

EXAMINATION

September 2006

Subject CA3 — 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 Stocker
Chairman of the Board of Examiners

November 2006

Comments

These are given before each solution.

Comments on question 1:

Candidates were asked to draft a memorandum to a personnel manager commenting on an independent report, commissioned by the company, on the possible first-year cost of a flexible benefits arrangement. In particular, candidates were asked to

- explain the meaning of selection and its impact on the first year costs*
- comment briefly on the appropriateness of the data and explain why charging a flat rate could result in the scheme being more costly than anticipated; and*
- include a brief reference on an appropriate level of premium*

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 the friend's queries, but not where the opening paragraph was lengthy and repetitive or did not refer to the initial query.*
- 2. Some of the scripts failed to define selection properly – the description was too brief or contained too much jargon. In a minority of scripts, the explanation of selection was too theoretical and not related to the question; e.g. one party knowingly using information about itself to gain an advantage over another party.*
- 3. Better scripts also mentioned the action that could be taken to manage the risk of selection.*
- 4. Some candidates did not state that employees with pre-existing medical conditions are more likely to join in the first year and that such people are likely to claim straightaway. Therefore, there is likely to be an initial "rush" of claims resulting in the scheme more costly than expected.*

A few scripts incorrectly stated that selection would only increase costs after several years.

- 5. Whilst the majority of candidates explained why charging a flat rate premium could result in the scheme being more costly, a number of candidates did not refer to a more appropriate level of premium. Candidates gained marks for stating a more appropriate level of premium.*
- 6. Better candidates included only a brief reference to the appropriateness of market research data. Scripts longer than 550 words often included a lot of unnecessary information on the market research data.*
- 7. Some candidates lost marks because of the use of jargon, such as health status, age profile or selection without an explanation.*
- 8. Many scripts gained marks for a good final paragraph which briefly summarised the main points and finished with comments suitable for a memo to a personnel manager.*
- 9. Candidates used different styles to sign off the memo (e.g. only using "regards" or only a signature). Since a range of styles was acceptable, candidates were not penalised for this.*

10. *Most scripts were in a suitable format and tone to be a memo to a personnel manager.*
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 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.

To: John Smith, Personnel Manager, XYZ Limited

From: Tim Brown, Actuary

Date: 31 March 2006

Flexible benefits scheme — estimated cost of new healthcare option in year 1

Thank you for sending me details of the healthcare option to be included in the flexible benefits scheme with effect from 1 January 2007. You have provisionally decided to make a first-year charge based on the average cost applying to similar companies.

You asked for my comments in relation to two points made in the independent survey report you commissioned, namely:

- (1) What is meant by being “selected against”; and
- (2) Why charging at £700 in year 1 might be too generous, and what a more appropriate premium would be.

Selection — “being selected against”

Since you intend to allow individuals to join without excluding pre-existing medical conditions, you are exposed to the situation in the first year that the individuals who do join are those who are more likely to make a claim. They may have “stored up” complaints like bad knees and bad backs which would cost more than £700 to treat, but at a cost of £700, it becomes attractive to join your company scheme.

You therefore run the risk that some individuals would claim immediately after joining. This is what we mean by “being selected against”. In contrast, the survey covered schemes which have existed for some time and so do not have this initial “rush” of claims.

Thus, the overall claim rate for your scheme in the first year is likely to be higher than average, and therefore your scheme could be more expensive than budgeted.

Average cost of £700 inappropriate

Your employee data shows that 70% of employees are over age 45 and 30% under age 45. The market research data showed the reverse — i.e. 30% over age 45 and 70% under age 45. The survey data is therefore not a good representation of your company because your own company has a significantly higher proportion of over 45s.

Since the over 45s are more likely to make a claim than the under 45s, and the expected claim amount is higher, this means the average cost per employee for your scheme is likely to be higher than for other schemes.

I have calculated that a more realistic premium is around £1,200 based on your own membership compared to the £700 from the survey data.

Another factor to consider is that older employees may be more likely to join the scheme than younger ones because a flat-rate charge gives relatively better value at older ages. This further increases the likely average cost.

