



59 Keslake Road, Queen's Park, London, NW6 6DH

Tel: 020 8969 4541 Fax: 020 8969 4542

Web: www.investorsassociation.org

Email: steve@hux.co.uk

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

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Dear Sir Derek

Further Comment on Conflicts of Interest

Since our meeting with the Review staff in January, we have given further thought to the issue of 'Conflicts of Interest' and the way they impact the field of Occupational Pensions as an example. We have seen the response of the Institute of Consulting Actuaries to the *Interim Assessment*, and we are not entirely surprised that they found very little merit in the proposals that it contains.

Essentially the Profession's reaction is to deny that there are significant problems, to deny that there is any need for substantive reform, and in effect to deny the validity of your own analysis. In our original submission we said:

"These problems arise from a deeply ingrained culture, which has developed over at least two or three decades. That culture is cynical, self serving, inwards looking and largely indifferent to the public interest. In the absence of strong measures to remedy such defects, the existing culture will surely prove strong enough to pervert any new structures that are put in place."

The reaction of the ICA surely confirms our analysis of the Profession's fundamental problems.

On the subject in question we wrote:

"The first is at company pension funds, where the same "benefit consultant" (actuarial) firm frequently acts as advisor to both the company supplying the pension scheme and the trustee who looks after the interests of the scheme members. As has recently become clear in the corporate activity involving WH Smith and Marks and Spencer, the interests of the two sides may often be at variance."

It is hard to see how the frequent contribution holidays recommended or at least gaining acquiescence from the actuaries in the 1990s accorded with the interests of scheme members. Equally the widespread use of pension funds as 'profit centres' during the market boom in the late 1990s, where actuarial consultants allowed liabilities to be backed by equities rather than fixed interest investments, was not necessarily in the interests of scheme members, though it may be beneficial for the sponsoring companies."

These are not theoretical concerns. It will not be necessary to remind the Review of the seriousness of the situation of funded defined benefit [DB] schemes in the UK. The nominal shortfalls in those schemes are comparable in size to the National Debt. As a result, the pensions of hundreds of thousands of people (if not millions) have been imperilled. This has occurred despite the involvement of the Profession at every stage, in advising on scheme law, scheme structure, on reserving rules, and in carrying out statutory and professional duties on behalf of both scheme Members (via the Trustees) and scheme Sponsors.

However, from the ICA's submission it would appear that the existing system has no substantive flaws, and that the profession has no responsibility for what has occurred in this area. Frankly, we find that this response lacks all credibility. In contrast we believe that the *Interim Assessment* has demonstrated that there are fundamental problems here, and we also believe that such problems require fundamental but simple responses, if they are to be resolved.

The issue at the root of many of these problems is the conflicted role of the Scheme Actuary, who in so many cases attempts to advise both Sponsor and Trustees, despite the fact that the former wishes to minimise its contributions while the latter should be seeking the highest relevant level of funding, in order to maximise the security of pensions in payment and pensions yet to mature.

The effects of the Actuary taking on such an all-encompassing role are obvious: he (or his firm) becomes the sole source of expertise, and becomes in effect the arbiter rather than the advisor. In so doing he deprives the Sponsor and the Trustees of the ability to identify and address the issues which they are ultimately responsible for.

We also maintain our view that the Scheme Actuary should not normally be responsible for asset allocation and investment strategy, (contrary to established practice at many Schemes). His role is the careful analysis and presentation of the Scheme Liabilities, current and anticipated. We see this as quite distinct from the investment management role which is to determine the most cost effective way of investing the fund to cover those liabilities within an acceptable level of risk.

Under current conventions the liability computations are 'contaminated' by assumptions about future rates of return, which are specific to the Fund in question, and this creates a hidden bias about what the investment strategy should be. We prefer the approach of the 'Financial Engineering' specialists, exemplified by Mr John Ralph, who argues that liabilities should be valued against a common frame of reference, namely the market prices of Government Stocks of various maturities and types.

The solution that we envisage would resolve these conflicts of interest by a number of related and coherent measures:

- a) The Scheme Actuary would be limited to advising the Trustees (and through them the Members) and would be primarily and exclusively responsible for the computation and the presentation of the liabilities.
- b) The Investment Consultant would develop and present the investment strategy including asset allocation and would monitor compliance with that strategy by whoever was made responsible for managing the investments.
- c) Funding levels and Investment strategy would need to be agreed and ratified between the Sponsor and the Trustees, with the latter remaining responsible for the security and administration of the Fund.
- d) The Investment Consultant would also be free to advise the Sponsor on wider issues if so requested.
- e) The Scheme Actuary would be the primary repository of Public Interest duties, with responsibility for 'Whistle Blowing' in regard to any matter posing a potential threat to the adequacy or security of the Fund, including (but not limited to): misuse of Fund assets, improper favouritism in pension payments or transfers, or allocation of pensions rights, inadequate funding, evasion of promises re shortfalls etc.
- f) In order to prevent complacency and 'back-door' arrangement and to encourage effective competition in the Profession, Actuaries and Investment Consultants would be limited to five year terms in large funds and seven year terms in small funds, with the restriction that both advisors should not normally change at the same time.

Cost Impact: The present system gives rise to inadequate identification of vital issues that arise in the management of DB Funds, and thus to inadequate debate and muddled thinking. We have indicated what needs to be done to address these problems, and the question arises as to how much these changes need cost.

We would argue that the changes proposed would create simpler and better defined roles for those advising and managing the fund, and that this would have beneficial effects across the whole range of funds. In particular we would expect to see greater efficiency and more effective competition on the part of external advisors, and that in the larger funds these improvements would balance out any theoretical increase in costs as compared with the current all encompassing role of the Scheme Actuary.

In the case of the smaller funds, some increase in administrative cost would seem to be inevitable, but this merely highlights the broader issue of how small firm schemes can be managed in a way that reflects the public interest that they should be both safe and good value for money.

Yours sincerely,

Steve Huxham
for The Investors' Association