INSTITUTE AND FACULTY OF ACTUARIES

September 2019

Subject CP3 – Communications Practice

Scenario Material

INSTRUCTIONS FOR CANDIDATES

You are provided with this advanced information to enable you to digest it in your own time, and not under exam conditions. Please note that this is an exam to test your ability to communicate technical information to a non-technical audience. It is not a test of your knowledge of any technical actuarial knowledge or skills. As such, any technical actuarial information or techniques that you need to answer the question will be provided. You do not need to spend time revising other subjects or looking for further information on the topics covered in the paper. You must assume that any numerical information provided in this scenario material is correct unless otherwise stated.

Background

Safehaven is an insurance company which sells pension saving and retirement products. Their newest and best selling product is their Safehaven Retirement Income Solution launched on 1 August 2013. This is a drawdown product which allows policyholders to take an income during retirement. The policyholder specifies the income they wish to take and can then amend it periodically according to their changing needs, subject to overriding legislative limits prescribed by government. The policyholder bears the investment and longevity risk because there are no investment guarantees with this product. If there is insufficient growth to sustain the policyholder's required income level throughout their retirement, the policy value may fall to zero before the death of the policyholder.

Safehaven is regulated by the Financial Oversight Authority (FOA), which has recently issued an update to its Handbook, 'FOA Update Notice 123'. This update specifies the required disclosures to policyholders of drawdown products. The FOA has also issued an attachment to this update, 'Annex 1', which includes sample data and sample results.

The update impacts disclosure to Safehaven Retirement Income Solution policyholders. A project is being started to ensure Safehaven will be compliant with the changed rulebook.

The following documents will be considered by the project during its work:

- Product summary for Safehaven Retirement Income Solutions
- Extract from the internal monthly investment report dated 1 August 2019
- Summary of FOA Update Notice 123
- Supplement Annex 1.

Product summary for Safehaven Retirement Income Solutions

<u>Premium type</u>: single premium. This can be from more than one approved source but the entire premium must be received at the start of the policy. No additional premiums are allowed after commencement of the policy. Approved sources are retirement savings products or similar savings products from another provider.

<u>Withdrawals</u>: policyholders can take regular withdrawals by providing a written instruction to Safehaven. The fund(s) from which the withdrawal is taken must be specified by the policyholder. These must be monetary amounts in whole Euro. Policyholders can change or cancel their withdrawal instruction at any time.

Investment fund choice & charges

There are five funds available for policyholders to choose from, all of which are professionally managed by the Safehaven Investment team in line with clear mandates and objectives.

There are no restrictions on the minimum amount invested per fund or the number of funds that the policyholder may select.

Policyholders can switch funds at any time. The first two requested switches per calendar year are free. Thereafter €2 per instruction to switch will be applied by deduction from the policy fund value.

Extract from internal monthly investment report dated 1 August 2019

At 30 July 2019 the total fund value for Safehaven Retirement Income Solution policies is €6,750 million. This investment report shows how this is split by fund and the actual growth rates achieved. The average actual growth rate has been calculated using the time weighted method. The table covers this data and shows the latest long term forecast of annual growth by fund taking into account both the expected asset mix in each fund and the economic outlook.

Fund name	*Fund value at 30 July (€m)*	*Actual growth rate p.a.*	*Long-term forecast of growth p.a.*
Balanced	2,000	3.71%	5.25%
Secure Conscious	3,500	2.42%	1.25%
Adventurous	750	6.13%	8.00%
Active Managed	375	4.33%	6.75%
Safety	125	1.15%	1%

Recent policyholder behaviour

For new business written from 1 January 2019 to date, over 90% of customers have selected a mixture of Secure Conscious and Balanced funds.

Despite the higher long term forecast growth rate, the Adventurous fund continues to be unpopular. No new business policyholders during 2019 have selected the Adventurous fund, and no switch has been made into this fund during 2019 to date. This may be due to the assets this fund can hold showing a high level of price volatility.

At 30 July 2019 there are 200,000 Safehaven Retirement Income Solution policies in force. The average regular withdrawal is now €345 per month and 95.6% of policies have a regular withdrawal instruction in place.

Of those policyholders increasing their regular withdrawal instruction during July 2019, the average increase was around 1%. This is broadly in line with the latest government released inflation figure of 0.9%.

Growth rates for drawdown product projections

In accordance with company policy the long term forecasts published in our 1 August investment report are used to derive the growth rate for use in drawdown projections applicable from 1 October each year. The 'Basic Rate' of growth assumption is calculated as the weighted average annual long term forecast growth rate at 1 August where the weights are total fund values at 30 July. The result is rounded up to the next integer. An 'Alternate Rate' is the Basic Rate minus 1%. The Basic Rate with effect from 1 October 2019 is therefore 4% with a corresponding Alternate Rate becoming 3%. Under Safehaven's existing approach to providing projections, these rates apply irrespective of the policyholder's actual fund choice.

