



The Actuarial Profession
making financial sense of the future

**SUBMISSION BY
THE ACTUARIAL PROFESSION**

**In Response to the Morris Review's
Initial Consultation Document of June 2004**

9 September 2004

Sir Derek Morris
Morris Review
GC/08
1 Horse Guards Road
London
SW1A 2HQ

9 September 2004

Dear Sir Derek

On behalf of the Institute of Actuaries and the Faculty of Actuaries, working together as The Actuarial Profession, we enclose a response to your Consultation Document of June this year. None of the content is confidential. As you would expect, we are placing a copy of the response on our own web site in addition to the copy that you will be placing on your site.

We look forward to reading other commentators' submissions in due course and to seeing what observations and proposals they make about the profession. There are bound to be suggestions that we have not thought of, some of which we will agree with, as well as some, perhaps, that we will not. As a target of this review (along with the Government Actuary's Department) we would welcome an opportunity to comment, where appropriate, on other submissions if we think a response or comment is needed.

In April of this year, in the period between the announcement of your review and its commencement, we submitted a factual background paper, *An Introduction to the Actuarial Profession* ("our April submission"). We are pleased that you found it helpful, drawing heavily on it, as we hoped you would, in your Consultation Document. We have tried to avoid repeating material from that paper again here, but may have done so occasionally where a recall of the earlier submission is essential to an understanding of this submission.

Yours sincerely



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A INTRODUCTION

Most people see risks and try to avoid them. The Actuarial Profession was created by people who wanted to manage the financial consequences of a risk that could not be avoided.

The profession has moved on from its origins, over 150 years ago, when life assurance was the focus of its work. The financial services sector has developed a range of products aimed at savings as much as, if not more than, protection. At the same time, increasingly sophisticated capital markets have delivered many more traps for the innocent investor. Actuaries work in areas where the management of assets and liabilities, especially over the long term, is assisted by a combination of mathematics, economics and finance.

Despite the popular myth, actuaries cannot predict the future or make unshakable forecasts. We have never been able to. Actuaries build financial models – some as familiar as a spreadsheet projection, others based on stochastic (random simulation) processes – all founded upon assumptions about uncertain future events and all designed to throw light on alternative future circumstances so that people can plan for a range of outcomes.

Making financial sense of the future

Naturally, it is the role of actuaries to help interpret their models. In recent years, the professional body adopted the strap line, *Making financial sense of the future*, as a means of capturing, in a single phrase, what the profession is all about. The chosen expression was consistent with one of the core aspects of actuarial training: learning to identify which potential outcomes are more probable and how not to be distracted by combinations of assumptions that are implausible. Nevertheless, it is not an exact science. The time scales over which an actuary has to plan are typically from five to 50 years. If our profession had complete mastery of financial and economic projections over such timescales, economists would be out of business and actuaries would be running the Treasury. Neither of those outcomes has occurred, nor are they ones we consider to be remotely plausible.

In the latter stages of the last century, it was the economic aspects of actuarial models that were the main challenge. Mortality of policyholders and pensioners in the UK was, in general, improving, but the changes could be anticipated with a sufficient degree of accuracy (although, with the onset of AIDS, that confidence was threatened for several years). Now, that aspect of stability in our calculations has been overturned once again, this time by medical advances which have improved longevity rather more than had been anticipated (by anyone).

Actuaries have begun working with gerontologists, epidemiologists and medical scientists to find ways to escape from a reliance on statistical analysis of historical data. There remains, however, great uncertainty about the future prospects: no amount of statistical skill can anticipate whether today's younger generation will exercise for a fitter and longer life or eat its way to obesity and an early grave – to cite just one behavioural choice that affects longevity.

Changing ethos in society

The mechanisms originally devised by actuaries existed because of a well-ingrained paternal ethos in society. Mutual insurers and employer-sponsored pension schemes (with compulsory membership) are classic examples of such an ethos. Demutualisation and the freedom of individual workers to select their own pension providers have been relatively recent phenomena. The ban on employees having more than one concurrent pension provider, which will not finally be lifted until April 2006, is a relic of that ethos – a relic that created the all-or-nothing environment without which the 1990s pensions mis-selling scandal might never have escalated to the level that it did.

That paternal ethos created an environment in which cross-generational “smoothing” was the predominant financial management device: pensions and life assurance relied on a process in which either the money going into savings (eg the employers' pension contributions) or the benefits coming out (eg bonus declarations for with-profits policies) was to be smoothed over many years.

The paternal ethos has been replaced by one of transparency in which individual consumers – as savers or prospective pensioners – must be given sufficient information to be able to fend for themselves.

This change is a societal choice, which actuaries must work within. It is noticeable, however, that the drive for transparency, and its implementation, has preceded the education of (most) consumers to handle the new information. Increasingly, actuaries are expected to make financial sense, directly or indirectly, to individuals as well as to business managers and pension fund trustees. This change has come about rather faster than actuaries, at large, have been able to acquire the communication skills to meet the new demands.

Learning from recent events

The events at Equitable Life, and the Penrose report which followed, were a shock to many actuaries. Those leading the profession during this period had commenced a series of initiatives designed to identify what role the profession – actuaries in general and the professional body in particular – had to play and what changes were necessary.

The initiatives we began before the Penrose report was published reflect a determined desire of the profession to reappraise itself. Those initial thoughts identified the need for:

- an independent Actuarial Standards Board (see Section P of this submission);
- periodic revalidation of professional competence (see Section N);
- peer review/compliance monitoring (see Section Q); and
- a revised, more independent disciplinary scheme (which had been introduced by the time the Penrose report was published and was commended in the report – see Section R).

The Penrose report itself gave further food for thought. Publication of the report was simultaneous with the Treasury’s announcement of the Morris Review, so the opportunity to initiate further procedures on the back of Penrose has been limited by the need not to race ahead of the findings of this Review.

That has not, however, deterred us from reflecting on the messages from Penrose. In one of the most telling passages of his report, Lord Penrose wrote:

“One has the impression that actuaries have at times acted as if they were fully qualified in accountancy, law and other disciplines so as to need no outside support.” (Penrose 20.36)

Few readers who made it to Chapter 20 of Penrose can have read that sentence without an intake of breath. For actuaries, it falls into that category of revelations which may never have crossed one’s mind previously but, on reading it for the first time, one knows immediately that it is true – not of all actuaries all of the time, but enough actuaries enough of the time – and deserving of its promotion from Chapter 20 of Penrose to Chapter 1 of Morris.

The tendency has been for actuaries to regard life assurance and pensions as “our territory”, leading to the belief that the actuary’s experience, rather than any specific training, has equipped him or her to deal with a more comprehensive range of questions than is the case.

This sense of consummate expertise in a narrow area is consistent with another observation which the Consultation Document repeated from the Penrose report, the observation that the scope of the actuarial profession has at times been too narrow. The Consultation Document juxtaposed these two observations of Lord Penrose, commenting that they were perhaps the reverse of each other. We suspect that they are merely the opposite sides of the same coin.

CHAPTER 1

The role of actuaries, the profession and the actuarial services market

B THE SCOPE OF THE ACTUARIAL ROLE

General remarks

We recognise that the opening questions were conceived primarily to attract comments from outside the profession, rather from actuaries themselves. We think there is merit, however, in having a response from The Actuarial Profession, reflecting the perception from within. If it turns out that there is a sharp contrast between the perceptions of users of actuarial services and our own perceptions, that will be instructive in itself.

Q1.1 What do you see as the main value provided by actuaries and, conversely, what are their weaknesses? In general, are actuaries properly equipped for the roles that they perform?

Many professions can be characterised at two levels: a technical skill and the use of that skill in a broader context. So, for example, the technical skill of accountants is the compilation and checking of a set of accounts. But the real value that accountants add is to be found in the financial management of a business, which is rather broader and more complex than the “score keeping” skills.

Likewise, the technical skill of a lawyer is knowledge of the law. The real value lies, however, in a variety of ways in which that knowledge is combined with another skill to great effect, for example in trial advocacy.

So, whilst the technical skill of an actuary lies in the construction of financial models, the talent lies in the ability to combine the technical skill with an in-depth training in problem-solving to manage long-term financial vehicles. [Although actuaries and accountants have “finance” in common, the similarities end there: the actuarial field is typically narrower than the range of businesses in which accountants operate, but very few accountants are comfortable operating models over the time-frames that actuaries work with.]

The skills that actuaries use as *inputs* to a problem include:

- experience in distilling a problem down to manageable proportions (for example, using large quantities of data, while appreciating the limitations of that data)
- judgment in determining appropriate assumptions for projecting future scenarios
- analysis of trade-offs between risk and reward, or between short and long term.

The *outputs* from an actuary’s work include:

- a strategy for accepting (certain) risks, and managing them, rather than avoiding them
- the fair and appropriate exercise of discretion between different groups, for example distributing surplus equitably between different cohorts of with-profit policyholders or different generations of members in a pension scheme.

It goes without saying that the relative abilities of those within a profession will vary enormously. Talent at the top of a profession is perhaps characterised as the ability to see a problem through a clearer lens and to devise solutions which others cannot. Having a range of talents within a profession is an inescapable concomitant of having a profession.

There are, inevitably, a number of weaknesses that tend to accompany these strengths. It is in the nature of people who apply their mathematical training to solving complex problems involving much data that there can be a tendency to see the problem as being bounded by the scope of the information provided.

To an archetypal actuary, the “big picture” often means seeing the message within the numbers, to the exclusion, sometimes, of the world beyond those numbers. The profession is not without people who have the ability to see both, but the combination of such skills, developed at a high

level, is not always found within the same individual.

This simple statement begs the question whether there is any *value* in the ability of an actuary to discern patterns from the numerical data and to interpret those patterns. We think there is, as illustrated in the bullet points above. We would be disappointed if the observations of other commentators, or the conclusions of this Review, were otherwise, but it is in the nature of an external review that such beliefs will be challenged.

Another weakness, alluded to in the Introduction to this submission (Section A), is in meeting the challenge created by the need to communicate actuarial concepts to non-actuarial audiences. Once again, this calls for a skill which is not a natural fit with being mathematically oriented problem solvers. For such people, an understanding of the complexity of a problem can get in the way of clarity of advice. This issue, and how to remedy it, is raised more specifically in Q1.25 and we will have more to say on the subject there.

The question also calls for a conclusion on whether actuaries are properly equipped for the roles they perform. Not surprisingly, we think the answer is “yes”, but we accept that the answer should be qualified. Yes, actuaries can improve. Yes, actuaries can benefit more from the observations of informed external commentators than we have done to date (see also our answers to questions in Section P, regarding an independent Actuarial Standards Board).

Above all, we think that any initiatives for improvement need to involve actuaries at the highest levels. It is no coincidence that the very successful chairman of the independent *Accounting Standards Board* (and now the International Accounting Standards Board), Sir David Tweedie, is an accountant.

Q1.2 Are there areas of business that you think actuaries should become more involved in or conversely are there areas of work you think actuaries should leave to other professionals?

Historically, in the UK, there has been a fairly limited demand for actuaries outside the core areas of pensions, insurance and investment – less than 10% of practising actuaries, which means just a few hundred people at most (and, until recently, probably quite a lot fewer than that).

Few actuarial consulting firms have wanted to pursue very aggressively a strategy of spreading the range of work that they do, especially when the demand for core services has been more than sufficient to keep them busy.

Q1.3 Do you think that there is still a need for particular roles for actuaries to be reserved by statute and, if so, which roles and for what reasons? If not, why not?

If others have (or can acquire) the appropriate skills and expertise, there is no reason, in principle, why actuaries should have a statutory monopoly over any work.

In practice, regulators and/or the legislature want the security of knowing that someone suitable is carrying out the work. So there needs to be some recognised body (or bodies) which determines whether an individual has attained (and maintains) the relevant qualification and which lays down any standards for carrying out the work (unless it is determined that the work can be unregulated, which seems an unlikely conclusion in the circumstances). There will be cost, and other implications, but given the size of the institutions for which actuaries provide reserved services, that need not be an obstacle.

Will others come forward to do the work?

- *Life assurance*: Reserved work has hitherto required the services of little more than 100 actuaries (see Section 2 of our April submission). Another 1300 actuaries are currently engaged in life assurance practice unchallenged by any discernible competition and unprotected by any reservation of work.

[Note: The reservation of work to actuaries in life assurance is no longer directly by statute. The Appointed Actuary regime and its successor is a matter for the FSA to decide, using their statutory powers under the Financial Services and Markets Act 2000.]

- *Pensions*: The main reservation of pensions work to actuaries stemmed from the practice of various groups to place their trust solely in actuaries, without being required to by statute. For example, the Inland Revenue requires periodic funding reviews by an actuary as a condition of granting schemes tax-approved status and lawyers typically included a requirement in pension trust deeds for a periodic funding review to be carried out by a Fellow of either the Institute or the Faculty of Actuaries.

The *statutory* reservation of work to actuaries has been in widespread existence only since 1997 when the minimum funding requirement (MFR) regime was introduced. Prior to that, the statutory reservation was limited to pension schemes contracted out of the State second pension.

- *General insurance*: The entry of actuaries into the general insurance market is as recent as the last 30 years. Prior to that, and during the early years when actuaries were establishing their position, the calculation of reserves was typically carried out by underwriters, deploying little, if any, mathematical or modelling skills. The displacement of underwriters from this function was purely market-driven, as underwriters became increasingly uncomfortable setting reserves without the mathematical assistance that they did not regard themselves as having and/or managers of insurance businesses lost confidence in their underwriters as setters of reserves.

In the US, some reserving work, especially in long tail business such as environmental and product liability claims, has been carried out by firms of economic consultants. Some firms carrying out that work tried to gain an entry into the UK market in the early 1990s (when there were no reserved roles in general insurance), but they proved largely unsuccessful and have since retreated.

[Note: There is a comment at the foot of page 20 of the Consultation Document to the effect that the role of the Syndicate Actuaries “exists because Lloyd’s syndicates undertake some life business”. This is not correct. The role of the Syndicate Actuary relates to the general insurance liabilities of syndicates.]

This issue is revisited in Q2.9 and Q2.16.

Q1.4 What impact, if any, has the existence of reserved roles had on the effectiveness with which actuaries work with non-actuaries?

We suspect that the driver behind this question has more to do with the actuary’s reserved role in life assurance, rather than the other reserved areas. The distinguishing feature of life assurance is that, not only was a role reserved to actuaries (hitherto, the Appointed Actuary), but the role was also excluded from the scope of the life office’s audit. This led to a “my patch/your patch” attitude between the two sets of professionals, which Lord Penrose characterised as “like commissioning the two legs of a pair of trousers from separate tailors” (see Penrose 20.47, repeated in the Morris Consultation Document at paragraph 2.30).

That behaviour can be contrasted with the relationship between auditors and actuaries in pensions and general insurance, where the actuary acknowledges that the auditor has a role to play, which may involve reviewing the actuary’s work, and the auditor recognises that the actuary has calculations to perform, without which the client’s accounts cannot be drawn up and the auditor’s audit cannot be completed.

The question is, however, broader than just actuaries and auditors. The question asks about the relationship between actuaries and non-actuaries in general. In advance of seeing the submissions from non-actuaries, we suspect that any comments identifying any detriment to the

effectiveness of the actuary's role may also arise predominantly in the area of life assurance. Our experience is that some life office directors have had a tendency to place too much reliance on the role of the Appointed Actuary and, in some cases where that has happened, not enough has been done to correct that. This may have spilled over into a tendency by the directors to rely on actuaries in areas where legal advice may have been of benefit, as noted in Section A of this submission.

Q1.5 If roles reserved exclusively to actuaries are maintained, do you think that there is a need to introduce greater peer review and scrutiny of such work?

The Actuarial Profession is already committed to introducing greater peer review – see Section 7 of our April submission and also Section Q of this submission.

Q1.6 Could other professions work more closely with actuaries or in related functions to help maintain and improve actuarial effectiveness?

In keeping with our comment in Section A, we think the real issue here is one of ensuring that individual actuaries do not get into the habit of regarding life assurance and pensions as “our territory”, leading to the belief that the actuary's experience has equipped him or her to deal with a more comprehensive range of questions than is the case. There aren't any specifically identifiable circumstances that we are aware of where it is possible to say: “When [this] happens, you must get input from a member of [that] profession.”

This reasoning suggests a behavioural change, rather than a regulatory one (although disciplinary sanctions can be imposed after the event if seriously wrong judgments are made). We would welcome any suggestions that would assist in instilling the right mind-set.

One proposal of our own is to address it as a specific issue in the professionalism training that is compulsory for all newly qualified actuaries and again in any further professionalism courses that are introduced as part of the revalidation of professional competence.

[The professionalism training for newly qualified actuaries was referred to in Section 8 of our April submission as a course in “professional ethics”. The implication of our suggestion here is that the course would be extended to include professional behaviour, not just ethics. The revalidation of professional competence was referred to in Section 7 of our April submission and is discussed in more detail in Q2.22 of this submission.]

C ACCOUNTABILITY OF ACTUARIES

Introduction

The questions in this section have as their theme the public interest and the accountability of *advisers* to the public interest, an issue which is common to all professions. The quite separate question of the duty of a *professional body* to serve the public interest – and the very different answers it leads to – are addressed in our response to Chapter 2 of the Consultation Document. In our responses, below, to the specific questions posed in Chapter 1, we deal with the public interest issue as it applies specifically to actuaries and financial services, but first we offer some generic comments.

Overview

It is extremely tempting to suggest that every decision made by a professional should take into account the public interest – or perhaps, even stronger than that, every decision should be *in* the public interest (the distinction being that where the public interest conflicts with the client's interest, the former should prevail). It is easy to see, however, that such a general rule breaks down when it is exposed to examination.

- The duty placed on barristers, for example, to represent any client who approaches them – and to put the client's case as effectively as the barrister is able – means that murderers, paedophiles and many other undesirables in our society are all entitled to the best defence that their chosen barrister can muster and, if convicted, the best arguments on appeal. It is clearly not in the public interest that criminals should escape punishment, but if an accused person were unable to find a trained advocate willing to put his or her case, our justice system simply wouldn't work.

What this example demonstrates is that, sometimes it must be the *system* which is constructed in the public interest and individual professionals required to advise strictly in their client's own best interests in order for the system to work.

- One might also ask whether it is in the public interest that some consumers purchase a brand name drug instead of a cheaper, chemically identical generic (for example, Panadol as opposed to paracetamol, or Nurofen as opposed to ibuprofen)? On the face of it, the public interest objective suggests that no accountant or doctor should co-operate in the manufacture or sale of the branded products, if generics exist, because customers are clearly overpaying.

If, however, the brand manufacturer uses the higher prices to generate funds for research into new medicines, whilst the generic manufacturer can only afford to manufacture out-of-patent look-alikes, perhaps it is in the public interest after all for the brand manufacturer to capitalise on the willingness of some customers to pay over the odds for a brand name they feel comfortable with.

What this example suggests is that, sometimes it may actually be in the wider public interest for individual customers to be free to buy an overpriced product.

- A particular theme of present policy-making by the UK government is that a vibrant economy depends on active competition – that rival products should be able to fight for market share – which suggests that customers (and not accountants, actuaries or any other professionals) should be trusted to decide which products they want to buy. That simple statement has to be tempered, however, by the fact that, for competition to work, there must be something approaching a balance of information on all sides, so that producers cannot exploit customers' lack of knowledge.

