REPORT OF THE BOARD OF EXAMINERS

September 2003

Subjects 201— Communications

EXAMINERS' REPORT

Introduction

The attached subject report has been written by the Principal Examiner with the aim of helping candidates. The questions and comments are based around Core Reading as the interpretation of the syllabus to which the examiners are working. They have however given credit for any alternative approach or interpretation which they consider to be reasonable.

J Curtis
Chairman of the Board of Examiners

11 November 2003

EXAMINATIONS

September 2003

Subject 201 — Communications

EXAMINERS' REPORT

Question 1

Candidates were asked to draft a letter to a customer to explain why the transfer value of their pension was unchanged, when the customer had expected it to increase. The main points that the examiners were looking for and some common problems encountered were as follows.

1. Candidates were expected to explain both the upwards and downwards influences on the transfer value. Candidates who explained the 25% shortfall without explaining the reasons underlying the rise from £24k to £32k missed a number of marks.
2. Some candidates stated the facts of increasing age and reduced investment return assumptions having the impact of transfer values, but did not explain this. More marks were received for better explanations which drew out the logic of reduced investment returns received , and then explained the rationale that more funds would be required today.
3. Candidates who linked the 25% reduction in transfer value to the 25% scheme shortfall gained marks. Some candidates failed to make this clear. A small number of candidates lost marks because the reply was phrased to read that the 25% reduction in transfer values could or would contribute to reducing the shortfall for the remaining members.
4. Some candidates failed to gain marks because they did not differentiate between the recent history of poor investment returns, and the changed assumption of future investment returns. Other candidates made errors of referring to predictions of future returns.
5. A number of scripts were confused because they referred to both the £32k and £24k as the "transfer value". In other cases, scripts came to a conclusion that the transfer value had increased, before a new section then started to talk of the decrease. The better scripts either painted the picture of the opposing forces at an early stage; or used differentiated terms such as the underlying transfer value and the actual transfer value.
6. Better scripts gained marks by staying away from words which could be unfamiliar jargon to the customer. Complicated phrases of unusual words such as "changes to financial market conditions which impact on asset values" did not gain as many marks. Actuarial valuation liabilities, policies, defined benefit schemes – all were unnecessary to the reply and had the potential to confuse a customer.
7. The paragraph structure and headings were well drafted by some candidates. Some scripts lost marks because they returned to themes such as reduced investment returns several times over. Better headings were those which either referred directly back to topics mentioned in the introductory paragraph, and/or referred to main themes of the letter in familiar language to the customer. Some poorer letters had a couple of headings and then wandered into fresh territory without a further heading.
8. Most scripts gained good marks for the basic format of the letter. Many scripts also had good introductory paragraphs and summaries or conclusions. Some poorer scripts missed out on marks where the introduction consisted of more than one reiteration of the customer query. Most candidates gained marks for giving the customer the opportunity to ask further questions.
9. A number of scripts suffered from poor spelling, grammar and punctuation. In particular, a number of scripts confused "effect" and "affect".

10. The guideline length was 500 words. Scripts which were below 450 words generally missed out some of the explanation. Scripts which were longer than 550 often lost marks for including unnecessary repetition or irrelevant detail.

Question 2

Candidates were asked to draft a memo to a marketing manager who had questioned the design of a new product.   Many of the same broad themes apply to this memo as to question one. The main points specific to this question were as follows.

1. Some candidates had difficulty in demonstrating that the product was good value.   Some of the scripts reiterated details of the product but did not link this through to the marketing manager's question.
   Better scripts understood that the main point of the marketing director's concerns were about the value for money, and focussed the entire memo as an answer to this overall question.
2. Most scripts gave a good explanation of the basic workings of the product. Some scripts had confused explanations.
3. Better scripts gave a clear picture to the marketing director that the nature of the product was a loan and not an investment. There were several different ways of putting this across. Candidates missed marks for scripts that left the marketing manager unclear on why the £35k received was less than the £60k.
4. Some scripts inappropriately referred to Pension. Other scripts used unnecessarily technical words such as Time value of money.
5. Most candidates stated that the loan was not linked to the value of the property, and correctly drew out that if the house value increased, the customer retained all of the additional value.
6. Most candidates explained the rationale behind the tax rate clearly. Some scripts were confused and thus did not gain marks.
7. Most scripts gained good marks for the format of the memo, the introduction and summary or conclusion including the opportunity to ask further questions.
8. Better scripts made good use of paragraphs and headings. Some scripts were lacking in headings to paragraphs, or had inappropriate titles for paragraphs.
9. A number of scripts suffered from poor spelling, grammar and punctuation.
10. The guideline length was 500 words. Scripts which were below 450 words generally missed out some of the explanation. Scripts which were longer than 550 often lost marks for including unnecessary repetition or irrelevant detail.

Possible solutions to each question are attached. They do not cover all the possible points and are not intended to be model solutions. In practice a wide range of solutions was acceptable.

1 Ms J Brown
10 London Road
Anytown

Company Address

9 September 2003

Dear Ms Brown

XYZ Pension Scheme — Transfer Value

Thank you for your letter querying the transfer value recently quoted to you. You state that in June 2003, we quoted a value of £24,000 based on a pension of £1,300 p.a. payable on retirement at age 60. This is the same as that quoted in June 2000 when the pension was £1,200 p.a.

