EXAMINATIONS

April 2003

Subject 404 — UK Fellowship Pensions

Paper One

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.

Mrs J Curtis
Chairman of the Board of Examiners

17 June 2003

1

- Operate within the principles of trust law
- and within the trust deed & rules
- and within current legislation.
- Act prudently, in good faith
- Maintain confidentiality
- Act in best interests of beneficiaries, not for own profit
- Strike a fair balance between interests of different beneficiaries
- Obtain advice from and delegate duties to appropriate specialists
- Prepare SIP and act within it
- Custodianship of assets (often delegated)
- Maintain membership records and accounts
- Ensure benefits are paid correctly
- Provide information under disclosure regs
- Use discretion to distribute lump sum death benefits
- Determine whether to grant additional benefits, or entitlement to benefits
- Meet regularly and maintain records
- Report to Opra?

This question as well answered as the material is covered in the core reading, and is fundamental to UK pensions. It is very clear that some candidates are sitting the exam without being fully prepared.

2 (i) The trustees are required to prepare & maintain a written statement setting out the principles governing decisions about investment for an occupational pension scheme
having regard to advice from a suitably qualified person
and to consult with the sponsoring employer
The Statement of Investment Principles (SIP) is a legislative requirement under the 1995 Pensions Act

The SIP will consider:

The liability structure of the scheme
any likely changes in the short & medium term
and the scheme's funding position

The SIP will detail:

The minimum and maximum holdings permitted in different asset classes
The stance on socially responsible investments
The trustees policy for securing compliance with the MFR
this may be simply to monitor the position and ensure the employer makes good any deficits
together with a policy pursuing a diversified and suitable investment strategy
The kinds of investments to be held

The balance between different kinds of investment
The risks relating to the current investment policy and the expected returns
The realisation of assets
and any other prescribed matters
The trustees must review the SIP regularly
In particular following any major changes affecting the scheme (e.g. merger of schemes, benefits changes etc.)
Considering any changes in the liability structure of the scheme
Any changes in the funding position
The investment managers past performance

(ii) The value of the scheme's assets will have fallen but the actual liabilities will have not
There is an immediate need to measure what the current and possible future market conditions means for:

The "on-going" funding solvency level
MFR
Future funding requirements
Accounting expense

The employer may take the following types of actions in the short term:
Do nothing and hope for a subsequent recovering in asset values
with short term fluctuations not a matter of concern for the company
Increase contributions into the Pension Scheme
Indeed the MFR may force this
Discuss the possible changes to the way the pension assets are invested with the trustees
Review the possible changes to future pension benefits
or review the overall pension arrangements (e.g. close the scheme)
and assess the investment and corporate risks

<u>Accounting Valuations</u>

FRS 17

Asset Values on market value of assets whereas the liabilities are based on corporate bond yields
Hence the solvency position will have deteriorated
Surplus or deficit will be disclosed in company accounts
The employer will need to explain / reassure shareholders
Possible changes to the company's external credit rating

SSAP24

There is much greater flexibility regarding the method of valuing assets and liabilities
A discounted income method would normally be used to value the assets

Hence to achieve consistency with the liability valuation a stable long term interest rate would be used
As a result a fall in the value of UK assets is unlikely to be very significant in the short term

(i) Although candidates know the main contents of the SIP, most candidates did not demonstrate that they knew why a SIP is required and its main purpose. Some candidates got sidetracked with the recommendations of the Myners code.

(ii) Reasonably well answered.. Candidates did not fully appreciate the potential affects on the UK accounts, nor all of the actions that the Company could take to mitigate the shortfall.

