals. This will remove uncertainty."

A seller can also reduce the liabilities through an enhanced transfer value exercise or pension increase swaps. Baker says: "Benefits professionals can add a great deal by getting involved early in the transaction."

After a merger, there is no requirement to replicate a DB pension scheme for staff transferred into the new organisation. The Transfer of Undertakings (Protection of Employment) regulations protect salaries and benefits, but do not insist on the continuation of a DB pension plan. Baker adds: "The strategy needs revisiting so it matches the new employer's objectives." ■

Sponsor's profile

a d v e r t i s e m e n t

TOWERS WATSON



Background information

Towers Watson is a leading global professional services company that helps organisations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of employee benefits, talent management, rewards, and risk and capital management.

Our focus is on giving you the clarity to make the right decisions and take the right actions. And our approach is grounded in perspective — the kind that comes from our deep experience working on a wide range of issues.

But more important, our perspective begins at eye level — with a clear understanding of our clients, the way they work, their goals and challenges.

By connecting the big picture and our client's picture, we help them achieve real-world results.

Contact details

address

Towers Watson
21 Tothill Street
Westminster
London SW1H 9LL

contact

Steve Allan

telephone

0207 227 2418

email

steve.allan@towerawatson.com

website

www.towerawatson.com



People are the key to

successful M&A

A clear path forward



People are the key to any merger or acquisition. Without their commitment, energy and ideas, a deal won't succeed. Let us help you build and execute an integration approach that recognises the cultures of both organisations while creating the change necessary for the new organisation to flourish. Using proven change management and communication strategies, we work with you to manage the process from the pre-deal stage through integration.

Towers Watson. A global company with a singular focus on our clients.

Benefits
Risk and Financial Services
Talent and Rewards

towerswatson.com

Copyright © 2011 Towers Watson. All rights reserved.
TW-EU-2011-20570c. May 2011.

TOWERS WATSON 