AMERICAN ACADEMY *of* ACTUARIES

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By Electronic and Overnight Delivery

Sir Derek Morris
Commission of Inquiry into
Actuarial Profession
GC/08
1 Horse Guards Road
London SW1A 2HQ
United Kingdom

Dear Sir Derek:

The American Academy of Actuaries ("Academy"), acting on behalf of the United States actuarial profession,[1] appreciates this opportunity to submit additional information to the Morris Review in response to your December 2004 interim report. The Academy was particularly pleased to have had the opportunity to meet with you and your staff in January and hopes that the information provided during that meeting and here will support your efforts to develop a fair, balanced and appropriate final report.

We recognize that the interim report reflects a sincere effort on the part of the Morris Review to present fairly its initial findings and to avoid unfairly impugning the professionalism of the actuarial profession. We particularly appreciated Section 1.12 of the interim report, and would agree that the vast majority of actuaries in the U.K. and around the world are, in fact, "dedicated, skilled professionals providing important and useful advice to the best of their abilities, with commitment, integrity and a strong sense of professional duty." The Morris Review's final report and recommendations will be read and discussed worldwide and may have a significant impact not only on actuaries practicing in the U.K., but on the entire actuarial profession across

[1] As described in our September 2004 submission to the Morris Review, there are five organizations in the United States that represent actuaries: the American Academy of Actuaries, the American Society of Pension Professionals and Actuaries, the Casualty Actuarial Society, the Conference of Consulting Actuaries, and the Society of Actuaries. Pursuant to a working agreement between these organizations and actuarial organizations in Canada and Mexico, the Academy serves as the voice of the U.S. actuarial profession with respect to professionalism issues involving actuaries and its primary voice with respect to public policy, while the Casualty Actuarial Society and the Society of Actuaries focus on education and research, the American Society of Pension Professionals and Actuaries focuses on issues involving U.S. pension plans, and the Conference of Consulting Actuaries focuses on the needs of actuaries in consulting practice.

the globe. For this reason, we would strongly urge the Morris Review to take particular care to limit the scope of its final report to the U.K. and to avoid stating its conclusions in an unnecessarily harsh or sweeping manner. As you observed during a recent public meeting of the Institute of Actuaries in London, press descriptions of the interim report were more negative than the report itself. The press tends to emphasize the negative aspects of any story to generate interest and controversy. We urge you to take that tendency into account when preparing your final report and recommendations. In particular, please make sure that any positive findings or observations that you wish to make are set forth as prominently and clearly as possible to reduce the risk that they will be overlooked or discounted in press reports.

In making your final recommendations, please recognize that, in most instances, actuaries serve as advisors, not decision makers. It is the Board that bears overall responsibility for the financial solvency of an insurance company, just as the trustees are responsible for the successful operations of an employee benefit scheme. Actuaries can and should be held responsible for the quality of their advice, but they should not be held accountable for solvency beyond their authority to implement policy decisions, nor should they be made the scapegoat for bad management decisions. Moreover, the vast majority of insurance companies, employee benefit schemes and other entities to which actuaries provide professional advice and services are well funded and function successfully. It would be unfortunate if the Morris Review's recommendations went beyond what is necessary and imposed responsibility on actuaries beyond their authority to act.

With respect to communications, we recognize that actuaries (and other professionals, for that matter) can always improve their communication skills and that enhanced communications are usually beneficial in most business settings. For this reason, the Actuarial Standards Board ("ASB") has published Actuarial Standard of Practice No. 41, *Actuarial Communications*, to give U.S. actuaries guidance on how to communicate their findings and recommendations in written, oral and electronic form. However, if the Morris Review wishes its recommendations to be helpful to the U.K. actuarial profession, it will need to be more specific about what actuaries should reasonably be expected to communicate, and it will need to address specifically the responsibilities of the users of actuarial work when they receive communications from actuaries.

