

# Morris Review of the Actuarial Profession

Response to the interim assessment

February 2005

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## **Morris Review of the Actuarial Profession**

### **Response by Watson Wyatt to the interim assessment – February 2005**

#### **Summary of options**

#### **Chapter 2: The market for actuarial services**

#### **Increasing competition**

##### **Options**

- Option 1: to the extent that the availability of professional indemnity insurance cover is acting or may in the future act to constrain entry and limit choice, ways could be explored of introducing liability caps; and/or
- Option 2: in the pensions area, unbundling the provision of advice related to statutory roles from other types of advice (particularly investment consulting services) would help open up the market to greater competition.

##### **Option 1: Liability caps**

All of our UK clients already have liability caps in place in their agreements with us. If the Review believes that clients willing to tolerate liability caps will have a wider choice of adviser than those that are not prepared to accept them, one assumes that the latter group are content are with the choice of adviser available.

Liability caps that presently exist are negotiated between adviser and client. If a mandatory scale of caps was introduced, it would need to be tightly defined and would need to reflect a balance of size-related factors such as fee level, total liability at risk and ability to bear any risk.

##### **Option 2: Bundling**

The word ‘bundling’ is unfortunate because, as the Review points out, there is no evidence of any formal tying provisions that make the supply of one service conditional on acceptance of another. Clients are already free to choose separate providers for different services, and many, especially amongst the larger pension schemes, already do. Acting in accordance with the recommendations of Myners Review, the majority of our clients already have separate contracts for liability and investment services, but only some have chosen to change advisers as a result. We believe there are good reasons why pension scheme clients have chosen to seek strategic asset allocation advice and investment manager selection from the firm that provides advice on their liabilities. In part this is because the approach to valuing liabilities is influenced by asset allocation, and vice versa. But it is also part of a desire for a joined-up approach to monitoring assets, liabilities and risks on a continuous basis rather than once very three years. This point was elaborated in an article in *The Financial Times* on January 31 by Nick Watts, our European Head of Investment Consulting, which is appended to this response.

In paragraph 2.25 of the interim assessment it is noted that several respondents voice concerns about the extent of the influence that a relatively small number of long established *actuarial consulting firms* appear to have over the investment strategies of most of the UK’s largest pension schemes. However, in paragraph 2.26 it is noted that some members of the investment management community expressed concern about what they perceived to be excessive influence of *actuaries* outside their core competence. Many of those who provide investment-related advice on behalf of

our firm are not actuaries. Of the 50 or so senior consultants in our investment practice roughly half are actuaries, working mainly on the asset allocation side (where actuarial skills are highly relevant), and the other half are qualified as Chartered Financial Analysts or equivalent. Around 40 per cent of them have worked for fund managers or similar for an average of 14 years each so, as a whole, the practice has a knowledge of fund management which is at least comparable to the largest fund management operations.

## **Increasing market testing**

### **a) Greater scrutiny of performance**

#### **Options**

- Option 1: increased education/expertise of users; and/or
- Option 2: regular formal reviews of advisers could be recommended or required every 3-5 years; and/or
- Option 3: performance measurement of actuaries could be encouraged; and/or
- Option 4: effective peer review of actuarial advice could provide actuaries with a set of incentives that encourages them to improve the clarity of advice they provide, both technical and in relation to underlying assumptions.

Our experience is that greater scrutiny is exercised by the larger pension schemes who have the resources to devote to it. There is less effective scrutiny by smaller pension schemes where the degree of specialisation of staff involved is less and the resources available in terms of time and training are also constrained. One option for improving scrutiny would be to promote the operation of umbrella pension schemes, whether through industry-wide or regional arrangements, so that economies of scale could be achieved. We support efforts to increase the education and expertise of users, in particular by offering training courses which are open to clients of the firm and others.

We agree that clients who regularly review advisers may be in a position to obtain a better result in terms of value for money and levels of service. Whilst the Review notes that users of actuarial advice find that the cost of a tendering exercise are not high, the Review does not appear to have considered the costs incurred by those tendering for service, part of which will, one expects, be borne by users, one way or another. We would support a recommendation that regular formal reviews of advisers are conducted at intervals but would question whether, given the normal period between full actuarial valuations of three years, it is advisable that the recommended review period only spans one valuation cycle. For example, if the recommended review period was three years and trustees chose to change their adviser each time, they would never have an actuarial valuation conducted by the same firm more than once. We think it would be preferable for the recommended review period to be a longer period such as seven years.

