



## **MORRIS REVIEW: ABI RESPONSE**

### **Executive Summary**

The ABI would wish to make the following major points:

- The FSA has radically changed the structure of regulation for life insurers. In particular, the board of a life insurer is clearly responsible for the actuarial function similarly to other functions of the company. The actuarial liabilities of the life fund are now audited and the role of the actuary is like that of any other professional employed by the company. Actuaries have an important, but specialized, role as part of the overall risk management of life insurance companies. It is important that the Profession fits into this framework, and does not attempt to impose an actuarial alternative on life companies. This provides the background to our response to the Morris Review.
- We see the primary role of the actuarial professional bodies as being to ensure adequate standards of competence and ethics for their members. This is the same as for comparable professions. Important considerations are to ensure that the requirements do not lead to unnecessary barriers or expense. In particular there should not be professional requirements, such as peer review, which predetermine the approach of boards to their responsibilities in this area or which duplicate the FSA regulatory structure.
- The production of actuarial standards is a matter of public interest and other interested bodies should be represented in the process as with the formulation of accounting standards for instance.
- Modern financial market instruments and risk control techniques should be permitted as alternatives to actuarial techniques where possible. This would provide a market test to present approaches though in some cases it will be dependent on EU rules which are being examined in the context of the Solvency II exercise. The key issue here, which the Morris Review should develop, is the need to provide capital market alternatives to actuarial techniques – so as to provide a counterfactual test for the value of actuarially based products. This will not be straightforward but is important if actuarial value in products is to be tested.

### **Introduction and Approach of ABI Response**

This response is written from the perspective of insurance companies. Their interests in the actuarial profession arise from:

- The role of actuaries in insurance companies, both in reserved and wider management roles;
- The actuarial requirements of FSA regulation of insurance companies;
- As employers of actuaries and buyers of actuarial consulting services.

The review must be seen in the context of the programme of change initiated by the FSA. This radically alters the framework in which the insurance industry and the actuarial profession operate.

The change is characterised by formulated standards and disclosure. The FSA High Level Standards are built on “Principles for Business” which are fundamental obligations on all firms in the financial sector under the regulatory system. The following are particularly relevant to the role of actuaries:

- Proper management and control (PRIN3)
- Adequate Financial Resources (PRIN4)
- Customer Interests (PRIN6)
- Communications with Clients (PRIN7)
- Management of Conflicts of Interest (PRIN8)

The responsibilities of the firm are exercised through senior management for whom the SYSC section of the FSA Handbook sets detailed rules on apportionment and documentation of responsibilities to individuals. Individual actuaries working in insurance companies operate in this framework.

There has been a sea change in two areas affecting actuarial work:

Firstly, the FSA has moved from the approach it inherited to insurance regulation, namely almost sole reliance on returns of historic information, prepared in the case of life business on a consciously conservative, almost secretive basis, to a more open and forward looking approach. In particular all insurers are required to establish on a forward looking basis through their individual capital assessments any capital needs over and above those specifically required by the Enhanced Capital Requirement (ECR). This, together with realistic reporting for with-profits business, aligns the approach to regulation far more with management decision taking.

The second change concerns the role of the actuary. Previously appointed actuaries had executive and regulatory functions. It was not totally clear how far they were accountable to the Board. The non-audit of the actuarial liabilities increased the impression of non-accountability within the company. Much of this structural uncertainty has now been removed.

In particular the new structure leads to:

- Clear definition of accountability: the roles combined by the appointed actuary are now separated and it is much clearer to whom the

responsibilities of an actuarial office holder lie, for instance, to with-profits and other policyholders, to the board or to shareholders;

- A clear sense of responsibility by directors for decisions based on actuarial analysis: previously this was not necessarily recognised;
- The extension of the audit to the actuarial liabilities in life company accounts and FSA returns clarifies that, while the actuarial function has responsibility for calculation of liabilities, these liabilities are the responsibility of the Board as in all other organizations;
- A clear sense of the need to avoid conflicts of interest;
- A new emphasis on communication with customers (policyholders) and financial markets: here both conduct of business rules in general and PPFMs mean that actuarial responsibilities now include a significant element of communications in the sense of explanation of actuarial matters.

These changes mean that the actuarial function now operates in a similar structural environment to the rest of management and other employed professionals. It is clearly accountable to the Board and subject to audit. It is also subject to the same communication imperatives as other functions. In this framework the role of the actuarial professional bodies becomes like that of other professions with responsibility for the ethics and competence of its members. The production of actuarial standards is of wider public interest and should be the role of an independent body as with accounting standards.

At the same time as regulatory change, there has been significant development of capital market products that provide alternatives or near alternatives to traditional products. This could allow greater competition through the greater use of financial market instruments and risk management as the basis for products instead of the present actuarial reserving basis. This would currently have to comply with EU directives but a debate would be a valuable contribution to the Solvency II project under which the Commission is examining updating the regulatory framework for insurers. It is also relevant to public policy agenda issues such as the savings gap, retirement income and the provision of annuity style products.

