Response to the questions in the Morris Review Consultation Document

In have started with my comments on question 1.11 because they are extensive and provide some general background relevant to my comments on the other questions in the consultation document.

In any event I feel that in many ways the issue of "How effectively does the profession engage with government, business regulators and other professions?" is an area where problems have occurred in the past. In practice the profession has failed to have sufficient involvement in the formation of government policy. This has had disastrous consequences for pension funds in particular.

Question 1.11

In considering the role of the actuarial profession in the Life Assurance and Pensions industries it is important to distinguish between the roles of the individual members of the profession and the role of the profession as a body.

As individuals we have to abide by the law as laid down by parliament. We also necessarily have commercial interests, which although not conflicting with our professionalism do influence our behaviour.

The profession as a body also however has a public service role in protecting and informing the public. The question is whether that duty is carried out by purely implementing the wishes of government, or whether it should, as a body, actively participate in the formulation of government policy or at least try to influence it.

The problems of the Equitable were largely a result of its philosophy. Many companies by using conservative actuarial valuation methods tended to hold back some profits from each generation of policyholders to support the next. These profits were released in time to enhance the profits of the next generation of policyholders. However, as the volume of business was increasing due to inflation, the amount held back from the current generation was always greater than released from the previous generation of policyholders. As a result reserves increased if not explicitly, then implicitly.

The Equitable tried to distribute investment profits arising from one generation of policyholders to that same generation of policyholders. This might be considered only right, but as the volume of business grew the reserves backing those policies grew only slowly or not at all.

This meant that when the annuity guarantees in its policies had to be met the company did not have the reserves to meet them.

The net effect was that in achieving one desirable objective, a risk was taken which in the long term had disastrous results.

Much of government policy in regards to the pensions industry has been like this. In achieving what were seen as desirable objectives, it has taken risks with the very existence of the industry.

The two factors that make the problems of the life assurance industry and pensions industry so serious is their size and their sensitivity to investment returns and general economic conditions.

Sensitivity to investment and economic conditions is intrinsic in making long term financial commitments that cannot be directly matched by suitable investments.

A pension promise made to a young person may result in him being in receipt of pension in eighty years time, but economic condition change drastically in that time-frame. In the 1930s the coupon on War Loan was reduced to 3½% as the coupon was thought to be too high. In the 1940s it was still considered to be a redeemable because of the high coupon. In the 1950s the yield on equities fell below that on Gilts because the perceived prospects for dividend growth were suddenly then considered to outweigh the greater risks. In the mid 1970s inflation was around 20%. It is now back to around 3% but this is still significantly higher than it was in the 1930s.

This does not represent random year to year changes, but long term changes in investment returns over extended periods of time. An immediate pension of one pound a year to a retiring pensioner that might cost seventeen pounds to purchase if interest rates were 3% would cost less than five pounds if interest rates were 20%.

Even this understates the variability in the value of pension scheme liabilities, as a substantial proportion of members are either active or deferred members and their pensions will not be payable for some years.

Although investment returns are very volatile in the short term, over the medium term there is generally a positive return over inflation but that is effectively an income item. The value of investments will change and in particular long Gilts will reflect the new economic conditions and therefore counteract this volatility.

However, for a pension scheme, a substantial part of the change in the value of their liabilities due economic change cannot be matched by the change in the value of the investments and the scheme must fall back on its guarantor, the employer.

There are two problems with this:

1. The ability of the employer to meet these guarantees will depend on the company's profitability and the conditions under which the guarantee will be called upon are exactly the economic conditions under which profitability is likely to be low.

2. The other problem is one of scale. Even in the 1980s it was already common for the value of the pension scheme's assets to be greater than the market value of the employer. That is the guarantee was bigger than the guarantor was.

Government legislation has served to make this worse: It has improved the benefits of pension schemes

When many pension schemes were set up in the 1970s, the approval regulations resulted in most of them having a similar benefit structure. The pension was a flat pension base on an accrual rate of a sixtieth per year of service based on salary near retirement. Leavers with less than 5 years service received a refund of contributions and leavers with more than 5 years service had a fixed pension which may or may not have had a GMP element that increased at 8½% per annum during deferment. With inflation well over 10% this was a relatively cheap benefit structure and contributions could be significantly less than 10% of earnings.

