EXAMINATION

April 2005

Subject SA4 — Pensions and other Benefits Specialist Applications

EXAMINERS' REPORT

Introduction

The attached subject report has been written by the Principal Examiner with the aim of helping candidates. 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.

M Flaherty
Chairman of the Board of Examiners

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1 (i) Advantages

Reduced administration costs
and professional fees
Future pension benefits harmonised
Which may help corporate identity
May use surplus in A to strengthen funding in B
but this depends upon rules
Increased funds may give greater flexibility
More purchasing power for insurance contracts
Reduced investment manager charges
Less company management time
Only one set of trustees
Some employees happier because better off

Disadvantages

Professional costs of the merger
and communication exercise
Each set of trustees will want independent advice

Employees may be suspicious and not want change
Some employees may be worse off and therefore unhappy
Increased complexity of administration
Risk of legal challenge or disputes
If separate divisions more difficult to separate later
Potentially an increase in cost of changes
but offset by reduced NI
Future service benefit structure may not suit Scheme B workforce
May need benefit improvements to get trustees to agree

Standard question which was well answered, although some candidates assumed that Scheme A was better than Scheme B in all areas.

(ii) Both sets of trustees:

Will require independent legal advice
and will need to consider their scheme rules
and any legislative requirements
They will need to act in the interests of all categories of members
and not discriminate between them
Generally not concerned with future benefit accrual
but interested in protecting past service benefits
and the security of those benefits
They will need to consider whether they can say no to the merger
and whether they can get benefit improvements for members

	Funding Level	*Assets*	*Liabilities*
Scheme A	140%	£280 m	£200 m
Scheme B	100%	£100 m	£100 m
Total	127%	£380 m	£300 m

If no arithmetic shown, award ½ mark if comment that merged scheme funding level greater than B funding level, 1 mark if, say, merged scheme funding level broadly 130%.

Trustees A:

What is the power in the rules to receive bulk transfer
Who can amend scheme rules
Who determines benefits in respect of bulk transfer
Are sufficient assets being transferred to support benefits
What will happen to current surplus
Can it be ring fenced for Scheme A members
Will discretionary pension increases still be granted

Their 'bargaining' power *
Impact on priority order (including funding level on wind-up basis)
Future trustee arrangements *
Future administration arrangements
Communication with members *

Trustees B:

Who determines that a bulk transfer will take place
Will the trustees carry it out without member consent
Can the actuary give necessary certification if no consent
Will members get future discretionary increases
What are the differences in powers in the two schemes

A lot of candidates wrote too much about post-merger issues including future service benefits which generally are of less concern to trustees.

(iii) Issues covered in professional guidance GN16
Am I the Scheme Actuary?
Do I have sufficient data?

Actuary must consider three separate aspects

Security of accrued benefits

Level of guaranteed benefits
Discretionary practices
Is there likely to be a significant reduction in security

Review ongoing funding level pre and post merger
And the wind up positions
Immediately before and after merger
Consider how PPF may affect this
Draw trustees attention to any differences in winding up provisions

Guaranteed benefits

Must be broadly no less favourable in receiving scheme
Do not need to be identical

Discretionary practices

Discretionary practices in receiving scheme should be
broadly no less favourable
Need to have "good cause to believe" this is true
Can take account of stated policy on discretionary increases

Should point out to trustees that certificate permits them to transfer
subject to other legal advice and considerations
Ultimately it is their decision

Candidates seemed to struggle with this question and it was not uncommon for them to state that receiving the GN16 means that the transfer would go ahead automatically.

