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Sir Derek Morris  
Morris Review of the Actuarial Profession  
HM Treasury  
GC/08  
1 Horse Guards Road  
London  
SW1A 2HQ

Date: 22 September 2004

Dear Sir Derek,

## **REVIEW OF THE ACTUARIAL PROFESSION**

1. As your paper makes clear, actuaries play an important role in the financial services sector, especially the insurance industry. Because of this, the FSA, as the regulator of the sector, and particularly insurance, has a strong interest in the effectiveness of actuaries and the Profession generally. Our response focuses on our interest as the financial services regulator, including our oversight of the Institute of Actuaries as a designated professional body under the Financial Services and Markets Act 2000 (FSMA). We have also commented on issues of interest to us as an employer of actuaries and a user of the services of actuarial consultants.
2. We have followed the structure of your consultation paper, responding only to those sets of questions on which we have comments.

### The scope of the actuarial role (Questions 1.1 to 1.6)

3. Your review of the actuarial profession was established in the light of conclusions of the Inquiry led by Lord Penrose. As your paper notes, we are currently in a transitional phase as we implement a new and enhanced approach to regulating the insurance sector, which includes the role played by actuaries in the regulatory process.
4. A key feature of the regime created under the Insurance Companies Act 1982 was the "appointed actuary" role for life insurers. The appointed actuary had responsibility for setting the reserves for firms with long-term business liabilities. The regulatory returns of the company were prepared on the basis of the appointed actuary's investigation into the liabilities of the company. This element of the financial

statements was not traditionally subject to external audit. Similar arrangements applied to friendly societies carrying on long term insurance business.

5. As part of our reforms of insurance regulation<sup>\*</sup>, we have introduced, with effect from the end of this year, important changes to these arrangements:
  - we have emphasised that we regard decisions on the valuation of long term liabilities to be a matter for the regulated insurance firm's board and subject to audit. The defined function of the appointed actuary, with the responsibility for setting reserves etc, is therefore being abolished; and
  - we have underlined the importance of firms treating with-profit policy holders fairly by imposing a new requirement for the appointment of a with-profits actuary who will advise on issues of fairness in the context of with-profits funds. Because of the particular responsibilities of with-profit actuaries to make a public report on fairness to policyholders as well as giving advice to management, we think it appropriate to require them for the present to be members of the Profession. This requirement gives us confidence that they will be acting in accordance with agreed professional standards when applying their judgement on the balance between the policyholders' and shareholders' interests. For the same reason, with-profits actuaries will be prohibited from being members of the board.
6. We have also emphasised the importance of the senior management of firms continuing to receive good quality, professional actuarial advice, particularly on the calculation of policyholder liabilities. To ensure that they do so we have introduced a new requirement for firms undertaking long-term insurance business (i.e. not just with-profits business) to take advice on certain key financial issues from an actuarial function holder. Because we think that this advice is currently most likely to come from a member of the actuarial profession, we have for the present required firms to ensure that the individual in this role not only has the required skills and experience but is also a Fellow of the Institute or Faculty of Actuaries.
7. In principle, however, we are not concerned about the qualifications of the individual giving advice provided that the advice itself is appropriate. We therefore see no reason why aspects of the calculation of policyholder liabilities should not be carried out by people with skills other than actuarial skills, provided that the board of a company can satisfy itself that a proper valuation has been conducted and that the auditors were content with what had been done. The scope of the new actuarial function therefore allows firms to seek professional advice on a wide range of financial and other risks from non-actuaries if they wish to do so.
8. We are also mindful of the fact that our requirements on the valuation process for insurers are different from that for other kinds of firms we regulate where we leave it to the senior management (and the auditors) to ensure that a valuation is properly

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<sup>\*</sup> See the FSA's publication: The Future Regulation of Insurance, October 2002

prepared. While this distinction might have been justified in the past because of the inherent complexity of some types of insurance products, in practice developments in other sectors mean that the distinction may now be less clear.

