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Morris Review of the Actuarial Profession

Submission by

The Consumers' Association

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Morris Review of the Actuarial Profession - Consumers' Association Submission

Introduction

CA is pleased to submit a response to the Morris Review. The role of the actuarial profession at the heart of some of the most serious financial scandals of recent times in the UK certainly warrants such a wide ranging review.

Much of the review focuses on technical issues which we are not in a position to respond to. Therefore, we have concentrated on the structural and governance issues relating to the role of the profession. Many of the issues covered by the review such as the regulatory framework for actuaries are so fundamental to the public interest as to warrant policy reports in their own right. We have provided summaries of our views but would be more than happy to discuss these in more detail with the review team.

Actuaries have come in for some justified criticism about the role they have played in financial scandals such as pension and mortgage endowment misselling and pension scheme deficits. We believe the actuarial profession failed to protect the interests of consumers.

However, in defence of the profession it would be wrong to lay the blame entirely at the door of actuaries. Although actuaries played a role in these scandals we attribute most the blame for these failures to wider corporate governance and systemic failures in the sectors in which they operate.

The main recommendations we make are:

- the regulatory and representation roles of the professional bodies should be separated

- a new regulatory framework is needed with two key overriding objectives:

  - to ensure that the profession is legally required to act in the public interest (primarily to provide a counterbalance to the explicit duty directors have to shareholders under company law); and

  - ensuring the quality of the science and the market practitioners. This would include professional competence and standards for actuaries; overseeing standards and development of actuarial practices; monitoring, complaints and enforcement/ disciplinary responsibilities.

  - this would be best achieved through the establishment of a separate regulator akin to the General Medical Council. This would need to be underpinned by the appropriate governance, public representation, and disclosure provisions. We would be happy to discuss further with the review team our preferred model for this regulator.

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Background

In the two main areas where there has been major consumer detriment - the life insurance sector and the occupational pension fund sector (mainly defined benefit schemes) – with the exception of a few high profile cases it is difficult to argue that actuaries have been the ‘directing minds’ which deliberately caused or recklessly allowed financial scandals to develop.

The role of the auditors must also be questioned. As Lord Penrose pointed out in his report (Penrose 19.148) ‘*the auditor has been in some instances over reliant on the appointed actuary ……..* ’. In our estimation, these major failures have occurred as a result of a combination of governance, regulatory and professional shortcomings. Reforming the actuarial profession will go some way to addressing some of the root causes of detriment but we are convinced that wider reforms are needed to ensure that actuaries are not put in the same position in future where the profession and its practices are exploited by vested interests.

What is corporate governance?

There are many theories and definitions of corporate governance which have appeared in various reviews. For example, Cadbury describes governance as ‘the system by which companies are directed and controlled’. Most of the reviews relate mainly to the governance of a firm from a shareholders perspective and are reflected in the Combined Code on Corporate Governance published by the Financial Reporting Council which is annexed to the FSA’s listing rules.

However, we use a more fundamental approach which describes and sets out the purpose of governance, integrity and accountability and business ethics from the *consumer’s* perspective.

Governance, integrity, accountability and ethics:

- identifies sources of power and influence within firms, which offices and officers have the power to make decisions which affect consumers and

- ensures there are structures and checks and balances in place to ensure that the consumer interest is represented properly in business planning and decision-making particularly when directors have a legal duty to other more powerful and influential stakeholders such as shareholders

- consumers needs are properly understood

- directors have an incentive to treat customers fairly

- conflicts of interests are identified and resolved fairly and transparently (where necessary separating duties and responsibilities to ensure transparency and accountability)

- those in positions of power do not exploit those positions either individually or collectively, deliberately or inadvertently

- when checks and balances don’t exist, ethical standards are in place to ensure that directors and other company officers act with integrity and do not exploit absence of controls

- those in positions of power (and those they represent such as shareholders) are held responsible and accountable when abuse of control or position does occur

It is important to emphasise that opacity in and of itself does not cause corporate governance failings – it simply exacerbates poor corporate governance. It follows that relying on greater transparency alone will have limited impact in enforcing high standards of corporate governance in complex sectors where consumer influence and competition is very weak, and is unlikely to require firms to treat customers fairly. However, greater transparency if properly deployed could be a useful spur to reform.

The life insurance sector

The life insurance sector is a prime example of how the actuarial profession was exploited by firms. The sector is characterised by major governance flaws. It is interesting to look at the structure of the life sector. Details can be found in Profits at the Consumer's Expense[1] and our responses to the FSA's with profits reviews. But briefly the structure can be summarised as follows:

- when consumers invest with a life firm the legal ownership of the assets resides with the firm not with the consumer, This in contrast with, say, unit trusts where consumers' assets are ring fenced and administered by custodians, or pension schemes which have trustees to look after scheme members interests

- consumers have a contract with the firm which undertakes to provide certain benefits. This coupled with the discretion afforded to directors to manipulate returns and bonuses puts policyholders in a vulnerable position

- directors have an explicit legal duty to maximise shareholders returns under UK company law with no corresponding duty to policyholders except a regulatory requirement to 'treat customers fairly' – although in practice directors have significant discretion to define and interpret what this means and monitor whether this requirement is met.

This structure means that actuaries working within firms must find it difficult to challenge directors on the running of the business. We believe that actuaries have been under pressure within firms to use unrealistic projected returns for marketing purposes and so on. Overall, the corporate governance structure provides very little opportunity for actuaries to act as a restraining influence on directors.