When there is an imbalance of knowledge, the standard remedies are to ban offending products and/or to provide customers with more knowledge. The first of these options (banning) would seem to be a matter for regulators, not individual employees who happen to be members of a profession. In the financial services industry, there are limited

circumstances in which the regulator (FSA) might ban a product outright, but there is a system of compensation and/or penalties for mis-selling products. By these two means, sales are unwound (banning them after the fact) and the provider/salesmen can be punished (as a deterrent to mis-selling).

The second option (making consumers more knowledgeable) can be pursued through general educational channels (schools, newspapers, TV etc) or it can be achieved through specifically targeted warnings, eg on the product packet or on a web site. Warnings can be made the responsibility of the manufacturer, in which case, the responsibility for compliance normally rests at the top level (ie the boardroom) and not drilled down to specific individuals within the company based on their professional qualification.

So, for example, the government requires cigarette manufacturers to publish warnings that cigarettes can damage one's health. There is no requirement, however, to put a wealth message on a packet of branded painkillers, nor is it clear whether the public interest would be maximised by wording the message: "this medication is more expensive than it needs to be" or "thank you for donating to drug research." It would be impractical to expect individual accountants, doctors or any other professionals employed by pharmaceutical companies to take responsibility for determining which, if either, message to give to customers.

In financial services, newspapers provide regular educational material. The FSA has a warnings page on its web site.

We draw the strands of these arguments together by observing that, if current economic thinking has any continued belief in the Invisible Hand described by Adam Smith (broadly that, although individuals pursue their own advantage, the greatest benefit to society as a whole is achieved by their being free to do so), one may be forced to conclude that it is counter-productive to ask one group in society – those called "professionals" – to abandon the interests of their clients in favour of the community as a whole.

One recent example which supports our argument is Parliament's decision, in the Enterprise Act 2002, to transfer decision-making on merger approval to the Competition Commission and, at the same time, to change the test for approval from one based on the public interest to one based on the level of competition. Our understanding is that the legislature considered the determination of the public interest to be a matter for Government.

Q1.7 To what extent should actuaries accept some responsibility for their role in designing financial services products that have subsequently turned out not to be "fit for purpose" for consumers? Why were these issues not brought to light by the profession earlier and therefore perpetuated to the detriment of consumers? What lessons can be drawn from these experiences for the future?

... not fit for purpose?

The first part of the question is based upon the premise that there are (or have been) products that are not "fit for purpose for consumers". The support for that premise is given in the text (at paragraph 1.14) as a passage from a speech to the Institute of Actuaries by Walter Merricks (Chief Ombudsman of the Financial Ombudsman Service) as guest lecturer at the 2001 AGM.

As important and as incisive as Walter Merricks' speech was in stimulating the profession to make several of the changes now in place, or proposed, the particular passage picked out in the Consultation Document is more reflective of the passion that Mr Merricks put into asking challenging and provocative questions, than it is a convincing case for change. The notion that an investment product (other than a fraudulent one) can be said, in advance, to be not fit for *any* customer is not one that we think commands wide acceptance.

No matter how risky a savings product might be – and, therefore, how carefully it needs to be sold (and to whom) – it is going too far, in our submission, for anyone (with the exception of a regulator) to say "no member of the public, not even a high net worth individual with money for

speculative investment, should be allowed to know that the product exists.”

... *accept some responsibility?*

In the area of financial services, government has already created *systems* (called “regulation”) to control, in the public interest, the use to which products are put (ie, broadly, the marketing and selling of the products). As Chief Ombudsman, Walter Merricks is, himself, part of that system and our reply to his question is to challenge whether it is practical or economically efficient to place a burden on the individual designer of a financial services product to be held responsible for the manner in which the product is sold by his or her employer.

Indeed, if the *system* was created with a view to putting the UK financial services and markets at the forefront of world markets, and not as a means to ossify the market, we would suggest it is essential that designers be left to design.

What then is the responsibility of the individual actuary?

- The actuary as *director, marketer, salesman or compliance officer* has a role – along with every other director, marketer, salesman and compliance officer – to ensure that the customer is not misled or mis-sold a product that is unsuitable for that individual customer.
- The actuary as *appointed actuary* (or one of the successor roles) has a duty to advise the company on the reserves to be held (including, if the actuary suspects any mis-selling, a reserve for future compensation claims), to monitor risks that the life office runs so far as they affect policyholder liabilities and certain other duties placed on the actuarial role (see paragraph 2.5 of the Consultation Document).
- The actuary as *product designer* has a responsibility to design a range of products and to explain them to colleagues so that decisions can be made whether to market the products to customers and, if so, how to do so appropriately. It is a step too far, however, to say that the designer should be the policeman of the customer-facing salesman. Even the intermediate step of asking the designer to audit the marketing brochures is not realistic given the very different skills and judgments required for each role.

Why were these issues not brought to light by the profession earlier?

The “issues” referred to in the question are identified in the accompanying text (paragraphs 1.15-1.17) as pensions mis-selling, unit-linked policies and endowment mortgages.

- *Pensions mis-selling*: Walter Merricks asked (see paragraph 1.16 of the Consultation Document): were actuaries for schemes out of which people were transferring unable to see that many customers were being mis-sold?

The answer is that the employers, scheme trustees, their actuaries and the National Association of Pension Funds could *all* see it quite clearly. There was, however, no willingness on the part of the government of the day to hear that their ground-breaking legislation was having this effect and certainly little acceptance by employees of any advice that they were giving up something valuable for something less valuable. Government advertising at the time reinforced the employees’ attitude. (More details and background information are provided in the Appendix to the submission.)

Actuaries do need to have the confidence to speak out. That confidence will increase if they are listened to more. The same applies at the level of the professional body. We were much heartened by the very positive reaction the profession received when the Presidents of the Institute and the Faculty of Actuaries wrote an open letter in March of this year to the Secretary of State for Work and Pensions warning about the future operation of the Pension Protection Fund. We do not envisage making a habit of this – nor do we envisage it being necessary to do so – but we have been reassured that, if the need were to arise for us to speak, we will be heard.

- *Unit-linked policies:* The Consultation Document suggests that, according to some commentators, unit-linked policies were designed to “maximise sales for [life offices] rather than ... to meet policyholders’ expectations” (paragraph 1.17).

Unit-linked policies are directly linked to the underlying value of the policyholders’ investments, in the same way as unit trusts. They were created as an alternative to with-profit policies for those who preferred to benefit from market movements directly and not to entrust themselves to the office’s discretion. The suggestion that these policies were “designed [not] to meet policyholders’ expectations” is not one we have heard before, nor do we comprehend it. (See the Appendix to this submission for more on unit-linked products.)

- *Endowment mortgages:* Appointed Actuaries have been blamed for not warning insurers that investment returns would fall. The evidence for this is, at best, anecdotal and the criticism has generally been highly one-sided.
 - Banks and building societies had a major incentive to encourage customers towards endowment policies: for a loan over 25 years, the lender would expect to receive between 40% and 60% more interest under the endowment route compared with repayment.
 - The growth rates used for projection purposes, when the policies were sold, were determined by the (then) regulator, not (as is often said) by actuaries.
 - The removal of tax relief on mortgage interest exacerbated the shortfalls that have subsequently emerged. A typical projected shortfall today of £5,000 or £6,000 would, if tax relief had remained in place, be just £100.

(The details behind this calculation, and additional information about endowment mortgages, are contained in the Appendix to this submission.)

Lessons for the future?

We think it goes without saying that making products more attractive – and making sales as a result – is not objectionable, so long as the attractiveness is genuine and not a cover up or disguise of something untoward.

Pensions mis-selling involved presenting personal pension policies as more attractive than the employer’s scheme in cases where they were not. Unit-linked products, however, were (and are) a response to a demand for products which are not subject to the smoothing and discretion inherent in with-profit policies. Some unit-linked products came into disrepute because some salesmen (allegedly) misrepresented them to customers (again see Appendix).

Q1.8 Are actuaries sufficiently accountable for their actions? To whom should actuaries be primarily accountable – to their clients or employers, to pension fund trustees or sponsors, or to a broader public interest, which encompasses the strength and stability of the insurance and pension sectors and the interests of those consumers involved?

Our views on accountability follow directly from the opinions expressed in the Overview to this Section, which addresses the role of the public interest in determining behaviour. Primarily, advisers should advise their clients (or their employers in the case of in-house advisers) and be accountable to them. Where clients ask their advisers to produce an opinion or certificate to be shown to a third party, the adviser takes on responsibilities to the third party, as laid down by the common law (see Q1.10).

It is for legislators, or regulators operating within their legislative powers, to impose modifications where that principle requires modification, for example to correct for information asymmetries.

Q1.9 How would you characterise the current situation in the UK in this respect? Are there changes you would like to see introduced in terms of the accountability of actuaries to their employer or to the public interest?

For the reasons explained in the Overview to this Section and in the preceding answers, we think the present arrangements in the UK are satisfactory so far as they concern the accountability of actuaries to parties outside the profession.

Accountability of actuaries to the profession itself is addressed in Section 2, in particular in Q2.1-Q2.4 (the profession's regulatory role), Q2.20-Q2.23 (practising certificates and continuing education requirements) and Q2.38-Q2.43 (discipline).

Q1.10 Are actuaries sufficiently liable for their actions? If actuaries provide poor advice, to whom should they pay compensation?

Actuaries are subject to all forms of redress that the law allows. The law of negligence, in particular, applies where inappropriate advice is given.

The question also asks: *to whom* should compensation be paid. The law in this area is complex and, so we are advised, constantly evolving through the mechanism of emerging case law. Our understanding is that it is normally the client who is entitled to claim compensation. Third parties may also be able to claim in certain, legally defined, circumstances.

We have seen no suggestion, to date, that the actuarial profession should be treated differently from other professions in this area.

D THE PROFESSION

Q1.11 How effectively does the Profession engage with government, business, regulators and other professions?

So far as government and regulators are concerned, The Actuarial Profession engages frequently on a range of issues. Recently, the main topics have included the introduction of scheme specific statements of funding principles (in response to enquiries from the DWP) and the transition from the appointed actuary regime to the new triple-actuary arrangements (in response to enquiries from the FSA).

Whether these dialogues are *effective*, as opposed to *frequent*, is a more difficult question for us to answer. We have not received any feedback that we have failed to engage effectively, but this Review provides an opportunity for other bodies to comment where, previously, they may have remained silent.

From our side, we have not always felt that our views have been taken on board. For example, in June, we learned that the FSA had abandoned its previous indications that the new regime would include a published certificate from an actuary on the adequacy of the provisions in the regulatory accounts of life offices. The inclusion of such a certificate (or report) had been crucial to our belief that the new regime would provide the necessary protection for policyholders. Our support for the FSA's changes was predicated on that expectation.

So far as business and other professions are concerned (eg the Institute of Chartered Accountants, as distinct from the Accounting Standards Board, and the CBI etc), there is, of course, frequent interaction between members during their day-to-day work. Contact between the professional bodies takes place through our membership of the UK Inter-Professional Group (which was chaired by one of our members from 2001 to 2004).

Q1.12 Has the Profession successfully expanded the horizons of actuarial knowledge and promoted innovation?

The Actuarial Profession regards itself as having a very strong tradition in the field of research and innovation. Our April submission contained a section devoted to this topic, in which we cited various examples of research activity, both generically and with specific examples, including longevity, genetics, state pensions, private pensions, new reporting mechanisms (eg fair value), demand for different classes of investment and so on.

A review of our files indicates that more than a third of all UK practising Fellows (1,500+ actuaries) have been involved in research in the past five years. Even allowing for the possibility of some accidental double-counting of individuals, that is a very significant proportion of the profession. We doubt that many mainstream professions could match that.

Q1.13 Has the Profession done enough to promote the work of the actuarial profession?

We doubt that The Actuarial Profession could ever do enough to promote the work of actuaries!

Ours is a small profession with limited resources and an uphill struggle to communicate the work of actuaries to those who are affected by what we do.

On the other hand, the firms of actuaries which sell actuarial services seem to have no difficulty attracting work in the areas of work that they target, so we doubt that there are businesses and individuals in desperate need of actuarial services, but unaware where to turn to (or unaware that they could turn to an actuary). In any event, it is a matter for the Association of Consulting Actuaries, the representative body for consulting firms, rather than the professional bodies, to exploit those untapped opportunities.

Q1.14 Are there any aspects of the Profession's governance structure that you would like to draw to the attention of the review? Do the Profession's various decision-making bodies represent a diverse range of interests? Should there be greater lay input into the Profession's key decision-making bodies?

Governance structure

Our April submission contained a summary of our governance structure.

Diversity of interests

It is certainly our aim that the various decision-making boards and committees should represent a wide range of interests from within the profession. In general it is not difficult for volunteers from amongst our membership to find a way to make a contribution to the profession.

Lay input

The involvement of individuals from outside the profession is something we have considered and would welcome. Prior to the announcement of this Review, we published a proposal to have participants from outside the profession comprise at least 50% of the membership of the proposed Actuarial Standards Board. Specific bodies or groups might need to be represented – eg appointments made by the Association of British Insurers and/or the National Association of Pension Funds – or the positions might be left open, subject to a suitable person or group having the power of appointment (or veto) to ensure that the membership of the board contains an appropriate mix.

To date, we have non-members involved at various levels in our regulatory processes:

- The disciplinary scheme has a significant number of roles designated for non-actuaries (including roles on the appointments committee, management board and the tribunals themselves). Some of these roles are specified as being for lawyers, some for accountants and others are open to all disciplines (other than actuaries).
- There is a lawyer and an accountant on the committees which deal with the Institute's status as a designated professional body for the purposes of regulating investment business (see Q2.19).
- Eleven members (out of 75) on the Board of Examiners are non-actuaries: four economists, four statisticians and three accountants.

There are also some lay members on various other committees, but these are relatively few in number (a dozen or so) and the committees in question are rather more research-oriented, than business-oriented.

We are very open to involving individuals from outside the profession in other aspects of our governance. We suspect that, until the Actuarial Standards Board is up and running (or at least fully specified and approaching implementation), it may be premature to draw up job specifications for the other "key decision-making" roles which will benefit from lay input.

E ENTRY INTO THE PROFESSION

Q1.15 How important an influence on the Profession are the companies that recruit and train student actuaries? To what extent is the curriculum shaped by the needs of employers? Is this good or bad?

Our experience is that employers provide a useful feedback on what is needed. Representatives of employers are members of the profession's Education Committee. Annual meetings are held at which both an actuary and an HR representative are invited from each (UK) employer of actuaries. We also receive important input from the academic community. No single employer has enough power to dictate the syllabus and we have no experience of employers trying to dominate or to exert a negative influence.

The risk that employers might try to influence the training of actuaries in such a way as to reduce the rigour with which actuaries subsequently carry out reserved work can be discounted. Of the 25% of UK practising actuaries engaged in work which is reserved to the profession, some 90% are employed in (or partners of) consulting firms independent of the organisations which instruct them to carry out reserved work. Only a very small number of actuaries are employed by the organisation for which they carry out reserved work and the time lag between the hiring of actuaries in training and the point at which they carry out reserved work for their employers is a considerable number of years.

Conversely, and bearing in mind that 75% of UK practising actuaries are engaged in work which is *not* reserved to actuaries, it would be surprising if employers had anything other than a significant and very positive influence on the education and curriculum of actuaries.

Q1.16 What is your view of the appropriateness of the current actuarial qualification syllabus (set in 1999) in preparing actuaries for their actuarial and broader business and management roles?

Historically, actuarial training focussed on the traditional areas of life insurance, pensions, general insurance and investment, with little room to educate actuaries for more varied careers, which the profession believes is essential if it is to attract more diverse talents in future.

The 1999 syllabus maintained that practice, addressing the core technical needs, especially in terms of the skills needed to carry out reserved work. The feedback we received was, however, that the training was not entirely meeting needs of employers and individuals in the changing business environment that they faced. There was, broadly, insufficient recognition of the range of current and future roles for actuaries.

Q1.17 In particular, do you think that it should take on average 5 or 6 years for an actuary to qualify? Is there the right balance between academic and practical experience, sufficient breadth of subjects studied or not studied and the appropriate degree of specialisation at the right time?

Of the students who qualify, some 20% do so in three years. The median time has been improving slowly and, based on figures since 2000, is now five years. The longer time periods taken by other actuaries reflect several factors:

- The program is modular, allowing students to sit as many or as few subjects as they wish at each (bi-annual) exam sitting. This leaves students free to take the examinations at a speed of their own choosing. This is different from many other professions, where the education and exams often have a more structured timeline.
- The examinations are currently taken by most students while in full-time employment. This means that students experience pressures from three directions: employer, examinations and social life. This is the same as for accountancy (and some other professions') students, who normally complete the exams whilst in full-time employment, but different from, for example, lawyers who normally complete the exams before starting out in their career.

The time period to qualify is, we believe, as much a statement about the commitment of students (and some employers) as it is about the difficulty in passing. The median period of five years is not something the profession aspires to and certainly not something we seek to preserve. The qualification period – and the spread of qualifying times – has been improving slowly over several decades. We are continually looking for methods to assist students to reduce the qualifying time. For example, we are currently encouraging universities to provide courses covering more of our subjects.

Any further suggestions for reducing the qualification periods, without jeopardising the need to train actuaries so that they are fit for purpose, will be gratefully received.

Q1.18 Has actuarial education and training kept up with developments, particularly in the financial markets and in financial economics?

We believe that the education and training has kept up to date. The syllabus is subjected to a fundamental review typically every five years (the last three major changes coming into effect in 2005, 1999 and 1994). Between major reviews, the syllabus is reviewed annually and fine-tuned as appropriate.

The frequency and regularity of reviews does not, of course, *prove* that the changes are effective or as modern as they should be, but we believe that they are. In pursuit of that goal, we have maintained a continuous engagement with the academic community, employers of actuaries and other actuarial associations internationally, both in Europe and worldwide.

The profession encourages extensive post-qualification training through its CPD scheme (continuing professional development). Many programmes of training are provided by, or in association with, the profession, but we expect actuaries to investigate the open market for training opportunities, just as members of other professions do.

CPD is an essential means by which practising actuaries can keep up to date in the fields in which they practise. It is also a means by which members can choose to add new skills which enhance the services they can provide to their employers or clients. Some new subject areas migrate from being outside the field of actuarial endeavour to part of our core training over a period of several years as the subject moves from being peripheral (or even experimental) to central (and proven) – see also Q2.21 and Q2.23.

There are also strategic considerations. There is no doubt that developments in financial markets, for example, have created financial products and services that actuaries have not played a major part in developing. Is this a sign of a profession behind the times or evidence that there is competition amongst providers of advice? If the actuarial profession were to impose every new financial innovation on its students, it would tend to lengthen the time to qualify, because material cannot be eliminated from the syllabus as easily as new material presents itself for inclusion.

Financial economics is another case in point. The financial market developments referred to in the previous paragraph are, in part, a consequence of developments in financial economics. The profession has not been a leading light in that area. In the past few years, it has been argued (mainly, but not exclusively, by voices within the profession) that actuarial techniques had become out of date and should effectively have been replaced by techniques based on financial economics.

On analysis, it seems that, as valuable as financial economics is as a subject, and as essential as it is to an understanding of modern financial practice, financial economics does not replace the entirety of techniques used to deliver core actuarial services.

Those actuaries who work in areas where financial economics does replace older techniques (principally in the valuation of off-market assets and liabilities) have adopted financial economics without any of the argument that has been seen in, for example, the pensions arena where we

teach traditional methods as well as financial economics, in recognition of the fact that, for over 20 years, financial economists have told us that “funding reviews” and “economic valuations” are two quite different things, notwithstanding siren voices in the profession which have argued otherwise.

