EXAMINATIONS

10 September 2001 (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. *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.*

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

3. *Write your surname in full, the initials of your other names and your Candidate's Number on the front of the answer booklet.*

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 and this question paper.

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

1 A large UK employer has for many years operated a defined benefit (DB) pension plan (which is not contracted-out) for all staff. The employer has decided to close down this plan and set up a separate defined contribution (DC) pension plan for new recruits and for future service for existing employees, who may also transfer the value of their DB plan past service into the DC plan. If they do not transfer, then past service benefits in the DB plan will be linked to final pensionable salary at their future date of exit or retirement.

The employer and trustees have agreed that the DB plan can be operated as a closed scheme for the foreseeable future, and have approached you as Scheme Actuary for advice on how to operate it.

(i) With reference to the actuarial control cycle, outline how you can advise the trustees on managing the risks in operating the DB plan. [6]

(ii) The DB plan has a practice of granting discretionary pension increases to pensions in payment in respect of benefits accrued before 6 April 1997. Discuss the methods by which the plan's surplus could be measured and the issues the trustees should consider in deciding whether to grant the next annual discretionary increase for pensions in payment. [8]

(iii) Outline the factors the employer should consider in drafting proposals on how to calculate transfer values for active members who wish to transfer their past service benefits into the DC plan. [7]

(iv) Discuss briefly the other issues (not covered in (ii) or (iii)) that the trustees have in operating the DB plan, and the constraints under which they must operate. [6]

(v) The latest actuarial valuation of the DB plan as at 1 July 2000 showed an MFR funding level of 120%. The employer has suggested that this level of funding should mean that there will be no need for any future contributions to the DB plan, and has asked for your confirmation of this. Draft your response. [13]
[4 marks for drafting]
[Total 40]

2 The finance director of Company A has retained you to advise on the pensions aspects of Company A's purchase of Subsidiary B from Company C. You have the following information:

- The current market value of Company A's publicly quoted shares is £1,000m.
- Company A is financed by a significant amount of corporate bonds as well as its own shares. Company A's philosophy is to take risks in only those areas where it has expertise — whenever possible it avoids taking risks outside its areas of expertise.
- The proposed sale price for Subsidiary B is £500m. Company A plans to raise £250m of this by issuing more corporate bonds.

- Company A operates an occupational defined contribution scheme which is not contracted-out of SERPS. The company matches member contributions up to 5% of basic pay.

- Company C's culture is strongly paternalistic and strongly unionised. Company C operates a contracted-out final salary scheme with limited price indexation on pensions which are based on 1/60th of total earnings for each year of service and are payable without reduction on retirement at age 60. Members contribute 5% of total pay and the company pays the balance.

- It is public knowledge that Company C considered introducing a defined contribution scheme a year ago but that it did not proceed because of the strength of feeling of its workforce.

- The total accrued pension (i.e. deferred pension on leaving) of the employees of Subsidiary B who are members of Company C's final salary pension scheme is £25m per annum. The average age (weighted by accrued pension) is 45 years.

(i) Stating your assumptions, estimate the value of the liabilities of Company C's scheme in respect of Subsidiary B members. [8]

(ii) The finance director has no experience of final salary pension schemes. She is particularly concerned to ensure that she fully understands the risks involved in continuing to run a final salary scheme for Subsidiary B employees if the acquisition proceeds. Summarise the advice you would give her. You should cover:

(a) the potential liability to Company A now and in the future

(b) Company A's ability to manage or mitigate any risks, and

(c) factors which may reduce Company A's control over its risks [17]

(iii) List the other information which you would like (from both Company A and Company C) before providing detailed advice on the pensions aspects of the deal. [10]

(iv) Company A has decided to set up a final salary scheme for employees of Subsidiary B who will continue to earn the same benefits for the future as the existing scheme operated by Company C. Describe the ways in which the transfer of assets and liabilities between the schemes might normally be structured. Discuss whether or not these would be in Company A's favour. [15]

(v) Company C’s actuary is initially proposing a bulk transfer value basis which is 80% of the amount which you estimate would be required to secure the benefits with an insurance company if the scheme were to wind up. As justification, the actuary has referred to the expected long term return on equities. The finance director cannot understand how the value of liabilities which are primarily linked to long-dated real and nominal interest rates can depend on expected equity returns. Outline the points you would make to the finance director regarding:

(a) why Company C’s actuary might put forward this basis

(b) whether you consider it reasonable with justifications for your arguments

(c) suggestions as to how Company A could respond [10]

[Total 60]