Actuarial work is usually highly technical and difficult to understand no matter how clearly the actuary presents it, especially if the actuary's intended audience lacks a fairly sophisticated understanding of the insurance or pension industry. Therefore, we believe that users of actuarial services have at least some responsibility either to educate themselves to the point where they can make appropriate use of actuarial advice or to hire an outside advisor to help them do so. In the United States, the recently enacted Sarbanes-Oxley corporate reform legislation requires the Board of Directors of a publicly-traded company to include on its Audit Committee a board member who is a "financial expert," *i.e.*, an individual who is educated and experienced in reading financial statements and applying generally accepted accounting principles. This financial expert (an actuary with an appropriate background qualifies as a financial expert) is intended to provide the Audit Committee with support in working with the audit firm and understanding the conclusions of the auditor. It might be beneficial for the Morris Review to recommend that similar requirements be put into place in the U.K. to encourage insurance company Boards of Directors and pension scheme fiduciaries to include the necessary competency to fulfill their own responsibilities with respect to the advice of their actuaries.

We also recognize that the general public does not understand or may not be willing to accept the concept of investment risk and may wrongly understand illustrations of possible returns in insurance sales materials to be guarantees. Unless an actuary has authority to influence the content of an insurance company's sales materials (as apparently may have been the case with respect to Equitable Life), it is not appropriate to hold the actuary responsible if policyholders develop unrealistically optimistic expectations of returns based on those sales materials. However, if the actuary is given appropriate statutory authority and protection from unfair risk of suit, the actuary *can* contribute to the development of sales materials that reflect a realistic understanding of illustrations of return on investment. In the United States, the Academy helped develop a model regulation that involves the actuary in the development and periodic certification of a "disciplined current scale" that underlies illlustrations in life insurance sales materials. It might be beneficial for the Morris Review to recommend the adoption of a similar regulation in the U.K.

United States law permits pension actuaries to provide professional services to pension plans and their sponsors, a situation that the interim report characterizes as a conflict of interest. However, the conflict may be more apparent than real. In the United States, plan sponsors can terminate their pension plans at will, subject to the terms in the plan documents, which can be amended. Consequently, the interest that plan participants might have in maximizing contributions is tempered by the fact that excessive demands for funding and benefits are likely to cause sponsors to terminate plans altogether. Similarly, plan sponsors' (and corporate shareholders') immediate apparent interest in minimizing required contributions is tempered by the need to meet the sponsor's long-term funding obligations and by the tax benefits sponsors receive from establishing and funding plans. Thus, one can argue that the apparent conflicts are resolvable because all parties share an overarching interest in maintaining reasonably funded and solvent plans over the long term. Against that background, U.S. actuaries can act as "honest brokers" in providing plan design, tax and funding advice to plans and their sponsors. In providing those services, U.S. pension actuaries are guided by an express statement in federal pension law to the effect that they must act on behalf of participants when calculating annual contributions. A similar statement in U.K. pension law might be helpful to practitioners there.

The interim report makes reference to a retirement savings crisis in the U.K. Retirement savings are also of concern in the U.S., but U.S. federal tax law creates far more disincentives for employers to fund plans in a conservative manner than any action taken by pension actuaries. We believe that the U.S. retirement savings system would be better served if federal tax law encouraged more appropriate funding of defined benefit pension plans. The Academy regularly objects when proposed changes in federal tax law would adversely impact sponsors' willingness to fund their pension plans. Several years ago, the American Society of Pension Actuaries (now the American Society of Pension Professionals and Actuaries) even went so far as to sue the U.S. government to retain the right to maintain an appropriate level of conservatism in pension actuaries' funding assumptions. Unfortunately, the U.S. actuarial profession is small, and its objections are not always heeded. If they were, we believe the U.S. retirement savings system would be in a better position. It may be that the U.K. system would also benefit if lawmakers listened more closely to the recommendations of the U.K. actuarial profession.

With respect to the scope of actuaries' involvement in non-traditional practice, we were somewhat dismayed by the implication that actuaries have had undue influence in areas such as asset allocation and fund manager selection. The core activity that actuaries are trained to provide may once have been limited to the assessment of long-term liabilities as the Review suggests, but many actuaries in the United States now have extensive responsibilities for analysis of both asset and liability cash flows and are trained to carry out those responsibilities. Other professionals with appropriate qualifications certainly can work in those areas, but nothing should prevent individual actuaries from doing so as well if they are qualified. Indeed, any narrow specification of actuarial services will fail to cover the full scope of the actuarial profession and the diversity of assignments that actuaries successfully fulfill. Many U.S. actuaries are actively involved in asset valuation and allocation in both the insurance and pension fields. Indeed, actuaries may be best qualified to engage in asset allocation based on asset-liability matching due to their unique understanding of liability cash flows. In the U.S., the Code of Professional Conduct prohibits actuaries from performing professional services unless they are qualified to do so, even if less qualified individuals from other professions claim they are also capable of performing the same services. The U.S. profession considers its qualification requirements to provide a long-term competitive advantage because they give the users of actuarial services more confidence that they are receiving advice from well-qualified, knowledgeable professionals.

