

1st September 2004

Sir Derek Morris,
Morris Review of the Actuarial Profession,
1 Horse Guards Road,
London SW1A 2 HQ

Dear Derek,

Thank you for asking the ALM to participate in the consultation process. Your review is very broadly based. The ALM's focus - we represent third party capital providers at Lloyd's - is very specific; it is the work of actuaries in Lloyd's, most notably their work within syndicates that concerns us. Our comments will be limited by this interest, though some of them may have more general relevance. Many of your questions refer to the training of actuaries and their operational interface with other professions; we have no understanding of these issues. Our perspective is, we hope, that of well-informed consumers of actuarial services. Responses will therefore be made only to a minority of the questions asked in your consultation document and we shall identify the specific questions to which our responses refer, in italics, before each response.

There is a significant element of mutualisation within Lloyd's that crystallises when inadequate pricing or reserving causes one or more members to fail. For many years, the ALM has been an advocate of higher levels of professionalism throughout the market.

(Q1.1 "What do you see as the main value provided by actuaries and, conversely, what are their weaknesses? In general, are actuaries properly equipped for the roles that they perform?)" Successful syndicate management requires appropriate management and risk information and the ALM sees the role of the actuary in securing and marshalling this information in order to evaluate risks and develop robust pricing models for underwriting. We believe that members of the actuarial profession do have the appropriate skills, though the penumbra of mystery with which actuarial techniques have, historically, been surrounded does not enable us to assert this with confidence.

The proportion of a syndicate's capital that is provided by third party members will vary from year to year. The ALM, therefore has a particular interest in accurate and consistent methodologies being applied to reserving of risks, particularly at the "closure" of each syndicate's annual venture at the end of three years when the profit or loss for the year of account is determined. (Please see the response to *Q1.5*, over, for further comment on this point.)

(Q1.3 "Do you think that there is still a need for particular roles for actuaries to be reserved by statute and, if so, which roles and for what reason? If not, why not?)" While any properly managed business will apply expertise from across a range of disciplines in assessing risks and establishing claims reserves, it is the ALM's view that a properly regulated professional should be required to take responsibility for

reserving accuracy, and that this is best made the responsibility of a member of a reformed actuarial profession.

(Q1.5 “If roles reserved exclusively for actuaries are maintained, do you think that we need to introduce greater peer review and scrutiny of such work?”) We think that greater peer review and scrutiny of actuaries work will undoubtedly be required, but that it will have little impact on raising confidence in actuaries’ work unless it is accompanied by greater transparency. In a recent take-over negotiation between two listed companies (Highway and Cox), an unedifying conflict arose. Highway’s actuaries declared that Cox’s claims reserves were materially inadequate: this was strongly denied by Cox’s actuaries. Outsiders could take sides; Cox had by far the better trading record combined with a history of steadily releasing prior year reserves that Highway could not claim - so the negative assessment looked improbable. However, there was no basis for informed evaluation. Two professional firms were each asserting the that results of using their own “black box” was correct while the other had not evaluated the data properly.

In our view this is unsatisfactory. One cannot expect professionals to agree on all points; lawyers, famously, differ all the time. Their disputes, however, take place within a structure of laws and rules of procedure that generate solutions that are open to public scrutiny. (While not wishing to take the analogy too far, competing lawyers arguing their cases, each employing their own secret codas, would receive short shrift from the judiciary, lose public esteem and might even attract the interest of the Law Society). Actuaries should not be able to rely on the “black box” approach that was criticised so eloquently by Lord Penrose in his report on Equitable Life (9.181) and repeated in section 2.30 of your consultation paper; his observations can be extended to general insurance actuaries.

“It appears to have been a particular conceit of actuaries that the exercise of discretion was as much their exclusive preserve as the arithmetic that instructed it. In general it is the defining characteristic of an expert that he or she can communicate the results of his or her expertise with sufficient clarity to enable any reasonably intelligent person vested with a decision making power effectively to exercise that power. Actuaries need not be in an exceptional position in this respect, and life offices’ boards can be as competent as others to reach decisions on the basis of intelligible advice.”