We think there are very real difficulties with measuring the performance of actuaries given the long-term nature of the subject on which they are advising and the uncertainty surrounding it. If performance measurement were encouraged we fear it would focus on matters that could be measured, but might be relatively important, such as timeliness and presentation, and would ignore more fundamental areas.

We comment later on peer review.

## **b) Improving user understanding**

### **Options**

- Option 1: user knowledge and understanding should be encouraged by measures to raise the required standards of knowledge and expertise, of which several initiatives are already in train; and/or
- Option 2: in relation to pensions, trustees could be given information on the Profession's own guidance notes, to better understand what actuaries are supposed to do. This could be used as a basis for encouraging more systematic challenge; and/or
- Option 3: greater use of professional trustees or trustees who are members of several trustee boards.

We note that the Review was told by several actuarial firms (paragraph 2.50) that they considered that the "understanding gap" was not significant, at least amongst larger clients. In taking steps to improve user understanding it would therefore be unfortunate if the operation of larger pension schemes were to be disrupted, unless there was a significant tangible benefit.

We can see merit in making the Profession's Guidance Notes more accessible to clients, but note that they are already available on the Profession's website, albeit in the same form as they are supplied to the Profession, and that smaller clients will be less inclined than larger clients to invest the time, or acquire the expertise, necessary to use these notes. We believe that professional trustees, whether companies or suitably qualified individuals, will see a growing role, although we would not support a mandatory requirement to use professional trustees because of both the cost implications and the present successful operation of many trustee boards.

### **Improving clarity of advice**

#### **Options**

- Option 1: leave it to the market, on the basis that if users can be encouraged to challenge more effectively, actuaries will stand or fall by their ability to respond positively; or
- Option 2: improve actuarial training and CPD requirements to equip actuaries with improved communication skills; and/or
- Option 3: require clearer disclosure of actuarial advice, assumptions and key sensitivities. For example by requiring the disclosure of forward-looking financial condition reports; and/or
- Option 4: explore means by which regulatory requirements might be simplified.

All of these options would be helpful

There is a tension here between advice that is succinct and advice that is comprehensive. In our experience different clients want advice at different points in this spectrum. We therefore believe that the market, as described in option 1, will always be important. We should always strive to improve training and CPD requirements. We can see the scope for regular user assessments of a sample of trustees and directors as a way of monitoring the effectiveness of the investment in training and CPD.

Great care would have to be exercised when requiring clear disclosure of actuarial advice, assumptions and key sensitivities, not merely to overload clients.

Regulation of pensions and life assurance has become steadily more complex over recent decades, typically with new legislation being additional to the legislation already in force. In our experience most of the attempts to simplify regulation have had the opposite effect.

## **Chapter 4: Actuarial roles**

### **Reserved role in general insurance**

#### **Options**

- Option 1: continue with the status quo – no reserved role; or
- Option 2: no reserved role, but require certification of the reserves by an approved person with appropriate skills, who may or may not be an actuary; or
- Option 3: a full role reserved to actuaries, with associated public interest duties and whistleblowing requirements; and/or
- Option 4: a requirement that the auditor take appropriate actuarial advice when auditing general insurers (a role akin to the Reviewing Actuary role for life insurers).

Broadly we favour option 4, a requirement that the auditor, when appropriate, takes actuarial advice ( see further our response to the options from 8.71 below). This is a finely balanced issue that has been much discussed by actuaries practising in this area. Elsewhere in the world (e.g. Ireland, USA, Australia and parts of Asia) there are requirements for actuaries to sign off general insurance reserves. If such requirements were to be introduced in the UK, there would need to be acceptance of the (in some cases considerable) uncertainties affecting non-life insurance, and any actuarial certificates would have to be framed in that light. It would also be necessary to be satisfied that there were sufficient actuaries with the relevant experience to perform the role and sufficient capacity in the professional indemnity insurance market.

