JSS 33 (1993) 233-239

SYNOPSES

PENSION ILLUSTRATIONS— A FAIR COMPARISON OR A CONFIDENCE TRICK

BY E. SHORT

(Synopsis of a paper presented to the Society on 18 October 1988)

THE paper is concerned with investigating how the provision of pension information has developed in the light of the aims set out in the White Paper that preceded the Social Security Act 1986 with particular reference to quotations, illustrations and projections to see whether employees have enough information to make a fair comparison. In particular the paper analyses whether the financial services legislation has removed the use of misleading projections.

The paper considers the purposes of life company illustrations and the alternatives of monetary and real value bases. Five principles that should guide the preparation of illustrations and the provision of information are developed, namely:

—The illustrations must be readily understood by the employee.
—The illustration should not set out misleading information, even if it is apparently understood by the employee.
—The various types of illustration should be prepared on a consistent basis with consistent assumptions.
—The illustrations should focus on providing information that assists the employee in planning an adequate pension.
—The illustration should help the employee differentiate between the various alternative arrangements and various investment media.

Five examples of illustrations are examined to determine the extent to which they satisfy these principles. These cover benefit illustrations for the State Scheme, an Occupational Scheme, a Personal Pension, a non investment (Building Society) personal pension, and a contracted out Money Purchase scheme.

As a result of these comparisons it is concluded that the illustrations give no help at all to employees assessing the merits of company schemes and personal pensions, though they do help in deciding between SERPS and Personal Pensions. This failure arises from three outstanding features:

—Lack of cohesion over the methods used for the illustrations.
—Lack of consistency in the underlying assumptions.
—The illustrations make no attempt to compare like-with-like concerning the totality of benefits provided.

Finally some suggestions are made of ways in which illustrations might be made more meaningful.

LIFE OFFICE EXPENSES

By R. C. Wilkinson

(Synopsis of a paper presented to the Society on 21 February 1989)

THE paper outlines the main problem areas generated by the document 'Life Assurance and Unit Trust Disclosure—The Regime for 1990' published by SIB in December 1988. It highlights the main topics which the appointed actuary, the actuarial profession and the industry have to consider in some depth to:

—help the regulators fully appreciate some of the practical problems;
—help formulate meaningful measures for with profits business;
—identify the areas in which further guidance is still required from the regulators;
—discuss the merits or otherwise of 'partial' disclosure which has now been proposed.

The Financial Services Act has created a new second tier of regulators who are more concerned with the marketing of investment products and protection of the policyholder in the case of life assurance, in addition to the existing regulation performed by the DTI. The paper traces the evolution of the disclosure rules and comments on the implications of different distribution channels.

The disclosure of charges and expenses is considered and it is suggested that the proposed basis of disclosure of actual charges is sensible and helps to bring down to one measure the very complicated subject of unit linked life policy charging structures. This together with quoted surrender values on a similar basis will give the policyholder much sensible informed advice. The requirement to disclose expenses brings to the fore the subject of their allocation, both to different funds within the life company and to different contracts. The proposal that expenses should be disclosed by means of a reduction in the yield to the policyholder is discussed, and some examples are given.

The paper concludes that the original aims laid down by Professor Gower do appear to be being achieved but at a very high cost to the industry and to the policyholder. The consumerist bodies have played a valuable part helping to formulate realistic disclosure to help protect the investor but they must admit that the majority of investors in life policies will be worse off as a result of these proposals.

RETIREMENT PROVISION ISSUES FOR EMPLOYEES AND EMPLOYERS

BY N. D. V. BODIE

(Synopsis of a paper presented to the Society on 28 March, 1989)

THIS paper deals with the alternatives faced by employers and employees in providing retirement pensions. It starts by considering the aspirations of employees and introduces the concept of a replacement ratio. This is the relationship between the salary received in the last year of employment and the level of pension required by the individual to maintain the same standard of living in the year following retirement, taking into account (a) tax, and (b) National Insurance and pension scheme contributions.

