Subject SA1 — Health and Care
Specialist Applications

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.

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Chairman of the Board of Examiners

December 2009

Comments for individual questions are given with the solutions that follow.

General comments

Candidates who approached the questions, especially the more substantial elements of each question, in a methodical and detailed manner were far more likely to satisfy the examiners and receive a pass in the subject. Candidates will lose marks if they do not address the question asked. There was often a lack of sufficient detail in the answers. The mark allocation for each question part gives an indication of the relative length of answer or number of points to be made to gain full marks. In general each valid point in the answer would normally attract 0.5 marks with the more basic elements e.g. details in a pricing basis such as age and sex, attracting 0.25 marks.

Some papers were not clearly marked at the top of each page as to which part of the question was being answered.

Marks may be lost where answers are difficult to read.

Comments on individual questions

Question 1

Candidates did not always differentiate whether they were talking about the transferring company, the company to which the policyholders were being transferred, the policyholders being transferred or those remaining with the transferring company. Marks were often lost through a lack of different points being made. Candidates who had practised techniques for generating a large number of points for long questions may have found this question easier to answer.

It is often helpful to use subheadings when answering this type of question.

Question 2

Generally the attempts at this question were good, especially for parts (i) and (iii).

Question 3

Parts (i), (ii) and (vi) were generally well answered; the other parts less so. Knowledge of current market developments would certainly have given candidates an advantage here. Thinking logically about the situation this would put advisers in would help. As is frequently the case, if candidates were *struggling to think of sufficient points, considering the short and long term position separately would give rise to some additional points.*

Question 4

This was generally well-answered.

1 **Purpose of Report**

To describe the impact of the Scheme on the policyholders, how the transfer would affect the security of their benefits and how it would affect their reasonable benefit expectations

Sets out how the Scheme is consistent with the requirements to treat customers fairly.

Background

Names of the parties

Brief description of both companies

Date on which the application is being made to the High Court for approval

Business to be transferred

Fund structure of the transfer

Fund structure of the transferee

Statement that the receiving company is authorised to transact this business

Advice and opinions

State own role in the company. i.e. the Actuarial Function Holder

Advice received from external actuarial advisers

Their conclusion/opinion on the likely impact of the transfer on the company's risk profile and on the capital requirements

The conclusion from the Board stating whether they believe the proposed transfer would be beneficial for both transferring policyholders and for the remaining policyholders

Signatories/signatures

Disclosure

Specify own qualification. e.g. FIA/FFA etc.

Date of appointment as the AFH

Declare whether currently is an employee of the company

Declare whether currently is a director of the company

Declare whether currently is a policyholder of the transferring company and/or the transferee

Declare whether currently hold any shares of the transferring company and/or the transferee

Overview of the company

History/authorisation of the company

Nature of business written in the company

Types of business (eg ACII, CI)

Distribution channels

Terms and conditions

Details of the transferring business

Number of current policyholders

Size of sum assured

Size of premium income

Value of liabilities

Any discretionary elements eg reviewable premiums

If so, details of how the discretion has been applied in the past and how it is planned to be applied following the transfer

Stringency of claims management

Quality and availability of rehabilitation services

Continued availability of options and maintenance of current terms

What liabilities will remain with the seller (e.g. IBNR, claims not settled)?

Underwriting

Data quality

Any existing legal cases/complaint cases and how dealt with post transfer

Existing reinsurance and plans on transfer

Profile of policyholders. e.g.

Age/sex distribution

Socio-economic mix/occupation

Smoker/non-smoker split

Average policy size

Proportion of rated cases

Details of the transfer

Rationale behind the transfer

Proposed date of transfer

Assets attributable to the transferring business:

amount relative to statutory reserves

types of assets

Financial position before and after the transfer

Separate considerations for transferring business and remaining business

Capital position before and after transfer

Individual Capital Assessments before and after

Security of the benefits of the policies before and after

Credit ratings of both companies

Policy terms and conditions not expected to be affected as a result of the transfer

Quality of administration and client services of both companies

Any tax implications

Other

Notification of policyholders

Discussion and opinion of the FSA

The costs of implementing the Scheme

How these costs will be met

Any monopoly considerations

2 **(i)** As the pricing actuary you are not expected to possess a detailed medical knowledge on the areas where drugs have been developed that are approved but not used by all areas of the NHS.

