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Morris Review
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Our Ref:

Your Ref:

REVIEW OF THE ACTUARIAL PROFESSION

1. We welcome the opportunity to comment on the Interim Assessment published in December. It seemed to us to be a comprehensive review of the issues facing the actuarial profession and the options for reform.
2. As we noted in our response to the Review's June 2004 paper, actuaries play an important role in the financial services sector, especially the insurance industry. As the regulator of the sector and particularly insurance, we have an interest in the effectiveness of actuaries and the profession generally. We focus in our response on regulation and accountability issues for the insurance sector. Our responses follow the structure of your paper.

Chapter 3: The Profession and Regulation

3. We welcome the analysis of the current regulatory framework for the Profession and possible models for the future. As the issue of future regulatory structure is at the heart of the Interim Assessment, it may be helpful to comment here on our preferred approach.
4. We agree with your analysis that Model B (Independent Oversight) is promising. In particular, it is likely that it would:
 - respond to the strong public interest in the quality of actuarial work (as already recognised in the statutory regulation of insurance and pensions) and the effective functioning of the Profession;
 - build on the regulatory approaches for other professions;

- help to enshrine independent input into actuarial work, for example in standard-setting; and
- help to underpin confidence in the Profession generally.

As the paper notes, independent oversight, as opposed to full statutory regulation, would provide for a continued engagement of the Profession and its members in regulatory functions. Model B would enable different approaches to be taken to the different areas of regulation; and it would allow for development in the regulatory model in the light of experience as well as wider developments in the profession and the financial sector generally.

5. Because of this flexibility, Model B would also require a carefully planned approach to implementation. It would be important to us, as the regulator of insurance companies, to ensure that in designing the new approach, the roles and responsibilities of the body charged with independent oversight and the continuing responsibilities of the Profession were clearly defined in relation to the FSA's regulatory objectives in the Financial Services and Markets Act.
6. The FSA does of course make rules and guidance that relate directly to actuarial work undertaken in insurance companies. These requirements cover not only issues relating to financial soundness but also the obligations of firms to treat their customers fairly. For with-profits business in particular, we see an important role for actuaries within insurance firms. We also monitor compliance with our rules and guidance – our supervisory activity. And we have powers to take action against individual actuaries, including (but not limited to) actuaries who are approved persons under the Act.
7. It would be important that the work of a new independent oversight body took careful account of FSA's regulation. Even if there were no conflict, duplication or overlap this could impose unnecessary additional costs on the industry. Whatever the nature and scope of the independent oversight, addressing the issue of costs of oversight and how they would be recovered would be a high priority. We are conscious of the current cost pressures on the Profession resulting from the expansion and development of its work, including its new standard-setting and discipline arrangements.
8. We are ready to work with the Review, government and any new oversight body on the detailed design of the Model B approach. The FSA has well-established links with the Financial Reporting Council (for example, we are represented on the Council by one of our Managing Directors). We work closely with the Council on accounting and auditing issues of common interest. We can therefore appreciate the advantages in FRC taking on the oversight role for actuarial work. Many of the existing functions of the FRC in respect of financial reporting and audit work could in principle be extended to the actuarial profession – as could the FRC's oversight of professional bodies and arrangements for discipline.

9. There is also an increasingly close relationship between accounting and audit issues and actuarial work. For example:
- much of the existing financial reporting by insurers (principally the published FSA regulatory returns) reflects extensive input from actuaries, e.g. in the valuation of policyholder liabilities, as does the recent new UK accounting standard for the with-profits business of life insurers (FRS 27);
 - internationally, the current initiative to reform accounting standards (Phase 2 of the IAS work) will require actuarial input, which is being provided by the International Actuarial Association (IAA); and
 - there is now a requirement in our Handbook of Rules and Guidance that life insurance companies require their auditors to seek advice from an independent actuary (the "reviewing actuary") in the audit of key parts of the FSA return. The Auditing Practices Board, one of the FRC's operating bodies, has already issued practice guidance for auditors in relation to this work.

In addition, as you are aware, Lord Penrose's report into the events at Equitable Life suggested that life insurers should be subject to joint audit and actuarial review.