Q1.19 Do you have any comments about the proposed new qualification syllabus that will come into effect in April 2005?

The new qualification syllabus was devised to meet six key needs identified during a review of actuarial training:

Content

- a basic *common core* of knowledge followed by *options*, designed to allow future actuaries to qualify in a much broader range of specialisms: the core has been extended to cover techniques across a range of different business areas in order to ensure a broad conceptual knowledge base; the detail of day-to-day work is addressed in the specialist options.
- a *business awareness module* to set the actuarial training in a broader business context and to help future actuaries acquire a broader understanding of business
- development of practical skills, including *business and managerial skills*, recognised through the maintenance of a learning log book of skills addressed.

Delivery

- a shift in emphasis from examinations of the type that actuarial students currently take, with *alternative assessment techniques* introduced as appropriate, for example an exercise in practical data modelling where the students are required to demonstrate their skills in analysing data and presenting their results for a technical audience, supported by good audit trails and documentation
- greater opportunity for *full-time courses at university* (either undergraduate or postgraduate) followed by the work based skills requirement once a student is in employment.

Qualification

- qualifications at an intermediate stage through the *realigned Associateship* status.

Q1.20 Is there sufficient diversity in the composition of the student body and are there enough links with other professions' qualifications?

The Consultation Document identified national diversity, noting that there are currently 3,100 students in 80 countries in addition to 4,100 based in the UK. There is also gender diversity (more than 30% female, both in the UK and elsewhere).

The students all have a numerical background: it is a requirement for entry to the profession, given the topics that have to be studied and the skills that have to be learned.

To some extent, the intake is determined by employers, since entrants to the profession will typically want to be employed as they embark upon their studies, but we are not aware that employers are rejecting graduates from any disciplines that would add to the diversity of suitable background skills. We are, for example, disappointed that the intake of graduate economists is very low (only 3% in 2002 – see paragraph 1.24 of the Consultation Document) but, so far as we are aware, that statistic reflects the career selections made by economics graduates, not the selection policies of employers.

The profession is a member of the UK Inter-Professional Group, which (amongst other things) enables us to ensure that we are aware of developments in education of relevance to this profession. We have, over recent years, talked to several professions about the possibility of sharing some common modules, but this has proved impractical because of the different entry backgrounds for different professions and the different depths to which professions take each

subject. We have found that a more effective way to concentrate on aspects most relevant to actuarial work and to cover topics at a suitable pace for most actuarial students, is to involve people from other professions as examiners (see Q1.14). For example, the *Finance and Financial Reporting* paper has a syllabus written by accountants, with the exams also set and marked by accountants.

We also work with the Financial Services Skills Council to ensure our qualifications are relevant for the market. At the CPD level, we hold joint seminars and other events shared with various professional bodies.

Q1.21 Is it of concern that, apart from a few universities that offer degrees in actuarial science, there is only a single provider of actuarial education in the UK?

Given the small size of the profession, it seems unlikely that more than one educational body would survive in the market for cradle-to-qualification training, although some universities do offer courses which entitle the successful students to exemptions from earlier exams. There is, however, nothing to stop a new entrant coming into the market if the current provider's standards slipped.

That is exactly what happened in the early 1990s when Hazell Carr Training saw an opportunity to win students away from the previous incumbent (the profession's own Actuarial Education Service). Hazell Carr was extremely successful, effectively forcing the profession to consider the ongoing viability of running its own full range education service in competition with them. At least two further organisations have started offering (limited) training since Hazell Carr began and some universities have offered courses on specific topics. Students are also encouraged to select literature published by overseas actuarial associations.

As explained in our April submission, the profession monitors the prices and tuition quality of ActEd (the successor entity to Hazell Carr, now part of BPP Professional Education).

F THE MARKET FOR ACTUARIAL SERVICES

Q1.22 What have been the main drivers of demand for actuarial services over the last ten years? How do you see the demand for actuarial services evolving in the future?

The main drivers of work for life and pensions actuaries have been reactions to events external to the profession, including:

- *Legislative and other regulatory reform:* In the pensions arena, there has been an increase in member protection (for example the creation of the Scheme Actuary role); a tendency to turn discretionary pension benefits into guarantees; and changes in accounting standards.

In life assurance, there have been wide ranging changes to the prudential solvency regime to accommodate relatively new forms of product and a wish to introduce a market consistent valuation approach for guarantees and options. The FSA's with-profits review, increased emphasis on stochastic modelling of financial guarantees and call for more quantitative risk management techniques have generated significant demand for actuarial services. The implementation of international accounting standards have also increased the involvement of life actuaries in the preparation of accounts.

- *Markets:* The bear market of 2000-02 has given rise to a demand for enhanced scenario testing of the interaction between assets and liabilities and increased demand for capital and profit projections. There has also been significant product development activity, both in terms of protection products and alternatives to with-profits business.
- *M&A activity:* Mergers, acquisitions, demutualisations and de-mergers within the insurance industry have created significant work for actuaries, as has takeover activity in the corporate sector generally, arising from the need to address the issues relating to the target company's pension scheme.
- *Fund closures:* Both in the pensions arena and in life assurance, there has been significant closure of funds. This creates significant amounts of work, just as insolvency creates work for accountants, as the transition is managed and strategic or structural decisions need to be taken.
- *Litigation and compensation:* Personal injury and medical negligence claims have created a need for actuarial calculation of damages.

It must also be acknowledged that the compensation pay-outs following the pensions mis-selling of the 1980s and 1990s has also called for actuarial input. For a few years, a significant number of actuaries were involved in calculating the compensation payments. More recently, but at a lower order of magnitude, compensation for mis-sold mortgage endowments has been a factor. [Despite the criticisms made of actuaries for not identifying these problems earlier (see Q1.7), we think it would require an outlandish conspiracy theory to suggest that actuaries deliberately failed to identify the problem in anticipation of the work it would later yield for other, more junior members of the profession.]

With such a demand for pensions and life actuarial services, there has been little scope for the proactive development of new areas of work and services. Actuaries have, however, expanded their services in other areas:

- *General insurance:* There has been considerable growth over the past three decades in the supply of, and demand for, actuaries to provide claims reserving and premium rating services. This has continued strongly within the past decade, including for example the creation of the Syndicate Actuary role at Lloyd's. Reports from recruitment and search agencies suggests that, currently, the demand for general insurance actuaries significantly outstrips the supply.
- *Investment banking:* The number of actuaries working in investment banking is relatively

small (perhaps around 50), but this is a substantial change compared with ten years ago when there were very few actuaries in the area. In investment banking, the work is split between those working on the asset side (primarily in either equity or fixed income analysis or trading) and those working on the liability side (capital raising, risk management, asset/liability management and M&A).

- *Retail banking:* On the retail banking side, the numbers are very few and the work tends to be dependant on individual circumstances which drove a particular employer and a particular actuary to come together. It is known that there are actuaries in retail banking holding roles such as Chief Executive, Strategy Director, Head of Risk, but these are isolated instances, rather than main drivers of demand.

The demand for actuarial services in future is broadly expected to be as follows:

- *Pensions:* The impending Pensions Act 2004 will initially create significant additional work for actuaries, as schemes are required to develop new scheme specific funding targets to replace the MFR (minimum funding requirement) which is to be withdrawn. The Inland Revenue's tax simplification proposals, starting in April 2006, are expected to create many complications, replacing eight disparate tax regimes with a new unified regime.

Legislative changes are not, however, the only drivers. Following recent market events, employers have become increasingly risk aware, which creates a further demand for actuarial advice. There have also been a number of closures of defined benefit pension schemes, a trend that is expected to continue and which creates a need for advice initially, but reduce the client base in the longer term.

- *Life assurance:* The FSA's new regime requiring larger with-profits companies to prepare "realistic" regulatory reports which present risk-based capital in a more easily recognisable and comparable form (see Q2.8) will require significant actuarial input. The further development of quantitative risk management prompted by the FSA's individual capital adequacy framework (ICAS), and at some point by the EU Solvency II initiative, will create continuing demand.

Increasing competitiveness amongst life companies is leading to more actuarial resource going into pricing decisions (eg more data analysis, risk classification and so forth). Further consolidation of the life assurance industry, driven by pricing considerations and capital pressures, and further changes to international accounting standards for insurance companies are also expected to increase the demand for actuarial expertise, although some of these drivers (eg consolidation) will reduce the need for "senior management" actuaries.

- *General insurance:* The FSA is currently in the process of introducing a more risk-based approach to establishing capital within general insurance companies (see Q2.15). Although the FSA's requirements do not mandate involvement of actuaries, the regime is already generating a significant demand for actuarial services to help companies carry out an Individual Capital Assessment as required by the new regime. Developments in fair value accounting under the International Accounting Standards Board, and the evolving requirements of the EU Solvency II initiative are also likely to create further demand.

We also anticipate more actuarial analysis being directed towards pricing and managing low-frequency/high-severity risks.

- *Investment and other areas:* This is more difficult to predict, because it depends on the growth in the relevant sectors, coupled with the attractiveness of actuaries compared with competing professionals. Given, however, that the recent trend has been for the horizons of actuarial work to expand (albeit slowly) and given also that the new education syllabus is more broadly directed, we are expecting the demand for actuaries to increase.

Q1.23 Do the consumers of actuarial services have access to a wide range of providers or is choice in this market in any way constrained? If so, in what way and why is consumer choice limited?

So far as we are aware, consumer choice is wide and there is little or nothing in the way of constraints.

The range of providers of actuarial services is widest in the field of pensions (where the number of potential clients is far and away the greatest). Firms providing pensions actuarial services range in size from the three consulting firms heading the list of actuarial employers in Table 1.3 of the Consultation Document¹ to many firms of only one or two actuaries (either serving small clients or providing specialised services). The providers also vary from specialist actuarial firms to multi-disciplinary firms, including three of the Big 4 accounting firms.

The range is a narrower in the field of life insurance, and a little narrower again in general insurance, reflecting the fact that there are fewer insurers than there are companies with pension schemes. Nevertheless, there are at least a dozen firms from which to select an actuarial adviser in each of these areas. This is rather more than was the case 10 or 15 years ago, especially in some of the more exclusive specialisms such as reinsurance mergers where the choice was often no more than two firms.

The growth in the number of firms in recent years gives us confidence that the number of firms offering services is very much dependent on the demand side of the market and not some systemic feature or constraint.

A list of actuarial advisers, and their areas of work, is publicly available, in hard copy and from every page of the profession's web site.

Q1.24 Is it easy for consumers to switch between actuarial service provider? If not, what do you think could be done to encourage switching?

So far as we are aware, switching between providers is very easy and happens with sufficient frequency to justify our confidence in that statement, without being so frequent as to suggest that there is widespread dissatisfaction with the services that actuaries provide. Some clients retain more than one actuarial adviser, dividing different aspects of the work between the various firms they take advice from.

Given that most clients of actuarial firms are business-related, not private individuals, and that they are either insurers or they have sufficient sophistication in their business to have a self-administered pension scheme (as opposed to a scheme provided by an insurance company), we doubt that many clients, if any, are unaware that they are free to change advisers or unsure how to find names of alternative suppliers (their banks and their auditors being two obvious sources of knowledge).

The second part of the question asks what could be done to "encourage switching". Given the link back to the first part of the question, we infer that the intention was to ensure the ease of switching – ie the competitive process – not to increase the frequency of switching regardless of customer satisfaction with their existing providers.

So far as we are aware, there is only one aspect of the switching process that could amount to a systemic impediment. This is the rule in the profession's code of conduct which requires a member who is invited to give *reserved advice* (ie advice which is reserved to actuaries) not to take up the appointment without first consulting the incumbent adviser to see if there are any

¹ Contrary to footnote 13 in the Consultation Document, the Actuarial Directory does, in fact, list all members (and the firms that they tell us they work for). It is the separate list of advisers and their services which is limited to those firms who choose to be publicly listed.

professional reasons why he should not take up the appointment (Professional Conduct Standards, section 7).²

The purpose of the rule is to protect the public by ensuring that a client who is required (by statute, regulation or some other legal means) to consult an actuary cannot use the selection process as a means to secure the advice it wants to hear by withholding from the new adviser information which caused the incumbent adviser to give advice which the client did not like.

The rule is restricted to advice which is reserved to actuaries, which usually means that the client has had a *duty* imposed upon it to get actuarial advice, often because there are third party interests at stake. The rule applies only where another actuary has already advised *on the same matter* (as opposed to advising the same client on another matter). The rule expressly prohibits the outgoing actuary from delaying his or her response in order to inhibit the client from changing adviser.³ Any breaches of this rule would almost certainly be reported to the professional body by the client or the incoming actuary (for obvious commercial reasons). We can recall only one such instance, which was ultimately referred to a disciplinary tribunal and the member fined £5,000.

The rule is very similar to the rule which requires an auditor taking on a new appointment to consult the predecessor auditor before accepting the appointment.⁴

Q1.25 Do you think that those receiving actuarial advice sufficiently understand what they are being told and how the advice was produced? If not, what generates this informational shortfall, how important an influence on the market is it and what, if anything, do you think might be done about it?

It is said so often that actuarial reports are difficult to follow that there is little point trying to argue with the statement, other than to comment that the assessment is unlikely to apply to all actuarial reports. Clearly, though, it applies to many (if not most) of them.

There are three reasons for this state of affairs that we have identified:

- As noted earlier in this submission (Q1.1), the skills needed to communicate actuarial concepts to a non-actuarial audience are not a natural fit with the requirement for the high levels of numeracy without which actuaries would be unable do their work. In response to this, the profession introduced a *Communications* exam as a compulsory part of the qualification syllabus. The exam has been in place since 1994. The results are feeding through to actuaries who have qualified since then.
- The challenge has turned out to be more subtle than simply getting older actuaries to teach younger ones to write “good English”. Once taught, most actuaries acquire a very well developed sense of grammar and sentence structure. The real communication problem lies

² If a member who is invited to give reserved advice to a client or to the member’s firm knows or has reason to suspect that another member is acting or has recently provided advice on the same or a related matter, the member should normally contact the other member at as early a stage as possible to ask whether, in that member’s opinion, there are any professional reasons not to accept the appointment or any particular considerations which ought to be borne in mind before giving advice. Upon receiving such an enquiry, the other member must provide the required information as soon as possible and may make no attempt to obstruct a client who wishes to change advisers. [PCS paragraph 7.2]

³ See final sentence of the immediately preceding footnote.

⁴ “It is in the interest of the public, and of the existing auditor or adviser and of the prospective auditor or adviser, that a *member* who is asked to act by a prospective client in respect of recurring work is aware of and appreciates the background and reasons for the change, so that he can then make an informed decision as to whether to accept the appointment. This position can only be achieved by communication between the prospective auditor or adviser and the incumbent auditor or adviser.” [Changes in professional conduct, ICAEW, 1 August 2001]

in choosing *what* to communicate, not in the use of language for the communication.

In response to a request to explain their reports, the natural tendency for actuaries is to attempt to explain their calculations in greater detail, rather than explaining the inferences to be drawn from the results. More effort goes into explaining *how* the mathematics was carried out, rather than *what* the client should do with the results. To the actuarial mind, the implications often seem obvious whereas the calculations themselves are recognised as complex.

This challenge is starting to be recognised and addressed. The examiners for the *Communications* paper have made a decision that, in future, testing will focus on communicating information that is relevant to the audience, rather than on explaining the calculations.

- There may be a tendency for actuarial reports to be written from a compliance point of view, rather than a communications perspective. This is not unique to actuaries. Many other professions exhibit the same habit in their writing. The tendency to write from a compliance point of view is an inevitable result of the compliance culture in society. The fear of regulatory sanctions or negligence litigation encourages actuaries to write defensively, just as it encourages all professions to think about ways to minimise claims, rather than maximising delivery.

Q1.26 Which factors have influenced the supply of actuarial advice over the last ten years? What are likely to be the most significant influences on the industry structure in the future?

The short answer is that the market for actuarial *services* has tended to be demand-led (see Q1.22 above for the factors determining demand).

The market for *actuaries* (ie the supply of actuaries coming into the profession) is largely led by career choices, coupled with the demand from employers to have student actuaries to carry out work at that level. Individual employers no longer look at their prospective demand for qualified actuaries five years into the future and aim to recruit student actuaries to feed that expected demand.

A secondary effect is the migration of actuaries across countries. General insurance actuaries, for example, have been recruited from North America to meet a shortage of UK actuaries in this specialism. We do not, however, have reliable figures for international transfers (see Q1.31 for the reasons).

Q1.27 What determines whether actuarial advice is provided by in-house employees or external advisers or consultants? Does it reflect a clear difference in the actuarial role and function? Do firms employing in-house actuaries ever experience recruitment difficulties?

Insurance

On the whole, there is a clear difference in the actuarial role and function between in-house actuaries and consultants. An insurer's decision to engage consultants, rather than hiring in-house actuaries would typically be fuelled by one of more of the following considerations:

- A one-off project (eg an M&A activity or a corporate re-structuring) may require specialist expertise and/or large numbers, both on a temporary basis
- Specialist experience may be required on a recurring basis, eg the appointed actuary role, but at insufficient volumes, perhaps because of the company's size, to justify full-time retention of the actuary. The greater independence of an external Appointed Actuary (or the successor roles under the new regime) may also be valued by some companies
- As with most industries, research and/or intellectual capital may be more readily, or cost-

effectively, obtained from a consulting firm, because consultants can sell the results to multiple clients, thereby spreading the cost

- Other needs include peer review and/or to cover temporary recruitment difficulties (see below).

Conversely, in-house actuaries provide a more cost-effective solution when there is an ongoing need for actuarial services from the same team. Actuaries have a good understanding of how the insurance business works and are often at the heart of the business helping companies to meet their goal. Not having an in-house team therefore impacts upon the day-to-day running of a company.

Recruitment difficulties can and do arise. In-house actuaries are often tempted into consultancy, frequently one or two years after qualification. There is also movement the other way, but more usually when a consultant takes on a key senior actuarial and management role inside a company. There are clearly fewer such opportunities than in the reverse direction.

Pensions

Some actuaries (fewer than 50) are employed by large employers to manage their pension schemes. For most employers, it simply wouldn't be cost-effective to employ an actuary full-time on the affairs of their own scheme(s).

Where an in-house actuary is employed, the role may include giving strategic advice on questions relating to funding and investment, as well as technical advice on scheme design, communication, pensions aspects of mergers and acquisitions, etc. In-house actuaries do not normally carry out actuarial valuations, because it is not cost-effective to acquire and operate pensions valuation software for just one employer (even one with a large scheme).

Firms employing in-house actuaries do occasionally experience recruitment difficulties.

Q1.28 What is your overall assessment of the degree of competition in the market for actuarial services? Is competition in any way constrained by existing professional rules or conventions? If so, which ones and to what extent could they be modified?

The Profession believes the market for actuarial services is highly competitive. We point to our answers to Q1.23 and Q1.24 above for the evidence to support that.

We believe there are no practical constraints on competition caused by the existing professional rules. Our answer to Q1.24 identified one rule which could, if abused, be a problem but, as noted in our answer to Q1.24, that does not arise in practice.

Q1.29 Do you think that the Government Actuary's Department competes with private sector suppliers of actuarial services in the market? What impact do you think GAD has on competition in the market?

Our understanding is that the private sector is able to compete with GAD for most of its business, for example in supplying pensions actuarial services to public sector schemes. GAD, however, is limited in its capacity to compete for private sector clients and is expected to concentrate on providing services to government departments and the wider public sector.

In practice, therefore, the issue is not whether GAD has an impact on the market, but whether the market has an impact on GAD. We do not have the appropriate information to answer that question.