The interim report's observations and recommendations concerning actuarial education seem to us to be problematic. Whenever an educational system is developed, an appropriate balance must be struck between providing sufficient content and setting a reasonable time to complete the course of study. We are not persuaded that university education is necessarily always the best means to deliver an appropriate level of technical content or would address the areas for improvement in actuarial education identified in the interim report. Actuarial education in the U.S. is not a substitute for the more general education that an undergraduate university degree provides; rather, it is more akin to professional, post-graduate education in medicine, engineering or law. These programs are also highly specialized and focused almost exclusively on the discipline being taught. (As an example, an understanding of the principles of accounting and financial economics might well be helpful to a student of business law, but those topics are rarely, if ever, taught in a U.S. law school course). We also believe that the "on the job" training that actuarial students receive is invaluable in equipping newly credentialed actuaries with the necessary background to deal with the challenges of daily practice, and note that other professions do not necessarily use traditional lecture based education to address practice issues. Many U.S. law and medical schools now offer courses on client communications and relationship management, for example, but those courses are clinical in nature rather than lecture and examination based.

Moreover, the small size of the actuarial profession makes it impractical to develop full university degrees in actuarial science. There are at present approximately 16,000 actuaries in the United States and, typically, fewer than 1,000 new actuaries entering the profession each year, an insufficient number to entice U.S. universities into creating a meaningful choice of actuarial science undergraduate programs. It may be that the profession would benefit if it allowed more academic credit for university coursework, and the Casualty Actuarial Society and Society of Actuaries are giving serious consideration to the possible future role of university education in actuarial training. However, given that actuarial science is extremely challenging and that the public interest aspects of actuarial work are so significant, we think the profession would be derelict in its responsibilities if it failed adequately to screen and educate candidates regardless of whatever university training they may have obtained.[2]

We also believe that continuing professional development is essential to maintaining actuaries' ability to practice in a changing and ever more complicated business world. Ideally, continuing professional development programs should focus on maintaining and enhancing the quality of an actuary's understanding of the actuary's specialized area of practice, and should not simply consist of a quantitative, "tic box" approach. While broad general knowledge of actuarial practice is helpful especially for newly qualified actuaries, specialization becomes increasingly important over time. We therefore believe that actuaries should retain considerable discretion to select continuing education opportunities that will meet their individual professional needs.

We agree with the Morris Review that the concept of "public interest" can be extremely difficult to define. Different segments of the public may have different, and even competing, interests, depending on the circumstances. For example, members of the public who purchase stock in an insurance company may have an interest in keeping reserves and surplus low to allow for the release of stockholder dividends and keeping the value of their stock high. Other members of the public who purchase insurance and annuities from the company have an interest in keeping reserves high to maximize the likelihood that their policies will pay out as anticipated. Many actuarial practice roles tend to place actuaries in settings where, as advisors to management and the Board, they support the stockholder segment of the public. Reserved roles generally define where actuaries are expected to function as advocates for other interests instead of, or in addition to, the interests of their principals. Those other interests need to be clearly defined and supported with appropriate statutory protections against liability.

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[2] The U.S. actuarial profession is experimenting with new ways to deliver actuarial education. For example, the redesigned educational syllabus of the Society of Actuaries, which will be implemented between 2005-07, has been designed to reduce "travel time" by making the first actuarial examination available online and on demand. More use will also be made of a module system of online training coordinated with the actuarial cycle. The American Society of Pension Professionals and Actuaries offers online, on demand examinations, and all of the U.S. organizations are experimenting with offering continuing education online. We have also increased the professionalism content at every level of actuarial education, and will continue to work to heighten candidates' awareness of the professional standards that they, as practicing actuaries, will be required to satisfy.