10. An oversight role for the FRC could also help to ensure a coherent approach to the relationship between accounting, actuarial and regulatory standards. We have already been working with the FRC and others to articulate our approach to the relationship between accounting standards and regulatory requirements for adequate capital (see our CP 04/17 issued in October 2004). In broad terms, we shall continue to require firms to follow generally accepted accounting practice in drawing up financial statements for regulatory purposes. But we shall require them to vary the normal accounting where necessary to meet our objectives.
11. We can envisage a similar approach to actuarial standards. Insurance companies are already required to have regard to generally accepted actuarial practice, for example in valuing policyholder liabilities for both company accounts and regulatory returns. We also note, however, that all financial reporting standard-setting at a national level is now constrained by the requirements of the EU regulation on IAS reporting.
12. Equally, there are other aspects of the work of actuaries where the interface with existing FRC responsibilities is more limited, particularly the role of actuaries in treating customers fairly. We note that the scope of the existing standards published by the Profession is wide, ranging from financial reporting issues to professional conduct matters. Early consideration would need to be given to which areas should fall within the responsibility of the FRC. In principle, we would expect to retain a lead role in issues relating directly to the way in which the work of actuaries in (or working for) regulated insurance firms bears on regulated firms' obligations to treat customers fairly.
13. Overall, the model of independent oversight through the FRC promises to deliver much of what the Review is seeking to achieve – including better standard-setting, improved

accountability, enhanced review and potentially also improved arrangements for discipline. But further work is needed on the detail of the oversight arrangements, including costs implications, before a final view can be taken.

Chapter 4: Actuarial roles

14. We agree with the analysis on life insurance – on which we commented in our earlier response.
15. Clearly, we may want to review the continuing need for reserved actuarial roles in the light of the introduction of independent oversight arrangements – for example if the standards currently applying indirectly to insurance companies via their employment of members of the Profession were in future to be applied directly to firms via an Actuarial Standards Board within the FRC. We would also have regard to the implications for whistle-blowing of any changes – because, as you note, the statutory protections for whistle-blowers currently apply to holders of reserved roles.
16. We have not so far made rules imposing requirements for the general insurance sector outside Lloyd's to appoint actuaries. But we have indicated that we will revisit this question. Our current requirements are only for a Lloyd's Actuary Function at Society level and a Syndicate Actuary at managing agent level for each syndicate. The Prudential Sourcebook, taken with Companies Act requirements, give guidance to the effect that directors obtain actuarial advice to inform the judgements about the value of technical provisions for which directors are responsible. But we are considering whether we should make more explicit a requirement for actuarial advice on technical provisions. The obvious way to deliver this would be by creating new actuarial roles.
17. We are less clear that such roles should be reserved to members of the Profession rather than to individuals with the appropriate skills and experience. As we mentioned in our response to your earlier paper, we intend to keep under review the need for reserving of roles. We therefore in principle favour Option 2 of the alternatives set out on page 69 of your paper – with the proviso that we would favour external audit over certification by the approved person (which is our approach in life insurance). Again, we would need to have regard to the availability of protection for whistle-blowers.
18. We also think there is a case for requiring actuarial input into the audit of general insurance reserves in future along similar lines to the life insurance requirements which we have recently introduced. This is Option 4 on page 69 of your paper.
19. We will be working further on these issues, including the preparation of the cost benefit analysis that is required to support any proposals for new FSA rules. Depending on the outcome of the CBA work – and on the recommendations of your Review - we plan to bring forward proposals for consultation later in the year.

Chapter 5: Public interest and accountability

20. Our main comments on this chapter relate to the options for the With-Profits Actuary.

21. As a general comment, however, we question whether, because it focuses on the accountability of the actuary, the paper places enough weight on the accountability of the senior management of regulated firms for their compliance with regulatory duties. Much of our supervision focuses on identifying when this duty is not being properly fulfilled. Actuarial role holders advise senior management. Any additional requirements on them should therefore be proportionate to the incremental benefits likely to result.
22. With regard to the Actuarial Function Holder, we do not see a strong distinction between whether or not the role holder is employed by the firm. The role holder is in either case remunerated by the firm. In any event, many firms have already engaged external Actuarial Function Holders – reflecting the widespread use of consulting actuaries by medium/small firms.
23. By the same token, we question the value of requiring firms to appoint external With-Profit Actuaries (WPAs). Nor are we sure about the benefits of the With-Profits Committee or the Audit Committee appointing the WPA. Both are committees of the firm's board. We do not require firms to have either a With-Profits or an Audit Committee and not all firms have such committees. We do require, however, that firms' governance arrangements for with-profits business include some element of independent judgement in the assessment of compliance with our requirements. It might be good practice for firms to seek the views of the committee or person who provides this independent judgement when appointing its WPA.
24. You have raised important issues about the responsibilities of the WPA. As you will appreciate, the new arrangements for the WPA have been subject to extensive consultation and, having only recently taken effect, have yet to be tested by experience. You will understand that we are therefore bound to prefer status quo options at this stage without compelling reasons for change. In particular:
- we doubt whether requiring firms routinely to send to us the WPA's report to the Board will enhance accountability and serve the public interest – and could risk distracting from our emphasis on the WPA's accountability to the board and the overall accountability of the board itself. We do of course have access to the WPA's report to the Board if we need it; and
 - we question the benefits of giving policyholders a copy of the WPA's board report; as the paper recognises (in paragraph 5.85), this may constrain the WPA from commenting on the widest range of issues. And as you note, an annual report will be made available to policyholders including an opinion from the WPA, addressed to the policyholders, on whether the firm's exercise of discretion takes into account their interests reasonably and proportionately*. We plan to consult shortly on requiring firms to submit these reports to us with their annual returns or as soon as possible thereafter.

