INSTITUTE AND FACULTY OF ACTUARIES

EXAMINERS' REPORT

April 2018

Subject CA1 – Actuarial Risk Management

Paper Two

Introduction

The Examiners' Report is written by the Principal Examiner with the aim of helping candidates, both those who are sitting the examination for the first time and using past papers as a revision aid and also those who have previously failed the subject.

The Examiners are charged by Council with examining the published syllabus. The Examiners have access to the Core Reading, which is designed to interpret the syllabus, and will generally base questions around it but are not required to examine the content of Core Reading specifically or exclusively.

For numerical questions the Examiners' preferred approach to the solution is reproduced in this report; other valid approaches are given appropriate credit. For essay-style questions, particularly the open-ended questions in the later subjects, the report may contain more points than the Examiners will expect from a solution that scores full marks.

The report is written based on the legislative and regulatory context pertaining to the date that the examination was set. Candidates should take into account the possibility that circumstances may have changed if using these reports for revision.

Luke Hatter
Chair of the Board of Examiners
July 2018

A. General comments on the *aims of this subject and how it is marked*

1. The aim of the Actuarial Risk Management subject is that upon successful completion, the candidate should understand strategic concepts in the management of the business activities of financial institutions and programmes, including the processes for management of the various types of risk faced, and be able to analyse the issues and formulate, justify and present plausible and appropriate solutions to business problems.

2. This subject examines applications in practical situation of the core actuarial techniques and concepts. To perform well in this subject requires good general business awareness and the ability to use common sense in the situations posed, as much as learning the content of the core reading. The candidates who perform best learn, understand and apply the principles rather than memorising the core reading.

3. The examiners set questions that look for candidates to apply the principles specific to the situation set out in the questions, having read the question carefully. Many candidates gain few marks by writing around the subject matter of the question in a more general fashion. Detailed specialist knowledge is not required and nor is very detailed development of particular points.

4. Good candidates demonstrate that they have used the planning time well to understand the breadth of the question and to structure their answer – this is a big advantage in making points clearly and without repetition. This also enables candidates to use the later parts of questions to generate ideas for answers to the earlier parts.

5. Time management is important so that candidates give answers to all questions that are roughly proportionate to the number of marks available.

6. The comments that follow the questions concentrate on areas where candidates could have improved their performance. Candidates approaching the subject for the first time are advised to use these points to aid their revision.

7. Candidates who give well-reasoned points, not in the marking schedule, are awarded marks for doing so.

B. General comments on *student performance in this diet of the examination*

- The standard of the answers to Paper 2 was stronger compared to other sessions. Better candidates planned out their answers, particularly for the longer questions and were rewarded because there was less duplication in their answers and they ensured they thought widely enough to score well.
- As per previous sessions answers to the application questions were mixed in that those that were structured scored well, whereas those that weren't had problems getting sufficient depth into their answer
- It was clear that the candidates producing well thought out answers had planned them better; this is a good use of reading time.
- In this diet the scoring for the exam was done out of 200 and therefore the mark scheme shows a total of 200 marks available for the paper.

C. Pass Mark

The Pass Mark for this exam was 59.

Solutions

Q1 **Financial reinsurance** has the main aim of exploiting some form of regulatory arbitrage in order to more efficiently manage the capital, solvency or tax position of a provider. [3]

Securitisation involves converting an illiquid asset into tradable instruments. The primary motivations are often to achieve regulatory or accounting off balance sheet treatment. [3]

Subordinate debt. A provider can raise capital through issuing subordinated debt in the capital markets. The repayment of the debt is only guaranteed after the policyholders' reasonable expectations have been met. The main aim of subordinated debt is to generate additional capital that improves the free capital position of the provider. [3]

Banking products:

Liquidity facilities which can be used to provide short term financing for companies facing rapid business growth or to more effectively manage risk e.g. to avoid forced sale of assets is stressed or illiquid markets. [3]

Contingent capital can be a cost-effective method of protecting the capital base of an insurance company. Under such an arrangement capital would be provided as it was required following a deterioration of experience (i.e. it is provided when it is needed). [3]

Derivatives. Prudent management requires that any provider entering into derivative contracts must exercise caution. The provider needs to ensure that its derivative strategy assists in the efficient management of its business and serves to reduce risk. An example of when a derivative contract might be used is when a provider is concerned about the impact of a fall in its equity values. [3]

