

INSTITUTE AND FACULTY OF ACTUARIES

EXAMINERS' REPORT

Subject CA3 Communications

Day 2

Introduction

The Examiners' Report is written by the Principal Examiner with the aim of helping candidates, both those who are sitting the examination for the first time and using past papers as a revision aid and also those who have previously failed the subject.

The Examiners are charged by Council with examining the published syllabus. The Examiners have access to the Core Reading, which is designed to interpret the syllabus, and will generally base questions around it but are not required to examine the content of Core Reading specifically or exclusively.

The Examiners' preferred approach to the solution is reproduced in this report; other valid approaches are given appropriate credit.

D C Bowie
Chairman of the Board of Examiners

2013

A possible answer is posted on the website. This is not intended to be a model solution. In practice, a wide number of solutions was acceptable and candidates would have achieved good pass standards without having the same level of detail as the specimen solutions.

Candidates were asked to draft a response to a letter from a Finance Director of ABC company explaining what factors can affect a pension scheme's funding level and why the deficit has arisen in the ABC pension scheme. Candidates were expected to focus on the significant items affecting the funding level, including the effect of the purchase of XYZ and the relative strength of the sale basis compared to the valuation basis. When ABC purchased XYZ, the pension benefits of the XYZ employees involved, were transferred to the ABC pension scheme and would be provided from that scheme going forward. At the time, sufficient funds were transferred to the ABC pension scheme to cover the cost of providing those benefits. The cost of those benefits was determined using a "best estimate" basis which was the same as the sale basis.

The main points that the examiners were looking for and some common problems encountered were as follows:

1. Most candidates had a suitable opening paragraph to the letter. Scripts gained marks for a clear summary of the query, but not where the opening paragraph was lengthy and repetitive or did not refer to the initial query.
2. There was no evidence of candidates running out of time and therefore not completing the answer.
3. Poor scripts were unstructured and simply repeated a lot of the information provided in the question paper. They did not attempt to exclude any information that was not relevant for the Finance Director.
4. Many candidates lost marks for not getting to the point indicating that they did not identify the key objectives of the letter.
5. Majority of candidates confirmed that the valuation results are correct.
6. Poor scripts simply repeated the information provided in the question paper. They did not explain succinctly that the investment outperformance would have increased the surplus but this has been offset by greater than assumed salary increases and the effect of the XYZ transfer.
7. A number of candidates used language and tone that would not be appropriate for a Finance Director. These scripts were dumbed down significantly.
8. Many candidates explained that the change in funding level between two valuations depends both on the assumptions used for each and the scheme experience between the two valuation dates. Better candidates confirmed that the deficit has arisen due to scheme experience only.
9. Candidates gained marks for confirming that the investment outperformance increases the surplus by €21 million.

10. Most candidates explained that higher than assumed salary increases has increased the deficit by €48 million.
11. Whilst majority of the scripts stated that the purchase of XYZ has increased the deficit by €34 million, very few scripts explained that the use of a “best estimate basis” for the transfer instead of a “prudent basis” would increase the deficit.
12. Good candidates explained that the effect of salary experience and the XYZ purchase has more than offset the investment outperformance.
13. Candidates gained marks for stating how an increase in contributions would remove the deficit. Only a few candidates made this point.
14. Better scripts included a summary of the effect of the three key factors (investment performance, salary increases and the XYZ transfer) and related it back to the query.
15. Candidates lost marks because of the use of jargon such as “prudent valuation basis” and “best estimate basis” without explanation, reference to regulatory requirements etc.
16. Poor scripts added too much detail on the less significant items (shown in the reconciliation) that led to a change in the ABC pension scheme’s financial position.
17. A number of scripts suffered from poor spelling, grammar and punctuation.
18. The guideline length was 500 words. Scripts which were below 400 words generally missed out some of the explanation. Scripts which were longer than 600 words often lost marks for including unnecessary repetition or irrelevant detail.

SOLUTION

<Mr William Westfield>
<Company ABC>
<Company address>

Dear Mr Westfield

ABC Pension Scheme (“scheme”) – valuation as at 1 July 2010

Thank you for your letter of 7 August in which you asked me to recalculate our valuation results for the above scheme.

I can assure you that the results are correct and there is a scheme deficit of €46 million as at 1 July 2010. I will explain below why this has arisen, despite the surplus of €1m as at 1 July 2007. I apologise if this was not clarified before.

The funding level

The funding level depends on the assumptions used in the valuation and the scheme's experience. You are correct in saying that the assumptions adopted in the current valuation were the same as those used in the last valuation. Therefore for the ABC scheme the deficit has arisen as a result of actual experience since 1 July 2007. The funding level will change if the scheme's actual experience differs from the assumptions adopted.

Why the deficit arose

There are a number of factors which have contributed to the deficit.

Members' salaries increased by more than assumed in the valuation. Because the scheme's benefits are linked directly to salaries, this will increase the cost of benefits by more than expected. We estimate that this has reduced the funding level by €48 million.

The purchase of XYZ has reduced the funding level by €34 million. The funds transferred into the scheme at the time were expected to be enough to cover the cost of the benefits in respect of transferring members. However, this was calculated using assumptions based on our realistic expectation of the scheme's experience. Under this basis, we would expect there to be an equal chance of the funds either being enough or not enough to cover the cost of benefits. However, when setting the assumptions for a funding valuation, that is, the valuation as at 1 July 2010, we include a margin for prudence to ensure that the funds held are more than we expect will be required to meet the cost of benefits. We would therefore expect the cost of these benefits as calculated on our funding valuation basis to be higher than the money received.

You are correct that the scheme's investments outperformed our valuation assumptions which has increased the surplus by €21 million. However, this has been more than offset by the impact of the salary increases and the purchase of XYZ as covered above. Along with some other less significant variations, this has overall resulted in the funding level changing from a surplus of €1 million to a current deficit of €46 million.

Summary

In summary, therefore, you are correct that the valuation assumptions have not changed which has had no effect on the scheme's funding level. You are also correct that the investment outperformance has served to improve the funding level. However, the effect of salaries increasing at a greater rate than that assumed in the valuation and the need to allow for a prudence margin in respect of the purchase of XYZ have more than offset this. This has given rise to the deficit as at 1 July 2010.

Please let me know if you would like to discuss this further.

Yours sincerely

Susan Actuary

END OF EXAMINERS' REPORT