Subject CA3 — Communications

April 2008

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 A Stocker
Chairman of the Board of Examiners

June 2008

Question 1

Candidates were asked to draft a letter for an administrator to send to a pension scheme member explaining why a pension is reduced on early retirement and that the change in the reduction factor over 3 years reflects a change in the approach for calculating an early retirement pension.

The main points that the examiners were looking for and some common problems encountered were as follows.

1. Most candidates had a suitable opening paragraph to the letter. Scripts gained marks for a clear summary of member's query, but not where the opening paragraph was lengthy and repetitive or did not refer to the initial query.
2. Candidates lost marks for confusing a defined benefit pension scheme with a defined contribution scheme. Additionally, a number of scripts referred to a policy rather than the ABC pension scheme.
3. Candidates failed to gain marks for not explaining the reasons for reducing the pension on early retirement.
4. Candidates also failed to gain marks for explaining that the early retirement factor reflects that the scheme has a shorter time period to earn any investment.
5. A number of scripts incorrectly suggested that the early retirement factor had not increased or that the pension was not being reduced.
6. Better scripts demonstrated that early retirement pension was the same under both approaches.
7. Poor scripts compared the loss of investment return (due to the pension coming into payment earlier) against a savings account in a bank.
8. Good scripts included a selection of the most important relevant numbers. Some scripts included inappropriate technical calculations/formulae eg 1.05^8 x pension. Candidates did not lose marks if the formulae were explained more simply.
9. A minority of scripts included additional pension figures whose derivation they did not explain.
10. A few scripts made some inappropriate comments such as "the 5% revaluation is your reward for the interest that can be earned on your unpaid money", or "allowing early retirement without reduction makes the scheme insolvent".
11. Some candidates lost marks because of the use of jargon such as insolvent, compound interest, life expectancy, actuarially cost neutral, discount rate and methodology.
12. A few candidates seemed to confuse "revaluation" with interest.
13. Some scripts included irrelevant information such as an explanation of inflation.
14. Many scripts gained marks for a good final paragraph which briefly summarised the main points and finished with comments suitable for a letter to a pension scheme member.
15. Most scripts were in a suitable format and tone to be a letter to a pension scheme member.
16. A number of scripts suffered from poor spelling, grammar and punctuation.

17. 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 words often lost marks for including unnecessary repetition or irrelevant detail.

A possible answer is attached. It is not intended to be a model solution. In practice a wide number of solutions were acceptable.

<Company Letterhead>

<address>
<address>
<address>

<Date>

Dear <Mr Blogg>

Re: The ABC Pension Scheme (the "Scheme") – Your early retirement pension

Thank you for your letter of [ ] in which you queried:

1. the reason why your pension is reduced if you retire early; and

2. why the current reduction factor at age 62 is more than double that quoted three years ago.

I have set out my response to your questions below.

Rationale for reduction

Your Scheme provides a pension on retirement at age 65. If you decide to retire earlier (for example at age 62 in your case), the pension you would receive would be smaller than if you retired at age 65. This is because at age 62 the pension is expected to be payable for longer than at age 65 and the Scheme has less time than anticipated over which to build up funds in order to pay the pension.

The combined effect of these two factors means that your pension is lower if you draw it earlier than 65. The level of reduction is such that the value of the pension you receive from age 62 would be the same as the value of the pension you would receive from age 65.

The level of reduction applied depends on the age at which you want to retire. Generally, the earlier your pension commences, the larger the reduction in your pension.

Difference in factors

Your pension earned when you left the Scheme on 31 July 2005 was £13,537 p.a. This increases each year by 5% p.a. before retirement giving an estimated pension at age 65 of £20,000 p.a.

If you retire before age 65, the pension is calculated as the pension at date of leaving with increases to age 65, reduced by the relevant factor (which depends on the number of years a member retires early). In your case, as you intend to retire at age 62, the reduction factor would be 21.11%. Therefore, your early retirement pension would be £20,000 p.a. reduced by 21.11%, equating to a pension of £15,778 p.a.

