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Sir Derek Morris
The Morris Review
Room GC/08
1 Horse Guards Road
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Dear Sir Derek

I write on behalf of The Investors' Association. Our primary area of interest is whether the products and services of the Financial Services industry are appropriate for the private investor/consumer, and if so, whether they are presented in a fair and intelligible manner suitable for their lay market.

It is now clear to us that the proper working of the Actuarial Profession is central to the UK system of retirement saving, and that many of the ills in that system relate to inadequacies on the part of the Actuaries.

In this submission we comment on generic problems of the profession. There are further significant matters which have recently come to our attention in the context of Equitable Life that our Special Advisor intends to comment on in a separate letter.

Our contacts with the Actuarial Profession have largely arisen in consequence of our concerns with such matters as:

- The mismanagement of With profits funds
- The failure of Equitable Life and near ruin of Standard Life
- The deficits in company final salary pension funds
- The misselling of financial products

It is our overall assessment that such problems might have occurred however the Profession conducted itself, but that the severity and prevalence of these problems point to deep-seated flaws in the current structure and ethos

We have already submitted to your Review our paper "Concerns About The Actuarial Profession" prepared some 18 months ago for Lord Penrose's Inquiry. This highlights, in blunt language, many of the matters arising directly from the Equitable Life affair.

For this present submission we have reviewed our wider experience of matters actuarial as they affect savers and investors, with the aim of identifying some of the primary causes of the Profession's current ills.

The Primary Role of the Profession

1. It is the view of Investors Association that the intrinsic role of the profession is to serve as a centre of expertise and best practice for the field of **insured liabilities**, particularly those liabilities associated with individual and collective mortality. We see this field of expertise as involving substantial elements of technical difficulty as well as widespread consequences for users and for the wider economy and environment. All professions with such "financial engineering" related technical knowledge have unavoidable public duties as a result.

2. A fundamental aspect of such 'public interest' duties is that Government, public bodies and private interests should be able to look to the Profession to provide clear, expert and impartial comment on issues touching on its sphere of expertise. This cannot happen if the Profession has supervening commercial allegiances, as appears currently to be the case. These allegiances are creating conflicts of interest on such a scale that in combination with the problems within the profession itself, severe detriment to the interests of the investors and the general public is resulting.

Conflicts of interest at company pension funds

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

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

5. The fact that actuaries were also often advising on board members' remuneration gives even more cause for concern.

6. It is a continued matter of concern with the structure of the current system that in order to challenge asset allocation directives made by the actuaries, trustees would need to be able to show in court that they had adequate investment expertise. Few have such expertise and thus risky allocations reflecting the actuaries' adherence to the "Cult of the Equity" (see below) went unchallenged in the past. The Government's new plan to increase the number of trustees directly representing members' interests may help but it still does not address the underlying expertise-related problem.

Conflicts of interest at life company With profit funds

involving the Appointed Actuary

7. The second area of conflict of interest is at the life companies and arises particularly when we look at the position of the Appointed Actuary and his role of protecting the "reasonable expectations" of policyholders who have investments in With-profits funds. We address elsewhere the worst example of conflict of interest - the appointment concurrently of Appointed Actuaries at Equitable Life as managing director. This has now been widely condemned, indeed by the actuarial profession itself in the Corley report, and has been ruled out formally by the FSA.

8. However, along with the FSA we are highly doubtful that any internal Appointed Actuary will ever be in a position to support successfully the interests of policyholders in the teeth of a Board which plans actions which are opposed to these interests. There are many examples of this.

9. We draw your attention to the current tribunal case between the FSA and Legal and General, in which evidence is likely to be brought that the internal Appointed Actuary warned the board that a particular type of endowment policy would not be able to pay off clients' mortgages based on their assumptions, but was unable to stop the Board from selling the product. This has eventually resulted in a substantial FSA fine and a large number of successful misselling claims, payment of which will fall to other members of the company's with-profits fund.

10. We note also the evidence given by the Appointed Actuary of Standard Life to the House of Commons in 2000, when he noted that members of the company would not be disadvantaged by the demutualisation which members were then voting on. Concurrently the company was running a media campaign seeking to persuade members to vote against the demutualisation effort on the basis it would slash future policy returns. The AA, though he also held the senior Board position of Finance director, was unable to prevent the company from sending misleading literature to policyholders and making misleading media statements.

