Faculty of Actuaries **Institute of Actuaries**

EXAMINATIONS

April 2001

Subject 404 — UK Fellowship Pensions

Paper Two

EXAMINERS' REPORT

Overall

- There was evidence of good question-reading generally (main exception being ignoring the unmarried partner throughout answers)
- There was generally good drafting — overall structure, plain English, and so forth.
- Most candidates produced "complete" answers; i.e. length of question did not cause undue time pressures.
- Some candidates took Mr Smith's reasons for not wishing to join as instructions and did not attempt to dissuade/educate him.
- The better candidates consistently put their knowledge into the context of Mr Smith's situation.

Investment

- Most candidates generally scored well on this, but failed to translate their analysis of the characteristics of the various OPS funds into firm recommendations for Mr Smith.
- Poorer candidates believed that PP could/would not offer range of investment options, possibility of lifestyle type switches and so forth.

Expenses

- Few candidates clearly stated that member meets full PP expenses, company may meet some, so saving likely.
- Some candidates include far more detail than 3 marks available warranted.

Contributions

- Virtually all candidates included references to AVCs, 15% limit for OPS, age-related PP limits.
- Generally candidates scored well on this section.

Desirable Level of Pension/Contributions Necessary

- How to arrive at a desirable level of pension was not answered well by many.

  Typical approaches were:

  - pluck 2/3 out of the air as being "right" without any explanation
  - mention reduced expenditure but not consider increased costs
  - ignore state benefits (or allow for them from 60)

- Calculations were variable.

  - some only did then at one age
  - many candidates failed to explain them well to Mr Smith
  - it was often unclear to what extent existing PP/BSP/SERPS was allowed for in targets, particularly where no detailed calculations were shown
  - better candidates included calculation detail as a preface/appendix to the report to ensure full credit for formulae etc. and set out clearly the main results in the body of the report

Nature of Benefits/Limits

- There was a general failure to state the obvious in this section re options for increases, dependant's pension, guarantee.
- Overall, candidates still scored reasonably well by setting out the appropriate limits.
- Few sought to question why the scheme has restricted cash to 10% of the fund on behalf of Mr Smith.

Death Benefits/Limits

- Candidates who had picked up on the unmarried partner scored better on this section.

Leaving Service Benefits

- Most scored the marks available for stating that the fund will continue to receive investment returns and can be transferred — few covered the situation if Mr Smith left within 2 years.

Recommendations

- Perhaps due to time pressure in some cases, but consistently the worst answered section with few candidates including enough to reflect he 14 marks available.
- Many candidates failed to give a recommendation.
- Often recommendations were, if there at all, buried amongst the factual content, and not obvious as recommendations to the non-expert reader.
- Most did, however, recommend joining to get the employer contributions.
- Those that recommended the PP route generally did so because they thought that Mr Smith needed the higher limits on contributions, but often didn't consider whether 30–40% contributions were actually affordable.
- Very few who recommended the OPS made clear their investment strategy recommendations.

1

(i) His current personal pension investments are similar to the Adventurous Fund, they are both company shares.
The Adventurous Fund might be slightly more risky as it invests in overseas equities but it might also give a better return overall.
Over the long term equities, company shares, have given better returns than fixed interest investments and cash deposits
Over the short term they can go down in value
but so can fixed interest investments
and inflation linked investments
Values can move quite quickly up or down over a very short period of time
Cash deposits do not go down in value
but they provide a much poorer return over a long period
The tax position is the same for both employer pension schemes and personal pension schemes
It is not possible to reclaim tax paid on dividend payments received by pension funds
Dividend income used to be tax free for both
Interest payments from loans, bonds and gilts is tax free
Capital gains on all investments are tax free
He has indicated that he intends to buy a pension with his personal pension fund; if he joins the scheme a pension will be bought when he retires
The price of non increasing pensions tends to move in line with the value of fixed interest investments e.g. fixed interest gilts
The price of pensions which increase in line with RPI tends to move in line with the value of RPI linked investments e.g. RPI linked gilts
When he gets closer to retirement he should consider switching his investments into investments which are likely to move in line with the cost of buying a pension
to safeguard against the cost of pension increasing and his fund value not increasing at the same rate or even decreasing in value
That is what the Lifestyle Fund is trying to do
However the Lifestyle Fund does not protect any retirement cash sum
All of the above investment choices are available under the scheme
The lifestyle fund automatically switches funds from equities to gilts between age 55 and 65
but this means that the fund will not be fully invested in gilts by age 60, the age at which he wants to retire
and so will not allow the fund to be fully protected against adverse market movements
All of the above investment choices should be available under the personal pension
Also in one case the manager is selected by the Trustee and in the other by the contributor to the personal pension

(ii) Companies often pay some or all of the expenses of running their pension schemes
The investor has to pay all the costs of operating the personal pension
Joshua may save on expenses by joining the pension scheme

He could make a further saving if he also transfers his personal pension fund into the pension scheme

Need to check what penalties there are or charges deducted if contributions stop and when funds are transferred away from the insurance company.

Company scheme should be able to secure cheaper investment charges.