* The Review is aware, we believe, of continuing representations to us by the Profession that the WPA's opinion should be addressed to directors rather than to policyholders.

25. Any concerns about the fair treatment of policyholders identified in the WPA's report to the board may be reportable to us by the firm under Principle 11 (Relations with regulators) or the more detailed notification requirements in our Supervision manual. We are, however, prepared to work further with the Review on ways in which we will integrate the WPA's report to the Board into our risk-based supervision of life insurance companies. As the requirements took effect on 1 January and reports must be submitted by firms at the end of their accounting years, we have some time to work further on this before the first reports are made.
26. Our comments on the role of the reviewing actuary are set out in below under Chapter 8.
27. On whistle-blowing, the paper presents a useful analysis. But we have nothing to add to the comments in our earlier response.

Chapter 7: Standard-setting

28. Our thoughts on this chapter are mostly covered in the comments on Chapter 2 above. Our preference is for option 2 on page 131. We would look for discussions on the appropriate way for us to involve ourselves in the work of a new Actuarial Standards Board, whether through direct membership or observer status.

Chapter 8: Scrutiny and discipline

29. Our comment here responds to the ideas in the paper on improving the scrutiny of actuarial work in life insurance business.
30. As I have mentioned, there is a new FSA requirement on life insurance companies that they require their auditors to appoint an actuary to support their work on the audit of the FSA regulatory returns. This reviewing actuary must be independent of the insurance company. The reviewing actuary is therefore appointed by the auditor and it is the auditor who defines the scope of the reviewing actuary's work in accordance with the guidance issued by the APB; in doing so, the auditor requires the reviewing actuary to comply with professional guidance issued by the Profession. The actuary reports privately to the auditor and the auditor is required under FSA rules to pay due regard to the actuary's report.
31. This approach was developed after extensive consultation, including with the Profession, insurance industry and auditors. We acknowledge that there is a view in the Profession that the reviewing actuary's work needs to be supplemented – to cover all the work of the Actuarial Function Holder*. This lies behind the peer review proposals of the Profession.

* Note that the reviewing actuary already considers a wide range of actuarial issues indirectly through the requirement on the auditors to review compliance with generally accepted actuarial practice.

We also note the Review's point that there is no requirement on auditors under the Companies Act to take actuarial advice.

32. We welcome the emphasis of your paper on ensuring there is adequate scrutiny of actuarial work in future. This will help to deliver high quality work. We note, however, that if we were to extend the role of the reviewing actuary, as envisaged in your Options 3 and 4, we would need to have justified this with full cost benefit analysis. In the light of the work done when we were developing our proposals in this area, we doubt that the CBA case could be made.
33. More generally, we should avoid placing excessive weight on regulatory requirements to deliver the objectives of increased scrutiny. In particular, we can see difficulties with extending the reviewing actuary's role to report on compliance with actuarial standards generally - as suggested in Option 3. Not all of these standards do now or will in future have a bearing on the FSA's regulatory objectives.
34. We think that it is appropriate to consider the issue of improving scrutiny alongside the development of independent oversight of the Profession. In particular, if there were to be a role for the Financial Reporting Council in performing this oversight, then it would be sensible to consider not only a role for an Actuarial Standards Board as suggested in the paper but for a framework of actuarial review, which may have some parallels with the role of audit in the accountancy profession.
35. Clearly the FRC, with its responsibilities in relation to auditing practices as well as accountancy standards, would be well-placed to devise and deliver appropriate solutions in this regard. Standards or guidance on such review could helpfully define the relationship between the reviewing actuary, the auditor and the board of directors of insurance companies, including the role for the management letter - whether signed by auditor or actuary or jointly.
36. As we have mentioned above, we believe there to be a case for the extension of our arrangements for the audit and review of FSA returns in life insurance to general insurance. Similarly, we think that in principle any more wide-ranging changes to the arrangements for audit of insurance companies should be considered for both life and general insurance.
37. We are of course ready to discuss this response with you and to support you in the remaining work of the Review. We look forward to reading and, in conjunction with others, to acting upon your final recommendations.