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SENTENTIAL CHANGES

The Morris Review leads to a major restructuring of actuarial governance in Britain

BY W. PAUL MCCROSSAN



MARCH 2005, Sir Derek Morris released the final report on his review of the British actuarial profession. He recommended a fundamental restructuring of the governance of the U.K. profession.

The actuarial profession in the United Kingdom had been subject to sustained criticism concerning both pension fund and insurer financial difficulties, particularly those of Equitable Life (the oldest mutual life insurer in the world), which had to be closed to new business in late 2000 and which was headed by a chief executive officer who was also chief actuary. Lord Penrose was appointed by the British government to investigate the circumstances underlying the Equitable's difficulties. When the Penrose report was published in 2003, it voiced a number of concerns about the actuarial profession. (See sidebar.) Almost immediately, the British government appointed Sir Derek Morris to make an independent review of the profession.

The Morris Recommendations

Sir Derek's recommendations, accepted by the U.K. Chancellor of the Exchequer in Parliament on the day they were released, were these:

- The regulation of the actuarial profession should be subject to independent oversight by the U.K. Financial Reporting Council (FRC), which also oversees the British accounting profession.
- The FRC should create an actuarial standards board (with a majority of actuarial members and representation from users of actuarial advice, consumers, and regulators) to set future actuarial technical standards.
- The FRC should also oversee the other activities of the actuarial profession, including setting ethical professional standards of conduct (codes of conduct); administering basic and continuing actuarial education; monitoring compliance with professional standards; administering disciplinary procedures.
- The standards board should have the power to set ethical standards if it believes them to be appropriate, or if it feels the profession's ethical standards aren't

sufficient. The report notes that the FRC's Auditing Practices Board had published ethical standards in December 2004 for the first time, replacing ethical standards that had previously been set by accountancy professional bodies.

Replacing Self-Regulation

Sir Derek's principal conclusion was that, in order to restore confidence, actuarial self-regulation needed to be replaced by another system. He found that self-regulation had led to a number of weaknesses, including "professional standards that have been weak, ambiguous, or too limited in range and perceived as influenced by commercial interests;" "an absence of pro-active monitoring of members' compliance with professional standards;" and "a profession that has been too introspective, not forward-looking enough, and slow to modernize."

He concluded that "continued self-regulation by the Profession is unlikely to restore public confidence." (Note: In the Morris Review, "Profession" refers collectively to the Faculty and Institute of Actuaries, while

The Penrose Report's Observations About Actuaries

The 817-page Penrose report, released in early 2003, doesn't contain a specific section on actuaries. However, scathing criticism of actuaries can be found in many places in the report. Among the criticisms:

Professional standards concerning policyholders' reasonable expectations were weak.

■ "The guidance offered no standards of performance ... such as might have been expected of a professional body."

■ "In attempting to put a professional gloss on the language of the Act, the profession appears, no doubt unintentionally, to have seriously misled itself."

■ "The actuarial profession as a whole failed to develop any coherent principles or rules of practice ... (because) the profession resisted prescription."

Guidance about liabilities on embedded options (GAOs) was absent.

■ "As late as 1997, when it set up a working party to consider the issue, the actuarial profession had not established any specific guidance on reserving for annuity guarantees ... despite a clear requirement to value all guarantees in the regulations."

■ "(Even) when the working party reported later in 1997, it failed to recommend an approach to be taken."

■ "Professional bodies that confer privileges on their members have corresponding obligations to ensure that there are sufficient and effective professional standards by which to measure members' performance of their duties to their clients and the public."

■ "Recognizing the idiosyncratic practices of individual members is not an acceptable substitute."

Professional discipline was weak, due to inadequate standards and poor disciplinary processes.

■ "If any external reliance is to be placed on the professional opinion of any actuary, the actuarial profession must be encouraged to impose appropriate discipline ... If the profession does not wish to be judged by the lowest common denominator: (a) it must have a well-developed set of prescribed standards; and (b) it must have a properly developed procedural system to confront deviant conduct."

■ "It would improve the public image of the profession if it were seen to accept the responsibility for direct intervention.... I would invite ministers to offer encouragement and support for initiatives that the profession might take in this direction."

There was over-reliance on the role of the appointed actuary.

■ "Regulation was based on an over-reliance on the appointed actuary ... There must be concern at the reliance that has been placed in the past on an office that could encompass such extremes in terms of experience and authority within life offices."

