

THE REGULATORY ROLE OF THE ACTUARY IN UK LIFE INSURERS

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In January 2003, the Financial Services Authority (FSA), the regulator of life insurers in the UK, issued a consultative paper, CP167 on “With-profits governance, the role of actuaries in life insurers, and certification of insurance returns.” Section 1 of this paper outlines the proposals, Section 2 to 5 amplify the proposals, Section 6 describes the response of The Actuarial Profession, Section 7 reviews the proposals in the context of the themes of my Presidential Address – Thinking and Behaviour. Section 8 concludes the paper.

1. The Proposals

With-profits insurers would be required to:

- define and make publicly available the Principles and Practices of Financial Management (PPFM) applied in their management of with-profits funds;
- ensure their governance arrangements offer assurance that they have managed their funds in accordance with the PPFM they have established and published; and
- produce annual reports for with-profits policyholders on how they have complied with this obligation, including how they have addressed any competing or conflicting rights, interests or expectations of policyholders and, if applicable, shareholders.

There would be changes in the role of actuaries:

- discontinuing the existing appointed actuary regime;
- introducing two new actuarial functions, both of which would be controlled functions and would be subject to the requirements of section 340 of the Financial Services Markets Act (FSMA):
 - an actuarial function for all life firms, with responsibility to advise directors and senior management on the valuation of policyholder liabilities and on wider issues as determined by a firm’s senior management; and
 - a with-profits actuary only for firms carrying on with-profits business, with responsibility to advise the governing body on the use of discretion in that business; and
- introducing a new requirement for firms to avoid appointments of the with-profits actuary which give rise to significant conflicts of interest.

There will be new reporting requirements to reflect the FSA objective of making directors and senior management more explicitly responsible for setting up technical provisions and other decisions taken on actuarial advice.

These changes would include:

- introducing a change in certification by directors and in regulatory reporting by management;
- broadening the scope of the audit to include the valuation of policyholder liabilities and requiring auditors to seek actuarial advice independent from the firm when auditing life policyholder liabilities; and
- requiring the directors of firms carrying on with-profits business to confirm that the with-profits fund has been managed in line with their PPFM.

The rationale for the proposals concerning the governance of with-profits

Delivering the features of with-profits products relies on discretion in investment strategy, smoothing and bonus declarations. This discretion and the lack of transparency makes it difficult for consumers to understand the product and to feel confident that they have been fairly treated, in particular, relative to shareholders and other groups of policyholders.

There are currently no specific or transparent methods for firms to show how they use their discretion, manage conflicts or ensure policyholders are treated fairly.

The FSA concluded that the governance framework for with-profits needed strengthening with:

- greater transparency over the nature and extent of discretion used by firms, and the parameters within which it will be used;
- improvements to the way in which the interests of policyholders are accounted for in managing with-profits funds; and
- clearer ways to demonstrate that, in using their discretion, directors have balanced competing interests and fulfilled their responsibility to ensure that all customers are treated fairly.

2. The Principles and Practices of Financial Management (PPFM)

The principles would:

- be enduring statements of the overarching standards the firm adopts in managing with-profits funds; and
- describe the business model used by the firm in meeting its duties to with-profits policyholders and in responding to longer-term changes in the business and economic environment.

The practices would

- describe the firm's approach to managing with-profits funds and responding to changes in the business and economic environment in the shorter-term; and

- contain sufficient detail to entail a knowledgeable observer to understand the possible risks and rewards from effecting a with-profits policy with the firm.

The PPFM would include:

- how the firm determines the amount payable under a with-profits policy, including:
 - The methods it uses to guide its determination of the amount it is appropriate to pay individual with-profits policyholders;
 - Its approach to setting annual bonus rates;
 - Its approach to setting final bonus rates; and
 - Its approach to smoothing the value of with-profits contracts;
- significant aspects of its investment strategy for with-profits business;
- the exposure of its with-profits business to business risk;
- the way in which it applies charges and apportions expenses to its with-profits business;
- its management of any inherited estate and the uses to which it may put that inherited estate;
- its practice for reviewing limits on the quantity and type of new with-profits business and the actions it would take if it ceased to take on new with-profits business of any significant amount; and
- its approach to achieving a balance between the interests of with-profits policyholders and the interests of any shareholders of the firm.

