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Dear Sir Derek

## **Interim Assessment - Our Response**

We are writing to set out our comments on your Interim Assessment, (the Assessment). You have covered a great deal of ground in this Assessment and invited comments on the various options identified. Three main themes run through our response:

### **1 Responsibilities and conflicts**

We believe that there needs to be greater clarity about:

- (i) Where responsibility for decision making in an insurer or a pension fund lies, or should lie,
- (ii) The role of any actuary in that decision making process and
- (iii) To whom the actuary is accountable for his actions and opinions.

We believe that it is important that these accountabilities are clarified in order to inform decisions about the need for reserved roles, independent assessments and the reasonableness of proposals for liability capping. Further this clarity of accountability and its consequences will better enable an assessment of any conflicts of interests that arise from the present structure of the profession. We illustrate this below.

## *Conflicting loyalties*

The governing body ultimately is responsible for the decision making. The level of reserves and their funding is complex and the members of the governing body should be appropriately skilled to make those judgments. If not actuaries themselves, they should be sufficiently financially and mathematically literate to understand the actuarial advice received and to act upon it.

By way of example, in a corporate insurer the responsibilities of the Board of Directors (the governing body) are to the Company (and its members), rather than its creditors in recognition of the inherent conflict of interests that would arise between those of creditors and members (in any situation where it matters).

In our view, since the board is a collective decision making body, the responsibilities of an actuary who is also a director, should be no wider than any other director. It follows that the accountability of an employee actuary who is also an actuarial office holder should be no wider than that of any (other) board member (including any that are also qualified actuaries).

The analysis of accountabilities contained in Chapter 5 of the report contemplates the accountability of employees extending beyond their employer, attributing to them accountability to policy holders in their capacity both as With Profits Actuaries (“WPA”) and indirectly to Actuarial Function Heads (“AFH”). The report goes further to suggest that all actuaries can have “indirect liability” to consumers.

In our view, this dual loyalty places employee actuaries in an invidious position of irreconcilable conflict and is entirely inappropriate. If it is the case that the public interest requires someone to protect the interests of creditors (i.e. policy holders) then that assessment should be conducted independently, e.g. by external actuaries. This independence would be vital if policyholders’ interests are to be served. We return to this concept below.

## *Accountabilities*

The review identifies several potential components or consequences of “accountability” at page 81. It is not clear whether these accountabilities are intended to establish legal liabilities beyond those already established in law. However, now that the Interim Assessment has raised the issue of accountability it seems to us that the final report will need to deal, in each case, both with to whom accountability lies and to whom liability can be expected as a consequence.

There are similar blurred accountabilities responsibilities and conflicts already inherent in the structure of other parts of the profession, for example as implicit in your questions in the pensions arena which we return to below. We also analyse further the present and suggested accountabilities of the WPA.

## 2 Structure and oversight of the Profession

We agree that a framework oversight of the profession including a system of monitoring and review of quality of advice needs to be established. However, the task involved is significant. Assuming that there is to be a requirement for peer review supported by a disciplinary process, then a framework of professional standards needs to be established by which the quality of an actuary's work can be judged. This will require objective Standards to be set including methods by which reserves should be calculated. There will also need to be Standards which set out the:

- (i) Extent of verification expected to support the actuarial calculations,
- (ii) Standard of evidence expected to support an independent review and
- (iii) Quality monitoring systems which would be expected to be established by a practising firm of consulting actuaries (including arrangements for periodic peer review of the quality of individual actuaries' work).

That profession needs to be overseen by a body with some independence from the Profession itself. Ideally, this mechanism would be consistent with that currently proposed by the Profession

## 3 Monitoring the quality of actuarial advice - peer review

There is a public interest in maintaining the quality of independent practising actuaries. We believe that the judgements involved in actuarial work are such that in most cases a proper peer review of an actuary's work will be an essential feature. Through the development of professional Standards, practising firms should be required to establish internal peer review of particular work products and reports. (Smaller firms or sole practitioners may need to establish reciprocal arrangements with other firms).