For the employer, the paper suggests that a 'target' employee should be defined, in terms of length of service up to retirement and retained benefits from former employment, giving rise to a full career in terms of a period of pensionable service. By using this target employee, the employer can test various final salary benefit designs to see whether they satisfy the requirements of the necessary replacement ratio at different salary levels, and various other criteria. The paper demonstrates that schemes that are not integrated in some way with at least the Basic State pension, if not SERPS, fail by this measure. Alternative final salary scheme designs are considered, and again assessed against the various criteria previously established.

The next section considers defined contribution schemes. An example of the volatility of such arrangements, taking into account actual investment conditions between 1950 and 1987, is set out. The paper then goes on to use stochastic techniques to model the future volatility of defined contribution schemes. Even with a modified investment strategy, the results show that the variability of the outcomes is so great that, as a basic method of retirement provision, a serious misallocation of resources between different employees can arise purely as a result of the vagaries of investment markets. However, it is also pointed out that, at young ages, the extent of this volatility can be far outweighed by the magnitude of the pensions emerging by comparison with the benefits that would have arisen from a final salary scheme.

The final section is concerned with transfer values. Again using stochastic techniques, the paper illustrates the improvement that may be achieved by virtue of taking a transfer value that is calculated by reference to fixed interest yields and investing it in a personal pension which is largely invested in equities, which are expected to give a better overall real rate of return. Although the volatility of the personal pension is again greater than that of the final salary scheme deferred pension, the expected benefit at young ages is so much greater that the volatility becomes relatively insignificant. Indeed, taking a transfer value is shown to be capable of replacing much of the benefit lost by becoming an early leaver.

The paper concludes that if the new forms of pension provision, with their associated uncertainties, become widespread, or if voluntary membership of pension schemes leads to a reduction in the provision made for retirement, an adequate safety net in the form of the Basic State pension is essential. The gradual erosion of National Insurance benefits, as evidenced by the deterioration of the State pension relative to earnings and the stated views of certain politicians, is viewed as highly regrettable.

THE ACTUARY'S ROLE IN DETERMINING PENSION FUND INVESTMENT STRATEGY

BY I. W. WOODS

(Synopsis of a paper presented to the Society on 11 April 1989)

THE paper outlines some of the practical issues currently facing actuaries in their current involvement in assisting clients define pension fund investment strategy.

Increasingly pension funds in the UK are considering the adoption of an investment strategy geared towards the particular circumstances of the fund and its sponsoring company.

The major reason for the move towards customized investment strategies has been the acceptance amongst corporate financial management of the importance which pension fund assets play in company finances.

Much of the work of the profession to date has involved reviewing past investment performance although little thought seems to have been applied in actually identifying whether or not the performance yardsticks being applied are really valid. Contrary to accepted business practice, companies have expended much of their energy reviewing the return on a substantial portion of their assets without a clear 'Business Plan' having been pre-determined.

The profession is ideally suited to assist in devising the long-term strategy of a pension fund although it is considered that conflicts of interest would arise between the actuarial adviser and the investment adviser should actuaries become involved in the short-term tactical asset allocation designed to take advantage of short-term movements in markets.

There should be a clear division of responsibilities between the liability-led nature of the advice on long-term strategy, which would be the responsibility of the actuary, and tactical asset allocation which would be the responsibility of the investment adviser.

It is suggested that the investment objectives for a pension fund should be based on the sponsoring company's business expectations for its pension fund. In this way, the objective of the pension fund's investment strategy can be directly related to the achievement of the company's strategic business objective for its pension fund.

It also allows the introduction of a meaningful and objective definition of 'risk'. 'Risk' is often used indiscriminately in statements of investment policy or investment objectives. By introducing the concept of a Business Objective for the pension fund, the 'risk' inherent in a particular investment strategy can thus be related objectively to the probability of not achieving the stated Business Objective.

Such an approach can be criticised on the grounds that it views the investment strategy purely from the viewpoint of the company rather than the members of the pension fund. The interests of the members can and should be allowed for typically by including the attainment and continuation of minimum funding ratios within the Business Objectives.

Much of the discussion on pension fund investment strategy has, to date, involved the matching assets to liabilities. By relating investment strategy to the achievement of the Business Objective, account can also be taken of the likely range of cost which the employer is prepared to accept and the employer's degree of risk averseness relative to the likely range of cost.

