
MORRIS REVIEW

Background

Tillinghast is a global firm that consults to the insurance industry and other financial institutions, operating in 18 countries worldwide. The London office was established in 1973, and now employs about 65 qualified actuaries and 45 trainee actuaries. We act as appointed actuary to 11 companies in the UK, and provide consulting services to most of the major insurance groups. Further details on the services we provide can be found at www.towersperrin.com/tillinghast.

Responses to Questions

Unless otherwise stated, this response relates to life and general insurance consulting. Not all questions have been answered as our response has been restricted to areas where we have a perspective on the issue, given the nature of our business.

The word “consumer” is used in many questions. In some cases it is clear that consumer is intended to mean policyholders or potential policyholders. In other cases, where the reference is to a consumer of actuarial services, we have taken this to be a corporate consumer.

Q1.3 Yes. The with-profit actuary and Actuarial Function Head should be reserved by statute (or FSA rules). The former is self evident. The AFH role should also be reserved because the very technical nature of the FSA rules for valuation of liabilities require extensive actuarial experience and judgement, and in respect of a with-profit company the AFH needs to be able to discuss matters with the with-profit actuary on equal terms.

Q1.4 The existence of reserved roles has been effective in giving influence tantamount to authority to the actuary within an organisation. In some organisations the actuary concerned may have the same degree of influence and access to the Board without the reserved role, but this is not so for all organisations.

The effectiveness with which actuaries work with non-actuaries depends on personal style. However, in the absence of active compliance review monitoring, the existence of reserved roles has enabled individuals so-minded to be less communicative with non-actuaries and indeed with other actuaries.

- Q1.5 As a firm, Tillinghast has a very long established requirement that all our work must be peer reviewed (within our firm) before it is presented to our client. However, despite being a supporter of peer review, we are aware that clients are reluctant to “pay twice for the same job”.

Given the extension of the audit to the actuarial provisions, we question why the Profession should require further review. However, if it is believed more widely that there should be a peer review of reserved roles, then that need should be mandated through regulation

- Q1.6 In general the Actuarial Profession does work closely with the other professions. In view of the experience of the House of Lords judgement on Equitable Life’s bonus policy it might be helpful if there were a non-adversarial forum for discussions between the legal and actuarial professions on matters of technical complexity which have significant financial implications.

- Q1.7 As a matter of law, we would expect that the companies manufacturing or selling the products would be formally responsible.

Whether or not individual actuaries in specific companies were “responsible” (either solely or as part of a team) for products that, with the benefit of hindsight, have failed to provide the expected benefits, is a matter of fact. Whether, and to what extent, the possibility of such failure could have been reasonably foreseen at the time the products were sold is the more relevant question, and the answer will depend on particular circumstances.

Many of the problems that have emerged relate to the sales process and characteristics of the customers to whom the products were sold. The Actuarial Profession (as compared to individual actuaries involved in product design) does not have any remit, nor the resources to monitor sales and marketing literature or determine whether products were suitable for the customers to whom they were

sold. In respect of endowment mortgages, the profession did issue a paper in 1999, highlighting, inter alia, the need for disclosure of the relative risks and rewards of different types of mortgage repayment approaches and the need to understand individual customers' personal circumstances. Similarly, in 1996, the Profession drew attention to the risks inherent in precipice bonds.

Lessons for the future have already been learnt in terms of financial service companies (including those where actuaries are typically not employed) being more careful to describe the risks and rewards of different products in a balanced way.

- Q1.8 In general, actuaries should be primarily accountable to their client. This could be overridden by legal requirements, for example where actuaries act as the Independent Expert in a Part VII transfer of one insurance company to another, where the primary responsibility is to the Court. In addition, for certain types of work, particularly in respect of pension scheme valuations, actuaries may also have a duty of care to the beneficiaries.

It is unreasonable and unrealistic to expect actuaries to be primarily accountable to a broader public interest, since it presupposes that there is a single public interest in respect of a particular issue, and it breaks the essential relationship between the actuary and the client. To the extent that there are public interest issues, specific responsibilities should, if necessary, be assigned through legislation, rather than the profession or individual actuaries having to shoulder that burden.

- Q1.9 See 1.8. In addition, in our view, the Actuarial Profession did somewhat oversell its ability to protect the public interest, particularly in the second half of the 1990s, and this has possibly led to unrealistic expectations of what the profession could achieve in this area. That having been said, the Profession has done good work in publicising issues.

