

Dear Sir Derek,

As an overseas Fellow of the Institute of Actuaries, my interest in your review is remote, but I have had an ongoing interest in some of the issues you raise, and may be able to give an alternative perspective.

My career includes four years as Chief Actuary of the Prudential Assurance Company of South Africa and fourteen as Professor of Actuarial Science at the University of the Witwatersrand, Johannesburg - and now two with the Australian regulator. I mention this because the major thrust of my comments derives from my experience that our material interests can significantly influence our perspectives - and I wish to disclose my own.

As background to my submission I enclose two papers. The first on the education of South African actuaries, which I presented to the annual convention of the Actuarial Society of South Africa in 1998, and the second, on changes I believe should be made to the life insurance syllabus, published in volume 2 of the South Africa Actuarial Journal in 2002.

In reply to your questions, I have attempted not to answer those where I add nothing to the response of the professional bodies:

Chapter 1

- 1.1 Actuaries bring their mathematical skills, their background in economics, statistics and accounting, and their detailed knowledge of the vocabulary and workings of the insurance and pensions businesses to their statutory roles. In this I would place more emphasis on the latter than the profession. I do believe that actuaries are largely equipped to fulfill their functions. (A slightly more detailed answer is given in sections 1.1.1 to 1.1.3 of the Education paper.)
- 1.2 I do believe that actuaries could be more involved in ensuring that clients' needs are met, and in the prudential regulation of the banking industry. (See section 1.3 of the Education paper - noting that I would now withdraw the first paragraph of section 1.3.3. on a banking role.)
- 1.3 I do believe that the statutory actuarial roles are a useful contribution to financial markets, and should be reserved for people with the background and skills described in 1.1 above.
- 1.4 Hiding behind one's status and purported expertise is a common failing - especially when under pressure. I have seen the statutory role used in this way - and would readily believe that such actions are common. On the other hand, it would seem unavoidable: if one needs a certifiable expertise to make the statutory recommendations, then the experts will face the temptation to abuse their certification. The solution seems to be to foster an environment where transparency is valued, and all judgments are open to debate.
- 1.5 I do see a place for compulsory peer review, not so much of individual actuarial reports, but of the whole practice of an actuary. Such review would not have to be independent or even objective, but competent from both a technical and business viewpoint. It should also cover professional ethical issues. I think there is a good case for suggesting such reviews should be required on a periodic basis (say every five years). In such a case, the actuary would commission the review and be free to accept or reject any recommendations.

It seems to me that the major moral pressure on actuaries to reduce their standards comes from other actuaries prepared to recommend lower reserves or premium rates or to accept a lower quality of data. In order to protect against this type of competition amongst the profession, it seems to me that the profession (or the regulator) should be more active in producing data bases of assumptions and methodologies to provide a benchmark. Transparency - in the form of reports that are widely available and which include details of the assumptions and a report on the data - would then allow for peer review. It might even enhance competition. I

hope that the introduction of new international accounting standard (currently included in ED7) will eventually produce such a result. It would not however address systematic issues, where all actuaries had succumbed to pressure from their clients. In order to examine the fundamental structure of professional practice and the industry in which they operate, a review would have to be disinterested and informed - a difficult combination. Can a practising actuary publicly criticise her peers for failing to stand up to their clients' faults? Yes she can, but it might mean commercial suicide.

The key point is that our material interests play a critical role in determining our beliefs and behaviour. When they start out, actuarial students are not aware of problems in the industry. Once they do become aware, it is extraordinarily difficult in mid-career to take a critical view of the processes from which they rely for material, social and psychological sustenance. Some who do ask these questions, drop out of the industry rather than attempt reform.

There are however various sources that can generate a disinterested and informed critique of systematic issues.