When speaking of the "public interest," it is helpful to recognize that actuaries as individuals have different responsibilities than the actuarial profession as a whole. In the U.S., individual actuaries are accountable to their principals, the regulators who review their work, and their professional organizations.[3] The U.S. Code of Professional Conduct requires actuaries to act honestly, with integrity and competence, and to take reasonable steps to prevent their work from being used to mislead or to violate or evade the law. However, it does not purport to make individual actuaries personally responsible to every member of the public at large. Rather, the U.S. actuarial profession as a whole, acting through its membership organizations, takes on a collective responsibility to the public by:

1. Education

   1.1. giving candidates an appropriate education in actuarial science;

   1.2. helping actuaries maintain their credentials by imposing and enforcing continuing education requirements; and

   1.3. providing opportunities for those requirements to be met;

2. Professionalism

   2.1. requiring adherence to a code of professional conduct;

   2.2. establishing and enforcing standards of practice to guide actuaries in providing professional services;

   2.3. disciplining individual actuaries whose conduct materially breaches the Code of Professional Conduct; and

   2.4. counseling actuaries in good professional practice;

3. Public Policy

   3.1. advising lawmakers concerning the actuarial aspects of proposed changes in law and regulation;

   3.2. educating the public about issues such as planning for their own personal security; and

   3.3. advocating in behalf of sound public policy from an actuarial perspective.

Ultimately, the purpose of regulation is to strive for security and delivery of promised benefits while maintaining a healthy marketplace whether in insurance, pensions or elsewhere. The public policy goal of regulation should be security and availability of offered benefits, not just

[3] They may also be held accountable by law to other individuals whom they intended to influence through their work.

oversight of a particular profession. We believe that the public interest is best served when every sector with a responsibility to the public appropriately fulfills its responsibilities. Policymakers (whether legislators or regulators) need to be cognizant of the public good when developing the laws and regulations that govern highly regulated industries, striking an appropriate balance between profitability, accountability and communication. Regulators with oversight responsibility need to have access to adequate resources and be able to rely upon their regulatory agencies to support them when a regulated entity resists oversight. Company management and Boards need to embrace their own responsibilities and fulfill them capably and ethically. Actuaries, accountants, attorneys and other professional advisors need to work cooperatively to provide their principals with competent and ethical advice. Auditors need to perform their duties conscientiously with full cooperation and support from boards, management and the professional advisors who assist them. If any of these sectors falls short the public interest suffers, and expecting another sector to fill the gap is likely to yield unfair or inadequate outcomes. Open communications between the various sectors can be highly beneficial, particularly when conducted in an atmosphere of mutual cooperation and courtesy with appropriate respect for confidentiality. Thus, for example, in the United States, actuaries routinely speak directly with insurance regulators concerning the operations of insurance companies, but information concerning companies' competitive strategies is kept confidential as to the public at large.

We recognize that the Morris Review's charge was to investigate the actuarial profession. However, to the extent the final report recommends changes in regulation, we think would be beneficial to look at the overall regulatory scheme in the U.K. for industries that actuaries serve. This broader perspective is likely to yield a balanced approach that will best serve the public interest.

The interim report makes reference to situations in which an actuary might serve as a "whistleblower," and we believe that term needs to be clarified. In the U.S., the word "whistleblower" commonly refers to an individual who has immediate knowledge of wrongdoing on the part of an individual or corporate entity, usually of a criminal nature, and who, by law, is required to report that wrongdoing or face separate prosecution. "Whistleblowing" statutes are very rare in the U.S. and, where they do exist, usually include explicit protections against retaliation for the whistleblower. If the Morris Review is referring more broadly to requirements for opinions or certifications from actuaries concerning the adequacy of reserves or pension contributions, for example, another word or phrase might be more readily understood by those outside of the U.K.. Whatever the Morris Review's intent, however, we believe it is essential that appropriate statutory protections be incorporated into any statute that requires an actuary to make a communication or disclosure that could result in retaliation against the actuary.