- Q1.10 Actuaries in consulting practice are liable to their clients in contract and tort in the same way that other professionals are. We do not believe that there is a case for imposing additional liabilities. If "poor advice" is taken as "negligent advice" (which should largely preclude the use of hindsight), then compensation would be

payable to the actuary's client and possibly to any other party to whom the actuary has a duty of care.

Q1.13 See Q1.14

Q1.14 The Profession is a relatively small profession. It is very dependent on the voluntary support of its members and their employers. Those wishing to contribute to research activity or to the direction and governance of the Profession can in practice only do so with the strong support of their employer in terms of allowing the time commitment, providing financial support and ensuring there is no adverse impact on career prospects. A consequence of this is that it can be difficult for sole practitioners or those employed in small firms to contribute.

The larger firms have provided the necessary support, but this can lead to conflicts of interest or at least to a perception that those active in the Profession are influenced by the financial interests of their employer. Furthermore, it is also possible that those active in the Profession, may also be active in employer trade bodies such as the ABI, and therefore provide input on the same issue (eg accounting developments) in different forums.

The impact of this is that it can be difficult to reach a conclusion on contentious issues with significant financial impact. This particular problem with the governance structure may be improved with the establishment of an Actuarial Standards Board free from conflicts and with relevant experience and adequate funding.

Q1.23 The market for actuarial services in the life insurance sector is relatively small. There are several large consultancies but sole practitioners may struggle to support the corporate consumer owing to difficulties of keeping up to date, obtaining PI cover and arranging backup in the event of illness. It is possible that choice may be constrained by conflicts of interest.

Q1.24 It is easy to switch actuarial service provider or the particular consultant within a provider. There is no need for further encouragement.

Q1.25 The bulk of our clients are knowledgeable corporate consumers.

Q1.27 Many factors determine whether actuarial advice is provided in house or by external actuaries. For example:

- Small, simple life companies may not have sufficient actuarial work to justify the cost of an in-house actuary
- Companies may have a need for independent actuarial advice (either through a legal requirement, or as part of their governance processes)
- Companies may not possess certain specialist skills, or may have insufficient staff to meet peaks in demand
- Larger with-profits offices are more likely to have an in-house appointed actuary, in order that the individual can keep fully informed on all material matters, and influence decision making processes in a timely manner.

Q1.28 The market is competitive and is not constrained by existing rules and conventions, other than to constrain clients from “shopping” for the weakest opinion in respect of reserved roles.

Q1.29 We do not consider that GAD has a material impact on our segment of the market.

Q1.30 We believe that the skill and professionalism of UK actuaries and the UK actuarial profession is very favourably regarded internationally. Indeed, many countries have been moving towards adopting our Appointed Actuary system.

Q1.31 Actuarial skills are highly transferable but it would be necessary to understand the regulatory, accounting and tax environment of the particular country as well as the products and culture in order to be fully effective. Actuarial associations have Codes of Conduct that require an actuary to be competent to undertake the proposed work.

Q1.32 It would be interesting to see whether in these countries, they have overcome the “conflict of interest” and funding issues discussed under Q1.14 above.

Q1.34 Yes - but in applying lessons to our Profession (and in particular having regard to its small size), we would need to address how to finance an independent regulator,

and how to ensure that such a body was sufficiently practitioner based but still free from conflict of interest.

Q1.36 We understand that under the professional framework for lawyers it is clear that a lawyer's duties are to his/her client. There are certain overriding duties, for example not to mislead the Court, but public interest obligations do not override duties to their clients.

Q2.1 The objective of any regulatory framework for the Actuarial Profession should be to facilitate the provision of high quality, objective and cost effective actuarial advice.

Q2.2 The protection of consumers is the responsibility of the FSA. The Actuarial Profession has a role in the regulatory framework through the establishment of sound actuarial practices, training and licensing of its members and through its disciplinary processes. It does not have a direct duty to protect consumers, although its members, to the extent that they have positions of authority within regulated firms such as insurance companies, do have obligations to ensure that their firms treat customers fairly.

In considering the role of the Profession, it should be borne in mind that when it comes to disciplinary matters, the Profession has no right of access to all relevant data. This restricts its role; as an example, the Corley report on the Equitable was prepared without the right of access to Equitable Life's files.