9. With the development of complex financial instruments and new techniques of risk measurement and risk management, we think that the boards of insurance companies will want to seek a wide range of expertise. And the increasing use of stochastic modelling techniques to value the guarantees in insurance contracts may create opportunities for advice to be sourced from experts with skills and expertise developed in capital markets rather than the insurance sector.
10. We do not think that the reservation of the actuarial function role to members of the Profession is in conflict with this development. On the contrary, it may foster closer working between actuaries and other experts. We intend, however, to keep under review the need for reserved roles, including the with-profits actuary function. In particular, we will reconsider our approach in the light of the findings of your review and the response by the Profession.
11. There is also a reserved role for actuaries in the restructuring of a life insurer. Section 109 of the Financial Services and Markets Act 2000 (the FSMA) requires a firm to appoint an independent expert to report on the effects of a business transfer scheme. Under our Supervision Manual, life insurers should appoint an actuary to perform this function. Section 113 of the FSMA further allows the court to require the appointment of an actuary to advise it on any proposals to reduce the benefits under a contract of insurance as part of a business transfer. Again, there are corresponding arrangements under the Friendly Societies Act 1992.
12. We think that these are valuable protections in the circumstances which these provisions address. To the extent that comparable issues arise in other processes, such as during a scheme of arrangement under section 425 of the Companies Act 1985 or where a firm aims to make a reattribution of its estate, we would expect firms to appoint an independent actuary to advise on such arrangements (to the extent that they are not already required to do so under section 109 of the FSMA).
13. The use of actuaries is, of course, developing outside the life insurance sector. As you note, the role of actuaries in the valuation of the general insurance liabilities of members of Lloyd's has been a requirement under Lloyd's own rules since the mid 1990s and that regime, along with the requirement for the Lloyd's Actuary, has been underpinned by FSA rules in the Lloyd's Sourcebook. In our recent consultation on the future regulatory arrangements for Lloyd's, we have not proposed material change to the actuarial aspects of the regime. In particular, the requirements for the Lloyd's actuary and for syndicate actuaries (for life and general syndicates) will continue.
14. We have not so far made rules imposing requirements for the general insurance sector outside Lloyd's to appoint actuaries, although we have indicated that we will revisit

this question<sup>\*</sup>. It is clear that the industry has itself already recognised the value that actuaries can add to the quality of management of firms. We find that regulated firms are making increasing use of actuaries even though this is not a requirement. We are aware of work being carried out by the Profession on the possibility of reserved roles in general insurance and will consider the issues further when this work is complete and in the light of the outcome of your review.

15. Where we find specific situations that require actuarial expertise in general insurance, it is within our powers to require such an appointment where we think it necessary or desirable to do so (by a variation of permission under section 45 of the FSMA or the information and investigation powers in Part XI). This might apply, for example, if we became concerned about a general insurer's exposure to particular long tail risks.
16. To the extent that there continue to be actuarial functions reserved by statute, you asked whether it would be desirable to have greater peer review and scrutiny. As noted above, the changes we are introducing from the end of this year will make the actuarial functions more clearly advisory functions which, by definition, expose them to review and challenge by decision takers. We are also:
  - requiring auditors to take actuarial advice when reaching their audit opinion on all the reserves (both realistic and those assessed on a regulatory basis) for the major with-profits firms; the actuary providing this advice (the "reviewing actuary") must be a member of the Profession; and
  - requiring firms to seek independent input into the assessment of their compliance with their Principles and Practices of Financial Management (documents which we require with-profits insurers to produce and make public on their approach to managing their with-profits funds).

Firms may of course choose to put in place wider peer review arrangements.

17. We think it is too early to form a view on the effectiveness of the changes outlined above, which do not take effect fully until the end of this year. But we expect that our approach will be more robust and at the same time more flexible than previous arrangements. Further, the new arrangements are consistent with our general reliance on senior management responsibility alongside an appropriate reliance on accounting standards as well as actuarial standards.