(iv) Expected level of total benefits from the Scheme will change
but in respect of service up to merger there is no change

Funding level improves following merger so more security
Likely to be improvement in proportion of assets on wind up
Since Scheme A much less mature

Will become contracted out
So will no longer accrue S2P in addition to Scheme benefits
But will pay lower National Insurance
If contracted-out through PPP will have to cease contract out

Will pay higher percentage of pensionable salary to scheme
and full PAYE earnings are pensionable not just basic
will be significant if member has a lot of overtime, shift work etc
but offset to a large extent by lower NI

FPS takes a three year average in ten not one in five
Will benefit those whose earnings may fall away near retirement
but less disadvantage for those with little variable earnings and/or
steadily increasing basic salary

Higher accrual rate of 1/60ths not 1/80ths

Less lump sum death benefits in service
So may need additional personal insurance
But spouse's pension based on prospective service
Therefore married likely to be better off under new scheme

Pension increases are minimum under legislation
But a history of discretionary inflation increases
Not likely to be important unless RPI takes off
Given legislation requires RPI up to 5% (becoming 2.5%)

Other benefits, eg NRA, ill-health

AVC arrangements

Will require communication to explain reason for change
and individual benefit implications
May not be happy about being transferred without consent

Can do nothing and will just transfer
or opt out (losing future benefit accrual)
and/or consider possible claims under employment contract

Many candidates failed to mention the 'do nothing' option.

(v) (a) Is an enhanced transfer value available?
Will they be able to get better benefits by transferring
Compared to benefits they would have received from scheme
Possibility of benefit improvements in scheme
and/or discretionary pension increases
due to funding level
although these may be reflected in transfer value basis
Security of benefits important and likelihood of being paid in full
allowing for any legislation

Consider level of investment return needed to get higher benefits
After expenses
Consider level of risk this will require
and whether this is acceptable to the individual
Level of acceptable risk will depend upon personal circumstances
e.g. importance of benefit in overall finances

Consider and compare other benefits such as:

Death before and after retirement benefits
not important to single person
Tax free cash sum available under each approach
Retirement options pre and post transfer (early and ill health)

Will also have emotional views on whether or not to transfer
and may seek professional advice

(b) If transfer-out prior to merge, no change
Otherwise:
Post merger scheme will be less funded overall
and worse coverage for non pensioners
therefore security reduced
but may not matter if strong employer
or some form of ring fencing

less likelihood of benefit improvements
and discretionary pension increases
which may be removed from transfer basis
Alternatively, transfer basis might be more generous if
trustees opt for a more bond based investment strategy

Credit was given where members answered part (b) under (a). Inevitably, this approach meant they had little to write under (b). Only the better candidates compared the expected benefits and the risks involved.

It was disappointing that many candidates misread the question and looked at the position of a member of the wrong scheme.

(vi) Scheme A is currently well funded
With a relatively small pensioner population
Likely to be no cash flow issues for some time
Therefore more flexibility to not match assets and liabilities

May have taken a view to hold more bonds/gilts to reduce volatility
Or more equities because higher expected return
What assets will be transferred from Scheme B?

Following merger funding level reduces
And much more mature scheme
With significant pensioner population

May need more bonds/gilts to specifically match this liability
particularly minimum pension increase
and deal with cash flow issues

Increased funds may allow greater diversification
Perhaps direct property, alternative classes

May review investment managers
Introduce more specialist briefs
and negotiate new fee basis
might want to consider other bases, eg buy-out
and undertake ALM investigation

Generally well answered, although too many candidates seem to use a scatter gun technique to cover investment issues rather than relating them to the particular circumstances.

2 (i) The benefits provided by the scheme may have changed
For all members, a category or individuals
Before carrying out assessment need basic scheme details
Scheme Trust Deed and Rules
Scheme booklet
Any announcements issued to members
Any special deals or augmentations

The investment returns may not have been in line with assumptions
Need accounts over the last three years
Need list of current investments
Statement of Investment Principles
and details of any changes in strategy since the last valuation
including details of any buy outs with an insurance company

Contributions may not have been paid in line with recommendations
So need a copy of Contribution Schedule
and confirmation that contributions paid in line with schedule
Contributions paid may not equal accrual cost

