Faculty of Actuaries **Institute of Actuaries**

EXAMINATIONS

April 1999

Subject 404 — UK Fellowship Pensions

Paper Two

EXAMINERS' REPORT

***Comment on Question One**: The paper produced a good spread of marks and there was little evidence, particularly amongst the better candidates, of time pressure. The main failing continues to be that standard solutions are reproduced at length which are not related to the specifics of the question. A number of candidates also miss many of the marks available by stating there is a right answer to a question without demonstrating the logic behind a recommendation or outlining why alternatives may or may not be appropriate.*

Comment on the individual parts of the question follow the solution in italics.

1 *A number of points could be made with equal validity in the separate parts of the question and this was taken into account by the Examiners.*

(i) The trustees will wish to maximise returns subject to an acceptable level of risk.
But should consider the attitude of the employer to risk / the need for additional contributions (the trustees should consult the employer).
They should also take account of any restrictions imposed by the Trust Deed.

The trustees will need to consider the liability profile of the scheme i.e. the nature and term.
A large proportion of the scheme's liabilities are pensioners and deferred pensioners with fixed liabilities.

The scheme size is £50 million and either is segregated or unitized business.

Any reasonable justification e.g property exposure.

The trustees need to consider the current funding position.
The scheme is healthy on the MFR basis
therefore more flexibility to invest for higher returns without worrying about solvency position. [This is amplified in part (iii)].
If the expected lifespan of the scheme was short the trustees are likely to be more concerned with matching liabilities.

The trustees should consider the financial health of the sponsoring employers in this regard.

The trustees will consider a variety of measures of solvency including MFR.

If the scheme has to meet its obligations on discontinuance it may need to consider (at least in theory) purchasing annuities from an insurer.

These are expensive and the surplus is likely to be much reduced.

The trustees need to consider cash flow considerations.

As a mature scheme there may be liquidity issues as pension payments may exceed contributions.

The trustees will require an appropriate level of diversification.

Historically equities and property have been highest returning asset class they are real asset i.e. they provide protection against unanticipated inflation.
and provide a reasonable match for real liabilities such as active salary linked liabilities.
Overseas equities will add diversification.

Fixed interest and index linked stocks have had lower returns historically over the longer term.
but provide a reasonable match for known liabilities
such as pensions in payment and deferred pensions.

Consider self-investment which should not exceed 5%.

Cash will assist short term liquidity and investment strategy considerations.

Part (i) was primarily book work which was answered reasonably well.

(ii) The model projects forward the financial progress of the scheme for a given investment policy.

The trustees can look at the possible impact on the financial strength of the scheme under differing investment strategies.

In particular the trustees will be interested in the discontinuance position
as they will not want to adopt a strategy which will lead to the scheme being unable to meet its accrued liabilities.

In addition the trustees will get an indication of the ongoing funding levels and the contributions which they will need to obtain from the company.

An optimisation process can be adopted which will derive the "best" investment strategy
for a given level of risk.

For the trustees this could mean ensuring the discontinuance funding position (however defined) does not fall below a prescribed level.

The trustees should consider the appropriate measure risk, e.g. the probability of the measured item falling below a certain level is x%.

The model can also produce information for the trustees on cash flow requirements so they can manage the investments more appropriately.

Limitations

Model uses historical data, which may not be valid, to derive future returns.

Results may be sensitive to small changes in assumptions
The model will include some simplifications
The results may only be valid for a limited time horizon
Results will provide an insight rather than a true optimisation tool
Level of risk depends on attitude of employer/trustees
There will need to be a compromise between the trustees and company

May be difficult for trustees to understand.
The model may not adequately model practical aspects e.g. difficulty in selling a large property

This was primarily book work which was answered reasonably well.

(iii) With a 100% MFR funding level the trustees will need to follow an investment strategy which ensures the funding position does not worsen.

The trustees have responsibility to comply with MFR
and must state how they will do this in their Statement of Investment Principles.

Within asset classes the trustees should consider whether the investment should be on an active or passive basis.

If active management need to consider the appropriate outperformance group and commensurate risk the manager needs to take.