G INTERNATIONAL COMPARISONS

Q1.30 How are the skills and professionalism of UK actuaries and the UK actuarial profession regarded internationally?

It is our understanding that the skills and professionalism of UK actuaries and the UK actuarial profession are highly regarded in the international arena, although clearly that is for actuaries, regulators, policymakers and others internationally who have contact with the profession to say.

The UK actuarial profession plays a full, and, we believe, influential, role in the both the European actuarial body (the Groupe Consultatif Actuariel Européen – see Q1.31 below) and the International Actuarial Association (IAA), the association of actuarial professional bodies from around the world. The UK profession's views are sought on many issues by actuarial bodies overseas.

The IAA has told us that it is submitting a response of its own to the Morris Review.

Q1.31 How easy is it for actuaries to work across international boundaries?

Actuaries can take their qualifications overseas with some ease. Our records indicate that the number of actuaries practising in the UK who qualified overseas is approximately 150, representing around 3% of the qualified actuaries working in the UK.

It is difficult to estimate the numbers moving in the reverse direction (ie qualifying in the UK and then moving to work overseas). We know that there are 1,800 Fellows who qualified with the Institute or Faculty and are now working overseas, but this figure will include a substantial number who have worked overseas throughout their career and qualified via the UK. As noted in our April submission, the UK Actuarial Profession is also the examining body for actuaries in Ireland and South Africa and one of a choice of examining bodies for actuaries in a number of other countries around the world, including, for example, India.

The Profession's training and qualification in the UK gives actuaries the tools and the competence to work internationally, so it is relatively easy for much actuarial work to be carried across international bodies. Legal and financial frameworks do, of course, vary by country, but they can be mastered, just as new regimes in one's own country have to be learned from time to time.

Since 1992 there has been a mutual recognition agreement between the actuarial associations which are full members of the Groupe Consultatif Actuariel Européen (this embraces all the members of the European Union save for two of the associations from the 2004 accession countries) and also the associations from Switzerland and the EFTA countries. The agreement gives full members of one association the right to become full members of another body.

Subsequent and similar mutual recognition agreements have been signed with the Canadian Institute of Actuaries, the Society of Actuaries (USA), the Australian Institute of Actuaries and the Actuarial Society of India.

Q1.32 Do you agree that there are lessons to be drawn from a consideration of the work of actuaries in Canada, Australia and the US? If so, on which aspects of the work of actuaries in these countries do you think the review should focus?

We agree that lessons can be learned from the three countries listed. There are many similarities between UK actuaries and actuaries in those countries, but also significant differences which are worthy of exploration:

- In the USA, there is a multiplicity of professional bodies, carrying out different functions and, in some cases, covering different specialist areas of actuarial work: the roles of education and qualification, representation, standards and discipline have been split into separate actuarial bodies, some of which are linked:

- *education and qualification* is the responsibility of several bodies, including the Society of Actuaries, for life and pensions work, and the Casualty Actuarial Society, for general insurance
- *representation* is the role of the American Academy of Actuaries
- *standards* are the responsibility of the Actuarial Standards Board
- *discipline* is the responsibility of the Actuarial Board for Counseling and Discipline.
- The Canadian Institute of Actuaries has had significant experience of external peer review of life office actuaries.

Care needs to be taken in interpreting the differences (and the similarities) in the context of the underlying legal and regulatory structures, the local attitudes towards litigation and to the role of the professions in society.

Q1.33 Are there any EU or other countries that the review should be considering in seeking to identify best practice?

The Review may particularly wish to explore developments in Germany, where there have been significant changes following the establishment of a new professional body, and in Scandinavia where the track record for innovation in actuarial science is very strong, but each EU actuarial society has, in its own way, made a contribution to the Groupe Consultatif Actuariel Européen.

H OTHER PROFESSIONS

Overview

There are changes taking place in the way professions are regulated in the UK. The role of the Financial Reporting Council (FRC) as the accountancy regulator is an example, which began 15 years ago with the establishment of its role as the setter and monitoring body for accounting standards and has been extended recently with regulatory roles in the areas of (broadly) auditing, ethics and discipline.

The legal profession is another example. Although the changes there are, as yet, still under review, the Law Society has indicated in its June response to the Clementi Review that “the Society recognises the need for clearer separation of its regulatory and representation roles.”

Although the actuarial profession is much smaller and rather different from both the accounting and legal professions, we doubt that the interests of the public, or of actuaries, would be well served if the profession were operating in a regime that was fast becoming out of date or out of touch with the modern view of a professional body.

Q1.34 Do you agree that the review can learn lessons from recent developments in the UK accountancy profession, for example, in areas such as standard-setting or in the establishment of a single unified and independent regulator – the Financial Reporting Council?

On the question of standards, there may be much to learn from the FRC. The principle that stakeholders are represented on, and contribute to the costs of, the standard-setting body is a good one. That would suggest involvement in an Actuarial Standards Board by:

- actuaries
- insurers, pension funds and, perhaps, their regulators (the FSA and the new Pensions Regulator)
- policyholders and pension scheme members.

The FRC has yet to establish itself firmly in its other roles, which were added in the past year. There may be weaknesses and strengths in the model which have yet to reveal themselves.

One particular aspect of the accountancy regime that has yet to be tested over time is the way that education and qualification of accountants has been left with the original professional bodies, whilst (broadly) everything else has been transferred to the FRC. So each of the original accountancy bodies has the responsibility for admitting individuals into the profession, but has very limited control over the environment in which they operate. One can envisage a scenario in which the accountancy bodies continue to be blamed – for letting the “bad apples” in – if and when problems arise in future.

To put the same point another way: we take the view that the responsibility for determining which individuals are qualified to carry out reserved work is a regulatory function (see also Q1.3, Q2.9 and Q2.16 on the future of reserved roles for actuaries). As this is not one of the FRC’s functions, we have slight misgivings about the FRC’s description of accountancy regulation as now being under a “single unified ... regulator.”

One particular difference between the regulation of actuaries and the regulation of accountants is that, under the existing regime, we have no power to discipline firms which provide actuarial services – we can only discipline individuals (our members) – and we have no mechanism for extending our powers. That has not always worked to the best advantage of all. A regime in which firms that provide actuarial services, as well as individual members, were subject to scrutiny by the profession would, if there were a way to introduce such a regime, be deserving of careful examination.

Q1.35 Are there any forthcoming EU directives or international accounting standards that are likely to impact on the actuarial role?

Those that we are aware of are:

European Union directives

- Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, which requires listed companies to adopt international accounting standards, as franked by the EU, for the year 2005, will replace existing accounting directives for insurance companies.
- The International Association of Insurance Supervisors are promoting changes in insurance supervision standards, which may be adopted in the EU under the Solvency II initiative. This will embrace a review of accounting standards appropriate to insurance companies. The review is being conducted by Committee of European Insurance and Pensions Supervisors, an independent advisory group on insurance and occupational pensions.
- The Pensions Directive (in full, the Institutions for Occupational Retirement Provision Directive) will introduce a pensions regulatory environment which will facilitate cross-border membership of EU pension schemes. From a UK perspective, disclosure requirements are increased (including reporting to members of the share of scheme assets attributable to them) and actuaries to UK pension schemes will need to value benefits payable to members resident and working in other EU States.

International Accounting Standards

- IFRS 4, accounting for insurance contracts, effective from 1 January 2005
- IAS 19 (and its UK relative, FRS 17), accounting for defined benefit pension costs in company accounts, become compulsory from 2005
- Phase II of the International Accounting Standards Board project on insurance accounting may include a requirement for insurers to report general insurance liabilities on a fair value basis, which many companies may look to actuaries to assist in calculating
- Proposed amendments to IAS 39 (Financial Instruments: Recognition and Measurement)
- Proposed new IFRS on Financial Instruments: Disclosures, on which the IASB is consulting via Exposure Draft 7.

Q1.36 Are there lessons for the actuarial profession from comparison with the professional and regulatory framework of the legal profession?

As indicated in the overview to the section, the general principles relating to professional governance in a modern environment may well be comparable. At a level of detail, the differences between actuaries and lawyers may outweigh the similarities, for example:

- The interface between lawyers and the public is very different from the interface between actuaries and the public. Lawyers deal with both individuals and companies as clients. The clients of actuaries are typically companies or organisations (eg pension trusts) which have individuals as their customers or members. As a corollary to that, consumer protection issues in the actuarial sphere are generally covered by the FSA and (currently) Opra, not the professional body.
- Actuaries are permitted to work with other professionals. Lawyers are not yet able to do so; indeed, even the different branches of the profession (solicitors and barristers) are not permitted to work in partnership.

Q1.37 Which other professions' regulatory models, and what aspects of them in particular, do you think the review should consider?

So far as we are aware, this review is at (or, at least, near) the forefront of professional reviews. We have not yet found any professions which have (or are moving to) regulatory models which appear to set a path for the actuarial profession to follow in current circumstances.

The Professional Associations Research Network (www.parn.org.uk) holds factual information on professional associations and publishes research into governance models. It appears, however, that the research is focussed more on the delivery of services to members than on the (self-)regulatory aspects of professions such as ours.

CHAPTER 2

The current regulatory framework of the actuarial profession

I THE REGULATORY ROLE OF THE PROFESSION

Introductory remarks

Paragraph 2.1 of the Consultation Document says The Actuarial Profession “shares regulatory responsibilities for the work of actuaries with” the FSA and Opra. This simple statement may be mis-interpreted by some readers as implying that there is a regulatory overlap. Indeed, it might even be said by some commentators that there is no need for The Actuarial Profession as a regulatory body: the FSA and Opra should be left to get on with it.

There is, however, no real overlap between The Actuarial Profession and the FSA or Opra.

- The FSA and Opra regulate providers of *financial* services (or vehicles for the provision of such services), ie insurers, pension schemes and the like.
- The Profession regulates its members, ie the providers of *actuarial* services to (amongst others) the organisations that the FSA and Opra regulate.

Any regulatory link from the FSA or Opra to actuaries is only indirect. Such links arise because the FSA and Opra set rules for the entities they regulate which include the requirement for (some of) those entities to retain an actuary to carry out functions prescribed by the FSA or Opra (or by the legislation from which the FSA and Opra derive their powers).

Actuaries who choose not to take on regulatory functions for FSA-regulated or Opra-regulated entities are not answerable to either body. All actuaries, however, can be called to account to The Actuarial Profession for any activities which may amount to misconduct as defined in the Profession’s Rules and Bye-Laws,⁵ regardless of whether the activity giving rise to the alleged misconduct occurred during the course of their professional activities or at any other time.

Q2.1 What should be the objective of a regulatory framework for the actuarial profession?

In many ways the answer to this question is given in the terms of reference for the Review, which ask for a framework which will deliver:

“high-quality and continuously developing actuarial standards, openness in the application of actuarial skills, transparency in the professional conduct of actuaries, accountability for their actions and an open and competitive market for actuarial advice in the UK ... [and which] will be independent in representing the public and consumer interest, and be accountable, flexible, transparent, and no more burdensome or restrictive than is clearly justified.”

It is hard to quarrel with any of those words.

The Government’s Better Regulation Task Force might also expect objectives which address *proportionality* and *targeting*: we suggest “public protection at an acceptable cost.”

We would add that the objectives of a self-regulatory organisation should be no narrower than the objectives of an externally regulated one. The objectives may, however, be a little broader given that a self-regulatory body typically has additional (internally directed) responsibilities.

As indicated in our answer to the final question of Chapter 1, this review is one of the earliest (but not the first) to address how professions should be adapted to contemporary needs. Although the framework for each profession may need to vary from the frameworks for other professions in order to reflect each profession’s distinctive features, we doubt that every profession should completely reinvent the wheel (or have the wheel reinvented for it).

⁵ Misconduct means, broadly, any failure to comply with the standards of behaviour, integrity, competence or professional judgment which other actuaries or the public might reasonably expect of an actuary, whether committed whilst carrying out professional duties or otherwise.

In the long run, there is much to be said for having recognised themes which are common to most (or all) professions, so that rules, customs and habits can develop in line with each other, over time. Several of the questions posed in the Consultation Document implicitly start from the premise that, unless proved otherwise, commonalities and comparators are beneficial (see, for example, Q1.34, Q1.36 and Q1.37).

Q2.2 What is your overall view of the strengths and weaknesses of the current self-regulatory approach as applied to actuaries by the professional bodies? Does it adequately protect the interests of consumers? If not, are there key aspects of the regulatory framework that you think should be changed? Is there too much emphasis on reserved roles for individual actuaries?

Strengths and weaknesses of the current self-regulatory approach

In a self-regulatory regime, it is the members of the profession, themselves, who set the standards of skill, competence and integrity that the members must follow. For 100 years or more, it had been a widely held view in Britain and elsewhere that the people best placed to know what is achievable and what is acceptable were the senior members of the relevant profession. That was the perceived “strength” of self-regulation.

The contemporary view is rather different. The advice given by professionals can affect millions of individuals, either directly or indirectly. They, or their representatives, should have a say in the basis on which professionals give that advice. There is also an inescapable conflict in assigning the responsibility for setting standards to the same group of people who apply those standards in a commercial and competitive marketplace. That is the “weakness” inherent in self-regulation.

For this reason, the Profession announced at the beginning of the year (before the Morris Review was announced) that it intended to devolve the setting of standards to a combination of (a) actuaries who have no part to play in the Councils of the Institute and the Faculty of Actuaries and (b) lay individuals. Our Disciplinary Scheme had already been devolved in like fashion with effect from the beginning of the year, extending a process that had begun some years previously with the introduction of lay individuals to, and the removal of Council members from, tribunal panels.

Does the regulatory framework adequately protect the interests of consumers?

Our answer to this question follows on from our earlier remarks on the accountability of actuaries (Section C of this submission) and our introductory remarks above.

The Actuarial Profession has a public interest duty. It does not, however, exist in splendid isolation, charged with sole responsibility for protecting consumers. The Profession exists as part of a broader regulatory system, which sits within a (largely) free-market economy. Parliament has charged the FSA and Opra with the responsibility for regulating financial services and occupational pension schemes. The FSA and Opra have, in turn, as noted above, charged the organisations they regulate with a duty to obtain opinions and certificates from individual actuaries, in the knowledge or expectation that The Actuarial Profession will set compulsory standards which those actuaries must follow in carrying out their duties.

The Actuarial Profession already consults the FSA, Opra and many other organisations when setting standards and it is implicit in our existing proposals for change that we think the framework can be improved. Subject to the outcome of this Review, we intend standards to be set more remotely from the professional body, in future, as outlined earlier in this answer.

Too much emphasis on reserved roles?

As mentioned in the introductory remarks to this section, the Profession requires actuaries to meet the standards of behaviour, integrity, competence and professional judgment expected by the public. This applies to *all* aspects of an actuary’s work, not just to reserved roles.

Our ethical code, the Professional Conduct Standards, also applies to all work done by

actuaries, save for two very specific exceptions where it is considered that the rules would be unduly restrictive if extended to work which actuaries take on in competition with non-actuaries. For example, the rule which requires an actuary not to take on a new assignment without first consulting the previous adviser is one that we consider would be an impediment to clients seeking to change advisers if it were extended to work which was not reserved to actuaries (see Q1.24 for the reasons for imposing the rule in cases where work *is* reserved to actuaries).

It is only the Profession's *technical* standards that have a focus on reserved roles. If actuaries are restricted, by the professional body, in the advice they may give, or the form in which they must give the advice, whilst other competing advisers are unconstrained, some clients may be discouraged from taking advice from an actuary. Clients may be better served in the long run if, when actuaries compete with other advisers, they are bound only by the general duty to observe standards of behaviour, integrity and competence etc, rather than being locked into a prescribed advisory framework.

There is a very practical point also. When work is reserved to actuaries, the scope of the work is normally defined by the legislation or regulation which reserves the role. Other advice does not fall so easily into a pre-defined scope which would enable a technical standard to be written.

Q2.3 Does the Profession's dual responsibility for representing its members to the outside world and regulating them in the public interest create a conflict of interest? Is this conflict acceptable?

There is no doubt that conflicts between the two roles can arise and that the modern tendency is to find mechanisms for separating the regulatory and representative functions of a professional body. We have already referred in this submission to steps we have taken, or are taking, to effect a separation of standard-setting and discipline from the representational functions (see for example Section P and Q2.2).

Whether the conflicts are acceptable depends, perhaps, on the costs and the consequences of introducing alternatives. Our actions so far have been limited by the powers we have at our disposal. Greater separation of representation from self-regulation may require external intervention and/or resources. This submission demonstrates our awareness of the potential for conflict and that we take steps to manage the conflict consistent with contemporary views of society – which undoubtedly change over time. We shall be interested to see what other respondents to the Consultation Document have had to say on the balance that has to be struck and whether they consider we have struck it sufficiently well.

Q2.4 Are there areas where you believe the burden of regulation is disproportionate and should be reduced? Are there areas that you believe should continue to be self-regulated by the professional bodies?

Disproportionate burden of regulation by the profession?

We do not consider the burden of regulation imposed by the profession to be a problem, but if other commentators think we are currently over-regulating our members, we would naturally look at that very carefully.

Areas that should continue to be self-regulated?

We have discussed standard-setting and discipline in our answers above. The remaining area of self-regulation is the responsibility for determining who has met the standards for qualifying as an actuary. We have noted elsewhere in this submission that, if any of the work currently reserved to actuaries by statute were to be opened up to other professionals, there may be a need for some recognised body (or bodies) to determine whether an individual has attained (and maintains) the relevant qualification.

J THE ROLE OF THE APPOINTED ACTUARY

Introductory remarks

The FSA requires life offices to hold enough capital to withstand a 25% drop in the stock market. During 2000-2002, the stock market fell by 50% and all life offices survived. We believe the efforts of actuaries made a significant contribution to this outcome.

This is not to deny that outturns were less than expected by policyholders. That is hardly surprising when interest rates fell and stock markets crashed. An actuary cannot manufacture an ongoing boom in investments when the market is going sharply downwards. Indeed, financial markets could not work if all products had an implicit guarantee of capital and rates of return.

Nevertheless, one celebrated criticism of actuaries in the circumstances was that “a monkey could have predicted what was going to happen.”⁶ We can only observe that, if the consequences were so obvious, why didn’t insurance company directors anticipate the problem? Or their investment managers? Or independent financial advisers? Or consumer bodies? Indeed, given the gravity of the circumstances, one might even ask whether the financial regulators (or Government itself) might not have given warnings.

The reality is that, during the late 1990s, too many people were caught up in the excitement of the prolonged bull market. There was talk of a new commercial paradigm driven by the internet. Those who warned that the boom was not sustainable – actuaries (not all of them) and others – were regarded as conservative or old-fashioned. They were not listened to.

Q2.5 Do you think that the FSA’s proposals to change the appointed actuary regime address the concerns that Lord Penrose raised in this regard? Is there a need to do anything further to address Lord Penrose’s concerns?

We believe the proposed changes to the regime will meet Lord Penrose’s explicit concerns, provided that life office boards are sufficiently capable and the three new actuarial roles are supported by clear standards from the professional body (which we fully intend they will be).

Q2.6 Do you have any other concerns about the role of actuaries working in life assurance?

We have two concerns so far as the new roles defined by the FSA are concerned:

- The FSA proposals create a framework for the regulating the exercise of discretion in with-profits business, but the proposals do not go far enough in relation to the discretion in non-profit business. Examples of discretion in non-profit business include unit pricing, policy fees, annual management charges, and mortality/morbidity charges. Responsibility for advising the board on this should probably fall to the Actuarial Function Holder, but clarification by the FSA would be welcomed.
- The independence of the With-Profits Actuary will always be in jeopardy if the actuary is employed on terms which link remuneration to the office’s profit or growth targets. Some of these bonus schemes can become quite substantial: it is asking too much of an individual to spot when the incentives have become too great for the conflicts to be managed.