Life companies seek from the profession:

- Professional standards both in competence and ethics
- A training system which ensures appropriate standards but does not impose unnecessary barriers to entry
- An avoidance of unnecessary costs through over exacting requirements on members such as inappropriate peer review requirements. A key objective here is to avoid duplication of professional and FSA requirements.

These are the criteria which will be applied in responding to the questions below.

## **Question Heads in Morris Review**

### **The Scope of the Actuarial Role**

*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 which they perform?*

Actuaries are trained in specialist areas relevant to insurance. These skills are necessary for the management of an insurance company. In the case of life companies, a number of these roles are reserved by regulation for actuaries. In the case of non-life companies this is not the case. Irrespective of statutory roles the tasks currently undertaken are essential. We would however see an increasingly multi disciplinary and cross-disciplinary approach in many areas, e.g. risk management, financial planning, product design. That said we consider that it is as important to consider the overall framework and structure applicable as to seek to open up the functions currently reserved to actuaries.

As argued above many of the weaknesses in management involving actuaries as individuals were also partly the result of structural weaknesses which the FSA has largely addressed.

In the past the Institute and Faculty had, through professional guidance, a quasi-regulatory role and questions arise as to how that was exercised. This response is concerned with the future and therefore does not address this.

Broadly we agree that actuarial training has generally equipped members of the profession technically for the many of the roles which they occupy although we do raise further points on this below. It is also significant that actuaries are active in broader fields where their training has been perceived as having value.

*Q1.5 If roles reserved exclusively to actuaries are maintained do you think that there is a need to introduce greater peer review and scrutiny in such work?*

Broadly, we think that the right balance is achieved by bringing actuarial liabilities within the scope of the statutory audit and through general and specific governance arrangements, in particular those relating to board responsibility for actuarial matters and to with profits governance.

The focus should be on the actuary as a member of the overall team rather than a special regime which runs the risk of duplication and overlap with FSA regulation. We are also concerned that a special approach for actuaries could dilute the sense of the need on the part of the board, in whom overall responsibility rests, to be responsible both for actuarial functions and also for consideration of actuarial advice received. In particular we question the need for peer review in the light of audit requirements and the responsibilities of the Board.

*Q1.7: Could other professions work more closely with actuaries or in related functions to help maintain and improve actuarial effectiveness?*

We envisage closer working between actuaries and all other members of management than may have been the case in the past. This is a logical development of the new regulatory structure and the emphasis on overall responsibility of the firm generally and the board in particular.

In this context there should be a greater willingness to look at the use of alternative approaches to products based on modern financial market instruments and risk management techniques. This will need to be in the framework of the EU Directives but these are being reviewed under the Solvency II project.

### **Accountability of Actuaries**

*Q1.7: To what extent should actuaries accept some responsibility for their role in designing products which have subsequently turned out not to be fit for purpose” for consumers? Why were these issues not brought to light by the profession earlier and therefore perpetrated to the detriment of consumers? What lessons can be drawn?*

These questions raise complex issues regarding the past. Our concern is with the future but a number of points need to be made:

- It is important not to apply retrospective criteria in judging such cases;
- The problems with product design in many cases centred on assumptions made as to future market trends. The exact apportionment of blame is difficult but it should be noted that the main failure, inadequately quantifying option and guarantee costs, can also be attributed in part to the then prudential regulatory rules in the UK and the EU. These overemphasised prudent margins and placed insufficient emphasis on the valuation of options and guarantees. The FSA has changed this in the UK and the EU is expected to do the same with Solvency II;
- Similarly now it would be necessary to examine whether such cases breached the relevant FSA Conduct of Business rules, PRIN 6 on Customer Interests and PRIN 8 on managing conflict of interest.

These have set up a framework which should reduce future problems in this area and provides a clear set of criteria to judge future breaches.

*Q1.8: Are actuaries sufficiently accountable for their actions? To whom should actuaries be primarily accountable—to their clients or employers.... or to a broader public interest that encompasses the strength and stability of the insurance ...sector.. and the interests of those consumers involved?*

*Q1.9 How would you characterise the current situation in the UK in this respect? Are there changes you would like to see introduced in terms of the accountability of actuaries to their employer or to the public interest?*

In the case of actuaries working in insurance companies, we see their accountability being in the first place to the board. The board on behalf of the company is responsible for the broader public interest responsibilities of the company including those to consumers. This would be the normal channel except in exceptional circumstances where, for instance, “whistle blowing” is involved. The duties of an actuary here are not different in principle from those of other executives although, like other experts, they may be better placed to judge implications than those without their expertise. This on normal principles increases their duty of care.

In the case of consulting actuaries, they should be, and are, like other professionals accountable to their clients.

*Q1.10 Are actuaries sufficiently liable for their actions? If actuaries provide poor advice to whom should they pay compensation?*

The general rules on negligence etc should apply here whether the actuary is an officer of a company or an external consultant. In the context of insurance companies, advice is given to the insurance company. As a result of that advice, the insurance company may act in such manner as to open itself to claims from policyholders and other third parties. In such cases the rights of policyholders etc are against the insurance company although the insurer may, under the general law, have claims against actuaries as individuals or as consulting firms.