And for monitoring the assests the appropriate constraints.

The lower funding level will reduce flexibility
and potentially increase long term costs.
The trustees could approach the company for a short term cash injection to increase funding level and retain flexibility.

If no cash injection then the trustees will need a more matched position depending upon their view of the long term viability of the scheme this matching will be carried out on an ongoing basis, probably linked to MFR or linked to wind up liabilities.

The liabilities for pensioners under the MFR are linked to medium term UK gilts and index linked stocks

the cost of annuities are also determined by insurance companies based on similar stocks.

The trustees are likely to move those assets covering the pensioner liabilities to UK gilts and index linked stocks i.e. 50% of the fund.

The liabilities for active members are still linked to final salary provided the scheme is likely to continue these liabilities remain linked to real assets such as equities and property.
MFR liabilities are linked directly with UK equities for members more than 10 years from retirement
moving towards gilts as members get closer to retirement

If the trustees believe the scheme is likely to wind up they might put more assets in fixed interest holdings to match the cost of buying out deferred annuities.

Part (iii) was not well answered. Solutions were typically short including a few general comments on matching. They did not relate the issues to the specifics of the question or discuss the conflicting considerations the trustees need to address.

(iv) Option A - Advantages

Fixes liability for future new members
whilst retaining existing pension promise for current employees

Depending on staff turnover may move quite quickly to money purchase commitment for majority of staff.

Option A - Disadvantages

Employees doing same job have different pension arrangements.
Still have salary/investment risk for current members.
No possibility of using surplus in scheme to fund money purchase benefits.
Contribution rate in final salary scheme will increase because no new entrants.
Expenses of running two arrangements.
No guarantee that money purchase will not be subject to government interference (e.g. minimum contributions)
Money purchase may store up problems for future (e.g. if contributions inadequate, or poorly communicated)
What to do with existing members who want to switch to money purchase

Option B - Advantages

Only one pension arrangement
therefore lower expenses.
Subject to Rules
May release surplus reserved for salary increases
may be able to use surplus to fund MP benefits.
Removes salary risk for active members.

Option B - Disadvantages

Still investment risk. Could be a debt sometime in the future.
Without the cushion of active members likely to have to move to bonds sooner which will increase the long term cost of the scheme.
Existing members will not like losing their final salary scheme.
And may have a claim under employment law for constructive dismissal

Some form of compensation for loss of salary is likely
Which could be expensive in short term
Difficult to explain to members who are receiving two different types of benefit from the same scheme.

Option C - Advantages

Removes future risks of adverse experience (other than government interference etc.) .
No possibility of a debt in the future from GPP.

May crystallise short-term wind up debt

Company is able to fix long term costs.
No need for trustees
no compliance with the pensions act currently needed
easier to deal with leavers.

Option C - Disadvantages

Staff might not be happy with change.
Difficult to fund early and ill health retirements and redundancies.
Incur costs and spend time winding up existing arrangement.
Leaving service benefits must vest immediately (i.e. not after 2 years). This may incur costs.
Will have to pay contributions to a GPP (cannot allocate surplus).
GPPs are regulated - there are implications on what the company can tell members.
GPPs may be superseded if current government proposals encourage alternative provision.
GPPs can be more expensive than occupational DC schemes.
IR limits are different - may be advantage or disadvantage.
May not actually be able to wind up if trustees retain control.

There was a general lack of breadth of comments, and many candidates demonstrated a lack of understanding by being too dogmatic (e.g. money purchase saves money). There are also a number of standard lists produced and a lack of understanding of the practical aspects.

(v) Under Option A there is no immediate change in the membership profile or scheme liabilities which remain, for active members, linked to final salary.

A change of this type signals a change in the company's long term commitment to a final salary arrangement and the trustees will become more concerned with the discontinuance liabilities
and although there is likely to be no immediate change in investment policy the trustees will need to consider a gradual move to fixed interest and index linked stocks as the active members liabilities reduce.

The timing of such a move will be influenced by the level of surplus.