Equity. An obvious source of capital is simply to increase equity, which increases assets without increasing regulatory liabilities. The equity may come from a parent company, from existing shareholders by a rights issue or directly from the market by a new placement of shares. [3]

Internal. There may be ways to simply reorganise the existing financial structure of an organisation in a more efficient way:
For example funds could be merged, valuation basis could be weakened, assets could be changed, business could be diversified, capital could be retained in the organisation by deferring the distribution of surplus or not paying dividends to any shareholders. [3]

Other. Reinsurance, ART or senior unsecured financing could also be used if these result in increasing the available capital. [1]

[Total marks available 25, maximum 12]

Generally well answered, although some candidates did not give a sufficient number of examples to score full marks

Q2 A European insurance company only operating within its domestic market is likely to only have one supervisor. [1]

If all business is written through one company this will have the least capital transferability and substitution constraints as all the capital will be within the one company. [2]

Some transferability and substitution constraints will exist where there is more than one company. However, a single supervisor will have responsibility to balance how it applies its regulations across all the entities of a group it directly supervises. [3]

If a company only operates in its domestic market it will have less diversification resulting in more volatile experience and relatively higher capital requirements than a more diversified insurance company such as a European insurance company with a North American insurance company subsidiary. [3]

Solvency II regulations apply to European insurance companies and European insurance groups. Solvency II will apply at group level across both the European insurance company and its North American insurance company subsidiary. [2]

The North American insurance company subsidiary will also need to satisfy the North American capital and solvency requirements. These requirements may well be different and may require different level of reserves and have different permitted assets. The local assets available to invest in may also be different. [5]

The North America regulations will be primarily concerned with the capital and solvency position of the US insurance company. [2]

The regulator will want to ensure that capital above standard capital requirements is maintained by the subsidiary so that the company can withstand a level of adverse experience without recourse to its parent. [3]

This means that capital above the standard capital requirement will be restricted reducing the capital available to the parent. [1]

In times of stress within the parent the capital that can be made available to the group may be further reduced as the North American regulator may take a more conservative approach on permitted dividends. [2]

In times of stress the transferability of capital within a group is reduced. The individual insurance company supervisors will prioritise the individual company they have responsibility over other companies within the group. [2]

The Solvency II capital standard has a different structure and form compared with the one operated by North American regulators. [2]

Whilst at group level the Solvency II standard recognises diversification between companies this can still contribute significantly higher marginal group capital requirements than the local North American capital standard. [2]

The relative behaviour of the capital standards will change over time due to their different design. [1]

The North American business, although similar, may be slightly different. The products sold may be different and the risks covered could be different. These would lead to different capital requirements. [3]

Currency issues my lead to different capital requirements e.g. mismatch reserve needed. [1]

[Total marks available 35, maximum 12]

Generally well answered; stronger candidates planned their answers and considered all angles rather than focusing on one specific point.

Q3 (i) The insurance company will need to build a model that will predict what it is expecting in the future. It is important that the elements of the expected profits are consistent in their own right. [2]

It is very likely that the insurance company already has a model that projects its profits, but the model will need to be adapted to reflect the expected future cashflows (the company is now closed to new business). [2]

In particular given the business is single premium annuity business, there will be no new premiums coming through and hence any projection in profit will come from changes in the expected experience of the business. [2]

The insurance company will need to consider the assumptions to be used in its model, and whether being closed to new business will affect these expected assumptions. [2]

Some assumptions will be unaffected (e.g. mortality) by closing to new business and therefore the approach to projecting the profits will be unchanged. [2]

The expense assumptions will need to be reviewed significantly as assumptions like commission and initial expenses will be significantly reduced but the per policy maintenance costs may increase at a faster rate now it is closed due to diseconomies of scale. [5]

Given that the business will be a closed book, the company will need to consider whether the model will need to be refined if the book is very mature and whether the assumptions will need to be revised because it is running off. [2]

Also the size of the fund and its expected position over the next three years will need to be considered in its assumptions as it may impact the capabilities to generate profits (e.g. restricted investment opportunities). [2]

The investment strategy may need to change – there may be liquidity issues. [1]

[Marks available 20, maximum 8]

(ii) The insurance company has closed to new business and therefore management will want to get the expense base controlled as quickly as possible. [1]

Management may want to accelerate the reduction in initial expenses by ensuring its sales staff are made redundant and will want to manage its redundancy costs. They will also want to reduce/make redundant as many of the staff responsible for setting up the business on the system as they can. They will again want to do this as quickly as possible (and will again look to manage costs). [2]

