EXAMINATIONS

September 2002

Subject 404 — UK Fellowship Pensions

Paper Two

EXAMINERS' REPORT

Introduction

The attached subject report has been written by the Principal Examiner with the aim of helping candidates. The examiners are mindful that a number of interpretations may be drawn from the syllabus and Core Reading. The questions and comments are based around Core Reading as the interpretation of the syllabus to which the examiners are working. They have however given credit for any alternative approach or interpretation which they consider to be reasonable.

The report does not attempt to offer a specimen solution for each question — that is, a solution that a well prepared candidate might have produced in the time allowed. For most questions substantially more detail is given than would normally be necessary to obtain a clear pass. There can also be valid alternatives which would gain equal marks.

K Forman
Chairman of the Board of Examiners

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1 (i) Advantages

Reduced administration costs
and professional fees
Central control over administration for whole group
Benefits are harmonised across the group
Which may promote corporate identity
May be able to use surplus in A to fund deficit in B
But would depend upon rules
Larger investment funds give more flexibility
More purchasing power for any insurance contracts
Reduced investment manager charges
Less management time needed across group
Some happier employees because better off
aids mobility of employees
Group can exercise control over its subsidiaries

Disadvantages

Costs in carrying out merger
and communication exercise needed
will be administration costs of harmonisation
and each set of trustees may want independent advice
Employees may be suspicious and not want to change
Businesses may be different therefore final salary not appropriate for some companies
e.g. those with low paid high turnover
More difficult to separate businesses if future sales
Overall likely to lead to higher pension contributions across group
May need to grant benefit improvements to get trustee agreement
and union agreement
Some employees may be worse off and unhappy
Increased employer risk
Maybe issues over employment contracts

(ii) All trustees will need legal advice
And will need to consider scheme rules
Will act in best interests of members
Not generally concerned over future benefit accrual
Must be concerned with past service rights

	Assets	*Liabilities (MFR)*	*Funding Level*
A	400	286	140%
B	700	778	90%
C	25	25	100%
Overall	**1125**	**1089**	**103%**

Scheme A trustees

What is power in rules to receive transfers
Can the trustees say no to merger
Who can amend scheme rules
What benefits must be granted in respect of transfers received
What is happening to current surplus
Can it be ring fenced for existing members
Can they get benefit improvements in return for agreement
How will security be affected
particularly given large pensioner section in scheme B
what will buy out position become
Will discretionary increases be less likely
can these be protected
And what are the consequences of saying no
Need to undertake due diligence on other schemes to determine whether any issues such as maladministration

Scheme B trustees

Who determines bulk transfer
will it be with or without member consent
will actuary be able to give required certificate
How will security for members change
Do winding up priorities change
will there be any ring fencing
Will members get future discretionary increases
Balance of powers
Windup provisions

Scheme C trustees

Basically the same issues as Scheme B trustees
What investment options will there be for members
How will future expenses be dealt with
What options will there be at retirement

(iii) Company A — advantages

May get benefit improvements
Lower costs may ultimately improve security/benefits
No change in benefit structure therefore continuity

Company A — disadvantages

Likely to be a reduction in security
Possible reduction in likelihood of discretionary increases

Company B — advantages

Likely to be improved security
If low variable earnings above basic salary then better benefits payable from scheme
because higher accrual rate
better FPS definition (assuming increasing earnings and low variable earnings)

Better early retirement terms
Increased DIS lump sum
Possible future discretionary increases
Pay lower national insurance

Company B — disadvantages

Higher scheme contributions
and no SERPS
Only basic salary is pensioned
Reduced benefits for those with variable earnings near to retirement
Reduced DIS pension
Lower FPS if earnings fall in final year

Company C — advantages

Get final salary benefit for future service
which is likely to be more valuable
Lower personal contributions if gross>basic
Pay lower national insurance
May be more investment choices

Company C — disadvantages

The scheme benefits from good experience not them
Lose money purchase which they may like
No SERPS benefit in addition
Less flexibility at retirement e.g. spouse's benefits for single people
Likely to be lower DIS pension

Company D — advantages

Same as company C
May be less expenses on money purchase fund

Company D — disadvantages

Same as company C
Only get refund if less than 2 years service
May be penalties on closure of Group PP
Higher personal contributions needed
To transfer require IFA advice which will have to be paid for

Company E — advantages

Now get pension and death in service benefits
Pay lower NI

Company E — disadvantages

Have to pay for benefits
No SERPS in future
May lose other benefits to pay for this
But membership not compulsory

(iv) Tell them existing scheme is closing down
and explain reason for the change
Comment on security in merged scheme
Describe benefits and contributions for future service
Outline options in respect of existing funds
Outline investment choices in respect of existing fund
Explain any differences in expenses
If consent needed to transfer include option form
If no consent explain why
Explain current benefit basis
depends upon investment returns
and annuity terms
Future benefits based on formula
linked to final salary
Explain changes in contracting out position and national insurance
State where they go for further information
what action is needed
Timetable
If consent not given explain consequences

(i) Fairly straightforward question and the good candidates demonstrated a breadth of thinking.

(ii) Some candidates did not appreciate that it was not a sale and purchase situation, where there is a negotiated transfer amount, interim period, etc.

Many candidates did not think about practical solutions for dealing with the deficit in scheme B, and how members' benefits in scheme A could be protected. Many candidates failed to demonstrate that they were aware of what the combined schemes funding level was, nor that the Trustee should seek legal advice and act in members' best interests.

A number of candidates mentioned that a GN16 could not be signed because future benefits would be different. This is not a GN16 problem as this deals with the transfer of past service rights.

(iii) Candidates who worked methodically through this question scored well. Some candidates confused 'company' with 'employees', even though part (i) dealt with the company issues.