Government legislation subsequently improved the benefit structure in several ways:

1. It gave preserved pensions after only two years
2. It made preserved pensions for future accruals increase in line with inflation up to 5% during deferment
3. The government redefined GMPs by reducing them by 20% but requiring them to escalate at 3% per annum. The net cost of the GMP remained roughly the same but the net effect was to make a part of the pension escalate in payment at 3% per annum while maintaining the same overall accrual rate, thereby increasing costs.
4. From 1990 all deferred pension for subsequent leavers revalued at 5% or the rate of inflation if lower during deferment
5. From 1997 future accruals also had to escalate at 5% or the rate of inflation if lower on pensions in payment

These changes were regarded as simply correcting faults in the original benefit design of schemes. However, as accrual rates remained the same, the net effect was to multiply the cost of the benefit structure by a factor of three to four with a matching increase in the size of the benefits being guaranteed by the employer.

Pension scheme liabilities were already comparable with the market value of the companies sponsoring them in the 1980s. This made it much, much worse.

It might be argued that if the schemes were conservatively funded and there was a margin for adverse economic conditions, with the compensating movements in investment values any disaster might have been avoided. However, in the late 1980s the government placed restrictions on the level of funding of schemes to protect its tax revenue. If excess funding, as defined by government regulation, were not reduced, tax penalties would be applied.

Some employers were forced to take contribution holidays and or provide benefit improvements. Other employers were not forced to, but they took contribution holidays anyway. Once a contribution holiday was taken, there were inevitable difficulties in getting contributions restarted.

The fall in inflation and the lower returns on equities was all that was required to create the current situation.

It might appear that employers are failing to keep the pension promises they voluntarily made, but in fact the government through legislation made those promises.

Also through legislation the schemes were prevented from having sufficient reserves to meet adverse economic changes.

The government has also changed the tax regime to remove the tax credit given on the schemes' dividends under the legislation at the time the schemes were set up. These tax credits were first reduced by the Conservative government and then removed by Gordon Brown when the Labour party was elected. This increased tax revenue by between four and five billion pounds a year but that loss has to be made good employers eventually.

If the current requirements had been in force in the 1970s some schemes would have had benefits accruing at a lower rate and many or probably most schemes would simply not exist.

Government action is primarily responsible for the current situation of pension schemes. However the Actuarial profession has largely stood by while all this has happened and failed to point out the risks being created.

Regulations can do little in this situation. They cannot put money into pension schemes. Unless the economic environment for pension schemes improves, pension promises will have to be reduced. If it means that the employers have go into liquidation to achieve that, that is what might have to happen. Legislation cannot stop a company becoming insolvent.

Regulation has not helped a great deal. The cost of compliance in terms of management time coupled with the monetary cost now means that it is simply not economic for anybody to set up a pension scheme for less than several hundred members. For existing small schemes, compliance cost are simply absorbing money that would be better spent providing benefits to members.

The MFR regulations have in many ways been positively damaging, in that they have focused attention on a funding target that always was inadequate and now represents left than half the cost of buying out benefits. Buying out benefits is only possible for small schemes anyway. Insurers too have only a limited capacity to provide such guarantees.

The Profession must involve itself in the political process and make the issues clear, so that there can be debate about the best way forward. There are no easy answers.

The current situation in the pensions industry is largely a result of government action. What the actuarial profession is responsible for is standing by and letting it happen.

The other questions

Question 1.1

The main value of actuaries is their approach to financial problems where there is no definite answer and their ability to deal with uncertainty. We have two weaknesses.

The first a limited ability to communicate the result and a tendency to give overcomplicated answers which confuse the client.

The second is more subtle. Clients believe actuaries can answer their questions. Some questions we can answer but for most questions that we are asked we do not actually know the answer. We can only advise on a sensible way forward given that ignorance. The problem is that we are bad at explaining the extent of our ignorance. I suspect that we sometimes lose sight of it ourselves. Financial conditions experienced over the last ten or twenty five years represent a kind of central expectation of how things will be in the future. However what we forget is that conditions certainly will be very, very different and the central expectation is only a result of us not knowing how they will be different.

For example I do not believe that when the annuity guarantees were written into retirement annuity contracts the actuaries involved really believed that those guarantees would actually be called upon sometime in the future. History should have taught them that they probably would be and that the main uncertainty was when they would be called upon not whether they would be called upon. They therefore failed to address the problem that if the guarantees were called upon they would apply not to the odd individual policy but to a whole generation of policies.

Question 1.3

Statute requires actuarial calculations to be carried out. This is perceived to be the main role of the profession and no other profession does them.