## Chapter 5: Public interest and accountability

### Report and whistle-blowing

#### Options

- Option 1: more comprehensive guidance from the Profession or from regulators on the circumstances in which whistle-blowing is permitted and when it is required, covering all relevant statutory, regulatory and professional provisions, matters which regulators are likely to regard as significant, and the safeguards and sanctions available; and/or
- Option 2: ensuring that, on the one hand, legal protections for whistle-blowers are wide and give appropriate room for individual judgment, based on good faith and what an actuary “reasonably believes”; while nonetheless ensuring that, on the other hand, duties to whistle-blow are clear, objective and enforceable, for example based on what an actuary has “reasonable cause to believe”; and/or
- Option 3: bringing whistle-blowing requirements for auditors and all actuaries more closely into line, and extending protections for whistle-blowers, e.g. supplementing the existing relief from duties of confidentiality with statutory provisions conferring qualified privilege (ie when acting in good faith) from actions in defamation.

We would regard the three options outlined as being complementary and not mutually exclusive.

Additional guidance which clarifies when whistle-blowing is “permitted” and where it is “required” is likely to be helpful. Further guidance may be most useful in enabling an assessment to be made as to whether a matter is likely to be considered of “material significance” by the relevant regulator.

There are nonetheless limits as to what guidance alone may achieve. Whilst there are a number of practical situations in which the actuary is likely to consider that he or she is under a clear obligation to whistle-blow, these are likely to be the most extreme cases where a report is “required”. An example in a pensions context would be where there is evidence of misuse of contributions.

It would be impractical to expect any such additional guidance to constitute a definitive list of all conceivably relevant circumstances. The guidance would therefore need to be sufficiently broad to cover practical situations not specifically defined.

If additional guidance is to be issued, we consider that it should be issued by regulators. The Profession is nonetheless likely to be able to assist in identifying certain of the practical situations in which an actuary may elect, or otherwise be required, to whistle-blow. Some consequential amendment may also be required to ensure that the Professional Conduct Standards are consistent.

The Interim Assessment paper identifies the different tests which apply in relation to whistle-blowing “obligations”. A single test is likely to provide clarification.

As to what that test should be, we would consider it appropriate for the actuary to retain professional judgment to assess the nature and extent of any breach, before considering whether to report. That is especially so in those scenarios where whistleblowing is “permitted”, rather than where it may be “required”. The limitations of any additional guidance which may be issued in identifying all of the practical situations which the actuary could conceivably face would also tend to support a judgment-based test.

We consider that a test based upon a combination of the actuary’s professional judgment and the objective requirement for “cause” is mostly likely to ensure that material significant circumstances are reported. A reporting obligation based upon what the actuary has “reasonable cause to believe” would seem to be appropriate.

Ensuring that adequate protections are in place for whistleblowers is extremely important. We would regard those protections as both cultural (that is, within the individual’s own firm or company and within the Profession), and legal in nature.

We note that an actuary who makes a report may be entitled to protection under the Public Interest Disclosure Act 1998. Introducing statutory provisions conferring qualified privilege may be a useful additional protection.

We would regard the whistle-blowing requirements for actuaries and auditors in a life insurance context as being closely aligned. In a pensions context, we consider it important for any reporting obligation to reflect the actuary’s professional judgement, although assistance may be provided as to how that judgment is to be exercised by clearer, scenario-based guidance.

### **Actuarial function holder**

#### **Options**

- Option 1: status quo – Actuarial Function Holder role as currently specified by the FSA; or
- Option 2: greater protections for whistle-blowers.

We are broadly content with the Actuarial Function Holder role as currently specified by the FSA (and supplemented by the Profession’s proposals surrounding peer review).

We have no additional comments to make regarding the current protection for whistle-blowers.

### **With-profits actuary**

#### **Options**

- Option 1: status quo – With-Profits Actuary role as currently specified by the FSA; or
- Option 2: the With-Profits Actuary should be external to the insurer; or
- Option 3: the With-Profits Actuary should be appointed by the With-Profits Committee, if one exists, or otherwise the Audit Committee; and/or
- Option 4: the With-Profits Actuary makes a full report to the regulator. Policyholders receive a copy of the With-Profits Actuary’s opinion and have access to the full report.

Our primary view is that it would be premature to seek to make substantive changes to the With-Profits Actuary role as currently specified by the FSA, until the effectiveness of the role as presently drawn has been tested.

We recognise why an external With-Profits Actuary may be perceived by policyholders as being less susceptible to the influence of the insurer’s senior management, and accordingly that his or her

assessment as to whether policyholders have been treated fairly may be considered to be more objective.

