

# Actuarial Governance A Discussion Paper

February 2002

This discussion paper has been prepared by the Actuarial Governance Working Party of the Life Board, and is being issued by that Board to promote debate.

Anyone wishing to offer written comments on this paper should send them by the end of March 2002 to:

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## 1. INTRODUCTION

### 1.1 Background

At the current time, the whole basis of regulation of the financial services industry is undergoing considerable change and the regulation of the insurance industry, in particular, is under intense scrutiny as a result of recent high profile cases such as the Equitable and Independent Insurance.

As well as a number of investigations relating to the specific circumstances and events surrounding the closure of the Equitable to new business, the FSA are currently undertaking a review of various aspects of the operation and regulation of with-profits business, including the issue of Governance and Discretion.

Although the Appointed Actuary system is perceived to have worked well in the past, the perception is also that the influence of Appointed Actuaries has been gradually reduced over the last few years with the role narrowing towards an increasingly detailed set of formal requirements. This has led to some concern that changes may be required if Appointed Actuaries are to carry out their responsibilities effectively.

Post N2, the framework within which the Appointed Actuary operates has been strengthened with the introduction of the FSA Supervision Manual which formalises the existing obligations in professional guidance and places corresponding obligations on the company and its directors. The current FSA review of with-profit business may lead to changes in the governance framework for this business. Further, more significant changes are expected to be introduced in January 2004, as proposed in the draft Integrated Prudential Sourcebook (FSA CP97), leading towards a risk-based capital approach to supervision.

### 1.2 Terms of Reference

The terms of reference of the Actuarial Governance Working Party ("AGWP") are as follows:

Taking account of other relevant policy developments and, in particular, proposals being formulated by the Life Board for compliance review of Appointed Actuaries, the group's remit is

- To consider governance issues relating to the role of the Appointed Actuary in life assurance in the UK and
- To make recommendations to the Life Board on changes that may be needed to such governance.

Following the Life Board's consideration of its recommendations, the group's remit is also:

- To reflect the outcome of the Board's consideration in a discussion paper to be exposed to the membership during the 2001/02 Session and
- To support the Life Board in considering feedback to the discussion paper and in deciding whether to promote changes to actuarial governance in the light of such feedback.

### **1.3 Composition of Working Party**

The working party is made up as follows:

- P. Needleman - (consultant) Chairman
- A. Chamberlain - (consultant)
- A. Eastwood - (employed Appointed Actuary)
- W. Hewitson - (FSA)
- A. Saunders - (employed Appointed Actuary)
- M. Shelley - (consultant) Chairman, Life Compliance Review Working Party

### **1.4 Scope of Work**

The working party has undertaken the following work programme in compiling the discussion paper:

- Review of current investigations and reports (report by the Corley Committee of Inquiry; FSA report on review of ELAS regulation 1999/2000 – the 'Baird Report'; HM Treasury consultation on draft whistle-blowing regulations)
- Interviews and responses from a range of interested parties including

- Board members
  - Current and future Presidents of the Institute/Faculty
  - FSA
  - A limited sample of directors, management, and Appointed Actuaries of life offices
  - Consumers associations
  - Other Appointed Actuaries
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- Review of Turnbull recommendations on Corporate governance
  - Discussion with major audit consultancy re auditor independence
  - Review of current recommendations for Compliance Review
  - Review of governance aspects of Schedule 2C Schemes of Transfers
  - Review of current roles and functions of Appointed Actuary (GN1/GN8 and FSA Supervision manual)

It is recognised that the overall framework for governance of life companies will have a significant impact on the ability of Appointed Actuaries to fulfil their responsibilities, and may influence the appropriate model for actuarial governance. The AGWP have not taken into account any changes which may arise as a result of the FSA's review of governance of With-Profits funds in framing this discussion paper.

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## 2. ACTUARIAL WORK IN LIFE OFFICES

Before considering the specific scope of the responsibilities of the Appointed Actuary it is helpful to review the full range of actuarial work required within a life office.

Many of these areas will not be the direct responsibility of the Appointed Actuary, but aspects of the work may directly or indirectly overlap with the work of the Appointed Actuary. Later sections of this paper will discuss the extent to which this work is currently required by statute or professional guidance.

### 2.1 Solvency and Capital Management

#### 2.1.1 *Statutory Valuations*

Carry out statutory valuations and prepare reports to the relevant regulatory authority. In particular:

- Ensure data is complete and accurate
- Determine appropriate valuation methods and procedures
- Maintain appropriate valuation calculation models
- Analyse historic experience
- Determine valuation basis, including appropriate margins making due allowance for risk
- Include appropriate provision for all options and guarantees
- Report in writing to the directors and to the regulatory authority
- Take steps to ensure that the company can meet its liabilities at all times between successive annual investigations.

#### 2.1.2 *Solvency Projections and Solvency Management*

Carry out projections of the future progress of statutory solvency, including:

- Expected new business plans

- A number of scenarios chosen to illustrate the range of potential outcomes or to highlight a particular risk exposure of the company
- Stochastic modelling taking account of expectations of how management might react to each simulation (e.g. in respect of bonus or investment policy).
- Monitor the company's ability to meet liabilities to policyholders both now and in reasonably foreseeable future circumstances

Advise the company on potential sources of capital and ways to use existing resources most efficiently.

### **2.1.3 Reassurance management**

- Consider whether reinsurance arrangements are adequate and appropriate
- Monitor arrangements having regard to situations where contracts may be unenforceable

## **2.2 Profit Reporting & Shareholder Issues**

Enhance shareholder value through:

- Business portfolio management

Involvement in business planning

Calculate reported profits, potentially including:

- Modified Statutory
- Achieved Profits
- Embedded Value
- US GAAP

## **2.3 Terms of Business**

Advise on all aspects of the terms on which new business is sold by the company, including:



### **2.3.1 Premium Rates**

- Prepare a realistic profit assessment in order to demonstrate that the proposed product can meet the required return targets.
- Ensure that premium rates are adequate taking into account the resources of the company.

