ACTUARIAL STANDARDS AND REGULATION

FUNDING THE NEW REGIME - FRC CONSULTATION PAPER

Introduction

The Financial Reporting Council (FRC) is the United Kingdom's independent regulator responsible for promoting confidence in corporate reporting and governance.

The FRC is taking on new responsibilities for setting actuarial standards and overseeing the regulation of the actuarial profession. The purpose of the new regime will be to enhance the quality of actuarial reporting and to promote the integrity, competence and transparency of the actuarial profession – to the benefit of all those who rely on actuarial advice. The annual costs of the new arrangements are expected to be less than £2m.

The FRC is planning to assume its new responsibilities from April 2006 and, in order to do so, it will incur set-up costs during 2005/06. The new funding arrangements need to be effective for the financial year 2006/07.

This paper explains the FRC's proposals for funding the new regime.

The proposals are that the FRC should meet its costs of the new arrangements through:

- an annual levy on insurance companies and pension funds
- an annual contribution from the actuarial profession

The paper seeks responses to four questions arising from the FRC's proposals.

Comments on the proposals are invited by 4 January 2006.

This paper contains a summary of the FRC's proposals for actuarial standards and regulation. More information on these matters and on the FRC's current work and its funding, governance and accountability, including its Regulatory Strategy and Plan & Budget for 2005/06, are available on its website at: *www.frc.org.uk*.

The FRC's strategy and funding of its existing responsibilities

The FRC believes in wealth creation. It believes that its role in promoting confidence in corporate reporting and governance can make the creation of wealth more likely, and is committed to the principle that it should add value through its activities and that its approach should be proportionate to the issues it is addressing. The FRC's regulatory philosophy is based on the principles of good regulation - proportionality, targeting, consistency, transparency and accountability. It will apply this approach to its new responsibilities.

The FRC's current functions are the setting, monitoring and enforcing of accounting and auditing standards, overseeing the regulatory activities of the accountancy profession, statutory oversight and regulation of auditors, operating an independent investigation and discipline scheme for public interest accountancy cases, and promoting high standards of corporate governance.

These functions are delivered principally by its operating bodies - the Accounting Standards Board, the Auditing Practices Board, the Financial Reporting Review Panel, the Professional Oversight Board for Accountancy and the Accountancy Investigation and Discipline Board – and by the FRC Council.

The FRC is a non-profit-making organisation. Its intention in raising funds is merely to cover its costs and to ensure that it has an appropriate level of reserves.

The FRC's core operating costs in relation to its present responsibilities are funded in equal proportion by the accountancy profession, the business community and the government. This is known as the tripartite funding arrangement. Certain other costs (eg of audit inspection and the investigation and discipline of accountants) are funded entirely by the accountancy profession. This arrangement will remain in place to fund the FRC's present responsibilities.

The FRC's budget for its present responsibilities for 2005/06 is £12.5m, comprising £10.3m for its core operating costs and an additional £2.2m for audit inspection costs. In addition, the FRC incurs costs in relation to investigation and disciplinary cases, which depend on the number and complexity of cases and cannot be subject to firm budgetary limits.

The Morris Review

The Morris Review of the Actuarial Profession was set up in March 2004 to undertake a wide-ranging independent review of the actuarial profession in response to the criticisms of the profession made by Lord Penrose in his inquiry into the Equitable Life. The review was asked to consider:

> "What professional and/or regulatory framework would best promote recognised high quality and continuously developing actuarial standards, openness in the application of actuarial skills, transparency in the professional conduct of actuaries and an open and competitive market for actuarial advice in the UK."

The review published its final report in March 2005. The central recommendation of the review was that regulation of the actuarial profession should be subject to independent oversight by the FRC. The review noted that there had been broad support for this recommendation among a large number of respondents to its Interim Assessment.

The Morris Review is available on the HM Treasury website at: *www.hm-treasury.gov.uk/independent_reviews/morris_review*.

The review included a number of recommendations which flowed from this central recommendation. The review recommended that the FRC should:

- create a new FRC operating body, the Board for Actuarial Standards, to set actuarial standards
- extend the remit of the Professional Oversight Board for Accountancy (POBA) to oversee the regulatory activities of the actuarial profession
- extend the remit of the Accountancy Investigation and Discipline Board (AIDB) to public interest cases involving actuaries.

The review envisaged that that the costs the FRC would incur in fulfilling these responsibilities should be met by the main beneficiaries of the new regulatory framework: life and general insurance companies, pension funds and the actuarial profession. HM Treasury have endorsed the principle that the costs should be met by the main beneficiaries and not from public expenditure.

The FRC's non-statutory arrangements for funding its present responsibilities have worked flexibly and successfully since 1990 – though there are powers in the Companies Acts for the Government to put these arrangements on a statutory basis if it was considered necessary.

The FRC hopes that the new arrangements can also be funded through non-statutory arrangements, on the basis of an understanding with the insurance and pension sectors and the actuarial profession.

The Companies Bill currently before Parliament will provide powers to make the FRC's funding arrangements for its responsibilities for actuarial standards and regulation a statutory charge. Should a voluntary approach prove unsustainable, use of these statutory powers would be required.