- Competition within industry and the profession. In the market for financial security, size is more of an advantage than in other markets, which seems to make this a slower process. There is also less competition from overseas as the products have to be sold locally.
- Different strands of development within the profession. E.g. Pensions actuaries may be able to critique life actuaries - but they serve largely the same interests.
- Actuaries based at universities. In this respect I think it is a pity that the UK profession has not developed university departments that have taught the later subjects. I think it would be true to say that the universities have been a source of critique, and spur to development, of a number of technical questions especially those related to financial economics - such as those related to the pricing of annuity guarantees. I think most South African actuaries would agree that my university position gave me an independence that enabled me to be a critical voice on a number of controversial issues. Academics are however frequently under-funded, and dependent on consulting income from industry.
- Actuaries within the regulators and other government departments. They face politically constraints and cannot be too public in their criticisms of systemic, and therefore political, questions.
- The press and consumer organizations. The media face significant pressure from advertisers, while consumer organisations are less well funded than universities.
- Committees of inquiry - relying sometimes on foreign agencies and professionals. While these may be disinterested, there is a significant danger that they will fail to appreciate the intricacies of the issues.

The main point I want to make in this submission is that all should be encouraged. I have always thought that actuaries at the end of their careers and therefore not so dependent on their peers' goodwill, could be more active in reflecting upon and critiquing the status quo. It would be good to find ways of encouraging universities, government and consumer organizations to employ them for this purpose.

- 1.6 There is much actuaries can learn from a wide range of other professions: law, accounting, economics, statistics and computer science. I believe that we should attempt to incorporate some of these options in the initial training, and in ongoing professional development. (As discussed in sections 3.4 to 3.6 and in the third paragraph of section 5.2 of the education paper.) This would I believe lead to greater use of other

professionals, as in many cases, failure to consult others arises from unconscious ignorance.

Summarizing this section, I do think that the task of evaluating the solvency of financial institutions is a complex one that requires the skill set and experience to which actuaries aspire. It would be inappropriate for the actuary to be subject to auditors who are unlikely to have the necessary skills and experience, but it is similarly inappropriate for an actuary to act without subjecting his methods and conclusions to review by his clients, the regulators and, in some cases, the public - including his peers and competitors. I do think however we should look to a greater diversity of interests and opinion, and aspire to more vigorous contestation of ideas within the organs of power.

1.7 While I have criticized the South African profession internally on misselling (sections 1.2.4 and 3.7 of the education paper), I would want to offer something of a defense to those outside the profession. Is it widely held that accountants who work out profit maximizing prices for their firms are acting irresponsibly? Is there any social pressure on bank managers for making higher rates of profit than insurers?

While I think that the profession's response to you might appear overly defensive, the internal debates on public interest reflect a high awareness of the issues, and willingness to reform. I would go as far as to suggest that the presence of a strong social conscience within the profession is one explanation for the public profile of the issues mentioned in this section of the consultative document.

The mis-selling scandals seem to me to arise mainly from systematic conflicts of interest faced by purported advisors who obtain commissions dependent on the results of their advice. My experience is that all actuaries are uncomfortable with the system, and that most would want it abolished. In South Africa, the cabinet appointed "Committee of Inquiry into a Comprehensive Social Security System for South Africa" recommended that commissions should be payable for selling standardized products and not for advice. The question was raised with members of the Actuarial Society of South Africa in a survey and at 2 meetings at which I presented the idea - as a member of the Committee. About half of those responding or present abstained, but no one argued against idea. It is a bit like global warming: everyone is against it, but it is extraordinarily difficult to do anything about it.

1.8 to 1.10 No comment.

1.11 My view is that the profession is particularly energetic in making contact with government and other key players. It might be useful to publish a permanent record of representations to government - as the Institute of Actuaries of Australia does in its Australian Actuarial Journal.

1.12 I do think that the profession's educational system has tended to neglect the later practical subjects at the expense of earlier technical subjects. My paper on the life assurance syllabus and sections 3.1 to 3.7 of the education paper address this issue. I mention a number of economic and management concepts that are not included in the syllabus, which we had included in our courses and our graduates have found useful.

It is in the area of research where I think the profession's excessive focus on mathematical models to the exclusion of the social role of insurance and pensions has fallen down. We do not know enough about the effect of our policy and benefit design on the lives of our beneficiaries.

