

INSTITUTE AND FACULTY OF ACTUARIES

Scenario Material

13 April 2022 (am)

Subject CP3 – Communications Practice Core Practices

INSTRUCTIONS FOR CANDIDATES

You are provided with this advance information to enable you to read and understand it in your own time and not under examination conditions. Please note that this is an examination to test your ability to communicate technical information to a non-technical audience. It is not a test of your technical actuarial knowledge or skills. As such, any technical actuarial information or techniques needed to answer the question will be provided to you. You do not need to spend time revising other subjects or researching further detail on the topics covered in the paper.

Background

Safe Tomorrow Insurance Limited (STIL) is a large, well-established life office that is regulated by the Proper Oversight Authority (POA). STIL specialises in unit linked savings products sold via a direct salesforce.

The following sections cover:

- overview of STIL's unit linked funds.
- extract from a recent STIL board paper.
- investment managers' report on equity funds.
- recent Statement from the POA.
- customer research on climate change.

Overview of STIL's unit linked funds

The company has six unit funds available to policyholders as described in the table below. Each has a risk index that represents the degree of risk inherent in the fund, based on a number of factors, including the volatility of return and probability of default of the underlying assets. The index ranges from 1 to 9, with 1 being the lowest risk and 9 the highest. An index of 1–3 inclusive is low risk, 4–6 is medium risk and above 6 is high risk.

A high-level description of each fund and its risk index are given below.

<i>Fund</i>	<i>Description</i>	<i>Risk index</i>
Safety	A fund invested in government issued bonds and cash. It traditionally displays lower rates of growth and has low volatility in return.	1
Cautious	Similar to the safety fund but with lower cash holdings and up to 10% holding of high-quality corporate bonds issued by companies with at least a credit rating of AA.	3
Corporate	Invests predominantly in secured and unsecured corporate bonds issued domestically and internationally in a broad range of companies from manufacturing through to leisure groups and ethically sustainable industrial businesses. Up to 12% may be invested in equities and no more than 5% in cash.	4
Energy	Invests in gas and oil companies around the world.	5
Property	Invests in high-quality commercial property and in overseas property unit trusts.	8
Adventurous	Invests solely in international venture capital businesses.	9

Each fund has a different charging structure, including a different annual management charge levied on the fund as a percentage of fund value.

Policyholders can invest in up to three different funds in a single policy. Currently, 81% of policyholders invest in just one fund, with only 8% invested in three.

Extract from a recent STIL board paper

The following tables show the distribution of investments across the available unit linked funds, together with the actual growth rates achieved on each fund.

Funds under management

The history of funds under management since 2017 in \$m measured at 31 December each year for pensions products is shown in the table below:

Year	2017	2018	2019	2020	2021
STIL fund under management \$m	130.7	112.5	110.1	108.7	107.3
Of which % split by fund					
Safety	11	12	10	11	10
Cautious	14	16	15	16	15
Corporate	32	35	38	39	40
Energy	25	22	20	19	16
Property	10	12	12	10	14
Adventurous	8	3	5	5	5

Historic and recent growth rates

The following rates are calculated based on the bid value of investments:

<i>Fund</i>	<i>Average annual growth rate calendar years 2017–2021 inclusive (%)</i>	<i>Annual growth rate for calendar year 2021 (%)</i>
Safety	0.2	0.3
Cautious	0.3	0.4
Corporate	7.3	9.5
Energy	8.1	9.7
Property	6.6	7.3
Adventurous	4.3	10.8

Investment managers' report on equity funds

Asset selection

STIL's investment managers use Price Earnings Ratio (PER) as a key metric when choosing which equity sectors to invest in. PER is defined as the market price of a share, divided by the net earnings per share, and a PER of less than 15 is assumed to indicate that shares are undervalued and worth considering for investment.