Under Option B the trustees need to consider whether they should immediately move all, or a proportion of the assets, into a class which more closely matches the liabilities to buy out annuities for pensioners

and purchase deferred annuities or pay transfer values for other members.
They will also need to consider who might benefit (i.e. the members or the company) from the trustees taking a risk with a non matched investment policy.

The existence of surplus may permit a non-matched policy but on a buy out basis surplus will be much reduced.

The company's intentions on how long the scheme will be run on this basis will be relevant

Under Option C if the scheme is to be wound up the expected investment term is significantly reduced

and the trustees will need to consider whether to move all the assets to asset classes which match the wind up liabilities e.g. deferred and immediate annuities
this may lead to a wholesale switch to fixed interest and index linked stocks.

Good candidates scored well in Part (v). There was, however, a tendency to jump straight to the answer and not to demonstrate a depth of understanding.

(vi) Trustees will first need to consider trust deed and rules.

And the level of surplus in the scheme.

Trustees should consider who has power to wind up or run as a closed scheme

For Option A they will need to look at the current eligibility conditions

and whether these conditions need to be changed.

For Option B they will need to consider who has power of amendment and under what circumstances this power can be exercised.

Under Option B they will need the company to set out the details of the new money purchase contribution structure
and any changes to the death in service benefits.
The trustees may need to review any insurance arrangements for death benefits.

If the trustees need to give their consent to any amendment they need to consider whether they can obtain an improvement in benefits for the existing members.

Under the Pensions Act they can not change benefits unless the actuary gives section 67 certificate
that no members accrued rights or expectations for discretionary benefits have been reduced
or obtain individual member consent.

Need to consider if surplus (if any) can be used to finance a contribution holiday.

If Option A is chosen they will need to review the future contribution rate required from the company for a closed group of employees.

The trustees will need to decide whether any changes are needed to how the scheme is administered
and whether under Option B a new administrator is needed for the money purchase benefits.

Under Option C the trustees need to consider who has the power to wind up the scheme
and in what circumstances.
They may need to consider whether they have the power to continue the scheme as a closed scheme and whether they should exercise this power.

If pensions are to be paid from the scheme under B the trustees (in conjunction with the company) need to consider the terms.

If the scheme is to be wound up they need to discharge the liabilities in accordance with the prescribed order of priorities and then in accordance with the scheme rules.
They will then need to consider whether there is a debt on the employer

or if there is a surplus how this is shared amongst the members and/or whether it can be returned to the company.

The trustees will need to consider how any changes are communicated to the member
and how they will if necessary help the members informed of any progress.

Part (vi) was generally well answered.

***Comment on Question 2**: This was a difficult question which required candidates to apply basic principles to a non-standard (but not unusual) situation. The better candidates produced well constructed drafts though it was surprising that a sizeable minority made little or no attempt to draft despite the significant number of marks available.*

2 *The report should be written in clear non-technical language appropriate for the Finance Director.*

(i) *Interested party:* seller

Seller's interests:

- Satisfactory overall deal.
- Pay no more money than required to secure transferring employees' promised benefits.
- Seller in no worse position after as before.
- Ensure that transferring employees are treated "fairly" (because of effect on remaining employees).
- Ensure remaining employees are not disadvantaged.

Interested party: buyer

Buyer's interests:

- Satisfactory overall deal.
- Maximise transfer value.
- Not incur additional costs for prior service of employees transferred.
- To what extent will they be committed to continuing discretionary benefits out.
- Ensure transferred employees (who are not made redundant) will be satisfied with the terms on offer.

- Ensure its existing employees not unhappy with terms for transferring employees.
- Avoid additional complexities introduced into its scheme.
- Ensure that the payment of the transfer value can be finalised after the purchase.

Interested party: trustees of seller's scheme

Their interests:

- Ensure terms of their trust deed are complied with.
- Which may mean not paying what the employer agrees in the sale agreement.
- Have regard to interests of all their members (i.e. both those transferring and those remaining) in relation to benefit levels and security.
- Ensure that monies transferred for future discretionary benefits are used for that purpose (and not a contribution holiday)

Interested party: trustees of buyer's scheme

Their interests:

- Ensure terms of their trust deed are complied with.
- Satisfied that the benefits being offered in exchange for the transfer value are reasonable and do not diminish the security of the existing members.