In identifying the most appropriate long-term investment strategy, use is increasingly being made of modelling techniques applied to both the fund's assets and liabilities.

The impact of different investment strategies on the financial factors influencing pension funds such as contribution rates and funding ratios can be examined by modelling probability distributions of both the assets and the liabilities incorporating consistent projections of future inflation.

The technique also permits the impact of different valuation bases to be assessed. For example, the likelihood of a particular asset mix resulting in the emergence of a statutory excessive surplus can be assessed using the prescribed bases for such calculations whilst the impact on the ongoing contribution rate can be assessed using a different basis.

In this way a clear insight is obtained on the degree of 'risk' involved in pursuing a particular investment strategy.

The move of pension funds towards investment strategies geared towards their own circumstances has implications for the monitoring of investment performance. The acceptance by a pension fund of a long-term asset mix suggests that the basic yardstick against which performance should be judged is the performance of a passive portfolio invested in line with the long-term asset mix and achieving Index returns in each market, rather than the performance of the 'average pension fund'.

Performance monitoring will thus concentrate, in future, on the added value arising as a result of tactical divergences from the strategic long-term asset mix and of stock selection within markets relative to the performance of predetermined indices.

EXPENSE CHARGES AND BEST ADVICE— OUT OF SIGHT, OUT OF MIND

BY G. V. BUDD

(Synopsis of a paper presented to the Society on 16 May, 1989)

THE paper examines the relationship between expense charges and investment performance in the best advice process. In particular the prevailing industry view that expense charges are of relatively peripheral importance is challenged.

With the use of an asset share model the sensitivity of variations in expense charges on final benefits is investigated for specimen personal pensions and endowment contracts. The results are discussed in the context of the industry debate on the Securities and Investment Board's documents on expense and commission disclosure.

A number of important conclusions drawn from the investigations are listed:

—Differences in expense charges between offices are extremely wide.
—Actual expense charges are usually higher than the industry average expenses.
—The differences are usually more significant at terms of 10 years or less than differences in investment performance.
—Over shorter terms it is difficult for an average charging company to overtake the lowest charger unless exceptional investment performance is achieved.
—Early termination values can be extremely penal and should be carefully considered in the best advice process.
—Over longer terms investment performance variations are more significant than variations in expense charges but not overwhelmingly so.
—There is little evidence to suggest that top performing past investment performance is a useful guide to the future.
—Good with profit performance does not automatically equate with superior investment performance as other factors such as expenses, mix of business, miscellaneous surplus and bonus policy are also important.

The closing remarks of the paper are as follows:

Absolute investment performance is always going to dominate other factors in determining the benefits emerging from a particular investment contract. However, within realistic parameters, relative investment performance only becomes the clearly dominant factor over the longer terms where the ability to select the investment winners and losers is more doubtful. For this reason the known initial level of expense charges should become an important factor, alongside the assessment of future investment performance, in the best advice process.

SUMMARIES OF RESEARCH DISCUSSION PAPERS

(Copies of these papers may be borrowed from the Institute Library)

EVALUATION OF THE PERFORMANCE OF LIFE COMPANIES IN MALAYSIAN CONDITIONS

BY S. C. TAN

(Paper No. 41 Deposited in the Library in April 1989)

THE central objectives of this paper are to provide a brief outline of the methodology, and to recommend a practical reporting framework, in evaluating the performance of life offices in the context of a with-profits (participating) environment. The perspective adopted is slanted to those of the shareholders and the management of the life office. These parties need to understand the peculiar pattern of the financial flows of life insurance products, which are very different from other products, and the parameters which they need to control in order to maximize the performance and value of their companies.

A single policy is used as an illustration for profit testing and sensitivity analysis. Some questions relating to the conflict of growth objectives and the desire for the early profits of the overall life fund are also discussed.

The statutory rules governing shareholders' transfers from a with profit life fund are explained.

The concepts of the Capital Strength and the Appraisal Values of a Life Fund to shareholders are introduced and explained.

The author concludes by recommending a comprehensive reporting system embracing short and long term performance measurements of life offices as a practical management tool for both managers and shareholders of life offices.