FINANCIAL REPORTING COUNCIL

Risk and Public Interest: the role of actuarial work in the financial markets

Note of a consultation discussion held at the Financial Reporting Council, 8th Floor, 125 London Wall, London, EC2Y 5AS

HOST

Stephen Haddrill	Chief Executive, Financial Reporting Council (FRC)
PANEL	
Melanie McLaren	Executive Director for Codes and Standards, FRC
Giles Fairhead	Head of Department, Retail Life, Prudential Regulation Authority (PRA)
Nick Poyntz-Wright	Director, Long-Term Savings & Pension, Financial Conduct Authority (FCA)
Des Hudson	Chairman, Professional Regulation Executive Committee, Institute and Faculty of Actuaries (IFoA)
Chinu Patel	Actuary, The Pensions Regulator (tPR)

Stephen Haddrill welcomed the Panel members and attendees, explaining that the Joint Forum on Actuarial Regulation had been put in place following a review by the FRC into its own actuarial oversight work in which it became apparent that the regime for the regulation and oversight of actuarial work was not very coherent nor well coordinated.

The disparate nature of the arrangements for regulating actuarial work represented a risk of things falling between the cracks and of the FRC undertaking unnecessary work that was already being covered by one of the other organisations. The FRC did not undertake formal monitoring of actuarial work (as it did in the accountancy sector) and it was felt that the various bodies concerned with actuarial work could benefit from sharing what they were learning from their various oversight roles. The PRA, FCA and tPR did not directly oversee actuarial work but their roles in relation to the oversight of companies and pension trustees gave them insights into the bigger picture and access to information which it could be beneficial to share.

The JFAR had started with each of its members contributing what they thought were key areas of potential risk in relation to actuarial work which were developed into a discussion paper covering issues that might form the basis of an agenda for future work. It was not a menu for future regulation but for coordinating the work of JFAR members in gathering evidence, assessing that evidence and considering whether action needed to be taken within the existing regulatory framework. By exception, the need for regulatory change might be identified, but this was not the objective.

Respondents to the consultation were being invited to aid in steering JFAR's future work by critiquing the contents of the discussion paper.

Melanie McLaren invited the JFAR members on the Panel to give their personal perspectives on the discussion paper, first outlining her own.

As the FRC's Executive Director responsible for all of its work on codes and standards she could see the key importance of the FRC's current work around actuarial work and risk. The FRC's mission was about encouraging good governance and reporting to foster investment. Its aim was to promote trustworthy behaviour and trustworthy information that would support investment, a key role in relation to the UKs overall infrastructure.

Over a number of years she had come to recognise the importance of the role of actuaries through her experience of the insurance industry and regulation. At the FRC, investment and risk management was being looked at more broadly and the Corporate Governance Code had recently been updated to take a broader view of the accountability of boards in relation to risk management and going concern. The work leading to that amendment to the Code had highlighted that there was a need for boards to take advice that would often need input from actuaries and that there was consequently a need to look carefully at the skill sets that actuarial work could bring to bear on the whole approach to risk management. The FRC's interest ran right through from very granular and detailed actuarial work to its contribution to strong corporate accountability.

She was delighted with the way the JFAR had come together in constructive dialogue to identify potential issues and collaborate in what was a new venture.

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Des Hudson explained that he was the lay Chairman of the Institute and Faculty of Actuaries' Professional Regulation Committee. The IFoA shared regulatory responsibility for the actuarial profession with the FRC with the IFoA concentrating predominantly on ethical behaviour. As the vast majority of actuaries would always be trying to do the right thing the IFoA's challenge in providing regulatory guidance centred around ensuring clarity of information. Over and above the points made by Stephen Haddrill and Melanie McLaren about JFAR's role in identifying major risks, the consultation offers to the profession, users and regulators the opportunities to look over the horizon at strategic issues and collaboratively consider how they might be addressed.

"Strategic" is an often overused word which in this context referred to things that were not the ordinary workaday issues facing the profession and its regulators - looking ahead at whether there were themes having the potential to affect the public interest that should be considered.

The consultation document inevitably focused on the work of actuaries but it should not be assumed that the risks identified would necessarily materialise nor should it be used to overstate the role of actuaries in relation to the public interest. The consultation was not about identifying the need for further regulation but about preparing for and considering how the risks identified could be addressed using all the means available.

Respondents to the consultation were being invited to consider and contribute to the process and to consider whether the risks that had been identified had been adequately explained and whether there were other important risks that had not been identified.