Commission would automatically be reduced as no new business. [1]

Will also need to reduce costs on other business functions e.g. could sell office buildings, move to smaller or cheaper premises. [2]

Need robust claims controls procedures e.g. check annuitants still alive. [1]

In terms of managing the back book, management will want to understand its options, i.e. it could be cheaper to outsource (or indeed offshore) elements of the managing of back books (e.g. operations, actuarial area) – will need to understand the relevant difference in costs. [2]

Management could not offer any salary increases to its staff, the savings on this would be dependent on the assumptions used in projecting its profits. [2]

Management will need to consider if they can increase investment income by potentially moving to more risky assets, but will need to consider the matching position and relevant regulations. [2]

It also may not be possible to invest in some assets if the size of business is in decline. [2]

If legislation allows, the insurance company could consider paying out transfer values to its policyholders. If this was done at a lower level than the reserves held then this would improve the profits of the company. [2]

Management could consider selling some of its back book to other insurers, with the aim of receiving a premium that exceeds the value of the reserves for the business that is being sold. [2]

Or indeed could consider its longevity reinsurance arrangements, which could lead to more profit. [1]

Management could also consider whether being closed to new business allows the company to adopt a more effective tax policy. For example, if it accelerates its redundancy programme for initial expenses does this help in terms of tax payments. [2]

If any of the benefits are discretionary (e.g. paying spouses benefits on death of policyholder) then management could not offer this anymore. [1]

Management could consider other assumptions (e.g. mortality) and remove any prudence – however the regulator may be able to object. [1]

Capital needed to support new business could be released. [1]

[Marks available 25, maximum 10]

[Total marks available 45, maximum 18]

This question was poorly answered.

> *(i)* *The stronger candidates focused on the specific question rather a general discussion and this scored better marks*
> (ii) *This was not as well answered as expected – again those candidates that considered in depth scored well.*

Q4 (i) (a) Scenario analysis

For each group of risks a representative plausible scenario is developed. [1]

For each scenario the consequences of the event occurring are calculated. [1]

A number of different scenarios may be considered. [1]

(b) Stress testing

Modelling of extreme changes and scenarios. [1]

Will be looking at correlations and volatilities which are observed to simultaneously increase during extreme events. [1]

Aim to identify weak areas by looking at effect of different combinations of correlations and volatilities number of different scenarios may be considered. [1]

Key area is constructing appropriate stress test scenarios. [1]

(c) Stochastic modelling

Variables are modelled using probability distributions. [1]

Dynamic interaction between variables. [1]

The result will be a distribution of outcomes. [1]
[Marks available 10, maximum 6]

(ii) The new stochastic model is likely to be more complex. It may model the company more accurately and allow for diversification and management actions so a lower capital requirement may be expected. The actuary will need to spend time understanding the new model. [5]

The actuary may have previously worked for a company carrying out different business with different types of policies and policyholders and/or operating in different countries. This may explain why the results are different from those he expected. [3]

The actuary will need to find out more about the model to ensure he understands how it works. He could talk to his colleagues about the new model and also arrange to meet those responsible for developing it. He could go through the documentation and the assumptions made. [7]

He can check the data input and check for any obvious errors. Will also need to check the regulatory requirements for this model. [3]

The actuary could do sensitivity testing on the model to ensure that by changing an assumption has the desired effect to the results – this would improve the confidence in the model [2]

He could understand the reconciliation from the old model if there is one and also whether assumptions were refined as part of the modelling changes [2]

He should also ensure that he understands the business of the company well. [1]

This may give him enough information to be confident with the results. If this was the case, no further action would be necessary. [2]

The results will only be as good as the model used. [1]

If he still has concerns about the model then this may be the reason for the unexpected results. [1]
In this situation, he will need to talk to his boss. If she is happy with the model the actuary may need to recognise that this view is valid. [2]

He should consider any professional guidance. He could also take advice from the professional body. [2]

If he still not satisfied, he may need to take this further. [2]
[Marks available 33, maximum 14]
[Total marks available 43, maximum 20]

(i) *Most candidates knew this part of the course and answered the question well.*
(ii) *This question was generally well answered – with candidates focusing on a number of areas.*

Q5 (i)