■ GN1's note to actuaries who are directors ("A special responsibility is owed to the AA [appointed actuary] by any other actuary who is a director ... he should be careful not to act in any way as to diminish the status of the AA") led to a reluctance to criticize.

■ Even with respect to Lord Penrose's own actuarial adviser, "actuaries have proved singularly reticent in criticism of fellow professionals."

■ "Without firm rules or well-developed principles there was ... an inadequate basis for criticism that would have been robust in the face of hostile reaction."

The actuarial profession was too narrow to bear all the responsibilities it had assumed.

■ "The published accounts ... became progressively less relevant as reflections of the actual conduct of business of the Society ... consistent with practice that had failed to keep up with industrial developments."

■ "Actuaries ... were not competent to adjudicate on the (legal) issues that emerged."

The actuaries' work was not open to scrutiny.

■ "There is no effective monitoring, and [there is] poor understanding, of the dividing lines between the technical actuarial area and the exercise of discretionary powers based on technical material."

■ "It appears to be a particular conceit of the actuaries that the exercise of discretion was as much their exclusive preserve as the arithmetic that instructed it."

■ "It is the defining characteristic of an expert that he or she can communicate the results of his or her expertise with sufficient clarity to enable any reasonably intelligent person vested with decision-making power effectively to exercise that power. Actuaries need not be in an exceptional position in this respect."

“profession” refers to all actuaries in the United Kingdom who are members of the two actuarial organizations.)

An Actuarial Understanding Gap

The Morris Review identified the existence of an “understanding gap” in the work of actuaries. Sir Derek’s interviews with many users of actuarial reports (including pension trustees, insurer board members, and insurer chief financial officers) led him to conclude that many actuaries in the insurance and pension fields had not succeeded in communicating the risks to which their clients were exposed.

Consequently, a key recommendation of the Morris report is intended to cure the actuarial understanding gap Sir Derek found. The report recommends that the new actuarial standards board develop—as its first priority—a generic communication standard for all actuarial reports. The report specifies that the standard should cover:

- the disclosure of assumptions used and a discussion of the extent to which professional judgment was exercised;
- what methodologies were chosen, and why;
- a sensitivity analysis of outcomes to changed assumptions and methodologies;
- probabilistic analyses of key variables or indicators under particular scenarios;
- concerns the client should have, bearing in mind the client’s capacity to cope with various types and levels of risk.

New Rules for Pension Actuaries and Trustees

In dealing with criticisms of pension actuaries’ advice, Sir Derek has proposed that pension fund trustees conduct informal professional reviews of their actuaries’ advice every year and formal reviews following each triennial report; that trustees increase their knowledge and understanding of pension issues through education to be sponsored by the pensions regulator; that they tender for actuarial services separately from strategic-investment-related and fund-manager-selection services; and that if they review or retender for actuarial services less often than is called for in the Morris report at least every five to seven years, they explain their inaction to plan members. In addition, the trustees are to identify in advance circumstances under which conflicts of interest between plan members and plan sponsors might become too large to manage, and they have the first right of refusal to actuaries’ services should such conflicts emerge.

While acknowledging that the profession introduced voluntary pension peer review in December 2004 that will become mandatory at the end of 2006, the Morris report notes the lack of any requirement that the peer reviewer be independent of the scheme actuary, and it recommends that the pension regulator “ensure that the scheme actuaries’ advice is subject to formal scrutiny by independent experts.”

The report also attempts to manage potential conflicts of interest for actuaries advising both a pension scheme’s trustees and its sponsors. Since there is always the potential for a conflict of interest between a plan sponsor and plan members:

- an explicit written agreement should be entered into between the plan trustees, the plan sponsor, and the actuary outlining why the parties believe the conflicts can be managed;

- if any of the three parties deem at any point that a material conflict of interest has occurred, the trustees should have the option to retain the existing adviser;

- the Profession, or another appropriate body, should develop guidance for actuaries on the issues to take into account when considering the materiality of potential conflicts.

Serving the Public Interest

One of the most significant areas the Morris Review addresses is having actuaries with reserved, or statutory, roles support the public interest through reporting and whistle-blowing to statutory regulators. The review endorses the idea that senior management is responsible for an insurer’s actions and that pension scheme trustees and plan sponsors share responsibility for the actions of pension schemes. However, Sir Derek feels that when an actuary holds a reserved role, the duty to make relevant information known to regulators takes precedence over any other type of accountability.