We believe it is the duty of the actuarial profession to provide its members with the necessary tools to fulfill their responsibilities. To that end, the U.S. profession maintains a hierarchy of professional standards that its members must satisfy. Of paramount importance is the Code of Professional Conduct, which members are required to observe at all times. The Code, in turn, requires members to satisfy applicable actuarial standards of practice (published by the ASB) and qualification standards promulgated by the Academy's Committee on Qualifications.[4]

The Academy also publishes several types of advisory materials to support actuaries in satisfying standards of practice. Applicability Guidelines list various tasks routinely performed by actuaries and identifies the actuarial standards of practice that normally apply to those tasks. Practice notes provide descriptions of practices commonly employed by actuaries to complete particular responsibilities but do not represent binding authority.. Discussion papers on various aspects of professionalism (relationships with users of work products, selection and use of actuarial models, and disclosure under the Code of Professional Conduct, etc.) are developed by the Academy's Council on Professionalism to heighten actuaries' sensitivity to professionalism concerns. These materials are available on the Academy's Web site, and are presented in educational sessions at national actuarial meetings. These educational materials can help clarify and enrich professional standards.

We concur with the Morris Review's recognition that appropriate scrutiny is needed for all professions, and we recognize that regulatory oversight, peer review and self-regulation all contribute to the overall professionalism of actuaries. However, we believe that the interim report did not reflect a full appreciation of the value of self-regulation and may have overemphasized independent oversight. Observers outside a profession can bring a fresh perspective when a professional's conduct is called into question, but they cannot necessarily recognize or evaluate technical flaws in a professional's work, nor can they necessarily appreciate the nuances of the business environment and customary practices under which a professional operates. To reach a truly meaningful understanding of an actuary's conduct in a particular situation, another actuary's participation is almost always needed. For this reason, we believe that self-regulation by the actuarial profession will continue to be essential, regardless of what other types of scrutiny may be put into place.

In the United States, the profession regulates itself through the work of the Actuarial Board for Counseling and Discipline ("ABCD"). Like the ASB, the ABCD is an independent board directly accountable to the U.S. profession as a whole, and undergoes periodic process reviews by the leadership of the actuarial membership organizations. We are considering ways to enhance the independence of both bodies as well as the transparency of the discipline process, but should emphasize that the integrity and independence of the ASB and ABCD have not been called into question.

As we mentioned during our meeting with you in January, we believe that the confidential guidance offered to members upon request by the ABCD is particularly valuable. We also believe that the option to offer confidential guidance to actuaries who have been accused of unprofessional conduct gives the ABCD appropriate discretion to improve actuaries' practice without causing them undue injury. For the vast majority of actuaries, even the possibility of

[4] The U.S. ASB and Academy Committee on Qualifications welcome commentary from interested laypersons but, given the highly technical nature of the work involved, do not involve non-actuaries in the final development of professional standards.

being brought before the ABCD is ample deterrence to misconduct.[5] Further, the U.S. Code of Professional Conduct expressly permits actuaries to disagree with each other and requires them to bring any apparent, material violations of the Code to the ABCD's attention if they are not otherwise resolved. While different approaches to self-regulation are always possible, we believe the ABCD approach strikes an appropriate balance between protecting the public interest and avoiding harm to our members and we would urge the Morris Review not to recommend any oversight system that is unnecessarily punitive.

The financial community is watching closely and will take the Morris Review's final report conclusions very seriously. Given the interim report's explicit recognition that most U.K. actuaries are highly ethical professionals, we hope that the final report will avoid recommendations that are excessively harsh or likely to foster an adversarial relationship between actuaries and their principals. As we advised you during our most recent meeting, the U.S. already suffers from an exceptionally adversarial business culture due, at least in part, to the increase in litigation in the business community and society as a whole. It is difficult for our members to function in the adversarial culture that dominates the U.S., and we think the U.K. would not ultimately benefit if it adopted a system that resulted in a similar adversarial climate.

Thank you for the opportunity to respond to the *Morris Review* interim report. We would be happy to respond to any further questions or to provide any additional information that would be helpful. Please do not hesitate to contact me through the Academy office if there is any additional information or assistance we can provide to you.

Sincerely,

Robert E. Wilcox

Robert E. Wilcox
President

[5] Each of the U.S. organizations disciplines its members based on recommendations from the ABCD. Consequently, all of the organizations play a part in maintaining the integrity of the actuarial profession.