The average PER for key sectors of the equity market, for the past 4 years, are shown in the table below, measured on 1 January:

<i>Sector</i>	<i>2019</i>	<i>2020</i>	<i>2021</i>	<i>2022</i>
Agriculture	13.8	14.5	14.9	15.3
Construction	13.9	12.4	10.1	9.8
Leisure	9.3	9.8	10.2	9.7
Manufacturing (goods)	12.1	13.2	14.1	14.2
Oil and gas	13.1	14.2	13.8	14.1
Pharmaceutical	14.0	14.9	15.6	20.1

In addition to the PER, the investment managers consider qualitative factors when choosing investments.

Recent sector concerns

The investment team has concerns regarding the oil and gas sector. The outlook for this sector is less optimistic than for other sectors such as agriculture or construction; however, the PER is at a comparable level.

The value placed on oil companies is often based on oil reserves that are still in the ground. There are growing concerns globally about climate change and the impact on the environment of extracting these reserves. This, together with an increasing appetite for alternative fuels and electric vehicles, leads us to conclude that stocks in the oil and gas sectors are overvalued.

Recommendation

As investment managers, we believe that gas and oil will continue to decline in popularity and anticipate a sustained decline in the share price of such companies. In order to avoid transition risk, holdings in these funds should be reduced, and we suggest it may be appropriate to withdraw STIL's Energy Fund in the near future.

The continued decline in the use of the existing Energy Fund and concentration of risk suggests it may be appropriate to launch a new fund that aims to provide good growth prospects while being diverse and demonstrating concern for the environment. A suitable investment mandate may be:

- to choose equities from an unlimited range of sectors and companies domestically and across the world.
- to include only companies that demonstrate a commitment to act responsibly and reduce their carbon footprint in the course of their operations.
- to have a relatively high target return of 9% p.a.
- to review asset selection every 6 months from the fund launch date (the review will look at PERs and future-looking qualitative factors).

Recent statement from the POA

There is growing international concern about climate change. Carbon emissions from a variety of sources are causing increased temperatures and rising sea levels. There has been extensive modelling of the impacts of climate change, and these are widespread and likely to impact all aspects of financial services.

We are encouraging all financial services companies to carefully consider their carbon footprint. This includes reviewing:

- their behaviour as an organisation, for example in efforts at energy conservation and general waste management.
- the indirect impact their products and services may have on global warming. This could include scrutinising their own investments and any investment choices offered to policyholders.

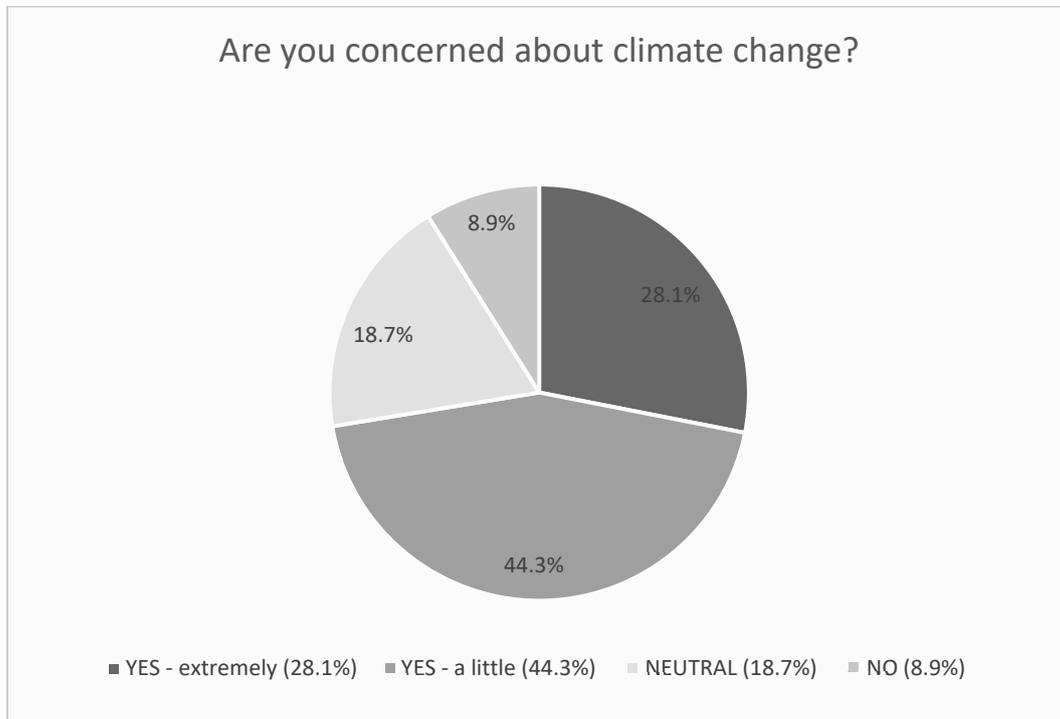
Over the next 2 years, we will be monitoring actions taken by boards to address their carbon footprint. We propose to introduce a requirement for companies to publish additional disclosures detailing and evidencing their organisations approach to environmental responsibility. These disclosures are expected to include qualitative and quantitative assessments that, from 2026, will have the potential to trigger an additional capital requirement.