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Chinu Patel said that his background was in pensions consulting. He was currently assisting the Pensions Regulator with policy and strategy work, trying to understand the risks embedded in the landscape of 6,000 pension schemes that had started their journeys in different places and were moving in a number of different directions on different bases. The remit of tPR did not cover actuaries directly. Its responsibility was for and to scheme trustees and the easy assumption was that actuaries were always doing the right thing enabling tPR to focus on other things. Whilst there is a well defined reserved role for actuaries most of them make a sales pitch which went wider than that and tPR needed to understand that wider role. Participating in JFAR would help tPR to check whether their assumptions about what actuaries were actually doing was correct, to learn about the skills actuaries could bring to the table, and to understand how they were being applied to the problems they were being asked to solve.

In relation to the consultation itself tPR was interested in developing its understanding of some of the risks. There were many potential combinations of factors that could affect tPR's work including changes in economic conditions which impacted on pensions as much as on insurance businesses or selling groceries. Among the common areas of interest were how different regulators were approaching what appeared to be similar problems and what they could learn from one another.

At the tPR two areas of particular concerns were the risks arising from economic conditions and the fast-changing pensions market. In particular, the changes in the pensions market raised a range of issues including the need to learn new tricks, to provide appropriate training and the adequacy of regulation. The hot spots for pensions identified in the consultation document would be nothing new to actuaries but JFAR provided the opportunity to look at those risks in more detail and from a different perspective.

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Nick Poyntz-Wright said that he was a member of the actuarial profession, so must declare and interest, but he was speaking at this event and participating in JFAR with his FCA hat on.

The FCA set principles and rules governing the conduct of firms, including insurers, pension providers and financial intermediaries. Many of those firms were advised by, managed by or sometimes governed by actuaries. Actuaries could therefore play an important part in the way those firms made decisions, their practices and the ways they behaved in the market, all of which were important to the FCA, particularly the outcomes experienced by customers.

As with tPR, the FCA did not routinely monitor the work of actuaries in contributing to those outcomes but it did encounter important actuarial input to a firm's decision making or behaviour and would be a focus for attention where the fair treatment of customers was an issue.

Among the illuminating discussions that had taken place around the JFAR table were those relating to risks that actuaries could help to mitigate and those that actuaries could cause or exacerbate. In an ideal world actuaries would be doing more of the former and less of the latter. The consultation document tried to weigh up all the contributing factors in exercising a judgement about whether to do more or do less.

Some risks were particularly relevant to a conduct regulator, such as the understanding of 'risk and return'. This is an area that actuaries are possibly uniquely placed to contribute to. The FCA concentrated on outcomes experienced by ordinary consumers who are often not well placed to balance the risks and returns in a product. Actuaries could have a role influencing the way firms disclose risks and returns and help customers to understand them and weigh them up. In relation to pensions, the FCA was interested in seeing how firms innovate in response to changes in the market to help meet the needs of consumers. The changes that put pensioners more in control meant that it would be important that they were in a position to make an informed choice and to contemplate the risks they may be taking on. Actuaries are in a good position to influence the information provided to consumers.

Another significant risk for the FCA was around product design and distribution. Actuaries are often involved in the design and pricing of insurance and pensions products. The FCA's interest was in whether the products are appropriate and meet the needs of the target consumer segment. It was important to consider not only the particular segment but also whether the distribution mechanism would ensure the products arrive only in that segment. Providers needed to make what consumers need and not just sell them what they had. In some segments of the market, price was the primary point of comparison, increasingly so with the use of new technology, and it is important that consumers understand what they were getting for that price. Actuaries could play a part in ensuring that this aspect was considered.

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Giles Fairhead said that he had found the sharing of different views and perspectives among JFAR members very useful and he hoped for a very vibrant discussion around the consultation paper.

The PRA did not directly regulate actuaries but a significant number of actuaries in the UK operated in the insurance business that the PRA did regulate. Their work was often scrutinised as part of PRA's involvement with individual businesses. The PRA did not challenge actuaries over compliance with FRC or IFoA standards but would seek to address any perceived shortcomings it encountered.

The PRA was doing work on a number of risk areas identified in the consultation document. One of these was its work around modelling and Solvency II. Many firms were producing internal models for Solvency II and the PRA was doing a lot of work in this area. Actuaries played a very large part in the production of those models. The PRA was also reviewing the models used for the ICA regime, bringing it into contact with the work of actuaries on the areas covered, the assumptions made and the amount of challenge, and giving the PRA an insight into the quality of work being done by actuaries in the insurance sector.

