INSTITUTE AND FACULTY OF ACTUARIES

EXAMINERS' REPORT

April 2021

Subject SA4 - Pensions and Other Benefits
Specialist Advanced

Introduction

The Examiners' Report is written by the Chief 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.

For numerical questions the Examiners' preferred approach to the solution is reproduced in this report; other valid approaches are given appropriate credit. For essay-style questions, particularly the open-ended questions in the later subjects, the report may contain more points than the Examiners will expect from a solution that scores full marks.

The report is written based on the legislative and regulatory context pertaining to the date that the examination was set. Candidates should take into account the possibility that circumstances may have changed if using these reports for revision.

Paul Nicholas
Chair of the Board of Examiners
July 2021

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A. General comments on the *aims of this subject and how it is marked*

1. The aim of the Pensions and other Benefits Specialist Advanced subject is to instil in successful candidates the ability to apply knowledge of the pensions and employee benefit environment and the principles of actuarial practice to providers of pensions and employee benefits both in the United Kingdom and the rest of the world.

2. This subject examines the ability of candidates to apply actuarial practice and concepts to potentially complex problems, integrating their analysis into a coherent whole, and evaluating and interpreting results to draw explicit conclusions.

3. From 2019 the requirement for detailed knowledge of the UK's legislative and regulatory frameworks has been moved to the UK Practice Modules (UKPM). The Specialist Advanced subjects will still require knowledge of the principles of the UK market and regulatory regimes but there has been a re-balancing to include comparison between different jurisdictions and expansion in non-UK-specific topics.

4. The Examiners therefore look for candidates to demonstrate their understanding of the syllabus but in particular they need to demonstrate ability in applying their knowledge and core actuarial skills to the specific situations that the Examiners have raised, having read the question carefully. Consistently, many of the unsuccessful candidates provide answers that are not sufficiently specific to the subject matter of the question, reproduce core reading that does not directly relate to the question context, or focus on one specific point without covering a sufficient range of points to answer the question. This does not enable the candidates to achieve the required marks. The Examiners encourage future candidates to remind themselves of what they learned in the Core Actuarial subjects, and to use past paper questions to practice applying these skills to the specific scenarios tested.

5. Good candidates demonstrate that they have structured their solutions well - this is a big advantage in making points clearly and without repetition. There is a significant incidence of points being repeated in slightly different ways, restricting the scope for candidates to score marks. Good structure enables candidates to use the latter parts of questions to generate ideas for answers to the early parts (or use their solutions to earlier parts of questions to create a structure for latter parts). Time management is important so that candidates give answers to all questions that are roughly proportionate to the number of marks available. The questions are set so that it should take approximately twice as long to answer a 10 mark question as a 5 mark one. Answers should therefore be similarly proportionate.

6. In addition, candidates should carefully consider the instruction - for example an instruction to list points should be answered with a list without attaching discussion. Similarly, a question asking for a discussion cannot be answered with a list of undeveloped points.

7. Finally, it is very helpful to the Examiners if candidates clearly identify points made; if they are set out clearly, well-spaced and easily legible. Whilst there is no loss of marks for not doing so, doing so does make it easier to identify scoring opportunities.

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8. Candidates who give well-reasoned points, not in the marking schedule, are awarded marks for doing so.

B. Comments on *candidate performance in this diet of the examination.*

1. As the exams continue to be sat online, it is pleasing to see candidates settling in to the new format.

2. The better candidates were those who read the questions carefully, tailored their answers to the questions and thought about what was actually being asked, rather than just writing about what they know on a particular subject (which was an issue in some previous sittings).

3. The paper also required candidates to think beyond the obvious answers in a number of places, and the better candidates were able to bring in ideas from other areas of the course to score higher marks in these parts. A number of weaker candidates just didn't write enough points to ever be able to score highly.

4. The application aspects of the course are harder to score well on. This is an area that SA4 candidates consistently need to work harder on in preparation. By taking a methodical approach to answers, step by step, however, there are opportunities to score well. It is important that candidates make sure they provide a full answer to all questions.

5. The importance of structure in the exams should not be underestimated because this will lead to much more efficient work post exams. It is harder to get good marks in the absence of a good structure because it means that logical points are more likely to be missed. Sometimes points are just repeated further through the answer meaning that the response was more likely to look of sufficient length than it really was for the marks available. The new online format should make it easier to structure answers well.

6. Breaking the question down into smaller parts helps to make sure that a suitable breadth of answer is supplied. It is critical that candidates check that their answers specifically refer to the details of the question, using all of the information in the question pre-ambles. It is not the intention of the examiners to include information in the questions that is not relevant to the answers.

C. Pass Mark

The Pass Mark for this exam was 61.
202 presented themselves and 60 passed.