The Morris report states that the public interest will be served through actuaries’ compliance with high-quality standards and that this can best be ensured through enhanced



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The Morris Report—Why Should I Care?

By Peter Perkins

Uou're sitting in your office anticipating a fast-approaching project deadline. Your client or boss has a great idea to follow up on. Your mechanic just called, and you need a new transmission. We're all very busy, why should we care about the Morris Review?

First, let me help you with reasons we all might use to ignore it. The report was prompted by the failure of a life insurance company to meet its promises... you don't work in life insurance. The life insurance company in question is in Britain ... you aren't! You provide actuarial services in the United States, and you don't expect to practice anywhere else. Finally, the report scrutinized the U.K. actuarial profession and its organizations, and you are a member of one or more U.S. organizations, and the profession is doing quite well, thank you.

Pretty good reasons to ignore the report. However, they can be dangerous to invoke.

Today, retirement security is under scrutiny in the United States. Actuaries play a key role in making retirement-related promises secure. Issues in this or

any other financial-security area could increase scrutiny of our profession.

While the Morris report focused on British actuaries and you may never plan to practice outside the United States, you are likely to feel the impact of the report. As a result of the report, British actuaries will now be subject to review and oversight by a non-actuarial entity. Think this couldn't happen in the United States? Wrong! As a result of Sarbanes-Oxley, U.S. accountants are now subject to a government oversight board.

The Morris report also suggested that the U.K. actuarial profession's education and examination process did not keep up with emerging practices. Sound familiar? The Society of Actuaries and the Casualty Actuarial Society work hard to keep their education and exams relevant to today's products and methods.

So why care about the Morris report? Because it serves as an example. It's an example of what can happen to a profession that does well but changes slowly. It's an example of how government can get involved in overseeing and even directing a

profession. Finally, it's an example of a thorough review of a profession.

Sir Derek Morris reviewed all aspects of the actuarial profession in developing his report. Our profession is currently doing a similar comprehensive review. With the unwieldy name of the Critical Review of the U.S. Actuarial Profession (CRUSAP for short), a task force is in place to use an enterprise risk management approach to assess our profession across many dimensions. CRUSAP will be reaching out to actuaries and non-actuaries for input on what our profession does and how we do it.

Why should you care about CRUSAP? Because this group will be reviewing our profession and very likely will be suggesting some changes that will affect what you do and how you do it. Want to care more? Go to the website at www.crusap.net to learn more and share your thoughts.

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scrutiny. The Financial Services Authority (FSA), the Pensions Regulator, and possibly the Financial Reporting Council should have the power to confer whistle-blowing duties on actuaries in specified roles and should clarify the reporting and whistle-blowing requirements.

Regulators should ensure that actuaries with reserved roles are subject to formal scrutiny by independent experts, the report recommends. And the government should ensure both that there are appropriate gateways and reliefs from duties of confidentiality and that actuaries have an appropriate degree of legal protection (such as by granting qualified-privilege protection from libel actions).

A Need for Casualty Risk Advice

The report also examines the need for risk assessment advice for general insurance (known in the United States as property/casualty insurance). The review concludes that "it is critical that [general insurers'] senior management receive advice from someone with relevant skills in risk assessment and the valuation of liabilities" and that "the Financial Services Authority should

consult on introducing a requirement for general insurers to take advice from an approved person with relevant skills who may, or may not, be a member of the actuarial profession."

Is North America Next in Line?

Newspaper articles about massively underfunded pension liabilities are appearing more frequently in the United States and Canada, and prominent individuals such as Warren Buffett have taken to criticizing actuaries' roles in this underfunding. Criticisms of the inadequacies of insurer statutory accounting and GAAP accounting are heard more frequently in the press and in the industry.

So far, the spotlight in North America has not shone on the actuary. In my opinion, we've been lucky. Interest rates in North America were generally lower than in Europe during the 1970s and 1980s. Today, interest rates are generally higher in North America than in Europe, so the problems from insurer-embedded options coming "into the money," such as guaranteed annuity purchase options (which were a major contributor to Equitable's financial difficulties), are smaller here. Also, North American insurers and pension funds were generally less ex-

The Morris Review— Outside the U.K., a Chance to Take Stock

By Bob Beuerlein

The Morris Review provides an opportunity for the actuarial profession around the world to take a step back and check the compass. Are we still on track as we work to expand actuarial roles—and actuarial opportunities—in the global business community?