Question 1.4

Frequently the actuarial profession in conjunction with legislation lays down a set of assumptions on which statutory calculations have to be performed. The results therefore relate purely to the legislative requirements and it makes it difficult to explain that those assumptions and results have limited relevance to the issues being discussed. The client wants “the answer”. The client believes “the answer” exists and the statutory valuation appears to be it.

Question 1.5 Should there be greater peer review?.

The first point to make is that in the larger firms of consulting actuaries peer review already exists to a large extent. They review compliance and they have a house view on other matters.

For smaller firms of actuaries in general I suspect that peer review would improve compliance, however it has a number of disadvantages

1) It imposes further costs on small pension schemes, which means that even more money is spent on compliance and less money is spent on the provision of benefits.
2) The overall impact of small schemes and therefore small firms on the industry is in any event, limited.
3) It would tend to standardise actuarial advice even further and effectively silence actuaries who take views other than those conventionally adopted. This could well be to the detriment of the profession. The conventional view has often proved to be wrong in the past, See point 4.

4) It must be pointed out that particularly in the life assurance sector it was perfectly normal for actuaries to have participated in the design and sale of products involved in various miss-selling scandals. In practice they were all doing it so peer review would not have stopped them.

Question 1.6 Working with other professions.
This is an area where conflicts of purpose arise. A case in point is FRS17. The accountants want to present a "True and Fair View" in the accounts of the company's financial condition at a point in time. FRS17 does this but the figures are so sensitive to market levels on a particular day that we end up providing wildly fluctuating results as the gilt market moves up and down. This causes embarrassing figures to appear in the company accounts, which give little indication of what is going on in the scheme over the long term. It also serves to provide even more encouragement for employers to reduce their pension commitment.

Question 1.7 Design of financial products
The first point make is that there is that actuaries design these products for their employer and that is not the problem. What people have complained about is the selling of them. The question is how well were consumers warned of the risks they were taking. As risk is supposed to be an actuarial expertise it follows that actuaries should be involved in the design of literature marketing the products. Looking at actual miss-selling scandals

Pensions miss-selling
In the circumstances of the time transferring out of schemes by deferred members would probably have seemed to be a good thing. Transfer values were good to generous and had the then current economic conditions continued most people would have profited from taking out a policy. However the problem was that they were not warned that economic conditions could change drastically and they could end up losing a significant proportion of their pension. Actuaries were involved in this and were aware of what was going on. But everyone was doing it. It seemed to be good business. It might have helped if actuaries had had a more formal role in vetting the marketing process.

It must also be remembered that the government with its accent on individual self-reliance in financial matters positively encouraged such transfers. However this is now largely forgotten.

Personally I never recommended a transfer at the time because I thought pension scheme benefits might be improved following the Pensions Act 1990 and or the Barber judgement. The effect of both was uncertain at the time. I gave the right answer for the wrong reason. I hope that I had I advised someone to take a transfer I would have given realistic advice on the risks being taken.

Endowment Mortgages.
It is important to appreciate that at the time many of these policies were sold, life office bonus declarations had been on a steadily rising trend for at least eighty years. However, higher returns are frequently obtained at the expense of greater risk and it was a higher investment return that was being offered. Once tax relief on life assurance premiums was removed, one clear benefit was also removed and given the

commissions paid the risk reward trade off was less attractive. However given a long history of changing financial conditions the risks should have been explained more fully.

Precipice Bonds Etc.
Banks employing clever mathematicians believed that they could make a profit with the underlying derivatives. Insurers knew they could make a profit selling the policies and paying substantial commission. Investors were told that they were unlikely to lose as stock markets generally rise and they could earn a return substantially greater than current interest rates. This never did add up. Someone had to have got it wrong and not unsurprisingly it was the consumer. There is no such thing as free lunch and these products should not have been sold.

Actuaries are the only ones with a sufficiently long perspective on investment markets to have advised on the risks in the first two cases. In the case of precipice bonds common sense should have alerted financial advisors and it is doubtful whether they should have been sold at all. They were overcomplicated with several levels of expenses in the contract.

I believe that marketing literature on financial products should be actuarially certified, but policing is still difficult.

The problem is the delays in the process. The problems do not appears until five, ten or fifteen yeas after the products are sold. The actuary involved may well have retired.

Peer review probably will not work on life office products. In the past insurers have copied each other and new product designs have quickly become accepted within the Life Office community. A clever design may even be admired

However the technical design is not really the issue. It is suitability and recognising the underlying risks. What is needed is for any review to be a carried out by someone with an actuarial background who is aware the risks generated by the product.