Changes to principles would be notified to policyholders three months in advance. Changes to practices would also be notified to policyholders but when and how is left to the discretion of the firm.

Directors would certify that they have conducted the business in line with their PPFM.

3. The Governance of with-profits business

Firms will be required to:

- ensure compliance, in the conduct of with-profits business, with any applicable PPFM; and
- provide an annual report to with-profits policyholders stating whether the firm believes it has complied with these obligations and the evidence and reasons for that belief.

Other rules concern the annual report to policyholders including how the firm has used (or refrained from using) any discretion it has in the conduct of with-profits business. It should also address any competing or conflicting rights, interests or expectations of its

policyholders (or groups of policyholders) and, if applicable, shareholders (or groups of shareholders). In preparing the annual report to policyholders, the firm should take account of the proposed report from the with-profits actuary on key aspects of the firm's use of discretion.

Firms will be expected to set up a With-profits Committee (WPC) including members drawn from the independent non-executive directors and including some 'external non-directors'. Such a committee could have a monitoring and advisory role, including publishing an annual report for policyholders on its work and the firm's compliance with the PPFM. The WPC would consider, and provide the governing body with an independent assessment of, the firm's compliance with the requirement to conduct its with-profits business in accordance with its PPFM. It would not be a decision-making body; responsibility for decisions on the use of discretion and for the firm's report to with-profits policyholders would remain with the governing body itself.

In advising the governing body, a WPC should monitor and consider all relevant issues and information, including:

- the rights, interests or expectations of different classes and generations of with-profits policyholders;
- the way in which the firm exercises its discretion;
- the way in which it addresses any competing or conflicting rights, interests or expectations of its with-profits policyholders (or groups of policyholders) and, if applicable, shareholders (or groups of shareholders); and
- its compliance with any applicable PPFM.

The WPC would make a brief annual report to policyholders having taken account of the proposed report from the with-profits actuary on key aspects of the firm's use of discretion.

4. The Rationale for the proposals concerning the future role of actuaries

A cornerstone of the FSA's regulatory regime is that directors and senior management are responsible for securing a firm's compliance with its regulatory requirements. This is consistent with the requirement in the FSMA for the FSA to have regard to the responsibilities of senior managers of regulated firms. In addition, the FSA recognises the importance of actuarial expertise to the sound management of life insurers.

The FSA is of the view that the responsibilities currently placed on the Appointed Actuary may lead directors and senior management to place too much reliance on the views of the Appointed Actuary, rather than reaching their own views. In support of this view the FSA cites that:

- in the regulatory returns, the liabilities are currently signed off by the Appointed Actuary;
- whilst the directors are responsible for all aspects of the regulatory returns, they do not sign off on the reserves, nor are they audited. The FSA considers that directors

ought to satisfy themselves on these matters and that they should be brought within the scope of the audit.

The FSA distinguish the responsibilities for directors for the valuation of policyholder liabilities, and for the use of discretion in with-profits business. The rationale for the establishment of the role of with-profits actuary derives from that, currently, the Appointed Actuary has personal responsibility to advise on the use of discretion. The FSA view is that there may be tension between the interests of shareholders and management and those of policyholders. The new separate role of with-profits actuary would be focussed on policyholder interests to deal with real and perceived conflicts of interest.

The current Appointed Actuary role is to be discontinued and replaced by two new advisory functions, the actuarial function, for all firms, and the with-profits actuary, only for with-profits firms.

The FSA do not propose to require firms to take actuarial advice on the use of discretion in non-profit business.

In relation to the policyholder liabilities, currently, the Appointed Actuary advises the directors and senior management. However, the FSA are clear that decisions on financial resources are the responsibility of the directors and senior management, as in all other business regulated by the FSA, chiefly banking and funds management. The duties of the new actuarial function would be to:

- advise the governing body on the methods and assumptions for the valuation of policyholder liabilities;
- calculate the liabilities using the methods and assumptions determined by the governing body; and
- report to the governing body on the results of this calculation.