Q2.7 Do non-executive directors in life insurers have sufficient expertise and information available to them to enable them to challenge the actuarial calculations of the value of the insurer’s assets and liabilities or whether policyholders are being treated fairly?

Resources available to non-executive directors include:

⁶ These words are taken from a question by the Chairman of the Treasury Select Committee to the then President of the Institute of Actuaries on 27 April 2004, at Q746.

- reports from the external auditors (who will have taken advice from the Reviewing Actuary on the adequacy of mathematical reserves).
- reports from the firm's Internal Audit function.
- reports from the With-Profits Actuary and the With-Profits Committee
- advice from the executive management team and any non-executive directors who are actuaries or have previous experience of actuarial matters.

Typically, however, these reports are provided at a level which shows the total results across the whole company, rather than by individual product (the bonus declarations are an exception to the general rule). Actuaries and management work at the level of individual products. If the non-executives are in doubt, further expert reports may of course be commissioned. However, having a non-executive director with an actuarial background should significantly increase the Board's ability to know what to challenge.

We referred earlier to the historical risk of over reliance by directors on technical advice (see Q1.4). In order for a board to make effective use of the inputs described above, it is important that the advice be tested in collective discussion. It is collective expertise and commitment to challenging process which make for an effective board. It could well be that The Actuarial Profession, or individual actuaries and their firms, are able to provide input to periodic courses targeted at non-executive directors.

Q2.8 Will the FSA's realistic reporting basis make actuarial calculations more accessible for non-actuaries?

The new reporting regime aligns the solvency monitoring system to the way in which management runs the with-profits fund. This should make it easier for directors and users of the published balance sheet information to comprehend. [For the avoidance of doubt, "realistic reporting" won't make the *calculations* more accessible, but the reports that flow from them should be.]

The position for policyholders may be different. Further disclosure of the security and volatility of their investment will be required if policyholders (or, more realistically, analysts and advisers) are to be able to assess the risks to their savings and the management of their assets.

The Accounting Standards Board's current exposure draft, FRED 34, on accounting for life assurance should ensure similar improved clarity to the accounting for with-profits business in the published accounts.

K THE ROLE OF THE SCHEME ACTUARY

Introductory remarks

The creation of final salary pension schemes really started to take off in the 1970s when inflation left money purchase schemes and average salary schemes looking very unattractive for employees. The link to final salary enabled employers to offer a pension that was a recognisably good income in real terms. That was, of course, only the initial pension on retirement. As each year went by, inflation eroded the value of the pension payment unless increases were granted.

To remedy the falling value of pensions in payment, many employers set a goal of prudently funding the pension scheme so that surpluses would, more likely than not, be generated which could later be paid out in the form of pension increases following retirement. So a standard practice emerged of setting a stable contribution rate (stable in terms of a near-constant percentage of employees' salaries), designed to meet the "prudence" target and give employers predictability over the cost (or, at least, the "cost" as it was perceived by accountants at the time).

As a profession which, for over a century, had developed mechanisms for managing the orderly release of surplus from with-profit endowment policies, actuaries found this an easily recognisable financial vehicle to manage. Like with-profit endowment policies, pensions were based on the principle of a contribution (premium) income which was more than sufficient to meet a contractual liability, with the expectation and delivery of annual increases (bonuses).

The provision of a company pension was seen as the mark of a "good" employer, one who set up a scheme "voluntarily." The award of pension increases was a further demonstration of the employer "looking after" its ex-employees. This language was consistent with the paternal ethos of the time. In economic terms, the creation of a pension scheme was unsurprising behaviour by those employers who saw themselves as having established a permanent, and profitable, presence in a market and who needed to ensure the recruitment and long-term retention of employees. The pension scheme was a valuable benefit negotiated with employees.

The pension was not, however, guaranteed. Two very practical factors intervened. First, employees who left service early received a pension based on their salary at leaving, which was quickly eroded by subsequent inflation, reducing its real value, often significantly, by the time the individual reached retirement date. Second, the trust vehicle used to separate the funds from the employer (an Inland Revenue requirement if the scheme was to be tax-approved) lent itself naturally to the inclusion of a clause in the trust deed to the effect that, if the employer stopped contributing, the scheme would be wound up and benefits would be based on whatever funds were available. This clause provided a safety net that many employers considered essential before being willing to commit themselves to the long term liabilities of a pension scheme.

Over time, company pension schemes became almost universal. The funds they held became a very substantial proportion of the economy and governments and other regulators started to change the laws and regulations surrounding them:

- The Social Security Act 1985 made it compulsory to increase early leavers' benefits (up to a specified level) during the period between the date of leaving service and their retirement.
- In 1987, the tax rules were changed specifically to limit the build-up of surpluses. The temporary suspension of contributions ("contribution holidays") that followed in the 1990s were an inevitable consequence of that rule. Few advisers can persuade a client to build up surplus in its pension fund if the result is that tax will become payable that could otherwise be avoided.
- The Pension Schemes Act 1993 made further in-roads on the surplus, *requiring* it to be used to provide pension increases in retirement (up to a specified level).

- Since the 1990s, there have been progressive in-roads into the right of an employer to walk away from its pension scheme without any financial consequences. With effect from 2003, pension scheme deficits were made a debt on the employer in the event that a scheme is wound up whilst the employer is still solvent.
- In 1997, the removal of advance corporation tax credits reduced the investment income of pension schemes by an amount which was estimated at £5 billion pa. This was not the only windfall tax imposed that year but, unlike the tax on utilities, it was not a tax on past, crystallised profits (or surpluses). It was a tax on surpluses whose existence depended upon, amongst other things, an assumption about future rates of return which the economy has not delivered (in fact, the very assumption that, today, it is said even a “monkey” should not have believed in – see the introductory remarks to Section J).
- Progressive changes in accounting standards altered the manner in which accountants viewed pension costs. Accounting standard SSAP 24 first broke the link between the cash contribution and the amount shown in the accounts. This was consistent with the migration from a regime of stable contribution rates coupled with benefits that contained a significant discretionary element to a regime in which the benefits were becoming increasingly prescribed by statute and the cash contributions were now much more variable (or zero – the “contribution holidays” referred to above).

The subsequent introduction of accounting standard FRS 17, fully compulsory with effect from 2005, makes a further fundamental alteration in the manner in which pension costs are now to be measured, calculating the cost by reference to the yield on AA-rated corporate bonds. Implicitly, this assigns a cost to the pension benefits as though they were as guaranteed as AA-rated corporate bonds, even in the case of schemes where neither the assets are bonds, nor the employer AA-rated. This has increased the perceived cost of pension schemes very significantly.

At the same time as these regulatory and legislative changes, two other major changes were occurring which altered the finances of pension schemes. First, the bull market of the 1990s (heavily linked to internet exuberance), followed by the bear market of the early 2000s (as the exuberance faded) has taken pension schemes through a roller-coaster of surplus and deficit. The effect was exacerbated by a trend away from the actuary’s traditional tool of smoothing the asset values, because smoothing was not acceptable for reporting purposes in accounts. Second, the improvements in mortality beyond the levels previously anticipated have added to the cost of schemes.

We recognise the public policy issues underlying some, if not all, of the changes described above, for example the compulsory increases in early leaver benefits were a response, in part, to concerns that the prevailing regime was damaging the free movement of labour. Our point is that the cumulative effect of these changes has been to alter the role of the actuary fundamentally. The information now called for is a much more precise statement of cost (wanted by companies, analysts and shareholders) and a much more short term view of benefit security (wanted by trustees and scheme members) than was ever envisaged when final salary pension schemes were designed.

Q2.9 Should the Scheme Actuary’s role be reserved exclusively for actuaries? Could other professionals provide similar advice?

As we indicated earlier in this submission (see Q1.3), if others have (or can acquire) the appropriate skills and expertise – or better skills and expertise – there is no reason, in principle, why actuaries should have a statutory monopoly over any of the work.

In practice, regulators and/or the legislature want the security of knowing that someone suitable is carrying out the work. So there needs to be some recognised body (or bodies) which determines whether an individual has attained (and maintains) the relevant qualification and which lays down any standards for carrying out the work (unless it is determined that the work

can be unregulated, which seems an unlikely conclusion in the circumstances). There will be cost and other implications, but given the aggregate size of the pension funds for which actuaries provide reserved services, that need not be an obstacle.

The Pensions Bill 2004 proposes to change the Scheme Actuary's role. Currently, there is a minimum funding requirement for defined benefit schemes, which must be calculated by the Scheme Actuary, but it is largely mechanical. Once the new Pensions Act is in place, pension scheme trustees will be required to agree with the employer a strategy for funding the pension commitments and for correcting any pension deficits, with the Scheme Actuary required to provide the trustees with advice and a periodic valuation.

We doubt that any other professionals could take on the role of Scheme Actuary (present or proposed) without some additional training, but it might be that the role could be granted to individuals who had passed a specified set of exams. For example, at the Specialist Technical level of the actuarial exams, only the pensions subject might be required, rather than the two subjects required for Fellowship. This could be allied to passes in all the Core Technical and Core Applications papers (in which case, the individual would have qualified for the revised Associateship), or the qualifying body might set a narrower requirement – or perhaps set other exams for this purpose.

In addition to passing exams, we would expect the qualifying body to impose an experience requirement, as does The Actuarial Profession, with a system of supervision or mentoring for inexperienced practitioners.

It would be desirable that those individuals carrying out this role should be subject to appropriate standards, discipline and scrutiny by others qualified in the role (see Q2.11 below).

Q2.10 Do pension scheme trustees have the expertise and information to question and challenge the advice of Scheme Actuaries? In the absence of effective challenge from trustees are Scheme Actuaries effectively making policy decisions by default on the distribution of benefits between different generations of pensioners and on funding strategies?

Clearly, expertise varies from scheme to scheme. In general, there is probably not enough expertise to challenge the actuarial advice. We wonder, however, whether that is any different from saying that many companies don't have enough expertise to challenge the legal advice they receive, or the health and safety advice etc. Trustees should certainly have the expertise to understand the advice they are being given; how to implement it; and how to choose between (and/or enquire about) alternative options, if the adviser puts forward alternatives. Proposals in the Pensions Bill reinforce the requirement for trustees to have "knowledge and understanding."

Beyond that, however, we would argue that the real question is: "Are the trustees receiving *good quality* advice?" If the answer to that question is "no", something needs to be done about it, directly. The indirect approach of equipping trustees with the knowledge to challenge the advice they receive may have the appearance of being an efficient way to generate debate from which quality decisions can be reached, but we wonder whether this really is an efficient solution.

A further, more subtle issue is the difference in knowledge between trustees nominated by the employers and those nominated by the scheme members. Although there are no hard and fast rules about this, one can find that one sub-group has noticeably different expertise from the other, creating a potential for conflict to arise within the trustee group itself. [Note: The conflict of interest that can arise when one actuary advises both the trustees and the employer is a separate point addressed in Q2.12, below.]

All trustees are obliged, in law, to have regard for the interests of their members, but this oversimplifies the issue. In the long run, members' benefits are secure only if there is a strong company, standing behind the scheme and committed to paying contributions or, in the case of

mature schemes, high funding levels capable of being maintained. Once the financial strength of the employer falls into doubt, there is a tension between, on the one hand, ensuring that the scheme is well-funded in case the employer falls by the wayside and, on the other, allowing a deficit to go unchecked in the short term so that the employer has a chance to get back on its feet. There is no right answer to this. The worst case scenario is the deferral of contributions followed by the collapse of the employer.

Accordingly, we would not consider it to be surprising or objectionable if, in the words of the question, some “Scheme Actuaries do effectively [make] policy decisions by default” – either because their advice is asked for and accepted, or because the two sub-groups of trustees defer to the actuary for a view. Once again, we doubt that the position is very different for the legal advice that trustees may receive.

Q2.11 Is there sufficient audit or peer review of the Scheme Actuary’s advice to provide checks and balances on the influence that could potentially be exerted by the Scheme Actuary?

Most large pension schemes are advised by the larger firms of consultants, most of which (if not all of them) operate peer review arrangements for actuarial advice, including but not limited to, their Scheme Actuary’s advice. In this context, a “peer review” is a review of work *prior to* issuing advice to the client, carried out early enough to be able to influence the advice before it is issued. The peer review is normally carried out internally and the Scheme Actuaries can be expected, under the rules of their respective firms, to make any changes called for by the peer reviewer (subject to any procedures for resolving disagreements between the reviewer and the Scheme Actuary).

There are, however, many thousands of small schemes, some (but not all) advised by smaller firms of advisers, possibly (but not necessarily) at lower cost. Some of those smaller firms do not currently operate peer review schemes. The Profession would like to make reviews compulsory. The Profession has also explored an alternative form of review, called an “audit review” (also known as “compliance monitoring” in other circles), by which we mean a *retrospective* review of advice issued previously.

The Profession published proposals in February of this year, in an exposure draft, EXD 52, for the introduction of a scheme under which written advice given by a Scheme Actuary is subject either to peer review or to audit review against the requirements of actuarial standards. In the case of an audit review, the frequency of review must be at least once every six months and the scrutiny based on a sample of work, the size and selection of the sample to be decided on by the reviewer, not the actuary who originated the work. The Scheme Actuary is permitted to select a colleague to be the reviewer – see also Q2.41 on the Profession’s powers to monitor individuals, but not firms – and, in the case of a peer review, is likely to do so on practicality grounds.

The Profession’s proposals in EXD 52 relate solely to advice given by an actuary in the capacity of a Scheme Actuary. The Profession’s intention is to introduce the scheme by the end of the year. The proposal would be recommended practice in the first instance, having compulsory effect after a one-year bedding in period.

Following the consultation period, the intention is to follow the path that has been set by EXD 52. The longer term aim is to extend the scrutiny further, over time, at least to all areas of pensions work for which there is an actuarial standard in place and possibly to all pensions advice (see Q2.35 for scrutiny of non-pensions work, where similar considerations apply). The decision as to what aspects of advice are subject to an actuarial standard will be the responsibility of the independent Actuarial Standards Board (see Q2.31 and our introductory remarks to Section P). Any further extension of scrutiny beyond matters covered by actuarial standards will depend upon finding a basis against which to test the advice being reviewed.

Q2.12 To whom should the Scheme Actuary be accountable? What will be the effect of the intended removal of the minimum funding requirement on the potential for conflicts of interests if the same Scheme Actuary is advising both the trustees and the pension scheme sponsor? Is there a need for a separation of these roles?

Accountability of the Scheme Actuary

So far as the legislation is concerned (the Pensions Act 1995 and the Pensions Bill 2004), the Scheme Actuary is appointed by and, so we understand, accountable to the scheme trustees.

Insofar as the law dictates (or is subsequently held to dictate) that Scheme Actuaries owe any third parties a duty of care in relation to their work, Scheme Actuaries can be said to be “accountable” also to such individuals. Nevertheless the Scheme Actuary takes instructions from, and reports to, the trustees. (At the present time, we are not aware that the law does generally impose any such additional duty of care, but it may do so in specific circumstances.)

Potential for conflicts of interest?

As noted in Q2.9 above, once the proposed Pensions Act is in place, pension scheme trustees will be required to agree with the employer a strategy for funding the pension commitments and for correcting any pension deficits, with the Scheme Actuary required to provide the trustees with advice and a periodic valuation.

We have already alluded, in our answer to Q2.10 above, that there is scope for differences of view between different sub-groups of trustees (most notably the sub-groups appointed by the employer and by the members) but, in law, all the trustees must act in the interests of the scheme members and the actuary advises the trustees as a group and, therefore, owes no allegiance to one sub-group over the other.

When there is a difference of view between the employer and the trustees, that does create two separately identifiable clients and, if the same actuary advises both, there is a potential for conflict. In practice, this is not very different from the position that has prevailed in the past: it has not been at all unusual for the employer and the trustees to have a shared interest in the financial success of the pension scheme and for them both to seek advice on funding from the same actuary, knowing that the same actuary is advising both clients. (The Profession’s conduct standards do not permit an actuary to advise two clients where there is a conflict of interest, or even the appearance of a conflict, unless both clients give their express consent. In the absence of that consent, the actuary must withdraw from advising one or both clients.)

The potential for conflict is not, however, the same as an *actual* conflict. The Profession has taken legal advice on the matter, which is that there is no legal obligation which requires that the roles must *always* be separated (see Herbert Smith’s legal advice to the Profession, published at www.actuaries.org.uk/files/pdf/pensions/COI_LegalAdvice.pdf).

The Profession is, however, evaluating whether to impose a duty on all actuaries never to advise both the employer and the trustees in relation to the same scheme. Such a rule would seem to go further than the law requires. If both parties wish to retain the same actuary, and given that the scheme members’ interests are represented by one of the parties (the trustees), it would be a significant step for the Profession to impose a rule on its members which had the effect of denying clients their wish.

The Profession must also bear in mind that a separation of roles would automatically create additional costs for the clients. Given that the Scheme Actuary’s role has been reserved to actuaries by law, it would also be a significant step for the Profession to impose a rule on its members which has the effect of putting up the clients’ costs (especially when those costs would be incurred employing our members).

Notwithstanding the legal clarification referred to above, there remain strong policy arguments on both sides and the matter is still under active consideration by the Profession. The responses to this question from other commentators will inform our thinking on the matter.

Other potential sources of conflict

We should add that the issue of potential conflicts does not arise solely from the removal of the MFR and its replacement by a scheme specific funding strategy. The issue was brought into sharp focus by the Government's announcement on 11 June 2003 that, henceforth, any scheme deficit in relation to the accrued pension liabilities was to be treated as a debt due from the employer to the trustees. Herbert Smith's advice, referred to above, dealt with that issue also.

Q2.13 To what extent has actuarial advice contributed to the way occupational pension schemes are funded in the UK? How will the Pensions Bill's proposals affect the role and power of actuaries advising pension schemes sponsors and trustees?

Scheme funding

We expect that it will be common ground amongst most (if not all) commentators that actuarial advice has had a very major impact upon the way in which schemes are funded.

Many factors, however, have contributed to the effect of following that advice, ie the *level* of funding as it stands today. As indicated in the introductory remarks to this section, markets, government, and accounting standards have all played a part in creating the environment in which the actuarial advice was given and the outcomes emerged.

Role and power of actuaries

In strict legal terms, the Scheme Actuary has no "power" at all. The Scheme Actuary's role is to advise the trustees, who hold the legal powers. As noted above (see Q2.9) the Pensions Bill proposes to give the trustees a say in the determination of the contributions paid into to scheme and requires the trustees to take advice from the Scheme Actuary. In most schemes, this constitutes an increase in the trustees' involvement in the contribution-setting process, vis a vis the scheme sponsor. Whilst this also increases the statutory role of the Scheme Actuary, it is not, in practical terms, a greater role for members of the profession, because the determination of the contribution rate, whoever that fell to in the past, has always been made on the basis of actuarial advice, even though that was not a requirement of legislation.

Standing back from the purely legal interpretation, however, we view the reference in the question to "the power of actuaries" as the converse of the trustees' "expertise and information to question and challenge the advice of Scheme Actuaries" referred to in Q2.10. In other words, the question seems to be an allusion to the dictum, "knowledge is power".

The proposals in the Pensions Bill for trustees to have an appropriate degree of knowledge and understanding of pension scheme finance and related matters should certainly help to increase the trustees' knowledge and, therefore, the trustees' power (in the non-legal sense in which we are now using the term).