We are of the view that unless these fundamental governance and structural flaws are addressed then reforming the profession per se will have limited impact. Indeed, the FSA's review means that even more power and influence is being placed in the hands of directors so further weakening the position of actuaries to exercise a restraining influence.

Occupational pension fund sector

[1] Profits at the Consumer's Expense, Consumers' Association, 2001

Similarly, we are of the view that actuaries operating in the occupational pension fund sector face similar pressures to produce results which suit powerful vested interests. The investment system encourages actuaries to satisfy these interests.

One of the key criticisms levied at actuaries in the sector is that they have encouraged overly aggressive or optimistic assets allocations (biased towards equities) which has contributed to pension fund deficits. The bias towards equities allowed employers to justify lower contributions which left funds exposed when the investment climate took a dramatic turn for the worse (ie. the fall in stockmarket values and reduction in expectations for investment and bond returns). The investment markets reward firms which make high profits and clearly it is in firms/ director's interests to minimise pension costs which feed through to the bottom line. Even with the trustee structure, employers exercise major influence on actuaries (larger schemes have 1/3rd member nominated trustees).

Historically, there has been little incentive for actuarial firms to be conservative in the assumptions as this would have pushed up pension costs for employers. Firms which attracted a reputation for conservatism would have suffered in business terms. Peer group pressure or the herd instinct must not be underestimated in the actuarial sector. In the UK pension fund sector we had a situation where the herd instinct of fund managers was exacerbated by the instinct to conform within the actuarial sector as well.

In addition, the consolidation in the investment consultancy sector may have played a role as well. The concentration of market share in the hands of such a small number of major players must encourage conformity of behaviour.

Furthermore, this tendency to conformity we think has been compounded further by the dual role played the professional bodies ie. the regulatory and representative role.

Finally, the lack of training and expertise of pension fund trustees contributed to the problem as few were in a position to challenge the 'experts'.

Overall, the dynamics of the investment market and ineffective regulation created a dangerous cocktail. Clearly, actuaries played a major role in allowing these problems to develop but the wider environment must be factored in.

Hopefully, some of these pressures may be alleviated by recent reforms. Changing to the funding regimes for pension schemes, the creation of a new proactive regulator and improved training for trustees should provide some checks and balances if implemented properly. However, a sense of pragmatism is important. There are limits to the extent to which 'lay' trustees can be expected to challenge experts such as actuaries. So there is still a very real need for the profession to be reformed and to accept responsibility.

Actuarial 'science'

Actuarial science and practices are neither good nor bad in and of themselves. As with any other science or technical speciality the detriment or benefits derived depend on how it is applied and what checks and balances are in place so that those who use the science act in the public interest and are not compromised.

There are striking parallels with other consumer sectors. The key point is that actuaries are specialist professionals just like scientists or doctors. Consumers face the same issues with the role of professionals in the pharmaceutical industry, doctors in the health system or the role of scientists in the BSE scandal. There is a need to separate out the person from the science/ discipline to ensure that the science is good quality and is updated, and there are checks and balances in place so that the professional person uses those specialist skills in a way that benefits the consumer or public interest.

Reforming the profession

Despite the comments above, the profession should not escape criticism and is in need of reform. We take the view that the combined role played by the professional bodies must change to avoid compromise and to restore confidence in the profession. We think the dual role introduces conflicts of interest and makes it difficult for the profession to act objectively.

We would prefer to see a separation of duties. The question is how best to regulate the profession. There are three key issues to be addressed:

- the quality of actuaries and practices used by the profession. This relates to professional standards and ethics training and competence of the individuals; the quality of the science itself which should be subject to greater peer review and external scrutiny by investment and legal specialists

- how that science and advice is used and regulated. This requires new forms of governance and checks and balances to ensure that actuaries and their advice and recommendations are not subject to manipulation and undue influence by vested interests[2].

- finally, if we are to see real transparency in the life insurance markets we need a reform of the protections given to commercial information under Section 348 of FSMA 2000. This statutory prohibition is unnecessarily protective of commercial interests given that the FOI Act due to take effect in 2005 already protects commercial interests but with a public interest override. FSMA 2000 undermines corporate and regulatory accountability. We suggest that section 348 of FSMA 2000 be referred to the Department for Constitutional Affairs to be amended or repealed to allow the intention behind the FOI Act to take force. As the saying goes, ‘sunlight is the best disinfectant’.

There are two possible models for regulation. The separate groups of professionals ie. scheme actuaries and life insurance actuaries could be regulated by their respective regulator – namely the new pensions regulator which will replace OPRA and the FSA.

Alternatively, a single separate regulator akin to the General Medical Council could be established. On balance we prefer the single regulator approach which could continue to work with the profession on standards and competence.

[2] The irony is that CA believes there is a case for a stronger role for actuaries within life funds for example rather than a weaker role which results from the FSA’s with profits review. We argue that they should be given greater independence and legal protection to act in the interests of policyholders rather than their position being compromised by directors of firms who have an explicit legal duty to maximise shareholders returns.

This would need to be underpinned by the appropriate governance, public representation, and disclosure provisions. We would be happy to discuss further with the review team our preferred model for this regulator.

RESPONSE TO SPECIFIC QUESTIONS

1 The role of actuaries, the profession and the actuarial services market

Q1.1

Actuaries play a hugely important role from the consumer perspective particularly in the life insurance and occupational pensions sector. It is a specialist and necessary function particularly when identifying assets and liabilities.

