

### **Morris Review of the actuarial profession.**

Firstly I would like to say that I have read the report with great interest and have been most impressed with much that is contained in it. Sir Derek is to be congratulated.

This report is tremendously important. Although the actuarial profession is a small one it is central to the operation of the insurance and pensions industry.

One of the most important aspects of the review is the fact that the profession is perceived not to have adequately protected the Public Interest.

The pensions industry is in a position where a high proportion of pension schemes have insufficient assets to meet their liabilities. The life assurance industry is also not a financially healthy as it might be. It is important in reviewing the profession to understand how this came about and what part the profession played in this.

In doing this it is important to identify what is meant by the “the profession” because the profession exists at three levels and this is important when making comparisons with other professions.

- 1) There is the individual actuary and how he acts. For individual actuaries issues of competence dishonesty and self interest arise and it is for the institute to police this. These are issues for all professions although particularly for the medical and legal professions. Other professions have no real equivalent of Shipman and solicitors have much more direct access to client money.
- 2) The type and quality of service provided by the group or the average actuary is another issue. This involves questions of what service is delivered and how efficiently. The existence of the NHS means that the medical profession's involvement in this is limited.. For solicitors there are issues of organising the profession so as to provide accessibility to the law by all sections of the population. This implicitly involves balancing the desire for low cost with providing a professional service. For accountants while there are cost issues the main problem is consistency of treatment. Here the main consumer is the investor. Tax accounts are a quite separate exercise. However accountants, at least as auditors, are primarily charged with describing what has happened rather than determining what is going to happen.

The actuarial profession shares many of these same problems. Cost and accessibility are not necessarily a problem for large schemes as the cost of actuarial advice can be quite small in relation to overall pension costs. However for the large number of small schemes costs are a big issue. The usefulness of a very sophisticated actuarial report may be limited by the ability of trustees to understand it, particularly with small schemes. Comparability may be less of an issue than it is with accountants as there is not a free market in pension schemes. The other difference is that actuarial reports have a number of users with different and conflicting interests such as members, trustees, employers and regulators. An actuarial report has a direct and practical effect in that the employer has to pay money into the scheme. Although it can be argued that this aspect applies equally to individual actuaries, as it is effectively the source of industry wide problems it belongs here.

- 3) There is finally the profession as a body and the impact of that body on public policy and the regulatory regime. Here the actuarial profession has particular problems. At least for other professions the cost and quality issues are addressed by the same people and are reasonably simple.

For the actuarial profession there are still issues of cost versus quality and here the costs are not necessarily born by those who receive the benefit. There is also a much bigger problem. The profession's advice causes contributions to be made to schemes. This has an impact on various groups interested in pension schemes in different ways. The effects are both short and long-term and frequently short-term benefits generate long-term costs. Decisions have direct and indirect affects on the economy generally, not only on the pensions industry.

Given the broad effects of what the profession does, it is important that there is some debate as to what ought to be done and for that to be possible the profession as a body needs to encourage public awareness of the issues. There is much discussion about how pension provision should be organised. Defined benefit schemes may well have a place in this structure but there needs to be some discussion as to how this is to be organised.

It is important to appreciate that any regulatory environment is essentially regulating human behaviour as much as purely financial matters. In much of my submission I therefore cover what has happened in the past because certainly in the past there have been mistakes and it important to understand how those arose in order to reduce the probability of similar but different mistakes in the future.

### **Conflicts**

The review specifically refers to the conflicts of interest that arise for the profession. My own experience is with company pensions and it is an area where conflicts of interest abound. Frequently those conflicts exist within single individuals or organisations.

The Company director can be a trustee and a member. All three of these roles have different and conflicting interests.

As mentioned in Paragraph 30 the actuary has multiple and conflicting roles. He has duties to the trustees the members, the government and the profession while his appointment is generally a matter for the employer.

The government's role also has inherent conflicts. It has an interest in protecting the public, but its interest are not necessarily the same as the public. It has a financial interest in ensuring a healthy pensions inindustry in order to reduce its own costs of pension provision in the long term which conflicts with its desire to reduce the loss of tax revenue in the short term.

This highlights the fact that long term benefits have short term costs and visa-versa. Reducing contribution rates in the short term may reduce the employer's immediate cost but any delay in funding will in the long term increase costs overall not reduce them.

One of the most important aspects of this review must be how the profession deals with these conflicts and exactly what its public interest role is.

Given this I would have hoped that the report would concentrate a little more on the role of the professional bodies as opposed to that of individual actuaries. The conflicts of interest that exist for individual actuaries are less sharp for the profession as a body. Although individual actuaries might lose appointments because of their actions they will be replaced by another actuary. The professional body is above these issues and is well placed to protect the public interest.

I was therefore somewhat surprised to see that there was so little on the interaction between the professional body and it and government, which itself has conflicts of interest in that its short term interests may conflict with its long term interests. More specifically its role vis a vis statutory requirements.