### **2.3.2 Manage Insurance Risk**

- Advise company on appropriate underwriting standards and ensure that premium rates, valuation assumptions and underwriting standards are aligned.
- Advise company on appropriate risk reinsurance arrangements

### **2.3.3 Encashment terms**

- Maintain calculation bases for policy surrenders that are fair, both relative to underlying asset values and to other policy classes
- Manage the application of MVAs on unitised with-profits policies similarly

### **2.3.4 Disclosure**

Ensure that incoming policyholders are not misled:

- Prepare appropriate analyses of expenses for use in point of sale and post sale disclosure of commission equivalent rates and the effect of charges
- Prepare RIY, surrender and investment return disclosures for With-Profits Guide
- Prepare statements of bonus policy and MVA policy for use in With-Profits Guides and elsewhere
- Review all policyholder literature to ensure misleading claims are not made
- Increasingly, prepare disclosure for inclusion in annual mailings to (in particular) with-profits policyholders

## **2.4 PRE/Customers Interests**

### **2.4.1 Advise on PRE**

- Monitor literature to ensure that nothing is being said that may cause unreasonable expectations to become established.
- Advise the Board on PRE and any action that should be taken to manage PRE, including any examples where PRE may have become established to the extent that additional reserves are required.

### **2.4.2 Determine discretionary charges on policies**

- Where required by policy conditions, determine appropriate charge deductions in respect of mortality, morbidity or expenses, having regard to PRE and the experience of the company

## **2.5 Investment policy/ALM**

- Advise the board on appropriate investment policy taking account of the liability mix and PRE (e.g. bonus policy, statements made about asset mix)
- Advise on investment constraints that may be necessary to protect policyholders
- Advise on the use of derivatives
- Carry out regular asset – liability modelling to ensure that asset portfolios remain adequately matched to liabilities

## **2.6 Bonus Policy for With-Profits Business**

- Advise on the extent to which surplus may be distributed to with-profits policyholders and shareholders
- Make recommendations on the allocation of profits, having regard to equity between different classes of policy and between reversionary and terminal bonuses
- Maintain appropriate models of policy asset shares to support the above

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- Analyse achieved investment returns (allowing for tax effects) and allocate to appropriate policy classes

## **2.7 Unit Pricing**

### ***2.7.1 Monitor Equity in Unit Pricing***

- Ensure that all aspects of unit pricing are carried out with regard to PRE and Unfair Contract Terms legislation

### ***2.7.2 Box Management***

- Manage the unit “box” maintained by the company to ensure adequate matching of unit sales and purchases.

## **2.8 (Long Term) Risk Management**

Actuaries will often be involved in risk analysis to support the company’s risk management processes.

## **2.9 “One Off” Transactions**

### ***2.9.1 Advise Company on Restructuring, capital raising and M&A Transactions***

- Provide advice on valuations of life portfolios for purchase, sale or corporate restructuring
- Advise on possible structures
- Evaluate alternative options
- Advise on alternative forms of capital raising

### ***2.9.2 Responsibilities Arising from Corporate restructuring***

It is common for the Appointed Actuary to be given specific additional responsibilities under Section 2C Schemes of Arrangement such as those arising from demutualisations. Often these will relate to protections for groups of transferring policyholders and may cast the Appointed Actuary in the position of being the sole protector of these policies interests. Such requirements can sit uneasily alongside

the Appointed Actuary's need to operate as an impartial adviser in the ongoing running of the business.

### **2.10 Services to Other Customers**

There may be some actuarial services provided to clients other than the life office, for example carrying out periodic scheme valuations for final salary pension schemes insured or managed by the company, or providing services of a Pension Scheme Actuary to the trustees of such schemes.

### **2.11 Duties to Regulator - "Whistle-blowing" responsibilities**

The Appointed Actuary has always had a statutory obligation to inform the regulator if he or she believes that the company may be acting in an inappropriate way.

Historically, the Appointed Actuary was required to inform the board first and make efforts to persuade the company to change its ways. Under proposed new regulations, it will no longer be necessary (or in some cases appropriate) for the Appointed Actuary to discuss with the board before approaching the FSA, although we would expect that in most circumstances the issues would be raised firstly with senior management and/or the Board before approaching the FSA. The intention is to speed up the process and to keep the regulator more informed, creating a more open dialogue.

### **2.12 Exercise of Discretion**

In order to carry out many of the above activities, a degree of discretion is often required. Advising on the application of discretion in a manner that maintains fairness is an integral part of the actuary's work.

An actuary has an obligation to influence the manner in which discretion is exercised by advising the Board of his or her interpretation of fair treatment, both for particular classes of policyholder, between different classes and potentially between policyholders and shareholders (for example in respect of the management of the free estate). The application of discretion by the Board also needs to be monitored.

Historically, some actuaries may have tended to recommend that the Board approve the results of their judgement without a detailed explanation of possible alternative

views on the factors taken into account. In the future it may be necessary for actuaries to bring out the different interests of groups of policyholders (and the shareholder) to enable an open debate at the board so that the balancing of interests is better understood by the board and discretion is more clearly exercised by the directors.

The recent Equitable Life judgements have resulted in the need for companies to consider the legal dimension, where the legal interpretation of fairness may not be in line with a normal actuarial approach.

### **2.13 Formal Requirements of Actuaries**

Broadly, the work required of the Appointed Actuary under statute is covered by sections 2.1 (Solvency and Capital Management), 2.6 (Bonus Policy) and 2.11 (Duties to regulator). FSA rules also impose some duties under 2.3.

Professional Guidance in GN1 and GN8 extends this to include 2.3 (Terms of Business), 2.4 (PRE), 2.5 (Investment Policy) and 2.7 (Unit Pricing). GN22 covers commission equivalent and charge disclosure.

The next section gives more detail on the current regulatory framework for the role of the Appointed Actuary.

### 3. REGULATORY FRAMEWORK

#### 3.1 Pre-N2 Role of Actuary

The statutory role of an 'Appointed Actuary' was first recognised in the legislation introduced in 1973 and continued in the Insurance Companies Act 1982 and associated regulations. These required the appointment of an actuary to all life insurance companies, who had to be a Fellow of the Faculty or the Institute and at least 30 years old. The statutory duty of the actuary was to carry out the annual valuation of the long-term liabilities in accordance with the liability regulations (which would also establish whether there was any available surplus that could be distributed from the long-term fund) and to provide an appropriate certificate in the returns each year.

There were a number of gradual developments in both the regulations and the associated professional guidance over that period. For example, the Appointed Actuary was required from around 1983 to disclose in the annual returns all relevant financial interests in the insurer, including both share options and with-profit policies.