The report would include commentary on the available surplus from which distributions to policyholders and/or shareholders might properly be made. This report would not be made public and would be available to the FSA on request.

In addition, the FSA would expect the actuarial function to provide input on a range of issues important to the sound management of the firm. Firms should have procedures in place for obtaining professional advice on financial and risk analysis, monitoring of capital and adequacy of premium rates. The FSA guidance would not mandate from whom firms should seek such advice. In this way, responsibility for the other current duties of the Appointed Actuary would be transferred to the directors.

The with-profits actuary would report directly to the board and would give advice to complement the work of the With-profit Committee. The with-profits actuary would advise on key aspects involving the use of discretion as this refers to the fair treatment of policyholders.

Advice from the with-profits actuary would include:

- bonus rates to be applied to policies at maturity or on the death of the policyholder;

- proposed investment policy in the light of the product description disclosed to customers;
- proposed changes to surrender value methodology (including market value reductions);
- changes in new business plans and premium rates;
- proposed allocation of expenses to with-profits business;
- proposed investment fees to be charged to with-profits business;
- any proposed changes to PPFM; and
- communication with consumers on the aspects listed above.

The responsibilities of the with-profits actuary would be to:

- advise the firm on its use of discretion within its with-profits funds;
- report to the governing body at least once a year on key aspects of the discretion used by the governing body regarding with-profits business;
- request from the firm information necessary to perform these duties; and
- advise the firm on data and systems needed to provide such information.

On the other hand, the firm would be required to:

- keep the with-profits actuary informed of the firm's business plans and other plans;
- provide him with sufficient resources;
- set up and maintain appropriate data and systems;
- request advice from him about the likely effect of material changes in the firm's business plans, practices or other circumstances on the fair treatment of customers; and
- pay due regard to his advice.

The with-profits actuary would complete a report on the use of discretion. The report would be a key input to the firm and to any With-profits Committee in their reports to policyholders. Reports from the with-profits actuary would not be made public.

Firms should have risk management processes in place to ensure that all relevant matters are referred to the with-profits actuary for advice. Where appropriate, in particular for some mutuals, it might be possible for firms to ask the actuarial function to carry out the with-profits actuary role as well. However, firms would need to consider carefully whether there are potential conflicts of interest that would suggest that two different people would fulfil the roles better.

It is proposed that the with-profits actuary cannot also be chairman or chief executive or hold other posts giving rise to significant conflicts of interest. No such restrictions would

be placed on the actuarial function, unless, of course, the two actuarial roles are combined.

Both the actuarial function and the with-profits actuary would have whistle-blowing requirements and protections.

5. The Rationale for the proposals concerning the changes in scope of audit and certification

The proposed changes in certification reflect the aim of the FSA to place more explicit responsibility on senior management for compliance with FSA principles and requirements – for non-life as well as life insurers.

Directors would, in future, complete:

- a management report, akin to the directors' report in Companies Act accounts
- a directors' certificate, akin to the current actuarial certificate

The directors' certificate would include certification that:

- the firm has complied with rules and guidance in the FSA's high-level standards;
- policyholder liabilities have been assessed in line with FSA requirements;
- premiums for new business during the year were sufficient, taking into account the income earned and the other financial resources of the firm, to meet the commitments in respect of the contracts; and
- (where applicable) with-profits funds have been managed in line with the PPFM.

The scope of the audit review would be widened to cover aspects of the regulatory returns currently the responsibility of the Appointed Actuary. The FSA also propose to require auditors of life firms to obtain a report from an actuary on the valuation of policyholder liabilities as part of their audit work. This advice would be provided by an actuary who is independent of both the regulated firm and its actuarial function. This actuary could be an employee of the audit firm, or any other suitable independent actuary. The actuarial work on the valuation of liabilities would thus be subject to the professional challenge of audit, including review by an independent actuary.

The revised auditors' report would be in two parts:

- a full audit applying to the financial forms, expressing an opinion on whether they have been properly prepared. This would include an opinion that the amounts have been properly assessed in line with FSA prudential rules; and
- a review of the management report items, confirming that the statements made by directors and management are not inconsistent with the explanations given and information reviewed as part of the audit.