There have been two sets of regulations applying to pension funds. The first goes back to the 1980s and these are the surplus regulations specifically designed to prevent over-funding of pension schemes with a view to limiting the loss of tax revenue to the exchequer. In retrospect it is possible that the profession should have reacted to this and pointed out the risks of adverse economic changes.

The second is the MFR regulations introduced in 1997, which on the face of it were intended to ensure a minimum level of solvency for pension funds. I think that it is now generally accepted that this minimum standard was in fact too low. Indeed it could be argued that MFR regulations had a negative effect on funding levels for many schemes, as it appeared to many employers that if the scheme was fully funded on the MFR assumptions they were adequately funded overall. It certainly weakened the case of any actuary advising a more prudent funding regime.

The Institute has recognised this and successive practice notes have increasingly pointed out the MFR basis is not sufficient for funding or transfer values.

The review makes no mention of what role the professional body had or should have had in setting these standards.

It might be asked whether anyone benefited from the setting of a minimum solvency standard based on optimistic assumptions. On the face of it no-one.

However, in fact the Treasury itself might have had an interest in the weakening the valuation assumptions for pension schemes. As is pointed out in 1.36 the government finally removed dividend tax credits in 1997. However previous chancellors had been reducing the level of these tax credits in period immediately before that.

Although the effect of the removal of the tax credit was only to reduce the return on equities by something of the order of ¾% per year, the overall effect of this was to increase the government's tax revenue by an amount some commentators have estimated to be about £5Bn a year.

This figure reflects the enormous size of pension schemes and illustrates their economic importance.

The reduction in yield of  $\frac{3}{4}\%$  might seem small but this is only apparent. A reduction in investment return of this order of magnitude is likely to increase the cost of accrued benefit by between a sixth and a third depending on the scheme membership structure.

From the point of view of the Treasury the problem was to raise tax revenue without adverse political repercussions. It was therefore in the Treasury's interest that the assumptions underlying pension scheme actuarial valuations remain the same. That way the additional cost would not become apparent until some years after the introduction of the tax change. Indeed the immediate effect would be to raise £5Bn a year without any apparent cost to anyone and any increase in costs in the future would be obscured by economic factors.

Given this situation it is unclear what the profession as a body ought to have done. It could be argued that the Institute should have required pension scheme actuaries to report to trustees on the cost implications for schemes when dividend tax credits were first reduced. It seems with hindsight that failing to do so might indicate that the profession was failing in its duty to its clients and the public in general. As it was the failure to act when the dividend tax credits were reduced made it much easier for the chancellor to remove them all together.

In the circumstances the introduction of a weak minimum solvency standard very much suited the government of the day. However, the effect on the industry was to reduce contributions from employers while also reducing pension scheme income through the tax system.

The situation very much highlights the conflicts that apply to the professional body. It makes clear that Public Interest is not necessarily the same as the government's interests. The Institute as a professional body is probably in a better position to deal with this conflict than any other but the report does not seem to deal with this.

Although the profession must itself be above politics it is surely part of its Public Interest duties to ensure that there is informed political debate.

### **Best Practice: The practical effect**

The report makes much of ensuring best practice is achieved while at the same time stating that no one knows what future economic conditions will be.

There is a great drive in the profession to standardise valuation bases. The problem is that this creates its own problems. Consider the effect of MFR.

One important question, probably the important question that trustees want an answer to is "How much money should there be in the scheme?"

The MFR basis appeared to answer this question. If the fund was a 100% funded on the MFR basis its assets were sufficient. The Regulations said so.

For some schemes it might be the case that the MFR reserve was correct. The schemes might continue, gilt yields might rise dramatically and equities might provide superb returns over the next ten or twenty years. However one might feel that that is taking a somewhat optimistic view of the future and it does nothing for schemes winding up currently.

Another question is “What benefits should members get on wind-up of the scheme?” The answer is the MFR reserve. The Regulations said so.

The only problem with this was that the members expected to get the benefits described in the scheme booklet, not the MFR reserve.

However such an interpretation had its attractions. It recreated the previous situation in that wind-up benefits were less than for a continuing scheme. It was just that wind-up benefits were defined in terms of MFR rather than explicitly having early leaver benefits less than those of active member benefits. This meant that schemes had one level of target benefits and another level of guaranteed benefits. A scheme could move from one to the other by being wound up. This accorded much more closely to an employer’s ability to pay.

The problem was public perceptions. It was all buried in the regulations. Actuaries were aware of it, in my view too aware of it, and they were not sufficiently aware that other people were totally unaware of it and probably would not have been very happy with it had they known.

The old system with reduced benefits for early leavers was unfair to early leavers but it was at least explicit. Members were aware that if they left or the scheme was wound up they would get lower benefits.

The introduction of improved early leaver benefits through government regulation removed the unfairness and increased expectations. The MFR may well have served to provide some financial flexibility and implicitly recognised the limited financial resources of employers. However in practice it meant a sharp divergence between public perceptions and reality which inevitably led to considerable disenchantment with pension schemes.