In the context of life assurance, it is difficult to understand why greater requirements should be applied to actuaries than to other approved persons. The Profession should not regulate for FSA breaches.

Q2.3 There is a conflict between these two roles for the Profession. We understand that other professions have adopted different approaches: for example the medical profession has the British Medical Association acting as a trade union; education and professional standards set by various professional bodies (eg Royal College of Surgeons); and disciplinary matters dealt with by the General Medical Council.

However, it should be recognised that the medical profession (and for that matter the legal and accountancy professions) is more than ten times the size of the actuarial profession.

The actuarial profession has recently addressed this point through changes to its disciplinary process, and we think this should be left in place for the time being to see if it works out well – which we expect it to.

Q2.4 No. The Profession should not be self-regulated as far as conducting investment business. In other matters, it should remain self-regulatory.

Q2.5 The FSA's proposals were developed prior to the Penrose report. They cover the areas raised by Penrose but it is too early to identify what might later turn out to be deficiencies of the new system. Under the Appointed Actuary system, the firm was required to keep the Appointed Actuary informed of all relevant matters, but in future the Board can seek actuarial advice from many different sources and there is a risk that this advice may inadvertently be given from limited knowledge.

The Appointed Actuary took individual responsibility for the mathematical reserves. This requirement gave the Appointed Actuary a level of authority which was potentially invaluable when dealing with contentious issues. The diluted influence of actuaries under the new proposals may reduce consumer protection. Penrose identified lack of scrutiny of the Appointed Actuary's work as a problem, rather than the role itself.

The FSA's proposals place responsibility firmly on the Board who seek advice from the head of Actuarial Function and the With Profits Actuary, and the actuarial liabilities become subject to audit. There appears to be some similarity here with the governance structure within an oil company such as Shell, where there was a Group Reserves Auditor reviewing the valuation of proven reserves, and where the Directors valuations were then subject to external audit. Under this framework, the Group Reserves Auditor had no external facing role and the individual could be overridden by the Board. Based on the Shell example, the new regulatory framework may not provide greater protection than its predecessor.

The importance of discretion in non-profit business has been understated, possibly as this was not an issue for Penrose. There remains a need to ensure appropriate scrutiny of actuarial advice, but it is currently unclear whether the reviewing actuary will provide sufficient comfort given that he/she will be working to “audit standard” only.

Q2.6 We have a concern that the new framework will be less effective than the Appointed Actuary system owing to the reduced empowerment of actuaries. Whilst a need for additional scrutiny of the work of the Appointed Actuary had been identified, many of the other observations made on the Equitable are that individuals are alleged not to have followed rules. Does this mean that we need to change the rules or that we need to check that the rules are being followed?

Q2.7 Many life insurers are part of a corporate Group structure. Recently it has been common practice for non-executive directors to operate at Group level and not at subsidiary company board level. Clearly under the new Regulations, Groups will need to review their governance to ensure that their non-executive directors have sufficient access to what is happening at subsidiary level but it still seems likely that few non-executive directors will look at the detail.

It is unlikely that non-executive directors will have a sufficiently strong technical background to enable them to challenge the calculations. They will have to rely on the processes established by the Group Board to satisfy itself on this point. Their role will be made easier if the actuarial calculations are presented in a way designed to encourage discussion rather than to close it off. The better non-executive directors do have the broad business knowledge to ask relevant questions and to probe further if they receive less than satisfactory replies, or if the report presented to them appears to be “imprecise” or lacking in detail. However, the role of non-executive director is part-time and even if the non-executive director is sufficiently engaged it is asking too much to expect them to be an expert in this area.

Q2.8 The details of the calculations will probably make the results less accessible, and in our view the presentation format is not particularly clear. However, given that the resultant reserves will be making proper provision for all liabilities, the

realistic reporting basis will make a company's true financial position much more transparent, and should improve comparability between companies.

