EXAMINATIONS

28 September 2004 (pm)

Subject 201— Communications

Time allowed: 1½ 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 1½ 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. *Attempt EITHER question 1 OR question 2 but NOT BOTH questions.*

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 You work for a company which offers lump sum investment plans. Your team has recently been considering launching a new product where the lump sum is designed to provide a choice of continued investment or a regular income fixed for life. The details are as follows:

- From the start, the customer receives a monthly income at a level that they choose. Each income payment is paid for by cashing in part of the fund.

  Once the level is chosen it cannot be varied during the first 5 years. However, if the fund is ever insufficient to pay the next instalment of income in full, then the residual fund is cashed in to provide a partial lump sum payment and the plan ceases with no further income payments being made.

- At the end of the 5 years, the fund that is left becomes the start point for the customer to choose between 2 options:

  – Either, to select another monthly income level paid for by cashing in part of the fund for the next 5 years.

  – Or, an income that is fixed for life at a level determined by the company. Once the level is determined it cannot be varied under any circumstance.

- When a customer who has selected the first option reaches the end of a 5 year period, they again choose between the 2 options. This repeats every 5 years until either they select the second option, or the plan ceases.

For the first five years and for customers choosing the first option, the lump sum is invested in units of a fund of the customer's choice selected from the company's usual range of unit-linked funds, including equity funds, and the customer receives quarterly statements of the number of units remaining and their value. In the event of death the full value of remaining units is payable.

With the second option, the lump sum is used to purchase the fixed income. There is no quarterly statement of value. All payments cease on the death of the customer.

A senior manager has written to you as follows:

Memo to: Bob Smith
From: Jane Jones, Marketing Manager
Date: 2 August 2004
Re: New investment plan

Thanks for sending me the outline of the new investment plan. It seems to have great potential.

In addition to the options you have listed, one of my team has suggested an extra one: to have an income fixed for 5 years at the "income for life" level paid for by cashing in part of the fund each year. Then, at the 5 year point, to be offered the same set of choices again, but with a guarantee that, if they wish, they can continue the income at that level for life.

The customer gets the same payments as for the "income for life" option, but gets the benefit of greater choice.

Please can you give this some thought and advise on whether it would be possible to offer this as a straight alternative, or whether there might need to be some additional cost that we need to charge to the customer.

Your assistant, an actuarial student, has sent you the following comments:

- Jane has overlooked the impact of mortality, and the fact that once the plan is locked into the "fixed income for life" option, customers are given an average income level — so that those who die early cross-subsidise those who live longer.

- However the biggest problem is the significant mismatching risk, as the life annuity is backed by gilts and other fixed interest securities, whereas the other options remain fully invested in the customer's choice of funds — often our equity fund.
  Note that I've assumed there is no restriction on investments under the new option – there is no mention in Jane's note.

Draft a memo in reply to the manager of about 500 words.

Notes

1. You should ignore any regulatory constraints or tax considerations.

2. You need not consider the range of funds available for customers beyond the facts stated.

3. You need not consider the possible use of derivatives as a means of managing any mismatching risk.

2 As the customer services manager of a general insurance company, you have been dealing with an insurance claim for a particular policyholder. The facts of the case are as follows:

- The policyholder recently applied for £30,000 of home contents insurance cover, stating that this was the value of all of his home contents.

- Following a break-in at his property, the policyholder then submitted a total claim of £15,000. This comprised £14,000 for theft of contents and £1,000 for theft of cash.

- Your claims assessors visited the property after submission of the claim. They recommended a lower settlement offer than the original claim amount.

The policyholder received a letter from the claims assessors offering £8,750 as settlement for the claim. He has written to query the reasons why the offer is only for this amount whereas the claim he submitted was for £15,000. In particular, he has noticed that there is an "excess" mentioned on his policy document, and has asked whether this has been the cause.

Draft a letter in approximately 500 words explaining why the offer to settle the claim is lower than the original claim amount.

Notes

1. The policy's terms and conditions and documentation sent to the policyholder state the maximum insurance for cash to be £500.

2. Following their visit, the claims assessors have concluded that the policyholder's home contents were underinsured. The "true" value of the contents (excluding cash) should have been £50,000 and not £30,000 (as had been indicated on the application form). Therefore the claim amount for non-cash items has been reduced to 3/5ths of the claim, as only 3/5ths of the "true" premium has been paid.

3. A voluntary excess of £150 applies in the event of a claim. The settlement offer is net of this excess.

4. You need not consider the implications for the premiums paid or the correction of premiums for the future as a result of underinsurance. Additionally, you should ignore any possible issues relating to no claims discounts or bonuses.

5. You may assume that there were no other problems with the details provided on the application form or the claim form.

END OF PAPER