- Set and impose professional standards [2]
- Serve the public interest and improve public confidence [1]
- Act as a trade body for its members [1]
- Co-ordinate research [1]

[Marks available 5, maximum 4]

(ii) Can be a drain on time, [1]
and cost extra money, [2]
for various stakeholders. [1]

Examples:

- professional body may take longer drafting/maintaining/disciplining the rules [1]
- members may take longer preparing and checking work [1]
- increased costs will get passed onto clients [1]
- who may consider the additional cost unnecessary/excessive [1]
- for example even straightforward work may need to be peer-reviewed in excessive detail [1]

Clients may decide to employ different professionals to do the same work instead (to get it cheaper/quicker), [2]

unless there are statutory limitations on who can do the work. [1]
Demanding rules might get rigidly adhered to, instead of judgment being applied, [1]
where the latter may have produced a better outcome. [1]
Demanding rules may be related to inflexibility/slowness to change to prevailing circumstances (so that poor advice may be given). [1]

And the professionals involved may be less inclined to seek innovative/improved approaches to their work. [1]

It may reduce the reputation of the profession. [1]

It may be more difficult to attract new members to the profession. [1]
[Marks available 18, maximum 8]

(iii) In his or her opinion [1]

Proper records have been kept for the purpose of the valuation of the liabilities. [2]

Proper provision for the liabilities has been made. [1]

The liabilities have been valued in accordance with any legislative rules [2]

The methodology and assumptions are appropriate for their valuation. [1]

The liabilities have been valued consistently with the assets, [2]

which in turn have been valued in accordance with the appropriate rules. [1]

(In his or her opinion) the premiums/contributions for future years will be sufficient to enable it to meet its commitments in respect of the contracts written, [2]

based on reasonable actuarial assumptions, [1]

and taking into account the free assets of the provider. [1]

A statement of the difference between the value of the provider's assets and its liabilities. [1]

He or she has complied with relevant professional guidance. [1]

[Marks available 16, maximum 10]

[Total marks available 39, maximum 22]

(i) *Candidates generally covered one or two of the main points but did not achieve full marks because they could not mention all of the relevant bookwork points*

(ii) *Generally answered well, but candidates needed to think of more than one reason to score well.*

(iii) *Generally answered well, but candidates needed to think of more than one reason to score well.*

Q6 (i)

Cover will be provided for different animals e.g. cattle and sheep as opposed to cats and dogs say. [1]

These animals will be kept in different locations and will be susceptible to different illness. [1]

Livestock animals may be covered as a herd. [1]

Whilst the basic perils covered will be the same, some will be a lot more important or have a different focus. [1]

Vet's fees would be a regular cost of business so not generally insurable at the routine level but higher than expected costs or emergency treatment would be. This would probably mean different terms and conditions. [2]

For example theft (cattle rustling), liability (damage if animals get loose) or cover linked to transport (to market say) will more significant risks. [2]

Give up to 2 marks for valid examples.

There may be cover for fertility guarantees. [1]

However, livestock is owned for business purposes. [1]

Therefore cover related to loss of profits will need to be provided i.e. loss on death or illness is more than just vet or funeral costs. [2]

Cover – sum insured may vary depending on number of young at any point in time [1]

Claims are likely to be a lot higher on average – livestock can be very valuable and costs of treatment per case would be more. [2]

For example vets would need to be called out in emergencies at unsociable times – weekends and nights. [1]

Claims may be more frequent or more expensive due to health and safety legislation. For example drastic action if illness breaks out or compliance with food safety measure – basically a legislation risk. [2]

Pet insurance will tend to cover lots of "small risks" whereas livestock will have fewer but "larger risks" – claims will be lumpier and more volatile. [2]

Livestock insurance will involve significant concentration risks. [2]

Illnesses will spread quickly amongst a herd and could easily contaminate other farms. [2]

[Marks available 24, maximum 10]

(ii) *We are asking for a description i.e. say what the problems are. We are not asking about how to mitigate or deal with them – (iii) covers this.*

The insurance company has no experience of writing this type of business. [1]

This type of business is materially different from the business it currently writes. [1]
Hence it will lack relevant expertise – the expertise it does have is not really that useful (ok in general but not in specifics). [2]

So, for example, it will need to familiarise itself will the specific legislative issues surrounding this business e.g. compulsory cover and any relevant regulations. [1]

Likewise, any data it has (e.g. claims experience) will not be of use when considering livestock insurance. [2]