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Solutions for Subject SA4 – April 2021

Q1

(i)(a)

Advantages

Early retirement will save money for the sponsor as salary payments stop [1]
and there will be no offsetting cost to provide enhanced early retirement terms [½]
With cost-neutral early retirement terms on a best estimate basis there may be again on the funding or buy-out bases as these are likely to be more prudent [1]
Cost-neutral terms on a best estimate basis are also likely to lead to little accounting impact [½]
The costs of buying out benefits at some point in the future are also likely to be improved by moving membership from active/deferred to pensioner which are cheaper to insure [½]
Shows a paternalistic attitude by providing an income when replacing the salary for older members may be difficult [½]
The risk profile of the scheme's liabilities may change with less salary risk and more inflation risk. [½]

Risks

An early retirement pension [with shorter service and reduced for early payment] may be insufficient to for members' needs without enhancements so they may not volunteer for redundancy [½]
which may result in forced redundancies causing reputational damage [½]
and extra costs if forced redundancies give enhanced benefits [½]
Encouraging employees to take early retirement is dangerous for the sponsor's reputation and could cause them to fall foul of employment law [1]
unless the sponsor provides support – eg paying for financial advice [½]
and/or providing a financial incentive to make the offer sufficiently attractive for a financial adviser to recommend [½]
Ordinarily this incentive might take the form of redundancy payments in excess of any statutory requirement [½]
or asking the scheme trustees to offer beneficial early retirement terms [½]
which would likely incur additional sponsor contributions to the scheme [½]
but both of these costs might be tax efficient [½]
The cost of encouraging early retirement with enhanced benefits may be cheaper than increasing the redundancy payment for older members [1]
as it may be more appreciated by those who might otherwise struggle to find another job [½]
Targeting older members for the redundancy exercise may leave the sponsor with a young and inexperienced workforce [1]
which may expose the sponsor to other business risks [½]
The employer may need to impose limits on the proportion of older and younger members allowed to volunteer to counteract this [½]
Bringing forward pension payments could cause liquidity issues and costs in thescheme which could increase the need for sponsor contributions. [½]

(b)

Advantages

The bridging pension option might make the voluntary redundancy exercise more attractive for members who can retire [1]
and therefore more successful for this group [½]

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meaning that any redundancy incentive in excess of the statutory redundancy payment could be made smaller [½]
because normally the early retirement reduction might have led them to reject retirement as their reduced income would be too low [½]
but the option allows the members to consider retirement when they might otherwise have been struggling to find another job to get sufficient income [½]
There is a positive impact on the pension scheme because bringing pension payments forward will reduce the risks in the scheme for inflation [½]
and longevity [½]
and this might help keep sponsor contributions to the scheme lower than they might otherwise have been [½]
The terms could be set to produce a cost saving to the employer [½]
but the cost of producing the terms may be excessive if there is low take-up. [½]

<u>Risks</u>
However, there is a selection risk in that those who expect a shorter life could be more likely to take up the option to maximise their benefits [1]
A bridging pension adds to the complexity of administration and communication [½]
which could cause reputational risk if the option is not explained well or if it leads to errors [½]
There is a risk of State benefits changing so that income drops at SPA [½]
Ultimately the sponsor will want to find the most efficient balance of costs between member advice, redundancy incentive payments and sponsor contributions to the pension scheme.[½]
[Marks available 22½, maximum 8]

(ii)(a)
The trustees will want to seek legal advice to determine: [½]
who has the power to allow members to take the option [½]
if the rules specify the terms for the option [½]
and, if not, who sets the terms for the option [½]
the impact of the bridging pension option on other benefits and options [½]
such as spouse's pension [½]
guaranteed period [½]
pension increases [½]
or cash commutation [½]
whether there is any guidance or legislation governing the communication to or advice for members [½]
The trustees will want to know: details of the State benefits [½]
XYZ's view of the scale of the redundancy programme and likely take-up rates to assess significance [½]
the views of trade unions [½]
past practices of XYZ or their competitors [½]
whether the admin system will need enhancement [½]
The trustees will seek actuarial and/or investment advice to indicate: [½]
what the terms of the option might be [½]
whether they will be fixed or market-related [½]
some examples and costings [½]
methods and assumptions [½]
if there will be any funding cost which might require additional sponsor contributions [1]
whether different commutation factors will be needed for cash commutation [½]

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if there will be any implications for the investment and funding strategies of the scheme [½]
as a consequence of the reduced inflation and longevity risks if the option is taken up [½]
and of the maturing of the scheme due to the reduction in active members and increase in pensioner members [½]
and to understand the implications for member security of those who take up the option or don't [½]
and any impact on the sponsor's covenant. [½]

[Marks available 14, maximum 5]

(b)
The trustees will want to encourage the sponsors to meet the costs of the exercise [½]
and pay for members to receive advice to make sure retirement is an appropriatechoice for them [½]
and indicate that they expect to set the terms of the option so that members are not disadvantaged by exercising the option [1]
They will also want to explain the potential funding impact on the scheme [½]
arising from the reduction in longevity and inflation risks [½]
the costs of a move to lower yielding assets with the maturing of the scheme [½]
and the cost of any selection risks [½]
so the sponsor needs to be ready to provide any additional funding that may be required [½]
The trustees will want to be able to review any communications to members to ensure they are clear and accurate [½]
and don't put pressure on the members [½]
Subject to these matters being satisfactorily resolved, the trustees are likely to support the proposal. [½]