In addition, the Appointed Actuary has been required since 1992 to obtain a practising certificate from the profession before appointment and this has to be renewed each year. The criteria for obtaining such a certificate are that the actuary has the relevant skills and knowledge, has not been the subject of professional disciplinary action or been convicted of criminal offences involving dishonesty, and has maintained appropriate CPD over the year.

The annual actuary's certificate in the FSA returns, in the form that applied from around 1996, confirmed that a proper provision had been established for the long-term liabilities, that adequate records had been maintained for that purpose, that appropriate premiums had been charged for new business, and that professional guidance notes GN1 and GN8 had been complied with.

While GN8 was concerned primarily with professional guidance to supplement the regulations on the valuation of the liabilities, GN1 established a number of additional professional responsibilities for the actuary. These included the continuous monitoring of the financial condition of the insurer and production of a report to the

directors prior to the transfer of any surplus to shareholders or any declaration of bonus to policyholders by the insurer. For with-profit companies this report also involves advising on the appropriateness of that bonus declaration after taking account of the need to balance the ongoing financial soundness of the insurer with the need to take account of the reasonable expectations of policyholders.

In addition, GN1 required the actuary to advise the company more generally about his or her interpretation of the reasonable expectations of policyholders. This included advice on areas where the company had discretion to vary charges under the terms of its contracts with policyholders. The phrase 'reasonable expectations' was not defined in the legislation, but the inability to meet these expectations was a ground on which the regulator could intervene in the affairs of the company.

The actuary was required to inform the company whenever a material risk had been identified that the company might not be able to meet its obligations. If the company did not take appropriate remedial measures, then the actuary was required by professional guidance to inform the regulator.

In addition, GN1 required appointed actuaries to undertake the range of specific responsibilities described in Section 2.13 above.

A separate best practice guidance note GN2 recommended that the actuary should produce a financial condition report each year for the board of directors which would include some analysis of the effect on statutory solvency of different possible future scenarios in relation to both economic and business risks. This was expected to include dynamic solvency testing which looked at the sensitivity of the financial projections to different assumptions. The report was also expected to explain how the insurer could deal with adverse developments and thereby mitigate the potential risks to the insurer, where possible.

In addition, each life insurer was expected to consult its Appointed Actuary over the determination of the amount of remuneration to agents that was required to be disclosed to policyholders. GN22 provided guidance to actuaries on giving this advice about remuneration, along with guidance to actuaries giving advice to insurers on disclosure of the amount of appropriate charges under with-profit products, and also on disclosure of the cost of risk benefits to policyholders under these products.

Therefore, while the formal responsibility for the sound and prudent management of the company in accordance with all the relevant statutory criteria, including the need to have due regard to the interests of policyholders, rested with the directors, the actuary was expected to provide appropriate advice to the directors about how these criteria should be met. This broad responsibility of the directors, as advised by the Appointed Actuary, has now been carried forward in similar form into the post-N2 regime, although with greater emphasis on the responsibilities of Directors to look after the interests of policyholders, as well as shareholders.

### **3.2 Post-N2 Role of Actuary**

Under Section 340 of the Financial Services & Markets Act 2000 (“FSMA”), the FSA is able to make rules requiring the appointment of an actuary to all firms carrying on life insurance business. Rules may also then be made requiring these firms to have a periodic financial report that is reported on by an actuary (or an auditor), and imposing other duties on actuaries as may be specified. At the same time, rules may also be made giving the actuary appropriate powers in order to carry out his responsibilities.

An offence is committed if a firm knowingly or recklessly provides information to an Appointed Actuary that is false or misleading in a material particular. Similarly, an individual director or manager who deliberately attempted to mislead an Appointed Actuary, whether by act or omission, would not be complying with the FSA statement of principles for approved persons, and could therefore be subject to the relevant FSA disciplinary sanctions.

The Act also enables HMT to make ‘whistle-blowing’ regulations that would require appointed actuaries to communicate certain matters direct to FSA. A consultation paper has been issued in October 2001 concerning these regulations, and these are expected to be introduced early in 2002.

Under the FSA rules, the insurer must take reasonable steps to ensure that the actuary has the required skills and experience to fulfil the regulatory role at the insurer, and is a Fellow of the Faculty or the Institute. The profession has continued its practising certificate requirement for the Appointed Actuary, and the insurer is expected to verify that this certificate is indeed held.



The role of the Appointed Actuary is then defined more closely in the FSA rules contained in the Supervision Manual. These set out a prime responsibility that the actuary should identify and monitor the risks that may have a material impact on the firm's ability to meet its liabilities to policyholders as they fall due. These liabilities would of course include any constructive obligations in respect of future annual or final bonuses to with-profit policyholders.

Secondly, the actuary is expected to inform the management (and directors) of any material concerns about the current and ongoing ability of the firm to meet these liabilities, in both the present and reasonably foreseeable future circumstances, including the adequacy of the financial resources available for this purpose, and taking account also of the adequacy of the premium rates for new business.

Thirdly, the actuary is expected to carry out the actuarial investigation of the firm each year and produce the appropriate abstract to be included in the FSA returns. This investigation has to value the long-term liabilities in accordance with detailed FSA rules which include an overall requirement that the valuation should be made on actuarial principles that make proper provision for all liabilities.

Accordingly, the present requirement is for the Appointed Actuary to provide this report directly, rather than to report on a financial return produced by another individual, as might be construed from the wording of Section 340 of FSMA (see above).

For the purpose of carrying out all these responsibilities, the actuary may request from the firm such information and explanations as may be considered reasonably necessary, and is expected to advise the firm of data and systems that are reasonably needed for this purpose. The firm must then establish those systems and provide the necessary resources for the actuary.

In addition, the firm must keep the actuary informed about its business plans and request advice from the actuary about the effect of material changes to those plans or other circumstances that may affect the rights or the reasonable expectations of policyholders. The firm must then pay due regard to this advice, and indeed all other advice from the Appointed Actuary, and allow him or her direct access to the board of directors.

The actuary is also required to take reasonable steps to maintain freedom from any perceived conflict of interest, and to be objective in the performance of all duties. This should also follow from application of the profession's Professional Conduct Standards.