The insurance company will have difficulty in obtaining suitable assumptions to be used for pricing and reserving. [2]

It is likely that new staff or retraining of existing staff will be needed. [1]

Capital will be needed to fund the expansion. [1]

As well as staff costs, there will be office, systems costs – existing infrastructure probably won't be sufficient. [2]

As a small company, they may not have the reserves to be able to finance this and they may also struggle to raise outside finance at a reasonable cost – e.g. if investors consider the expansion to be risky. [3]

Linked to this, is the issue of the different nature of the risk profile. [1]

Larger, more volatile claims may need higher reserves (e.g. statutory solvency), which the insurance company may not be able to provide – a form of new business strain. [2]

Similarly, the insurance company may end up being over-reliant on a few large policies say with large farms – this will increase volatility and the risk of non-renewal. [2]

The business is likely to be yearly renewable. There may be some new business strain but this may not be a big issue. [1]

However, any assumption of significant renewals may cause problems if they don't materialise. [1]

The insurance company must consider the marketability of the product and how it will attract the new business. [1]

It would appear that they have a limited sales force and contacts with potential policyholders. [1]

Clearly the owner of the vets practice sees an opportunity here. [1]

The insurance company may end up being over-reliant on this practice for its business (with pet insurance, more vets, more policyholders hence less dependence on external parties). [2]

This will have cost implications (commission to the vet) and a weakness in negotiating position. [1]

There may be a concentration risk by farm or location if the business is not well diversified. [1]

Will need to consider the competition in this market. [1]

Existing insurer's may cut rates or have strong relationships with policyholders so making entry difficult or expensive. [2]

There will be potential moral hazards once the insurance is in place. [1]

There will be volume risks if the level of business is not as anticipated. [1]
[Marks available 35, maximum 14]

(iii)

Reinsurance cover can help to mitigate the problems caused by the different risk profile i.e. potentially larger and more volatile claims. [1]

In particular, non-proportional reinsurance will control the impact of large claims – single or aggregate (a few large claims could be serious). [1]

Catastrophe cover may be especially useful given the concentration risk e.g. an outbreak of BSE. [2]

Proportional reinsurance may help the insurance company take on more new business than would otherwise be possible (by reducing capital needed). [1]

This may be important here since diversification across many farms and by location will help with the concentration risk. [2]

The use of reinsurance will involve the payments of premiums to the reinsurance company, which may have implications for liquidity and the ceding of profit as well as risk i.e. there are downsides as well. [2]

It is likely that some reinsurance companies will have experience of covering livestock risks. [2]

Hence they will have access to data and possess technical skills, which would be of use to the insurance company. [2]

For example, a reinsurance company may be able to provide training, second its own staff or help develop procedures (underwriting say), which will help set the new business up. [2]

But the insurance company will have to pay for this help directly or indirectly. [1]

Likewise, as this is a very niche market and product (quite localised) it is important to select a reinsurance company that has relevant data. [2]

The use of financial reinsurance may help with the insurance company's capital or financing needs. [2]
But care will be needed since the legal position may not be clear. [1]

A reinsurance company may have useful contacts with banks or other providers of finance who could help. [1]

As this is a specialist area of insurance, traditional reinsurance may not be readily available. Hence some forms of ART (discounted or integrated risk covers) may be useful. [2]

[Marks available 24, maximum 12]

[Total marks available 83, maximum 36]

(i) This question was well answered by most candidates

(ii) This part was well answered, with most candidates giving sufficient ideas to score well

(iii) *This was reasonably well answered, with the stronger candidates considering more than one point.*

Q7 (i) The policy would cover data breach costs. [2]

There will be costs involved in notifying customers of any breach and offering support to the small business and/or its customers. [2]

There will also be costs relating to any claims of infringement of privacy following a breach. [2]

Business interruption loss would also be covered. This would cover any loss of income if business has been interrupted due to a cyber-attack. [2]

Extortion may also be covered. If there has been an attempt made withhold access to data until a ransom is paid then advice may be offered and the ransom amount reimbursed. [3]

Hacker damage may also be covered. This would reimburse the costs of repair, restoration or replacement following damage caused by a hacker. [2]

[Marks available 13, maximum 8]

(ii) **The insurance company**

They will need to ensure that the product is profitable. This will be influenced by their chosen market, the capital they have available and expertise available. They will also want to make the product attractive to sell to customers. They will also want to avoid moral hazard. [5]