You suggested in your letter that the reduction factors referred to in earlier correspondence were lower than those quoted to you recently. For example a factor of 8.68% was used at age 62. These earlier factors apply to a different method of calculation adopted previously.

Under that method, the early retirement pension at age 62 would have been calculated as the pension at date of leaving with increases to age 62 reduced by 8.68%. The pension you would have built up at age 62 would therefore have been £17,277 p.a. which when reduced by 8.68% also equates to a pension of £15,778 p.a.

Summary

The Scheme reduces pension on early retirement so that the value of the pension at the early retirement date is equivalent to the value of the pension from age 65.

As explained, the change in the factors has not affected the amount of pension payable from age 62. The change simply reflects a different method of calculating an early retirement pension. In either case, the value of your pension at age 62 is estimated to be similar to the value of the pension you would receive from age 65.

If you decide to early retire at age 62, please contact us again and we will advise you on the process. In the interim, please give me a call on 01234 567890 if you have any further questions.

Yours sincerely

<name >
<title>

Question 2

Candidates were asked to draft a slide presentation to a project team covering different charging options to recover the administrative expenses of a lump sum investment product. In particular, candidates were asked to show:

- whether option 1 or 2 was most appropriate giving consideration to both the company's and customer's view
- Option 1 & 2 result in broadly similar values for customers after year 4
- Option 2 is loss-making for the company
- Options 3 & 4 both are acceptable for company
- Option 3 reduces value to customers who stay more than 4 years

1. There was evidence of some candidates running out of time and therefore not completing the answer. Credit was given to those candidates who submitted their draft working papers.
2. Students should not spend time colouring in graphs or drawing boxes around the slides particularly if they are running out of time.
3. Most scripts had an appropriate first slide with a clear title, date, name of presenter
4. Most scripts had an agenda. On better scripts the agenda linked directly to the titles of the following slides.
5. There was a great variation in the quality of the format of slides. There were examples both of slides with only a few bullet points, and slides with too much information.
6. Better scripts included a variety of formats on different slides, with perhaps a couple of different graphs and a table, or a graph and a diagram.
7. Where scripts included a table, marks were gained for how clearly it brought out the messages. Large tables of data were unlikely to bring out the key messages clearly. A number of scripts failed to gain marks if they repeated entire tables from the exam paper.
8. Where scripts included a graph, marks were gained for the appropriate labelling of axes.
9. Candidates made different choices as to what information they presented in a graph. Graphs were particularly useful when demonstrating how the funds grew each year over 4 years under options 1 and 2. Often a brief comment underneath a graph to highlight the key point being shown proved helpful.
10. A number of candidates included graphs but failed to draw any conclusions.
11. A minority of scripts including a misleading graph e.g. the graph showed the growth of the fund instead of fund values when demonstrating the impact of the main charging options.
12. Poorer candidates made inappropriate comments on the slides e.g. "1.46% charge is less intuitive for customers" or "under option A the charge has a drawback that it cannot be varied".
13. Candidates lost marks for failing to point out the impact of surrenders.
14. A few scripts discussed options 1, 2 3 and 4 without explaining what each of the options represented.

15. Some slides made reference to "winners and losers" which was often laboured and also did not indicate if the comments were looking at the company or policyholder perspective.
16. Candidates were expected to assess the information provided and choose the parts that were relevant for the audience. For instance, a number of scripts included a slide showing all of the assumptions, which made it seem like a key matter for the audience to consider. Better scripts included a brief mention of the key assumptions within other slides.
17. Some candidates put full-length narrative sentences on the slides. This was not appropriate to the slide format and tended to make slides over-busy.
18. Most scripts gained marks for having a closing slide. The better scripts include a brief summary of the key messages and the opportunity to ask questions.
19. Most scripts gained full marks for having up to 8 slides.
20. Candidates were not asked to provide a script to accompany the presentation.