Interested party: transferring members

Their interests:

- Usually expect equivalent accrued benefits ...
- unless closure of the business is the alternative.
- Expectations will be that future salary increases will be reflected in past service benefits.
- Likely to expect same future service benefits.

Interested party: remaining members of the seller's scheme

Their interests:

- Not want security of their past or future benefits prejudiced.

Interested party: existing members of buyer's scheme

Their interests:

- Not want security of their past or future benefits prejudiced.

Interested party: Pension Schemes Office

Their interests:

- Agreement required for continued participation of buyers' employees in the seller's scheme after the sale.

- Agreement required for payment of any bulk transfer:

  – need to be satisfied that buyer's scheme is properly constituted

  – surplus regulations have been complied with
  – benefits to be granted do not exceed approvable limits

Interested party: Contributions Agency

Their interests:

- Consent required for transfer of GMPs.

Most candidates knew the list of parties involved and had a good grasp of their responsibilities.

(ii) Structure of the deal:

Details are usually set out:

- in a separate pensions section of the sale and purchase agreement, and

- an actuary's letter from the seller's actuary to the buyer's actuary

These will specify:

- obligations of seller:

  – to supply relevant information

  – to use best endeavours to ensure trustees pay agreed transfer amount

- to make good any shortfall
- to allow transferring employees to remain in the scheme temporarily
- to seek approval from the PSO and CA
- usually, to pay a past service reserve (rather than share of surplus etc.
- warrantee given/received by buyer/seller

- obligations of buyer:
  - to provide adequate past service benefits for transferring employees
  - to contribute to the seller's scheme for an agreed period
  - to make necessary announcements to members
  - calculation of the transfer amount and timing of the payment
  - who does the calculations and who agrees them
  - what happens in the event of a dispute
  - whether transfer payment is cash or in specie

Usually

- the terms of the transfer are agreed before the purchase
- the transfer of assets takes place afterwards
- the transfer is done with member consent (because otherwise restrictive legislation applies)
- the subsidiary purchased by the buyer continues to participate in the seller's scheme for a limited period of time to allow for all the administrative practicalities to be dealt with

Points of interest to the buyer:

- The transfer value can be calculated at the beginning (in which case buyer contributions for transferring members are added to the amount transferred) or at the end of the participation period:
  - if calculated at beginning and transfers are made for all employees then high withdrawals favour the buyer otherwise they favour the

seller

- In practice many leavers will not give their consent in this situation and the deferred pension stays with the seller.

- if calculated at the end then and there is a long participation period then the buyer's contribution rate while participating in the sellers scheme is important — the lower the better for the buyer

- if calculated at the end there may be possibilities for giving any pay rise in time to increase the transfer value (although this is usually prevented by the terms of the sale and purchase agreement)

- If there are favourable redundancy terms available within the seller's scheme then these may be taken advantage of during the participation period (although again sellers usually try to prevent this).

- The terms of calculation of the transfer value will have a direct impact on the immediate funding position of the buyer's scheme — the more favourable the better.

- Special care needs to be taken to ensure that:

  - the transfer value is increased by reference to the "right" measure of investment return over the period before it comes into payment

  - there is a feasible mechanism for resolving any disputes

  - note that markets based/market consistents approaches may be advocated by buyers' actuaries in which case the value of pension scheme liabilities may be deemed to be significantly different from that given by the traditional approach.

The better candidates approached part (ii) by listing the principal pensions' aspects together with a short commentary on each point.

(iii) (a) The FD has to make decisions regarding

- whether to offer the same standard terms to everyone or play each disposal by ear. In practice ...