'Group think' was also covered in the PRA's risk model in terms of governance and oversight, including risk management, controls and audit functions. Actuaries were operating in all of these areas in roles that were important in providing oversight to the insurance model. All of this work was being done on an ongoing basis so that the PRA could look out for 'Group think', ensure that assumptions were being appropriately challenged and that outcomes were appropriate.

Understanding of risk and return is also important to the PRA. In the current economic environment insurers are looking for more yield on assets and at moving into alternative assets. On the back of that actuaries are playing a significant role in long term modelling of assets, particularly in relation to illiquidity premium, risk of default and assumptions about how much capital should be held against each asset class. This was an area where there was a lot of specialist judgement to be made and a need for appropriate challenge to be brought to bear on the assumptions made to ensure they were appropriate for the business as they could have big capital effects.

The PRA also had a particular focus on general insurance reserves and ensuring that reserving policies were adequate. Actuaries had an important role in reviewing reserving policies and procedures. The PRA is paying close attention to new and developing risks, such as PPOs, where insurance actuaries might have less knowledge or expertise.

The greatest uncertainty currently is the external environment around pensions reform. A lot of firms are having to change their business strategies and rethink their product designs. A lot of actuarial assumptions are being built into new business models, plans and product designs. The uncertain environment was making it difficult to predict what it would look like in one or two years' time. That uncertainty is also making it important that the right amount of challenge was brought to bear and that people are properly aware of the uncertainties being built into their assumptions.

Comments, questions and answers

Bob Scott *(Lane Clarke & Peacock LLP) - There were two travellers in a railway carriage, one of whom was tearing pages out of a telephone book and throwing them out of the window. His companion, on asking why he was doing it, received the response "To frighten away the polar bears" Told that there were no polar bears, is this was Australia, the first traveller replied: "See, it's working!"*

Specific points of concern:

- *The way the discussion paper had been produced by a group of regulators sitting down and thinking up a sweep of hypothetical risks had resulted in a number of polar bears.*
- *Although it was being claimed that the aim was not extra regulation, the risk was that the exercise would result in telephone books of extra regulation, not for tearing up to throw out of the window, but to add to costs, complexity and ultimately to reduce consumer confidence.*
- *The notion that financial risk was bad and must therefore be mitigated was misguided as was the concept that quality actuarial advice would mitigate risks whereas poor quality actuarial advice would not. The risks existed anyway and the purpose of actuarial advice was to inform and not necessarily to mitigate.*
- *Consumers did not need to understand risk and reward - it was up to the experts to understand and consumers did not need masses of paper explaining risks because they would still not understand.*
- *The common themes in the discussion paper seemed unduly negative, painting a picture of actuaries as a closed group following herd mentality and with undue influence.*
- *Over-regulation had been described as a major risk in itself but it had not been identified as one of the risks to be considered.*

Nick Poyntz-Wright - The evidence certainly was that most customers did not read the considerable volume of materials sometimes produced in order to support, disclose and be transparent about every nook and cranny of potential risk. There were those in the actuarial profession who did understand the risks and the discussion paper was about whether these could be designed out of products.

Michael Johnson *How will the success of the exercise be measured? Could it be through some measure of consumer trust in the financial services industry? Currently, the financial services industry had widened the trust gap and there was arguably a need to dismantle the current regulatory framework and start again, including reference to governance.*

Melanie McLaren - The discussion document represented the beginning of a process for identifying risks and getting agreement around how to address them but it would never be possible to declare victory in a constantly changing world. It may never be possible to declare that there was no longer a need for a JFAR so the aim would be to continue dialogue with regular reporting and outreach to respond to developing circumstances.

Des Hudson - The reality is that there will always be an asymmetric relationship between consumers and providers of financial services. The role of actuaries as advisers to or guides of providers of financial services added a further layer of complication in considering in terms of regulation whether and, if so, what action was required.

Giles Fairhead - The PRA has a strong focus on governance. Actuaries fill a number of roles, sometimes sitting on boards and sometimes providing advice to boards. In that latter role they would not be acting as top-level decision takers and the main issues would then be around transparency, clarity about the risks and communication in terms that were understandable to lay decision-takers.

Nick Poyntz-Wright - It was understandable that the way JFAR had aired the risks identified in the discussion paper would be seen by some as a negative way of looking at things. However, the discussion paper is just the starting point for discussion and debate. The benefit of the exercise should come mainly from that discussion and debate through which additional or alternative issues that needed to be addressed might be identified. In terms of measuring success, the FCA view was that entities were capable of making considerable improvement to the quality of their decision taking and behaviours. If the exercise can bring about a better focus on quality and standards, decision taking, practices and behaviours would improve and there would be less need for intervention by regulators.