Summary of FOA Update Notice 123

Background

This regulatory update is the result of policyholder complaints about drawdown products received by the FOA. Investigations over the past three years have highlighted the poor quality of policyholder updates, which have caused confusion and misunderstanding. It is the stated objective of the FOA to ensure policyholders receive a quality service after the initial sale. Policyholders must be given accurate information on the status of their drawdown policy and its potential in future.

The FOA has therefore decided to provide specific rules relating to drawdown products which have been set up from the proceeds of a pension saving plan and are being used to provide a retirement income.

All product providers affected must comply with the new rules by 1 January 2021 at the latest.

Section 1 of the update below relates to projections. Some aspects of the projection production and calculation are mandatory and all product providers must comply with these. However, there is some limited flexibility on other aspects particularly around the method of the projection and display of information.

Sample data and example output tables are supplied in Supplement Annex 1.

Section 1

Mandatory requirements

All drawdown product policyholders must receive a projection of their policy every year.

The projection term must be ten years from the date of calculation.

Future income withdrawals must be allowed for at the frequency and level that policyholders have selected.

Where additional premiums are expected and are known, these must be incorporated.

Growth rates used must reflect the actual policyholder choice of funds for their policy.

Charges must be allowed for in the projection.

Other requirements

Choice of methodology

There is a choice of approach to how the calculation is performed. Providers may choose EITHER the deterministic method OR the stochastic method. This choice must be applied to all policies rather than for individual customers or cohorts of customer. Note that the outputs required will differ according to the method adopted.

Deterministic approach

A range of outcomes at the end of the projection term must be given to policyholders based on three different assumptions namely:

- low growth rate
- mid growth rate
- high growth rate.

The rates are set by the provider but must reflect the nature of each fund.

The actual investment choice of the policyholder must be used so that a projection of each fund selected in each policy is performed separately and results amalgamated.

If a deterministic approach is adopted, the following additional items may be provided to a policyholder:

- the policy fund value at the end of years 2, 4, 6 and 8
- the month and year at which the total policy value will become zero. This could be beyond the end of the ten year projection term.

Stochastic approach

This method will require a minimum of 5,000 simulations. The model used is not being specified by the FOA but Monte Carlo simulation might be one suitable approach.

Suitable statistical distributions must be chosen for investment returns. The FOA has no specific requirements as to which distribution is used, but the provider selects a distribution they consider appropriate to reflect the variation expected. Examples might include, but are not limited to, log normal or Pareto distribution.

Three outcomes of these simulations must be shown at the end of the ten year projection term. These should represent the 25^{th} percentile, 50^{th} percentile and 75^{th} percentile of fund values at this duration. These may be displayed as integer values or to three significant figures. See Annex 1 for an example.

In addition, the provider may also show the equivalent results at end of years 2, 4, 6 and 8.

Supplement Annex 1

Options for the output of results to policyholders

Results may be tabulated or shown in the form of a graph.

Figures for the projected funds may be shown to three significant figures or shown as whole integer. In both cases, figures must be rounded down.

In the projection, providers must state what charges have been allowed for, and specify the level of withdrawals, including any future known increases where such increases occur automatically. If there are known incremental premiums due, these must also be stated.

The projection must be sent to customers by post. Projections may also be made accessible to policyholders in a secure area of a website managed by the provider.

Provider 1

This provider has chosen the stochastic approach and, in this simplified example, has generated twelve possible results at the end of the ten year projection as shown in the table below. (Note that in reality a minimum of 5,000 simulations are required.)

Simulation number	*Results*
1	79,000
2	86,312
3	99,543
4	102,986
5	90,333
6	128,755
7	105,432
8	102,337
9	90,754
10	81,475
11	83,765
12	103,725

The provider has chosen to supply results only at the end of the projection term and will use three significant figures only.

This results in the following to be either tabulated or shown on a graph to the customer. The document must clearly state what is meant by a 'percentile' but there will be no requirement to state the rounding convention.

So, before rounding, the percentiles are:

25th 83,765
50th 90,754
75th 102,986

But as the provider wishes to show three significant figures these will appear as 83,700, 90,700 and 102,000 respectively.

Provider 2

This provider uses the deterministic approach and generates the following table having chosen to give the additional results where growth rates are per year before the annual management charge. They chose whole integer format of rounding.

Duration (years)	*Low growth rate (3%)*	*Mid growth rate (4%)*	*High growth rate (5%)*
2	100,375	102,354	104,352
4	100,768	104,862	109,078
6	101,178	107,535	114,212
8	101,607	110,383	119,788
10	101,868	113,415	125,411

END OF SCENARIO MATERIAL