We do not see the position of actuaries being different from other professionals. In particular we do not consider that there should be any special system of liability applicable to them.

Structural changes in the regulatory framework to which we have referred are also relevant in considering some of the examples discussed in the narrative here of the Consultation Document.

## **The Profession**

Our main concern here would be that on occasions working parties of the profession have been of an academic rather than a practical nature and have often been relatively slow in producing a response. There is also the question of whether they have been too actuarially centered and perhaps should consider a more outward looking approach including increased involvement of other parties. See also our comments on standard setting below.

## **Entry into the Profession**

It is important to ensure an adequate standard of training while avoiding unnecessary barriers to qualification or other restrictions with the effect of unnecessarily reducing the supply of suitably qualified staff. It should be noted that the actuarial profession competes for graduates with a numerate background with other areas of finance. The market here is sufficiently tight that it is important to avoid unnecessary extra pressures on it.

Continuing professional training is important but it is also necessary to ensure that the framework for this is not over prescriptive nor expensive by comparison with

the requirements in similar professions. In particular recognition should be given to in-house training provided by employers.

### **The Market for Actuarial Services**

We favour a competitive market. Because of the relative shortage of the necessary skill sets, which are also shared with other sectors such as management consultants, it is important to ensure that any measures such as peer review are targeted and avoid duplication or unnecessary additional work which would further tighten the market.

The question of dominance of the market by a few firms is also shared in the accounting and legal services markets. This means that it raises wider issues and it is uncertain whether a review of the actuarial profession in isolation can make much difference.

An increased use of alternative modern financial market techniques in product design instead of current actuarial reserving would be likely to widen the market here. As mentioned, the industry operates in the context of the EU Directives but these are being reviewed in the context of the Solvency II project.

### **International Comparisons**

No comments

### **Other Professions**

There are useful precedents here to consider.

### **Regulatory Role of the Profession**

A distinction should be drawn between regulation of the conduct of members of the profession, which applies only to them, and technical guidance and standard setting which applies more generally and in particular applies to life companies. The first is an internal matter for the profession although exercised in the public interest. The second is a matter of wider interest and is commented on below.

### **Role of the Appointed Actuary**

We were closely involved in the FSA consultation exercises here and are broadly content with the new framework which removes, as discussed above, many of the previous structural weaknesses, such as conflict of interest, identified in this area.

We consider that non-executive, and non-actuary executive, directors should be in a position to take judgments on the basis of actuarial material. The onus is on the actuarial function to explain in clear terms the advice being given and equally the risks involved. The problems in the past have stemmed partly from directors not always appreciating their full responsibilities and the production, in some cases, of actuarial material in the form of conclusions for endorsement rather than analysis of the issues. The new framework should reduce the risk of this reoccurring.

Realistic reporting for with-profits business provides a much better framework for understanding the financial position and dynamics of the fund. In particular, by removing hidden margins and disclosure of the policyholders' current levels of expectation in financial terms, comparisons between funds will be greatly enhanced and this should assist directors.

Similarly the PPFM will provide the directors with a template of the intended financial management of the fund. Reserving, particularly realistic reserving, is required to take account of the approach in the PPFM to ensure that policyholder expectations as set out in the PPFM are covered by reserves and that assumptions as to management action are similarly accounted for. These reserves will be audited and both auditors and directors can be expected to use the PPFM as a starting point for examination of the actuarial work of the company.

### **Role of the Scheme Actuary**

No comments

### **General Insurance and the Syndicate Actuary**

We consider the question of whether there should be reserved actuarial posts on the non-life side to be primarily a matter for the FSA framework rather than going to the structure of the actuarial profession. In that context we shall take part in any consultations.

### **Maintenance of Professional Competence**

This is important but it is also important to ensure that the framework is cost effective from the perspective of insurance companies as employers of actuaries and buyers of actuarial services and for the cost implications for policyholders.

### **Whistle-blowing**

Generally the current provision are about right.

### **Standard Setting**

This must be seen in the context of the revised FSA framework. It is in the public interest to have, and we argue for, greater involvement of other interest groups in the production of standards and see the structure for accounting as a starting point.

### **Openness, Peer Review and Audit**

We favour aligning the approach here with that applying to companies generally. Full audit is the correct approach for actuarial liabilities and the primary responsibility for actuarial matters should lie with the Board.

Peer review is an approach which boards may wish to consider but which should not be a requirement on them. In particular actuarial professional requirements should not *require* peer review. In our view, so to do, would dilute board responsibility to ensure an adequate standard of actuarial advice to it and would

effectively preclude alternative approaches on cost grounds. We have made this point to the Actuarial Profession and propose to develop it in our response to the current Actuarial Profession consultation on Life Guidance Notes, Peer Review and Practising Certificates.

### **Monitoring, Complaints and Disciplinary Schemes**

No comments. The principles are the same as for other professions.

### **Role of the Government Actuaries Department**

No comments.

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