As noted in our answer to Q2.10, however, we question whether this is the right way to view the issue. As we see it, the critical objective is to ensure that trustees and the scheme sponsors receive *good quality* advice. If that isn't happening, something needs to be done about it, directly. The indirect approach of increasing the "power" of the trustees does not appear to us to be an efficient remedy for trustees who have (by hypothesis) received low quality advice.

Q2.14 Are there any other issues relating to actuaries' statutory or non-statutory roles in advising pension fund trustees and pension fund sponsors that you would like to bring to the attention of the review?

Our answers to questions 2.9-2.13 above address all the issues we wish to raise.

L GENERAL INSURANCE AND THE ROLE OF THE SYNDICATE ACTUARY

Q2.15 What are the implications for actuaries of the FSA's moves to a realistic reporting regime in general insurance?

The proposed regime does not explicitly require the involvement of actuaries, but it is reasonable to expect that it will lead to a significant expansion of actuarial work. The regime will involve, amongst other things, assessing reserving risk, ie estimating claims reserves and the *variability* of those reserves around the expected value. This will call for the use of statistical techniques, which general insurers have increasingly been turning to actuaries for.

Not all of the work for the new regime, however, will fall to the actuarial function. This applies particularly to the more qualitative aspects of risk management, such as the impact of corporate governance arrangements and operational risk, as well as to certain specialist risk areas such as market and credit risk. Those companies whose actuarial function is not well integrated with other areas of management will need to integrate these functions more effectively.

The profession is currently considering whether to introduce actuarial standards for capital modelling. The introduction of standards in this area raises new and difficult issues, because some of the reports to which the standard would apply might be prepared jointly by actuaries and non-actuaries.

Q2.16 Do you agree that a reserved role for actuaries in general insurance is unnecessary?

If there were to be a reserved role for actuaries in general insurance, it is likely to be either a requirement for insurers to obtain opinions on their claims reserves (similar to the Syndicate Actuary responsibilities at Lloyd's) or, as with life insurance, an advisory role to the directors on the setting of reserves.

At present, Lloyd's requires its syndicates to obtain opinions on the reserves by an actuary, but general insurance *companies* are not subject to such a regime. The FSA's Consultation Paper, CP04/7, has raised the possibility of bringing the two regimes more closely into line either by extending the reserve opinion regime to companies or by removing it from Lloyd's syndicates.

The former option (extending statutory opinions on reserves beyond Lloyd's) raises several issues. These have been addressed in a recent paper produced by a working party set up by the Profession.⁷

As to whether statutory opinions (or advice to directors) should be reserved to actuaries, our answer follows the same principles as our answer to the generic question in Chapter 1 (see Q1.3) and the corresponding question for Scheme Actuaries in pensions (see Q2.9). If other professionals have (or can acquire) the appropriate skills and expertise, there is no reason, in principle, why actuaries should have a statutory monopoly over the work.

In practice, regulators and/or the legislature want the security of knowing that someone suitable is carrying out the work. So there needs to be some recognised body (or bodies) which determines whether an individual has attained (and maintains) the relevant qualification and which lays down any standards for carrying out the work. At present, Lloyd's requires Syndicate Actuaries to be Fellows of the Institute, the Faculty or the USA Casualty Actuarial Society and to have a Syndicate Actuary practising certificate issued by the UK Actuarial Profession.

It might be that any extension of the reserved role in general insurance could be granted to individuals who had passed a specified set of exams, for example only the general insurance subject at the Specialist Technical level (rather than the two subjects required for Fellowship).

⁷ *Statutory Actuarial Involvement in Non-Life Reserving*, to be published in October.

This could be allied to passes in all the Core Technical and Core Applications paper (in which case, the individual would have qualified for the revised Associateship), or the qualifying body might set exams (or other criteria) of its own. For example, in the US, where an opinion is required for general insurance entities, the qualification criteria extend beyond the actuarial profession to include anyone who is a “loss reserve specialist”, as approved by the state insurance regulator.

It would be desirable that those individuals carrying out this role should be subject to appropriate standards and discipline.

Q2.17 Are there any other issues specifically relating to the role, responsibilities or regulation of actuaries working in general insurance that you would like to draw to the attention of the review?

Reserving methodology

Reserving for general insurance liabilities continues to pose challenges. In some areas, the past can be even less of a guide to the future than it is in life assurance and pensions. Asbestos-related claims, for example, continued escalating, long after they first emerged, as a result of many factors, including court decisions (here and, more especially, in the US) and the potentially very long time-lag (sometimes decades) between an individual’s exposure to asbestos and the onset of disease.

It seems to be widely accepted that the involvement of actuaries in this field has been a major improvement on what was available before, but in an increasingly blame-oriented culture, professionals who offer their services in uncertain areas are often blamed when their advice turns out not to have been a magic cure.

The profession has, so far, accepted the challenges this environment brings and is, both here and in the US, always seeking to refine its methodologies and approaches to dealing with the projection of such an uncertain future. Current activity in this area is the establishment by the UK Profession in March of this year of the General Insurance Reserving Issues Taskforce.

Guidance

The profession is reviewing the actuarial standard, GN 12, which (currently) deals with the content of formal actuarial reports. We are exploring, amongst other issues, whether it is appropriate to make the standard compulsory (rather than recommended) for certain types of work. The standard relates to work which insurers are not required (by law or regulation) to commission from an actuary and it is, therefore, debatable how far work which an insurer commissions in this way can properly be constrained by a professional body. Any arguments against such an intrusion are strengthened in the case of work done by in-house actuaries, because the output from such work is a private communication between an employer and its employee(s).

M INVESTMENT

Q2.18 Are there any specific issues faced by actuaries working in institutional investment that you would like to draw to the attention of the review team?

Actuaries working in the investment arena typically work alongside non-actuaries doing an equivalent job. There is no requirement for any investment services or advice to be provided by an actuary and we are not aware of any particular issues faced by actuaries working in investment.

Q2.19 Do you have any observations about the Institute's role in regulating investment business by actuarial firms as a designated professional body under FSMA?

For the avoidance of any doubt, the Institute's status as a designated professional body (DPB) does not mean that members of the profession who provide investment management services can choose to do so under the auspices of the Institute's DPB arrangements, rather than being regulated by the FSA. Firms carrying out investment management must obtain the relevant FSA authorisation.

The investment activities which a firm can carry on under a DPB licence are very limited. In particular, any regulated investment activities carried on under a DPB licence must be incidental in the context of the firm's activities generally and the particular service must arise out of, or be complementary to, other professional services provided to the specific client. (Details of what a firm can and cannot do are set out in Part 3 of the profession's DPB handbook.)

Asset allocation advice is not regulated as part of the Institute's DPB status, because such advice is not regulated under the Financial Services and Markets Act. Nevertheless, any members giving asset allocation advice are subject to the requirements of the Profession's conduct standards, as for all activities of all members.

N MAINTENANCE OF PROFESSIONAL COMPETENCE

Q2.20 Is there the right balance between the Profession issuing practising certificates and regulators giving their approval?

The practising certificate regime (currently) applies to three roles: the Appointed Actuary (life offices), the Scheme Actuary (pension schemes) and the Syndicate Actuary (Lloyd's).

When the regime was created in 1992, only the Appointed Actuary role existed. The purpose of the certificate, at that time, was so that the profession had a mechanism, should the need arise, by which to prevent a member from carrying out the Appointed Actuary role. Previously, the only way the professional body could prevent a Fellow from holding the post of Appointed Actuary was to suspend them (or expel them) from all actuarial activities. The practising certificate was not intended to be a mark of additional quality over and above that of a Fellow.

In parallel with the practising certificate regime, the life office regulator (ie the FSA and its predecessors) had a responsibility to ensure that the Appointed Actuary was a fit and proper person. In effect, the regulator had the responsibility to check the general fitness and suitability of the actuary and practising certificates were the profession's mechanism for providing reassurance on competence.

The roles of Syndicate Actuary and Scheme Actuary were introduced under Lloyd's Regulations (with effect from 1997) and the Pensions Act 1995 (also with effect from 1997). Neither of these regimes requires any additional approval by a regulator: admission to the Fellowship of the Institute or the Faculty of Actuaries is sufficient, in law, to entitle an individual to be a Scheme Actuary or Syndicate Actuary, as the case may be.

The profession attaches conditions to the granting of a practising certificate, including the requirements to demonstrate (a) suitable experience to equip the actuary for the role and (b) completion of the continuing professional development requirement (see Q2.21). The latter is an ongoing requirement for renewal of the certificate (required annually).

Arguably, there is duplication in the case of the Appointed Actuary, with the FSA and the professional body both having an approval role and the concomitant power to withdraw approval. The profession is working with the FSA to agree a procedure to share information which may assist each other with their responsibilities.

Q2.21 In your view are the current CPD requirements and the provision of CPD appropriate?

The Actuarial Profession promotes a culture of lifelong learning, under the label *Continuing Professional Development* (CPD). It is also a requirement of the professional conduct standards that members must not give advice unless competent to do so.

A minimum level of CPD is compulsory for actuaries who hold a practising certificate entitling them to act as an Appointed Actuary (life assurance), Scheme Actuary (pensions) or Syndicate Actuary (general insurance at Lloyd's). The minimum level is 15 hours per year of *formal CPD* plus one hour per week (on average) of *informal CPD*:

- *Formal CPD* is participation in courses, professional meetings or other formal events of equivalent standing.
- *Informal CPD* is any other activity of professional development such as reading, training, teaching etc, not necessarily of a technical nature.

[Because legislative changes and developments in technical practice etc tend to be "lumpy", CPD in some years will necessarily be greater than in others. Averaging over two or three years is allowed.]

For all other actuaries, ie those without a practising certificate, CPD is encouraged, but is not currently compulsory. The profession's proposal to extend practising certificates to cover all actuaries who give advice on actuarial matters will make CPD mandatory for a much greater number of actuaries than at present (see Q2.22).

By way of comparison with other professions, The Law Society requires solicitors to do 16 hours of CPD, of which a minimum of 4 hours must be met by participation in accredited courses and 12 hours may be met through the broad equivalent of our informal CPD.⁸ The Institute of Chartered Accountants in England & Wales (ICAEW) has a more onerous requirement. Those for whom CPD is compulsory must do a minimum of 20 hours equivalent to our formal CPD and a further 90 hours equivalent to our informal CPD. For each extra hour of formal CPD, the requirement for informal CPD falls by 3 hours.⁹

The profession's CPD handbook (updated and reissued annually) guides actuaries on how to direct their CPD so that it fits their own personal development aims and needs, embracing technical skills, professional behaviour and business and management abilities.

The profession is currently reviewing the CPD scheme (see Q2.23).

Q2.22 Do you support the Profession's proposals to extend the concept of practising certificates to cover all actuaries who give advice on actuarial matters?

Although the proposals in this area were originally presented in the terms described in the question (to extend the concept of practising certificates to cover all actuaries who give advice on actuarial matters), the proposal has since been refined and is now as set out below.

Members who are Fellows or Associates and (in either case) who have a pass in a UK practice module or its equivalent will be required to indicate, annually, whether or not they are working as an actuary. Those who indicate they are a *working actuary* will be required to complete the requirements of the CPD scheme. Fellows, or Associates, who have not (yet) obtained a pass in a UK practice module or its equivalent will not be permitted to call themselves a *working actuary*, whether or not they work as an actuary.

A *working actuary* will be permitted to continue working without obtaining a practising certificate, so long as the actuary's work does not fall within one of the following areas designated as requiring a certificate:

- *The Actuarial Profession's Practising Certificate*: This will be a new certificate, issued automatically to any actuary qualifying as a Fellow after the certificate is introduced, having also passed one of the UK practice modules. For actuaries who qualified before this certificate is introduced, the certificate will only be granted to those who have passed a historical equivalent of the new practice model, have satisfied the CPD requirement and have suitable work experience.

⁸ The Law Society's handbook, *Continuing professional development*, March 2004, describes the requirement as "Up to [12 of the 16 hours] may be met through a wide range of activities, such as attendance at accredited or unaccredited courses, writing law books and articles, undertaking NVQs in business and management and preparation and/or delivery of certain training courses."

⁹ The ICAEW's handbook, *Continuing Professional Education (CPE) 2004* contains the following: "A distinction can be made between 'structured' and 'unstructured' CPE. Structured CPE can be achieved through ... for example, attendance at technical meetings, seminars, lectures, courses [and/or] distance learning, where the course is assessed and/or leads to a further qualification. ... Unstructured CPE will normally be achieved through private reading and study. ... A reasonable target can be expressed as an average of 150 points year on year – with three points being recorded for each hour of structured CPE and one point for each hour of unstructured activity. Members for whom CPE is compulsory should observe this recommendation and should aim to achieve at least 40 per cent of their CPE (60 points) through structured activities (i.e. three days)."

The practising certificate will relate to the area of practice in which the UK practice module has been passed. Initially, renewal will be voluntary, but in due course, the profession may decide to designate circumstances or areas of work in which a practising certificate would be required. It is envisaged that, in time, it will become a requirement for all actuaries actively working in significant practice areas to hold a Profession's Practising Certificate.

The first renewal would be one year after it was issued. Subsequently, the certificate would be renewable at three-yearly intervals.

Statutory/Regulatory Practising Certificates: These will be the same as the present practising certificates, required for work which has been reserved, by statute or regulation, to actuaries.

Q2.23 Are there any other changes to the CPD programme that you would like to see?

As noted above, we are currently reviewing our CPD scheme. One particular issue for exploration is whether the current scheme is too narrowly focussed on recording time spent on activities rather than assessing whether the activities undertaken meet the individual's developmental needs, consistent with the aims of CPD. It is envisaged that the scheme will be re-tailored to reflect the three practising regimes described in Q2.22:

- working as an actuary, with a pass in a UK practice module, but no practising certificate
- working in one or more subject specific areas, with the Profession's Practising Certificate (in each area of work)
- working in a reserved role, with the associated Statutory/Regulatory Practising Certificate.

The three regimes would have progressive CPD requirements relating to knowledge in specialist technical areas. There is also a proposal under consideration to require a minimum of two hours each year on professional matters.

Members will be expected to maintain records of their CPD activity, which the professional body will have the right to review, for example on renewal of the member's practising certificate and at other times where it is relevant to do so. This is in line with the practice of other professional bodies, such as the Law Society and the ICAEW.

The profession provides a wide programme of events and other materials intended for members' CPD, but members are, of course, able to carry out CPD using any number of relevant sources, including external sources (conferences, journals, interactive learning packages via the internet etc) and development opportunities created by their employers. The profession's own CPD offerings include:

- Conference programmes in each of the main practice areas (life assurance, pensions etc)
- Seminars and workshops on current topics and focused short courses on specific technical topics, eg life office taxation and pension scheme wind-ups
- Additional training courses, sometimes with (voluntary) examinations, in new subject areas which have yet to be added to the syllabus and/or subjects which have been added recently and which older actuaries may wish to study
- Monthly meetings at which topics of current interest are debated following the presentation of a formal academic paper (referred to in the profession as "sessional meetings")
- Meetings for younger members (pre- and post-qualification) at local actuarial societies throughout the UK addressing topics of both a technical and general professional nature, including a two-day Younger Members Convention held annually.
- In the pipeline, a new series of actuarial science textbooks, published by Cambridge University press, with the first in the series due to be published early in 2005.

O WHISTLE-BLOWING

Q2.24 Are there appropriate legal and professional duties and safeguards for disclosures by actuaries to protect the public interest in regulated sectors?

Duties

We consider the statutory disclosure duties (described in paragraphs 2.25-2.27 of the Consultation Document) to be sufficient and, arguably, more than sufficient. It is always likely to be the case that, faced with a new statutory duty to disclose, individuals who are unused to such a regime may over-report until they are reassured that a lower level is acceptable. The remarks in paragraph 2.27 of the Consultation Document indicate that this may have happened in the case of actuaries whistle-blowing to Opra.

The professional duty to disclose possible instances of misconduct also seems to be appropriate, subject to the comment below on “safeguards” (see the Introductory remarks to section I of this submission for an explanation of the term “misconduct”).

Safeguards

The regime(s) which actuaries must comply with contain safeguards against any action for breach of confidence. In all walks of life, however, whistle-blowers face a potential behavioural backlash – perhaps more so where the whistle-blowing decision is taken voluntarily, rather than by force of law.

In the case of the professional duty to disclose possible instances of misconduct, there is no exemption from the laws protecting confidential information and the profession has no legal power to grant such an exemption, so actuaries are prevented from reporting matters if doing so would breach the duty of confidentiality owed to a client or employer.

Q2.25 Is it sufficiently clear to actuaries and others when they should report concerns to the regulators and the Profession?

Our understanding is that actuaries are clear on the requirements, so far as pension schemes are concerned, but there remains a concern in the field of life assurance, that the FSA may, at some point, decide that something not reported was materially significant and should have been reported to them. This is the same concern previously experienced by pensions actuaries which apparently led to them over-reporting (see Q2.24).

Q2.26 Is there an appropriate level of disclosures by actuaries to protect the public interest?

Despite the comment under Q2.24 above that actuaries have generally been over-reporting to Opra, we are also aware that there have been a small number of instances (fewer than 20 since the whistle-blowing regime began) where individual members have failed to blow the whistle in cases where they should have done. These cases have been reported to us and, if appropriate, addressed as matters for disciplinary investigation.

P STANDARD-SETTING

Introductory remarks

Our intention, announced prior to the setting up of the Morris Review, was to devolve the setting of standards from the Profession (through its various boards and committees) to an Actuarial Standards Board which was both more *independent* of the management of the Profession and more *broadly composed* than the current personnel, all of whom are actuaries. Our initial proposals envisaged that:

- The independence from Councils would be achieved using the same, or a similar, mechanism to that adopted for the new Disciplinary Scheme (which Lord Penrose described as a “quite an extreme approach to ensuring impartiality”¹⁰). That mechanism was to set up an appointments committee under the chairmanship of a non-actuary (a lawyer in the case of the Disciplinary Scheme, but a wider constituency might be considered for the standard-setting appointments committee). The appointments committee would then select members of the Actuarial Standards Board.
- The broader composition would be achieved by making it a requirement that the board’s membership would have a balance in favour of lay representation, including a lay Chairman.

These initial proposals were limited to what it is in our power to deliver. With the subsequent announcement of the Morris Review, under terms of reference which expressly call for recommendations which will deliver “high-quality and continuously developing actuarial standards”, there is clearly an opportunity to go beyond our initial proposals. For example, the selection of members could be made visibly more independent than an appointments committee that was appointed by the Profession. [We say “visibly” more independent, because we believe the system we described would achieve independence, as does Lord Penrose (see above).]

We remarked earlier in this submission (see Q1.1) that the success of the independent *Accounting* Standards Board owed much to its first chairman who is an accountant (as are the second and third chairmen of that board). If appointments to the Actuarial Standards Board can be made completely at arms length from the profession, it may be acceptable for the chairman to be a member of this profession (on merit, not as of right).

It is also important to note that we are a small profession (4,500 practising Fellows in the UK), with an even smaller number carrying out work that is governed by standards. In everything that the profession does, we have to bear in mind that the costs need to be contained within a level which members are willing to support, including those who do not need to continue as members in order to practice in their chosen area of work. One of our intentions in relation to the Actuarial Standards Board is to explore the possibility of external funding from those institutions whose finances are affected by actuarial considerations. We envisage that the Morris Review will also consider how an Actuarial Standards Board should be funded.

