EXAMINATIONS

19 April 2004 (pm)

Subject 402 — UK Fellowship Life Insurance

Paper Two

You must answer this subject only, you may not attempt another subject in the 400 series.

Time allowed: Three hours

INSTRUCTIONS TO THE CANDIDATE

1. *Enter all the candidate and examination details as requested on the front of your answer booklet.*

2. *You have 15 minutes at the start of the examination in which to read the questions. You are strongly encouraged to use this time for reading only, but notes may be made. You then have three hours to complete the paper.*

3. *You must not start writing your answers in the booklet until instructed to do so by the supervisor.*

4. *Mark allocations are shown in brackets.*

5. *Attempt both questions, beginning your answer to each question on a separate sheet.*

AT THE END OF THE EXAMINATION

Hand in BOTH your answer booklet, with any additional sheets firmly attached, and this question paper.

In addition to this paper you should have available Actuarial Tables and your own electronic calculator.

1 A UK mutual life insurance company sells a wide range of unit-linked and conventional with profits products. It uses asset shares to manage the payouts on its with profits policies. It currently increases the investment return credited to the asset shares of all with profits policies by 0.5% pa to reflect the profits earned on the unit-linked policies.

In recent years the volume of new unit-linked business has increased significantly. At the same time there has been a corresponding decrease in the volume of new with profits business. The company has decided to demutualise and put itself up for sale.

(i) Discuss the possible reasons for this decision. [15]

Two life insurance companies have made bids to buy the company.

Company A has offered an amount of £Xm. In return, the shareholders of Company A will receive all future profits from the existing unit-linked business and any new unit-linked business. The existing with profits business would be transferred into a new ring-fenced fund in Company A but the unitlinked business would be transferred into Company A's existing long term fund. No new with profits business would be accepted and the shareholders of Company A would receive $1/9^{th}$ of the cost of future bonus on existing with profits business.

Company B has offered an amount of £Ym. In return, the shareholders of Company B will receive all profits from any new unit-linked business. All the existing business would be transferred into a new ring-fenced fund in Company B. The profits from existing unit-linked business would continue to be used to enhance the payouts to existing with profits policies. No new with profits business would be accepted and the shareholders of Company B would receive no benefit in respect of the bonuses declared on existing with profits business.

(ii) Describe the investigations the mutual company would carry out and state any other factors it would consider in order to decide which bid to recommend to its members. [11]

It has been decided to recommend the bid from Company A.

(iii) Discuss the risks for the policyholders of the mutual company that may arise from this transaction. [12]

The mutual company is deciding on how much of the payment from Company A should be distributed as cash windfalls to its members and how much should be kept in the with profits fund and distributed over time as enhancements to asset shares.

(iv) Discuss the factors that the mutual company should consider when deciding what to recommend to its members. [17]

It has been suggested that the part of the compensation to with profits policyholders that is distributed as a cash amount should be split amongst them in proportion to asset share.

(v) Discuss this suggestion. [10]

[Total 65]

2 A UK life insurance company writes only unit-linked business. There is a wide range of unit-linked individual life and pensions contracts investing in internal linked funds run by the company. For each contract type, charges are levied by one or more of the following methods:

- A bid/offer spread.
- An annual management charge on the investment funds.
- An initial nil allocation period.
- An expense deduction from each premium (e.g. £2 per month).
- Allocation of a percentage (which may be more or less than 100%) of each premium to purchase units. The percentage invested in each policy year may not be the same for all durations, but the percentages are fixed at the outset of the policy.

Contracts designed many years ago are invested in funds with a fixed annual management charge. More recent contracts are invested in funds where the annual management charge may be varied at the company's discretion. No such variations have ever been made.

For some contract designs the expense deduction is fixed, for others it may be increased by up to the increase in the retail price index since the charge was last set, while for others the maximum increase is based on an earnings index. From time to time but not regularly, these charges have been increased to the maximum permitted by the appropriate index.

The Appointed Actuary is preparing the report he is required to make to the Board of the company detailing his interpretation of Policyholders' Reasonable Expectations ("PRE") and any other obligation to treat customers fairly.

Discuss the points you would make in the report under the following headings:

(i) PRE and treating unit-linked policyholders fairly. [5]

(ii) Investments and the determination of unit prices. [10]

(iii) Appropriate deductions for taxation in the unit pricing. [10]

(iv) The circumstances under which variable charges might be altered. [10]

No drafting style is required. [Total 35]

END OF PAPER