[Marks available 6, maximum 2]

(iii)
The two primary concerns will be:

- that the terms of the bridging pension option are fair to all members – ie that the value of benefits before and after exercising the option are equivalent and assessed on cost-neutral assumptions [1]
  and best estimate so that the members who do or don't take up the option are treated equally [½]
- and that members are given information and advice so that they can make informed decisions appropriate to their circumstances [1]

Will need to decide whether the terms will be market related or fixed [½]
Need to set out the impact of the terms on funding and buyout [½]
Include some scenario and sensitivity analyses for different take-up rates [½]
selection risks [½]
and market conditions [½]
Want to make sure that members have access to independent financial advice [½]
paid for by the sponsor since it is their decision to encourage retirement and the bridging pension [½]
The values of benefits after the option will need to take account of any changes to pension increases and changes to any other benefits – such as spouses' pensions [½]
The assumptions used need to be considered in the light of any changes in the sponsor covenant that have prompted the redundancy exercise [½]

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Although this is not likely to be considered an incentive exercise, will probably want to ensure that both the trustees and the sponsor consider any guidance or regulations for such exercises when determining the process adopted [1]
Trustees should be closely involved with the communication given to members [½]
to ensure that it is clear about what the option means for their future benefits [½]
and what impact, if any, it will have on the members' other benefits eg cash commutation and spouse's pensions [½]
Want to ensure that members have sufficient time to make the decision [½]
and that this is compatible with the redundancy timetable of the sponsor [½]
Need to agree with the sponsor what State Pension amount is used in the calculations if it could change between retirement and State Pension Age [½]
according to future inflation or marital status or some other reason [½]
Need to make sure the data is available to be able to make accurate calculations of the State Pension that is assumed to become payable [½]
in order to ensure that the member's total pension doesn't go down unexpectedly on reaching State Pension Age [½]

[Marks available 12½, maximum 6]

(iv)
The financial advisor will want to know:
personal characteristics such as age and gender [½]
And the following about the member's circumstances:

- what other income sources they have available to them [½]
- and whether they can draw on them now [½]
- information about their financial commitments now and in the future, eg mortgage and loan arrangements [½]

Award marks for other examples, maximum 2

- information about their current and future spending plans [½]
- information about their spouse and any dependants [½]
- and their financial circumstances [½]
- or other sources of wealth [½]
- their income needs for their spouse and dependants [½]
- what their general health is [½]
- tax status [½]
- attitude to risk. [½]

[Marks available 6, maximum 3]

(v)
The primary consideration is whether they consider themselves and/or their dependants to be financially better off [1]
The first thing members will probably want to consider is what their job prospects are should they wish to continue working [½]
when they had been planning to retire [½]
and how close they are to SPA [½]
This may depend on whether the difficult business environment is confined to their current employment sector or whether it is more general [½]
and if their skills can be used in other employment sectors [½]
Members will want to make sure they have enough income when they retire [½]

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allowing for all sources of income or wealth [½]
and when these are available to them [½]
so having the ability to take a higher initial figure until the State Pension is payable is a definite advantage [½]
although it does mean that there may be nothing extra later on [½]
so they need to consider whether the pension will be enough in the long term [½]
They will also need to understand how their tax status may change if they do or don't retire and whether they exercise the option or not [½]
If tax free cash is allowed then the amount available may be higher with a higher starting pension [½]
although they may only use it to gain the tax advantage if they still have need of the income to meet their living costs [½]
Members may note that the difficult business environment may reduce the income available from money purchase pots [½]
or make it expensive to draw income or tax free cash from the pots [½]
if market values are depressed [½]
They will need to consider what benefits will be payable to their spouse if they die before retirement as an active member [½]
compared to the amount payable if they were to retire and then die [½]
Members will want to take any financial advice available to make sure the terms offered for the bridging pension option are reasonable for their circumstances [½]
and to understand the implications of drawing on any other sources of income [½]
What benefits might be lost if they take redundancy – eg health plans, company car etc [½]
What is their view on their health and life expectancy [½]
What other benefit options might be available to them. [½]

[Marks available 13, maximum 6)

[Total 30]

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1(i) Generally well answered with a good number of risks and advantages - the better candidates thought more widely about all areas and were able to score highly. Quite a number of candidates focused entirely on the pension scheme, rather than from the point of view of XYZ. Some candidates conflated the two options, rather than answering separately which made it harder to score well. The poorer papers did not consider the impact on funding, investment and accounting.

1(ii) Generally well answered, albeit some of the points in relation to this question were raised in other parts of the question for which candidates would be given credit. Few candidates considered how the bridging pension may impact on other scheme benefits. Quite a few candidates talked about legal and actuarial advice without expanding as to what that advice would be. Some candidates missed out part (b) which shows the importance of reading the question fully.

