Subject CA3 — Communications

September 2009 Examinations

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.

R D Muckart
Chairman of the Board of Examiners

December 2009

Comments for individual question are given with the solutions below.

1
A possible answer is below. It is not intended to be a model solution. In practice a wide number of solutions were acceptable.

Company address

Mr Brown
1 Bridge Street
Upmarket
Newshire

23 June 2009

Dear Mr Brown

Re: Policy Number xxxx — 2008 and 2009 Illustrations

Thank you for your letter of 10 June to my colleague My Ridley regarding your 2008 and 2009 illustrations. You asked us to revise the 2009 statement as you believe that it contains an error. I can confirm that I have checked the 2009 statement and that the illustration provided is correct. I have explained this further below.

Calculation of monthly payments

The monthly payments are calculated as follows:

(A) We determine the amount of money that needs to be set aside at 1 January 2009 to purchase your annuity in 2020.

(B) We deduct from this the fund already built up to 1 January 2009.

(C) We calculate the shortfall: the difference between A and B.

(D) The monthly payments are the amounts required to cover the shortfall between 1 January 2009 and 2020.

Reasons for the increase in monthly payments

Your 2008 statements showed that if your fund had grown at 5% each year, you would need to make monthly payments of £127 from 2008 to 2020 to cover the shortfall.

Your 2009 statement showed that monthly payments of £182 (i.e. an extra £132 on top of your current monthly payments) would be required to be able to purchase the £5,000 p.a. annuity. There are two main reasons for this:

(a) **Actual experience to date**

Between 2008 and 2009, the fund grew by less than 5% p.a. which was the rate of investment growth assumed in the 2008 statement. You also continued to make monthly payments of £50 instead of increasing them to £127. The impact of these factors is that the fund built up to 1 January 2009 is lower than expected, resulting in a larger shortfall.

(b) **Future assumptions**

Since your 2008 statement was issued, the cost of purchasing an annuity has increased. This means that a larger fund is required than estimated in previous years. This increase has been partially offset by the higher rate of future assumed investment return used in the 2009 statement.

The combined effect is that the shortfall has increased resulting in higher required monthly payments.

An alternative way of looking at this is to consider the impact on the annuity if you continued to pay in £50 per month. In this instance, you would only be able to purchase an annuity of around £2,300 p.a.

Summary

In order to purchase an annuity of £5,000 p.a., your monthly payments will need to increase from £50 to £182. The main reasons for this increase are that a lower than expected fund has been built up between 2008 and 2009 and that the cost of purchasing an annuity has increased.

I trust this addresses your concerns. If you wish to discuss this further, please do not hesitate to contact me on 0123 456789.

Yours sincerely

John Smith
Actuary

Candidates were expected to comment that there were three reasons which had caused the premium to increase (low actual investment return over the last year, continuing to pay at £50 per month and increased annuity rate) and one (the change in investment growth assumption specifically mentioned by the policyholder) which would cause the premium to decrease.

Better scripts drew attention to all of these points and pointed out to the policyholder that whilst his point was correct in isolation, the three factors causing the increase outweighed his point and the overall effect was that the premium needed to increase.

Many candidates recognised that the low investment return of 1.6% achieved over 2008 was less than the expected return, but often too much emphasis was placed on this one point and they were less precise about, or even ignored, the much greater impact of the change in growth assumption. The result was that whilst many answers mentioned or addressed the factors which caused the premium to increase, many candidates did not adequately address the central point of confusion raised by the policyholder, whose query was specifically related to the future growth assumption.

A high number of candidates confused actual and expected investment returns by, for instance, implying that a higher assumed rate of return would increase the actual fund value.

Better scripts set out the points in logical fashion and addressed the policyholder with an appropriate degree of empathy and left him in no doubt as to why there was an increase in premium.

Better scripts were able to give some quantification of the relative impact of each of the factors involved.

Candidates did not gain marks for including examples without any explanation. Some candidates complicated and confused their answers by introducing their own fund value and annuity figures rather than relating the example to the policyholder's actual fund statement.

A number of candidates complicated their answer unduly by including jargon such as 'best estimates', 'today's money', 'predictions' and 'package of assumptions'.