We would nonetheless consider it inappropriate to require all appointments of With-Profits actuaries to be external, until the comparative benefits to policyholders of having internal and external appointments has been tested in the market.

Requiring the With-Profits Actuary to be appointed by the With-Profits or Audit Committee may be feasible but is unlikely to be appropriate in all circumstances.

In some instances, the members of the With-Profits Committee will be external appointments, and in this scenario the appointment of the With-Profits Actuary would be (and be seen to be) outwith the direct responsibility of the Board. That raises broader issues of accountability of the Board, and would in our assessment run contrary to the original intentions of the FSA in this regard. There are also likely to be similar issues if the appointment was made by the Audit Committee, which need not be a sub-committee of the operating company itself.

If, under option 4, a report was made available to policyholders, it would need to be made clear that the With-Profits Actuary had no liability to policyholders by means of an appropriate disclaimer.

### **Reviewing actuary**

#### **Options**

- Option 1: status quo – Reviewing Actuary role as currently specified by FSA, with the Reviewing Actuary reporting privately to the auditor; or
- Option 2: Reviewing Actuary role as currently specified by FSA, with additional duty to provide a private management letter to the Board on the Actuarial Function Holder’s compliance with professional guidance; and/or
- Option 3: Reviewing Actuary to have direct whistle-blowing duties.

We support Option 1, the status quo. This reflects our view that the responsibility of the Reviewing Actuary should be to his client, the Auditor, with the consequent responsibility for whistle blowing in respect of matters raised by the Reviewing Actuary resting with the Auditor. We consider that Option 2 and Option 3 will extend the role and responsibility of the Reviewing Actuary beyond the scope originally envisaged or required and will in practice be cumbersome and involve considerable duplication of the work carried out by the Actuarial Function Holder.

## Pensions

### Options

- Option 1: status quo – Scheme Actuary advises both the scheme sponsor and trustees, unless the actuary deems there to be a conflict, in which case the Scheme Actuary only advises the trustees; or
- Option 2: Scheme Actuary advises both the scheme sponsor and trustees, unless the trustees deem there to be a conflict, in which case the Scheme Actuary only advises the trustees; or
- Option 3: role of advising the scheme sponsor and the scheme trustees is separated in some clearly defined circumstances e.g. during scheme wind-up; or
- Option 4: role of advising the scheme sponsor and the scheme trustees is separated at all times.

Recent legislation has increased the likelihood of conflict between trustees and scheme sponsors. However, the actuary is not the only party who may have a conflict. Within the trustee body not only will senior executives be in possession of information about the prospects for the company that they are not able to pass on to the other trustees, but employee trustees may be torn between what is best for the pension scheme beneficiaries and the prospects of continued employment. Pensioner trustees may focus on the level of benefits payable to those who have retired, with perhaps less concern for other beneficiaries. To eliminate all these conflicts would require the appointment of an independent trustee, which, as well as being costly, would lose the advantage of the enthusiasm and special knowledge that trustees with a connection to a scheme can bring.

Against this backdrop our firm still has, through informed consent by clients, a number of cases of a joint appointment of a single individual as scheme actuary and adviser to the scheme sponsor. In other cases, especially amongst larger schemes, scheme sponsors and trustees have chosen to adopt an alternative arrangement we term the “Y-shaped” team. In this, calculations are performed by a common team on behalf of both the trustees and scheme sponsor, but two different actuaries within the firm perform the role of scheme actuary and adviser to the scheme sponsor. We believe that this arrangement keeps costs below the level they would be if there was complete separation of advice, but enables a greater level of conflict to be tolerated than would be possible if the same actuary was advising both parties. However, we, and our clients, recognise that there are situations in which it would be inappropriate for two actuaries within the same firm to continue to give advice to a scheme sponsor and a trustee in conflict. In such situations an advantage of the Y-shaped team is that one branch of the Y, typically the adviser to the company can be replaced by an actuary from outside the firm, possibly still sharing the calculations performed by the calculation part of the Y-shaped team. Sometimes this separation can be temporary and in others it can be permanent.

We have operated this structure for some clients for a number of years and is growing in popularity. Subject to the results of this Review, we expect it to become more prevalent as time progresses. It can be seen to be a special case of option 2.