#### Accountability of actuaries (Questions 1.7 to 1.10)

18. You ask about the role of actuaries in designing products that were not fit for purpose. Clearly, this is an issue of wider concern to us. We expect firms to put in place arrangements that include appropriate checks and balances to make sure that their

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<sup>\*</sup> See Chapter 2 of our Consultation Paper CP04/07, Lloyd's: integrated prudential requirements, and changes to auditing and actuarial requirements, April 2004.

products are indeed fit for purpose and sold to the right markets. This is something we are seeking to address through our work on Treating Customers Fairly\*.

19. As noted above, one of the cornerstones of our regulatory regime is the responsibility of senior management to ensure that a business is properly run. In the case of regulated insurance companies, the actuary providing advice is accountable to the regulated firm through its management. By removing the scope for confusion over responsibilities, the abolition of the appointed actuary will help to ensure that senior management recognise their responsibilities to take account of the interests of their customers in designing and marketing insurance products.
20. In addition, the with-profits actuary (and the independent expert in the case of a business transfer scheme) will have specific responsibilities to report to policyholders on whether and how their interests are being taken into account, particularly in areas of business such as with-profits where the firm has a degree of discretion. While open to alternative approaches, we believe that the creation of the with-profits actuarial function, our wider reforms of the role of actuaries in the governance of insurance companies and our emphasis on the senior management responsibility to ensure the fair treatment of customers will provide a clear and robust accountability framework for actuaries giving advice to regulated insurance firms in the future.
21. Finally, the new with-profits actuary and actuarial function will, in addition to their accountability to management, have some accountability to the FSA. Actuaries performing these functions, in common with other staff in “controlled functions” will have to be approved by the FSA. Actuaries in these roles may be held directly accountable for regulatory failures in the firm.

#### The Profession (Questions 1.11 to 1.14)

22. Our programme of reform of the regulation of insurance firms has involved extensive consultation with the industry and other interested stakeholders. There have also been complex issues that have arisen as a result of recent financial market conditions. We have had extensive contact with the Profession which has been well organised in providing its views on our proposals and has robustly defended aspects of the way the actuarial profession operates. The Profession has also engaged actively with us to discuss practical solutions to our concerns.
23. Inevitably, we have not always reached the same conclusions about the best way forward, reflecting our different objectives and goals. However, we have always been fully briefed on the issues for the Profession when taking decisions about regulation, and the Profession has supported discussions about potential new methodologies. The Profession has reacted to our new proposals by developing helpful professional standards that will take effect when our new requirements come into place.

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\* See our paper Treating Customers Fairly – progress and next steps, July 2004.

### The Market for Actuarial Services (Questions 1.22 to 1.29)

24. We employ a number of actuaries. The majority are engaged in advising the supervisors of life and general insurance companies. Most of these are engaged on life insurance, advising on actuarial issues in life firms, whether in the context of their returns, the outcome of risk assessments or other issues. While we have no formal actuarial requirements for general insurance firms outside the Lloyd's market, we increasingly use actuaries to support our general insurance supervision teams.
25. In addition, we employ actuaries for policy work, covering a range of disciplines such as reserving and capital requirements, dealing with the misselling of personal pensions, conduct of business issues and the management of with-profits funds.
26. There are also occasional projects that we undertake for which we need additional resource or where we require some independent input. This more usually occurs in the context of particular policy issues. If we wish to see an independent review of a particular aspect of a firm's business, we would normally require the firm concerned to appoint a consultant to undertake a review. But in exceptional circumstances, we have engaged consultants to give advice directly to us on such issues.
27. We have always been able to find advisers to act for us. But there have been situations where, because of the need to manage potential conflicts of interest, the choice of firms or individuals has been limited. One consequence of this is that we may not always be able to engage the firm or individual whom we consider would be best placed to advise on particular issues. Another consequence of this is that price competition may not be effective.
28. The consultation paper also specifically asks about use of the services of the Government Actuary's Department (GAD). GAD staff involved in the supervision of insurance firms transferred to the FSA in 2001. This was done as part of the process of building a single regulator for the financial services industry so that the FSA would be fully resourced when the FSMA came into force on 1 December 2001. We have not used the services of GAD since the transfer took place.