REASSESSING THE PLAN

Over the past few years, the Society of Actuaries has developed a strategic plan that serves as a road map to accomplish important SOA objectives. When the Morris report was published in March 2005, the SOA Board of Governors appointed a blue-ribbon task force to evaluate the strategic plan in light of the Morris Review and determine if the road map was taking us in the right direction. In June, the task force reported that the Morris Review validates the core tenets of the SOA strategic plan, as the Morris report repeatedly calls upon the actuarial profession to be:

- proactive in dealing with business and public-interest situations in which actuaries offer unique expertise;

- relevant and non-insular in developing professional methods for actuaries at all levels;

- forward-looking and broad-thinking in developing educational topics and techniques.

EDUCATIONAL ALTERNATIVES

Given that the SOA's mission focuses primarily on education and research, we were particularly attentive to the Morris report's comments on the British actuarial education system:

- "The syllabus has failed to take full account of new developments."

- "There has been insufficient attention to communication and general business skills."

- "The time to qualify has been lengthy. The work-based part-time education model contributes to the insular profession."

Such assessments reinforce the need for changes we have been making in the SOA's education and continuing education offerings. The development of actuaries' skills in business acumen and communication is increasingly necessary, and we must continue to explore university accreditation and alternative routes to an actuarial credential.

BROADENING OUR HORIZONS

The Morris Review has raised numerous questions concerning the perception of actuaries by many in the business community. That issue is one that the North American actuarial organizations have been addressing for some time; currently, one of our primary efforts is a coordinated marketing campaign aimed at enhancing the image of the actuary, preserving the value of actuarial credentials, and helping actuaries compete in the broader financial services market. This ongoing campaign provides practical guidance, support, and resources to help actuaries promote their own work as well as the broader value of the actuarial skill set to employers. The success of the campaign will better position the profession for greater influence both in our traditional markets and in nontraditional financial services.

Overall, the actuarial profession's horizons are becoming broader, and opportunities are expanding. The Morris Review serves to remind actuaries that we already have a great profession and that we can have more impact in the future. The actuarial profession must continue to reach for new heights as we work to expand our skills and our role in the business community.

BOB BEUERLEIN is president of the Society of Actuaries. He also chairs the SOA task force on the Morris Review. He is senior vice president and chief actuary with AIG American General in Houston.

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An Ounce of Prevention....

Actuaries in the United States and Canada have already considered the possibility that North America could spawn its own version of Britain's Morris Review.

There's no telling how it would look or what exactly it would find, given major national differences in the actuarial profession's structure, governance, history, and operating environment. But if it comes, the leaders of the North American profession want to be ready—and their preparation is well underway. If you'd like to know more about those efforts, other pertinent initiatives, and the Morris Review itself, here are a few places to start:

The Critical Review of the U.S. Actuarial Profession (CRUSAP)
www.crusap.net

The CAS Task Force on Actuarial Credibility
<http://www.casact.org/members/BoD/051505ES.pdf>

Reports from the CIA Task Force on the Role of the Pension Actuary and the CIA Task Force on Corporate Governance
http://www.actuaries.ca/publications/documents_reports_e.html

The Academy Task Force on ASB and ABCD Independence
<http://www.actuary.org/inside/0805.htm#8>

The Morris Review final report
http://www.hm-treasury.gov.uk/independent_reviews/morris_review/review_morris_index.cfm

Chris Daykin's summary of the Morris Review (*The Actuary*, August 2005)
<http://www.soa.org/ccm/content/about-soa-member-directory/the-actuary-newsletter/august-2005/the-morris-review-of-the-uk-actuarial-foundation/?printerFriendly=1>

The U.K. Faculty and Institute of Actuaries strategy review
http://www.actuaries.org.uk/Display_Page.cgi?url=/news/morrisreview.html

posed to equities before the 2000 market peak in the late 1990s than was the norm in Great Britain, making them somewhat less vulnerable to the 2000–2003 global bear market.

That being said, problems are emerging, and we in North America might ask ourselves whether our communication and analytical skills would be judged to have been sufficient if a major investigation were to be demanded. I suspect not.

In my work with the Morris Review, I found myself thinking all too frequently, "There, but for the grace of God, go we." In my mind, the top priority for the actuarial profession's leadership in North America should be to set about examining which of the problems that arose in the United Kingdom apply here. And then the leaders should set about rectifying them while there is still time.

W. PAUL MCCROSSAN was a member of the Morris Review External Advisory Panel. He is also a former president of the Canadian Institute of Actuaries. He lives in Toronto.

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