Setting actuarial standards

The FRC is in the process of establishing the Board for Actuarial Standards (BAS) and has agreed the BAS's terms of reference with HM Treasury, the FSA, TPR and the actuarial profession. The BAS will:

- contribute to confidence in corporate reporting and governance, and
- promote the integrity, competence and transparency of the actuarial profession

by establishing and improving actuarial standards and ensuring that they are coherent, consistent and comprehensive.

The BAS will adopt the current standards set by the actuarial profession to ensure continuity and to provide a starting point for its work.

The standards set by the BAS will apply to members of the actuarial profession. However, the quality of actuarial standards and compliance with those standards are not matters that affect only actuaries. The standards set by the BAS will also be relevant to those who use actuarial advice – including insurance companies and pension funds making commercial judgements on the basis of advice from actuaries. They will also be relevant to accountants and auditors operating in the insurance and pension sectors.

The FRC will ensure that the BAS's membership and approach to standard-setting reflects the wide interest in actuarial standards, and the economic significance of the areas in which its standards will be applied. The membership of the BAS will be drawn from the actuarial profession, the insurance and pension sectors, the FSA and TPR, and from other interests, including consumers.

The BAS will work closely with the FSA and TPR to ensure that its standards provide, where appropriate, the necessary basis for actuaries advising insurance companies or the trustees of pension funds to provide advice in a form which enables those entities to comply with FSA rules and TPR guidance.

In addition, the BAS will develop a process for consulting widely on new standards, responding to issues raised in the consultation process, assessing the impact of new standards and introducing them – aimed at ensuring clear accountability for the quality and transparency of actuarial standards.

Overseeing the regulation of the actuarial profession

The FRC is in discussion with the actuarial profession about the arrangements that will need to be put in place to enable POBA to oversee the regulatory and other activities of the actuarial professional bodies including:

- ethical standards
- compliance with the standards set by the BAS
- education and continuing professional development
- disciplinary procedures.

The Morris Review included a number of specific recommendations to the actuarial profession about education and continuing professional development. It recommended that POBA should oversee the profession's work to implement these recommendations.

The FRC will develop a formal agreement with the actuarial profession outlining the respective roles and responsibilities of the FRC and the profession. The agreement will require the actuarial profession to consider carefully FRC recommendations, to implement them within a reasonable period, or to give reasons in writing for not doing so.

Investigation and disciplinary cases involving actuaries

The FRC is in discussion with the actuarial profession on the arrangements to be put in place to extend the AIDB's remit to enable it to investigate and hear public interest disciplinary cases involving actuaries.

On the basis of these discussions, an outline of a scheme for public interest actuarial cases is being prepared for the purposes of consultation with the profession and other interested parties.

Following consultation, the AIDB will prepare a detailed draft of the new scheme, which will be the subject of further discussion with the actuarial profession.

The FRC's agreement with the actuarial profession will include a requirement that members of the profession are subject to the findings of the independent disciplinary arrangements to be put in place by the AIDB.

The cost of the new regime

The costs associated with the new regime will fall into the three categories set out below:

The FRC's "actuarial" operating costs

The actuarial operating costs will cover:

- the BAS (likely to be the largest element of the operating costs)
- the additional work undertaken by POBA and the AIDB
- a proportionate share of the FRC's overheads (which will increase by a modest amount as a result of the new arrangements).

These costs will be subject to firm budgetary limits.

The costs of actuarial investigation and disciplinary cases

Actuarial investigation and disciplinary case costs will depend on the number and complexity of cases, and cannot be subject to firm budgetary limits. The FRC is proposing to establish a fund to cover these costs, with an initial contribution of £250,000 in 2006/07.

The recovery of the FRC's set-up costs

The FRC will incur set-up costs arising from the need to establish the new arrangements and recruit new operating body members and a small number of additional FRC staff. These costs are expected to be in the order of £750,000, and the FRC intends to recover them over the first three years of the operation of the new arrangements.

The total cost of the new arrangements in 2006/07 is estimated to be as follows:

	£m
Actuarial operating costs	1.30
Initial contribution to the actuarial investigation and disciplinary case costs fund	0.25
Recovery of set-up costs	0.25
Total	**1.80**

Funding Proposals

The four main questions affecting the design of the funding regime are discussed below.

Proportion of the cost to be paid by the actuarial profession

The review envisaged that that the costs the FRC would incur in fulfilling its new responsibilities should be met by the main beneficiaries of the new regime: life and general insurance companies, pension funds and the actuarial profession.

The Morris Review did not propose a specific level of contribution from the actuarial profession.

The actuarial profession is comparatively small. There are 4,700 fully qualified practicing actuaries in the UK. Of these, 1,200 have practicing certificates to enable them to hold a reserved role.

There is a risk that a substantial increase in the costs associated with membership of the actuarial profession might have unintended consequences which reduce the benefits of the new arrangements. It might, for example, provide an incentive for a proportion of those members of the profession not in reserved roles to allow their membership to lapse, in which case the new regime would not apply to them.