The difficulty of option 3 comes down to defining all the circumstances where a separation may be necessary which include not only the nature of a conflict between scheme sponsor and scheme trustee but also accidental disclosure of information. We think it would be impossible to define circumstances which would capture all the necessary circumstances and not any unnecessary ones.

## Chapter 6: Education and CPD

### The syllabus and governance

#### Options

- Option 1: minor reform of the existing governance structure to promote greater academic and non-actuarial input; or
- Option 2: establish an independent body with oversight of the Profession's syllabus development along the lines of the accountancy profession's Professional Oversight Board for Accountancy (POBA).

As the Review note in paragraph 6.34 the 2005 education strategy was well formulated and it should be given time to bed in. For this reason we favour Option 1. Option 2 would carry an increased cost, which is unquantified, and which could be a significant burden for a small profession.

A more effective way of obtaining input on syllabus development from outside the Profession is through the direct involvement of universities and other interested parties (including relevant professional bodies) in the education process.

### Examination issues

#### Options

- Option 1: reform of the existing governance structure to improve quality control; and/or
- Option 2: involvement of full-time and dedicated professional examiners; and/or
- Option 3: involvement of an independent oversight body in exam setting and marking.

We favour a combination of options 1 and 2 and note that the profession already utilises full-time staff who assist with the examinations. Again, the Universities have a role to play. We would be concerned about the costs of option 3.

### Broadening actuarial education provision

#### Options

- Option 1: wider provision and accreditation of degrees that grant exemptions from the Profession's exams; and/or
- Option 2: promotion of post-graduate fast-track law-style conversion courses for those with university degrees.

Both of these have an important role to play.

It would be a mistake to focus too heavily on courses labelled as 'actuarial' since many good students graduate from broader disciplines having benefited from optional actuarial modules.

## Continuing professional development (CPD)

### Options

- Option 1: the Profession should set out clear objectives for the CPD Scheme and clarify what constitutes formal CPD. The Profession should ensure that CPD that qualifies as formal CPD is meeting an objective of the CPD Scheme, and is not simply a tick-box exercise based on attendance at meetings or conferences; and/or
- Option 2: the Profession should consider increasing the amount and quality of formal CPD required for reserved role holders, in recognition of the importance of these roles. For example, the Profession, with regulator input, could develop tailored CPD opportunities ahead of key changes in the regulatory environment for actuaries in reserved roles; and/or
- Option 3: closer links could be fostered between those within the Profession with responsibility for syllabus development, the actuarial research community and those focused on CPD to ensure that the CPD Scheme is kept-up-to-date and reflects recent developments in other disciplines and actuarial research; and/or
- Option 4: greater input to the CPD Scheme could be given to research-oriented actuaries, overseas actuaries and non-actuaries, for example through involvement in an oversight body, constitutionally independent of the Profession containing a mix of actuaries and non-actuaries. This could monitor the Profession's performance in relation to CPD Scheme development to ensure that the scheme is kept up-to-date, that links to other disciplines and actuarial research are made and that CPD is available to all actuaries, not just to those working in traditional areas.

We think all of these options have merit and are consistent with our own approach to professional development within the firm.

## CPD monitoring

### Options

- Option 1: the Profession implements its three-tiered professional revalidation proposal as currently envisaged, which introduces technical CPD requirements and annual monitoring for reserved role holders, technical CPD requirements and three-yearly monitoring for holders of the new voluntary non-statutory practising certificates, and basic CPD requirements and 10-yearly monitoring for the remainder of working actuaries; or
- Option 2: as Option 1 but non-statutory practising certificate regime is expanded to cover all actuaries (except those performing statutory roles) so the technical CPD requirements and three-yearly monitoring apply to all working actuaries; and/or
- Option 3: the task of monitoring CPD requirements and monitoring of compliance with the CPD scheme should be made part of the remit of the independent professional oversight body referred to above.

We believe that the Profession's proposals in Option 1 have been carefully thought out as an appropriate way forward given the resources of the Profession.

## Chapter 7: Standard-setting

### Actuarial standard-setting

#### Options

- Option 1: Actuarial Standards Board (ActSB) which is quasi-independent of the Profession (as per the Profession's proposal); or
- Option 2: Actuarial Standards Board (ActSB) subject to oversight by a suitably independent body, for example the Financial Reporting Council; or
- Option 3: the FSA sets standards in life and general insurance, and DWP/Opra sets standards for pensions.