Summary

In summary, I agree with the points made in the independent report, and confirm that a charge of £700 looks too low because:

- If you allow pre-existing medical conditions you are likely to have more claims than expected in the first year; and
- Your membership is older than average and therefore the cost of claims is on average likely to be much higher than £700.

Do let me know if you wish me to expand on any of the above points. I can be contacted on 01234 567890.

Comments on question 2:

Candidates were asked to redraft a letter (initially drafted by a summer student) to the widow of a policyholder about the payments from a family income benefit product.

- 1. Most candidates had a suitable opening paragraph to the letter. Scripts gained marks for a clear summary of the widow's query, but not where the opening paragraph was lengthy and repetitive or did not refer back to the widow's query.*
- 2. Some candidates lost marks because of the use of jargon, such as discounting, future value, sum of payments, or investment returns.*
- 3. 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 widow of a policyholder.*
- 4. Most scripts were in a suitable format and tone to be a letter to a bereaved customer. Better scripts included appropriate condolences to the widow.*
- 5. A number of candidates misunderstood the product and stated that payments had been made to the policyholder before his death. However, candidates were not heavily penalised for this.*
- 6. The customer had not realised that future payments would be discounted if paid as a lump sum, and candidates gained marks for a brief explanation of discounting.*
- 7. Some candidates had difficulty in drafting information in a way which was straightforward and still technically correct. For example some candidates explained discounting by referring to inflation and payments losing value over time due to general price increases. Scripts that were technically correct referred to interest rates when explaining discounting.*
- 8. Some candidates included inappropriate and dangerous comments such as suggesting that the widow will receive more money if she opts to receive monthly payments rather than the lump sum or provided a steer on which option to select.*
- 9. Some candidates lost marks for rounding the payments to the nearest pound rather than using the exact amounts that the widow would receive.*
- 10. Better scripts referred to the exact number of years and months of payments remaining instead of rounding to the nearest year.*
- 11. A number of scripts suffered from poor spelling, grammar and punctuation.*
- 12. The guideline length was 400 words. Scripts which were below 350 words generally missed out some of the explanation. Scripts which were longer than 450 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 Line 1>
<Address Line 2>
<Address Line 3>

5 September 2006

Dear Mrs Smith

Your husband's policy number 23581113

Thank you for your letter of 2 September. I am very sorry to learn about your husband's death.

In this letter I will explain how the payment due from your husband's policy is calculated. Unfortunately it is lower than the £75,000 you expected, and amounts to £53,332.65 if you choose to receive it as a lump sum. There are three elements to this.

1. Number of payments due

Your husband's policy is designed to pay a monthly income from your husband's death until the policy end date, which is on 31 August 2022. The first payment will be for last month (August 2006), and in total you are due payments for 16 years and 1 month.

2. Amount of each payment

Under the terms of the policy, the payments increase each year at the rate of 3 per cent. This means that for every £100 paid in any policy year, £103 will be paid in the following year. If payments had been due in the first year they would have been £250 each month (£3,000 over the whole year), and with the increases the monthly payment is now £316.69, which will rise to £326.19 starting from the payment due on 30 September 2006

3. Lump sum option

Although your husband's policy is designed to pay a monthly income, we are able to pay you a lump sum instead. However, the amount paid will reflect the fact that you are receiving it early. If you were to receive all the future payments due as a lump sum without any reduction, you could place it in a bank account where it would earn interest allowing you to take a higher level of income than the policy would pay. We allow for this in the lump sum payment, using a calculation that is equivalent to bank interest of 5 per cent a year. As mentioned above, the lump sum equivalent is £53,332.65.

Conclusion and next steps

I hope I have been able to explain how we have calculated what is due from your husband's policy. Please let me know whether you would prefer to receive the lump sum or the monthly payments. Please also send us your marriage certificate and your husband's death certificate, along with the enclosed form authorising the payment. Please let me know if you have any questions.

Yours sincerely,

P Brown
Actuarial Manager

END OF EXAMINERS' REPORT