- Q2.15 The introduction of risk-based Individual Capital Adequacy Standards (ICAS) for insurance companies and Lloyd's would be expected to increase demand for actuarial services.
- Q2.16 No. There are no reserved roles in general insurance companies. The reserved role in Lloyd's has evolved from market demand and best practices. The requirement for Statements of Actuarial Opinion (SAOs) reflects practice in the US where SAOs are a regulatory requirement. We believe that the reserved roles are important and necessary, and consideration should be given to extending the Lloyd's requirement to the company market. However, in our view it is open to question whether there are enough actuaries possessing the relevant skills and experience at the current time.
- Q2.19 The Profession should leave regulation of investment business to the FSA.
- Q2.24 The "whistleblowing" regulations do not actually refer to the public interest, but aside from that we consider the current duties and safeguards are appropriate.
- Q2.25 No. The current regulations are very widely drawn – essentially anything the FSA might be interested in.
- Q2.26 No. Appointed Actuaries are required to disclose information even if the company has already made disclosure to the regulator. This is unnecessary duplication and is not conducive to a good relationship between the company and its appointed actuary. A similar situation will apply to the replacement actuarial roles.
- Q2.27 Regulation sets out the framework in which insurance business is conducted. Professional guidance then sets the standards to ensure that "things are done properly". Policyholders' interests are not directly protected by professional guidance, but they are indirectly as the guidance should ensure that the regulatory framework is correctly applied.

Penrose highlights two areas where the Profession's technical guidance was insufficiently clear or up to date. Firstly, with respect to Policyholders' Reasonable Expectations, Lord Penrose interprets this term quite differently to the Profession's technical guidance. Actuaries working for companies and their advisers regarded PRE as ill-defined and as such useful to the Regulators in providing wide grounds for intervention. Interestingly, the Regulators saw the situation quite differently and felt that if challenged it would be difficult to justify intervention on PRE grounds. If the Profession did seek legal advice on the interpretation of PRE, then this important aspect was not reflected in the technical guidance.

The second area related to reserving for annuity guarantees. Penrose makes a very valid point that actuaries should always come to a decision. Certainly the legal process always comes to a decision – ultimately with the law lords – even though there may only be a 3-2 vote in favour of the “right answer”. Having said that, the legal process only considers the specific questions put to it and so for example in the Hyman case did not consider the broader public interest or the interests of other policyholders (other than Hyman) before determining the “right answer”. The Profession would need to set up a process which required a “right answer”. This will be a significant challenge on contentious issues, especially as those individuals with adequate experience and understanding of the issue who are allowed time from their regular employment to resolve such matters, are likely to be constrained, or could be perceived to be constrained, by conflict of interest with the interests of their employer.

- Q2.28 The Profession has a fast track process but it can run into difficulty in resolving contentious issues.
- Q2.29 Specific actuarial standards should be set by the mooted Actuarial Standards Board. Matters of regulatory policy, however, should be set by the regulator or government (for example capital requirements, or the requirement for peer review) with assistance from the Actuarial Profession.
- Q2.30 Yes. Currently the Actuarial Profession has very little of what could be regarded as standards. It has guidance, which is not the same thing.

- Q2.31 It is too early to tell. Clearly the proposals are a step in the right direction, and should be given the opportunity for their efficacy to be assessed.
- Q2.32 Yes, the Actuarial Profession works closely with other professions, especially accountants and lawyers. However life companies are not managed solely by members of the professions.
- Q2.33 Lord Penrose's assessment was presumably influenced significantly by what he saw at Equitable. We do not consider that Equitable can be regarded as comparable to other companies. Furthermore it has been our experience, at least prior to the Equitable debate, that the legal profession and others saw PRE as being very much the domain of the Actuarial Profession.
- Q2.35 The FSA's proposals have been developed in the light of problems relating to with-profits business. They do not reflect the importance of discretion on non-profit business.
- With regard to the protection of policyholders' interests, it must be remembered that life companies are not managed solely by individuals who are members of the profession. In addition policyholders' interests can also be affected by other involved parties such as intermediaries, mortgage providers and pension schemes (in the case of transferring funds).
- Q2.36 The existing circumstances are appropriate.
- Q2.37 No. Peer review of general insurance statutory reserves is conducted through audit review as a minimum. Some companies also conduct internal reviews or employ actuarial consultants for external review.
- Q2.41 The FSA is well placed to ask the Profession to investigate compliance with actuarial standards, or to commission a special persons report, if as a result of its review work it had reasonable grounds to believe that professional actuarial standards had not been applied.
- Q2.42 Both. By the profession in respect of breaches of Actuarial Standards, and by the FSA in respect of supervisory matters. One may lead to the other.

Q2.43 FSA is inadequately resourced with actuarial expertise. For example, FSA would benefit from an increase in the number of actuaries with a wider commercial experience beyond purely regulatory matters.