Actuarial science is not an exact science – it deals to all intents and purposes with the future which by definition is difficult to predict. Actuaries are subject to the same weaknesses and pressures that other specialists are – eg. food scientists, doctors etc.

However, as mentioned above the main weaknesses stem from wider systemic and governance flaws. We are of the view that unless there are wider governance reforms particularly to the life insurance industry then we will face the same problems. This is not to say that the profession should escape reform.

We are not in a position to comment on whether the training and qualifications for actuaries are sufficient to ensure they are equipped for the roles they perform. The level of technical knowledge required is outside our competency. However, again the main issue is to ensure there are suitable structures and processes in place to ensure that:

- actuaries are qualified to fulfil those roles
- importantly, safeguards in place to ensure actuaries are not subject to undue influence and act in the public interest and
- sufficient peer group review by actuaries and other market practitioners to ensure the 'science' and practices evolves to cope with a changing environment.

Q1.2

We have no real comment on this question except to say that we believe there could be more collaboration between market specialists. Clearly, it must be possible for auditors to challenge actuarial conventions used in the calculation and presentation of financial data. In practice, most large firms within occupational pension fund sector will employ and use investment specialists for advising on investment strategy.

Q1.3

We certainly believe there are roles which must be reserved for professionals who have demonstrable competencies in those specialist technical skills and knowledge which make up the actuary's job. Whether this needs a particular type of person called an actuary is perhaps not the main point. Actuarial science involves understanding a number of disciplines and actuaries must

consult more widely with experts in these disciplines. But the actuarial discipline is a distinct enough speciality to require a specialist who is trained in actuarial science.

We also think that these roles are important enough to be reserved for specialists who have this particular degree of expertise – in particular within insurance markets and the occupational pension fund sector.

Q1.4

It is not clear whether the existence of the reserved role per se has affected relationships between actuaries and non-actuaries. Again, we think this is more to do with the wider regulatory, legal and governance structures which put the role of actuary in such an influential position and paradoxically in such a vulnerable position open to manipulation by vested interests.

Q1.5-1.6

Yes, we do think there is a need to introduce greater peer review and external scrutiny. We do not think that this perceived problem associated with the reserved role would be best dealt with by downgrading the role of actuary. Rather this would be best dealt with by improving the checks and balances surrounding the reserved role.

Accountability of actuaries

Q1.7

As mentioned above, actuaries should accept a share of responsibility for the litany of misselling scandals which has left a legacy of mistrust in the financial system. But to reiterate, our firm view is that the main cause of the financial scandals such as misselling and poor value products (which were designed to suit firms' commercial models rather than consumers' needs) was the almost complete lack of a corporate governance and ethical framework. This ensured that when conflicts of interest arose actuaries naturally sought to satisfy those in positions of power and influence – namely directors of firms (and their shareholders) and employers.

Actuarial science is an important discipline but like any other science or technology it can be used for good or bad. Like any other science or technology it is also used by human beings who are subject to influence. This is compounded by a professional arrogance which again is not unique to the actuarial profession.

The challenge now is to learn the lessons of the past and ensure that the science is 'good' as it possibly can be and that the specialists who use it deploy this in the proper interests. In this case, we would argue that actuaries must be given a clear duty to act in the consumer or public interest or at the very least ensure that the consumer/ public interest is given the same consideration as other powerful interests such as shareholders or employers.

Q1.8- 1.9

Not surprisingly, perhaps, we take the view that actuaries are not accountable for their actions. Rather, to be more precise, the wider governance framework means that those 'directing minds' which use the services of actuaries are not accountable for how they use actuarial services.

We do think actuaries should accountable to the wider public interest and be required to protect consumers/ members interests as well as maintain stability. Perhaps there is a case for a ‘Hippocratic oath’ for actuaries to represent this duty to act in the public interest.

Some may argue that FSMA 2000 and pensions regulation means that directors are supposed to take consumer interests into account. We do not agree with this argument. The legal duty to shareholders overrides this regulatory duty to treat customers fairly given that directors retain significant discretion to interpret how this applies. If anything we would have preferred the role of actuaries to be strengthened and for them to be given a specific duty to represent policyholders’ interests within a life fund. Instead directors are being given an even more powerful role.

Specifically, we think pension fund actuaries should have a duty to pension scheme/ scheme trustees although we have reserved judgment on whether schemes/ trustees and employers should be required to use different actuaries until we see further analysis of costs.

In relation to life funds, we have argued previously that actuaries should be given the responsibility for ensuring fairness:

- between different classes of policy holder,
- between generations of policyholder and
- most importantly between policyhdolders generally and the board/ PLC.

Effectively, this would mean that life funds would be run as mutual funds within the wider corporate entity closer to the model used by unit trusts. The idea would be that the firm would receive an explicit commercial fee for managing the assets in the life fund and for marketing and other activities but the allocation of benefits would be the domain of the actuary.

Q1.10

Again, we think that the liability incurred by actuaries should be paid for the employer for whom the actuary is acting eg. the life firm or the actuarial firm providing services to an occupational pension scheme.

The profession

Q1.11-1.14

From experience the industry has increased efforts to engage with Consumers’ Association, and should be given credit for that.

The key problem is the dual role of regulator and representational role. We take the view that the public interest would be best served by removing the regulatory role from the professional bodies (similar to GMC and BMA relationship).