However, the scope and objectives of peer review will differ depending on the circumstances. For example, we expect that there will be different expectations of actuaries in consulting practice and those in employment.

As regards the quality assurance of the work of actuaries in employment (as opposed to in practice), it is the employing organisation that must determine what level of oversight and review it expects of its employees' work. Where there is a public interest e.g. in an insurer's reserving, the monitoring regime should mandate an independent external review (as has been established in the life industry in the position of the Reviewing Actuary and in our view is necessary for the With Profits Actuary).

We also believe it essential that the Profession's own disciplinary scheme is seen as credible. Therefore, in addition to Standard setting and education, we believe an oversight, monitoring and inspections process may be required to support the overall framework.

In summary, we envisage a regime of independent oversight, including independent external review of the reserving calculations prepared by an insurer combined with a monitoring regime over the quality of those independent actuaries' work.

We expand on these general principles in our responses below to the Options on which you invited a Comment. However, we are conscious that the Profession comprises only around 4,000 qualified actuaries many of which are not or are no longer in practice. There is little prospect of such a small group of people funding the kind of framework that is under discussion. If the public interest is in establishing such a framework, then the wider insurance and pensions industry will need to be prepared to fund it.

## **Increasing competition**

### **Option 1**

- The issue of liability capping and its potential impact on competition has been widely but inconclusively explored in the context of auditor liability. For all practical purposes there is no professional indemnity assurance available to actuaries that could begin to deal with the potential losses that they could incur as a consequence of their negligence. Accordingly, there is today no real prospect of any meaningful policyholder restitution in the event of loss.
- There would thus seem to be little public cost in providing some certainty for actuaries by clearly delineating their accountabilities and liabilities. We say delineate accountabilities (including responsibilities "to whom" and "for what") to include liabilities because the reasonableness of any proposed liability capping regime can only be judged in the light of potential losses that could flow from a failure to discharge a responsibility that an actuary has assumed.
- The ultimate objective of any oversight system must be to preserve the interests of policy holders. However, we believe it is not appropriate to provide that an employee actuary should be personally responsible or liable to policy holders (or pensioners) and your review of actuaries' accountabilities should make this explicit. Ensuring the public (and regulatory) interest that the reserving is appropriate should come from the independent external oversight.
- The accountability of independent actuaries to the company that appoints them can be dealt with in contract but their accountability - if any - to regulators and policyholders needs to be much more clearly defined, explained and justified (including the accountabilities of independent actuaries filling the roles of Scheme Actuary and Reviewing Actuary including those that can also be filled by employee actuaries, namely the AFH and WPA)

- The market will then decide whether and at what price those accountabilities can be discharged. It is our view that there is unlikely to be any price at which an actuary is likely to accept an appointment with direct responsibility to policy holders unless some statutory limitation of liability is established.
- In any case, we believe that the market will need to develop a professional indemnity insurance product for actuaries; the actuary should only be liable to the extent of that the insurance market is prepared to provide coverage.
- It is essential that the Profession's own disciplinary scheme be seen as credible to provide the public with reassurance that meaningful sanctions exist particularly when liability caps are introduced.

## Option 2

- There would seem to be no public interest in excluding perfectly well qualified actuaries from providing investment consulting services to their clients - to do so would **limit** competition. It is already open to any investment adviser to establish a relationship with the Trustees and build its case to replace an incumbent.
- One of the primary services provided by actuaries is advising on the selection of investment managers. Most investment managers have their own fund management activities and thus are inherently conflicted in offering advice on selection. Most actuaries are free from conflicts of interest in this regard. The number of independent boutiques providing such advice is very limited. Before any unbundling provisions are introduced some analysis of how the market would operate should be carried out to see if the overall impact would be retrograde.

