



The Actuarial Profession

making financial sense of the future

consultation response

BAS Preliminary Consultation paper - Towards a Conceptual Framework

Response from the Actuarial Profession

July 2007

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6 July 2007

Dear Sir

BAS Preliminary Consultation Paper – “Towards a Conceptual Framework”

Response of the Actuarial Profession

The Actuarial Profession welcomes the opportunity to comment on BAS's initial consultation on its intended structure for technical actuarial standards.

We regard it as a sensible aim to develop a framework for actuarial standards prior to undertaking any fundamental changes to the approach that has been inherited from the Profession. We consider the paper to represent a good and positive start to that quest. However we draw a distinction between fundamental changes to the standards structure and changes that are needed to ensure the currency of existing standards. It is vital to the reputations of both BAS and the Profession that sufficient focus is maintained on the latter while developing the former.

We also regard it as an extremely positive step that BAS is promoting discussion while the framework is still being developed. We do have a concern that, given the diversity of actuarial work and of the regulatory backgrounds against which it is carried out, finding an all-embracing 'conceptual framework' is a huge and perhaps impossible task. We are pleased that the initial emphasis has been primarily on structural rather than conceptual issues.

Our detailed comments are attached, but in essence:

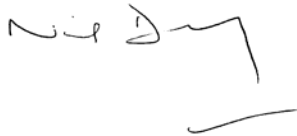
- We agree, generally:
 - with setting standards for outputs and hence the concept of 'actuarial information'
 - that prudence should not be a part of measurement
 - that measurement and decision-making should be separate
 - that excessive detail may obscure the more important information
 - that risk should be concerned not only with loss but also with the potential for gain
- We are uncertain about:
 - concentration on financial products which appears to exclude, *inter alia*, the information in accounts

- consistency, which should be over time for a particular entity rather than, or at least as well as, between entities
- danger in 'actuarial information' at a point of time rather than over time
- references to actuarial 'forecasting'

We should like to discuss further with BAS:

- the content of 'actuarial information'
- whether the issues of actuarial communication are solved by specifying standard reports
- clarity about where risk lies – primarily with the insurer in the case of protection contracts, and with the policyholder in the case of savings contracts
- terminology/definitions, particularly in respect of 'prudence', 'best estimate', 'variability', 'risk', 'consumers', 'managers', and 'third parties'.

Yours faithfully



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President, Faculty of Actuaries

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Comments of the Actuarial Profession

Specific questions posed by BAS

1. Whether the BAS priority should be to focus on standards that relate to actuarial information, over the other issues discussed (section 1.2)

The proposed distinction between information and advice is a valuable one, and we would be interested in developing this concept further with you, particularly defining the boundary between the two. Actuarial science endeavours to take the range of possible future events, and make them a part of present decision making. Because that range is so wide, judgements have to be made as to which future events are relevant to the decision in question, and further judgements have to be made as to how to encapsulate the range of relevant future events into a form that is practical for decision making. It is possible to reduce the variation between individual actuaries by laying down standards for these decisions. However, that does not eliminate the subjectivity of the decisions – it simply transfers that subjectivity from the individual actuary to the standard setters. Users of actuarial advice need to understand the existence of subjectivity.

It will also be important to draw a distinction between those who actively commission actuarial advice, and those who rely on the work of actuaries without being able to influence that work. We could draw the analogy with accounting standards, which are primarily concerned with ensuring good information for the shareholders of companies, and very little concerned with the quality of information or advice given to directors or management. In our view this distinction can carry over to actuarial work. Company directors and trustees should be able to commission the actuary to do what they want. Members and policyholders are the people who require standards. In this respect, the following framework would seem to be appropriate:

- Entities subject to actuarial risks should be required to produce regular actuarial reports for consumers
- Such reports should be in accordance with Standard Actuarial Principles and Techniques
- These reports should be made available to third parties, and in principle should be publicly available
- Technical standards are then not required for the provision of advice to those responsible for the management of such entities

If the BAS has not already done so, we would recommend a review of the Australian system, in which the standards differentiate between Actuarial Advice and a Professional Service.