In the short term, the governance structure would certainly benefit from greater lay input into the key decision making bodies. It is a specialist subject area - and some may question the added value of lay members in such a professional arena - but this is an argument which has been used

by professionals in other sectors to maintain exclusivity. Lay members can add a different perspective and value - particularly if provided with suitable technical support.

Entry into the profession

Q1.15 – 1.21

We have no comments on these questions.

The market for actuarial services

Q1.22

It is difficult to say with certainty what the main drivers have been for actuarial services or indeed how demand has changed. However, regulatory and legal developments along with the reorganisation of many major occupational schemes must have played a significant part in the development of the market.

For example, trustees of pension schemes face a considerable change to their responsibilities as a result of changes to pensions legislation. Clearly, they must rely on the expert knowledge of the actuarial profession to comply with duties under regulation and legislation. This is not a criticism of increased regulation of pension schemes merely a reflection of how the demands placed on trustees have changed.

Q1.23

It all depends on how the ‘consumer’ is defined. As the review suggests there would appear to be a great many providers of actuarial services in the UK. However, just because there are numerous providers or individual actuaries operating in the market does not automatically mean that the market is functioning in the consumer or public interest.

Looking at the life insurance market for example, we would argue that the actuarial profession does not serve the end-consumer ie. the policyholder, because of the legal and governance structure of the sector. The main theme of our response is that the office and profession of the actuary has been in effect ‘corrupted’ to some degree in the service of producer/ supplier interests (pensions misselling, mortgage endowments, product design etc).

Similarly, there are concerns that actuarial advice has been used to serve the interests of employers whether inadvertently or complicity seeking to cut pensions costs exposing scheme members to risks.

Therefore, we would argue that the actuarial market is indeed constrained, not in terms of classical competition models eg. limited supply etc but because of the wider governance and systemic flaws.

There are some specific areas of concern. As mentioned in the review document there is significant concentration in the investment consultancy market where four consultancies account for 2/3rds of the market in 1999. Interestingly, this does not appear to have led to high margins as might normally be expected in a market with such a degree of concentration. Rather the concern

is more to do with the potential concentration of risk in the sense that the consumers of actuarial services are playing safe by choosing one of the big four.

This can have adverse effects if it leads to the big four and their clients following the same strategies and those strategies turn out subsequently to have been ill-judged. This concentration would have been caused to a large degree by mergers and acquisitions but we suspect that a key driver has been the inability of consumers of services (pension schemes and trustees) to evaluate the 'quality' of strategic advice provided by actuaries hence leading to an understandable human desire to play safe.

Consumers' Association encountered a very specific example of market constraint during the Axa case. Axa decided to undergo a reattribution of the inherited estate within its life fund. CA found it extremely difficult to find an actuarial firm to work on our behalf. It was made clear to us that firms would not risk upsetting the life industry as it would be 'biting the hand that feeds it.'

Again, this situation is likely to happen again without wider reform of the legal and governance structures of life funds. The actuarial firms as with any other commercial entity understandably will seek to satisfy its paymasters (directors who represent the producer/ shareholder interest). This means that, when a conflict of interest arises between producer/ shareholder and consumer interests (policyholders), it must be wise to assume that the actuarial profession will be deployed in the service of producer/ shareholder interests.

Q1.24-1.25

It is not particularly easy for consumers such as pension schemes/ trustees to switch service provider for a number of reasons. One of the key reasons is to do with the sheer complexity and volume of information relating to scheme operations. Understandably, scheme trustees and administrators build up a relationship with the scheme actuaries. Switching provider is not a task to be undertaken lightly given the amount of familiarisation required and the possibility of upheaval given that new providers may want to change the way things have been done with all the associated costs. Switching providers requires the involvement of the trustees and given that most schemes trustees meet infrequently this is not an easy option.

This barrier to switching is likely to a permanent feature of the market unless significant improvements are made to scheme administration generally through real pensions simplification. A major source of administrative complexity is the ridiculous fragmentation of the UK pension system. Radical simplification of the pension system plus developments in technology may alleviate this particular problem.

The other major barriers to switching relate to 'consumer' confidence in and capacity for comparing actuaries. This is an oversimplification of course, but actuaries should be judged on quality of service (communication and administration skills etc), fees, and quality of advice. Clearly, trustees are able to judge for themselves whether they are satisfied with service quality, and are able to compare fees. However, comparing quality of advice is rather a different matter. Trustees for the most part are not experts in the key areas actuaries specialise in – calculating liabilities etc and investment consultancy (asset allocation and fund manager selection).

This could be addressed by improved trustee training so that trustees are better able to judge quality of advice. However, there is a more fundamental question of how far should trustees be expected to become experts in their own right. It is unlikely they would ever be capable of

becoming experts to such a degree that they could challenge confidently advice on liability modelling for example – after all what are they paying actuaries for?

There is undoubtedly an informational gap and a confidence gap. This gap is unlikely to be closed completely. This does cause problems in the sense that there is a tendency to play safe by choosing the biggest providers (the IBM syndrome). This has potentially significant risks if this conformity leads to concentration of risk eg. if the advice of the major players turns out to be detrimental.

Also, concentration in the hands of a small number of providers can lead to undue influence in the market. Others follow the market leader as we have seen with the increasing involvement of actuaries in strategic and tactical asset allocation decisions.