The substance of professional guidance notes GN1, GN2, GN8 and GN 22 have been largely maintained, but GN1 does now reflect the greater statutory role that has been given to the Appointed Actuary.

### **3.3 Current Regulatory Reviews**

Following the various reports that have been produced concerning the recent problems at Equitable Life, the FSA has initiated a broad review of the Future of Insurance Regulation. This will include a review of the role of the Appointed Actuary.

This review may include issues such as the allocation of actuarial responsibilities within the firm, the production of annual financial condition reports (including a risk analysis and stress and scenario testing), the separation of the role of the actuary from other executive responsibilities and the extent to which some of these actuarial responsibilities should either be carried out or reviewed by an external actuary. There is also a review taking place of the contents of the FSA returns, and the extent to which this information should be reviewed and published.

Separately, the FSA is undertaking a review of with-profits business, and this will include corporate governance issues. This is likely to centre around each firm having a clear set of principles for financial management which include an interpretation of the reasonable expectations of policyholders such as the need to treat customers fairly and regular monitoring within the firm of adherence to these principles. This could involve the setting up of a regulatory committee for this purpose, of which the Appointed Actuary would be one member. A regular report could then be produced by this committee setting out these principles, how the firm has attempted to meet them and some measure of its success in this respect.

## 4. COMPLIANCE REVIEW

The terms of reference of the AGWP included the assumption that there would be external compliance review of internal Appointed Actuaries, as part of the governance framework applying to Appointed Actuaries.

In March 2001 FIMC accepted the recommendations of the Professional Affairs Board that Compliance Review would be introduced for all areas of actuarial work covered by mandatory Professional Guidance. The Life Board was asked to prepare recommendations in respect of Appointed Actuaries and a working party was set up chaired by Mike Shelley. Following the initial report of the working party the Life Board agreed seven principles for Compliance Review. The Compliance Review working party has now been asked to suggest options for the scope (and associated cost) of compliance review.

The Compliance Review working party have kept in close touch with FSA and are aware that FSA intend to require:

- certification of the actuarial sections of FSA returns to an audit standard
- a more detailed compliance review of aspects of the Appointed Actuary role. Whilst these aspects are as yet not determined, their thinking is understood to be similar to that of the Life Board; i.e. that compliance review would provide appropriate professional challenge which would cover the following areas:
  - Solvency
  - Financial condition reports
  - Bonus declaration and financial management of with-profit funds, and other areas of PRE
  - Disclosure requirements covered by GN22

FSA rules in this area would be supported by actuarial guidance so that between them they defined who might act as a reviewer and the nature of the review.

The requirement for compliance review arises in part from the concern that, without independent review, the work of the Appointed Actuary does not benefit from

professional challenge or from the experience of another professional coming from a different background. In particular, independent review of actuarial advice should ensure that alternative views are not dismissed without professional challenge.

Thus the primary objectives of Compliance Review are:

- the peer review of the work of the Appointed Actuary by another senior and appropriately qualified actuary to ensure it complies with professional standards,
- the sharing of best practice and experience from a wider range of sources than might otherwise be available to an employed Appointed Actuary,
- to provide an external and independent review, which should give comfort that the internal actuary has given appropriate weight to his or her responsibilities to regulators and in relation to policyholder interests, and has not been overly influenced by the inevitable pressures which are faced in balancing these interests with those of his or her employer and its owners.

The final point should ensure that the use of internal Appointed Actuaries can continue, combined with the further benefits of external review.

The AGWP believe that it is important to consider the form and depth of review, which would achieve the objectives, at a minimum of additional cost. This will depend on the governance structure ultimately agreed for the Appointed Actuary and the extent of conflicts that remain in the role. The more conflicts remain in the Appointed Actuary role, the wider the role of the reviewer will need to be to maintain public confidence in the system of governance.

We have some concerns that if the level of review and form of “sign-off” is not suitably limited, then the costs of the review will escalate. Also, with a heavier level of review, it is likely that the reviewer will become more involved in some of the decisions and recommendations. There is then a risk that the effective responsibility shifts to the reviewer and away from the Appointed Actuary.

In Section 6 we have considered a number of alternative models for actuarial governance, which may require either a ‘lighter’ level of review, or a ‘heavier’ and

more intrusive level of review. We refer to the reviewer as the “Independent Review Actuary”.

## 5. KEY ISSUES

### 5.1 Context of Actuarial Governance

The AGWP's terms of reference are set out in section 1.2. The AGWP have taken "issues relating to the role of the Appointed Actuary" to include all issues relating to activities in a life assurance business that may frequently involve the Appointed Actuary – including those which are not necessarily the formal responsibilities of the Appointed Actuary. "Governance" has been interpreted as the process of ensuring and proving that these activities are appropriately governed.

The introduction of external compliance review of the discharge of the formal responsibilities of appointed actuaries is seen as a key element of strengthening actuarial governance. The AGWP believe that actuarial governance might be further strengthened by providing further detail on the duties of directors in safeguarding policyholder interests, as well as those of shareholders.

Potential conflicts of interest arise primarily where the company has discretion over certain policy terms that can influence the benefits paid to policyholders, and for the Appointed Actuary, when he is advising the company how such discretion might be exercised. Such conflicts can potentially arise both between the interests of policyholders and shareholders, and amongst the interests of different groups of policyholders. There is scope for such conflicts to be exacerbated where key individuals in an organisation have specific objectives and/or a remuneration package that could encourage actions in conflict with their responsibilities either

- (a) to have due regard to policyholder interests in exercising or advising on exercising discretion or
- (b) to manage the business in a sound and prudent manner.

The degree of external compliance review required should depend on the extent to which the scope for these conflicts has been eliminated. We discuss this further in section 6.

## 5.2 The Role of Directors

The first legal duty of the directors is to the company concerned. Ultimately directors are accountable to the shareholders of a proprietary company or the current members of a mutual company, and the shareholders or members may dismiss the directors for poor performance. However, the directors of a life insurance company must operate in accordance with the demands of the regulatory framework. If the regulatory framework imposes formal responsibilities on the directors, they should be able to justify their actions to shareholders or members accordingly. Nevertheless one of the actuaries providing input believes that it is unrealistic to expect the directors of a proprietary company to have to balance the interests of shareholders and policyholders.