The Interim Assessment paper indicates a preference for option 2. We recognise that embedding the Actuarial Standards Board within a separate body as is envisaged is likely to ensure the proper accountability of standards.

We agree, as suggested in paragraph 7.65, that the creation of a new entity that comprises members of statutory regulators, DWP, institutional users, consumers, the Profession, experts and lay members is likely to involve disproportionate cost. These costs would likely be funded through increased professional subscription fees, and there is a concern that these may be indirectly passed on to consumers.

Under this model, placing the Actuarial Standards Board under the remit of the Financial Reporting Council (FRC) would seem more desirable.

Appropriate arrangements would need to be made to ensure that any pooling arrangement in relation to costs was fair and proportionate.

A further issue which would need to be addressed is clarity of responsibility between the FRC and regulators. A clear separation of responsibility and closely defined limits of each's jurisdiction would be required in order to minimise the risk of overlap.

In addition, the composition of both the Actuarial Standards Board and the FRC would need to ensure appropriate levels of representation, both from the Profession and lay representatives.

## **Chapter 8: Scrutiny and discipline**

### **Scrutiny of actuaries in life insurance**

#### **Options**

- Option 1: Reviewing Actuary as currently specified by the FSA, with no mandatory peer review as proposed by the Profession; or
- Option 2: Reviewing Actuary as currently specified by the FSA, and peer review as proposed by the Profession; or
- Option 3: Reviewing Actuary's remit is expanded to include an explicit duty to report on compliance with actuarial standards; or
- Option 4: Reviewing Actuary as currently specified by the FSA, with additional duty to provide a peer review letter to the Actuarial Function Holder and/or the Board.

We support Option 1. We consider that the alternative Options extend the role and responsibilities of the Reviewing Actuary beyond the scope originally envisaged and would involve considerable duplication of work.

### **Scrutiny of actuaries in pensions**

#### **Options**

- Option 1: maintain the status quo of no formal scrutiny; or
- Option 2: include long-term liabilities within pension scheme financial statements, which are then audited; and/or
- Option 3: introduce peer review of the Scheme Actuary as envisaged by the Profession; and/or
- Option 4: audit the Scheme Actuary's triennial valuation.

Since the interim assessment was published the actuarial profession has published guidance note 48 which means that option 3 is already the status quo. Our firm was already operating peer reviews at this level.

Given the significant increase in fees which would result from option 2 (as estimated in paragraph 8.58), and more than likely from option 4 we think that the extra costs would be an unnecessary burden particularly for smaller schemes.

### **Scrutiny of actuaries in general insurance**

#### **Options (for the company market)**

- Option 1: introduction of requirement for actuarial advice as part of audit; and/or
- Option 2: introduction of peer review.

We do not believe there should be a requirement for actuarial involvement as part of the audit of insurance companies with general insurance liabilities. There are some kinds of general insurance business, for example, hospital cash plans or some property insurance where the setting of the

provision for outstanding claims is relatively straightforward. Rather, we consider it desirable that the relevant auditing standard should include a rebuttable assumption that actuarial advice, from an appropriately experienced actuary, should be sought when auditing general insurance claims provisions. Compliance with this requirement would then be subject to the control mechanisms of the auditing profession.

We consider peer review of actuarial firms' practice on a test basis along the lines of the Audit Inspection Unit model to be desirable. Further, the issue of to whom the peer reviewer reports and to whom, if anyone, the peer reviewer would be liable needs careful consideration. To promote an adequate supply of peer reviewing actuaries to perform this function at a reasonable cost we consider it would be preferable for the peer reviewer to report to the profession or the profession's oversight body.

#### **Options (for Lloyd's)**

- Option 1: if the Statement of Actuarial Opinion is produced internally then it must be externally peer reviewed; or
- Option 2: introduction of external peer review of the work of all Syndicate Actuaries; and/or
- Option 3: introduction of a requirement for actuarial advice as part of audit.

We favour option 1. Concern has been expressed that undue pressure may be placed by syndicate management on their employed actuaries. We consider a requirement for external and independent peer review to be a sensible mechanism to ensure robust advice is provided as to the level of provisions required.

Coupled with this we would support a peer review requirement of firms on a test basis along the lines of the Audit Inspection Unit model to be desirable where external firm provide Lloyd's sign-offs.