11. These two examples at least show evidence that some Appointed Actuaries have at least an awareness of what Policyholders' Reasonable Expectations, (PRE). On the other hand, we also know that at Equitable life PRE was completely ignored for many years. At one proprietary insurer, the With profits fund was used as a source from which to pay dividend income to shareholders, a practice subsequently stopped by the FSA. Again PRE was not protected.

12. Recently at Standard Life, individuals, analysts and groups made repeated efforts in the press and elsewhere to persuade management to reverse the disastrous investment policy pursued by the Board during the recent market crisis. The Board's policy of remaining invested in equities for much longer than competitor life companies resulted in the loss of more than 80% of the free assets – the company estate built up over decades.

13. Because Standard Life is a mutual this substantial estate was owned by its members. It is hard to see that their reasonable expectations that the money would not be effectively gambled away in the stockmarket were met. Yet the Appointed Actuary - a post now held by a somewhat junior actuary while the company was run by a number of seniors - did not take action.

14. It is the usual practice at life companies to pay misselling costs out of With-profits funds. Although the FSA has recently required the proprietary companies to pay fines out of shareholders' funds, there has been no change to the much larger compensation costs arrangements. There is no evidence that Appointed Actuaries have watched over policyholders

interests in the allocation of misselling costs - or in the development and design of products which may incur misselling problems in the future.

15. In general the role of the AA and the way it has been performed has been so dysfunctional that we tend to believe - like the FSA - that its value is questionable to say the least.

involving the Independent Actuary

16. The Equitable Members Action Group has drawn your attention to the questionable role of the Independent Actuary in the debt restructuring scheme of 2001-2. We agree that he accepted too narrow a remit and that, in consequence, his work did little for policyholders. Nor does it encourage respect for his independence to find that the same person who was tasked with analysing the Scheme for the benefit of the Creditors is now advising the Society in its action against the previous auditors.

17. It is an almost inescapable conclusion that the role of the Independent Actuary - who appears on a one-off basis when a company plans a major change such as a sale, flotation, asset distribution, or major restructuring - boils down to taking the management's proposal and "making it fit" a format which will guarantee a 75% vote in favour of the Board's proposal - be it objectively in the policyholders' interests or not.

18. Apart from the Equitable Life restructuring, we note the wide variations in methods used for the distribution of compensation for loss of membership during the demutualisations early this decade. The lack of consistency in these payments - in some cases very large - resulted in very different outcomes including in one case the disappearance of much of the bonus shortly afterwards. Such a wide variation in practices over a short period was unprecedented: it is hard to see that all systems of bonus distribution could have been in policyholders' interests.

19. Investors Association believes that there is an essential range of tasks inherent in the role of Independent or any other Actuary specifically charged with watching over PRE that must not be bargained away, and that such 'fundamental remits' should form part of professional standards. Even more important is the definition of the goals that the Independent Actuary should set himself, and the criteria by which his work should be judged, along with the scrutiny demanded of it. (Opaque language should be mentioned). More generally we believe that good professional standards are incompatible with cosy, back-room relationships. Their purpose is to bring issues out into the light of day where they can be properly debated and negotiated by the parties affected.

Conflicts of interest at the Government Actuaries Department

20. The third area of concern is the GAD, which has two main roles - to advise the Government on actuarial and pension matters in the public interest, and secondly to engage in commercial revenue producing consulting activities. In the past it also had regulatory duties. Although these have now been transferred to the FSA, the potential for conflict of interest remains. In particular, Investors Association believes that there is an inherent conflict between the role of 'Preserving confidence in the Industry', and the compliance roles of enforcing standards and protecting users, and that these very different roles need to be kept fully at arms length.

21. The field of long term savings via insurance and pensions is quite properly subject to government regulation. However, the involvement of the Profession in that regulation has not induced any sense of public confidence, either in the activities of the Government Actuary's Department, or in the role of the Profession as a setter and enforcer of professional standards.

The historical record of the last 30 or 40 years appears to demonstrate that the Profession no longer has any substantive awareness of its public duties, almost invariably putting the interests of 'its own' before the interests of the public who they are supposed to be protecting.

22. Investors Association is satisfied that the problems of Equitable Life were well understood by the Profession no later than 1989, and probably, at the governing levels, several years earlier. The GAD, which benefited from many and close connections with the F&IA, would also have known what was happening in great detail. Despite this knowledge, nothing substantive was allowed to leak out to the mass of policyholders, IFAs and prospective customers. Instead, a twin track situation was allowed to develop, whereby those with access to expert actuarial advice were enabled to advantage themselves at the expense of the ordinary saver. The Profession showed no qualms over benefiting itself from the deliberate concealment of key facts and understandings from the mass of policyholders.