The product should not too complex as it may make it more difficult to sell (particularly if relying on outside agencies). [1]

Potential customers

Will want to ensure their needs are met in a cost effective manner. This will be influenced by their capacity to pay, the risks to be covered, the benefits that are needed and their attitude to financial risk. [3]

Actuaries

They will be involved in the initial costing of the product and the subsequent determination of provisions that will need to be held. They will also be involved in the design process through assessing the impact on the cost and reserves of any modifications to the benefit design. [3]

Lawyers

They will be involved in drafting the contracts to ensure that the company is not exposed to any more risk than intended. [2]

Accountants

They will be involved to ensure that the insurance company properly accounts for the income and outgo. [1]

Administrators

They will need to administer the policies. The more complex the product the greater the costs of administration will be. [2]

Regulators

Will want to ensure the product is fair and understood by customers and that the company holds sufficient capital. [2]

Reinsurer

Will want to assist the insurer in launching the product and make profit. [1]

[Marks available 20, maximum 8]

(iii) **Risk appetite**

The product will need to meet the risk profile of the intended purchaser. The risks involved will need to be clearly explained. Small businesses taking out this insurance are not likely to have a large appetite for this risk. [3]

The level and form of benefit

This will depend on the policyholders' needs, the risks to be covered and their ability to pay. These could include reimbursement of costs or losses as well as technical and practical support. May need to avoid the policy being too complex. [4]

Any options or guarantees that may be included

These will need to be charged for. There may be an option for additional support to be provided for any of the events in part (i). There could be a guarantee that insurance would still be offered in future years. [3]

Financing the benefits

These are likely to be annual policies so premiums will be received over the same time period that cover is provided. [2]

Assets to be held

These are short term policies, so short dated assets suitable. However, there may be some potential future claims due to legal action being taken over privacy issues so assets would be needed to match these liabilities. [2]

Charges

The charges to be levied will need to meet the costs incurred by the insurance company in setting up and managing the policies. [2]

Capital requirements

The capital requirements will depend on the riskiness of the product. This product may be very risky as it is a new product for the company and it is dealing in a relatively new risk which is likely to be changing. There may be little data and the data available may become out of date rapidly. [7]

Terms and conditions will need to be made very clear. Particularly as the insurance company will need to avoid moral hazard. [2]

The insurance company will also need to consider the potential profitability of the product, relevant regulation and legal requirements as well as the level of competition in this market. [3]

[Marks available 28, maximum 10]

(iv) (a) **For a large company**

The potential claims will be very much higher. [2]

Benefit may be in the form of a lump sum to allow the company to employ professionals to resolve issues involved. [1]

A large company may be able to negotiate better terms. [1]

Capital requirements may be higher and the insurance company will need to transfer some of the risk; reinsurance will important. [3]

Terms and conditions will need to be very clearly stated. A large company will have professionals involved in prevention so support offered may be at a different level. [3]

(b) **For individuals**

The individual claims are likely to be lower. [2]

It may be more suitable to pool risk. However, the events giving rise to a claim may not be independent. [2]

Charges on each policy may be higher. [2]

There may be a higher level of business so profit margins could be lower. [1]

The level and form of benefit may be similar but business interruption loss would not be needed and breach of privacy may be less of a focus. Identity theft due to online fraud could be needed and/or help with monitoring credit rating. [3]

Terms and conditions will need to be very clearly stated with responsibilities on the policyholder clearly laid out. [2]

A help line may be more of a focus for individuals. [1]

[Marks available 23, maximum 12]

[Total marks available 84, maximum 38]

(i) *This part was reasonably well answered with most candidates covering the areas of the product well.*

(ii) *This was reasonably well answered, with the stronger candidates considering all the stakeholders.*

(iii) *This was reasonably well answered, with the stronger candidates considering all the angles.*

(iv) *This part was answered less well – with few candidates picking up marks mainly because of insufficient depth and breadth in the answers.*

Q8 (i) Regulation will exist to protect the consumer. This can result in a regulatory requirement on providers of financial products to consider the interests of their customers and to treat them fairly. [2]

This is considered necessary because of the complexity of financial products, their long duration, and the financial impact that unfair treatment could have on customers. The financial provider has significantly more knowledge than the policyholder and could take advantage (e.g. selling a product that would not pay out). [5]

These problems are exacerbated by the fact that in many cases financial products and schemes have benefits or charges that can be varied at the discretion of the product provider. [3]