## Increasing market testing

What is required here is to improve the effectiveness of communication about the actuarial process. That requires a combination of better education of users and better communication by actuaries. These two will facilitate the objective of greater scrutiny of external actuarial services.

### (a) greater scrutiny of performance

- **Option 1 (increased education/expertise of users)** is clearly desirable and should be encouraged. There needs to be a wider understanding of the reliability and use of actuarial assessments particularly among those responsible for governance including both Directors and Trustees. It is difficult to legislate to ensure that it happens, but the introduction of suitable training and the greater disclosure of the relevant experience of proxy users should help raise standards.

- **Option 2 (regular reviews).** It is commercial good sense periodically to review the quality of any supplier relationship. An external actuarial appointment is no different and periodic reviews should be encouraged as good commercial practice. Mandatory fixed periods of appointment or rotation would not be productive and would drive up costs. Corporates will need to rely on their normal HR processes to deal with employee actuaries, augmented perhaps by the comments of any independently appointed external actuaries.
- **Option 3 (performance measurement)** we have no constructive suggestions as to how this could be applied to external actuarial appointments.
- **Option 4 (effective peer review)** Peer review is in our view an essential component of the desired framework..

(b) improving user understanding

All three options, which are non-exclusive, are ones that we welcome.

One further possibility might be to encourage actuaries to participate as trustees on other proxy users of actuarial information – for example by encouraging pension funds to have an actuary as a trustee. This would seem most relevant in the pensions arena. However, there are a very limited number of people with the expertise to take on such a role and whether even this is practical depends upon whether the inevitable increased responsibilities (and liabilities) attaching to a professional-actuary-as-trustee are capable of management.

(c) improving clarity of advice

Whilst **Option 4 (simplification of regulatory requirements)** is always attractive, **options 2 (improve training and CPD requirements)** and **3 (clearer disclosure)** are both very welcome and may prove more practicable.

We suggest that the requirement should extend further to recommend the kind of information that should be considered by the directors or trustees. For example, in our view in a life business the Financial Condition Report (“FCR”) should contain a probabilistic analysis of the level of solvency and a discussion of possible management actions to influence future solvency where appropriate and that FCR should be considered by the Board. We do not believe that the FCR should be published. Most importantly, however, actuaries should be required to explain in a clear way the areas where they have exercised judgement, and the rationale for that judgement, referring to supporting evidence where this exists.

## Reserved role in general insurance

We believe that the market may not yet be ready for **Option 3 (reserved role)** and that **Option 2 (certification by approved person)** in conjunction with **Option 4 (auditor taking actuarial advice)** will provide the greatest degree of security for policyholders and investors at the present time.

There needs to be consideration about who should appoint the Approved Person (we presume management) and who has the benefit of his Report (we presume the Board). We see no need for any additional external or regulatory reporting in the general insurance business.

## Reporting and whistle-blowing

If whistle blowing is to be extended in the public interest then there must be much greater clarity about what requires to be reported, by whom (and what the sanction may be for failure to report).

It seems to us that to place a formal whistle-blowing obligation on employee actuaries is not practical. Not only does it give rise to a conflict of interests, experience shows that it inevitably such a system may be abused by disgruntled employees etc.

It may be appropriate for such a requirement to be applicable to those practising actuaries holding reserved appointments subject to clarity and proper safeguards. Clearly broader protections would create a more conducive environment for whistle-blowing. We also believe that the profession could do more to educate members as to their whistle-blowing duties.

As a multi-disciplinary firm, we are uncomfortable about different service lines operating under different whistle-blowing regimes, recognising that obligations may differ. Consequently, if it is required at all, **Option 3 (conflation of whistle blowing requirements with those applicable to auditors and extending protections)** would be our preference combined with **Option 1 (more guidance)**.

## Actuarial Function holder

As we have said, to place whistle blowing obligations on an employee appointee gives rise to a conflict of interest. To have differing responsibilities depending upon whether the AFH is an employee or not is illogical and the dual loyalties that result from this regime are problematic for employees.