However, there are a number of measures which could be introduced which could help consumers. The first relates to performance measurement. There is a huge performance management industry grown up around pension funds. Fund managers are scrutinised in minute detail on performance. We think more could be done to scrutinise the performance of actuaries in relation to their investment consultancy services for example. It is difficult to see how actuaries' advice on liability modelling could be rated objectively. However, we believe the standard of their investment consultancy services could well be. For example, actuaries advise on asset allocation and fund manager selection. There is no reason why actuaries' advice could not be rated so that consumers can judge the quality and skills of different firms.

Another effective method for improving the market would be for actuarial firms to move towards a performance related fee basis for asset allocation and fund manager selection advice. Institutional fund managers are accustomed to the idea of working on a performance related basis particularly given the rise of passive management techniques.

The involvement of actuaries in the asset allocation and fund management selection markets can lead to a double layer of charges for pension schemes – once the actuaries set the broad parameters for asset allocation to match liability profile it is not clear what value actuaries add in terms of detailed asset allocation. Given that the available evidence suggests that past performance is no guide to future performance and low cost passive management techniques are available for asset allocation (through consensus funds) and stock selection (through index tracker funds) the involvement of actuaries in asset allocation adds to overall pension funding costs unless their advice leads to better performance against the market consensus.

We think actuarial firms have exploited consumer ignorance and low levels of confidence in these markets to create a need for investment consultancy advice creating two layers of specialists advising on asset allocation and fund management – actuaries and fund managers themselves.

Clearly, one of the best ways to align the interests of actuarial firms and consumers would be for actuaries to work on a performance related basis where fees were levied according to the success or failure of actuaries' recommendations against benchmarks such as index tracker funds or consensus asset allocation funds. However, this is unlikely to happen unless the bigger consumers in the market ie. the biggest pension schemes adopt this strategy.

Q1.26-1.27

We have no comments on these questions.

Q1.28

We think there are two different questions here. Firstly, does the actuarial services function in the consumer interest and, secondly, what degree of competition is there in the market?

We make a distinction here because often there is an assumption that if the indicators of competition exist (choice of supplier, informed consumers, sufficient information etc) then the market must function in the consumer or public interest. As in so many cases relating to the financial services industry, this is not necessarily the case. It is not enough to assume that if the conditions for competition are created then the benefits of that competition will feed through to serve the consumer/ public interest.

It of course depends how the ‘consumer’ is defined. In this case the immediate consumer of services is the employer or the life insurance firm, not the employee or policyholder. And it could be argued that the actuarial market has served the immediate consumer very well indeed. The problem is of course that the immediate consumer was not always acting the interest of the end consumer (policyholder/ employee).

There are some specific competition concerns relating to the concentration of suppliers in the investment consultancy market which could be addressed by some of the suggestions we make above in Q1.24-1.25.

It is not clear that the existing professional rules or conventions act as barriers to entry. We do not believe that reducing barriers to entry or introducing other measures which would encourage competition will necessarily result in the profession serving the consumer/ public interest. The bigger challenge is to ensure that the profession takes sufficient account of the end-users (employees/ policyholders) by reforming the wider environment actuaries operate within.

Q1.29

We have no comment on this question.

International comparisons

Q1.30 – 1.33

We do not have access to information to comment on these questions except to say that there are obvious benefits to learning from experiences in other countries.

Other professions

Q1.34

We agree the review can learn lessons from developments in the accountancy profession. We support the carving out of the regulatory role of the actuarial professional bodies. There are two possible approaches:

- a dedicated regulator similar to the Financial Reporting Council (FRC) or the GMC. A single regulator would be responsible for standards, compliance with regulatory

requirements and other statutory eg. FSMA 2000, qualifications in conjunction with Institute and Faculty, complaints and discipline, ethics etc, or

- regulated separately according to different functions ie. pensions and scheme actuaries regulated by the new pensions regulator, with life insurance actuaries regulated by FSA.

On balance, we prefer a dedicated single regulator. This allows for transferability and would not prevent actuaries working in life insurance having to meet FSA requirements if undertaking a controlled function.

Q1.35

We have no comment on this question.

Law

Q1.36-1.37

Perhaps the most appropriate model is that of the General Medical Council and the British Medical Association. The GMC has a clear remit to oversee professional and ethical standards within the medical profession. This is not to say that the GMC is a perfect model as we have some concerns about the GMC in relation to governance, representation and funding mechanisms. However, in principle this model could be appropriate for the actuarial profession allowing the Institute and Faculty to continue with their representation roles similar to the BMA.

2 THE CURRENT REGULATORY FRAMEWORK OF THE REGULATORY PROFESSION

Q2.1

We think the regulatory framework should have two key overriding objectives:

- to ensure that the profession and practitioners are legally required to act in the public interest (primarily to provide a counterbalance to the explicit duty directors have to shareholders under company law); and

- ensuring the quality of the science and the market practitioners. This would include

    - professional competence and standards for actuaries

    - overseeing standards and development of actuarial practices

    - monitoring, complaints and enforcement/ disciplinary responsibilities.

As mentioned, we think this would be best achieved through the establishment of a separate regulator akin to the GMC. This would need to be underpinned by the appropriate governance, public representation, and disclosure provisions. We would be happy to discuss further with the review team our preferred model for this regulator.

Q2.2-2.4

We do not think the existing regulatory regime serves the public or consumer interest. It is difficult for the professional bodies to act as representatives and regulators of the profession. There is nothing wrong per se in self regulation – indeed self regulation can be an efficient and responsive mechanism for ensuring standards and good practice.