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

OPTIONS for PRODUCT CHARGES
Presentation to Project Team
27 August 2008

Bob Smith
Project Actuary

Page 1

AGENDA

Proposed Charging Options

Comparison from Customer viewpoint

Comparison from Company viewpoint

Other Alternatives

Summary

Page 2

PROPOSED CHARGING OPTIONS

Two charging options proposed:

- **Option 1**
  5% of initial amount invested
  (e.g. £500 on investment of £10,000)

  OR

- **Option 2**
  1.25% of fund at start of each of first 4 years
  (e.g. £125, £132, £140, £147 on investment of £10,000
  allowing for 7% fund growth each year)

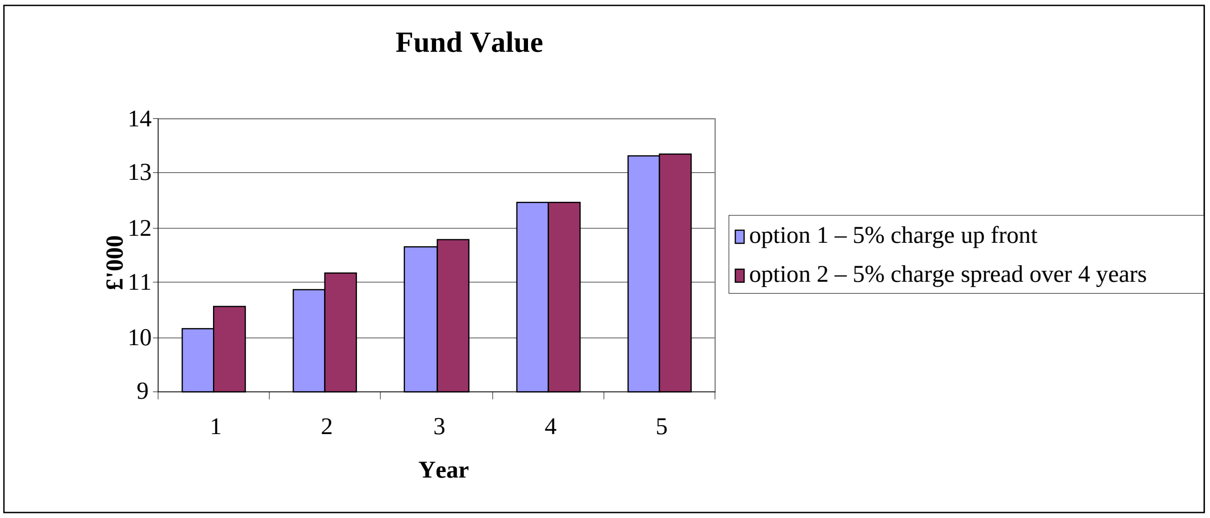
Now need to consider:

- how do these compare for customers ?
- how do these compare for company ?

Page 3

COMPARISON FROM CUSTOMER VIEWPOINT

- Customers prefer option giving higher fund value



Note: assumes investments grow at 7% p.a.

- Option 1 starts at lower value, but catches up over the first 4 years
- After 4 years – differences are negligible

