



SOUND NAVIGATION UNCHARTED WATERS

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Unit Pricing – I thought we’d done that?”

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The views expressed in the paper are the Author’s alone and do not necessarily accord with those of his employer – Kiwibank Limited

Unit Pricing – I thought we’d done that?”

- Rearing its head again - KiwiSaver
 - Capital Market Development Taskforce
 - MED “Review of Securities Law” discussion paper
- What is an error
- What is material
- FSC(formerly IFSA) / APRA
- NZSA
- Fixing errors – a generalised approach

Capital Market Development Taskforce

- Reported Dec 2009 – Chairman Rob Cameron
- “Require funds to establish entry, exit and unit pricing rules that are fair to all investors, and disclose these to investors. This could be achieved through self-regulation by industry bodies”
- Entry and exit → Buy/sell margin
- Self-regulation by industry bodies. Which ones?

Capital Market Development Taskforce

- “We believe that regulation should require the implementation of a unit pricing process that ensures equity among investors, and is carried out at a minimum frequency, possibly monthly. This process should be documented and made available to scheme members. Industry bodies can help to develop and promote best practice standards in this area”

MED “Review of Securities Law”

- “Fund managers have few incentives to invest in accurate pricing, and to adequately review pricing procedures.”
- “There are a number of issues regarding the treatment of pricing errors. There is no agreed industry wide policy as to how to deal with pricing errors. There is no regulatory oversight as to how these errors are treated by schemes or trustees and pricing error policies are not usually disclosed by schemes.”
- “it reduces the risk of a manager manipulating the unit price to serve their own purposes.”
- I think it is fair to conclude previous high profile negative publicity about unit pricing has found a receptive audience – hence the next slide

MED “Review of Securities Law”

- “The Ministry proposes that, in addition to the requirement to have a pricing methodology in constitutional documents, fund managers will be required to put policies in place on how they deal with pricing errors.”
- “Supervisors will be required to report to the Authority on breaches above a threshold set by legislation.”

Statutory Impacts

- “The Superannuation Schemes Act currently contains a whistle-blowing provision (section 18A) requiring any ... actuary or auditor of a scheme to disclose information to the regulator where they form the opinion there is a serious problem with the scheme.”
- Will unit price issues be a “serious problem” if other legislation requires remedial action?

Statutory Impacts

- Insurance (Prudential Supervision) Act 2010
- Actuaries and their risk management role

What is an error?

- Not as straight forward as it may seem
- Methodology okay but inconsistent with product disclosure
- Estimates later proven to be poor estimates may have been valid at the time (tax before PIE)
- Transaction costs – picked in more detail on next slide as an area not well understood

Transaction Costs

- Who pays?
- Single mid price – paid by fund
- Buy/Sell spread – any excess falls into the fund
- Net Buyer/Seller – how do you set the price?
- What is “Fair”?

What is material?

- What is a material error that warrants remediation?
- 2 reference points:
 - Financial Services Council standards (formerly IFSA)
 - ASIC and APRA “Unit pricing – guide to good practice”
- Error in unit price versus error in benefit value

Financial Services Council standards (formerly IFSA)

- IFSA Guidance Note No 4.00 - now repealed
“materiality is defined as 0.3% of the price of a unit”
- Error defined as % of unit price
- Introduced \$20 threshold

Financial Services Council standards (formerly IFSA)

- IFSA Standard No 17.00 - current
- Threshold is still 0.3% of the unit price but that is now a maximum
- Also introduces the concept of assessing the impact on an investor's value of benefits
- \$20 is now a maximum (if adopted)

APRA/ASIC

“Unit pricing – Guide to good practice”

- 0.3% of value
- Might need to be less than 0.3% in some cases eg a cash fund
- \$20 made an appearance in 2008 revision
- The “value” in question is not very clear – refer to paper for detail

0.3% value error vs 0.3% price error

- Value error has intuitive appeal to me
- But is not practicable - you have to do all the calculations to find out if you need to!
- 0.3% price error may lead to negligible value error
- Conclusion – the answer to what is material is not straight forward at all

NZSA

- The definition of a material error is not a trivial exercise
- Will we need to issue guidance for members (possibly just to clarify regulations)
- Who is going to work all this out?
- I believe we should be at the forefront of the debate – why?
- Understanding and experience

Fixing Unit Pricing Errors

- Identify the reason for the unit pricing error(s).
- Remedy the unit pricing process (and calculate prices on the current information).
- The date the unit pricing commences correctly ends the period of error(s).
- The first unit price correctly calculated at the end of the period becomes the accepted go forward unit price.
- Accepting the unit price at end of the period means there is no error from then on.
- Go back and recalculate unit prices as they should have been for the period (this can be completed without undue time pressure because the problem is now capped).

Fixing Unit Pricing Errors cont.

- Clients during the period of the erroneous unit pricing require individual assessment. The approach is to determine the value their holding would have had at the end of the period if the unit pricing error had not occurred (based on recast corrected unit prices) against the value determined from the unit price in use at the end of the period (which is now in use as the go forward unit price). Any difference in value for an in-force unit holder is measured in the number of units based on the unit price in use at the end of the period (the “go forward” unit price).

Fixing Unit Pricing Errors cont.

- For in-force unit holders any compensation due is effected by purchasing that number of units (from 8.) at the now current unit price when the remediation is effected.
- For unit holders who have left during the period any value owed can be rolled forward at an appropriate rate (could be the fund earning rate)
- Consideration can also be given to cancelling units if a client has benefited from the errors

Fixing Unit Pricing Errors cont.

- In summary the solution is based around fixing no. units as opposed to the unit price i.e. concentrate on the value to a customer (measured by units) not the unit price.
- This is an efficient approach because increasing the unit price to remediate unit holders' worse off makes those already better off even better off. The proposed approach reduces remediation costs.

Recasting Unit prices

- Can never be a perfect process – can't reconstruct history in different way
- Recasting of the unit prices is completed by recalculating for the error period what the NAV should have been on each day of pricing and then dividing this by the number of units on issue that day. The unchanged number of units can be used because of the method used to recalculate the NAV

Recasting Unit prices cont.

- Recalculating the NAV can be summarised as rolling forward a cumulative error adjusted for per period returns and unit movements and then using this error value to adjust subsequent NAVs.
- A novel feature is that per period returns are first approximated from the existing unit price series.
- An iterative process is then used to refine

Value Remediation

- Calculate the value unit holders would have had, had the error not occurred
- In-force unit holders worse off can then be remediated by (the fund manager) purchasing units and giving those units to affected unit holders thereby re-establishing the account value they should have
- Exited members owed money have the calculation done at time of exit

Finish

- Regulation coming
- Determining an error not a trivial exercise
- Issues for NZSA
- Methodology for determining remediation
- Questions?