The new solution seems to be to bring reality or at least regulation in line with expectations. The trouble with this is the implicit assumption that employers have infinite financial resources and that failure to pay high enough contributions constitutes an attempt by the employer to cheat its workers. More regulations will of course be introduced to prevent them doing that.

Employers financial resources are in fact not infinite. Additional regulation whether that comes from the professional bodies or government costs money and will at the end of the day reduce the amount of money available to provide benefits. That is not to say that there should be no regulation but it is desirable to minimise it while trying to ensure that it is both sufficient and appropriate.

The problem with an MFR valuation or indeed any valuation carried out on a prescribed basis is that such a valuation is in some sense correct by virtue of the fact that it is carried out on a prescribed basis. This inevitably leads to over-reliance on it.

A prescribed basis that is too conservative, carries dangers of its own. What happens if the employer simply cannot pay? Should the employer be forced into receivership? Even if an employer can pay what if it forces the employer to close the scheme to new entrants and possibly future accruals. Is such action in the Public Interest? It deprives new employees of pension provision and may in any event impose higher contributions than will in fact be required.

It can be argued that many schemes have been closed down in response to FRS 17, the accounting standard, partly because it requires higher reserves and partly because the results fluctuate wildly year on year and cause embarrassment in the company accounts.

As your report suggests the trustees employers and members have in the past taken the result of the actuarial valuation as being absolutely correct. They are naturally averse to risk and have possibly not appreciated the inherent uncertainties. However in practice employers have to put an amount of money into the scheme. That cheque is a real thing not subject to any actuarial uncertainty so there does have to be a fixed answer.

The question is to what extent that answer should be based on some specified set of assumptions for all schemes. Every scheme has a slightly different structure to its liabilities and every employer has different levels of profitability.

Although the design of the pensions industry falls outside the scope of your report the way the profession contributes to the debate is not. It is I feel a very important issue for the profession. It is also true that the financial condition of the pensions and Life Assurance industry is to a large extent the reason your report has been commissioned. It needs to be recognised that there is a political agenda. Government action has at least contributed to the current situation. There is a political desire to blame the profession and the profession probably deserves some blame but possibly not all of it. Even within the profession there is a desire to direct blame. Given the background to your report on the actuarial profession, your report must identify the extent to which members of the profession were doing the right thing badly or the wrong thing well.

### **Best Practice: The cost**

Ideally the trustees and the employer ought to be separately advised and pension scheme solvency could be more closely monitored. This is not necessarily a big issue with large schemes because the cost of actuarial advice and compliance are in percentage terms smaller than for small schemes.

The problem of costs is much more significant with the small 50 member scheme. Compliance costs are already high and the employer can ill afford extra actuarial work. Indeed money spent on actuarial advice may well reduce the amount of money available to provide benefits.

I feel that the draft report fails to address the issues for small schemes in sufficient detail. While it is true that the issues for small schemes are in many ways the same as for large ones the issue of the cost of actuarial advice is much more significant. The issue here is to minimise the amount of actuarial advice required while at the same time ensuring that the actuarial advice given is the right actuarial advice.

Currently at this sort of level the issues are not complicated. The issue is how to get as much money into the schemes as possible so that member's expectations can be met. The issues are the same but the resources available to deal with them are limited and the right way forward needs to be considered.

### **The profession and Public Policy**

How much should the profession be involved in looking at the broader public interests? Clearly if pension costs force companies out of business that may not be in the broader Public Interest even if it did benefit the pension scheme. Again there are inherent conflicts.

The profession needs to contribute. However individual actuaries have in the past had misplaced belief in their own omniscience and I suspect that the profession as a body may well suffer from the same failing. It has its own perspective on things and it does need outside influences to both bring more into the public domain and ensure that the right questions are asked.

Finally I would like to point out the economic conditions change and change radically. The problems of the 1980s were perceived at that time to be problems of surplus. There was much discussion in the Institute and the press of who exactly these surpluses belonged to. Was it the employer or the members?

To some extent our current problems reflect the fact that the early 90s were with hindsight largely devoted to dealing with the problems of the 1980's and perceived excess levels of surplus. This needless to say only served to help bring about the problems of today where it is deficits that are the problem.

Up until the early 90s economic conditions had been very favourable for pension schemes. We are now in a period where the opposite is the case. History suggests that economic conditions will improve but they may get worse before they get better.

It is important that the report puts the profession in a better position to deal with the changes that are to come, because come they will. Above all the profession needs to make sure that it does not repeat the past mistake of focusing exclusively on the problems of the present and the immediate past because we must avoid at all costs being blind to the new problems that the future will bring.

In the past our profession has been driven by government to fix problems in ways that with hindsight, have tended to store up different and worse problems for the future. While appreciating that there is great temptation to identify and propose radical solutions to problems it is important not to destroy what is there and be aware that change brings with it risks.

Ian McKeever and Co.