However, the central role of actuaries in various scandals calls in to question this self regulation of such an important profession. This dual role goes against the very principle of good governance which takes on a greater significance in light of the lack of governance and particular dynamics in the markets actuaries operate in – namely life insurance and pension funds.

We have no problems with it being a reserved function and indeed would argue that such key positions should be the reserve of professionals with the specialist expertise actuaries have. The problem is that as we explain above is that the office of actuary and actuarial science is exploited by vested interests to the detriment of consumers.

Q2.5 2.6

No. We are of the view that the FSA's proposals risk institutionalising even further the corporate governance flaws within life insurance companies. There is of course an advantage to preventing the actuarial function holder and with profits actuary from acting as chairman or chief executive. Separating key functions and offices is an important part of good corporate governance. But this is not enough in itself. Good governance as we define it involves identifying where decisions are made and recognising and dealing with conflicts of interests those in positions of power face. The

FSA's proposals do not address the fundamental conflicts of interest faced by directors of life insurance firms.

As we say in the introduction, actuaries are not blameless but where detriment has been caused we would argue that this is because commercial imperative and pressure from directors has put pressure on actuaries to conform to the will of the directing minds in the life insurance firms.

The FSA would argue that the requirement of the WPA to publish a report assessing how the board/ firm has exercised discretion will introduce transparency and therefore improve corporate governance and accountability. But this will have little restraining effect in our view.

To begin with, it mistakes transparency for proper governance – which goes much deeper than transparency. Nor does it address the fundamental concern that without some public interest duty, legal protection, or wider governance reforms, actuaries within life firms are unlikely to question the decisions made by the directors. The pressure actuaries will face to conform will still remain as strong as ever.

Moreover, the FSA's reforms still allow substantial discretion in the way asset shares, surrender penalties, reattribution of inherited estates and so on are calculated (these are the issues which determine in practice whether consumers are being treated fairly or under the previous regime whether policyholders reasonable expectations were met).

More needs to be done. Wider governance reforms are needed. Indeed we are of the view that the FSA's reforms institutionalise conflicts of interest. More power will be vested in the hands of directors through this governing body and we think the potential for actuaries to represent the policyholders' interest will be compromised further by these reforms. Furthermore, the already weak provisions on discretion published in CP207 have since been relaxed even more in CP04/14 following fierce lobbying by the industry.

We think it is self-evident that actuaries will come under more pressure from the governing body and directors to make recommendations which suit the firm and its shareholders rather than policyholders. The aim should have been to balance the duties provided to shareholders with a clear duty and responsibility to policyholders. This is not achieved by FSA reforms which actually vest more responsibility in the hands of directors to interpret what treating customers fairly means.

We were of the view that structural reform of the sector was needed with:

- assets ring fenced within the firm and the actuary being responsible for mediating how different classes and generations of policyholders are treated (jn effect a mutual within a PLC entity) and

- actuaries provided with a public interest duty under a new regulatory structure

- an explicit commercial relationship set up between the fund and the corporate entity (as with unit trust structure) and a move away from the 90:10 arrangement to an explicit annual fee for services provided by the corporate entity

- greater policyholder representation on boards of life firms, plus greater resources provided for training lay directors

- tighter fettering of the discretion afforded to directors to manipulate returns[3]

- we are particularly concerned at the FSA's move towards a high level principles approach to regulation which delegates even more responsibility for directors to ensure consumers are being treated fairly. This obviously institutionalises conflicts of interest even further given that the same officers who have an explicit legal duty to maximise shareholders returns will have almost total discretion as to how consumers are being treated. This places a degree of trust and confidence in directors of life firms which frankly isn't warranted given the previous behaviour of firms and the lack of governance reform within life firms. We think at the very least the new regulator[4] should be charged with carrying out spot checks on firms to see if the WPA report is objective and written free of influence from directors.

- all of this needs to be underpinned by reforms to the protections given by section 348 of FSMA 2000 which allows information relating to commercial interests to be withheld.

Q2.7

The ability of non-executive directors to challenge experts in firms which sell complex products applies not just to life insurance firms – it applies to any firm which produces a complex product eg. pharmaceutical firms, engineering, biotechnology firms etc.

The issue is one of ensuring that the experts present the information in a transparent and unbiased fashion so that non-executives can exercise their responsibilities. Again, unless actuaries feel protected enough and/or feel obliged to under a legal or regulatory duty to present information fairly and objectively this is unlikely to happen. Even then, given that directors/ governing body will have more authority to interpret what it means to treat customers fairly, we have little confidence that they will use this information objectively.

Q2.8

Yes, this should help – but see comments above on need for training and expert support for lay people.

Q2.9

Yes, we take the view that the scheme actuary should be reserved for actuaries. Or to be more precise, reserved for an individual who has the same technical skills and experiences as an actuary.

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[3] An example of how firms can manipulate returns and profits in life funds can be seen in the Money Management article attached, where an expert estimates that possibly £1billion a year is being transferred from surrender values to enhance maturity values to boost the marketing efforts of firms. Given that it is estimated that only a minority of regular premium policyholders maintain payments on long-term contracts for the full duration this exposes significant numbers of consumers to detriment.
[4] Not the FSA given that it would be preferable to have an external validator rather than the same regulator which is responsible for the high level principles approach to regulation

Actuarial science is a specialist enough function to warrant a separate role. In practice, many of the bigger firms will employ investment specialists to advise on specific investment issues.