At the time of writing, the FSA is still to publish its issues paper on governance of with-profits business. The AGWP would wish to study and discuss this document before drawing definitive conclusions. However, in common with most interviewees, the AGWP believe it is appropriate that all directors should have formal responsibilities to have due regard for policyholders' interests and reasonable expectations. There is a risk that the Appointed Actuary is seen by the board of directors as the one who has to consider policyholder interests, and that the board can regard themselves as having adequately fulfilled their responsibilities in this regard if the Appointed Actuary signs the relevant certificate.

Whilst it is the Appointed Actuary's duty to advise (and whistle-blow if inappropriate actions are taken), it is the directors' responsibility to have due regard for policyholder interests, and we believe this should continue. It would be inappropriate to place the burden of ensuring that policyholder interests are adequately considered on any single individual.

If the board of directors has insufficient time to consider some of the issues in adequate depth, a committee of the board of directors could be formed to consider issues in greater depth. The AGWP believe it would be preferable for such a committee to have a majority of non-executive members. One contributor argued strongly that independence is necessary. An independent committee may be appropriate for certain companies – particularly under certain Schedule 2C schemes. However, the AGWP believe that the primary responsibility for safeguarding

policyholder interests should lie with the ultimate decision-maker in an organisation – i.e. the board of directors. The board would therefore remain responsible for the Committee’s recommendations, just as it remains responsible for matters typically considered in more depth by the Audit Committee.

### **5.3 Exercise of discretion disclosure**

None of the above eliminates the potential conflicts of interest – although we believe that greater clarity of the priority of policyholders’ reasonable expectations over shareholder or member interests would help. Thus it is essential that there is adequate disclosure of how discretion has been exercised. Elements of such disclosure are currently made through the abstract of the Appointed Actuary’s valuation report included in the FSA Returns. Enhancements to disclosure are suggested in the Issues Paper on Regulatory Reporting prepared by the FSA under its With-Profits Review. Further disclosure might typically be made directly to policyholders in annual statements for with-profits policies or in other statements when charges under other policy types are reviewed. More detailed disclosure may be necessary from time to time.

We believe that disclosure should wherever practicable be made in public documents. However, we recognise that, particularly in the case of with-profits business, detailed and timely disclosure of certain information would create problems of anti-selection that could ultimately destroy the proposition for all policyholders. In such circumstances, disclosures might reasonably be made to the reviewer or the regulator on a confidential basis.

### **5.4 Key Questions relating to the Role of the Appointed Actuary**

The AGWP identified a range of inter-related key governance issues relating to the role of the Appointed Actuary in life assurance in the UK.



#### **5.4.1 *Should the Appointed Actuary be an employee of the company (or an external consultant)?***

Whilst many smaller companies employ external appointed actuaries, this is quite unusual for larger companies.

Some of those interviewed suggested that the Appointed Actuary would be in a better position to resist pressure if part of an organisation external to the life company itself. Such an arrangement should ensure that the Appointed Actuary has access to others who have faced similar issues. It would also help to avoid the unintentional acceptance of certain risks 'by tradition'.

On the other hand, the advantages to the Appointed Actuary of being 'naturally' involved in management decisions on a day-to-day basis are clear and are far more likely to be achieved through being an on-site member of the management team.

In practice, 'softer' factors will be critical to the successful execution of the Appointed Actuary's role, whether internal or external. The actuarial function in a life office, and ideally the Appointed Actuary, need to be perceived as business-enabling rather than solely acting as a constraint on the business. The ideal arrangement will also depend on the level of business and actuarial understanding amongst management making day-to-day decisions. The adequacy of the Appointed Actuary's day-to-day involvement will be heavily influenced by the personalities involved and the backgrounds of the executive directors. Some appointed actuaries may be happy to rely on others to ensure that actuarial perspectives are adequately represented where there is no formal requirement to involve the Appointed Actuary.

The AGWP recognise that an external consultant can become sufficiently closely involved in the running of the affairs of the company to overcome the disadvantages of being external. However, if this occurred, then one of the advantages of being external – namely being independent - could be diluted, as the advantages of being close to management and seen as 'part of the team' are gained. Commercial confidentiality may mean that an external actuary acting as Appointed Actuary and having a close involvement with one

client would not be able to perform a similar role as Appointed Actuary for another client.

One of the models considered in section 6 attempts to combine the benefits of both an external appointed actuary, with an internal actuary closely involved in management decisions.

#### **5.4.2 *Should an internal Appointed Actuary also be a director?***

As a board director, the Appointed Actuary might have greater influence. However the Appointed Actuary's obligations to advise the Board on his or her interpretation of policyholders' reasonable expectations heighten the potential conflicts of interest. With external compliance review and improved clarity over the priority of policyholders' reasonable expectations, these conflicts should generally be manageable. However the Appointed Actuary (or prospective Appointed Actuary) concerned should carefully consider the demands of both roles before accepting the joint appointment. In a mutual, the conflicts are more likely to be manageable, whereas certain Schedule 2C Schemes may place specific demands on the Appointed Actuary which make the conflicts more difficult, if he/she is also a Director.

#### **5.4.3 *How should the relationship between the Appointed Actuary and the board of directors operate?***

The Appointed Actuary should have the automatic right to attend and speak at all meetings of the board of directors. He should also receive all board and board committee papers and minutes unless explicitly advised that this is not the case (as may be appropriate for the deliberations of any Remuneration Committee).

Some contributors suggested that the Appointed Actuary should attend all board meetings as a matter of course. This would ensure that the actuary has the opportunity to be involved in all deliberations, but may not represent the best use of the Appointed Actuary's time if he or she has been provided with the agenda and advance papers and previously involved in discussions of any pertinent matters with any Executive Committee.

In groups, the right to attend and speak at board meetings would apply to the decision-making board or committee, as well as the insurance company board, which may only meet once or twice a year.

**5.4.4 *What restrictions should be placed on the wider management responsibilities that an internal Appointed Actuary should take on?***

The range of demands on the Appointed Actuary and the potential conflicts of interest between different groups of policyholders and shareholders or members are such that it is difficult to see how the role of Appointed Actuary can be combined with certain other key roles. Further the achievement of specific objectives (such as profit or sales targets) may from time to time conflict with the obligation to manage the business in a sound and prudent manner.