### Regulatory role of the Profession (Questions 2.1 to 2.4)

29. As your paper mentions, the Institute of Actuaries has power to regulate firms and partnerships in relation to investment business. This is because the Institute is one of the eight professional bodies designated by the Treasury under Section 326 of FSMA. Members of the Faculty of Actuaries become Affiliates of the Institute in order to benefit from the DPB regime.
30. It may be useful for your review to have some background on these arrangements, including the role of the FSA. Overall, we believe that the arrangements, which are designed to avoid firms having to seek authorisation from the FSA in respect of investment business incidental to their business of providing actuarial advice, to be functioning satisfactorily.

31. Part XX of FSMA provides that firms regulated by designated professional bodies (DPBs) and which only carry on certain regulated activities that arise out of or are complementary to their professional services do not need to be authorised by the FSA. These firms, known as exempt professional firms (EPFs) are supervised by and have to comply with the DPBs' own rules. These rules have recently been amended to incorporate mortgage and general insurance business.
32. The FSA has certain duties and powers under Part XX of FSMA in respect of the DPBs and their member firms. For example, we are responsible for approving certain of the rules referred to above as well as having an oversight role of the way in which the DPBs regulate EPFs and the way in which such firms carry on exempt regulated activities. Under Section 325 of FSMA, we must keep ourselves informed about these matters including complaints and redress arrangements.
33. We also have an interest in complaints arising from the exempt regulated activities of EPFs and the equivalent activities, known as non-mainstream regulated activities, carried on by those member firms licensed by the Institute and authorised by the FSA as these are both dealt with by the DPB. More generally, the FSA has a statutory duty to have regard to the effectiveness of each DPB's complaints handling arrangements.
34. We carry out risk assessments of the DPBs, most recently towards the end of 2002. We reviewed each of the DPB's complaints handling arrangements at the same time as the risk assessments.

Scope of Actuaries' Statutory or Reserved Duties (Questions 2.5 to 2.8 (Life insurance); 2.9 to 2.14 (Pensions); 2.15 to 2.17 (General insurance); and 2.18 to 2.19 (Investment business))

35. Many of the points made in the first section of our response are relevant to the questions in this section.
36. The criticisms made by Lord Penrose reflect in part the weaknesses of the regulatory structure we inherited, where the appointed actuary was not exposed to adequate external challenge on the setting of reserves and poor accountability arrangements, not least because there were no arrangements for the audit of long-term liabilities. They are also a reflection of the fact that a single, and powerful individual held the positions of both appointed actuary and chief executive at Equitable Life, which made it difficult for the board to challenge his authority effectively.
37. As noted above, the lessons learned from that experience are reflected in the new rules which we have been adopting and our more challenging and more risk based approach to regulation. For example, we have prohibited the with-profits actuary and actuarial function holder from becoming also chairman or chief executive of the firm.
38. We have separately prepared a response to the consultation by the Myners review which sets out the steps that we have been taking to ensure that corporate governance issues are now addressed more effectively. While that review is focussed on the governance of life insurance mutuals, it is clear from our response that many of our comments are equally relevant to our supervision of proprietary firms.

### Whistle-blowing (Questions 2.24 to 2.26)

39. As your paper mentions, we have received 10 whistleblowing reports since the new arrangements took effect in September 2003. These have been valuable in alerting us to significant developments in insurance firms. We think that the arrangements are working satisfactorily, allowing for the short time in which they have been in operation. For example, we have no reason to be concerned at this stage about over-reporting to us by actuaries. But we will of course learn from other responses to and the conclusions of your review.
40. We note another difference between the life and general insurance frameworks is the absence of whistle-blowing provisions in general insurance.