3 (i)

- Strategy may depend on whether the sponsoring employer is still committed to meeting any deficits that may arise in future.
- If not, then the trustees only have the existing assets in order to meet future benefit payments
- and the expenses of operating the scheme.
- the amount and timing of future payments cannot be known precisely
- Particular sources of uncertainty will relate to factors such as:
  - how long members live and whether they are succeeded by dependent beneficiaries and how long they live,
  - the rate of price inflation and so the rate of pension increases and the level of expenses
  - the extent to which members take up options such as early retirement and commutation
- One option is to secure some/all of the benefits with an insurance company
- Alternatively the trustees could operate the scheme as closed and meet future payments as they fall due from scheme assets
- This would be expected to cost less because the insurer would charge a premium for taking on the risks and to cover expenses and profit
- It is possible to make reasonable estimates as to the cashflows in each future period
- it may be possible to make investments which are guaranteed to provide matched cashflows
- guarantees are most likely to be provided by gilts
- and index-linked gilts can provide inflation-proofing
- but it is likely that investments will not be available to give full matching by term
- (for example cashflows beyond 30–40 years)
- so it would be necessary to make some investments which do not fully match, and this introduces risks from reinvestment and/or disinvestment
- also, there will be some risks in moving from the current investment portfolio to whatever new portfolio is decided on.

- It is extremely unlikely that the scheme's assets will be exactly enough to provide the best-match portfolio described by the above process.

- If there is surplus, the trustees could consider spending it on benefit improvements, or keeping it as a reserve in case of adverse experience
- But without keeping it so unnecessarily long that most members have died before it is released
- If there is a deficit, the trustees could consider adopting a more risky investment strategy involving classes such as non-government bonds or equities
  - with the intention of obtaining the level of investment return required to meet the scheme's cashflows
  - although this raises issues of fairness between different members, in particular between those whose benefits fall due for payment earlier and later — there is more risk that the latter will not be paid because of adverse experience in the intervening period.
- In these situations the trustees effectively have to decide whether it is better for members to receive say 90% of their benefits with some certainty, or to have a higher expectation of receiving full benefits with the risk of a greater cut-back.
- Or the trustees can give members this choice by offering them transfer values and then winding-up the scheme.

- The trustees will have to bear in mind any difference in priority classes set out in the rules

- If there is still a sponsoring employer, then the trustees need to consider the likelihood of the employer paying future contributions
- In view of their powers to force payment either under the trust deed or under legislation
- This may enable a more risky investment strategy if the trustees believe that the employer will be able to meet any deficits arising from adverse experience
- But they should also consider the circumstances in which the employer will be able to pay
- For instance if the employer will be unable to pay contributions at precisely those times when an equity strategy underperforms

(ii)

- An ALM uses a stochastic model for the economic elements of the cashflow analysis, i.e. price inflation and investment returns
- The results will provide an estimate of the probability of future events, such as
- the probability that all benefits will be paid,
- or that the funding level at any time will be high enough to meet an insurance buyout premium
- results will show mean and variance of the distributions modelled
- This will be particularly useful for setting investment strategy in the situation where there are insufficient assets to pursue either a gilt-matching strategy or to buy out the benefits.
- To compare the risk/reward pattern of different investment strategies.

- Results will be sensitive to the assumptions underlying the model
- And may simply reinforce "common sense", particularly for a simple situation such as this.
- Tendency to ignore the tail of distributions (i.e. the "worst" 10%)

(i) Not all candidates realised that just because the scheme was closing that the company would not continue to support the scheme nor pay in future contributions. Hence, liquidity of the assets is not necessarily a major concern. The stronger candidates pointed out that the Trustees need to decide how much risk they are willing to take, taking into account the funding levels and the company's covenant. The weaker candidates used the 'scatter gun' approach to answering this question, in particular with regards to the characteristics of the investments.

(ii) Generally poorly answered, which reflected that candidates talked about ALM's in general rather than their use in the particular situation in the question.