It is nevertheless essential that the Appointed Actuary is sufficiently involved in product development and business, capital and profit planning. There will typically be an Executive Committee responsible for these aspects and many of the day-to-day operations of the business. The Appointed Actuary might be a member of the Committee. If not, there needs to be a formal documented mechanism for ensuring that the Appointed Actuary attends the meetings of such a Committee when appropriate.

**5.4.5 *Should the Appointed Actuary's role be one of "Policyholder Champion"?***

The general view of those interviewed was that the Appointed Actuary needs to take a balanced view. The Appointed Actuary's role is currently seen more as one of adviser rather than negotiator. If the Appointed Actuary were to act as negotiator on behalf of the policyholders, it would clearly be difficult also to be a director or advise the directors on the fairness of any particular course of action. The normal continuing operation of a life insurance business should not generally require anyone to negotiate on behalf of the policyholders. Significant changes, particularly reconstructions, will however from time to time give rise to the need for such a role.

**5.4.6 *Should there be restrictions on the number of Appointed Actuary roles an individual actuary might take on?***

In deciding whether or not to accept an appointment, an actuary will typically take into account the implications of both workload and potential conflicts of interest. The introduction of external compliance reviews will introduce new potential conflicts. The number of roles it is appropriate for an actuary to take on will inevitably depend on the demands and complexity of each of them.

**5.4.7 *Should the Appointed Actuary's responsibilities and powers be extended in any areas?***

With the new Interim Prudential Sourcebook environment and the latest revision of GN1, the AGWP have not identified any material areas for further change at this stage.

Paragraph 3.6 of the latest version of GN1 requires the Appointed Actuary to satisfy himself that adequate systems of control are in place to ensure that the insurer's policyholders are not misled as to their expectations. Paragraph 6.6 requires the Appointed Actuary to advise on the appropriateness both of disclosed charges and expenses and of the with-profits guide.

It was suggested to us that the Appointed Actuary should be required to publish an annual report on how a life office has met policyholders' reasonable expectations. The Appointed Actuary is already effectively required to report on how the company has exercised discretion in the abstract of the report included in the FSA Returns. There may be a place for a more consumer-focused report produced by the company on how it believes PRE have been met.

**5.4.8 *What restrictions, if any, should be placed on the financial incentives of Appointed Actuaries?***

As a senior permanent employee of a proprietary life insurance company, the Appointed Actuary would probably be entitled to share options that are generally seen as a tax-efficient part of standard remuneration package for senior employees. It will be difficult to attract quality personnel to the role of Appointed Actuary without something equivalent. Further there is a risk that if

the Appointed Actuary has a radically different remuneration package, he or she will not be seen as part of the team. However share options in particular may damage the perception of the actuary's ability to act independently of the shareholders' interests. In principle, there are similar considerations for directors (who must act in the shareholders' interests subject to any regulatory constraints).

A number of those interviewed did not see a difficulty with a remuneration package including incentives at a level consistent with those of employees of equivalent seniority in the life office. However, opposite views were expressed by others who thought share options should not be permitted.

#### **5.4.9 *What should be the role of the actuarial profession in supporting Appointed Actuaries and the actuarial governance of life insurance companies?***

The principal areas requiring – or potentially requiring – input from the profession are:

- Ensuring fitness of the Appointed Actuary and external reviewer
- Encouraging compliance reviewers and appointed actuaries to share best practice on a non-attributable basis
- Identifying potential problem areas in advance
- Potentially to support the development and operation of an Actuarial Standards Board. This is seen as more likely to influence insurance company accounting in the short term, but its remit could be extended. We would not see this as being a prescriptive body, laying down detailed standards in a wide range of areas, but rather as focusing on a few areas where additional and more specific guidance would be most valuable.

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## 6. ACTUARIAL GOVERNANCE MODELS AND RECOMMENDATIONS

### 6.1 Introduction

Compliance review is a key element of actuarial governance. The overall approach to actuarial governance needs to take into account the level and form of compliance review, and function within the context of the general governance framework for life companies.

We have concentrated on the framework appropriate to the formal responsibilities of the Appointed Actuary including those required by guidance notes GN1, GN8 and GN22. Actuarial profit-reporting calculations will normally be audited and the work of the Independent Actuary in a transfer of business typically provides an effective control on the advice that the Appointed Actuary is likely to provide in such a situation. However, there will be other aspects of actuarial advice offered by the actuarial function in a life office which may be key, but not naturally subject to independent actuarial scrutiny. As directors become used to receiving external review reports on the advice of the Appointed Actuary, they may well seek similar reviews of advice on decisions that are critical for the business, but not part of mandatory guidance (and hence not otherwise automatically subject to external actuarial review).

We have assumed that, whilst some changes may be made to strengthen governance of with-profit offices and to ensure the appropriate use of discretion, nevertheless the current form of governance remains essentially unchanged. In particular we have presumed that directors will have responsibility for ensuring that policyholders are treated fairly and their interests are properly taken into account, in parallel with the directors' primary responsibility to the company and its members.

### 6.2 Alternative Models

In order to facilitate discussion and clarify the trade-offs between various alternative approaches to actuarial governance, we have considered the merits of a number of alternative models.

The four options we have given further consideration to are as follows:

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- A an internal Appointed Actuary, remaining an integral part of the senior management team, often as a director, supported by a level of compliance review necessary to demonstrate that conflicts are not biasing his advice.
  - B an internal Appointed Actuary who is not a director, and whose management responsibilities are primarily confined to the actuarial functions (including the broad roles outlined in section 2), so as to remove conflicts, allowing a more limited level of compliance review.
  - C the actuarial responsibilities are shared between an external Appointed Actuary, who has certain formal statutory and whistle-blowing responsibilities, and an internal Chief Actuary who also has certain formal responsibilities and obligations, but may be a director and/or member of the senior management team.
  - D an external Appointed Actuary, subject to peer review only at a level commensurate with or lighter than that in B above, reflecting the fact that the external Appointed Actuary is independent of the company and not subject to conflicts between shareholder and policyholders' interests.

As some form of compliance review of internal Appointed Actuaries is widely considered as necessary, we have not considered the status quo any further.

Our comments apply to proprietary companies where conflicts between policyholder and shareholder interests can be significant. We comment later on the position in mutuals.