Q2.27 Does the Profession’s technical guidance, as set out in the Manual of Actuarial Practice, provide unambiguous, up-to-date and clear standards for practising actuaries and other professionals e.g. auditors, who work with them? Do you agree with Lord Penrose’s view that professional guidance in the past has not protected policyholders’ interests?

The Profession accepts the criticisms made by Lord Penrose. Our proposals for remedying the problem are summarised immediately above in the introductory remarks to this section.

¹⁰These words are taken from Lord Penrose’s evidence to the Treasury Select Committee on 16 March 2004, in answer to Q642.

Q.2.28 Does the technical guidance need to be updated more regularly and are fast-track processes required to provide guidance on urgent issues?

The problem in the past was not that the updating of standards was too infrequent (or too irregular). The problem identified by Lord Penrose (for example, in relation to PRE) really stemmed from a lack of recognition within the profession that there was a “need for standards or for guidance relevant to the treatment of [these] liabilities” [Penrose 17.8, cited on page 24 of the Consultation Document]. The Profession does not dissent from this comment.

So far as the specific issue of life office liabilities is concerned, this is largely being addressed through the FSA’s new rule book effective from 31 December 2004, which is both explicit and extensive as to the way the FSA expects offices to demonstrate their solvency. To the extent that actuarial judgement remains, this will be addressed by actuarial standards. We envisage that one of the first tasks of the proposed Actuarial Standards Board, described in the introductory remarks to this section, will be to determine whether there are any other areas of actuarial practice where Lord Penrose’s criticisms apply.

Insofar as a “fast track” procedure may be required, there is one in place already which enables a standard to be introduced, or an existing one amended, without going through the normal “exposure draft” stage. Standards introduced in this way must be confirmed (or replaced) within a specified time period thereafter, following the standard process of exposure and consultation. The Actuarial Standards Board will be able to determine whether the procedure is fast enough (or too fast), used frequently enough (or too frequently) and any other issues the standards board wishes to address.

Q2.29 Who should provide the guidance: the Profession, the regulators or the government?

We doubt that government (ie Ministers) are the appropriate people to determine financial standards, regardless of whether the standards relate to accounting, investment, actuarial matters or any other aspect of finance. There are other mechanisms in place, or which can be set up. We would hope that Ministers would readily share that view.

The remaining choices would seem to be:

- a) professional bodies, ie The Actuarial Profession
- b) financial regulators, such as the FSA, Opra (or its successor as proposed in the Pensions Bill)
- c) bodies specifically set up with standard-setting powers under the authority of legislation or one of the above-listed bodies.

Our intentions prior to the setting up of the Morris Review had been to develop a body along the lines described in (c) above, ie the Actuarial Standards Board, described in the introductory remarks to this section. In part, this was because it was the only solution to the problem that could introduce independence to the standard-setting without legislative change – and, therefore, the only solution available to the profession under its own powers.

The existence of the Morris Review has given us an opportunity to re-visit the question from square one. Our analysis, as reflected earlier in this submission (see also the introductory remarks to Section I of this submission), is that there is a distinction to be drawn between the providers of *financial* services (and their regulators, such as the FSA and Opra) and the providers of *actuarial* services (and their regulators). We believe that the two classes of service (*financial vs actuarial*), and the types of organisation that provide them (*financial capital vs human capital*) are so conceptually different as to continue to require quite separate regulators.

The separation of the *Accounting* Standards Board (under its parent, the FRC) from the regulation of reporting entities (in part by the FSA) is an example of this principle successfully in

action elsewhere. We consider, therefore, that, whatever alternatives to our proposed Actuarial Standards Board might be contemplated, they should be separate from the financial regulators.

Q2.30 Is there a need to reduce the level of discretion permitted within guidance to come to some generally acceptable professional practices?

This is one of the conclusions that Lord Penrose reached, so far as life insurance is concerned, and we agree. Although the other areas in which actuaries work have different factors to consider, we think the central thesis of reduced discretion must be transportable to those other areas. This applies both to the actuarial *principles* underlying any work and to any *rules* derived from the principles.

The challenge will be to distinguish between limiting discretion (ie less freedom of choice) and limiting professional judgment (ie what is appropriate in any particular circumstances). Given the extent to which actuarial work relates to estimates about the future, rather than measurements relating to the present or the past, this may be more of a challenge than in other standard-setting areas, but it is a challenge that must be faced.

Q2.31 Will the Profession's own proposals for an actuarial standards board go far enough to improve the quality and timeliness of standard-setting to protect the public interest? Is there a need for even greater independence from the profession or a statutory underpinning to bring greater credibility to the technical standard-setting process?

This question is effectively addressed in our introductory remarks to this Section, which also formed the basis of our answers to earlier questions. We believe that our own proposals go as far as is achievable within our own powers. We welcome the opportunity afforded by the Morris Review to explore going beyond our initial proposals, whether in terms of independence, or in terms of any further steps that will improve the quality and timeliness of actuarial standards.

Q2.32 Does the Profession work closely enough with other professions e.g., accountancy, to ensure that its standards are widely recognised and to influence other profession's standards where appropriate, and to ensure that there are no regulatory gaps or overlaps in standards?

The profession's goal is to work closely with other standard setters. We believe that we make a significant contribution to accounting standards through our liaison with both the Accounting Standards Board and the International Accounting Standards Board. In the latter case, we usually make submissions via the International Actuarial Association, but occasionally we do so directly.

We think our views are not always given enough consideration by the accounting bodies. This may be because we are not clear, or because we are, sometimes, over-confident in our views. We believe that, on other occasions, the ASB or IASB has not always paid enough attention to our views.

We are not aware of any occasions, however, where there have been gaps or overlaps, other than those created by regulators or legislators outside the different professions. The "trouser legs" example cited by Lord Penrose (see Penrose 20.47, repeated in the Consultation Document at paragraph 2.30 and referred to in our answer to Q1.4) has its origins in legislation.¹¹

¹¹Ever since the Life Assurance Act 1870, and continuing until the FSA's new regime coming into force at the end of this year (see paragraphs 2.8-2.10 of the Consultation Document), the amount of the liabilities and any surplus falls to be determined by actuaries and is not directly subject to audit.

Q OPENNESS, PEER REVIEW AND AUDIT OF ACTUARIAL WORK

Q2.33 Do you agree with Lord Penrose's assessment of the lack of openness and transparency of the profession to non-actuaries, including other professionals, and their clients?

The text accompanying this question, and the supporting passages in Lord Penrose's report, address four issues the Profession:

- the quality of communications from life office actuaries to their colleagues and clients;
- the way in which some actuaries treated the exercise of discretion as their exclusive preserve;
- the way the latter issue was exacerbated by an accounting and auditing regime that effectively left one side of the balance sheet to the actuary and the other side to the auditor; and
- the now obsolete professional rule that inhibited actuaries from undermining the authority of the appointed actuary.

The first of these issues (quality of communications) is one that we discussed in some detail in Q1.25. As we said in response to that question, the criticism of actuaries' communications skills is made so often that there is little point trying to quarrel with it. We offered some reasons why the problem exists and explained what the professional body has been trying to do to remedy it, albeit not entirely successfully. We certainly do not want to duck our responsibilities in this area, but there is only so much that a professional body can do. The quality of communications from individual actuaries to their colleagues and clients, is ultimately the responsibility of the individual (or the individual's firm).

The second issue (exclusive preserve) is another one that we commented on earlier (see Section A and Q1.4). We recognise that actuaries have tended to regard themselves as the primary experts in pensions and insurance with the consequences that Lord Penrose refers to. There are lessons for actuaries to learn from the striking comments of Lord Penrose. It is also the case that life office directors should not have allowed their actuaries to treat discretion as their exclusive preserve. The FSA has taken action to stop directors doing that.

The third issue (separation of responsibilities for the two sides of the balance sheet) is not of our creation, but actuaries have undoubtedly gone along with the separation without any complaint. Once again, the FSA has taken action to remedy that.

The fourth issue (inhibition on criticism of the appointed actuary) was remedied in 1996. We might add, in this respect, that since February 1993, there has been an express obligation on all actuaries to take action if they become aware of any possible misconduct by another actuary.

Those were Lord Penrose's observations and our responses to them. The question, as posed above, however, could be read as suggesting something rather different. The implication of the question ("the lack of openness and transparency of the profession") suggests that actuaries and/or the professional body have deliberately sought to be secretive or opaque about actuarial matters. We do not accept that characterisation. Actuaries love to explain their calculations almost as much as they enjoy doing them. The problem is that actuaries have not always been terribly successful at it.

Likewise, the professional bodies make great attempts to communicate with the public about our affairs, about the work of actuaries and about topical issues in financial services.

Q2.34 What steps can be taken to improve communications between the actuarial profession and their clients or other professionals?

We think our answers to Q1.25 and to Q2.33 address this question.

Q2.35 Given the Profession's recent proposals on peer review, and the FSA's proposals for the reviewing actuary function in life assurance, will there be an appropriate level of peer review and scrutiny in the actuarial profession to protect consumers' or policyholders' interests in the future?

The Profession's current proposals relate to the three areas of work reserved to actuaries by statute or regulation. The Profession's intention is to extend that, over time, to all areas of work for which there is an actuarial standard in place. The decision as to what matters are subject to an actuarial standard will be the responsibility of the independent Actuarial Standards Board (see Q2.31). Any further extension of scrutiny beyond matters covered by actuarial standards will depend upon finding a basis against which to test the advice being reviewed.

Pensions

In our answer to Q2.11, we explained the peer review arrangements that currently exist in some firms and the steps being taken to extend them to all firms, either by means of "peer review" (a review of work prior to issuing advice to the client) or "audit review" (a retrospective review of advice issued over the previous six months). The proposals for extending the regime are set out in the Profession's exposure draft, EXD 52.

Establishing the right level of scrutiny is a challenge. As with any form of regulation, it is essential to measure the benefits against the cost. There are many thousands of small (and not so small) schemes for which the Scheme Actuary function is provided from a firm with only one or two actuaries. For such schemes, the incremental cost of scrutiny would be proportionately much higher than for a large scheme where a team of a dozen actuaries and students is not uncommon. Nevertheless, the Profession would like to make reviews compulsory across the board, believing that the costs are justified by the benefits.

We welcome any comments on the issues raised in this question, especially any which suggest that our proposals may not go far enough (or too far) to protect consumers at an acceptable cost.

Life assurance

The Profession's current proposals for actuarial scrutiny in life assurance are designed to be consistent with the new FSA regime. As described in paragraph 2.8 of the Consultation Document, the Reviewing Actuary, who will be external to the life office, will be retained by the auditor to advise on the insurer's calculation of its liabilities and related matters.

In addition to the calculation of liabilities, there are roles reserved to the Actuarial Function Holder or to the With-Profits Actuary which are not subject to external audit. Actuarial standards are being brought forward which will ensure that work reserved to an Actuarial Function Holder or With-Profits Actuary will be subject to peer review as appropriate. The Profession's fast track procedure for standard setting (see Q2.28) will be used to ensure that the new standards will be in place before the new regime commences on 31 December 2004.

Lloyd's

The reserved role in general insurance derives from the Lloyd's Valuation of Liabilities Rules. The development of a peer review regime in this area is, therefore, a matter for agreement with Lloyd's. Proposals for introducing peer review have not yet been settled.

Q2.36 When should actuarial opinions be directly addressed or otherwise communicated to members of the public, such as policyholders or scheme members?

In the first instance, the dissemination of reports to policyholders or scheme members is a

matter for the insurer or the scheme trustees to decide. In the absence of legislative or regulatory intervention, the reports are confidential to the client for whom they are written, perhaps with good reason, as explained below.

Looking at the question solely from the perspective of the policyholders and/or scheme members, we consider that communications on the following matters have the potential to be of real benefit:

- *Pension schemes*: The members clearly have an interest in knowing how well secured the accrued liabilities are. This can be measured in terms of:
 - The statutory liability on the employer, ie a shortfall of assets against liabilities measured by reference to the amounts needed to buy out the members leaving service benefits based on accrued service and salaries to date, uplifted for inflation to the extent required by statute (“limited price indexation”)
 - The liability measured as above *except that*, instead of communicating the cost of buying out the benefits from an insurer (something which is not always cost effective, or even achievable, in practice, especially for large schemes), the cost is measured in terms of purchasing assets to be held inside the scheme, as if it were run-off as a self-administered scheme
 - The liability as measured in the second example above, but allowing for projected salary increases to retirement. Although there is no legal requirement for the scheme to provide benefits at that level, once it has been closed, it is useful information for a scheme member of working age who wants to know whether the scheme is capable of financing the member’s reasonable expectations of the pension from the scheme in question
 - As a supplement to the third example above, the liability could be measured allowing for the costs of any discretionary benefits which members have reasonably come to expect they will receive.

For the communications described above to be useful to members, the information needs to disclose the proportion of cover for each of the different groups of members. This is because there is a statutory priority ranking in which current pensions are given first call on the assets in the event that there is a shortfall against the liabilities. Legislation already in place requires that scheme members must, on request, be given a copy of their schemes’ actuarial valuation report and the trustees’ annual report, which must include certificates by an actuary regarding contributions and the minimum funding rate.

- *Life offices*: The policyholders have an interest in knowing that the insurer’s assets (in conjunction with future premiums under the contract) will be sufficient to meet:
 - their guaranteed benefits under the insurance contract (including any bonuses already granted); *plus*
 - in the case of a with-profits contract, their reasonable expectations of future bonuses.

The first piece of information above, could be communicated by way of a public certificate from either the Actuarial Function Holder or the Reviewing Actuary. In the case of a certificate from the Actuarial Function Holder, it should be reviewed by the company’s auditor or the Reviewing Actuary before it is issued.

The second piece of information, if it is to be given, is perhaps a matter for the directors of the company, rather than the actuary, although the directors will need advice from the Actuarial Function Holder before giving it. If such a mechanism were to be put in place, there will need to be suitable checks to avoid any concerns about future security turning into a self-fulfilling prophesy as a result of policyholders surrendering their policies *en masse* to get out before the funds are depleted. The natural mechanism – surrender discounts – are

notoriously unpopular (“surrender penalty” being the term in common usage, rather than “surrender discount”) and can exacerbate the problem if policyholders exit in even greater numbers, fearing an increase in the discount/penalty as matters deteriorate.

Q2.37 Is there a need to further widen the scope of actuarial activities that are subject to peer review or other forms of scrutiny – for example into Lloyd’s syndicates and general insurance?

So far as Lloyd’s is concerned – the only reserved area in general insurance – our earlier answer (see Q2.35) explained that this is a matter which requires agreement with Lloyd’s; proposals for introducing peer review to this area have not yet been settled.

More generally, and as noted earlier (see Q2.35), although the Profession’s current proposals relate only to the three areas of work reserved to actuaries by statute or regulation, our intention is to extend that, over time, to all areas of work for which there is an actuarial standard in place. Any further extension of scrutiny beyond matters covered by actuarial standards (which we intend will be set by an independent Actuarial Standards Board – see Q2.31) will depend upon finding a basis against which to test the advice being reviewed.

R MONITORING, COMPLAINTS AND DISCIPLINARY SCHEMES

Q2.38 Do the new disciplinary processes implemented by the Profession from 1 January 2004 address the issues that Lord Penrose raised?

The new disciplinary processes referred to in the question were not set up to deal with the point raised by Lord Penrose (ie proactive intervention as distinct from reactive discipline).

We have, however, been reviewing the proactive aspects as well, through the steps we have been taking towards peer review (see Q2.35 and also Q2.11 in relation to pension schemes).

[Note: The term "peer review" was used in the Consultation Document and in our April submission before that. In fact, as commentators from other professions will know, peer review is just one form of scrutiny. "Compliance monitoring" is a more general term which applies where there are existing standards against which to test for compliance. Other descriptions (eg "quality review") may be used when work is reviewed in the absence of any test of compliance.]

Q2.39 Is the Profession's past record of 17 complaints over 15 years a sign of a successful profession or an indication that monitoring and disciplinary procedures were not effective?

The figure of 17 relates to the number of complaints which, after investigation, were referred to a Disciplinary Tribunal. The total number of complaints over the same 15-year period, including those which, after investigation, were not referred to a tribunal is around 50.

[Note: Prior to 2004, complaints were not referred to a tribunal if the complaint investigators did not consider the facts supported a charge of misconduct. Under the new scheme, introduced at the start of this year, the factual findings of an investigation are referred to a preliminary hearing by a panel of tribunal members at which a decision is made whether to refer the matter to a disciplinary tribunal, dismiss the complaint or adopt an expedited procedure which can be applied in certain cases where the respondent admits to misconduct.]

The question above asks whether the history of [around 50] complaints is a sign of a successful profession or poor monitoring. We suspect that the reality is neither. To explain our thinking on this, it is helpful, at the risk of over-simplification, to categorise complaints into two types:

- *Lacking integrity*: where an individual has taken actions which are, in some way, dishonest, dishonourable or deceitful.
- *Lacking professional judgment*: where an individual has, through action or inaction, failed to accord with the expected standards of competence or performance in their work.

No profession can guarantee never to admit a member whose behaviour may subsequently fall into the first category. We would like to think, however, that the actuarial profession has rather less than its fair share of such individuals. The figures do seem to bear this out – indicating, perhaps, that there are easier ways to find opportunities for disreputable behaviour than by setting out to qualify as an actuary.

So far as the second category is concerned (lacking professional judgment), our responses to earlier questions on standard-setting (Section P) perhaps do more to explain the low figures. Our history of having standards that focus rather more on roles, procedures and processes than on the specific calculation of liabilities (cf Penrose 17.8 and Q2.28) reduces the scope for misconduct of this type.

[Note: The Disciplinary Scheme does not adopt the categorisation used above. It is used here merely to assist with our explanation.]

The proposal for a new Actuarial Standards Board (see Section P), coupled with peer

review/compliance monitoring, will change the landscape in that respect. We believe that the framework of the new Disciplinary Scheme has been drawn widely enough to cope with complaints arising out of the standards we envisage emerging in due course.

Q2.40 Should the review consider whether a fully independent disciplinary process is needed?

We made our new scheme as independent as was viable given the powers that we have. As noted earlier in this submission (see the introductory remarks to Section P), the scheme incorporates lay membership at all levels, including the appointments committee, the management board and the tribunal members, which Lord Penrose described as a “quite an extreme approach to ensuring impartiality.”

If further independence is called for, we will co-operate fully in its implementation. We would, however, point out that the current scheme was expensive to introduce, both in terms of time and money, so we would like to be reassured that the benefits of change will outweigh any costs that may fall upon our members.

Q2.41 In the accountancy profession the joint monitoring unit verifies whether firms are complying with audit standards. Given Lord Penrose’s criticisms and the long-term nature of actuarial advice, is there a need to move away from reactive complaint-driven disciplinary procedures to a more proactive regime of monitoring of compliance with professional actuarial standards? If so, who should have responsibility for overseeing the monitoring and disciplinary proceedings and who should bear the associated costs?

As indicated above (see Q2.35 and 2.38) we accept the need to add to the compliance monitoring currently in place, in addition to disciplinary procedures, not as an alternative.

The accountancy profession’s Joint Monitoring Unit may not be a good comparator, however. Auditing is reserved to firms of accountants, as well as to individuals, and the JMU is able to enter into, and investigate, firms. This is rather different from our profession, where the regulators and the legislature have always reserved work to individual actuaries not their firms or their employers. This is entirely consistent with the fact that The Actuarial Profession has no general powers to regulate firms: no one currently does.