23. Such cover-ups do not take place by accident, although this is what the public were asked to believe (with some help from the Profession itself). It is clear from a careful reading of Penrose that Equitable had powerful support from within the GAD, but the true originators of the cover-up remain undiscovered. However, what is quite remarkable is that essentially the same strategy was used from 1986 to 2003 to conceal the realities of the situation.

This strategy had (or has) four legs:

24.1. Concealment of essential facts (such as the realistic liabilities.)

24.2. Misdirection as to the source of difficulties (pretending that guarantees were responsible for problems caused by over-bonussing.)

24.3. Persistent reinterpretation of the actuary's role in legalistic terms, while ignoring his primary professional duty to ensure the prudent safeguarding of policyholders' funds.

24.4. Withholding plain language expert professional comment that would enable non-actuaries to make sense of the limited facts that were available.

25. We have to conclude that the governing bodies of the profession acquiesced in the Equitable cover-up, whether reluctantly or willingly is not clear. In doing so, they flew in the face of any concept of ethical behaviour and public duty. Any reform of the Profession must make a repetition of such extended and extensive disregard of duty unlikely in the extreme.

Investment problems: The Cult of the Equity

26. Actuaries, benefit consultants and pension advisers have demonstrated a tendency both to invent and to parrot conventional wisdom in the investment world. Examples of the conventional wisdom espoused by the Profession include the cult of the equity in the 1980s and 1990s, the move to bonds in the early 2000s, and the current fashion for "alternative investments", especially hedge funds.

27. Actuaries purport to have investment skills, but the long term track record of those institutional investors dominated by actuaries, most obviously the UK life assurance companies, has been, at best, uninspiring.

28. Some people are clearly able to add value to the investment process, and some of these individuals do have actuarial training. The problem is that, even if one could identify such persons, why would they choose to work for a bureaucratic, relatively low paying organisation such as a life assurer or actuarial consultancy, when they could enjoy greater professional freedom and potentially make far more money working for a pure investment management firm or a hedge fund?

29. The actuarial practice of reviewing pension fund investments only every three years and the fixed rules of asset allocation they espouse has meant that the asset management companies employed to invest pension fund money were unable to take avoiding action - such as to switch money from equities to safer bonds or cash, when markets started to fall.

30. This inability has led to "black holes" in defined benefit schemes of the order of hundreds of billions of pounds, which has in turn led companies to close such schemes to new employees, thus seriously damaging a pension system which until recently has made the UK the envy of other countries still dependent on state provision.

31. The grip of the actuaries on the investment allocation system has also hamstrung the fund managers who have the skills to maximise pension funds returns. Investment models used by the actuaries are often backward looking, allotting for instance more weight in terms of the investment of new money to markets which have already risen to high levels compared with those which have slumped. This means that professional fund managers are committed to a repetition of the classic small investor's mistake of "Buy high, sell low."

32. The Investors Association believes there is a role for actuaries in organisations such as life assurers whose mission ought to be to achieve the benefits of diversification, economies of scale and professional management that most ordinary savers are not able to achieve for themselves. But most actuaries are not qualified to pursue investment out-performance, and they should not try.

Excessive secrecy and undue influence

33. In many ways, the Profession treats its area of expertise as if it were 'secret knowledge' with the actuaries being the appointed guardians of those secrets. This leads directly to the oft-remarked arrogance of many actuaries, an exaggerated regard for their own abilities, and a marked reluctance to enter into proper discourse with other interested parties (or 'stakeholders'). In contrast, other professions with expertise of comparable or even greater complexity have succeeded in sustaining serious debate and involvement with the non-specialists affected by their work in one way or another. This is a fundamental and serious defect which must be remedied.

34. One can summarise the situation described above by saying that the Profession has become 'Cartel Minded', rather like the mediaeval guilds. For example, there seems to be no good reason why consulting actuaries should have become the leaders in the field of setting boardroom remuneration, as it has the smallest connection to conventional actuarial methodology, but it has happened nonetheless.

35. The Profession has claimed a competence in other areas of finance, in particular that of Asset Management, which is not evidenced by the results of its efforts. Specifically, it collectively endorsed an ill defined 'Cult of the Equity', without ensuring that appropriate tools were available to measure and control the much higher risks inherent in equity investment, (as compared with conventional fixed interest and property investments where there were many decades of experience).