We can envisage circumstances in which the Board might propose to take a course of action which could critically endanger the future solvency of the company but does not unambiguously fall under the current whistle-blowing regulations. We would therefore welcome further discussion of this particular regime. In the meantime we would favour greater protection for whistleblowers (**Option 2**).

## With-Profits Actuary

The accountabilities of the With-Profits Actuary need to be more closely defined and in particular the extent to which the role is compatible with that of the Actuarial Function Holder and to whom - and to what extent - either of them might be liable.

On the face of it, in any case where it matters, the interests of the With Profits policy holders will be opposed to those of the shareholders giving rise to a conflict of interest if one individual (or one firm) seeks to fulfil both responsibilities. For the same reason, we question whether it is possible or appropriate for the WPA to be an employee of the insurer and believe the WPA should be independent of the company.

Consequently, we support **Option 2 (external to the insurer)** and it would make sense (although in our view is not critical) if **Option 3 (appointed by with-profits committee/audit committee)** were adopted. In the circumstances, we believe it is essential for the WPA to have a reporting line to the Regulator and support that element of **Option 4 (report to regulator)**. However, we do not believe it appropriate for the WPA to report to policy holders. Firstly, policy holders do not have the requisite skills to interpret a full report from the WPA. Any report that is sufficiently simplified to be understandable and useful to the generality of policy holders necessarily would be so misleading in its brevity as to render it dangerous.

The WPA has no formal contract with policy holders. Unless liability to policyholders was excluded or otherwise is capped at a level acceptable to the WPA, it will be difficult to fill the WPA appointments - at least from reputable consultancies.

## Options for Reviewing Actuary

Effective peer review of the Actuarial Function, consistent with the objectives set out in this Interim Assessment requires that the Reviewing Actuary evaluates the quality of the reserving. Consequently, we believe that **Option 2 (additional management letter to the Audit Committee)** would improve the effectiveness of the actuarial governance of life offices and could be easily accommodated into the normal audit process. We do not see the need to extend the whistle blowing responsibilities here beyond those already applicable to Auditors.

## Options for Pensions

In our view the Scheme Actuary should be appointed by, and be responsible solely to, the Trustees. The Scheme Actuary's reports can be made available to and explained to the Sponsoring employer and it is always open to the Employer to take its own advice (and sometimes that is required). It is the responsibility of the Scheme Actuary to identify and manage conflicts (**Option 1**). Clearly it should be open to the trustees to evaluate any conflict arising and it must be open to them to require the Scheme Actuary to cease acting for the scheme sponsor (**Option 2**).

Not all conflicts of interests require resignation - often they can be managed by appropriate segregation of responsibilities and/or with the consent of the parties.

## **The syllabus and governance**

As we have said at the outset, we believe that an independent body reviewing actuarial standards is necessary. If such a body were established, its role should include reviewing syllabus development (**Option 2** - although we do not think it needs necessarily reflect the accountancy profession's model) and consideration should be given to expansion of the syllabus to include a degree of general management skills and exposure to the principles of business and commercial law together with business ethics and conflicts of interest.

## **Examination issues**

It is important to balance the value of independent oversight with the economics of a small profession. Our preference would be to focus effort on Option 1, with external review by the independent body referred to above.

## **Broadening actuarial education provision**

The profession's reputation for insularity is unlikely to be dissipated if a greater number of graduate recruits come in with an actuarial degree. However, much is to be said for more clarity in terms of exemptions policy (**Option 1**). The fast-track conversion courses are attractive although the financial burden would need to be analysed (**Option 2**). The real challenge, however, is to keep the profession appealing to numerate and commercial graduates, against a background of negative newspaper headlines and the resurgent demand from better funded employers such as investment banks able to pay above market rates for the best graduates.