So:
- Option 2 is preferable for customers if cashed-in before 4 years

Some customers may dislike having the whole charge taken up front

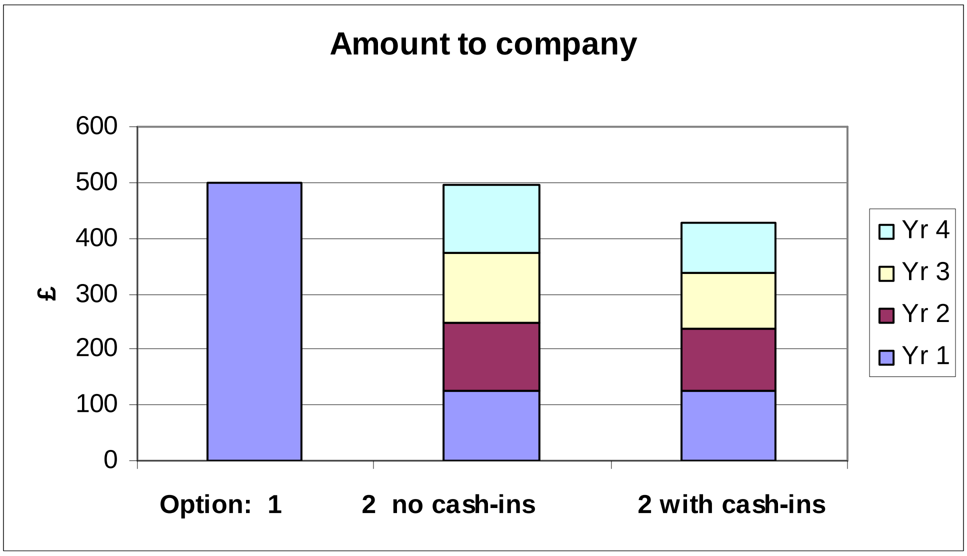
Page 4

COMPARISON FROM COMPANY VIEWPOINT

Company prefers option that recovers its expenses

We expect that roughly 10% of customers will cash in each year.

So the impact on charges received by company on average.



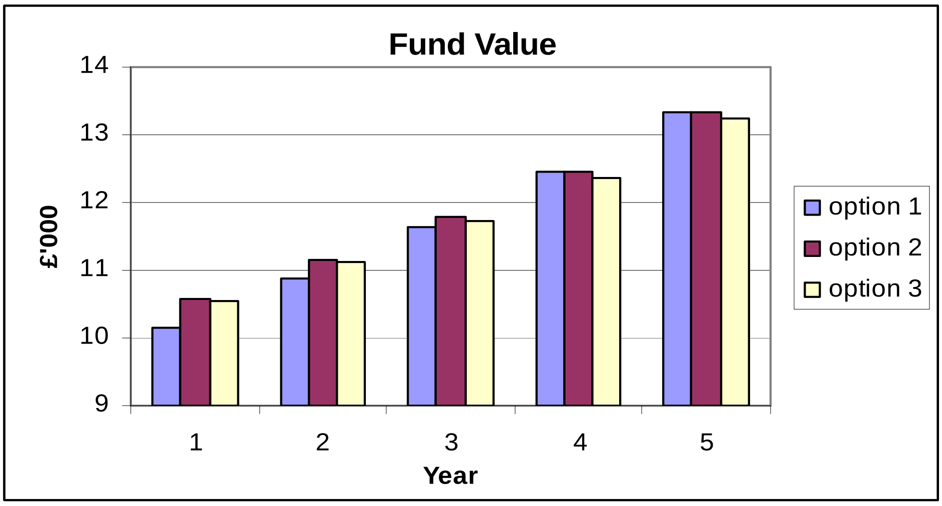
➔ ***cash-ins mean that company does not recover the £500 expenses under option 2***

Page 5

ALTERNATIVE

Another option which would allow the company to recover its £500 expenses

- Option 3: charge of 1.46% of fund at start of each of the first 4 years



➔ ***fund value from year 4 onwards is about £100 below options 1 & 2***

Page 6

ALTERNATIVE

Option 4:

- 1.25% of fund at start of first 4 years

- If customer cashes-in before 4th charge taken, company takes an exit charge:
  - after 1 year, exit charge 3.75%
  - and reducing by 1.25% each year

Page 7

SUMMARY

Option	Customer view?	Company view ?
1: 5% of investment	• Initial charge high • Poor value for those who cash-in early	• £500 received
2: 1.25% for 4 years	• Better for those who cash-in early • Marginally better for those who stay past year 4	• £500 not received (loss-making)
3: 1.46% for 4 years	• Better for those who cash-in early • Worse off if stay past year 4	• £500 received
4: 1.25% + exit charge	• financially similar to option 1	• £500 received

DISCUSSION AND QUESTIONS

Page 8

END OF EXAMINERS' REPORT