(iv) Despite the fact, for company C, it was about a conversion from DC to DB for future service, few candidates explained the difference between DB and DC.

2 (i) In general the reason is to help in decision making.

- by sponsors and Trustees in relation to benefit provision.
- by sponsors and Trustees or managers, in relation to funding and investment.
- by beneficiaries, in relation to adequacy/security of benefits.
- by shareholders, in relation to sponsors profitability.
- by regulators
- by all parties involved in a transfer of liabilities from a scheme.
- In the UK, valuations must be performed to comply with legal requirements
- Disclosure regulations require Trustees to obtain an actuarial valuation at least triennially
- As scheme must define this requirement in its Trust Deed to obtain IR approval although the Trustees may seek reviews more often
- and will wish to consider discontinuance position (part of GN9 requirement)
- IR Surplus Regulations require a triennial valuation on a prescribed basis to check for overfunding
- An MFR valuation is required triennially on a prescribed basis.
- A certificate T for contracted-out scheme must be provided periodically which will require a valuation
- FRS17 and SSAP24 (or FAS87 for US traded companies) require valuations to be performed when producing company accounts

Any of:

- Debt on employer
- Bulk transfers
- Individual transfers
- Executives disclosure

(ii) Report should be in simple layman's terms, covering the following points:

- There are five main methods

- which fall into 2 categories

- discounted cash flow
- market value based

the trend is towards a market value (or smoothed market value approach)

- reasonable explanation of "smoothed"

- this is for two main reasons:

- market values more easily understood by lay-people

- market value is more in accordance with standard company accounting principles

- Tax change

- More objective

The five methods are

(1) Traditional discounted cash flow method

- assets valued using discounted dividend model (DDM)
- reasonable explanation of ddm
- liabilities valued using a long term rate of interest

(2) Market Value Adjustment (MVA) method

- assets at market value

- liabilities valued at long term rate of interest, multiplied by MVA

- MVA is ratio of market value to value using discounted dividend model
- basis of MFR
- so a variation of method (1)

(3) Asset-Based Discount Rate Method

- assets at market value
- market based discount rate assessed for each asset class (e.g.) equities, Bonds etc.)
- liabilities then valued at a weighted average of these discount rates
- weighted either by actual or notional asset misc.

(4) Economic value method using bond yields

- assets taken at market value
- inflation, discount rates etc. derived from market information
- example is inflation set as difference between fixed interest and index linked gilt yields (or any other example)
- the method is amenable to many layers of sophistication
- e.g. interest rates variable by term to payment of benefit (or any other example)

(5) Bond yield plus risk premium method

- a variation of (4)
- starts with bond yield as base, but adjusts to take account of risk/return expectations on other asset classes
- needs reasonable explanation of risk/return concept

  For example:

  - Size of scheme
  - Current level of funding
  - Degree of Complexity sought
  - Reason for valuation

  - Current methods in use
  - Market Trends
  - Other valid reasons

- Given market trends, and need for some valuations required which are based on market value, I would recommend we move now to method 5

(OR any other conclusion well argued was given appropriate credit)

(iii) The scheme is now under funded

- It is below 90% on the MFR basis
- So rules kick-in to attain funded status
- And a new schedule of contributions may be required
- depending upon when last one was prepared
- taking scheme to 90% funded by 6 April 2003
- and 100% funded within by 6 April 2007

because of transitional period

- mention 8 week and 12 week deadline

The dramatic change is due to mismatch of assets to liabilities

- On the MFR basis
- Liabilities are shorter term than a typical scheme
- And Cash
- Implying zero coupon index linked investment
- But most of assets are in equities
- Which the MFR basis assumes for long term liabilities
- The Trustees may wish to reconsider their strategy
- Funding and investment policy should not be solely determined by
- the MFR
- the MFR is due to be abolished
- consideration should be given to any replacement for MFR
- a non-matched position may well be an attractive one
- if sponsor is keen to take the risk with the hope of better returns
- and if the sponsor understand this position and is willing to guarantee support for the scheme

Decision will depend upon a number of factors:

e.g.
- Sponsors willingness to make additional funds available
- The seriousness of the position will depend upon the size of the employer and their cash flow
- View on long term effect of market sentiment
- is the equity fall short term or temporary
- will equity markets fall further
- if go to a more matched position now, the effectively losses are crystallised
- and sponsor locked into increases contributions
- what will be the view of beneficiaries
- what do the Trustees consider is their Fiduciary duty?
- and what does statement of investment principles say
- Overall if market is still seen as fragile a move to matching may be appropriate
- If not, may decide to maintain strategy
- And may depend on the availability of appropriate matching assets
- The position is fairly extreme so a partial move to a matched position may be appropriate
- It may be possible to move to an insured arrangement
- Although this is a massive move away from current strategy
- And potentially more expensive because of profit allowance and capital requirements
- MFR is artificial so may be more appropriate to focus on
- Ongoing and/or buyout

(i) Generally well answered though few candidates mentioned that the purpose of a valuation was to aid in "decision making", or the parties that are interested in the valuation results.

(ii) This question was largely bookwork and candidates scored well. The examiners were looking for a report written in everyday English and a reasoned conclusion at the end.

(iii) Given the dramatic fall in equity markets, which is a real situation for schemes at the moment, this question was poorly answered.

Although candidates picked up on the fact that the MFR position had worsened, and this has implications for the Schedule of Contributions, very few followed up on this by mentioning that

- *MFR is generally not an appropriate way to fund the scheme and the ongoing basis should be considered*
- *The timing of the change, and crystallising the deficit*
- *The company/trustee attitude to risk*
- *market sentiment*
- *what the company can afford*