I confirm that both the values quoted were correct. This letter sets out why the transfer value has not increased despite the increase in your pension.

Transfer Value

A transfer value is the estimated sum required now to provide the pension payable when you retire. Generally, the higher the amount of pension, the higher the corresponding transfer value. As you stated, it is therefore reasonable to expect that the transfer value at June 2003 would be greater than at June 2000. However, in this case, the transfer value has not changed despite the increase in the pension. This is because:

- The XYZ Pension Scheme has a 25% shortfall and the Scheme's trustees have therefore decided that, for the time being, transfer values should be reduced.

However, there are two further effects that increase the amount of the transfer value which cancel out the reduction and mean that the transfer value has remained unchanged at £24,000:

- The assumptions used to calculate the transfer value have changed.
- Your age has increased.

These factors are explained further below.

1. Shortfall in the Scheme

As is the case with many pension schemes, lower than anticipated investment returns between 2000 and 2003 mean that the funds within the XYZ Pension Scheme are ¼ less than the total amount estimated to be required to provide the benefits offered by the Scheme for all its members. XYZ Plc has stated that it is committed to the scheme, and is currently considering how to address the shortfall. Until this has been made good, the trustees of the Scheme have decided that all transfer values should be reduced by ¼ to ensure that people leaving the scheme do not worsen the shortfall. The transfer value quoted to you has therefore been reduced by a quarter from £32,000 to £24,000.

2. Change in Assumptions

In calculating the sum required now to provide the pension payable when you retire, we need to make an assumption about future investment returns. This is saying that to provide the pension, we need to accumulate a certain amount of money by the time you retire. That amount of money comes in part from the funds available now and in part from future investment returns. So the lower the future investment returns, the greater the funds we need now — i.e. the transfer value — in order to provide the pension in the future.

As you may have recently read in the press, expectations for future investment returns have fallen in the last few years. Consequently, we have revised our assumptions and this has the effect of increasing transfer values.

3. Increase in Age

You are now three years closer to retirement than you were when the previous quote was issued to you. Of the total sum needed to provide the pension when you retire, rather less will therefore come from future investment returns, as there are fewer years left in which investment returns can be received. There is a corresponding increase in the sum that must already have been accumulated and that is reflected in current transfer value calculations. The effect of this is that, other things being equal, the transfer value rises as your age increases.

Summary

The increase in your pension, changes in assumed future investment returns and the increase in your age have all led to a higher transfer value. However, that increase has been cancelled out by the reduction now being applied to reflect the shortfall in the Scheme. Overall, the transfer value quoted in 2003 is the same as that quoted three years ago.

I trust this explains the position.

Please do not hesitate to contact me on 01234 567890 if you have any further questions.

Yours sincerely

A N Actuary

2 From: A N Actuary

To: A Marketing Director

Date: 9/9/2003

Home Value Release Product

Further to our recent conversation, I have prepared some notes to address the three concerns you raised relating to the value offered by the product. In particular :

1. The sums received by the customer in relation to the amount repayable.

2. The additional implications relating to possible future increases in property prices.

3. The impact of taxation on the annuity element.

Sums Received by the Customer

The key point here is that we are lending the customer £60,000 now, to be repaid only on his death. While he is alive, interest is payable at £3,000 each year (5% of £60,000) and, to ensure that he can meet the interest payments, £50,000 of the sum lent to him is used to purchase an annuity of £5,000, leaving him with a capital sum of £10,000 to spend as he wishes.

Another way to look at this is that the customer receives a capital sum of £10,000 now together with an annual income for life of £2,000 (i.e. what is left of the annuity after paying the interest) and, in return agrees that on his eventual death £60,000 will be repaid. In effect we are making payments as an investment in the expectation that they will be paid back later together with some additional investment return. So for this to be a fair arrangement, we expect the £60,000 eventually received to be more than we have paid out.

This might be contrasted with a situation where someone invests £60,000 at the outset and receives subsequent payments in return to total more than £60,000 if the arrangement is to give a fair investment return.

Implications of Increases in Property Values

The important point to note here is that although £60,000 is half the current value of the property, the amount to be repaid on death is fixed at £60,000 and is not linked to the property price. So, if the property were to increase in value to, say, £180,000, the amount to be repaid stays at £60,000. The customer therefore gets the full benefit of any increase in price.

Increases in property value do not, therefore, affect the value of this contract to the customer.

Impact of Taxation on the Annuity

In using a £50,000 sum to purchase an annuity of £5,000, we are allowing in our pricing for investment returns on the purchase price. Thus each annuity payment contains, in effect, some return of the original purchase price together with some investment return to the customer. Such investment returns are taxable in the same way as any other investment returns. The reduced rate of tax of 10% applied to the whole annuity is set to give the same tax burden as the full rate of tax would if applied just to the investment return element. So applying tax in this way does give a fair outcome.

I hope that this has helped to allay your concerns. If you have any further comments or questions, give me a ring on extension 4321.