TREASURY, RISK AND FINANCE PROFESSIONALS

CPD Spotlight Quiz - Solutions

Pensions Risk (June 2007)

Question 1

Answer

The right answer is (d) £1,000 million

There were three key factors increasing the deficit estimation: mortality, revised estimates of rates of return on investments and the lower quality covenant of the new scheme sponsor.

Financial Times, April 30th – May 3rd
http://www.thepensionsregulator.gov.uk/mediaCentre/pressReleases/pn07/pn07-07.aspx

Question 2

Answer

The right answer is (a) Pensions Act 2004

The requirement is a legal requirement rather than a recommendation in a Code of Practice. In helping to enable trustees to comply The Pensions Regulator has, in May, posted the final module of its e-learning programme to the trustees toolkit website at www.trusteetoolkit.com Although this completes the toolkit, the regulator is planning further modules to cover related areas.

http://www.thepensionsregulator.gov.uk/mediaCentre/pressReleases/pn07/pn07-09.aspx

Question 3

Answer

The right answer is (c) a sponsor returning significant capital to shareholders

This is an example of a financial transaction which is financially detrimental to the ability of a defined benefit scheme to meet its pension liabilities. Such events should trigger "clearance" from the regulator.

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http://www.thepensionsregulator.gov.uk/mediaCentre/pressReleases/pn07/pn07-07.aspx
http://www.thepensionsregulator.gov.uk/pdf/clearanceGuidance.pdf

Question 4

Answer

The right answer is (c) assurance not to use anti-avoidance powers in relation to a transaction.

The regulator has powers to require contributions to be paid to the scheme trustees under these "anti-avoidance" powers.

http://www.thepensionsregulator.gov.uk/pdf/clearanceGuidance.pdf

Question 5

Answer

The right answer is (d) £1,496 million

If the current pensioners were to live forever, then (b) would be the right answer, calculated by next years payment (£102m) divided by the discount rate less the growth rate (5% - 2% = 3%).

If the perpetuity formula were applied incorrectly using the current payment of £100m, then (a) would be calculated.

However, the current pensioners will not live forever. If the average life expectancy is 20 years, then we need to deduct from the perpetuity the PV of all payments after year 20, so we deduct the perpetuity whose first cash flow is in year 21. The first cash flow is 100×1.02^{21} = £151.5666. The perpetuity value (in year 20) is 151.5666 / 0.03 = 5052.2. The PV of this is £1,904.1m. Deducting this from our initial figure gives £1,496m. Incorrectly using the first payment of the perpetuity to be deducted as year 20 (rather than year 21) would give answer (c).

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Question 6

Answer

The right answer is (c) 3.5%

As for the previous question the liabilities with a 20 year life expectancy amount to £1,496m. If the figures are reworked using a 21 year life expectancy the liability rises to £1,550m, an increase of 3.64%.

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