  ... there is much which will be common to all deals and which can be standardised in advance (see (c))

- how much pension assets to transfer (i.e. how strong or weak a basis to offer) in particular whether transferring additional "surplus" is in the interests of the company because, for instance:

  – some surplus may not be realisable because the scheme is so well-funded

  – the conglomerate may not have the power to avoid having to give discretionary increases in the future (although a buyer might)

- whether the transfer value should be calculated at the beginning or end of the period (depending on which works to the conglomerate's advantage)

- how long a participation period should be offered (some buyer's may prefer a reasonably long period)

- whether the treatment of the smaller disposals should be different from the larger disposals (i.e. provide standard terms and refuse to negotiate)

(b) Any buyer will have access to the conglomerate's SSAP 24 disclosures and is likely to use this as a minimum basis. The FD needs to determine his tactics, e.g.:

– offer a realistic basis first with every intention of appearing to move to a more generous basis if the buyer really presses for one

– whether he can obtain a better overall price for giving away more "surplus"

– this requires that he works out the value of £1 of surplus (allowing for tax, likelihood of recovery etc.)

– whether his aim is to make the disposals quickly in which case he may want to offer generous terms on the pension transfer to start with

– how much additional information to disclose

– how much to leave to the actuary

(c) Put own house in order (e.g. legal documentation, booklets etc.).

Check what TD&R requires to be paid and what circumstances (e.g. require share of surplus)

Review disclosures under SSAP 24 (and any other publicly available accounts) to check what information a buyer can access as of right

Review the scheme's valuation basis with the trustees (if possible) ...

... because sometimes buyers are happy to accept the valuation basis in a negotiation

Draw up a carefully thought out standard set of terms (i.e. pensions schedules and actuary's letters) because:

– saves cost of doing separate ones each time

– will help speed up disposal process

– the seller can incorporate any special "catches" if it takes the initiative in drafting

Obtain the agreement of the trustees to proposed terms if required and (providing confidentiality permits this) ...

... to avoid having to get agreement on each deal after the deal is done, and ...

... to enable the conglomerate to negotiate in a position of knowledge.

Trustee agreement is likely to be required for:

– strength of transfer basis

– the minimum obligations to be imposed on the receiving scheme (e.g. identical or equivalent past service benefits, sometimes same future service benefits as well, treatment of any surplus transferred)

Note that the trustees are likely to want up-to-date on-going valuation and MFR information if their agreement is required to transfers from the scheme.

Calculate the effect of not including some pension scheme surplus in the transfer terms to be offered on the statutory surplus basis ...

... because the residual company may end up with an excessive surplus it can't take advantage of/is forced to make benefit improvements with.

Determine leeway for actuary to negotiate without reference to the FD ....

... to allow the FD more time to concentrate on unexpected issues and to speed the process up

To save time and cost, prepare the necessary data for buyers:

– documentation is likely to be the same for each disposal therefore prepare this once including copies of current and historic legal documentation, relevant previous company and trustee announcements, member booklets and any employee contracts containing pension promises.

– prepare standard extract programs to supply data to buyer's actuaries to save having to rewrite them each time

Consider communications aspects:

– remaining employees may need reassurance on pensions

– employees in businesses to be sold may need special communications to reassure them during a period of uncertainly

– be prepared to give employees transferring information about their accrued rights being transferred.

– (this is a legal requirement disclosure regulations to take place at least one month before the transfer if the transfer is without consent although this is unusual).

Liability profile:

– Need to be aware that disposing of activities will potentially, significantly change the scheme (making it more mature)

– This will impact on investment policy (because trustees will feel less inclined to invest in risky assets)

– Will this affect the "costs" of the scheme – e.g. expected returns will be lower and thereafter the conglomerate must be careful if it allowed for expected return based on the current matching investments.

Check likely impact on the conglomerate's published accounts. Could do some simple modelling/projections to understand this.

Consider impact on member-nominated trustee opt-out (because the trustees will have an opportunity to review the opt-out). It may be possible to agree with the trustees how to proceed with reorganising the opt out in advance.

Part (iii) was a good differentiator of the better candidates who tailored their responses to the specific points in the question. Many candidates' solutions missed a large number of marks by treating the issue as a one-off sale. This was particularly evident in the comments under Part (c) where only the best candidates recognised the preparatory actions and decisions necessary to ensure a series of transactions can go through smoothly and not just a single transaction.