So you will need access to your Company Medical Officer and other specialist doctors

Other sources of relevant drug information are:

Reinsurers CMO

Specialist Medical Societies

Medical journals

Consultants

Overseas

The research would use the following steps:

Identify the current drugs and drugs that might be added to (or removed from) this list in the future

Estimate the incidence split by normal rating factors (eg age, sex) and cost per drug

Estimate the length of treatment and therefore cost of treatment

Investigate which Primary Care Trusts (PCTs) provide what benefits and exclude others and the expectation of future trends in this

Data should be split by region

Allow for inflation of drug cost

Any secondary costs due to using the drug

Any competitors and what they charge

Allow for heavy margins in your estimates due to anti-selection by the policyholder

Allow for expected impact that introducing the new benefit will have on sales (eg due to likely increase in premium; this is needed to price for spreading the fixed/initial cost)

2 **(ii)** Problems that arise (P); M Mitigation

P How do you control the drug list so that any claim is managed

M Only cover drugs available in the UK

P Special drugs may be increasing in price faster than expected.

P Increased propensity to prescribe

M Medics must be trained in prescription levels

P There can be heavy anti-selection

M So you will need to have a pre-existing condition exclusion backed up by a claim control system alerted to this possibility and a waiting time before cover commences

M Make sure pricing allows for anti-selection

M Put back medical underwriting

M Apply an excess or some other form of co-insurance

P There will be concentration of these claims in some areas

M In time, differential pricing by post code / PCT might be needed

P Not all drugs suit everybody

M Monitor and stop treatment

M Ongoing research needed from the claims area

P This means that claim expenses will be higher

P The qualifying drug list will change quite quickly

M Medical research into what drugs are about to be medically approved

P Some claimants will be able to self select more expensive drugs against that normally provided under the contract

M On-going research

P Often the drugs concerned can be purchased on the internet so it needs to be resolved as to who buys these drugs

M The drugs are purchased by the Medics or the policyholder under guidance from the medics

P There is no control on the internet on the drug strength or is it the right version for the patient

M The patient requires a prescription

P The drug coverage will change as the PCT includes or excludes new and existing drugs from the list

M Liaise with PCTs

P Experience can change quickly

M Monitor and reprice

P Additional claim payments over and above that originally included in the premium basis

P Limited pricing data

M Increase the margins in the contract

P This is a contract where external advice might be needed (eg pricing, claims control)

M Use of reinsurance and / or consultants

P Existing reinsurers might not like it

M Liaise with them or find alternative reinsurers

P General disputes/lack of policyholder understanding

M Clear policy wording or clear guidelines at point of sale

P Reduced sales and/or increased lapses as price increases

M Offer as an option/increase marketing

P Big change in government policy

P Complexities from users moving between regions

P Systems and admin changes and complexity

M Staff training

P Risk of change in mix of business by postcode

M Price for mix of claims by postcode

P Increased capital requirements due to uncertainty

2 **(iii)** **Existing Reinsurance Arrangements**

Details required of existing arrangements

Profitability to reinsurer

Attitude of the Reinsurer

View of the existing arrangement, including view of the direct writer's risk management

Is this a valued client to be accommodated

Interested in this extension in this area/diversification

The reinsurer's capacity to accept business

Will the price and terms offered reflect concern over potential competition

The volatility of the risk

Administrative requirements to take in this element of reinsurance

A new reinsurer in the market will be tempted to offer good terms in order to build a business relationship

How will the risk be shared eg proportion to be reinsured

Quality/credibility of pricing data

Capital /reserving requirements and ability to accept risk

Opportunity to provide technical assistance

2 **(iv)** Stand alone policy

How to distribute the product

Impact on existing business

The need for margins on risk cost will be greater than in a comprehensive policy

Possible to produce a simple contract but great care needed to spell out the policy restrictions to the potential policyholder

Need to ensure treatment has prior insurer approval or non-approval

Declinature will attract media attention

There will be a high rate of declinature of initial proposals

Need to develop new underwriting approach

Reinsurance may be needed to remove the concentration of risk

Will there be enough demand for this policy

Consideration would need to be given to the premium level generated compared with insurer costs

Will sales volumes be high enough to recover development costs

Heavy anti-selection likely on this policy

Need to take this into account when setting both pricing and reserving bases

Greater impact of changes eg in NHS policy

3 **(i)** Factors affecting how to choose which IP to sell:

Whether or not they are tied to a particular company's products

The benefits offered by the product

Value for money / price

Bundling – what else is included with the product

Underwriting process

Claims management process

Ease of use – e.g. do they offer internet applications

Ease of use – are they listed on price comparison services (i.e. portals)

Quality of customer service

Quality of sales literature or marketing material

Sales regulations

The amount of remuneration available and the structure

Clawback arrangements

Product range coverage

Complexity of product

Financial security of provider

Specific customer requirements/needs

3 **(ii)** Why differing rates of commission

Most likely they see a difference in the quality of the business

This may be in the form of the morbidity experience or the lapse experience or even the underwriting administration experience where the morbidity experience is seen to differ between adviser this could be passed on via the premium or the commission

Alternatively:

Different commission structures

It may be that some intermediaries get other sources of funds, e.g. they may get a fixed sum per month from the insurance provider on top of the commission paid

Some advisers may already charge partial fees so that they don’t require full remuneration via commission

The insurer may have a strategic aim to increase market share in some areas and so might have increased commission in those areas eg the insurer may wish to increase the number of large size policies they write or they may wish to reduce risk concentration and focus on smaller policies

Different advisers will target different population segments and so will have more of one sort or another

The adviser may have a different mix of business by product type/term – e.g. one adviser may mainly sell immediate needs policies, this would have a different commission rate to the critical illness policies sold

The insurer may have had to agree to a higher rate of commission with some advisers in order to retain their business, because they were tougher negotiators

May pay higher where the insurer is in some form of a tie or on some kind of 'hot list'

Insurers may have put in place volume deals, whereby they agree to pay higher commission to brokers who bring in over £xm of business

Some brokers may do more admin (reducing the burden on insurers)

3 **(iii)** Advantages to the customer

Enables them to see what they are paying for advice

Enables them to compare the services offered by different advisers, and the fees charged for those services

Customers can feel assured that the choice of products is right for them and not influenced by commission rates

Disadvantages to the customer

Customers may now find they need to find cash for an initial fee which previously they would not have had to do

If customers lapse their policy they may lose some of the value invested in the initial fee

More administration, as they have outgo to both the insurer and the adviser

May be shocked by how much advice costs

3 **(iv)** Effect on intermediaries

Effect depends very much on whether they currently take initial or renewal commission

For initial commission based advisers, the move is likely to result in a one-off hit to their income

May need to find working capital from elsewhere

This will be countered by an ongoing stream of income, increasing over time (as the volume of business they have done in this way increases) so in the long run their total income could be unchanged

Fee based business may be harder to sell, because the amount the customer is paying for advice is transparent

A shift to higher net worth individuals/increased pressure on FIAs to obtain recognised qualifications and the customer may even get the advice but then go off and buy the policy directly

They will need to adapt to new sales methods and will need to reassess the products in the market to identify the new competitive winners and losers

Advisers moving from initial commission business will now have an income stream that is more dependent on retaining their existing customers rather than identifying new ones so they will have to redesign their business model, focussing on customer service, and with less emphasis on customer attraction

In the long run they may find their income stream is less volatile under the new regime, as they can predict more easily what fees they will receive, and will have more control over whether they do in fact receive those fees.

There may be an overall fall in the advised-sales market, as more customers seek more cost effective methods of obtaining cover so they may lose business to direct written products, and cheap and cheerful solutions such as bancassurers or white-labelled products sold in supermarkets.

Harder to sort out non-payments

3 **(v)** Effect on persistency

If the amount received upfront by the broker is lower than under the previous model, as would be expected (as noted above), long term persistency should improve but if customers seek out a new adviser under the new model, they may still be moved to a new provider, as they will not be willing to pay an initial fee for keeping the same policy

Change in shape of persistency curve; loss of spikes in offs ahead of clawback period

A change in business mix(eg more financially sophisticated) will also affect persistency (eg improve it as less likely to be unable to afford to continue premiums)

Under the new regime, we might find that more policies will be sold based on true need and affordability, and this should improve the level of offs due to finding that the policy was not, in fact, suitable and if the new regime does prompt a move towards customer service focus, customers may be happier with their adviser, and so they may be less likely to seek out a new adviser with a consequent revision of their health and care provision

The advice based drivers for persistency will be most seen in products with a varying charge with age, eg unit-linked products with risk charges calculated for different ages

For long term business with fixed levels of premiums, the effect would be much less marked, eg CI, where customers "overpay" at short durations, and "underpay" at later durations.