1(iii) This part was poorly answered. Many candidates focussed on the TAS requirements and focused their answer around this. The better candidates were able to think through as if they were the actuary and structure their response covering all the areas that the actuarial advice would cover – e.g. impact on funding, impact on members, ensuring all regulations and guidance are followed, etc.

1(iv) Many candidates got full marks and identified the key issues.

1(v) Again well answered as the better candidates elaborated on each point raised in part iv) above.

Q2

(i)

General

The trustees have a responsibility to ensure the members' benefits are secure [½]
and this relies on the sponsor being able and willing to continue to support the scheme while the strategy is progressing [½]
The sponsor should be consulted and a collaborative approach agreed [½]
The strategies should be comprehensive by allowing for contingencies [½]
The strategies should be reviewed to ensure they are still appropriate. [½]

<u>Design and choose and appropriate strategy mix</u>

The aim of any strategy to prepare a scheme for buy-out is that it increase the assets so that they are sufficient to meet the buy-out cost without exceeding the amount of risk that either the trustees or sponsor are happy they can withstand [1]
The level of risk that can be taken on will ultimately depend on the sponsor's covenant [½]
a weaker covenant will not support as much risk as a stronger covenant [½]
and the covenant depends not only on the ability of the sponsor to support the scheme but also on their willingness to support the scheme [½]
The means of increasing the assets is likely to be a combination of good asset performance and sponsor contributions [½]
if the balance is too much towards the contributions then the sponsor is likely to think that the cost of the scheme is too high and their covenant may reduce [½]

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whereas if the balance is too much towards asset performance then the risk may be higher than the sponsor can support [½]
Other options that might improve the funding position would be liability management exercises, such as an enhanced transfer value exercise, that reduce the funding liabilities more than the assets [½]
Employer business forecasts may help determine the timing of particular strategies [½]
and also get a view of their covenant and how it might change in the future. [½]

Investment strategies
A scheme's investment strategy normally seeks to achieve the optimal performance from the assets within a given budget for risk [½]
Strategies moving towards buy-out will normally look to lock in good performance by moving a portion of the assets into more matched investments as the funding level increases [1]
and this will automatically reduce the exposure to risk [½]
reduce the return on the assets [½]
increase the cost [½]
and increase the funding target as the valuation discount rate is reduced [½]
which increases the contribution requirements [½]
ie the funding target will gradually approach the buy-out cost [½]

although the increase in funding target may be limited if the reduction in risk improves the sponsor's covenant [½]
Increasing the funding target reduces the funding level again but this is against the higher target [½]
An ALM may help to determine potential investment strategies [½]
which are likely to be shifting towards bonds [½]
possibly inflation linked if benefits have an inflation link [½]
and cash for liquidity [½]
This may also help to ensure there is sufficient diversity in the portfolio. [½]
As the scheme is already funded at greater than 100% on an ongoing basis this may allow an immediate de-risking of the scheme assets [½]
However, the scheme is only 85% funded on a buy-out basis so the scheme may need to invest in more growth assets for a period in order to improve the asset value [½]
but this carries the risk that these assets could underperform and the funding level may fall [½]
Care is needed with investment strategies in order to ensure sufficient liquidity for a maturing scheme [½]
May buy-in tranches of liability [probably pensioners] ahead of buy-out to stabilise the funding level [½]
which probably commits to a particular provider for the buy-out [½]
May also consider other investments to mitigate risks such as longevity bonds and/or swaps [½]

Contribution strategies
Contribution strategies for increasing the assets normally fall into two types:
those that increase the sponsor contribution rate based on what is happening in the scheme [½]
and those that increase sponsor contributions based on what is happening to the sponsor [½]

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In the first category contributions would be expected to increase in line with the operation of an investment strategy that reduces the discount rate [½]
which increases the level of contributions to meet ongoing accrual and any deficit [½]
Although the sponsor may also agree to additional contingent contributions if the funding level falls as a consequence of poor asset performance [½]
but this would be a protection of the strategy rather than the strategy itself [½]
The trustees might also agree with the sponsor to move the funding target towards a buy-out basis and this may create a deficit which would result in the need for deficit contributions [½]
In the second group, the trustees and sponsor may agree to sponsor contributions being linked to dividend payments [½]
or to corporate transactions [½]
ie contributions might increase if sponsor dividends increase so that the scheme shares in the good performance of the sponsor [½]
or a special contribution may be paid if there are windfall profits arising from a corporate transaction [½]
or contingent assets could be introduced if the sponsor performs poorly [½]
In relation to any additional or increased contributions these might be put into escrow in order to avoid stranded surplus [½]
Also need to consider how ongoing and/or buy-out expenses will be met [½]
Contribution levels may also be set based on business prospects and plans of the sponsor to align with the availability of funds [½]
or deficit contribution patterns may be designed to be spread over the period to expected buy-out [½]
Also, additional contributions to move to buy-out funding may be stepped up as the ongoing cost of accrual declines with declining active membership [½]