## **CPD**

All the options are attractive suggestions and should be pursued. In particular, the partnership between commercial and academic actuaries has not been particularly effective in the past – the number of academic actuaries who have made a meaningful contribution to contentious topics of importance to the profession, or otherwise sought to influence the direction of the profession, has been very limited.

## **CPD monitoring**

This regime should take account of the different needs of its members. As the review has noted, 75% of full members of the profession do not hold a statutory role. The needs of actuaries in employment will differ from organisation to organisation. It is not the Profession's role to regulate the training needs of non-practising members in other than the most general terms. Consequently we recommend **Option 1 (Profession's proposals)** coupled with external review of performance by the independent body.

## **Actuarial standard setting**

The real problems in the industry do not stem so much from the calculations themselves as the business decisions that were taken in response to them. As the Review has pointed out, many of the failings of the profession arise from seeking to be “too helpful” in terms of providing a point-estimate, where a more appropriate response might be a probability distribution and discussion of assumptions. We therefore believe standards should promote a more discursive Financial Condition Report approach to reporting.

The direction in which actuarial best practice is heading is thus completely at odds with a conventional financial reporting paradigm which requires that every risk be reduced to a single number. The Financial Reporting Council has been established to deal with the needs of the users of third party reporting. The issues we are here concerned with relate to the effectiveness of communications between the actuaries and those charged with decision making - the Directors and Trustees and perhaps regulators. It is not part of the FRC’s remit to interfere in the internal management of companies or the supervisory regime and consequently believe oversight by the FRC to be inappropriate.

We do believe an independent (or quasi independent) body is required and that the Profession’s proposals are the most practical. We believe that close cooperation with regulators will be crucial in order to make this body effective, but that it needs the flexibility to be independent. Our preference is for **Option 1 (quasi-independent Act SB)**.

## **Scrutiny of actuaries in life assurance**

As we have said it is for the Board to determine what supervision it imposes on an employee AFH and so in our view there is no overwhelming reason why peer review needs in all cases be carried out by the Reviewing Actuary. However, in practice, in the fulfilment of his own responsibilities for the purpose of his reporting to the auditors the Reviewing Actuary will need to assess the quality of the AFH’s work, and its compliance with relevant actuarial standards. It would be expected that if there were any deficiencies, this would be reported to the relevant Board Committee charged with the responsibility for assessing the reserves as part of the audit process. We see no need for any further review of the AFH’s work nor should the Reviewing Actuary’s conclusions be routinely communicated to the Regulators.

We therefore suggest that **Option 2** be adopted.

## **Scrutiny of actuaries in pensions**

To the extent that (as is normal) the Scheme Actuary is independent of the scheme then our response envisages that the primary outputs of the Actuaries work should be subject to internal quality controls and monitoring of the consultancy concerned. We

# Deloitte.

also further assume that the actuary's work will be subject to periodic peer review on a test basis as part of that firm's internal quality processes and subject to periodic monitoring and inspection by the proposed professional oversight regime.

It should be open to the Trustees to decide whether they are content for the advice and reports to be subject to the consultancy's normal quality monitoring processes or whether they would prefer some further engagement related peer review beyond the consultancy's normal processes.

## **Scrutiny of actuaries in general insurance (for the company market)**

If a reserved role were introduced for actuaries in the general insurance company market, then peer review of internal actuaries' work could be carried out by introduction of the requirement for actuarial advice as part of the audit (i.e. **Option 1**). Indeed, in any case, we believe that there is merit in requiring the auditor to obtain actuarial advice.

## **Options for Lloyd's**

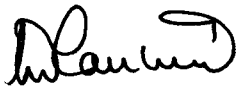
We believe that it would be in the interests of most stakeholders for internally produced opinions to be externally reviewed, and, as for the company market, for the auditor to obtain actuarial advice.

## **Discipline**

We believe that the independent body proposed should have oversight of the disciplinary scheme, and would welcome the involvement of regulators in this.

We would be very happy to discuss any aspect of our response with you.

Yours sincerely



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