The FSA propose an audit certificate that:

- provides assurance on all financial data on the full balance sheet and solvency calculation within the annual return; and
- gives an opinion on whether the statements in the directors' certificate and management report are consistent with the audited financial data within the regulatory return.

The firm would have to provide an annual report to with-profits policyholders, accompanied by reports from any With-profits Committee, all unaudited. These would be delivered with, but not form part of, the regulatory return.

The financial condition report is currently produced by the Appointed Actuary. The FSA propose that, in future, the firm would produce a risk assessment report which would address the material risks to which the firm is exposed, to be made available to the FSA, and not made public.

6. The Response of the Actuarial Profession to the Proposals

The profession has consulted with the FSA throughout the period leading up to the issuance of the latest consultation paper of January 2003. Whilst some changes to the proposals have been made at the behest of the profession, there are significant weaknesses in the proposals to the detriment of customer protection.

The profession accordingly wrote to the FSA along the following lines:

- The proposed changes run a serious risk of weakening customer protection because the strength of the proposed audit review of the directors' decisions on liabilities valuations would fall short of that achieved by public actuarial certification.

The press release emphasised that the Appointed Actuary's report and certificate, currently public, would be replaced by two private reports, one from the actuarial function to senior management, the other from an independent actuary to the auditors. The profession believes that the report to the auditors should be replaced by a report, commissioned directly by the directors, by an actuary independent of the insurer, on the review of the policy liabilities.

In addition, the profession recommended that:

- the PPFM should be extended to cover discretion in non-profit contracts
- any With-profits Committee should run like any other committee of the board rather than on a 'quasi-independent' body.
- the role of the with-profits actuary should be extended to include a report on the firm's compliance with the PPFM, which report should also be reviewed by an actuary independent of the firm.

The profession was also of the view that separation of the roles of with-profits actuary and actuarial function would be very difficult and that, together with the profession's recommendation for a direct independent review, the roles could be merged.

On the matter of the audit review, the profession is concerned that the scope and depth of the work undertaken, by the actuary reporting to the auditor, would be in the hands of the audit partner. Auditors are used to providing 'true and fair' opinions to Companies Act accounts. This is a very different opinion to that provided by the Appointed Actuary that the liabilities made 'proper provision' for policyholder claims. There is a risk that some audit firms may not be prepared to provide the form of opinion that is envisaged.

The profession is of the view that there is significant discretion in liked business – in policy fees, charges for mortality and other risk benefits, tax deductions and provisions etc. For long-term unit-linked contracts, such charges can have a material impact on the benefits customers receive.

The profession believes that the role of the with-profits actuary should be extended to include a report on compliance with the PPFM, subject to direct review by the independent actuary.

The profession prefers this independent review to the establishment of a new form of governance in the form of the With-profits Committee, with members who are not directors of the firm.

The financial strength of the with-profit fund will influence decisions over the level of surplus to distribute. Equally, the level of liabilities necessary to meet future policyholder claims will be highly dependent on the extent of discretion in varying future bonuses. Hence the roles of with-profits actuary and actuarial function are closely interrelated and, the profession believes, are best met by the same person.

7. Thinking and Behaviour behind the proposals – Implications and Observations

7.1 With-Profits

There is no doubt that with-profits products are complex to run and the mechanisms are difficult to communicate. In a world where trust is not taken on trust, but has to be demonstrated and communicated, with-profits is at an automatic disadvantage. With-profits has delivered very satisfactory results in the past (when less than the full investment return was passed on to policyholders). It is now delivering returns that are under attack even though more than the underlying return is being passed on to policyholders and policyholders are getting more than a unit-linked product would provide.

Nevertheless, it is the complexity and difficulty in communication that is now giving it a poor reputation. Sales practices and products that over-anticipated bonuses have made the perceptions and reality worse, leading to maturity values insufficient to repay mortgages and compensation claims.

Also, the FSA and the Treasury both acknowledge that the smoothing mechanism and some guarantees are attractive and valuable to consumers.

The design of with-profits products is already getting simpler and will get simpler still – many with-profits bonds now contain no investment guarantees at all.

The FSA proposals are arriving, therefore, somewhat after the event, although the millions of policyholders with existing policies, having had their awareness raised of the complexity of the products, now need their expectations fulfilled that the complexity is being managed in their interests.