<u>Implementation processes</u>
The process of implementing the strategies will need to be agreed in negotiation with the sponsor [½]
and the Rules may need to be checked before deciding what to do [½]
The process needs to consider the expected timeframe until there are no active members [½]
There will be costs to implementing these strategies such as:

- hiring investment consultants to change the investment strategy [½]
- monitor buy-out prices [½]

and funds must be set aside to meet these expenses [½]
There may be a gradual alignment of funding and buy-out bases [½]
and a need to monitor buy-out prices [½]
The common feature of all these strategies is that an action is taken when a particular trigger point is reached so it is important to monitor the scheme and/or the sponsor to determine whether these actions should be implemented [1]
The trustees and sponsor will need to agree who monitors each trigger [½]
and how often [½]
There will need to be a balance between the cost of the chosen monitoring frequency [½]
and the scale of regret if the trigger and the opportunity is missed [½]
Some of the actions required when a trigger is reached will need to be carried out quickly [½]
this may be particularly the case in relation to investment strategies [½]

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It is therefore important to establish a process for carrying out the action before it is triggered [½]
and whether it will happen automatically or whether there will be a decision to be taken. [½]

Examples of triggers might include:

- changes in the funding position [½]
- changes to the covenant [½]
- market opportunities – eg high equity prices or cheap buy-out prices [½]
- fixed times. [½]

May be appropriate to review the terms of member options. [½]

[Marks available 39½, maximum 16]

(ii)

<u>Cleaning the membership data</u>

There are two main benefits to cleaning the data:
improving the data quality so that the insurance company doesn't need to make so many assumptions about the scheme membership [½]
which will tend to be cautious to protect the insurance company [½]
and reducing the timescale taken to buy-out which means the scheme can move more quickly to take advantage of favourable market conditions [½]
The most likely data items that would benefit from data cleaning might be spouses' dates of birth [½]
which may not reflect deaths, divorce and remarriage and this could affect the cost of spouses' death benefits [½]
and address details for deferred members whom the scheme may have lost touch with after employment ceased and this could affect the mortality assumption for deferred members [½]
This is likely to be a time-consuming and costly exercise [½]
especially for a large scheme [½]
which could either be carried out by the sponsor and/or scheme administrator [½]
or a tracing service could be used [½]
Data cleaning can be done at any stage [½]
but if it is done a long time before the likely buy-out then the trustees will want to put in place administration processes that ensure the data remains accurate [½]
and this may add to the normal cost of administering the scheme [½]
May highlight the need to rectify some benefits once data has been cleaned [½]
and this will incur costs [½]

<u>Converting pension increases</u>

Some pension increases can be expensive to insure because hedging investments are either not available or are expensive [½]
or the insurer may might charge an inflation premium [½]
Increases with caps and collars can be particularly expensive to insure [½]
It may be possible to reduce the cost of the buy-out by changing the pension increase [½]
sometimes even if a slightly more generous increase is offered [½]
and, if the conversion terms are calculated on a best estimate basis, this is likely to reduce the cost of the buy-out [½]
It is also possible to carry out a pension increase exchange exercise where members are offered the option of a higher non-increasing pension instead of the normal scheme benefit [½]

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This may reduce the cost of the buy-out if the insurance company can now make a less cautious assumption for future increases in longevity [½]
Members may find the option attractive if the converted benefits better meet their needs. [½]
Any exercise involving member choice has to be run carefully to ensure members make informed choices [½]
meaning clear communications are needed [½]
and possibly access to independent advice [½]
and adherence to any best practice or mandatory guidance [½]
There will be costs of the exercise [actuarial, legal, admin] to be met [½]
and these may not be justified if the take-up is low [½]
This could introduce complexity with different increases between those who do or do not take up the option [½]
unless members can be forced to switch. [½]

<u>Removing or simplifying difficult or complex benefits</u>
The problem with difficult or complex benefits is that they may be very difficult for the insurance company to administer [½]
and this will increase the expense allowance included [½]
so the obvious benefit of removing or simplifying these benefits is that the cost should be decreased [½]
It could also reduce admin costs up to the time of buy-out [½]
but there will be costs of carrying out the exercise which must be met [½]
Members may appreciate the simpler benefits if they understand them better [½]
and they may reduce admin errors [½]
In the UK GMPs are an example of complex benefits so converting them to normal scheme benefits may be beneficial. [½]
Award marks for other examples in other jurisdictions.