### Standard Setting (Questions 2.27 to 2.32)

41. The obvious comparators to the professional guidance for actuaries are the guidance and rules that govern the preparation of accounts for firms more generally and the code of conduct governing legal advice. On the accounting side, however, the requirement to prepare accounts in a particular way falls on the firm and any person involved in the preparation of the accounts will be required to adhere to those rules. The directors and auditors of the company have a particular responsibility to confirm that the rules have been followed. By contrast, actuarial technical guidance applies to the individual actuary and is not directly binding on the firm that is being advised.
42. This arrangement is not in practice problematic for us. Our own rules on the valuation of reserves specify the rules at a level of detail that we think necessary and we have been able to rely on the fact that in complying with our rules, financial data have been prepared by an actuary who has complied with professional guidance with which we are familiar. In this connection, the continued reservation of actuarial advice on core issues to a member of the Profession is clearly helpful. To the extent that we have concerns about the guidance, it is open to us to require firms to carry out the valuation process in accordance with our preferred methodology rather than on the basis set out in professional guidance.
43. In contrast with life insurance, the accounting and reserving process for general insurers is driven by accounting standards, which are on the basis of a best estimate of the liabilities. Even in the case of Lloyd's, where the valuation of liabilities is subject to actuarial review under our requirements, Lloyd's members are still required to report on the basis of those standards. This means that even where there has been actuarial input to the valuation process, this is still within the scope of the senior management and audit review.
44. The different approach in life insurance reflects the fact that the setting of reserves for long-term life assurance liabilities for regulatory purposes is subject to EU Directives and specifically a requirement for prudent reserves. This has led to a mismatch between the regulatory requirement and possible accounting requirements. Over the years, a number of methods have been developed (embedded values, achieved profits,

market consistent embedded values) to reconcile prudent reserves that include margins and more realistic internal reporting and accounting reserves.

45. The changes to our rules for actuarial valuations (in particular realistic reporting by larger with-profit firms) have brought a greater degree of alignment between the position for general and life firms. However, there remains the fundamental difference, which is a reflection of the current accounting standard, that the accounts are required to show a provision for long-term liabilities calculated in accordance with the actuarial guidance, on a prudent basis.
46. We believe that in the short term, the emphasis should be on the Profession ensuring that technical guidance remains up to date and responsive to market developments. We are committed to playing our part in this process and are working with the Profession and the industry at present on new technical guidance that reflects the changes in regulatory requirements taking effect at the end of this year.
47. However, we remain open to alternative approaches to technical standard setting in the medium term. The forthcoming reform of the EU requirements (the "Solvency II" discussions), particularly if it results in closer alignment of regulatory and accounting standards, will be an opportunity to review the current approach to standard setting. There may also be a need to do so were we no longer to reserve key valuation processes to members of the Profession. Even then however, we could still require individual firms to comply with the technical guidance of the Profession, assuming that that guidance remained the generally accepted standard for the industry.

#### Monitoring, complaints and disciplinary schemes (Questions 2.38 to 2.43)

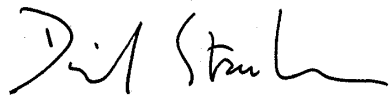
48. Your paper mentions in paragraph 2.38 the fact many actuaries have regulatory responsibilities under FSMA and may be subject to discipline by the FSA as well as by the Profession. We believe this to be appropriate – and no different from the situation applying to members of other professional bodies with disciplinary schemes who also perform roles in regulated firms that require our approval. As a statutory body, we clearly have wider powers than the Profession. So we do not think that disciplinary powers should be restricted to either the Profession or the regulators.
49. However, we recognise the need to review how we co-operate in practice. We are in discussion with the Profession on the need for any new procedures to take account both of the recent changes to the Profession's disciplinary schemes, which you mention, and the widening last year of the disclosure provisions under FSMA.

#### Conclusion

50. We welcome this wide-ranging review into the Profession and will continue to provide whatever input and advice you and your team require.
51. Our comments in this report focus mainly on life insurance, reflecting the scope and pace of change in this sector in recent years. I have referred to many of the reforms that we have made in this area, including the abolition of the Appointed Actuary role, the new audit requirements and the reform of regulatory capital requirements. We

believe that these reforms, on which we have worked closely with the Profession, will contribute to a regulatory framework that meets the objectives set out in the terms of reference of your review. But we welcome debate on where further change is required and will consider the need for any further changes to our own requirements in the light of your conclusions and recommendations.

Yours sincerely

A handwritten signature in black ink, appearing to read "Dil Stur". The signature is written in a cursive, flowing style with a long horizontal tail stroke.