#### **Discipline**

##### **Options**

- Option 1: the disciplinary scheme remains accountable to the Faculty and Institute's Councils; or
- Option 2: the disciplinary scheme is accountable to a suitable independent oversight body; and/or
- Option 3: encouragement of closer links between whistle-blowing to regulators and the disciplinary scheme.

We believe that the present internal scheme which was comprehensively updated a year ago has sufficiently strong built-in independent features and either options 1 or 2 would be appropriate. Option 3 would add considerably to the workload.

# Appendix

## **MYNERS REVIEW: INDUSTRY RESPONSE: Unbundling services or unravelling progress?**

**The Myners recommendations may have unintended consequences such as higher costs and disjointed decision making. Nick Watts argues for continuing along the 'integrated route',**

*Financial Times, January 31, 2005, By Nick Watts.*

We wrote about the need for joined-up investment thinking to solve pension fund problems in these pages 18 months ago, and firmly believe this is still the right approach.

But it is challenged by the recent review of the Myners principles, which called for the unbundling of strategic asset allocation advice from investment manager selection.

This has some logical merit in line with the principle of selecting advisers along "best-in-class" lines. It could also have unintended consequences, however, such as an increase in costs and, more importantly, a move towards disjointed decision making.

This would be unwelcome at a stage when the industry has taken many positive steps to break down barriers between disciplines to achieve more harmonious processes better aligned to the primary goal of managing the risks in the pension fund to meet liabilities.

Strategic asset allocation among our clients has evolved and now consumes much more of their time. This progress has taken place rapidly as sponsors and trustees have been empowered to manage risk better through innovations such as liability benchmarking, absolute return investing, portable alpha and risk budgeting.

In fact, a once static three-year approach to strategic asset allocation has been replaced by annual reviews incorporating a holistic view of the liabilities, the assets and the risk tolerance within the context of the employers' risk budget.

It is the evolution of risk budgeting as a powerful and inclusive process to guide all investment decisions in a consistent manner that argues most strongly for continuing along this integrated route.

Indeed, our clients now seldom view asset allocation and manager selection independently, but rather as a joined-up, risk-based investment strategy that is dynamic.

Separating these decisions using a prescriptive formula could undo much of this progress and take the industry back.

Investment consultants' advice is rightly under far more scrutiny as the pressure increases to demonstrate added value. As a result there has been a significant evolution in the industry with investment consultancies having moved from being performance measurers, heavily reliant on actuarial parents, to becoming investment experts.

This is only one of the reasons why the Myners process has been successful in that it has focused minds on the importance of matching investment problems with the appropriate skills.

This shift is demonstrated by the process undertaken by many of our clients in putting out to tender their actuarial and investment consulting mandates with a view to getting the best advice for both areas.

The result is that funds have satisfied the requirement to select "best-in-class" providers and can now be confident that, in many cases, investment professionals do indeed provide the specialist advice they require for increasingly complex investment problems.

An important point here is that if investment consulting firms want to be "best-in-class" it is vital that they have expert knowledge of liabilities through actuarial skills as well as the deep investment knowledge that comes through working in the industry.

All this has come at some cost to the industry. Ignoring the increased cost of sale and servicing for consultants and the loss of efficiencies (all of which raise barriers to entry), trustees, who already have limited governance budgets, will find these budgets stretched further if they choose to deal with another set of processes and providers. Further separation of strategic asset allocation and investment manager selection could also lead to a reduction in competition as barriers to entry exceed aspirant entrants' resources. Funds would then gravitate towards fewer "best-in-class" providers that have already invested heavily to achieve this status.

And as the investment marketplace becomes more sophisticated, there is likely to be a trend towards a more specialist model where investment consultants take on a higher level of responsibility. This too could lead to higher concentration.

On the other hand, while competition might decrease overall, the quality of the advice may improve, as one provider acts as a quality check on another. This may be worth the extra layer of cost, but probably only if the advice is impartial and independent.

It is appropriate that change takes place in the industry if we are to restore trust and a long-term view to pension fund investing. It remains important, though, that funds have access to an industry that can provide impartial and independent advice at an appropriate cost.

Nick Watts is European head of investment consulting at Watson Wyatt.





## Consulting Offices

### Asia-Pacific

Auckland • Bangkok • Beijing  
Calcutta • Delhi • Hong Kong  
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Melbourne • Mumbai • Seoul  
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