The two terms are defined as follows:

- "Professional Service" means a service provided by a Member in a professional capacity, including Actuarial Advice provided by an Actuary. A Professional Service includes such a service provided on a pro bono basis.
- "Actuarial Advice" is any conclusion, result, opinion or recommendation provided by an Actuary as a result of performing a Professional Service:

- in a Statutory Role; or
- within the scope of the Professional Standards;
- or for his or her Principal concerning a matter and in circumstances where the Principal reasonably believes that the conclusion, result, opinion or recommendation is being given in accordance with professional requirements governing impartiality, expertise as an Actuary and formal reporting.

Within the Australian model, “Actuarial Advice” can be provided only by an Actuary (being a qualified member) and is a subset of “Professional Services”.

2. Whether the needs of those who rely on actuarial information should be the primary foundation on which actuarial standards are developed as discussed (section 1.4.1)

We see a fundamental distinction between the needs of individual consumers and those of managers. Consumers are rarely in a position to make their own judgements on the reliability or relevance of the information presented to them. They do not meet the actuary; they cannot challenge the actuary’s methods and assumptions, nor ask for alternative advice to be presented. Without standards, consumers are totally unprotected.

Managers are in a very different position. They employ the actuary, decide what question to ask; can challenge the actuary’s view and can seek a second opinion. There have been instances where managers have been unduly deferential to their actuary, sometimes with serious consequences. Equally, there have been instances where managers have ignored sound actuarial advice. Neither of these problems can be solved entirely by actuarial standards; better education of managers is needed (and this is now happening). If managers are not getting what they need from their actuary then they can and should take action to correct this.

Third parties may be in a more difficult position. Some of them – such as regulators can get their own reports. In general, the report for consumers should be sufficient for third parties.

Standard reports for consumers (which would not be ‘actuarial reports’ but which may require actuarial information in their production) would need to cover the following areas:

- How much is my policy or interest worth?
- To what risks is it exposed?
- Against what risks does it protect me?
- How do the risks in this organisation compare with other similar ones?

3. Whether prudence should be regarded as decision–makers’ attitude to risk (evidenced by the risks they accept or avoid) and is not an element of measurement, as discussed (section 1.4.12 et seq)

Whereas we agree generally that prudence should not be regarded as an element of measurement, we nevertheless consider that prudence is (as suggested in 1.4.16) often capable of measurement. Therefore, we regard it as perfectly reasonable to use a composite measure for a specific purpose which includes an element of prudence. A current example is

the technical provisions for a pension fund. However, it should be a requirement that the extent of prudence should be disclosed and, where possible, the measurement thereof also disclosed. It is also important to consider that, as described in Appendix 6, quantification of many risks is practically impossible, in which case the extent of prudence in relation to such risks will not be measurable.

We would also like to think that a note¹ produced by a group of general insurance actuaries on best estimate provisions for general insurance is a useful contribution to the debate.

Finally, we would urge the BAS to communicate with the appropriate legislators on this concept of prudence, as the term is embedded, for instance, in Pensions Act 2004, and in European Directives.

4. Whether the concept of SAPT will provide a useful means of distinguishing high quality actuarial information (section 1.7)

Whereas we are generally supportive of the SAPT concept, we are unsure whether all actuarial information (under BAS's definition in 1.5.1) should be SAPT compliant, nor that all work done by actuaries should be SAPT compliant. We would appreciate clarification on whether the apparent objection to the content being set by contractual agreement would apply in all cases, or just in certain (as yet undefined) cases where there are third party considerations.

We also infer that BAS may be considering prescribing which methods are appropriate for SAPT compliant work. If BAS does intend to do this, then care should be taken to ensure that this does not hamper the development of new methodologies or the appropriate selection and tailoring of methods to fit particular circumstances.

In addition, we consider it important that the reasons for standardisation be made clear, because this then drives the type of standardisation required. There appear to be two purposes:

- The protection of third parties (such as policyholders or pension fund members)
- Protection for decision makers against being misled

The first purpose is clearly right. The second is more doubtful. If the problem is that decision makers are too ignorant, then the solution lies there, not in the actuarial advice they receive. Indeed, both the FSA and the Pensions Regulator have taken significant steps to ensure that boards of directors and trustees have the necessary competence. If the problem is that actuaries are not complying with their duties to the clients then the solution is in enforcement of those duties, not in standards.