Many scripts gained marks for a good final paragraph which briefly summarised the main points and finished with comments suitable for the policyholder.

Most scripts were in a suitable format and tone.

A number of scripts suffered from poor spelling, grammar and punctuation.

The guideline length was 450 to 500 words. Scripts which were below 400 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.

2

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

Memo to: New graduates
From: John Smith
Date: dd/mm/yyyy

Additional Pension Options at Retirement

This memorandum provides a brief introduction to Income Drawdown and Alternatively Secured Pension.

<u>What is Income Drawdown?</u>

In traditional pension products when an individual wishes to retire, they use the funds available from their retirement savings to purchase an annuity. (An annuity is an income that is usually paid for the rest of an individual's life in return for a lump sum at the outset.) Income Drawdown is a method which allows the individual to delay purchasing an annuity and to instead withdraw part of their retirement savings.

Limits are set by the government on the amount of funds that may be withdrawn. At the current time, a 62 year old male with a fund of £200,000 would be allowed to withdraw a sum from £0 up to £16,800 each year. Income drawdown is only available until age 75, at which time the individual needs to purchase an annuity or transfer their funds into an Alternatively Secured Pension (ASP).

<u>What is an Alternatively Secured Pension (ASP)?</u>

An ASP is a form of income drawdown. Instead of buying an annuity at age 75, an individual can continue to invest their pension savings and draw an income from their fund within limits laid down by the government. The maximum amount that can be withdrawn is different to that for Income Drawdown. Also there is a minimum amount that must be withdrawn.

Currently, a 75 year old male with a fund of £200,000 would be allowed to withdraw between a minimum of £11,440 and a maximum of £18,720 in the first year. The maximum amount of withdrawal is recalculated each year at the same percentage of the remaining funds.
The main advantages and disadvantages of income drawdown and ASPs, compared to purchasing an immediate annuity, are:

<u>Advantages</u>

- The individual is able to vary their income to reflect changes in their circumstances — for example an individual may be in part-time work and only require a small additional income for a number of years.

- The individual may wish their remaining retirement fund to continue to benefit from potential growth in the financial markets.

- The individual can use the whole of their remaining fund at any time to buy an annuity.

- Annuity rates are such that for the same sum invested, at any particular point in time, they result in a higher pension for older individuals. By delaying purchasing an annuity the individual may be able to take advantage of the higher rates that apply to older pensioners.

<u>Disadvantages</u>

- Unlike an annuity, the income that is received is not guaranteed.

- The individual is taking a risk both in respect of the growth of their remaining funds and on the future movement in annuity rates.

If you would like any further information on Income Drawdown or Alternatively Secured Pension please don’t hesitate to contact me in the actuarial department.

Regards

John

The question contained all the material required for a full answer and the task for candidates was to extract the relevant points, explain the products in simple language and to draw out the advantages and disadvantages of each. No prior knowledge of the products in question was required or expected.

Many candidates simply lifted large chunks of text from the question. Invariably this led to an overcomplicated answer which did not flow and was not suitable for the intended audience.

Some candidates drafted a memo for their finance colleague whilst others drafted a memo directly for the graduates. Both approaches were acceptable and gained marks.

Many candidates did not give a clear description of the products, in particularly it was important to draw out the different ages at which the products could be bought.

Many candidates pointed out that a feature of either product was that more income could be secured at older ages, and illustrated this by dividing the same fund value by an annuity at age 60 and 70. However candidates who went down this route omitted to explain that an individual would have foregone the income between ages 60 and 70.

Better scripts addressed the advantages and disadvantages of each product either within the same paragraph or in a table. Scripts which failed to do this did not necessarily lose marks but often led to a more repetitive or a disjointed, less structured answer, with advantages and disadvantages of each spread over four headings.

A large number of answers referred to the word interest when they meant investment return (the difference being that interest rates are generally positive).

Some candidates lost marks because of the use of jargon such as 'terms and conditions', 'disinvestment', 'GAD', 'financial planning', 'market risk', 'negative growth', 'annuity rate', 'gilt', 'attitude to risk'.

The guideline length was 450 to 500 words. Scripts which were below 400 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.

END OF EXAMINERS’ REPORT