1.13 No comment

1.14 Some lay representation on the governing bodies would enhance diversity. If possible, such representatives should be appointed by outside bodies to give them enhanced independence. Criticism will inevitably be muted if the lay representatives feel like invited guests.

1.15 No comment

- 1.16 See answer to 1.12.
- 1.17 It seems to me that 5 or 6 years of experience will normally be necessary before a person can be trusted to practice as a qualified actuary. The point is argued in more detail in section 2.1 of the education paper. I have subsequently read of research on brain development which suggests that those parts most required for prudence are still developing in people's early twenties. (Wallis, C. and Dell, K (2004) What Makes Teens Tick, *Time Magazine*, May 10)
- 1.18 The actuarial syllabuses were slow to catch up with financial economics, but the early parts have largely done so. Application in the later parts is inconsistent, not least because of ongoing debate within the profession about its application. In this, the actuarial profession is perhaps no more divided than the accounting profession - if the various flip flops in the development of international accounting standards are to be explained. It is difficult to know how the debate could be speeded up and brought to a satisfactory conclusion. Will it be the victory of one paradigm over another or a synthesis of old and new? If the former, it will require regulatory intervention to persuade the recalcitrant. If the latter, it requires people to work on the synthesis. From my perspective, universities that are more conscious of the actual practice of actuaries (contained in the later subjects) are the best place for this.
- 1.19 I only have access to the outline of the new 2005 syllabuses, so I am not sure that they will deal with the issues I have raised. I do believe (as suggested in sections 2.2 and 2.3 of the education paper) that moral issues need to be incorporated into the teaching of the technical material, and that their inclusion in the business awareness modules treats them as minor extras rather than fundamental questions. E.g. The new course CT2 looks as if it will teach "agency theory", which assumes that agents will not necessarily look after the interests of their principals, but will probably not teach the law of agency and its prohibition on conflicts of interest, which provides the legal and moral protections to ensure that agents are not unfaithful.
- 1.20 Lack of diversity in the student body in South Africa arose from the schooling system's failure to teach adequate mathematics to everyone. I suspect that this is the major problem largely beyond the ability of the profession to solve, but makes some suggestions in section 3.9 of the education paper about mentoring. I do think (as mentioned in question 1.6 above) that some actuaries could learn more of other disciplines.
- 1.21 Yes, for the reasons set out in 1.5, and the research output that a university might be expected to produce, I do believe that there should be more university involvement in teaching the later subjects. In section 3.8 of the education paper I express some concerns about the current structure that might be better addressed in the university environment.
- 1.22 to 1.24 No comment.
- 1.25 I do not believe that actuaries are unable to communicate, just that they frequently do not want to. It is not easy to communicate the uncertainty inherent in an actuarial answer to people who dislike, or fail to appreciate, uncertainty. As mentioned in 1.4 above, it may be easier to bluster. I see no easy answer to the problem, beyond the requirement for greater transparency and freedom for people to speak their mind.
- 1.26 to 1.29 No comment.
- 1.30 I think that the UK profession is well regarded for its business skills within the worldwide profession. The messiness of the financial economics controversy - linked to the current underfunding of pension funds - has however reduced its standing amongst both actuaries and non-actuaries.

- 1.31 My experience has been that actuaries are able to move internationally fairly easily.
- 1.32 and 1.33 No further comment.
- 1.34 and 1.35 I cannot comment on the UK Financial Reporting Council or the UK accounting profession.

I will say - after some months of engagement with the new international reporting standards - that I fear that the level of unnecessary complexity will prove an unbearable burden on smaller firms especially. The splurge of new regulations from government, in which accounting and actuarial standards are embedded as extensions and responses, have no redeeming features. They encourage conformity to the letter rather than the spirit of the law, and are too complicated to enforce uniformly, bringing the law into disrepute and making it more likely that opportunists will flourish. They require rote rather than understanding when they are learnt, driving people into narrower specializations and perspectives. They are normally poorly constructed and written, making them difficult and unpleasant to use.