4 (i)

- 35% represents average cost, not value to you
- and may be calculated on conservative assumptions
- likely that typical exec is older than you — DB is typically worth more for older members
- Probably you won't stay until age 65, so you are interested in the value of the benefit you will earn in the short term
- you can't even accrue 45ths if you stay until 65
- you will be subject to earnings cap (other execs may not)

- final salary benefit will be worth more if you get big salary rises
- but your personal utility function is such that you are more concerned about protection in the event that your career is not financially successful than about additional rewards if it is.

- Plan was in deficit at 1.1.02, and the position is probably worse now
- There is no legal requirement on the company to fund properly (MFR is not adequate)
- Will the company still be in existence in 32 years?
- Will the company keep the scheme open until then?
- Given the nature of its business, the company probably has few real assets to meet any deficit if company closes the scheme
- And because it is a long-established company, there will be lots of pensioners who would take higher priority over the scheme's assets

- Part of your job may be advising the company on how to minimise its pension obligations — want to avoid conflict of interest.

- Maybe you don't want such a high pension, preferring non-pension investments

- Or your immediate priority is cash and you intend to build up pension later in your career
- (for example to pay off your mortgage, pay school fees, etc.)
- may not be married and so some aspects are of not much value

(ii)

- Cash — simply add a 35% loading onto your salary
- Flexible, so you can invest as you choose and draw income when you wish

- An occupational DC scheme
- Retains tax efficiency of DB whilst ensuring you don't cross-subsidise others
- Flexibility

- Approved personal pension /stakeholder plan
- Maybe more tax-efficient because of different IR regime limits

- Unapproved final salary promise
- Gives you more security than the approved plan if the promise is linked directly to company assets

- Funded unapproved scheme
- Maybe more tax efficient than cash

- Shares/options
- Maybe more tax efficient than pension, or

(i) Most candidates scored well, but needed to think slightly wider to score very well.

(ii) Well answered.

5 (i) <u>Why required?</u>

- Where trustees wish to make a bulk transfer in respect of a group of members, without the members' consents, the transfer is governed by legislation.
- These Regulations require the trustees to obtain a certificate from the transferring Scheme Actuary before a transfer without consent can take place.
- GN16: Retirement Benefits Schemes — Bulk Transfers, sets out the practice standard to be followed by the Actuary together with a prescribed form of certificate.

- **In broad terms the purpose of the GN16 certificate is to confirm that the past service benefits of members being transferred without their consent will not be adversely affected by the bulk transfer.**
- However, the Actuary must point out to the Trustees that the GN16 certificate itself does not give the Trustees authority to make the transfer without members' consent.
- The Trustees also have to satisfy themselves that the payment of a bulk transfer is consistent with their responsibilities under trust law, and their duties to the transferring and remaining members.

(ii) Issues covered

In assessing whether or not a GN16 certificate can be given, the Actuary must consider three particular aspects:

- security of benefits
- level of guaranteed benefits; and
- discretionary practices

Security of Benefits

- GN16 requires the Actuary to consider whether or not there is likely to be a significant loss of security for members being transferred
- This requires the Actuary to review the ongoing funding levels of both the transferring and receiving schemes (post merger)
- and their relative winding-up solvency

- **The Actuary must be satisfied that, in the event of a winding up of the receiving scheme "immediately following" the transfer, the benefits of the transferring (without consent) members would not be materially less than those payable in the event of the winding up of the transferring scheme immediately before the transfer.**
- It is generally accepted that the reference to "immediately following" should not be taken literally, i.e. a one-day grandfathering would not be sufficient (assuming that lawyers and trustees could agree to it)!

- On the other hand, it is considered permissible to take account of the statutory order of winding-up priorities introduced by Pensions Act 1995. This overrides all scheme rules in respect of liabilities covered by the Minimum Funding Requirement (MFR), so the effective winding-up priorities for both schemes will currently be identical below the MFR level; any differences will apply only to liabilities above the MFR level.
- Specifically, GN16 requires the Actuary to draw to the attention of the trustees any differences in the winding-up rules of the two schemes.