Sometimes it can be difficult to remove or simplify these benefits in the same way for every member without increasing the value of benefits [½]
so it may be necessary to allow members to choose the manner of simplification or removal to avoid excessive costs. [½]
May need actuarial advice and/or certification to remove or simplify benefits [½]
or members may need to consent. [½]
Sometimes members are offered options at retirement where the insurer would invest for and price one very differently to the other [½]
which could make the buy-out cost very high if the option cannot be removed [½]
May need to adopt the same care and approach as for pension increase exchange options in relation to member communications and financial advice. [½]

<u>Enhanced Transfer Value exercise</u>
Transfer values can only be paid to deferred members so active and pensioner members would be excluded [½]
but deferred members are normally very expensive to insure because the premium basis is very cautious [1]
However, transfer values are normally calculated using a best estimate basis so they will be considerably smaller than the premium payable [½]
This provides plenty of scope to offer higher transfer values to members and stillreduce the buy-out premium by more than the assets paid out [½]

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so the excess is available to help meet the costs of buying out the remaining members [½]
The transfer may allow members to achieve benefits that better suit their needs [½]
There may be special requirements for carrying out such an exercise so these will need to be complied with [½]
In particular there may be a need to provide members with financial advice and include specific information in member communications [½]
The costs of running the exercise are therefore significant [½]
and the take-up rate on the exercise needs to be high enough to justify these costs [½]
The take-up rate will be sensitive to the scale of the enhancement – the higher the enhancement, the higher the take-up rate [½]
so there will need to be a balance as to the size of the enhancement [½]
This balance may depend on whether the costs are met by the sponsor or the scheme [½]
but the scheme could only meet the costs if this didn't reduce the benefit security for the remaining members [½]
Such an offer would be highly attractive to members in ill health so there is a selection risk. [½]

[Marks available 31½ ,Maximum 16]

(iii)

<u>Liability management</u>

Other liability management exercises could be run such as:

- a total commutation exercise to remove small pensions which are very expensive to administer [½]
- or a total pension increase exchange exercise where an enhanced value of benefits is normally transferred to a defined contribution arrangement which allows greater flexibility in the form of benefits taken. [1]
-

In both situations the scheme liabilities are reduced so the premium is reduced and the aim is that the premium reduction will be larger than the enhanced amount paid out. [½]

<u>Competitive tender</u>

It is also possible to keep the costs down by running a competitive tender process [½]
so that insurers will be forced to price at least as competitively as their rivals if they want the business [½]
This potentially increases the costs by engaging with multiple insurers [½]
and can increase the time to buy out the benefits [½]
May increase the insurer's costs so the potential saving could be reduced. [½]

<u>Other solutions</u>

The scheme could be closed to accrual which would reduce the ultimate benefits to be insured
Offer a transfer to an alternative arrangement [such as DC]. Align assets to likely insurer portfolio to facilitate asset transfer. Adopt medical underwriting approach if appropriate.
Review option terms ahead of buy-out
[Award marks for any well-argued alternative – credit best two suggestions]

[Marks available 4½, maximum 3]

[Total 35]

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In question 2(i) some candidates didn't pick up the main thrust of the question which was to explore the journey planning process to move towards buy-out in an orderly manner which will involve a combination of contributions and investment growth but where the mix will depend on the strength of the employer's covenant and the emerging experience of the scheme. As a consequence there was too much focus on specific investment approaches as the scheme matured and time based triggers to switch investments or increase contributions.

2(i) Generally answered fairly well, although not enough detail generally. Some candidates went off on a tangent talking about incentive exercises which wasn't the main focus of the question. Most candidates followed the breakdown into the four key areas well which was encouraging. A lot of candidates didn't specifically talk about triggers, but made a lot of the key points regardless so were able to score fairly well.

2(ii) Many candidates followed the question breakdown well and provided a good structure – some candidates used a table which worked quite well. There was some repetition in the answers to the different parts, and it is important to still make the point even if it seems repetitive, even better if it can be tailored specifically to the relevant part of the question - for example talking about the costs of each option.

2(iii) The better candidates scored well here fairly easily. Some candidates missed this part of the question out.

Q3

(i)

Candidates may combine corporate and individual contributions and add benefits as another option or they may offer other options altogether – clearly more marks available for some than others but award marks for well-argued suggestions and credit best 3 if more offered

<u>Provide tax relief on corporate earnings applied to support pension provision.</u> [1]
This encourages employers to use business earnings to provide pensions to their staff [½]
which reduces the need for the State to pay these people pension benefits [½]
because it acts as an incentive to employers to divert funds from shareholders or owners [½]
because it increases the contribution for a given post-tax spend and is therefore an efficient use of the money [½]
Could restrict eligibility to schemes providing minimum benefits or contributions [½]
to ensure it is targeted to schemes likely to meet a minimum standard of living [½]
Could consider partial tax relief by providing the relief at a lower rate [½]
It is unlikely that employers will abuse this incentive by over-provision because that might limit their ability to raise money to invest in their businesses [½]
however, it could be restricted if schemes are over-funded. [½]

<u>Provide tax relief on individual earnings saved for pensions.</u> [1]
For employed individuals this makes it easier for employers to require members to contribute to the cost of providing pensions [½]
because the impact on their take-home pay is smaller [½]
thereby helping to share the cost of pension provision for employed individuals between the State, the employers and their staff [½]

