Faculty of Actuaries **Institute of Actuaries**

EXAMINATIONS

April 2000

Subject 201 — Communications

EXAMINERS' REPORT

Candidates were asked to draft a letter to a client explaining the workings of an 'educational expenses' plan and the reasons for the differences between two quotations. This report summarises the main points the examiners were looking for, and some common problems encountered.

1. The question asked for a business letter written to a layman. This meant that it should neither be too informal nor full of unexplained jargon. Terminology such as 'annuity certain' and 'yearly in advance' lost marks.

2. Candidates were required to understand and use the information given. Quite a few suggested that charges were deducted as a percentage of each contribution, even though the question clearly stated that they were based on the fund value. It was also commonly stated that the client should choose the company whose assumptions she agreed with, even though the question said that she was able to choose a different contribution level, and so the choice of company was largely independent from the quote. Many candidates failed to mention charges in their letters.

3. While a variety of approaches was possible, solutions were generally clearer if they approached the explanation from the viewpoint of the plan-holder. This is that contributions are paid and invested for 10 years, after which a guaranteed income is bought. Many candidates started by trying to explain the way in which the insurance companies calculated their recommended contributions, which was often confusing.

4. The examiners expected letters to make it clear that the contributions suggested were based on assumptions, and that the contribution suggested by Company A carried the greater risk of the eventual income being lower than £5,000 a year.

5. It was not expected that grammar, spelling and punctuation would be perfect, but a lot of candidates lost marks because the standard of these was poor.

6. The guideline length was 450-550 words, but many letters were much longer than this. These generally lost marks for being repetitive and containing irrelevant material.

A possible letter is included with this report. It does not cover all the possible points, and is not intended to be a model solution. In practice a wide range of solutions was possible.

Mrs A Smith
100 High Street
Anytown

11 April 2000

Dear Mrs Smith

Educational Fees Plans

Thank you for your letter enclosing quotations for the two educational fees plans you are considering. In this letter I will explain the mechanics of the plans, and the effect of varying the assumptions made on growth and interest rates.

How the plans work

As you know, the purpose of these plans is to provide a regular income to help with education expenses. Both involve you making contributions for 10 years, after which they provide an income for 8 years.

During the first 10 years you pay the same amount into the plan at the start of each year. This is added to the existing value of the plan, and the company then subtracts 1% of the total as charges. The amount remaining is invested on the stock market to provide a lump sum at the end of the 10 years.

At that point the company takes the lump sum which has built up, deducts a further 4% as charges, and uses the remainder to buy a guaranteed income for you. This income is paid at the start of each of the next 8 years. After 10 years you will know exactly what income you will receive, but there are no guarantees before this.

The effect of the assumptions

In arriving at the suggested contribution both companies have made assumptions about the future. It is differences in these assumptions that have led to one company recommending a lower contribution than the other.

The first assumption is the return the company might earn on its investments. The return is in no way guaranteed, and the value of your investment could go down as well as up. If the overall return over the 10 years is less than assumed, the amount available will be less than shown in the illustration. Company A have taken a more optimistic view of the possible returns than company B. If you pay their suggested contribution you run a higher risk of having inadequate funds to buy the income you need.

The second assumption is the terms available when you use your plan to buy a guaranteed income at the end of 10 years. These will depend on interest rates then, and again are not guaranteed in advance. Your chosen company will buy investments to enable it to provide the income it guarantees. The cost of these investments falls as interest rates rise, enabling the company to guarantee a higher amount. Again, Company A has been more optimistic than Company B in its assumptions, so the risk of not being able to buy sufficient income is higher if your contribution is based on the assumptions from company A. If the companies were to achieve the same investment returns, the income you would receive from each would be identical.

Conclusion

The different suggested contributions arise only because of the different assumptions. You must decide what you wish to pay based on the risks involved and what you can afford. We can discuss this, and factors affecting your choice of company, when we next meet. In the meantime if you have any questions please feel free to get in touch.

Yours sincerely

J Brown