

Subject SA4

Corrections to 2021 study material

0 Introduction

This document contains details of any errors and ambiguities that have been brought to our attention in the Subject SA4 study materials for the 2021 exams. We will incorporate these changes into the study material each year. We are always happy to receive feedback from students, particularly details concerning any errors, contradictions or unclear statements in the courses. If you have any such comments on this course please email them to SA4@bpp.com.

You may also find it useful to refer to the Subject SA4 threads on the ActEd Discussion Forum. (You can reach the Forums by clicking on the 'Discussion Forums' button at the top of the ActEd homepage, or by going to www.acted.co.uk/forums/.)

This document was last updated on **9 September 2021**.

1 Assignments

Assignment X3 Solutions

Question 2(iv)

The solution should read as follows:

(iv) ***Appropriateness of the transition programme***

General issues

The trustees are usually responsible for specifying overall guidelines for investment strategy but may wish to consult / agree the approach with the company. [½]

In determining the investment strategy the trustees should ensure the scheme assets are properly and prudently invested and take proper advice. [½]

The trustees must work within the scheme's trust deed and rules (*eg* any restrictions on the type of assets held), comply with legislation and consider any guidance issued. [½]

In order to consider the appropriateness of the transition programme, the trustees need to consider whether:

- the investment target (100% government bonds) is appropriate [½]
- the process to reach this target is appropriate. [½]

The trustees may wish to ensure that the assets are / will be sufficiently diversified within each asset class (*eg* an equity portfolio might include overseas equities). [½]

Investment target

The transition programme aims to move to a matched position on the buy-out basis ... [½]

... by investing in long term government bonds with an appropriate balance between conventional and index-linked bonds to reflect pension increases under the scheme ... [½]

... so the target is consistent with the trustees' objective to buy out the liabilities. [½]

Process to reach the investment target

The process should reflect the method by which the buy-out position is expected to be improved ... [½]

... in particular the balance between improving the buy-out position through additional company contributions and through investment returns in excess of those reflected in the buy-out basis. [½]

The process involves a move to a 100% government bond policy in four stages ... [½]

... assuming the scheme currently holds 20% of assets in government bonds. [½]

The trustees should consider whether it would be better to have a different number of stages than four as: [½]

- more stages may result in faster movement towards the target [½]
- fewer stages may result in lower expenses. [½]

The process to reach the investment target can be set by switching assets:

1. at given time points [½]
2. when it is beneficial to do so given investment markets, such as when the price of equity is considered high and the price of government bonds low [½]
3. each time a test relevant to the investment target is met, as for the proposed transition programme. [½]

The assets to be switched can be set as a percentage of the assets or a fixed or changing amount. [½]

The advantages of the third / proposed approach include:

- it ensures the process is tailored to the overall aim, *ie* having sufficient assets to buy-out [½]
- equity investment is maintained until the overall aim is met which may result in the aim being met more quickly due to the higher expected returns [½]
- if the buy-out test (that would trigger an asset switch) is met, the assets and the liabilities become more closely matched. [½]

Problems with this approach arise if:

- the buy-out test is not set appropriately [½]
- the test is seldom met; the investment target may never be met or it may take longer than desired for it to be met ... [½]
- ... *eg* due to poor equity returns. [½]

Term to reach target

The trustees may wish to target a fixed term (or maximum term) to reach the agreed investment strategy. [½]

The shorter the term, the less equity investment risk taken by the scheme ... [½]

... although higher company contributions may be required which may be unacceptable to the company. [½]

Cashflow

The most efficient way to reach a given strategy is often by using new money to invest in the assets where the trustees wish to increase their holding. [½]

In this way there are no transaction costs from switching between assets. [½]

Since the scheme is closed to new entrants, contributions will have reduced. The scheme may therefore have a negative net cashflow position (and the position will worsen over time) and therefore this may not be possible. [½]

Additional contributions may now be required to eliminate the deficit and this will increase cashflow ... [½]

... which can be used to invest in government bonds. [½]

Aligning the funding strategy to the investment target

The trustees should consider directly aligning the contribution strategy to the investment target such that employer contributions will increase if the buy-out position worsens. [½]

The features of this approach are:

- benefit security is improved as the risk of a reducing buy-out funding level is reduced [½]
- employer contributions may be volatile and required at unexpected amounts and times which may not be acceptable to or affordable by the employer. [½]

Other actions to help to reach the buy-out target

The trustees should consider other actions which may improve the likelihood of reaching the buy-out target, such as:

- buying in the pensioner liability if terms are advantageous [½]
- incentive exercises, such as enhanced transfer value options for deferred pensioners. [½]

Monitoring the programme

The transition programme needs to be monitored and updated if the situation changes materially. [½]

Effective controls need to be put in place, including the assessment of the risks. [½]

Flexibility / controls

It may be advisable to build some additional flexibility or controls into the transition programme, for example ... [½]

... an adaptation of the second approach such that equity assets can be sold when values are high in order to lock in good returns ... [½]

... and equity assets cannot be sold when values are depressed. [½]

The quality of the investment managers may determine how much discretion the trustees are willing to grant them. [½]

[Maximum 15]

Assignment X4 Questions

Question 3

The actuarial liability of the deferred pensioners at the current valuation should be given as $90m$ (not $100m$).

Assignment X4 Solutions

Question 3(i)

Assumptions

The final point should read;

The total surplus at the current valuation is $570m - 300m - 90m - 190m = (10)m$. [½]

Salary increases

The penultimate point should read;

So that the total salary item is $(8.6)m + 0.9m = (7.7)m$ [½]

Final page

Page 18 should then read;

Hence we have:

Surplus brought forward	46.3m	
Investment returns	(26.6)m	
Salary increases	(7.7)m	
Contributions	(5.2)m	
Pension in payment increases	(18.8)m	
<u>Pension in deferment increases</u>	<u>0m</u>	
Total	(12.0)m	[1 for summary]

These items total to an expected deficit of $12m$, compared with an actual deficit of $10m$. [½]

We do not have enough information to analyse the sources of the remaining $2m$ although it appears that we are close enough not to further refine the calculations. [½]

[Maximum 9]