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For self-employed individuals or those making voluntary contributions to employer schemes, this encourages them to put money aside for their retirement rather than consume it now or save it in other vehicles [½]
which reduces the need for the State to pay these people pension benefits [½]
Over-provision is a risk for this group of people so the State may set limits on the amount of contribution that qualifies for tax relief [½]
or they may set limits on the size of pension saving pots that can be accumulated [½]
in order to keep down the cost of tax relief [½]
but need to balance any restrictions against the objective to ensure a minimum standard of living [½]
Could provide relief only on contributions above a certain limit [½]
in order to target the relief at those seeking to achieve a minimum standard of living [½]
Could consider partial tax relief by providing the relief at a lower rate. [½]

<u>Provide tax relief on investment returns in pension funds whether corporate or individual.</u> [1]
This encourages employers and individuals to invest the money being saved [½]
which helps keep the cost down for employers and individuals [½]
and also helps to increase the amount of pension provided for a given contribution [½]
so that the need for the State to pay benefits is reduced. [½]
Could encourage responsible investment by targeting relief toward specific asset classes or sectors. [½]

<u>Provide tax relief on benefits</u> [1]
Increases benefits to help ensure a minimum standard of living [½]
Tax could be applied progressively to benefits above the minimum standard of living [½]
to reduce the cost of the tax incentive to the State [½]
Reduces reliance on the State [½]
and makes pension provision attractive [½]
Makes it less likely that State will need to top up benefits to meet the minimum standard of living [½]

<u>Other options</u>
Lump sum State contribution to post-tax investment vehicles – eg Lifetime ISA
Could pay a fixed cash bonus into the fund instead of a percentage of salary tax relief.
[Marks available 20, maximum 9]

(ii)
<u>Set minimum sponsor contribution rates that must be applied to pension provision.</u> [1]
If the tax incentives are insufficient to encourage employers to make adequate contributions then this compels them to do so [½]
and keeps the State's benefit costs down [½]
It may also help to keep employee pension contributions down [½]
The minimum cannot be set too high without risking jobs as the cost of employment becomes excessive [½]
which in turn has the potential to reduce private pension provision and increase State benefit costs. [½]

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Set minimum and maximum personal contribution rates for pension savings. [1]
Similarly to employers, this compels adequate contribution to a pension where tax incentives have been insufficient [½]
which helps to keep down the cost of employer pension provision [½]
and State benefit payments [½]
Setting a maximum contribution rate helps prevent abuse of the tax relief system so that the State's costs are not inflated [½]
although this maximum may need to be set differently for employed and self-employed people. [½]

Provide a pension benefit for those unable to work or with no access to an employer or individual pension arrangement for whatever reason. Could be described as a State-run scheme for these individuals [1]
This might be a flat rate for those with little or no lifetime earnings [½]
and/or a limited variable amount to act as a substitute for those without access to other pension arrangements for a period [½]
The State will have had no incentive costs for this class of individuals [½]
so they can use those savings to provide the pension benefit. [½]

Set a minimum income in retirement and top up pension incomes to this level if necessary. Might express this as a means-tested pension [1]
The pension benefits built up from employer and individual contributions or State pensions may be insufficient to provide adequate income [½]
so this provides a safety net to deal with the final objective [½]
For simplicity this could be set at the same level as a flat rate State pension [½]
which then also becomes a safety net where the aggregation of pensions across different employment periods is insufficient. [½]

Other options
Regulator to ensure pension vehicles are properly managed and administered and provide guidance for sponsors and individuals re governance
Central Discontinuance Fund to provide safety net for those with pension from failed employers
Minimum/maximum benefit requirements
Integrated risk management requirements including minimum funding requirements

Award marks for the best two components that meet at least some of the objectives
[Marks available 12½, maximum 6]

(iii)(a)
Lump sum
Removing the tax concession on lump sums at retirement will probably increase the tax revenue as more people are likely not to exercise the option [1]
and a higher pension will generate more tax during the individual's retirement [½]
or tax revenue will be generated on the lump sum [½]
It may also produce savings in the cost of tax incentives [½]
as both sponsors and individuals may reduce their contributions [½]
to target a smaller pension benefit or pension pot [½]
and divert contributions to alternative vehicles that permit a lump sum to be taken which may also result in a smaller cost in exempting investment returns from tax. [½]

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Alternatively, contributions could be increased in order to compensate for the higher tax charge [½]
and this could increase the cost of tax relief [½]
The tax regime could be easier and cheaper to operate [½]
The change may be politically unpopular [½]
A higher pension income may also make it less likely that a State minimum income guarantee will be triggered which would save benefit costs [½]
Reduced lump sum spending could have a negative macro-economic effect. [½]

<u>Minimum contributions</u>
Introducing minimum contribution rates to attract tax relief will increase the cost of that tax incentive [½]
unless there are many contributors who choose not to increase contributions and therefore don't qualify for tax relief but it should encourage higher private pension provision which should reduce State benefit costs [½]
If set at the correct level it could result in an overall cost saving as the investment returns will result in a higher benefit cost saving than the additional cost of tax relief [½]
Increased investment from pension pots may have a positive macro-economic effect [½]
May be politically popular if it encourages employers to make higher contributions [½]
unless these costs are passed on to the members through lower salary increases [½]
May result in clustering around the minimum which could reduce contributions overall [½]
which could reduce benefits and increase State reliance [½]