¹ http://www.actuaries.org.uk/files/pdf/general_insurance/best_estimates_paper.pdf

5. Whether the BAS should develop a generic communication standard (as recommended by Morris (sections 1.7.8 and A1.14) as well as detailing specific communication requirements and standard reports in each SAPT standard. If so, which of the six items from the Morris listing are applicable to every report containing actuarial information?

We consider that the Morris recommendation has merit, since there should be a number of generic principles applicable to all actuarial communication, which go beyond what might be in specific reports. Therefore, we consider that a generic standard should be developed. However, we believe that any attempt to standardise reports risks adversely affecting the effectiveness of communication; it is essential to recognise the different needs of different audiences. We elaborate on this in our comments on section 1.7 of the consultation below.

Comments on other sections of the paper (paragraph numbers refer to the BAS paper)

1.5 The characteristics of actuarial information and the properties of Measurement

This section appears to overlook the fact that the purpose of most actuarial work is not about determining value for value's sake, rather as a means to demonstrate the effect of value – such as arriving at excess capital or surpluses. Paragraph 1.5.3, for example, implies that actuarial science is predominantly interested in projecting cash flows, as opposed to the establishment of a value/basis. We consider that care needs to be taken not to focus upon a single step in what is a much wider process, otherwise there is a risk of losing sight of the asset side of the equation, or of the actuary becoming a 'liability measurer' to whom a standard will apply, but with the responsibility for surplus or excess capital resting with a decision maker to whom standards will not apply. This division may not work in respect of actuarial advice in the way that it does for financial reporting.

In 1.5.5 it is stated that "*measurements of value or risk are neutral processes, and do not contain implicit comments on the investment strategy that should be followed.*" In general, the investment policy that is followed by an institution will affect the risks of an institution. For example, a mismatched investment strategy will normally be riskier than a matched strategy. Therefore, if the decision maker's objective were to minimise a particular risk measure, then the way in which investment risk is measured in that risk measure is likely to affect the investment strategy that will be followed. It is also possible for investment strategy to affect measure of value. For example, suppose the measure of value is "immediately realisable value". Then a decision to invest in a fund with early redemption penalties (for example many hedge funds) will reduce the value on that measure. It is therefore not true that measure of risk and value are neutral in relation to investment policy, and nor should it be true.

In 1.5.8 risk is defined as something bad. However, whether something is good or bad depends on the point of view. Thus, for example, improving mortality is good for a writer of life assurance but bad for a writer of annuities. Indeed, this point is made in 2.4.3. Moreover, the position can change over time, possibly quite rapidly. Thus whether a fall in bond yields is adverse to an institution will depend on whether the assets are invested longer or shorter than the liabilities, and this is something that can be changed very quickly. In looking at stock returns, risk is often defined as variability of outcome, commonly measured by volatility. This definition has the advantage that it is independent of the investor, but does not conform to the common meaning of the word.

The paper does not discuss stochastic measurement of risk, but this is a key area which is very lacking in standards. There are currently no standards on what information needs to be given on stochastic models, nor on what risk measures are appropriate for what purposes (eg standard deviation, value at risk, conditional tail expectation etc.). While not all risk can be represented stochastically, it is important that there are generally accepted standards for stochastic models.

In the context of communicating uncertainty, BAS may be interested in a paper being developed by a working party set up by the Profession's General Insurance Reserving Oversight Committee. This paper, which will be posted on the profession's website as a discussion document, will suggest various ways in which the uncertainty in general insurance reserves could be explained to a non-actuarial stakeholder.

Finally, we are unsure that the definitions of 'variability' and 'uncertainty' are common in statistical circles.