Chinu Patel - No one was saying that risk could not be. As a regulator, tPR is saying that risk should always be measured, understood and affordable and within the risk appetite. The downside as well as the upside of risk should always be considered. In relation to whether risks had to be set out in detail for and understood by consumers or whether it could be left to actuaries it was important that consumers such as pension scheme members who wanted to rely on actuaries having understood the risks were not left exposed to later losses through failure to disclose all relevant risks.

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Tony Hewitt *(Institute and Faculty of Actuaries) - It was pleasing to see that the discussion paper had drawn out the potential conflict between commercial interests and the public interest and the need for actuaries to resist pressures affecting their judgement. It was also pleasing to see what the FCA and PRA were doing in relation to the corporate culture in the banking sector. The pensions and insurance industries were not in the same dog-house as the banks but the same conflicts of interest were present in any financial institution. There were issues around personal incentives and the accountability of individual board directors (for example the need for the chair of the risk committee to be absolutely independent). Actuaries were often faced with a conflict between the public interest and their personal financial interest and there were numerous case studies where people had not done the right thing in those circumstances (such as bullying from Robert Maxwell or chief executives behaving* *badly in the recent financial crisis. Was JFAR considering what practical actions could be taken to improve the governance environment so as not to leave actuaries exposed to inappropriate pressures?*

Nick Poyntz-Wright - For some time now the FCA has been drawing attention to culture as a key driver of some of the outcomes in terms of customer experience. A good culture focused around the customer's needs can be an organisation's best risk mitigator. Unfortunately, the opposite has sometimes been the case. The FCA was now spending a lot of time thinking about the culture and governance of organisations rather than the previous focus on a tick-box set of rules. Independence of governance was extremely important. In looking ahead at developing products there was less focus on the downstream disclosure documents (which in the past may not have actually covered the particular issue that had gone wrong) and more on the governance around the design of the products in the first place and on the degree of independent oversight.

Giles Fairhead - Governance was also a key focus for the PRA. The potential for conflicts of interest, especially for the employed actuary, was well recognised. The PRA was placing emphasis on having an independent risk function (remunerated separately from the rest of the organisation and containing individuals sufficiently proficient to be able to challenge assumptions), on there being a majority of independent non-executives on the board of directors (not remunerated by the organisation and whose role was to challenge the executive and ensure the decisions at the top level were appropriate) and on the role of the risk committee. The PRA also looked at other mitigants around risk management to ensure they were being managed properly and the discussion paper was drawing attention to the need for actuaries to call it out if they felt their judgements were being put under pressure by the organisation.

Tony Hewitt *- A lot is being done in financial institutions to provide actuaries with channels through which they can deal with undue pressure. Actuaries also work in sectors outside the remit of the FCA and PRA so what was the FRC doing in relation to the Corporate Governance Code, particularly in terms of the whistle-blowing provisions still being operated on a comply or explain basis only, leaving individual companies to choose what they wanted to do?*

Melanie McLaren - The FRC has a cross-sectoral responsibility for maintaining the Corporate Governance Code which applies on a comply or explain basis. The comply or explain approach is kept under review but every time it has been looked at it has been found that very high levels of compliance were being achieved, higher than was likely from a hard-law approach. The reason for the high levels of compliance was the role of investors in holding the board of directors to account. The Code has recently been strengthened to provide for annual re-election of directors allowing any investor discontent to be expressed directly.

The FRC believe that the comply or explain regime continues to be very robust and it is being replicated around the world. However, the FRC is not complacent. One of the current issues at review was the possibility that the Code was becoming too prescriptive and diverting attention from the central principle of the accountability of the board and the culture. In the next review cycle the FRC would be looking at what it could do to get back to the core issues of embedding the right culture through the organisation.

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Peter Crowley *(Windsor Actuarial Consultants) What can actuaries learn from the banking industry's experience?*

Des Hudson - It was a bit of a struggle to understand the regulatory appropriateness of the decision to change the way tax law was applied to one part of the regulated community and to apply those changes to those banks who did not socialise their losses to the public exchequer. There were political reasons for doing this. Insurance and pension companies may not be responding to the need for cultural change at the same pace as banks. The profession needs to understand and appreciate the expectations of public interest, consider whether it was meeting them and contribute to the formulation of the standards to be met.

Nick Poyntz-Wright - There is a need to avoid complexity. In a market where professional buyers have been taking on products from banks, some of the products became so complicated that it was not only the sophisticated professional investor who could not understand how they operated in various scenarios but also some of those who were selling and even those who were designing them did not fully understand how they worked.