It is generally accepted that discretionary benefits and charges should not be too dissimilar from those customers were led to believe that they would receive when they entered into the contract or transaction. [2]

Without regulation to treat customers fairly there may be reduced confidence in financial products. This may lead to increased responsibility for the state. [2]

[Marks available 14, maximum 8]

(ii) (a) The insurance company is likely to have offered an amount considered to be the market value before the write off. They will make assumptions about the mileage and vehicle condition of the car. [2]

The customer may be looking at the current market price for buying a similar car in a car showroom and this may be much higher so the amount offered by the insurance company may be fair. [2]

It is, however, possible that the amount offered is too low; the insurance company may have assumed a poorer condition or a higher mileage. The insurance company may not show where the figure has come from. In this case, the customer may not have been treated fairly. [3]

(b) If the maximum annual limit was clearly stated in the policy this would be fair. [2]

If the marketing literature implies that all of the claim will be covered this may not be fair [2]

If the maximum limit has been reduced (or introduced) since the policy was first taken out this may not be fair unless the change has been clearly communicated to the customer. [3]

(c) The projected value of a personal pension at outset would be based on assumptions appropriate at the time. There would be assumptions made about growth of the fund before retirement and also relating to the annuity rates available at retirement (depending on mortality and interest rates). There will also be charges involved. [4]

It is very possible that this is fair. If the circumstances (mortality and investment conditions) have changed the income could well be substantially lower. [2]

The retirement age may be lower than assumed in the original projection. The pension may include benefit for a spouse or escalation of benefit not assumed in the projection. A lump sum could have been taken. [2]

However, it is possible that the fund was invested in inappropriate investments (e.g. high risk when customer wanted to take a minimal risk). The charges may also be much greater than expected. [3]

There should have been annual statements with clear warnings so that income at retirement date is not unexpected. Without theses, this would appear unfair. [1]

(d) The bonuses on a with profits policy will come from the distributable surplus available. The amount of surplus to be distributed will be affected by the capital that is needed for the business, margins for future adverse expectations and the business objectives of the company. Sustained under distribution is likely to be contrary to customers' expectations. [5]

The amount of surplus will depend on the difference between actual experience and the assumptions made. So if, for example, investment returns are much lower than expected the surplus available will be reduced. If other companies are still declaring bonuses in these circumstances then declaring no bonus is likely to be contrary to customer expectations. [4]

The insurance company may have changed the investment strategy. [1]

(e) The terms are likely to clearly state that the burglar alarm should be switched on. This will reduce the risk of a burglary. [2]

In this case, there was a fire which resulted in a very high loss which the customer would not be able to cover. It would seem unfair not to pay out in these circumstances.

It is possible that the fire was caused by a burglar but no payment would still be very severe. A higher excess would seem to be a more reasonable penalty. [3]

[Marks available 41, maximum 24]

(iii) The regulator should ensure that customers are provided with clear information about the contract when it is taken out. They should also be informed about any changes in the contact at renewal. [3]

Any unfair terms should be set aside. [1]

The regulator could appoint an ombudsman to deal with complaints/resolve disputes between customers and providers of financial products. [2]

The regulator could fine or sanction providers not abiding by the regulation. [1]

Relating this to the scenarios in part (ii):

(a) The basis of the valuation should be made clear in advance so the customer will know how the amount will be calculated and so what to expect in the event of a write off. [2]

(b) The maximum claim limits on the policy need to be clearly shown and any changes from previous years highlighted. [2]

(c) The assumptions made need to be clearly stated in any initial projections and it must be made clear that these could change. The risks taken should to be in line with the customer's expectations. The charges need to be clearly stated. [3]

Annual statements should be provided so that the situation is not unexpected at retirement. [1]

(d) The marketing literature should make the investment strategy and bonus position clear and any risks should be clearly stated. [3]

(e) The terms and conditions need to be clearly stated but these should be reasonable to ensure that the customer is covered for the risks they expect to be covered for. [2]

[Marks available 20, maximum 10]
[Total marks available 75, maximum 42]

i. *This was not answered as well as expected with few candidates going into sufficient depth to score well.*
ii. *Generally poorly answered with little detail given in the solutions to score really well. Generally only (a) was answered well.*
iii. *Again this part was answered poorly with few candidates applying their answers to the specific question being asked.*

END OF EXAMINERS’ REPORT