The PPFM grew up in mergers and acquisitions, so many with-profits funds are already working to them. Others (who have not been acquired recently) will have to create them and demonstrate that they are being followed. This will both ensure that directors, senior managers and actuaries think more deeply about how their with-profits funds actually are managed and provide more information to policyholders.

Whether, of course, customers will read the information remains to be seen. Empirical evidence suggests that few will read it, fewer will know what to make of it and even fewer will understand it.

7.2 Removal of the public actuarial certificate

One has to have sympathy for the FSA's aim to increase the responsibility of directors for the whole of the regulatory return including that the policy liabilities make proper provision. However, to remove the public certification of an actuary in order to achieve that aim, seems perverse. There are many other ways of obtaining the compliance of directors with increased responsibility than removing a major safeguard for customer protection that encourages directors to do precisely that. It is not obvious that real ills are being addressed in the removal.

7.3 The proposals are built on a questionable premise

The FSA is of the view that the responsibility currently placed on the Appointed Actuary "may lead directors and senior management to place too much reliance on the views of the Appointed Actuary rather than reaching their own views." There is no evidence presented to support this "may". Indeed, such evidence as there is suggests that there is at least as much over-influence by senior management on Appointed Actuaries, as there is over-reliance. The weakening of the position of actuaries in these circumstances allows directors a freer rein than before to stretch assumptions and methodologies to the limit to maximise dividend capacity. It is not clear that an audit (even with an independent actuarial support) and increased FSA supervision will deter this "assumption creep".

7.4 Conflicts of interest and a new role for auditors

Appointed Actuaries have prided themselves in the past for being able to cope with multiple conflicts of interest. This is to end, but at the cost of creating new conflicts elsewhere. Directors will have to certify that the liabilities make proper provision for policyholder claims whilst their main duty is to the company and the shareholders (or policyholders generally, in the case of mutuals). Auditors will continue to audit the insurer's Companies Act accounts on a "true and fair" basis, using best estimates with a touch of prudence. They are now to be asked also to audit the regulatory returns designed to deliver policyholders benefits in all reasonably foreseeable circumstances a wholly unfamiliar level of prudence for auditors. This would require the auditors to investigate

the tails of the risk distributions for the regulatory returns as well and the means of distributions for the Companies Act accounts.

Auditors have not traditionally audited the accounts that constrain the dividend to shareholders, by whom they are appointed. It is not clear if the auditing profession understands yet what is being asked of it and has yet to make a statement that it accepts that role and, in particular, is prepared to give an opinion on the directors' statements when one statement is that, throughout the year, the policy liabilities make proper provision. Can and should the actuary reporting to the auditors give such an opinion if the audit partner won't pass it on? Of course, an actuary employed by an auditor cannot produce a report outside the scope of the audit as that would constitute consulting by the same firm as do the audit, which practice is under some scrutiny after Enron.

7.5 New conflicts in surplus distribution

The report required of the actuarial function includes commenting on the surplus available for distribution. This perpetuates the myth that the available surplus is determined first and then distributed, whereas, as every Appointed Actuary knows, the intended bonus is tested for sustainability and the surplus available is derived as sufficient to support that bonus. This also illustrates the conflicts that would arise between the actuarial function and the with-profits actuary. Publication of these reports would help to bring a spotlight onto the mechanics of the distribution of surplus.

The way to resolve conflicts of interest is to appoint different advisers to advise in the interests of different stakeholders eg one adviser for with-profits policyholders, one for others. Appointing advisers to represent the different functions, as is proposed, of discretion and reserving, preserves the existing conflicts within each appointment and creates new ones between the two appointments.

8. Conclusion

The proposals from the FSA have some merit, particularly in the main aim of increasing the awareness of directors of their responsibilities. However, the execution is flawed and will give rise to opportunities for mis-reserving and mis-management until some public light is cast on the directors' new responsibilities and the scrutiny of the work of the new actuarial roles is done directly by an independent actuary appointed by the directors.

In the meantime it is the role of the profession to fill the wider gap in customer protection, opened up by these proposals, with appropriate guidance notes and practising certificates.