Giles Fairhead - A significant number of models had been rolled out into the banking sector prior to the crash and there may be lessons to be learned from reviewing how they worked during the crisis. It appears that most of the insurance models held up fairly well during the crisis so there may be some lessons there.

Melanie McLaren - There may be lessons that the banking sector could learn from actuaries. The project had been working primarily around economic uncertainty and needed to examine various stress scenarios and dare to think the unthinkable. There were already messages from previous experiences, such as Equitable Life, and it was encouraging that actuaries were increasingly becoming involved in banking and broader investment activities.

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Matthew Pearlman *(Lane Clarke & Peacock LLP) - In relation to 'Group think' and convergence of assumptions by actuaries, there appears to be little in the way of regulatory scrutiny. For example, in the case of setting tentative correlation assumptions between different risks in relation to insurance if there was little data to go on, common assumptions are used. There is a great temptation to pick an assumption that is within the 'pack' which would not therefore light any of the regulator's lights. How do regulators ensure a proper balance between carrying out necessary scrutiny and encouraging everyone towards common assumptions?*

Giles Fairhead - This was a key risk recognised by the PRA which employed some 90 actuaries who were working on reviewing internal models and in relation to whom there was a risk of 'Group think'. One of the protections within the PRA is its governance structures around many of the expectations in the ICA regime (and in Solvency II going forward) which have to go through a considerable amount of internal challenge before going to the board for decision. Internal supervisors (who are not actuaries) routinely challenge the assumptions being made to develop a consensus view to be reported up through the governance structure. The PRA's models for the ICA regime had been developed around an industry view but for Solvency II, which is far more complex, the PRA would be developing its own internal models.

Chinu Patel - This was a perfect example of the learning and sharing the JFAR had enabled. In tPR it had been assumed that actuaries would be using the right models and the focus was on whether trustees understood the information they were getting from those models and the advice they were being given. The challenge for tPR was whether they should be questioning the models. It used to be the practice in the banking industry to think about what it would be like to be at the bottom of an economic cycle that happened every 25 years which forced people to think what it would be like to feel that pain and how to get out of it. It was an exercise that led to good decision taking and was something that might be learned from the banking industry.

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Trevor Llanwarne *(former Government Actuary) - Welcoming and supporting the discussion paper and its aim of addressing the big picture issues and the aim of JFAR in getting people together suggested JFAR needed to try even harder to avoid falling into 'Group think' by ensuring a wide variety of input to its discussion. There was also scope to add a number of other areas of risk and to explore, in relation to any particular risk, the very many options for addressing them that would be preferable to regulation. By getting ahead of the game the need to fall back on regulation would be reduced.*

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Eric Anstee *(Sun Life Assurance of Canada(UK)) - Also welcoming the paper commented that it would merit from being brought to a broader audience. The pace of change, particularly in actuarial modelling, has not received enough attention. There might also be merit in looking at the scope of audits, particularly in the pensions and life insurance sectors, which typically do not look at actuarial models*

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Michael Tripp *(Mazars) - The key is risk, uncertainty and judgement. The terms risk and uncertainty were being used in a slapdash manner. is there actually a difference between risk and uncertainty that needs to be explored further? One view was that risk is randomness while uncertainty is unquantified randomness. People sometimes did not have the courage to say that they do not actually know (for example what an oil company's reserves were actually worth). This was where judgement came in and there needs to be some allowance for the subjective as well as the objective.*

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Kenneth Donaldson *(IFoA's Resource and Environment Board) - How will the conversation proceed in relation to things like climate change risk, where the past is no guide to the future?*

Melanie McLaren - The consultation document was seeking the wisdom of the crowd on which risks it should be possible to tackle, which risks could only be monitored and what could be done practically, for example in actuaries developing new techniques to address emerging risks or to improve communication of risks.

Stephen Haddrill said that he was encouraged by the contributions to the discussion at this event and by the evident desire to broaden the debate. It was right that risk was not a bad thing in relation to financial services because it is not possible to make money without taking a risk and not possible to make a lot of money without doing something that no one else was doing. Risk is therefore embedded. The key was that people should be enabled to understand the real risks they were taking and that the industry did not allow people to take risks that they did not understand. There would never be a perfect set of products and services but there was a need to get better. There was a major risk that with actuaries and others having their individual roles, the problem would always be seen as someone else's. By working together, JFAR members could try to ensure that within each of their individual frameworks the problems were shared and dealt with. As recent experience has shown, splitting risk did not make it go away.