- GN16 requires the Actuary to take account of the financial strengths of the schemes only to the extent that it affects rights and discretions that may be afforded to transferring members.
- A reduction in the funding level may not necessarily preclude the signing of a GN 16 Certificate, if members' rights and discretionary benefits are unlikely to be affected.
- However, GN16 requires the Actuary to point out to the Trustees that, in signing the GN16 certificate, no account is taken of the financial strengths of the various Principal and Participating Companies.

Level of Guaranteed Benefits

- **GN16 requires the value of the transfer credits to be granted in the receiving scheme to be broadly no less favourable than the value of the members' past service rights in the transferring scheme.**
- Note that the benefits do not have to be identical – but to provide the certificate the Actuary must be satisfied that no member, beneficiary or contingent beneficiaries will be given "materially inferior benefits in the receiving scheme".
- **Note also that a transfer from a defined benefit scheme to a defined contribution scheme, or vice versa, is unlikely ever to satisfy this requirement (i.e. such transfers are unlikely to be permitted without members' consent).**

Discretionary Practices

- **The value of any discretionary benefits or increases to be granted in the receiving scheme should be broadly no less favourable than the value of any discretionary benefits or increases in the transferring scheme.**
- (allowing for any differences in the guaranteed benefits)
- Since this issue concerns discretionary benefits, there may be an element of reasonable subjectivity in this assessment.
- The actuary is required to have "good cause to believe" that the award of discretionary benefits or increases will be broadly no less favourable.
- Where the receiving scheme is a new scheme or a scheme without an established custom of awarding discretionary benefits or increases, the Guidance Note specifically permits account being taken of any declaration of intent made by the sponsor and trustees of the receiving scheme "notified to the Pension Schemes Office as for the purpose of the statutory surplus test",
- provided the extent to which these discretionary benefits or increases in benefits are included in the certificate disclosed to the transferring members.

(iii) <u>Potential difficulties</u>

- Option Factors:
  - Cash commutation and early retirement are likely to be treated differently in the two schemes.
  - **Even where the scheme rules may be the same, practice could differ. For example, the scheme booklet might contain factors and present them as a guaranteed benefit.**
  - Deferred members might have old booklets/announcements or be subject to different procedures.

- Ill-Health:
  - Does the receiving scheme has a materially more restrictive definition of ill-health?

    - Usually only an issue for active members, where transfer *with consent* should be an option.

- Dependants:
    - Different definitions of spouse/partner, or the benefit on remarriage, could cause problems.

- AVCs and other DC benefits:
    - These will probably exist even though the scheme is DB.
    - Can AVCs be transferred with no loss of benefit (e.g. bid/offer spread)?
    - Are there any unusual features of the transferring accounts that will not be replicated in the receiving scheme?
    - If different providers are used, with different investment options, then it may be difficult/impossible to transfer without consent, particularly if the transferring trustees could not unilaterally change the investment options in the transferring scheme.
    - There may be potential for losses when a provider is a mutual company with a chance of windfalls, or if an orphan estate is rumoured to be liberated.

(iv) <u>Information Needed</u>

- Any changes to the transferring scheme of which you have not been informed (deeds, discretionary practice, communications)
- Transferring scheme investment performance and other major experience items since last actuarial valuation
- Trust Deed and Rules for receiving scheme, together with any rule amendments.
- Last Actuarial Valuation report for receiving scheme,
- together with an update from the Scheme Actuary of the receiving scheme to assess its current solvency position.
- History of discretionary practice for receiving scheme, and/or statement of future from Employer and Trustees, as appropriate.
- Any recent literature supplied to transferring members about their benefits.
- Draft of proposed communication to transferring members.
- Draft of the Merger Deed.

The question required a good knowledge of GN16, and candidates mentioned most of the key points though many answers lacked the detail contained in the guidance note. It is clear that not many candidates have thought through some of the practicalities and issues involved in signing a GN16.

