4-6 Questions

2. Major Funds in the UK

Objectives of funds

Maximising returns	Meeting liabilities
Defined contribution pension scheme	Defined benefit pension scheme
Collective investment scheme	Life assurance company
Investment trust company	General insurance company

Liability driven investment (LDI)

- Matching cash flows to liabilities (dedication)
  - Use of fixed-income securities
- Implication of real liabilities
  - Index-linked securities and equities
- Mixed approach, for example
  - Less than five years – cash matched
  - More than five years – increasing holding of equities and index linked securities

Further information

Types of fund

- Pension fund
- Insurance companies
  - General
  - Life
- Collective investment schemes
  - Unit trusts
  - Investment companies with capital (ICVC) or open-ended investment companies (OEICS)
- Investment trust companies
  - Venture capital trusts (VCT)
  - Real-estate investment trust (REITS
- Hedge funds
- Private equity

3. Pension Funds

Types of pension schemes

- Personal private pension plan
  - Stakeholder pension
- Occupational pension scheme
  - Defined benefit (guaranteed scheme)
  - Defined contribution (money purchase scheme)

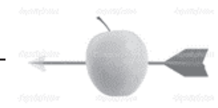
Occupational pension schemes

- Sponsoring company
- Members/Beneficiaries
- Approval by HMRC
  - No income or capital gains tax liabilities
- Trustee
- Investment manager

Keeping on target

Which of the following is FALSE concerning Defined Benefit pension schemes?

A: Final Salary schemes in the UK are the types of defined benefit schemes
B: The Risk of the investments not being enough to satisfy pension liabilities lies with the sponsor (employer)
C: Where the PV of the plan assets is less than the PV of the liabilities, the fund is said to be in surplus
D: Both the Employer and Employee may contribute to the fund



Hints

The largest institutional funds in the UK are pension funds, followed by insurance funds, unit trusts and then investment trust companies.

3. Pension Funds

Setting up the OPS

- The statement of investment principles includes:
  - Type of investments
  - Risk and how the risks will be managed
  - Realising investment
  - Whether and how any rights will be used

Scheme specific funding requirement

- Included in the statement of investment principles
- Trustees required to:
  - Prepare a statement of funding principles, explaining how the statutory funding objective will be met
  - Obtain regular actuarial valuations and reports
  - Prepare a schedule of contributions
  - Put a recovery plan in place for when statutory funding objective is not met

Hints

The statement of investment principles must be reviewed at least every three years.

Answer to the question on the previous slide:
C: Where the PV of the plan assets is less than the PV of the liabilities, the fund is said to be in surplus

3. Pension Funds

Pensions regulator

- Objectives
  - Protect members of work-based schemes
  - Reduce risk of compensation claims
  - Promote good administration in schemes
  - Maximise employer compliance
  - Empowered by Pensions Act 2004

Pension protection fund (PPF)

- To provide compensation to members of eligible defined benefit schemes on insolvency
- When a scheme is insolvent, then PPF will provide:
  - Up to 100% of benefits to existing pensioners
  - Up to 90% of benefits to those not yet retired
- Funded by levies on all defined benefit schemes

Further information

The Pensions Regulator has powers to act where it believes that an employer is deliberately attempting to avoid their pension obligations, leaving the Pension Protection Fund to pick up their pension liabilities. To protect the benefits of scheme members, and to reduce the Pension Protection Fund's exposure to claims for compensation, the Regulator may issue any of the following:

Contribution notices. Where there is a deliberate attempt to avoid a statutory debt, those involved must pay an amount up to the full statutory debt, either to the scheme or to the Board of the Pension Protection Fund.
Financial support directions. These require financial support to be put in place for an under-funded scheme.
Restoration orders. If there has been a transaction that under-valued the scheme's assets, the Regulator can take action to have the assets (or their equivalent value) restored to the scheme.

4. Insurance Companies

Insurance companies

- Products:
  - Term assurance
  - Whole of Life
  - Endowment
    - Basic sum assured on death or maturity
  - With profits
    - Basic sum assured plus opportunity of bonuses
      - Reversionary
      - Terminal

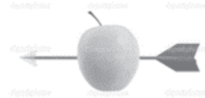
5. General Comments

	Young pension fund	Mature pension fund	Life assurance company	General insurance company
Investment horizon	Long-term	Short-term	Long-term	Very short-term
Attitude To short-term risk	Positive	Negative	Positive	Very negative
Liquidity	Low	High	Low	Very high
Liabilities	Real	Real/Nominal	Nominal	Nominal
Asset choice	Equities Property I-I gilts	Bonds	Equities Property Bonds	Cash Money market instruments

Keeping on target

Compared with life assurance funds, general insurance funds normally:

A: Hold shorter term assets
B: Hold more equities as a proportion of total assets
C: Have much longer liabilities
D: Hold less liquid assets



Further information

Many defined benefit schemes, have switched away from equities towards bonds. A number of schemes have adopted liability-driven investment (LDI) strategies that involve not just a switch to bonds but the use of swaps and other derivatives to more accurately match assets to liabilities.

Hints

Funds that do not pay tax, such as charities and pension funds should consider the implications of investments where tax is taken at source. For example, lost interest while waiting to reclaim tax.