Customer survey on climate change

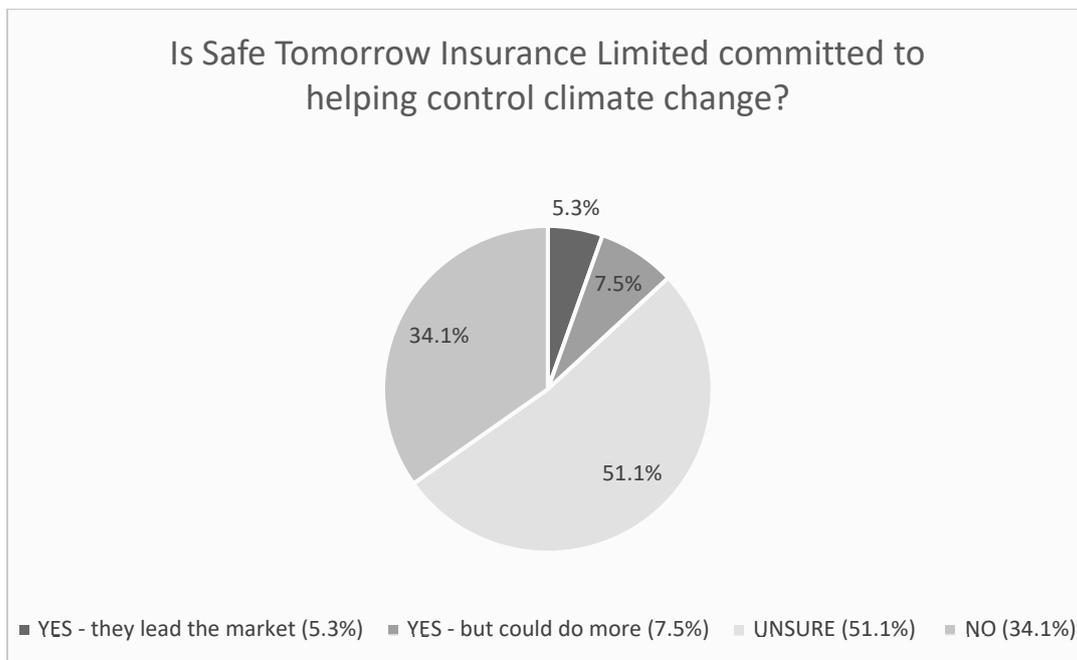
At the start of 2022, a brief survey on climate change was conducted by STIL's marketing team. It consisted of only two questions, and 71.3% of policyholders responded.

The questions and results are shown in the following charts:

Question 1



Question 2



END OF SCENARIO MATERIAL