Any significant changes in membership will effect funding position
need details of any bulk transfers (in or out)
and their basis
Also need total membership numbers
and reconciliation of how these have changed since valuation
to assess financial effects of any major changes
Funding levels will change if experience different to assumptions
get total pensionable salary roll
and details of general level of salary increases
plus specific salary increases for any major liabilities (e.g. directors)
Need details of early and ill health retirements if not cost neutral
(eg redundancy exercise)
Total pensioner payroll
and details of any discretionary pension increases
Cash equivalent transfer value basis
and details of any payments/options not in line with basis
Accept inflation different to assumption if well argued
Statistical experience (excluding mortality)
Significant deaths may affect funding

depending upon insurance position
need insurance details and any claims details

Any actuarial advice/reports since last valuation
Including GN11 report
MFR reviews and certification (if appropriate)
and company accounting figures (SSAP24 and FRS17)

Also check that there have been or are no significant disputes
which may increase the Scheme liabilities

Other items which will have changed financial position are:

Changes in general market conditions
leading to a different valuation basis now being used
In particular changes in gilt/bond yields
and mortality improvements
Legislation may have also added more constraints
Expenses deducted from the fund being different to allowance

Formulae were not required. In general, candidates lost marks by not explaining their points in sufficient detail.

(ii) In Final Salary (FS) scheme majority of risks with employer
In defined contribution (DC) generally with member

In FS benefits are generally fixed but costs are unknown
Opposite generally true under DC
although less certainty of employer cost if DC scheme has 'matching' contributions
Cost of FS depends upon experience not assumptions

Low investment returns in FS will increase costs
Higher returns than expected may be used to reduce contributions
Although there may be pressure for benefit improvements
Under DC members benefits directly depend upon investment returns

Higher than expected salary increases will increase costs in FS
Because applied to all of past service benefits
In DC will only increase contributions in current and future years
But expected pension will be of less relative value

Pre-retirement mortality risk can be reduced by insuring lump sum
and/or any dependants pension

FS scheme has risk of members living longer than expected
risk reduced if it buys annuities
In DC generally annuities purchased at retirement and risk transferred
Member options in FS scheme may not be cost neutral

Greater compliance, legislative and administrative risks with FS
May lead to increased costs
Due to political intervention
Minimum funding requirements
Debts on wind up

Risks of fines, legal action, disputes for trustees in FS
Trustees not needed if money purchase arrangement is a personal pension

FS scheme can affect company accounts due to accounting standards
and possible ability to pay dividends
For DC you just show the amounts paid
DC risk of complaints if emerging benefits much lower than anticipated

Generally well answered.

(iii) Could wind up the scheme
Only way to remove all risks
but could have significant immediate cash requirements
due to debt on wind up being based on buy out costs

Could switch to money purchase for future service
For current members and/or new entrants
Need to check employment contracts

Could amend future benefit structure
e.g. accrual rates
member contribution rates
Alternative structures CARE or Cash Balance

Control salary increases for pensionable purposes
Particularly long serving higher paid members

Encourage trustees to switch investments to bonds/gilts
Will give less volatility
Better matched
particularly if cash flow matching policy
But increased funding needed
Could inject cash sum to improve funding
to reduce short-term cash requirements
Review member options
Restrict trustees ability to increase liabilities (future service only)
Outsource administration
and encourage trustees to have more aggressive strategy
to reduce long term cost
Possibly carry out asset liability modelling exercise

Reduce/remove mortality risk by buying annuities
which transfers risk to insurance company
Review insurance policies
and controls/governance procedures

Many candidates concentrated on pricing issues. There was some evidence that candidates had not allowed sufficient time to answer this part of the question.

Overall comments

This was felt to be a straightforward paper, but poor exam technique let some candidates down. In particular, candidates should note that they only get credit for a point once however many ways they find of repeating themselves.

Candidates should note that although knowledge of the core reading is important, this exam is mainly testing application.

There was some evidence of a general lack of planning in that candidates included comments in the earlier part of their solutions that were appropriate to later part of the question. Appropriate credit was given only once for this approach so candidates who repeated the same points for the later part of the question were using up valuable time.

Finally, the examiners are concerned that too many candidates do not structure their solutions in a sensible way. Those who use properly constructed sentences seem to cover each point in sufficient detail. Those who use short bullet points frequently missed the easy marks that were available for expanding on the key points.