EXAMINATIONS

11 April 2002 (pm)

Subject 404 — UK Fellowship Pensions

Paper Two

You must answer this subject only, you may not attempt another subject in the 400 series.

Time allowed: Three hours

INSTRUCTIONS TO THE CANDIDATE

1. *Enter all the candidate and examination details as requested on the front of your answer booklet.*

2. *You have 15 minutes at the start of the examination in which to read the questions. You are strongly encouraged to use this time for reading only, but notes may be made. You then have three hours to complete the paper.*

3. *You must not start writing your answers in the booklet until instructed to do so by the supervisor.*

4. *Mark allocations are shown in brackets.*

5. *Attempt both questions, beginning your answer to each question on a separate sheet.*

AT THE END OF THE EXAMINATION

Hand in BOTH your answer booklet, with any additional sheets firmly attached, and this question paper.

In addition to this paper you should have available Actuarial Tables and your own electronic calculator.

1 ABC plc (a UK listed company) is negotiating to sell one of its business divisions to XYZ inc (a US listed company). In the UK, XYZ would acquire Target Ltd, a wholly owned subsidiary of ABC. XYZ does not currently have any operations in the UK.

Target is the principal employer for a final salary pension plan. ABC are proposing that Target will continue to be the principal employer after the sale, and that UK pensions can be ignored in the deal negotiations because the plan is in surplus.

XYZ has commissioned you to advise on the UK pensions aspects of the deal. Target carried out a redundancy exercise in 1999 which used pension plan surplus to early retire all the oldest employees. Since then the company has been on a recruitment freeze. ABC has sent you a copy of the current plan booklet and of the latest actuarial valuation report. The booklet states that:

- the plan is not contracted out of SERPS
- the accrual rate is 1/80ths with spouse's pensions accruing at 1/160ths
- the normal retirement age (NRA) is 65 but there is an established discretionary practice of granting unreduced pension on retirement from active service after age 60
- members can commute pension for cash on retirement, the rates are determined by the actuary and are currently £10.20 at age 60 and £9.00 at age 65

Pensions are guaranteed to increase in line with price inflation, each 1 July.

Members do not contribute (except to money purchase AVCs) and the employer contributes the amounts recommended by the actuary to maintain the solvency of the plan.

The valuation report shows the following information (as at the valuation date 1 July 2000):

Assumptions	
Discount rate	8.00% p.a.
Price inflation	2.50% p.a.
Salary growth	4.00% p.a.
Post-retirement mortality	PA90 – 1
Retirement age (actives)	60
Commutation	assumed to take a cash sum of 3/80ths of salary for each year of service
Assets (at market value)	£205.0 million
Pensions in payment	
Total annual pensions	£11.0 million
Average age	70.0 years
Past service liability	£106.5 million

Deferreds

Total annual pensions (revalued to NRA)	£10.0 million
Average age	45.0 years
Past service liability	£23.6 million

Actives

Total salaries	£30.0 million
Average age	40.0 years
Average past service	10.0 years
Past service liability	£23.2 million
Future service cost (projected unit credit)	£2.1 million
Recommended contributions	nil

(i) Estimate the past service funding level now (as at 1 July 2002) on the valuation basis, assuming that experience has been in line with the actuarial valuation assumptions. State any other assumptions you make. [9]

(ii) The valuation report stated that the fund was entirely invested in an index-tracking equity fund. The underlying index fell by 10% (on total return basis) over the period. Estimate the effect on your answer to part (i). [3]

(iii) Draft a report to XYZ setting out:

- the results of these calculations [3]
- your opinion on the suitability of the valuation results as a measure of the plan's financial situation [10]
- your assessment of the financial implications of the deal for XYZ [10]
- the advantages and disadvantages for XYZ of ABC's proposal that Target should continue to be the principal employer [7]
- an outline of alternatives to ABC's proposals [2]
- a summary of further information you recommend XYZ should seek from ABC/Target [5]

[4 marks are available for drafting]

Assume that this plan is not subject to the Minimum Funding Requirement (MFR).

The deal proceeds on ABC's proposals. After completion, XYZ ask you to become the actuarial advisers to the Target plan's trustees.

(iv) Outline the issues that you need to consider before taking on this appointment. [7]

[Total 60]

2 A large UK company publicly listed on the US stockmarket currently offers a wide range of employee benefits. The amount and availability of these benefits is determined solely by an employee's grade in the organisation (subject to regulatory requirements). At the top level the benefits are as comprehensive as any other UK company provides.

The human resources (HR) director of the US parent company has suggested its UK subsidiary should offer a system of flexible benefits.

(i) Describe the principles of a flexible benefits program (flex). [4]

(ii) Suggest, with reasons, benefits which may be unsuitable for the flex program. [2]

(iii) Suggest, with reasons, three core benefits (other than basic salary) which all employees must choose. [3]

(iv) Comment on why a particular benefit may be suitable for flex but not as a core benefit, giving examples to illustrate any points you make. [4]

(v) Describe the factors the company should take into account in pricing the benefits under the flex program. [6]

The company operates a non-contributory final salary 1/60th pension plan, which is funded on the projected unit method. At the last valuation the fund was in surplus on the funding basis adopted. The HR director has suggested that the contribution rate currently paid by the company should be used as the price of pension plan membership for all employees choosing the pension option under flex.

(vi) Comment on his proposal with particular reference to the funding principles associated with a final salary pension scheme. [11]

(vii) Suggest with reasons alternative methods of including pensions under flex. [6]

(viii) Discuss the problems with a final salary pension scheme being part of a flex program. [4]

[Total 40]