(b)
<u>Lump sum</u>
Removing the tax concession on lump sums at retirement will tend to make defined benefit pension schemes more expensive to fund [½]
as commutation terms are often set below market value because the option provides a tax advantage for the member [½]
Such a scheme may also become more expensive because it is exposed to more inflation and longevity risks from members who don't take commutation [½]
The sponsor may therefore decide they need to cut benefits to compensate [½]
and they may be comfortable doing this if they believe the residual pension income could be about the same after the change [½]
A similar approach may be taken by the sponsors of defined contribution schemes because they expect the scheme to produce a higher pension benefit if a lump sum is not taken [½]
or they could increase contributions to compensate for reduced value of benefits to the member [½]
However, value to member will be reduced due to taxation [½]
which could make scheme less attractive to member and make manpower planning more difficult [½]
May reduce incentive on employer to provide pension scheme if it is valued less highly by members. [½]

<u>Minimum contributions</u>
Introducing a minimum contribution rate for sponsors means the net cost of a scheme increases [½]
but it also means that there will be a level where it effectively becomes 'free' to increase the contribution rate to the minimum [½]

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because the net cost remains unchanged due to the tax relief [½]
There will likely be a tendency for sponsor contribution rates to cluster around the minimum level [½]
so there may be less hiring competition on pension benefit packages [½]
If the minimum contributions exceed the expected cost of a DB scheme then the scheme benefits may need to be improved [½]
which could become more attractive to members and improve their competitiveness of the sponsor to the employees. [½]

(c)
Need to review all communications to members and administration [½]
and ensure scheme documentation complies with legislation. [½]

<u>Lump sum</u>
Removing the tax concession means the cashflow profile of a defined benefit scheme is likely to change [½]
as fewer members take commutation [½]
This may require the trustees/scheme managers to review the investment strategy [½]
to recognise the different cashflow profile and respond to the potentially higher exposure to longevity and inflation risks [½]
They may also want to review the commutation terms if these were set to recognise the tax advantage [½]
May need to review valuation assumptions and funding strategy if these allow for commutation [½]
as member behaviour may change [½]
The trustees/scheme managers of a defined contribution scheme may also change the investment strategy of default funds [½]
if they're expecting many fewer members to take a lump sum. [½]

<u>Minimum contributions</u>
The minimum contributions for tax relief should have no impact on the trustees/scheme managers for a defined contribution scheme [½]
For a defined benefit scheme the trustees/managers may simply need to understand the impact it may have on the sponsor's negotiating position for funding discussions [½]
The trustee may have larger funds to invest which may affect investment contracts. [½]

(d)
<u>Lump sums</u>
Individuals will probably have appreciated the opportunity to have a tax free lump sum at retirement [½]
to settle any debts or help them with any significant expenditure as they begin retirement [½]
and being able to do this through a tax efficient savings vehicle will have been well regarded. [½]
Therefore, they will probably seek to replace this by switching some of their savings to an alternative vehicle that provides cash pay-outs [½]
without losing the tax-free status [½]
May decide to increase saving to compensate for lost tax on lump sum [½]
or recognise that some expenditure options at retirement may not be available. [½]

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<u>Minimum contributions</u>
Introducing a minimum contribution rate to obtain tax relief will increase the net cost of pension saving [½]
so individuals will probably switch savings into another tax-free vehicle if they can't afford the minimum [½]
and this may also give them more flexibility over what they do with the savings [½]
Increased contributions may reduce current consumption [½]
but will increase DC benefits [½]
DB benefits may not be increased for the higher contributions if the sponsor uses them to offset their own contributions [½]
provided the net figure exceeds their minimum [½]
As with sponsors, there is a level where increasing pension saving to the minimum becomes 'free' because it is paid for by the tax relief [½]
and there may also be clustering around the minimum. [½]

[Marks available 34½, maximum 20]

[Total 35]

Q3 was generally well answered although some candidates missed valuable marks by not considering both DB and DC schemes and the potential behaviours of individuals and employers that the State would have to guard against in planning their framework. This was particularly so in (iii) when candidates noted that the changes may be unpopular but didn't then consider how the parties might respond – e.g. by moving to other savings vehicles that overcame the disadvantages of the changes.

3(i) generally well answered as most candidates got marks for the relief on contributions, investment and partial tax relief of benefits.

3(ii) this was a tricky differentiating question. The better candidates had good ideas and were able to describe them well.

3(iii) Many candidates did not spend enough effort on this for 20 marks, perhaps because it was at the end of the paper, or it is a different type of question they might not have seen before. Having said that most candidates were able to make the basic points under each option, but only the better candidates expanded to get higher marks. Some candidates got mixed up with costs and savings for the various parties.

[Paper Total 100]

END OF EXAMINERS' REPORT

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