### **6.3 Option A**

Many existing Appointed Actuaries believe that they would be much less effective and would have less influence if they were not a director and/or part of the senior management team. They do not believe, in practice, that their position as a Director or senior manager, and any potential conflict this creates, are incompatible with their statutory responsibilities as the Appointed Actuary and their role in protecting policyholders' interests, recognising that all the Directors must consider the interests of policyholders as well as shareholders.

In this situation we would envisage a relatively heavy level of compliance review, which would be pitched at a level that would give comfort and avoid any public perception that the conflicts for the internal Appointed Actuary were inappropriate. The level of review and involvement of the reviewer, in key aspects such as the interpretation of PRE and matters affecting the solvency of the office, would be significant and commensurate with the level envisaged under option C below (although under this option, formal responsibility remains with the internal Appointed Actuary). We would envisage that most Appointed Actuaries would want to have discussions with the Independent Review Actuary on a continuous basis and would wish to refer key reports and recommendations to the reviewer prior to finalising and presenting them to the Board.

With the counter-balance of an effective and significant level of compliance review the AGWP believe that this option would be a viable, albeit quite costly alternative. It would be consistent with a strengthening of the governance framework to constrain the level of discretion (or at least create a better defined framework within which such discretion was exercised) and where more emphasis was placed on the directors' responsibilities to policyholders. It would also give the highest chance that the role of the Appointed Actuary did not become isolated or confrontational, which is a risk with some of the other options.

The role of the internal Appointed Actuary should remain influential and attract high calibre candidates.

Apart from the potentially heavy costs, the main risk is that the effective responsibility for decisions might shift to the Independent Review Actuary – who would become a 'shadow' Appointed Actuary. In the event that differences in opinion became apparent to the Board, then the Board might look directly to the Independent Review Actuary for advice and this might weaken the position of the Appointed Actuary or lead to the reviewer being appointed formally as the Appointed Actuary (i.e. a move to Option C or D).

#### **6.4 Option B**

If the main sources of conflicts were to be removed, we believe that the Appointed Actuary would not be able to hold any senior management positions such as CEO,



CFO or Sales & Marketing Director. Similarly the Appointed Actuary would not be a Director – although this would depend on the extent of changes to the overall governance approach. The Appointed Actuary would nevertheless, be entitled to attend all Board meetings. The Appointed Actuary would not be able to participate (to any material extent) in share option schemes or other value based incentive plans, or otherwise own a material interest in the shareholder profit stream. The level of materiality would have to be defined by the Profession. This would depend on the group structure and significance of the life operations to the group, but we would envisage a maximum level for the value of options granted around 25% of salary.

In this situation, we would suggest that a much lighter level of review would be appropriate, with the primary objective of ensuring the Appointed Actuary's work was consistent with professional guidelines, and to share best practice and experience from outside the Appointed Actuary's own firm. There would not be a need to provide an 'independent review' by someone not subject to the conflicts of the Appointed Actuary as in Option A, hence this lighter level of review might also be appropriate for Appointed Actuaries of mutuals.

The main advantages of this approach are that it retains responsibility with the in-house Appointed Actuary who is close to the business and keeps costs to a minimum. However, the status and influence of the Appointed Actuary is likely to be diminished quite substantially, as is the attractiveness of the job, and there is clearly a risk of losing the best internal actuaries to external firms. It may also make the Appointed Actuary job more confrontational, as there will be a clear separation of the role from that of the management team and directors.

We believe that this approach carries a risk of weakening the actuarial governance of life offices.

## **6.5 Option C**

This option is based upon Option A, but by moving the formal responsibility onto the external Appointed Actuary, it would avoid isolating the internal Chief Actuary and permit him or her to function within the senior management team on an equivalent basis to others. The costs could be similar to those of Option A. The loss of internal "on the spot" involvement might reduce the effectiveness of the Appointed Actuary

compared with Option A, but this should be counter-balanced by the involvement of the Chief Actuary.

This model is dependent upon there being a senior actuary in place within the insurer as Chief Actuary and is, therefore, only likely to be viable for an office of reasonable size.

The internal Chief Actuary would be responsible for all actuarial work, including the production of FSA returns, and the Appointed Actuary would discharge a formal reporting role, as envisaged under section 340 of the Financial Services and Markets Act 2000, and have the duty to inform FSA under section 342. This would require the FSA rules to be amended to allow the Appointed Actuary to report to the Board upon the firm's investigation, rather than be responsible for conducting it.

The division between the Appointed Actuary and the Chief Actuary could, of course, be adapted slightly according to circumstances. However, for a large office, the Chief Actuary would be responsible, on behalf of the insurer, to see that the actuarial work was carried out. In most areas the Chief Actuary would draft a report and cover within that report all issues that are relevant. However, the Appointed Actuary would review this, and would give his or her view on aspects impacting upon either the solvency of the Long Term Business Fund or upon policyholders' reasonable expectations.

The Appointed Actuary would be allowed professionally to place reliance upon the work of the Chief Actuary, subject to conducting reviews on a similar basis to a compliance reviewer on matters other than those where opinions are expressed, such as interpretation of PRE. In those areas he or she would take full responsibility. Matters of actuarial judgement would be reported upon and an opinion expressed. In particular the Appointed Actuary would have to give special attention to issues relating to the solvency of the Long Term Business Fund.

Although a significant part of the responsibilities of the Chief Actuary would, without doubt, be to ensure that the Appointed Actuary was aware of, and in agreement with, the approach being recommended by the Chief Actuary on all key issues, nonetheless, the Chief Actuary would be able to have considerable influence, and would be able to express proper professional views. Although not directly

responsible for advising the Board on issues such as policyholders' reasonable expectations, in meeting FSA Principle 6, the Chief Actuary would be able to influence the Board and management decisions, not least because of the importance of avoiding the Appointed Actuary having to report the firm to the FSA. The Chief Actuary would also, however, be free to give weight to commercial considerations in framing his recommendations. The Appointed Actuary would review and report on these recommendations having regard to their reasonableness from a regulatory/policyholder point of view.

## **6.6 Option D**

The external Appointed Actuary would be responsible for producing all the reports and recommendations to the Board and may, in some cases, carry out much of the underlying work.

Whilst companies may choose to use an external appointed actuary, and this may often be the most effective option for small life offices and friendly societies, we do not see any reason to make this alternative mandatory. If a life company wishes to employ an internal Appointed Actuary, and is prepared to meet the cost of external compliance review, then it should remain available as an option.