6 (i) Rules Based Approach

- Advantages

  Certainty

  - the transfer amount would be on a prescribed / definitive basis
  - Consistency across schemes
  - the transfer amount would be the same from whatever scheme the transfer was paid

  - - possibly enhancing the reputation of Pension Schemes
  - - and allowing the amount of the transfer payment to be used for other purposes e.g. pension & divorce or pension mis-selling compensation
  - Protection for trustees as they cannot be criticised for the choice of calculation basis
  - Protection for the actuary as he/she cannot be criticised for choice of calculation basis

- Disadvantages

  The approach will need to have a body responsible for setting the rules (e.g. government or the actuarial profession)
  The calculation may need independent monitoring to ensure compliance

  There may be contention in setting the rules

  - and a possible theoretical challenge to the overall model
  - together with possible political pressure

  There may be slowness in revising the rules as appropriate
  The method does not allow any professional judgement
  There may be credibility risks if transfer values fail to secure benefits

(ii) <u>Principles Based Approach</u>

- Advantages

  Professional advisers have flexibility to apply actuarial judgement
  - hence can ensure any transfer payments satisfies the basic definition of a cash equivalent transfer value

  Can be responsive to market conditions
  Can ensure the scheme specific matters are taken into account (e.g. life expectancy, any discretionary benefits)
  There should be limited political interference

The actuarial profession can provide practical guidance to scheme actuaries

- Disadvantages

  Potential for significant variation across different schemes
    - even as a result of small differences in interest rate assumptions

  and may not reflect changing market conditions very quickly
  Possible pressure from sponsors to keep transfer payments down and reduce overall costs

  Scope for dissention as to the interpretation of principles (e.g. within the actuarial profession)

  Greater difficulty in monitoring compliance

(iii) <u>Considerations</u>

Transfer values should be calculated having regard to market rates of interest i.e. the market rates of return on equities, gilts or other assets as appropriate although bond based measures may be considered more appropriate by some actuaries and financial economists
Need also to allow for the yields expected to be available on the future reinvestment of investment proceeds
Allowance may be made for the cost of calculating the transfer value
Pension increases promised in the scheme rules must be allowed for
Transfer Values must also include an allowance for any discretionary post retirement increases unless trustees direct otherwise

- in particular the trustees have a duty to act impartially between different classes

Other assumptions (e.g. mortality) may be in line with those used in the funding valuation

- or maybe more realistic "best estimates"
- together with any "scheme specifics" or individual circumstances as appropriate

A reduced transfer value may be paid reflecting the solvency position of the scheme
The transfer value should be equitable in relation to and consistent with any transfer value previously received
The basis adopted for incoming transfers should be consistent with out-going transfers

(iv) Does the transfer value genuinely represent fair value compared to the alternative deferred pension?
If the transfer value is "rules based" the prescribed transfer value basis should give confidence that it represents fair value
Does it reflect prevailing market conditions?
Does it provide full value for money for any previous transfers into the Scheme?
Has it allowed for any discretionary benefits (e.g. pension increases)?
If the transfer value is "principles based" the transfer value should allow for scheme specific matters e.g. discretionary benefits
Has the transfer value been reduced to reflect the current solvency position of the Scheme?
if so it may be better to defer taking the transfer until the solvency position improves
or simply opt for the deferred pension which would not be reduced
Is the Scheme likely to continue to the members retirement date?
this is important as it effects the "value" of the alternative deferred pension
What is the financial strength of the sponsor
If the transfer value is "rules based" the prescribed transfer value basis should give confidence that it represents fair value

(i) and (ii) Despite this being currently being faced by actuaries, candidates did not generally appreciate that MFR is a rules based approach and GN11 is a principles approach.

(iii) Candidates had a reasonable working knowledge of GN11.

(iv) Candidates realised that where the money is being transferred to and the security of the existing scheme were important, but did not give answers relating to the rest of the question, nor many of the issues that GN11 raises.