My transition from one jurisdiction to another has made this more evident to me. My view has been confirmed over some years by friends and acquaintances, but I have not been able to find more scientific data on the subject. I would however bring your attention to a related issue, being mistakes found by audits into public administration. Recent Australian research (Howard Pender (2004) Public policy, complexity and rulebase technology, The Australia Institute) records error rates in 4 countries. They vary from 4% for the UK War Pensions Scheme to 76% of "maintenance assessment debts" in the UK Child Support Agency! People and organizations have a limited ability to deal accurately with complicated rules.

It seems to me that both regulators and the governing body of professions have to be persuaded that the proliferation of rules is an unmitigated and dangerous evil.

- 1.36 and 1.37 I do think lay members and some government appointed members on the governing bodies would increase the diversity of views that would be represented. These representatives should preferably include representation of the interests of small companies and partnerships, and individual practitioners. Mancur Olson (The Logic of Collective Action, 1965) explores the collective action of the small groups that will often dictate the nature of regulatory debates. Large companies and professional partnerships are likely to be disproportionately represented in all debates and lobbying, and achieve outcomes that advantage them at the expense of smaller less well organized groups. The resultant loss of diversity undermines economic competition and the ferment of ideas so necessary for a vital industry.

Chapter 2

In the interests of brevity, I only comment on a few questions.

- 2.3 I do not think that it is helpful to describe the functions of the Profession to represent and to discipline its members as constituting a "conflict of interest". Prohibitions of conflict between an agent's (or fiduciary's) personal interest and his duty to his principle are an important common law principle. I do not think that the Profession has a contractual or fiduciary duty to the public. Individual actuaries have a duty to specific third parties that may rely on their reports. We all face a more general call to public service, but that - in this world at least - should not be actionable.
- 2.5, 2.7 and 2.10 raise the concern that lay people may place too much reliance on the actuary. My experience in dealing with barely literate trade union trustees in South Africa suggests that it is attitude rather than knowledge

that is at issue. I have been challenged by men with perhaps five years of formal schooling to produce my formulae for their inspection.

This means that directors and trustees must have courage as well as insight and experience. These traits are greatly enhanced if they are truly independent. I think this means - if at all possible - that they should be elected by different constituencies. Member or union elected trustees serve this purpose, and should make up at least half the trustee board. Canadian legislation requires life offices to use proportional representation methods in the election of boards of directors, which also has the desired effect.

2.23 As discussed in section 2.2.3 and 4.2 of the education paper, I think that CPD programmes should be more extensive and challenging. In particular, the periodic reviews suggested above in question 1.5 should begin immediately after the final examinations, and cover issues of personal growth.

2.27 to 2.32 deal with Lord Penrose's indignation at the failure of the guidance notes to deal with annuity guarantees and reasonable benefit expectations. I, respectfully, disagree and would argue against an extension. I give two arguments:

- The professional bodies have apparently found enough prima facie material to arraign the Equitable's management.
- The South African courts use reasonable benefit expectations (the equivalent of PRE) as a measure of equity. My attempts, over two decades to develop a working definition for both PRE and equity, have frequently drawn objections from actuaries and lawyers that it is not possible. This was the 1993 finding of the Institute/Faculty Brindley working party - although they were concerned at complacency about the topic within the profession. If three millennia of jurisprudence have failed to come up with an unambiguous definition of equity, then it is too much to ask the actuarial profession to do so for PRE in the three decades since the term was first used.

Chapter 3

Following from the comments made in question 1.5, I would suggest that the GAD should not take on private sector work, nor any other work that might have the impact of inhibiting its freedom to comment on matters of public interest. I offer nothing else in response to the questions in chapter 3.

In summary, my view is that the integrity and competence of actuaries would be best fostered by freedom from regulatory pedantry, and the development of a diversity of interests that leads to greater competition in the realm of ideas as well as commercial practice.

Yours sincerely,

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