EXAMINATIONS

September 2004

Subject 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.

M Flaherty
Chairman of the Board of Examiners

23 November 2004

Question 1

Candidates were asked to draft a memo to a manager to explain the difficulties with a new proposed product option. The main points that the examiners were looking for and some common problems encountered were as follows.

1. Most candidates gained marks for a brief description of the new option.
2. Most scripts considered the impact of the investment funds, and that under the new option the customer could both have a guarantee (usually backed by fixed rate investments) and get the potential benefit of being invested in equities.
   Better scripts had a good a good explanation of the risks and potential impact from the customer being able to invest in an equity fund.
   Some scripts also gained marks for also describing how the new option also effectively gave a guaranteed price at which fixed rate investments could be bought at a future date.
3. Some candidates found it difficult to give a clear picture of how the "fixed income for life" was made possible because of the cross-subsidy between those living shorter and longer lives. Better candidates cover this point well, and then gave a clear explanation of the risks from anti-selection under the new option.
4. Some candidates lost marks because of the use of jargon. Technical words that were well explained were acceptable, although candidates who could explain the same point without technical words gained more points.
5. Some scripts lost marks by broad and incorrect generalisation. For example it was incorrect to state that every customer would get the same income for £10k of investment; as this ignored the impact of age.
6. Some candidates took the overall stance that the new option was impossible. Others took the stance that it was possible, but with significant changes and/or cost. Both of these were acceptable.
7. Candidates needed to point out the difficulties with new options whilst acknowledging the good intention of the manager, and not being totally dismissive of the manager's idea.
8. The paragraph structure and headings were well drafted by some candidates. Some poorer scripts used technical words or jargon within the headings. Some poorer scripts had a couple of headings and then wandered into fresh territory without a further heading.
9. Many scripts gained marks for good introductory paragraphs and summaries or conclusions. Some poorer scripts missed out on marks where the introduction was excessively long. Others missed out on marks where the summary included new materials. Most candidates gained marks for giving the manager the opportunity to discuss further.
10. A number of scripts suffered from poor spelling, grammar and punctuation.
11. 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.

A possible answer is attached. In practice a wide number of solutions were acceptable.

Memo to: Jane Jones
From: Bob Smith
Date: 10 August 2004
Re: New investment plan

Thanks for your memo of 2 August suggesting a new option for the forthcoming investment plan. We've looked at what the challenges and costs would be in offering it. Unfortunately, there are significant difficulties both with the investments and with the cost of guaranteeing the fixed level of income. These are explained below.

New option — how it works

The new option allows the customer a guaranteed income for life, whilst retaining the flexibility of an investment fund. I've worked on the assumption that there is no restriction in the choice of investment under the new option.

Investments

Under the current options, we expect most customers will initially invest in our equity fund. When customers subsequently choose the "income for life" option the fund is cashed in and we invest in fixed interest investments which are more suitable for backing the guarantees.

If customers are allowed to remain within the equity fund whilst having the guarantee, this could lead to losses. If the stockmarket were to fall in value, then the fund could be far lower than was required to pay for future income payments.

Secondly, we would not have invested in the fixed interest investments that are suitable to back the guarantee. There is a risk that these become more expensive by the time that customers move to the original "fixed for life" option.

Cost of guaranteeing the fixed level of income

Under the original proposal, customers are either in the "fixed for life" or "no guarantees at all" situation. We use this to keep the costs down. This is probably best described by way of an example.

If 100 men reach the option point at age 70:
  50 choose to keep their funds;
  50 switch to a guarantee for life.

If in the next 5 years, 5 die in each group, then:

- For those who have kept their funds, the remaining value is payable.
- For those who have a guarantee for life, nothing further is payable. The total of all funds is now available to pay for the survivors. Effectively each of the 50 get a guaranteed income level based on the fact that, if they are one of the longest to live, they will get the benefit of the funds from those who have died earlier.

If customers were to get both the guarantee of the income for life and the fund value, this would be costly. We could make a charge to cover that cost, which would reduce the value of the remaining funds and might well make such a combined option rather less attractive.

Conclusion

While the new option you have suggested sounds great for customers, looking at the detail, the challenges of the investments and the cost of guaranteeing income make it impractical. However, I believe that there may be some further alternatives that may be worth exploring. I shall give you a call so that we can meet to discuss this further.

Regards,

Bob Smith

Question 2

Candidates were asked to draft a letter to a customer explaining the amount that they had been offered in settlement of their insurance claim, and to explain how the policy excess worked.

1. Better scripts were clear in stating that the impact of the policy excess was small compared to the overall reduction in the claim amount, and that under-insurance was the main cause.