Although, in theory, it could be made a condition (for example, through the mechanism of practising certificates) that actuaries carrying out work under professional standards must obtain the co-operation of their employers in any monitoring arrangements, including a waiver of any confidentiality requirements that might otherwise restrict or obstruct a compliance monitoring visit, it may be rather more difficult to secure in practice. Whilst members could, in the event on their employers not co-operating, resign from their firms, we think it would be accepted that this is an unreasonable burden to put on individual actuaries. If an actuarial JMU is to be introduced, we think it should be coupled with a statutory change under which the relevant firms, rather than the actuaries they employ, are the subject of the monitoring review.

We would envisage that responsibility for oversight of a monitoring unit should follow either the model adopted for the Actuarial Standards Board or the Disciplinary Scheme (as described in the introductory remarks to Section P and in our answer to Q2.40).

On the question of cost, we repeat, in summary, our comments from the introductory remarks to Section P. We are a small profession: the costs of the professional body need to be contained within a level which members are willing to support, including those who do not need to continue as members in order to practise in their chosen area of work.

Q2.42 Should discipline be undertaken by the Profession or by regulators?

The Actuarial Profession’s Disciplinary Scheme has been drawn so that it addresses misconduct using a very wide definition of the term (see the introductory remarks to Section I

and the accompanying footnote). This is necessary, in order to ensure that, where called for, the profession has the power to suspend or expel those members who are not fit to practise.

This can lead to overlap with the financial regulators where they also have powers to take action against individuals operating within their area of regulation. It would be wrong, in our view, to eliminate those powers, leaving discipline to the Profession, because the financial regulators have powers which the Profession does not have, eg to compel evidence from non-actuaries.

It would, however, also be wrong in principle simply to remove the power of the Profession to discipline, where appropriate, those of its members who had been disciplined elsewhere. No one would doubt that a doctor who had been found guilty under the criminal law of, for example, harming a patient should also face the possibility of expulsion from the medical profession. So, too, an actuary who has been found, under the financial regime, to have harmed consumers should face the prospect of expulsion from the actuarial profession. (These are extreme examples to make a point; there are less serious forms of misconduct and lesser sanctions.)

Q2.43 Do regulators make appropriate use of actuarial expertise to supervise the work of actuaries?

The quantity and the quality of actuarial assistance within the FSA have been under scrutiny since the Penrose report was published (if not before). It was also a matter which was the subject of questioning of several witnesses appearing in front of the Treasury Select Committee.

We think it is fair to say that, as the Pensions Regulator (proposed under the Pensions Bill) and the FSA set more rules which incorporate actuarial matters, so the need to strengthen their actuarial resources will increase.

It is, however, difficult for a professional body to comment on the adequacy of existing actuarial resources within a regulator's multi-disciplinary team, without first-hand knowledge of the way in which duties are distributed between the different professionals and the management of the teams.

Actuaries working for regulators are, of course, subject to professional discipline just as any other actuaries are. We would expect the regulators to be open with the Profession about any failings amongst their own staff.

CHAPTER 3
The Government Actuary's Department

S ROLES AND RESPONSIBILITIES OF THE GOVERNMENT ACTUARY'S DEPARTMENT

Preface

Our responses to the questions in Chapters 1 and 2 of the Consultation Document have been made in our capacity as the professional body for actuaries and, accordingly, as one of the targets (so to speak) of the Review.

Chapter 3, however, relates to the Government Actuary's Department (GAD) for which we have no responsibility and with which we have no particular relationship (see Q3.1 below). All the functions carried out by GAD that were the subject of criticism by Lord Penrose are now part of the FSA – a consequence of the Financial Services and Markets Act 2000 (FSMA) and unrelated to matters at Equitable Life.

It is not clear to us that it is appropriate for us to respond to the questions in Chapter 3. If a review of GAD, as it is now, post-FSMA, were taking place independently of a review of the actuarial profession, we think the professional body would not normally be expected to submit any comments. We are mindful, however, that silence may be misconstrued, especially since the Penrose report was critical of the department (albeit in its former capacity).

In the light of these considerations, we have decided to submit answers to the Morris Review's questions, based on the professional body's knowledge of the department.

Q3.1 What is your relationship with the GAD? Have you used, or do you currently use the GAD's services? If you are a client of GAD, have you put the provision of actuarial services out to competitive tender? If not, what process do you use and why is it preferable?

The Actuarial Profession does not currently have a relationship with GAD beyond the fact that GAD is an employer of actuaries.

Previously, when GAD was actuarial adviser to the insurance regulators in the UK, there were two standing committees of the profession and GAD to liaise on matters relating to the regulation and supervision of insurance companies. The subject matter covered by those committees relates to matters that are now the responsibility of the FSA.

The current Government Actuary, Chris Daykin, is a former President of the Institute of Actuaries (1994-1996). In accordance with usual practice, he continued as a member of Council for a few years following his Presidency, until July 1999. Currently, he is a member of the profession's Education and CPD Board, its International Committee and Chairman of the Profession's Genetics Group. (Almost all of the profession's boards and committees include members who are not on Council.)

One GAD actuary, George Russell, has been a member of the Council of the Institute since July 2002. (Council members are elected by the membership of the profession.) Other current and former GAD actuaries have been members of the Council of either the Faculty or the Institute in the past and a number of others have served on boards, committees or working parties of the Profession.

Q3.2 If you are currently, or have been in the past, a client of GAD's are you satisfied with the quality of service that you receive(d) from the GAD? How could it be improved? If you also have experience of working with private sector providers, how does GAD's service compare to that of private sector providers? Do you have any comments on the basis on which GAD charges for its services?

The Actuarial Profession is not a client of GAD.

Q3.3 The Government Actuary plays a public interest role in reporting to Parliament on social security matters and preparing the national population projections. Are you satisfied with how this role is currently performed? Could the market or anyone else perform these functions?

It must be technically possible for an appointee outside government to carry out the role. It may, however, be neither efficient nor cost-effective for the appointee and the supporting team to be replaced in its entirety and even less so if the appointee and the entire team were replaced at whatever frequency the work was re-tendered.

Q3.4 Are there any other services which are better provided by the GAD and/or the Government Actuary than by other providers of actuarial services?

It would seem to be efficient for GAD to retain any of the services to which the previous answer also applies.

Q3.5 In your view, which of the 10 reasons in para 3.20 highlighting the rationale for a separate GAD remain valid? Are there any other reasons for maintaining the GAD as an independent entity?

On the face of it, all ten reasons are valid rationales for having a separate GAD. The fourth one (value for money) may or may not, however, be valid at any given time depending on the economics of the department as against a contracted-out service. We have no data from which to make such a comparison ourselves.

Q3.6 Overall, in your view is there a continuing need for a separate GAD? Are there alternative institutional structures for the provision of actuarial advice to government departments, Ministers and the wider public sector that the review should consider?

Our answers to the previous three questions all support the proposition that there is a continuing value in having a separate GAD. There may be alternative models, but we do not think it is an appropriate role for The Actuarial Profession to construct them.

Q3.7 If you think that GAD should not remain as a separate entity, do you think there would still be a continued need for the role of the Government Actuary?

As we have not expressed the view described in the first part of the question, the second part seems to fall away. We would comment, however, that a Government Actuary without a department would seem to undermine the rationale we described earlier for having a Government Actuary (see Q3.3).

Q3.8 How does the GAD compare with structures used in other countries for the effective provision of actuarial services to government?

Our understanding is that the Review team has asked several overseas bodies, with direct knowledge and experience of actuarial services to overseas governments, to answer this question, so we have not researched the point ourselves.

CONCLUDING COMMENTS

T DRAWING THE STRANDS TOGETHER

In this submission, we have answered the 88 questions posed in the Consultation Document. We have also included general comments at various places within the submission in order to put several of the issues into context as we see it. We now add some concluding remarks by way of drawing several of the strands together to form a view of the future of actuaries and the professional bodies.

A continuing theme of this submission has been that, in a world of opacity (an inescapable concomitant of the paternal ethos), actuaries were needed, because no one else knew how to manage the inter-generational transfers built into many savings products. It is probably true to say that even though some mathematicians, economists and perhaps MBAs would probably have been able to build the underlying models, no one outside the actuarial profession came close to offering to do so or offering to manage those transfers and quite probably did not know how to.

In the modern ethos of transparency of products, the traditional savings vehicles are a dying breed. In some cases, the transition has been rather subtle. For example, the original positioning of pension schemes as a stable contribution vehicle, with discretionary post-retirement benefit improvements absorbing the emergent surplus, was not an obvious one and would not have been created but for the earlier paternalistic culture.

We have said throughout this paper that, if others have (or can acquire) the appropriate skills and expertise to take on the work now required of actuaries, there is no reason, in principle, why actuaries should continue to have any statutory monopoly. As a professional body, we think our members should be able to compete with others and that they deserve to retain the work only if they are able to survive the competition.

As we have said earlier, however, competitive markets cannot be allowed to run unchecked if there is a potentially damaging imbalance of knowledge between providers and consumers. In the professional arena, regulators and the legislature want the security of knowing that someone suitable is carrying out certain types of work. Where that happens, there needs to be some recognised body which determines whether an individual has attained (and maintains) the relevant qualification and which lays down any standards for carrying out the work.

The Actuarial Profession believes that the new education syllabus now coming into effect modernises the training in keeping with the world in which actuarial services are demanded. The previous encouragement of lifelong learning will become compulsory (for all except actuaries who are no longer engaged in actuarial work).

In parallel with these changes, we are realigning the Associateship qualification, so that it is awarded on completion of the Core Technical and Core Application subjects, providing a very sound grounding in the basic skills of an actuary, but without the specialisation that is taught for the remaining subjects required for Fellowship. We envisage that, in future, some members may take the Associateship qualification and stop at that point.

We believe, however, that there is value in the training that leads to individuals acquiring the full qualification of Fellow. We expect those who go on to this level will find that the extra work involved in completing the higher qualification will be rewarded in the market place, regardless of whether work continues to be reserved to Fellows by regulation or legislation. Time, of course, will tell.

In this context, the professional body's role as an "actuarial university of life-long learning" would be a very important role. The professional body will also continue to carry out research; it will continue to provide community and companionship for its members; it will continue to collaborate and co-operate with business, government and other professions; it will continue to lead international developments within the European and global actuarial bodies; and it will continue to promote the skills and diversity of its "graduates" (both Associates and Fellows).

Appendix

SUPPLEMENT TO OUR ANSWER TO Q1.7

Introduction

Paragraphs 1.15-1.17 of the Consultation Document refer to a number of criticisms made about actuaries in the context of their duty to their employers or clients and their duty to act in the public interest. Specifically, the Consultation Document identified three issues where commentators have suggested that actuaries did not act as they should have done and asked why those issues were not brought to light by the profession earlier. The “issues” referred to were: pensions mis-selling, unit-linked policies and endowment mortgages.

In our answer to Q1.7, we addressed the issue in broad terms, with the details left to this Appendix.

Pensions mis-selling

Whilst nothing in the paragraphs that follow is intended to exonerate the actuarial profession from all blame so far as pensions mis-selling is concerned, we think it is important to understand the environment in which actuaries were operating.

The 1980s was a time when several of the professions were going through quite dramatic change. The Office of Fair Trading was (quite rightly by any sensible modern standards) putting professional bodies under pressure, with the threat of legal action if they didn't comply, to eliminate many of the old-style attitudes towards “professionalism” which were, belatedly, being seen as anti-competitive. The professions' ban on advertising, for example, which was common to accountants, lawyers, doctors, actuaries and many others, and which had once been seen as a *sine qua non* of “professional” behaviour, was one of several practices being swept aside.

In this environment, the professions were simply not perceived as having the public's best interests at heart. Those professions which challenged government thinking at that time were utterly unsuccessful. In another part of Walter Merricks' speech, not quoted in the Consultation Document, he referred to the misguided and wasteful (in his view) attempt by the Law Society to advertise its way out of difficulty, by promoting the “virtues” of solicitors. The medical profession challenged the Secretary of State for Health head-on over proposals that the profession objected to. Billboard adverts were erected with the words “What do you call a person who won't take medical advice? Kenneth Clarke.” It had no effect.

The event which gave rise to pensions mis-selling was a change in legislation. Previously, employers had often compelled employees to join the company pension scheme and (as noted in Section A) thereby prevented the employees from having any other tax-approved pension arrangements. The mood of the mid- to late-1980s was that compelling employees to be in the company scheme was in conflict with individual choice and no longer acceptable.

Walter Merricks asked (see paragraph 1.16 of the Consultation Document): were actuaries for schemes out of which people were transferring unable to see that many customers were being mis-sold? The answer is that the employers, scheme trustees, their actuaries and the National Association of Pension Funds could *all* see it quite clearly. There was, however, no willingness on the part of the government of the day to hear that their ground-breaking legislation was having this effect and certainly little acceptance by employees of any advice that they were giving up something valuable for something less valuable. Government advertising at the time reinforced the employees' attitude.

If the professions had, collectively, entered the 1980s with an attitude befitting the times, as described above, they (and we) would not have found themselves (and ourselves) so out of touch and so lacking in influence. Our point here is simply that to conduct *this* review on the basis of a misinterpretation of the history of 15 years ago would lead to a misdiagnosis of the problem and, almost inevitably, a prescription for the wrong cure.

Actuaries do, now, need to have the confidence to speak out. That confidence will increase if they are listened to more. The same applies at the level of the professional body.

Unit-linked policies

The Consultation Document suggests that unit-linked policies were designed to “maximise sales for [life offices] rather than ... to meet policyholders expectations” (paragraph 1.17).

This is an odd criticism. Unit-linked policies are directly linked to the underlying value of the policyholders’ investments (in the same way as unit trusts). They are very different from with-profit policies, where the ultimate benefit depends heavily on the exercise of discretion by the office’s directors. Unit-linked policies were created as an alternative to with-profit policies for those who preferred to benefit from market movements directly and not to entrust themselves to the office’s discretion.

There has been a criticism that the charging structures used in association with unit-linked business were obscure, but as we explain below, we doubt that the reality can sustain that criticism – and certainly not a criticism that offices were “maximising their sales ... rather than delivering policies that are likely to meet policyholders’ expectations”.

The charging issue arises because life offices incur heavily front-end loaded costs when setting up a new life insurance policy, typically somewhere in the range 50%-200% of the first year’s premium. This is true, equally, of unit-linked and with-profit policies.

Rather than provide policyholders with very few units, or even *no* units, after incurring expenses and receiving the first year’s (or two years’) premium, offices topped up the units to 100% (or thereabouts) of the premium in the first year (or two), with the top-up recouped over succeeding years by way of a charge from the policyholders’ units. That charge was around 3% of the fund each year.

Units purchased in later years were subject to an annual management charge of some ½% or ¾% and were typically described as “accumulation” units. The first year’s (or two years’) units, which were subject to the extra 3% pa charge (ie 3½% or 3¾% pa in total) were typically described as “capital units”. In all respects, apart from the annual management charge, the units were identical. [Note: The nomenclature, “capital units” was almost certainly selected by marketers to be an attractive sounding name, but it is also the case that these were the units by which offices recovered their initial capital investment of 50%-200% of the premium.]

- Policyholders who died received the full amount of the units (both “capital” and “accumulation”), even though the life office had incurred initial expenses and, in the early years of the policy, was paying out more than it had received in premiums from the individual policyholder. This meant that the office had to put up additional amounts of capital in the early years (“additional” in the sense that, if the office had granted only the units that could be afforded after expenses were paid out, the policyholder would have received fewer units on death).
- For policyholders who surrendered their policy in the early years, the office made an explicit charge to recover costs. This meant that perhaps only 40% of the initial premium (or two) was repaid on surrender. This was entirely consistent with the practice on with profit policies.
- For policyholders who survived to maturity of their policy, the full amount of the units (both “capital” and “accumulation”) was paid out, the 3% pa extra charge having repaid the office’s initial expenses (and any un-recouped expenses in respect of policyholders who died early).

Plainly, the capital unit arrangement was designed to make policies appear more attractive to potential buyers, by offering more units up front and recouping the costs over a period of time. It is difficult to see, however, how this arrangement can justifiably be criticised for failing to deliver policyholders’ expectations. If life offices expected that policyholders would find it more attractive to be charged on the basis of 3% pa rather than 50%-plus of the first year’s premium,

it is hardly surprising that life offices topped up the initial units and applied such a charging structure.

The expectation that policyholders would be charged the extra 3% pa was precisely fulfilled. More importantly, the market was open to competitive pressure from any offices which thought they could recoup their costs with a lower charge or which thought that customers might prefer an upfront charge.

What seems to have happened in practice to bring unit-linked policies into disrepute is that some salesmen (allegedly) told customers that capital units were superior to accumulation units, when the truth was that capital units attracted a higher charge. That was indefensible.

Endowment mortgages

Appointed Actuaries have been blamed for not warning insurers that investment returns would fall. There were, however, other players in the market too.

Where were the banks and building societies?

It is widely recognised today that repayment mortgages are safer for borrowers than endowment mortgages. It is assumed that it was the insurers who encouraged borrowers to take out the (more risky) endowment policy. The situation is not, however, that simple. The lenders had (and still have) a major incentive to encourage customers towards endowment policies. The endowment route allows the banks to earn interest on the full amount of the loan over the entire loan period.¹²

When the shortfalls first started to appear, it was the assurers whom the FSA told to write to policyholders, but with interest rates coming down, banks should have advised policyholders to use the saving from lower interest payments to pay down some of the loan. They didn't. The banks may not have been worried, however, because their loans were secured against the value of the mortgaged properties.

... and the regulator?

In 1988, the FSA's predecessor imposed a rule requiring insurers to use the same industry-wide projection rates for illustrating outcomes under with-profit (and unit-linked) policies. Initially, life offices were required to project investment returns at 7% pa and 10½% pa (to show alternative outturns at low and high rates).

The popular perception that it was company actuaries who determined the projected growth rates is simply not correct. The endowment premium was calculated by the company, but then had to be translated into outturns for the policyholder based on the standard (regulator-driven) projection rates. The over- or under-shoot was plain for the policyholder to see, at the rates chosen by the regulator.¹³

... and the tax man?

A crucial factor in the endowment mortgage story is the removal of tax relief on mortgage interest (progressively through to April 2000). With tax relief in place, the endowment route offered borrowers a tax saving on the full amount of the interest throughout the loan, compared with the reducing relief (in monetary terms) under the repayment route.

Of course borrowers had to pay more interest in order to attract the higher tax relief, but with tax relief in place, the net annual payments under the endowment route fell, over time, below the

¹²For a £10,000 loan over 25 years, at an interest rate of 8% pa, the bank would receive total interest payments of £20,000 under the endowment route, compared with £13,420 under the repayment route – an increase of almost exactly 50%.

¹³For an average loan taken out in 1989 (£30,000), and an average endowment premium (£500 pa), the projections would have shown an expected pay-out at maturity of £23,200 at the lower projection rate (7% pa) and £38,500 at the higher rate (10½% pa).

net cost of the repayment mortgage. The relative cheapness of the endowment payments provided an ideal opportunity to top up the loan repayments to mitigate the effect of falling investment returns. With the withdrawal of tax relief, however, the relative cheapness manifested itself only briefly for many policyholders.

Consider the position of a borrower of £30,000 in 1989. As matters stand today, the borrower with an endowment policy is expected to have a shortfall of £5,600. If, however, tax relief had remained in place, the shortfall would be just £100. Even allowing for the reduction in the basic rate of tax, which could not have been known at the time the loan was taken out, the shortfall would be only £680. If the withdrawal of tax relief had been limited to new loans and not imposed on those who had already bought an endowment policy, the endowment mortgage story would have had a very different ending.