It may well be that the profession ought to set up a review process for new products carried out by actuaries not actively involved in that field of work. What is required is independent thought by actuaries not infected by generally accepted wisdom. Great technical expertise in the area is not required.
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Question 1.8 to 1.10 Are actuaries sufficiently accountable for their actions.
There are problems with this. They advise companies and if they are directors of the companies they are responsible as directors. As advisors to pension schemes they are responsible for compliance but they simply advise trustees who are responsible for decisions. There can be sued in the normal way, although there may be difficulties in establishing and quantifying loss in many cases.

A further problem is the delay between when the advice is given and when the results of bad advice become clear.

Question 1.11
See above.

Q1.12
It has successfully expanded the horizons of actuarial knowledge certainly. I am not sure whether it could have done more or not. On the whole I feel that it has done a reasonable job.

Question 1.14
It is the only profession I am aware of that allows actuaries from the same firm to act for both buyer and seller in a company take-over situation.

Some additional lay input might be useful. Listening to conversation at actuarial meeting I often think that the opinions expressed do not accord with the expectations of the general public. If one is absorbed deep in the technical aspects of a particular problem, it can be difficult to stand back and ask whether you ought to be doing it in the first place. If other actuaries are doing the same thing a general acceptance grows of the rightness of what is being done without the question ever being critically examined.

Q2.1 The Objects of Regulation
The primary object of regulation of the actuarial profession should be to ensure a healthy industry whether that be insurance or pensions.

It is important that responses are proportionate and keep in mind the overall health of the industry.

Precipice Bonds probably should not have been sold at all but the number of people involved was limited. The Maxwell Pension scandal involved more people and was politically embarrassing but the subsequent regulation probably did more harm than Maxwell.

Keeping the insurance and pension industries solvent and productive must be the key objective. Within that framework the system should be able to deal with individual insolvencies, as preventing them altogether may be counterproductive. Preventing all insolvencies is likely to involve a destructive level of compliance costs. The objective must be to prevent a situation such as the current one where most schemes and most insurers are at risk of insolvency.

In the case of pension schemes it can certainly be argued that compliance has actually contributed to the current situation rather than acting to prevent it.

The third thing that any regulatory regime must recognise is that it cannot regulate money into existence.

Regulation must be proportionate. The Marks & Spencer Pension scheme can afford actuarial advice more than the “Bloggs Engineering scheme” and the Marks & Spencer Pension scheme affects more people. The Pension industry in general is itself more important than any individual scheme.

Regulation is harmful because it is costly but it is sometimes necessary. Regulation is like a drug in that too high a dose can dangerous. It is also like a drug in that it tends to be addictive to legislators and regulators and is seen as the solution to all problems.

Q2.2
It is too focused on compliance with regulations and not enough concerned with whether they are the right regulations or whether they are proportionate to the risks involved. As with many professions today compliance has taken on the character of a morality. Most of the financial problems identified in the consultation document arose while complying with the then current compliance requirements.

Q2.3
Actuaries by working together tend to have a common outlook, which may differ from public expectations. On the other hand it is difficult to know how a non-actuary can judge an actuary's work. Actuaries must be involved but so must people outside the profession. It is a matter of striking a balance. I do not have a problem with the current balance.

Q2.4
The burden of regulation on small pension schemes is too great. Administration costs including actuarial fees represent a significant proportion of the total costs of small schemes. That is schemes with fewer than 100 members. The problem though is primarily statutory regulation.

Q 2.9
Actuaries are the only profession with the necessary training. Accountants deal essentially with the past and are not trained to deal with discounting for interest or the effect of inflation or mortality. The real problem is that regulation is too complex. Trustees need to be advised by someone with all the skills of an actuary an accountant and solicitor but such people do not exist. They are different people and the interaction between those skills is imperfect because each person can only really master one of them.

Q2.10
Trustees probably do not have the expertise to question an actuary's advice but to suggest that actuaries are able to effectively make policy decisions in current conditions is to misunderstand the situation. The government through the statutory valuation defines what the company must pay, as an actuary I advise what the company should pay, and the company defines what it can pay. The company frequently cannot pay all I recommend.

The government also still defines the maximum that can be paid through the surplus regulations. It is entirely possible for an actuary to be of the opinion that the maximum as defined by these regulations is insufficient. However, for the actuary involved it simply means that he cannot so recommend and in any event the employer probably cannot afford it.