2. The policy excess was explained well by a good number of candidates. Most scripts were clear that the excess was a deduction from the amount payable. Some incorrectly stated that the customer made a payment of the excess amount.

3. Better scripts clearly and simply stated the impact of the maximum limit of £500 cash. Some scripts seemed to put a number of sentences in the reply, which usually seemed repetitious and sometimes confusing.

4. Good explanations of the impact of underinsurance were found in some scripts, but some scripts struggled on this point. The better scripts left customers clear that a proportion of every item in their house was covered. With some scripts, there seemed to be scope for the customer to think that the items that were stolen were worth less than the amount insured and therefore to still think that they should be covered.
   Some scripts based their explanation that not everything was covered on the fact that the insurance company's profits could be eroded. This is factually correct – but as the main or only explanation, seemed unlikely to convince the customer.
   Scripts that suggested that the company could go bankrupt by paying claims in full also lost marks.

5. Explanations on underinsurance also started to introduce technical terms, such as "level of risk exposure", "declared policy value"

6. Some scripts lost marks for implying that the customer may have deliberately underinsured, or that the customer should have already read that the maximum cash was £500.

7. Better scripts talked consistently about 3/5ths, or alternatively talked consistently about the 2/5ths. Other scripts used 40p in the £1, which again conveyed the message successfully.

8. Most scripts clearly stated how the overall claim offer was made up from the 3 constituent parts.
   A few scripts instead clearly stated how much was lost due to underinsurance, excess and cash.
9. Most scripts gained good marks for the format of the letter, the introduction and summary or conclusion including the opportunity to ask further questions. Some scripts lost marks for having an introductory section that was overly long. Some of the better scripts had a short introduction, with a summary of the query and a sentence or short list of what the letter would cover.
10. Better scripts made good use of paragraphs and headings. Some scripts were lacking in headings to paragraphs, or had inappropriate titles for paragraphs. Scripts that divided into the 3 headings (value of contents, cash, excess) gained marks for clarity. Some scripts seemed to muddle these things together.
11. A number of scripts suffered from poor spelling, grammar and punctuation.
12. 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.

A possible solution is attached. It is not intended to be a model solution. In practice a wide range of solutions was acceptable.

<Address>

Date

Dear <policyholder>

Home Contents Insurance Claim — Policy number AB123XY

Thank you for your letter of <date> in connection with the reduction in your claim on your home contents insurance policy.

In your letter you queried the rationale for the offer of £8,750 as settlement of your claim even though you submitted a claim for £15,000. You also asked whether this might be due to the policy excess. In this letter I will explain why the £8,750 offered is less than the amount you claimed and how the policy excess works.

Why the £8,750 offer is less than the amount you claimed
This offer is lower than you expected due to the following reasons:

- the value of your home contents was estimated to be £50,000 whereas you insured them for a sum of only £30,000
- the policy restricted the amount payable for loss of any cash at home to £500
- the claim payment has been reduced further by the policy excess of £150

These reasons are explained in greater detail below.

Value of the contents
When applying for the insurance cover, you indicated on the policy application form that the contents of your home were worth approximately £30,000.

Following submission of your claim, our claims team visited your house to establish the insured value of the contents stolen. Their assessment of the total value of all the insured items was £50,000.

This suggests that, at the time the policy commenced, you insured only 60% (three-fifths) of the real value of the contents of your home and hence your contents were not fully insured. We have therefore reduced the claim amount for the non-cash items by the same proportion as the difference in the level of cover. So, although you have lost £14,000 of value, only three-fifths is covered by the insurance, giving an insurance value of £8,400.

Policy restriction on cash
Your policy documents show that the maximum payment for loss of cash is £500. Of the £15,000 claim you submitted, £1,000 was in respect of cash stolen. In accordance with the policy restriction, we have limited the claim for loss of cash to £500.

Policy Excess
Your policy has a £150 excess. This means that you bear the first £150 cost of any loss. So £150 has been deducted from the amount payable to you. The purpose of the excess is to make the premium lower than it would have been without an excess. This is because the insurer pays out less, and does not pay out at all for small claims below the limit.
The policy excess was set up when your policy commenced and is shown in your policy document.

How the £8,750 has been calculated

Your total insurance amount payable is therefore:

	£8,400	in respect of non-cash items,
plus	£500	in respect of cash,
less	£150	policy excess

giving a total of £8,750.

I hope this has clarified why the payment offered is less than your claim amount and how the policy excess works. I should be grateful for your confirmation that you accept the offered amount of £8,750. I will then arrange for the payment to be made.

If you have any further queries, please do not hesitate to contact me at the above address.

Yours sincerely

A N Other
Customer Services Manager