3 **(vi)** Possible courses of action

The insurer could seek to buy in sales by offering to fund advisers who are struggling to finance themselves through the change in regime

This would mean that those advisers would no longer offer products from the whole of the market and would instead commit to a multi-tie or a single tie to that insurer

This would depend on being within the regulator's rules

The insurer could seek to expand into other distribution channels, such as direct business, or underwriting bancassurer business.

It would also provide welcome diversification

The insurer could redesign its products to make them more attractive in the new regime or lower its prices

A "low start" premium product could be designed that would offset the cost of the initial fee to the customer or it could offer other services to make life easier for the adviser such as offering help with the underwriting process or providing computer admin systems that enable the adviser to see details of their customers products and fee arrangements together and the company could generally differentiate itself from the rest of the market by providing high quality customer service, or it could invest more in brand name awareness/advertising so that customers "know" the product when suggested by the distributor

Lobby against the change

Increased broker relationship management

Enter the PMI market or other market or expand overseas

4 (i) Pros

Can tailor specifically to the risk profile of business

Formula can suffer from inflexibility

The standardised approach will most likely be calibrated conservatively

Internal models could produce lower capital requirements

Hence advantages in capital management and pricing

The development of internal models is likely to improve risk modelling and provide additional insights in risk profile

This should give those firms which use them a competitive advantage

An internal model is likely to be an important part of most companies' risk management framework (i.e. it helps to embed a risk management culture)

Internal model may be based on existing model so may reduce training requirements

More control over periodic reviews

Getting regulator approval helps give credibility to internal management info (ie it gets senior management buy-in to the output)

Cons

Internal will need to be approved and reviewed

Need to get peer review or audit and regulatory approval can take a long time

Regulatory approval can take a long time if there is a backlog of initial applications

There may also be minimum requirement of its use within the company – the use test

It will take significant time to develop which will add to costs and cause strain on resources

Could be particularly a strain for smaller companies

The benefit could be marginally lower or even higher calculation requirement

Unlikely to have expertise in house

Designs and standards of model could diverge widely from one company to another

Having spent the upfront costs, the model might not be accepted

It could prove difficult to explain the model to senior management/board

Could be harder for external analysts e.g. credit rating agents to compare between companies

Difficult to set calibration of risk stresses specific to the particular company and similarly the correlations between risks, particularly how correlations behave under stressed conditions

May not have good data on which to base an internal model, for example for operational risks

May need to get reapproved regularly (eg when a new product is launched)

4 **(ii)** Model must be widely used within the company. eg pricing, reserving etc

One model (or at least models that are consistent) used throughout the business

It must play an important role in risk management and decision-making

The design must be based on sound actuarial and statistical techniques

Data accurate, complete and appropriate and reflective of the business

Covers all material risks

It must be able to produce analysis of causes and sources of profits and losses

The company must be able to demonstrate how the categorisation of risk is carried out

There must be regular cycle of model validation

The company must avoid over-reliance on external model providers

New users should be able to understand the operation of the model relatively easily ie no black boxes

The model should have the ability to look at various risk measures and levels of confidence

There should be detailed breakdown of risk

- market risk
- interest rate risk
- credit/reinsurance risk
- operational risk
- mortality and morbidity risk
- persistency risk
- expenses risk
- risks attaching to the firm's pension scheme
- liquidity risks
- group risk

Comprehensive documentation of model which should cover

- theory
- design
- assumptions
- results
- operation
- compliance

shortcomings/approximations

future developments

May specify calibration of the model (eg minimum shock tests/specified correlation assumptions)

Use of stochastic models in some circumstances

Specify treatment of new business

Regular regulator reviews after initial approval

Staff who work directly with the model should be thoroughly trained

There should also be a reasonable understanding of the model by the Board and senior management

The model must be able to produce formal, detailed reconciliation of results

Internal review of model and processes

Processes in place to keep models up to date

There should be segregation of duties

Independent external review should be carried out

The model should be signed off by internal and/or external auditors

Might specify minimum level of confidence to be achieved in specified time period

Disallow switch back to formula approach if have an approved model (to avoid capital arbitrage)

Set a minimum capital requirement

Set deadlines/time limits for approval applications

Require submission of a comparison with the formula approach

Require sign off by a nominated person

Disclosure requirements

END OF EXAMINERS' REPORT