Q2.10

It must be said that it is unlikely that most trustees would be able to challenge completely the advice of scheme actuaries given the specialist technical nature of the profession. Hopefully, some of these imbalances may be alleviated by recent reforms. Changing to the funding regimes for pension schemes, the creation of a new proactive regulator, better information disclosure and improved training for trustees should provide some checks and balances if implemented properly. However, a sense of pragmatism is important. There are limits to the extent to which 'lay' trustees can be expected to challenge experts such as actuaries. So there is still a very real need for the profession to be reformed and to accept responsibility.

Again, the key issue is that corporate governance only works when those in possession of and understanding of the implications of technical information act in the consumer interest and do not face unmanageable conflicts of interest.

Q2.11-2.14

It is probably fair to conclude that there is insufficient peer group review or audit of Scheme Actuary's advice. Certainly, in terms of valuing scheme deficits more could be done in cooperation with auditors to ensure realistic valuations of liabilities are produced and appropriate funding mechanisms so that future shocks are avoided.

We agree with the view that the introduction of the scheme specific funding strategy for funding pension commitments and funding deficits does introduce potential conflicts of interest if the same Scheme Actuary is advising the scheme and the employer. The MFR may not have been that effective as a measure for valuing liabilities and deficit funding requirements, but it did have the advantage of introducing a standard which meant the valuation was to a degree mechanical - which removes some potential for conflict of interest.

We are in a difficult position in relation to separation of duties. In principle, we strongly support the separation of duties as having the same actuary acting for both parties under a more 'discretionary' regime goes against the very fundamentals of good governance. Indeed, it would need to ensure that actuaries were from different firms not just different actuaries from within the same firm.

However, we add a caveat to this. We are concerned that this could add significantly to scheme costs and would be reluctant to support anything that might jeopardise employer sponsored final salary schemes unnecessarily. It may well be that this might not require an increase in costs if actuarial costs were absorbed within the audit function. But we are not able to say definitively where we stand until we further detailed cost/benefit analysis of separation of duties is produced.

It would seem fair to assume that actuarial advice has contributed to the way occupational schemes are funded. However, to reiterate, we take the view that while the profession must share in the blame, the greater share of the problem must be attributed to wider system in which actuaries operated. Actuaries operating in the occupational pension fund sector have faced pressures to produce results which suit powerful vested interests. We share the view that the changes to pensions legislation particularly the scheme specific funding requirement will increase

the power and influence of the scheme actuary and heighten concerns about governance and accountability.

Q2.15 – 2.19

No comment.

Q2.20 – 2.23

We are not in a position to say whether there is the right balance between the Profession issuing practising certificates and regulators giving their approval. However, we do think that under a reformed regulatory regime the new regulator would play the central role in ensuring that standards were appropriate and actuaries complied with these standards. The profession could still play a key role in working with and advising the regulator on development of standards and qualifications.

Q2.24-2.26

Overall, we do not believe there are appropriate legal and professional duties and safeguards to protect the public interest (or indeed any actuary who seeks to act in the public interest). The publication of the WPA report is unlikely to lead to disclosure of contentious issues given the pressures on actuaries to write favourable reports on how directors are exercising discretion.

As the review document mentions, the FSA has received ten ‘whistleblowing’ reports yet given the difficulties associated with disclosing the contents of these reports it will be difficult to establish whether the FSA has responded properly.

Major reform is needed including:

- a public interest duty for actuaries (including a form of ‘Hippocratic Oath’ for actuaries),
- more transparent and effective approach to enforcement and disclosure on the part of the FSA,
- governance reforms in the life sector,
- crucially, amending of the statutory prohibitions on disclosure of regulatory information in FSMA 2000

Further details can be found in our response to Q2.5 and 2.6.

Q2.27-2.32

We agree with Lord Penrose’s view that professional guidance did not protect policyholders’ interests. However, we do not think it is appropriate to lay the entire blame for poor standards or inconsistent standards on the actuarial profession. After all, the avoidance of a general rule or practice on reasonable expectations suited very well the interests of the life insurance firms who were able to use the substantial discretion available to manipulate returns to the detriment of vulnerable policyholders.

This reinforces the argument for an independent standards setting regulator accompanied by meaningful regulatory intervention in the form of fettering the discretion available to directors to manipulate returns. The impact of the FSA's approach to reforming with profits invests more power and authority in the hands of directors and retains a significant element of discretion on asset shares and issues such as inherited estates.

In terms of governance this is not appropriate as actuaries in life firms will still come under huge influence to put a seal of approval on directors' decisions. The existence of a public interest duty (plus an independent regulator that sets standards which must be complied with) would provide a very strong defence for actuaries to resist pressure.

Q2.33–2.37

We agree with the view that the lack of transparency and openness of the life industry (including the actuarial profession) has contributed significantly to consumer detriment. The language used by the industry compounded this opacity. Certainly, more could be done to make the terminology employed by the life industry more user friendly.

We stress that greater transparency, while welcome, will not in and of itself lead to meaningful corporate governance or improvements in the quality of with profits products. There is little evidence to suggest that information solutions have significant impact on making complex markets such as life and pensions work in the consumer interest[5].

It is unlikely that the WPA report or the PPFM will act as a restraint on corporate behaviour unless these transparency measures are accompanied by governance reform. We find it highly unlikely that WPA employed by a life firm will feel emboldened to challenge a firm's exercise of discretion. Moreover, the FSA's approach still allows firms significant discretion in relation to treating customers fairly. In most cases it will not be too difficult for the WPA to report in all good faith to policyholders that firms are complying with their obligations. To reiterate, the FSA's approach is largely a regime where firms:

- are able to define what treating customers fairly means,
- interpret compliance with those self-defined standards, and
- report on compliance with those standards.