(iii) He will only get employer contributions if he joins the scheme
This amounts to £1200 p.a. initially
If he joins the scheme he will have to pay £1800 p.a. or £150 p.m. initially
But he can pay additional voluntary contributions as well
The maximum he can pay to the scheme, inclusive of his compulsory contributions, is 15% of gross earnings
This would be £625 p.m. initially, more than 3 × what he is currently paying
He is allowed to pay more than this to the personal pension if he does not join the scheme
The maximum contribution to a personal pension is 17½% under age 35 and 40% over age 60
The desirability of paying higher contributions depends on the level of pension he wants to get at retirement
and how much he can afford to pay
He has to stop paying premiums into his personal pension if he joins his employers scheme
unless he has income from other employment
There is a limit on the amount of salary, the earnings cap, that can be taken into account for calculating contributions
But this is currently c£90,000
And so is unlikely to apply to him
He could check to see if his employer would be prepared to pay extra contributions to the scheme for him
There is a tax timing advantage in paying contributions to company scheme

(iv) He needs to decide on the level of pension he would like to get at retirement
Some of his expenditure will reduce,
e.g. his mortgage may be paid off, he may have fewer travel expenses
But other elements may increase
e.g. he may want to take more or longer holidays, heating bills may increase
State pension benefits will be paid from age 65
This will be made up of basic state pension
And State Earnings Related Pension (SERPS)
He should consider the level of income from all sources compared with his current level of income
Once a non-increasing pension is in payment its value could soon be eroded by inflation
even when inflation rates are low, especially if he lives for a long time
Marks were available for sensible calculations to illustrate the effects of inflation
There are limits on the maximum pension which he can get from an employer's pension scheme (see below)
From a personal pension he can get whatever his fund will provide

He is currently paying less than 5% of his total expected earnings
He will have to increase significantly the monthly amount he is saving in order to provide desirable standard of living in retirement
If he was to retire at 65 instead of 60 he could get a much bigger pension with his fund
Because he will have paid in for a longer period
the funds will have accrued investment income for longer
and pensions cost much less for a 65 year old than a 60 year old
Also some mention should be made to sensitivity of results
Marks were available for sensible calculations of contribution rates with formulae and assumptions

(v) With his personal pension fund he can buy a pension for himself.

The pension will depend on the size of his fund,
the type of pension he wants to buy
and the cost of buying the pension from an insurance company.
He can buy a pension
which does not increase in payment
which increases by a fixed percentage each year
which increases in line with RPI
He can buy a pension which is guaranteed to be paid for a fixed period, say 5 years (max 10 years), whether or not he dies before the end of the period

He can also buy a dependants pension to be paid following his death
He can take some of the fund as a tax free lump sum
Up to ¼ of the fund
Company schemes can provide all of these options
except that the pension must increase in payment each year by at least the lesser of the increase in the RPI and 5%
If he joins the scheme, his pension will be whatever his fund will buy i.e. the same as his personal pension
The maximum pension he can get from a company scheme is 1/30 of total earnings for each year of service
Plus transferred in benefits
Subject to an overall maximum of 2/3rds of total earnings
But the scheme can always provide benefits at a rate of $1/60^{th}$ for each year of service
Earnings over the earnings cap cannot be taken into account in the calculation of benefits
Tax free cash is limited to the greater of $3/80^{th}$ total earnings for each year of service
And 2.25 × the initial rate of pension
There appear to be constraints on the type of pension which can be bought in the scheme; he should enquire whether there is any flexibility
He should find out if he can take a larger cash sum at retirement age if he wants

If he retires from the company before age 65 then it is very likely that he will be able to take his company pension immediately

(vi) If he dies before he retires there are significant benefits payable from the scheme

The lump sum will almost certainly be paid to his partner
And the trustees are likely also to pay out the value of the fund to his partner
He should ask the trustees if the pension payable on death after retirement has to be payable to a spouse or if he can opt to buy a pension payable to his partner instead
Unless he has bought life insurance through his personal pension,
all that will be paid on his death before retirement if he does not join the scheme is the value of his fund
When he retires he can buy with his personal pension fund a pension for his partner payable when he dies

(vii) If he joins the scheme and then leaves after less than 2 years the scheme only has to give him a return of contributions
This would not be a very good deal
The scheme has to give a preserved benefit if he leaves after 2 years
And can offer a preserved benefit after less than 2 years service
If he transfers in his personal pension fund the scheme has to give him a preserved benefit no matter when he leaves
A preserved benefit means that his accumulated fund remains in the scheme and continues to move in line with investment returns until he dies or retires
On death or retirement the fund will be used in the same way as if he were still in service
He will therefore not lose out if he leaves after 2 years or if the scheme provides a preserved benefit irrespective of service or if he transfers his personal pension fund into the scheme when he joins
He would also be able to transfer the fund representing his preserved benefit to another company scheme or to a personal pension
The lump sum death benefit would stop if he left the scheme

(viii) He should join the company scheme
in order to benefit from employer contributions and death benefits
He will have to stop paying into his personal pension
unless he has earned income from another source which is not pensionable
Subject to affordability he should increase his contributions to 15% of total earnings
He should investigate the charges under the company scheme
And any penalties if he transfers his personal pension fund to the company scheme
And on the basis of these decide if he would benefit from transferring
Once calculations have been done, an expected retirement age can be determined at which an acceptable level of income may be expected.
He should plan his investment strategy so that his investments are in suitable funds by that age
If he wants to get the best pension at retirement he should invest in the Adventurous Fund until about 5 years before retirement age
He should then consider gradually switching over the period to retirement an appropriate amount into the Cautious Fund to cover his tax free cash
He can only change investment choice on 6 April each year so he should switch $1/5^{th}$ of the necessary part of the fund each year

The balance of the fund should be switched in the same way into the Protection Fund
If the retirement age is 65, this could be done by switching into the Lifestyle Fund
But he'll need to check what happens if he switches in with only 5 years to age 65 as this fund normally switches over a 10 year period.
Whatever he decides to do, he should review his pension regularly to check if they are still likely to provide his anticipated pension
He needs to take account of changes in his personal circumstances
changes in legislation
changes in his relationship with his employer
and changes in financial conditions