The FRC has therefore had to take a view on the level of contribution from the profession that would be reasonable in the light of the overall recommendations of the Morris Review and the benefits which the FRC's new regime will provide; but that would not discourage actuaries from retaining their membership of the actuarial professional bodies. The FRC considers that it would be reasonable to seek a level of contribution from the actuarial profession that would result in an average cost to members of the profession of around £40. (This would compare with an average cost of around £27 for members of the accountancy profession in 2005/06.)

On that basis, the FRC takes the view that it would be reasonable to expect the profession to contribute 10% of the costs of the new arrangements.

It will be for the actuarial profession to decide how the profession's contribution should be raised from its membership.

Consultation question

Q1 – Is it reasonable that the actuarial profession should contribute 10% of the cost of the new arrangements?

Proportion of the cost to be contributed by insurance companies and pension funds respectively

The FRC takes the view that, in principle, the proportion of the FRC's costs which is not paid for by the actuarial profession should be divided between the insurance and pension sectors on the basis of the relative proportion of the FRC's activities which are relevant to the two sectors. However, such a split would be difficult to operate in practice. A substantial proportion of the work is likely to be common to both sectors and the balance may vary from year to year.

It is not easy to identify measures of the size of the two sectors which are wholly comparable.

Actuaries' main focus is on the assessment of liabilities. The FSA data for insurance companies (life and general), used as the basis of 2005/06 fees and levies, suggests total liabilities of £878 billion for the insurance industry. There is limited reliable data on the size of occupational pension fund liabilities, but the Pension Protection Fund's estimate as at 30 September 2004 suggest the total liabilities of eligible schemes with more than 100 members are in the order of £1,000 billion.

The FRC therefore proposes a 50:50 split of those costs not covered by the profession for the purposes of funding the new arrangements on the grounds that the available data suggests that the two sectors are of the same order of magnitude.

Consultation question

Q2 – Is it reasonable that the costs of the new arrangements that do not fall to the actuarial profession should be split equally between the insurance and pension sectors?

Allocation of the remainder of the proposed levy between insurance companies and pension funds

Any levy imposed on the insurance and pension industries to cover the FRC's costs is likely to be very small in comparison with the other regulatory fees and levies imposed on insurance companies and on pension funds. For this reason the FRC believes that it is not cost-effective to operate an additional basis for allocating its costs to individual insurance companies and pension funds.

The FRC proposes that it would be reasonable, and most practical, to allocate the costs of the new arrangements on the same basis as the arrangements currently operated by the FSA in relation to insurance companies and TPR in relation to pension funds.

The FSA will apply regulatory fees of around £52m to insurance companies in 2005/06. For illustrative purposes, allocating £810k of the cost of the FRC's new arrangements to the insurance industry in 2005/06 (45% of the likely annual cost of the new regime) would have resulted in an incremental cost equivalent to only 1.6% of the FSA regulatory fees.

TPR will apply a general levy of around £31m to occupational pension funds in 2005/06, which will apply to both private and public sector schemes. Allocating £810k of the cost of the FRC's new arrangements to pension funds would have resulted in an incremental cost equivalent to only 2.6% of the TPR general levy.

Consultation question

Q3 – Is it reasonable that the amounts payable by individual insurance companies and pension funds should be calculated by reference to the FSA regulatory fees and TRP general levy respectively?

Fund for actuarial investigation and disciplinary case costs

Actuarial investigation and disciplinary case costs will depend on the number and complexity of cases and cannot be subject to firm budgetary limits. This means that it will be difficult to quantify at the start of each financial year how much should be raised. In addition, given that - as proposed above - there will be many organisations which will contribute to the costs of the new regime, it will not be cost effective to issue supplementary invoices part way through the financial year.

The FRC therefore proposes that the costs of actuarial investigation and disciplinary cases should be met from a fund. The fund will be replenished as necessary to cover the actual costs incurred. This is the mechanism which is currently used for the FRC's Financial Reporting Review Panel (FRRP) case costs.

The FFRP fund has been £2m for many years. The FRC has not yet come to a firm view as to the appropriate level for the actuarial investigation and discipline fund and this will be kept under review in the light of experience of the number and size of cases.

The FRC believes that a reasonable initial contribution to the fund would be £250,000.

The contribution that will be required to maintain the fund at an appropriate level will be reviewed each year. If in one year case costs exceed the annual contribution the additional cost will be recovered in the following year from insurance companies, pension funds and the actuarial profession in the same proportion as their contributions to the FRC's other costs in relation to the new arrangements.

Any fine income received or legal costs awarded to the FRC in relation to disciplinary cases will be added to the fund and will reduce the future contributions.

Consultation question

Q4 – Is it reasonable to meet actuarial investigation and disciplinary case costs from a fund that is replenished as necessary to meet the actual costs incurred?

Next steps

The FRC will publish firm proposals for the funding arrangements for its new responsibilities for actuarial standards and regulation in late January 2006, with a view to implementing the new arrangements from April 2006.

FRC
11 October 2005