36. The 'Cult of the Equity' had an unremarked side effect, which may well have been more momentous than was generally appreciated. In 1963, prior to the general conversion to the Cult, insurance and pension holdings represented only 15% of all UK equities by value. By 1981 the proportion had risen to 47%, and by 1989 it was over 50%. Even today, after dilution by a substantial inflow of overseas investors it remains above 40%. The proportion of the FTSE100 and FTSE250 would be even higher, because of the institutional preference for holding the more liquid shares of larger companies.

37. The clear implication is that, no later than 1980, the Insurance and Pensions Industry, with actuaries in the van, had acquired collectively, a controlling influence on the boardrooms of UK quoted companies. Since then there has been a significant concentration in the management of the funds in question, largely held on behalf of policyholders but voted by the Institutions operating those funds. At the same time, the influence of actuaries, whether in the role of consultants to pension funds or as directors of insurance companies, has grown significantly. As a result, actuarial influence and patronage in the ‘commanding heights’ of UK business, which was already strong in 1980, may well have increased yet further.

38. It is legitimate to enquire how the benefits of such patronage influenced the behaviour of individual funds and the behaviour of the Profession as a whole. The economic implications of such power are so profound that there must have been some significant effects, if only within the relatively small but influential group with the power to direct how shares would be voted. Certainly it is hard to visualise how the Cult of the Equity could be re-evaluated if the consequence would be to diminish the status of that fortunate group.

Conclusions and Proposals

39. In the Review’s Consultation Document, you have indicated an awareness of many of the issues that we have chosen to address, and you have asked for comment regarding possible organisational remedies and the like. By and large, the Association has no preference for one structure over another, taken from the various models that have proven their worth in other professional contexts.

40. However, the temptation to treat the problems of the Profession as simple structural defects must, in our opinion, be resisted most strongly. These problems arise from a deeply ingrained culture, which has developed over at least two or three decades. That culture is cynical, self serving, inwards looking and largely indifferent to the public interest. In the absence of strong measures to remedy such defects, the existing culture will surely prove strong enough to pervert any new structures that are put in place.

41. The fundamental need is for public acceptance, by the Profession as a whole, that it has gone seriously off-track, and that extraordinary steps are necessary to put it back on course. Complementing this, we would envisage a period of Supervised Operation by an independent secretariat charged with carrying out the reforms and an independent Oversight Board to monitor progress. Essentially, a form of ‘probation’ this should last for about five years depending on the progress made in reforming the attitudes, standards and procedures of the Profession.

42. In this context, Investors Association attaches great weight to the following necessary reforms:

43.1. Asserting and Reinforcing the Profession’s public responsibilities.

43.2. Re-stating and strengthening professional (i.e. technical and organisational) standards.

43.3. Establishing a separate statement of binding ethical standards.

43.4. Greatly strengthening enforcement, including the deliberate use of public ‘naming and shaming’ as a means of general re-education.

43.5. Fostering an ‘early warning’ culture, including suitable incentives and protections for whistle-blowers, even if many of the latter will turn out to be over-anxious or just plain mistaken.

43.6. Insisting that clarity and transparency are essential attributes in any professional work that may need to be used by no-actuaries.

43.7. Separating commercial from professional interests.

43.8. A clear delineation of what does and does not comprise the Profession's sphere of expertise. In our view, the Profession should only undertake such further roles as can be shown to be compatible and supportive of the primary role relating to insurance liabilities outlined above.

43.9. A full review and analysis of 'The Cult of the Equity', coupled with fresh guidelines on the place of equity investment in pension funds, so as to avoid future "black holes."

43.10. A similar review of the application of the 'With Profits' concept to Investment Contracts, leading to considered recommendations about the design of any future schemes, and as to the proper treatment of existing schemes.

43.11. An independent review of regulatory concepts and of the proper role of the Profession within the overall system of regulation.

43.12. The separation of the Profession as such from any involvement whatever in the control of publicly listed companies.

43.13 Considerable strengthening of both member scrutiny and independent review at mutuals, along with clear access by non-exec directors to outside assessment and advice.

43.14. A review of the GAD so as to determine whether a formal split of its commercial and public interest roles would be desirable.

We will be happy to expand further on any part of this submission should that be of assistance to your Review.

Yours sincerely,

Steve Huxham

for The Investors' Association