1.6 The scope of the BAS standards

It is not clear to us how your intended focus on standards for entities will apply in practice, given that the Actuarial Profession regulates individual members rather than insurance companies and pension schemes and, in particular, legislation requires that actuaries are individuals and auditors are entities. In due course, we would like to understand how you intend to achieve this (e.g. via legislation on the entities compelling them to use SAPT kite-marked actuarial information).

1.7 Standard Actuarial Principles and Techniques (SAPT)

17.4-1.7.6 Decision usefulness

We note that, in pursuing the concept of decision usefulness, BAS believes that this is best done by prescribing the appropriate content for actuarial information (Paragraph 1.7.6). BAS will be aware that GN12 (particularly in its latest incarnation, which has made more prominent its applicability in most instances of providing formal actuarial advice in a general insurance context) has met with some resistance, including some from stakeholders such as clients and employers, who engage actuaries to provide actuarial advice and do not wish to be bothered with thick reports setting out the background, methodology, assumptions, and so forth, every time they receive such advice.

We also wonder whether there is an over-concentration on data at a point of time rather than progress over time, e.g. does a negative run-off of claims reserves represent reserve strengthening or under-reserving at the period start?

Finally, we recommend caution around where the risk lies, e.g. protection contracts leave risk with the provider, and typically only with the purchaser if the provider fails. Savings products often leave risk with the purchaser.

1.7.7-1.7.9 Standard reports and communications

We are concerned about the concept of standard reports. This implies a level of standardisation and detail that we would not expect to come from a principles-based approach. Further concerns with this are:

- if standard reports are too limited in scope, clients will end up paying for two reports instead of one (the standard report, and the further work particular to their needs)
- industry-wide standard reports could be seen as ‘commoditising’ actuarial advice, and so downgrading its impact and importance to users
- preparing and maintaining a library of standard reports would be a labour-intensive task

1.7.15-1.7.20 Relevance, reliability, materiality and comparability

In 1.7.20 it is suggested that standards should ensure that information does not depend on who the actuary is. This is obviously appealing, but it creates great difficulties when most actuarial information is concerned with judgements about the future. If all actuaries are required to have the same view of the future it will simply mean that some group or standards committee will be tasked with determining that view. Such a view will not be objective, and indeed decision makers will have no opportunity to challenge or discuss with the committee the basis for their view. This approach has been attempted in pensions with the Minimum Funding Requirement, and was not a success. A single committee view of the future is likely to stultify developments, and is fundamentally in conflict with the principles of market economics – that the best results are achieved by allowing each economic agent to act on their personal view of the future.

Comments on Section 2 – “Some key conceptual issues” (accepting that BAS did not ask for comments on this section)

The categorisation of risks in 2.5 and Appendix 6 is appealing, but many risks fall into several categories. For example mortality has elements of several of these categories, with the possibility of epidemics (AIDS; Flu); the possibility of human causes such as war and terrorism; and the possibility of major medical advances eg through genetic identification and treatment of cancer. It also needs to be noted that risk mitigation often depends on others – eg the risk of AIDS was mitigated by health education, and serious financial risks are mitigated by the conduct of monetary policy.

Paragraph 2.7.2 is unrealistic in its expectation that lifestyle data may be collated with a view to setting payment premiums in the absence of a current legitimate means of its verification.

In Paragraph 2.6.2 we do not think ‘forecasting’ is a central element of actuarial practice, cf ‘Making financial sense of the future’. We note the J K Galbraith quotations ‘The only function of economic forecasting is to make astrology look respectable’, and ‘there are two classes of forecasters: those who don’t know and those who don’t know they don’t know’.

In Paragraph 2.7.1 we disagree that forecasting mortality is one of the main factors with which actuarial science has been involved since its inception. ‘Analysing mortality’ is what actuaries have done.

Terminology

For a common framework to be effective, some clarity of terminology is required. In addition to earlier

suggestions for definition, we would suggest:

- “consumers” to mean individuals who are relying on sound actuarial management of an entity to receive the benefit they expect - eg members of pension funds, or policyholders of insurance companies
- “managers” to mean those responsible for the management of the entities, be they trustees, directors or managers
- “third parties” to mean other parties who may have a legitimate interest, such as regulators, shareholders, sponsoring employers, etc.