It is difficult to think of a model which is so at odds with the very principles and practices of good corporate governance and accountability.

However, it is fair to say that the reviewing actuary should provide better scrutiny of liabilities and other prudential issues, which is to be welcomed.

Similar criticisms of governance in the occupational pensions sector could be made – but not to the same degree as the life insurance sector.

[5] for example, disclosure of charges and commission for the life and pensions sector was introduced in 1995 yet this had little downward pressure on prices until the arrival of stakeholder pensions.

We are of the view that as a general principle actuarial opinions should be addressed directly to policyholders and scheme members. It is not clear under what circumstances opinions should not be communicated to policyholders/ scheme members. There is the issue of legibility but that needs to be addressed. At least with scheme members, trustees can play a role in ensuring the information is clear, transparent and meaningful. Unfortunately, no such intermediating body exists within the structure of a life firm.

In terms of widening the scope of peer review and scrutiny there are a number of major issues which need to be addressed. In particular, we would mention the issue of genetic information and insurance (particularly the effect on the underwriting process) and a more general review of the insurance business to evaluate whether firms are being too backward looking when calculating risk premiums.

Q2.38 – 2.43

It is genuinely difficult to say whether the record of 17 complaints over 15 years is sign of success or failure. On the face of it, it would seem to us that given the amount of consumer detriment and market failure in the life sector alone these figures would suggest that few people are being held accountable – an average of just over 1 a year when set against the sheer scale of detriment[6] is rather a contrast.

However, the theme of our response is that the firms/ directors who have been primarily responsible for the detriment and who should be held accountable, not the actuaries. We are not aware of any examples where directors of major life firms were forced to resign as a direct result of a misselling scandal.

Having said that, we couldn't agree more with Lord Penrose that a more direct intervention approach where it was thought the administration of life funds was likely to threaten the legitimate interests of policyholders would improve the image of the profession. More to the point, this would be an effective way of protecting the public interest.

The question is: how best to achieve this proactive interventionist approach? We are of the view that this should be achieved by carving out the regulatory functions into a separate regulator who would be responsible for setting, monitoring, and enforcing ethical and professional standards and discipline. Again, the crucial point is that unless actuaries have a public interest duty to counter the duty directors have to shareholders to improve governance in firms - set within a robust regulatory framework - the key objectives of raising standards and protecting the public interest are unlikely to be met.

In terms of funding the regulator, a number of options could be used including levy on firms or professional fees paid by individual actuaries. It is difficult to say what the best option would be without further cost/benefit analysis.

We are not in a position to say with certainty whether regulators make appropriate use of actuarial expertise. There has always been a concern that regulators cannot match the resources or do not have access to the same expertise available in the private sector.

[6] we estimate that the total consumer detriment attributable to the life sector alone in the form of pensions, endowment and other misselling, poor value products and unfair treatment of inherited estates/ orphan assets amounts to some £30 billion over the past two decades.

3 ROLES AND RESPONSIBILITIES OF THE GOVERNMENT ACTUARY'S DEPARTMENT

Q3.1–3.8

Many of the activities of GAD which concern us have been transferred to the FSA. However, we still see a case for a separate entity to provide truly independent and objective advice to government on social security and pensions matters. Indeed, CA is lobbying for the creation of a new institution which would fulfil a similar function to the Monetary Policy Committee plays in economic policy. We are concerned that there is too much political interference and at the same time neglect of pensions, social security, health and long-term issues.

Future generations of workers do not have a real say in determining policies today. So any reforms must consider the interest not only of today's generations of consumers, but future generations, too, as they will be faced with the responsibility of picking up the bill as a result of demographic pressures. Pensions cannot be considered in isolation, as they are part of a complex web of issues which determine an individual citizen's quality-of-life and living standards in retirement – including access to affordable health care, access to work, the housing market and debt. This complex interaction means that pensions cannot be considered a pure consumer issue: it is a public policy issue, meaning that the market cannot determine and deliver a solution in isolation.

However, the UK lacks a coherent, integrated public policy framework to meet the demographic challenge. New institutions and policies are needed to introduce accountability in government, employers, industry and consumers. Pension and other public policy needs to be shielded from short-term political influence – both today and in the future. Today's generations of consumers need to be held accountable for the intergenerational transfer of risk that will loaded onto future generations if they don't provide for the future. As the elderly constitute an ever increasing share of the UK population, it seems unavoidable that public policy questions will increasingly coalesce around age related issues. Politicians must think outside the four to five year election cycle and instigate reforms aimed at delivering long-term sustainability, or else we face major social tension in the UK.

To deliver this long-term vision, a new independent Financial Futures Commission[7] should be established. This would combine the skills and expertise of the DWP, Treasury, GAD and others to oversee the formulation and implementation of public policy and prevent short-term political decisions interfering unduly with what are long term public policy challenges.

It is not possible to remove the politics from pensions entirely – after all what constitutes a fair and decent pension or amount of public spending committed to health care is a matter for society through its elected representatives to decide. However, it is possible to introduce greater political accountability and scrutiny into public policy.

This marks the end of Consumers' Association submission.

Consumers' Association
September 2004

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[7] This is just a working title to reflect the purpose of this proposed body