Statute and the trust deed define how the assets are divided.

Q2.11
Currently there is little peer review but this is expected to change. However, the actuary has less freedom of action than is implied by the question. For small funds more actuarial involvement means more costs and less money going into the scheme.

There are many schemes with fewer than 100 members, closed but not wound up, where the employer is trying to contribute sufficient to pay for the pensions that have been promised.

If the company can only afford to pay £50,000 or £100,000 a year how much of that should be spent on actuarial fees? My answer is as little as possible. Mr Morris needs to decide on what his answer is.

Q 2.12
Ideally there is a case for separation of those roles but once again cost is the key issue.

Q 2.13
Actuarial advice has had less influence than legislation.

Q 2.14
For small schemes compliance costs must be reduced.

Q 2.20
Probably the balance is fair

Q2.21
Generally yes

Q2.22 Practising Certificates
No, it is potentially an unnecessary cost, which must eventually be born by the client. Practising certificates in the context of statutory requirements are reasonable. In some less technical areas it is unnecessarily as the actuary is advising clients on what is reasonable in their circumstances. In some technical areas of practice such as the valuation of trust interests, the volume of business is so small that the issue of practising certificates is not worth the costs involved. If practising certificates were needed, the result would be that even fewer actuaries would be involved in the area, potentially making actuarial advice unavailable. This would not be in the public interest. It might also restrict the profession from going into new areas.

Q 2.24
Yes in principle in the past the requirement have probably been excessive on cost grounds.

Q2.25
The new rules in the pension area now require judgement, which is better but gives less certainty.

Q2.27
On the whole the professional guidance is good.

Q2.28
We already have fast track procedure that is pretty fast,

Q2.29
If the profession has a major fault it is that it follows government policy too closely and fails to lead it. See the answer to Q1.11

Q2.30
See 2.11. The problem is that even if there is a general consensus, it is almost certainly wrong. If there is anything the profession needs to keep in mind it is that actual outcomes will depend on what economic changes occur over the next 80 years and we in the profession have no idea what they will be. Problems occur when we lose sight of our own ignorance. Allowing different opinions keeps the profession aware of this and is beneficial to the profession.

Q2.32
No. FRS 17 has attractions for accountants because it is true and fair based on market conditions at a point in time. However it does little for pension schemes and possibly does harm while the figures are of limited use in company accounts. We need to discuss this with the accounting bodies and others.

Q2.41
The question assumes that compliance has been a problem and that pension schemes and insurance companies have failed because of a failure to comply, of which no one was aware of until too late. Problems have generally occurred while there has been full compliance. In the case of the Equitable I understand the regulators were aware of non-compliance. The question assumes that if we follow a given set of rules everything will be fine. It also assumes that compliance with regulations will prevent disasters. That has never been the case in the past and will not be in the future.

The problems are also different to the extent that actuaries are essentially dealing with an uncertain future while accountants are concerned with the presentation of what has actually happened in a standard way. Accountants are also preparing accounts for a standard purpose. Actuaries need to tailor their reports to the circumstances of a particular client.

Ultimately the cost will be born by the client. Whether that is through a direct charge or through an increased charge out rate is essentially merely a matter of presentation.

2.42 Who disciplines the profession
As professionals we are responsible to the profession and to the law. There are therefore two disciplinary procedures for dealing with problems.

Question 3 The GAD
As I see it the Gad has two roles.

1. It is there to advise government on the impact of proposed regulations and statutes on the industry.
2. It is there to supervise the implementation of the regulations

The first case occurs in situations where the government needs to legislate without consulting the industry involved. On those occasions the GAD needs to represent the interests of the industry to government so as to minimise the adverse impact of the new regulations.

In the second case the GAD needs to translate the government's wishes into a practical implementation. In that case the GAD is representing government.

There is a built in conflict between those two roles. I do not believe that doing outside work creates any additional conflicts and may well allow the GAD to perform its primary roles better. I do not think that there is any question that the GAD should be as independent as possible from both government and the profession.

In practice the GAD must be accountable to someone. This in itself makes independence very difficult. A possible solution may be for the GAD to be have formal accountability separately to a Parliamentary Committee and a Committee of the Institute. In both cases there should be a built in delay and any report should cover a period ending at least 12 months ago. (for example a report covering 2004 should not be presented until at least 2006). This is in order to prevent the examination of current matters which may involve sensitive issues.

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