Where an external actuary is appointed, we believe that a lighter level of compliance review would be appropriate.

The main professional firms have internal compliance review procedures. Provided it can be established that this Appointed Actuary role forms a small part of the firm's income (in the same way that auditors show independence from their client) it is possible that an external practice review will be sufficient. However, we recognise that, whilst this satisfies two of the objectives of compliance review mentioned in Section 4, namely 'peer review' by another Actuary, and independence, it does not necessarily meet the third objective of sharing best practice and experience from a wider range of sources.

As with internal Appointed Actuaries, there are circumstances where an external Appointed Actuary, or his or her employer, are not seen to be sufficiently independent of the life company to which he or she is appointed. In such

circumstances, a heavier level of review, from someone outside of the external Appointed Actuary's firm, would be appropriate or in certain cases it may be desirable that a different actuary is appointed, from a firm without such a conflict.

The level of costs under this option will depend on the extent of work carried out by the external Appointed Actuary. Although costs may often be greater than, say, Options A and C, there would be a saving where there are no significant internal actuarial resources or senior actuary.

## **6.7 Summary and Recommendations**

### **6.7.1 *Internal or external***

We believe that for many life companies there can be significant advantages in having an internal Appointed Actuary who is both close to the business and can influence the senior management team and directors. We therefore believe that Option A should continue to be available. Nevertheless we recognise that, in some cases, the role of the Appointed Actuary and the influence accorded to the Appointed Actuary within firms have been diminishing in recent years. There is also the risk that changes to the governance structure designed to strengthen the position of the Appointed Actuary may in fact have the opposite effect. If this occurs, then we believe that the option of an external Appointed Actuary, combined with some formalisation of the role and responsibilities of the senior in-house actuary, (Option C) would be preferable. Given the potentially substantial costs of compliance review, this alternative is unlikely to be significantly more costly than the alternative of an internal Appointed Actuary (Option A).

Overall, we believe Option A or C provide the best alternatives from a governance perspective – combining the benefits of both an influential internal actuary and in the case of A, a strong compliance review, or in the case of C the shifting of the formal Appointed Actuary responsibility to an external independent actuary. We recognise that these options may be the most costly, but favour them over B which we believe is likely to be a less effective model in the longer term. We also recognise that alternative D is an acceptable alternative, especially for small offices.

### **6.7.2 Management positions and directorships**

Where either Option A or C is adopted, we believe that few, if any, changes are required to the current position of Appointed Actuaries/Chief Actuaries as directors or senior managers. As at present, it would not usually be considered appropriate for the Appointed Actuary to be the CEO or Marketing and Sales Director.

We believe it is also preferable, under Option A that the Appointed Actuary of a proprietary life office does not hold the position of Finance Director, where the primary responsibility of this position is the enhancing of shareholder value.

However, we recognise that in some companies this responsibility rests primarily with the CEO, and the FD role is primarily one of 'financial controller'. In such cases the roles of finance director and appointed actuary could still be combined. Nevertheless, we would not see this as 'best practice' other than in mutual companies where there may well be advantages in combining these roles.

If a company wished to combine the roles of their senior actuary with that of Finance Director, we would see Option C as being more appropriate.

If Option B is adopted, we would recommend that the Appointed Actuary did not hold any other major management roles which might lead to potential conflicts with the duties of the Appointed Actuary. Under this option, and assuming no radical changes to the overall Governance framework, we would also recommend that the Appointed Actuary in a proprietary office was not a director.

### **6.7.3 Financial Incentives and Independence**

In relation to share options or other incentives, we believe that any internal Appointed Actuary should consider, as required by existing professional guidance, whether the level of such financial incentives may be such as to create undue influence in their decisions. However under Option A, we would not recommend an outright ban on Appointed Actuaries being entitled to participate in such share option or incentive schemes. Similarly, under Option C, we would envisage that the Chief Actuary would be entitled to participate in share option or incentive schemes. Under Option B, we would suggest a more restrictive approach.

We also recommend that disclosure of remuneration, in particular the basis used to disclose share options, be improved.

For external Appointed Actuaries and those carrying out compliance review, the profession should consider setting guidelines relating to fee income and other factors which might prejudice the independence of those carrying out these roles.

#### **6.7.4 *Policyholder Champion***

We do not consider it appropriate to require the Appointed Actuary to act as a 'policyholder champion'. In the normal course of business a balanced approach is required and in exceptional circumstances, such as a reconstruction, a separate person might be appointed as a 'negotiator' on behalf of the policyholders.

#### **6.7.5 *Wider responsibilities?***

We do not believe that the breadth of responsibilities of the Appointed Actuary needs to be extended further, although we recognise the need for greater involvement in all elements of disclosure – which will become increasingly important in establishing PRE and limiting the extent of discretion which can be exercised by the Directors.

A number of issues arise for the Appointed Actuary out of whistle-blowing requirements of the FSMA 2000, which have been set out in the profession's response (January 2002) to HM Treasury's consultative document (October 2001) on the draft "Communications by Actuaries" regulations.

The increasing demands on the Appointed Actuary in a complex business can – even without the additional responsibilities that are likely to come with additional influence – be such that in practice the Appointed Actuary needs to rely on the work of professional colleagues, including that of other actuaries. The Professional Conduct Standards and guidance notes make it clear that actuaries giving advice remain responsible for it. There is currently no explicit recognition that actuaries may rely on reports from other actuaries, in giving advice and remaining responsible for it, and we recommend that this is addressed.

### **6.7.6 Role of the Profession**

Finally, we have considered how the role of the profession may be extended to support Appointed Actuaries (and reviewers). We believe that further consideration should be given to practical ways of providing additional technical 'guidance' as to best practice and appropriate methods and assumptions in relation to key areas of actuarial practice.

This might involve the formation of some form of actuarial standards board (separate from or as part of any similar requirement in relation to financial reporting); developing the profession's equivalent of 'Dear Appointed Actuary letters', or providing some more technical papers or more detailed 'position statements' in respect of key topics.

The AGWP also felt that the Profession should review the approach to issuing practising certificates. In particular, it might be appropriate to monitor the knowledge and experience of the actuary in relation to the business for which he/she is appointed.

Practising certificates should also be required in some form for reviewing actuaries, thus the current approach to issuing certificates will need to be reviewed.