In establishing claims reserves, the bases of calculation should be transparent and, if not consistent over time, any changes in the assumptions and methodologies employed should be identified and justified. Lloyd’s three-year accounting is slow to produce results and is often considered archaic. But it is also conceptually very simple and transparent; the members of one syndicate year (the “annual venture”) transfer their business on a no profit: no loss basis to the members of the successor syndicate year (another “annual venture”). As already explained, portfolio decisions by third party capital provision vary annually, which often results in the proportion of the capital supplied by controllers of the managing agent changing. If the changes result in a significant increase or decrease in the proportion of capital provided by controllers of the managing agent, a moral hazard emerges if the actuarial basis of reserving is changed. Any strengthening the basis of reserving transfers profit from

the year being closed into the succeeding year, and vice versa. It is possible that temptation may not always have been resisted.

Third party capital providers also attempt to allocate their capital in the most efficient manner. They would make this allocation more efficiently if they and their advisers had access to information that provides full information about the way in which reserves are being established. We take the view that the interest of policyholders is served by action to improve reserving practices and that this will be promoted by these practices being exposed to scrutiny.

(Q2.1 “What should be the objective of the regulatory framework for the actuarial profession?”) The regulatory framework should cover the five items covered in the bullet points in 2.3. “Scope of the actuarial role: maintenance of professional competence: standard setting: openness, peer review and audit of actuarial work: monitoring, complaints and discipline”.

(Q2.2 “What is your overall view of the strengths and weaknesses of the self-regulatory approach as applied to actuaries by the professional bodies? Does it adequately protect the interests of consumers? If not are there key aspects of the regulatory framework that you think should be changed? Is there too much emphasis on reserved roles for individual actuaries? And Q.2.3 “Does the Profession’s dual responsibility for representing its members to the outside world and regulating them in the public interest create a conflict of interest? Is this conflict acceptable?”) To the extent that the current regulatory structure has caused and maintained the “black box”, secretive attitudes within the actuarial profession, the ALM believes that it has failed consumers; the general experience of the ALM’s board members is that the conflicts that are endemic to self-regulation means that it is generally an inappropriate model.

(Q2.15 “What are the implications for actuaries of the FSA’s move to a realistic reporting regime for general insurers? & Q2.16 “Do you agree that the reserved role for actuaries in general insurance is unnecessary?”) We believe that the move to “realistic reporting” will require the adoption of the transparent standards described above and take the view that there is a requirement for a professionally qualified person to take responsibility for claims reserves, etcetera, for general insurers, including Lloyd’s syndicates. It seems that a suitably qualified actuary would be the most appropriate person: we also note that the FSA in CP04/7 confirmed Lloyd’s current practice and did not bring Lloyd’s into line with companies by abolishing the role of the syndicate actuary; perhaps wrongly, we have assumed that this was a precursor to the FSA adopting a parallel requirement for a company actuary.

(Q2.33 “Do you agree with Lord Penrose’s assessment of the lack of openness and transparency of the profession to non-actuaries, including other professionals, and their clients?”) We agree with Lord Penrose’s assessment.

(Q2.36 “When should actuarial opinions be directly addressed or otherwise communicated to members of the public, such as policyholders and scheme members?” & Q2.37 “Is there a need to further widen the scope of actuarial activities that are subject to peer review or other forms of scrutiny – for example into Lloyd’s syndicates and general insurance?”) We believe that actuarial reviews should

be available to members of Lloyd's syndicates and their advisors and accept that competitive considerations on the part of managing agents may require that recipients of this information be subject to confidentiality restrictions. Peer review and other scrutiny procedures, together with enhanced standard setting procedures should be applicable to Lloyd's syndicates and to general insurance activities; in our view such an extension is required in the interest of the credibility of the profession.

My we mention one concern. Actuaries generally have an asymmetrical attitude to error; if a claims reserve proves to be a small underestimation at settlement it is considered a serious fault, while a large overestimation is seen as no more than the application of appropriate conservatism. The collapse of the Independent and the disastrous impact of the continuing failure of the Equitable Life to acknowledge one material risk factor (the cost of guarantees) may have the effect of inducing actuaries to move further in this direction. This would be unfortunate: actuaries should attempt to calculate reserves accurately; after this assessment has been made, a specific adjustment for conservatism may indeed be appropriate, but it should be identifiable and transparent. One trusts that the Inland Revenue would not abuse the new information to tax a provision that reflects proper commercial caution and which protects the interest of policyholders.

Yours sincerely,

Paul Kelly
Treasurer.