



BAS Preliminary Consultation Paper of April 2007 “Towards a Conceptual Framework” Comments from the Government Actuary’s Department

General comments

1. The Government Actuary’s Department welcomes the work upon which the Board for Actuarial Standards has embarked in order to try to develop a conceptual framework for their future standard-setting activities. This preliminary Consultation Paper is a useful first step. However, in our view quite a lot of further development is needed before a usable framework can be established.
2. The Consultation Paper appears to us to fall short of the target in a number of respects. It appears to take a somewhat narrow view of actuarial responsibilities and to be unduly influenced by life insurance applications. There is insufficient recognition of actuarial roles in general insurance, health care financing, social security, risk management or investment. Even in the core activity of pensions, only a rather limited view of the actuarial role appears to be envisaged.
3. The paper does not recognise the existence of actuarial work for public sector clients, where actuarial work may be governed by different circumstances than apply in the private sector, and barely recognises the essential stakeholder interests of the government, with only a slight nod towards the interests of the regulators. What might be appropriate for the private sector may well not be appropriate for the public sector and this should be recognised explicitly.
4. In a number of places the Consultation Paper takes what seems to us to be a rather narrow stance of focusing on financial products. Most of what actuaries do is not concerned with financial products as such but with what might better be described as the risk management of financial security systems. Financial products, as the term might be normally understood, represent only a small subset of that canvas for certain types of entity, most notably for life insurance companies.
5. The paper would benefit from greater clarity in talking about users of actuarial advice who are themselves the commissioners or purchasers of that advice, as contrasted with the interests and needs of a variety of third parties. Third party stakeholders may be an important group for some types of actuarial advice, but most actuarial advice is directed at parties who are themselves taking the decisions which will affect consumers (be they pension schemes or insurance companies or shareholders of plcs for example). The actuarial advice may not be seen or indeed appreciated by any of those wider stakeholders.
6. There does in fact seem to be a general failure to distinguish carefully the different levels of knowledge and sophistication of users of actuarial services. The presumption in a number of places seems to be that standards should be devised on the basis that users are essentially retail customers with very limited knowledge. This is not the case for many direct users of actuarial advice. The advice surely needs to be tailored to the

understanding of the audience. That will differ, even, for example, between different groups of trustees, some of whom are highly sophisticated and others considerably less so. On the other hand, it is reasonable to expect that, when giving advice to senior government officials or a board of directors of a plc, the audience will have a reasonable degree of knowledge and financial sophistication.

7. On the other hand, there also appears to be insufficient recognition in the Consultation Paper of the importance of some types of actuarial information having a wider function in support of, for example, the 'freedom with publicity' aspect of insurance regulation. This does not even merit a mention in the summary of types of actuarial information in Appendix 5.

8. Some play is made of the principle of not making implicit assumptions about decisions and other aspects which usurp the role of decision-makers. Clearly it is important, in cases where the client is responsible for making decisions about assumptions, that they are given the appropriate ammunition to enable them to do that. However, there are many situations where this is not the case and the client is relying on the actuary to make appropriate assumptions. This is not usurping their role as decision-makers.

9. We believe that the paper takes too simplistic a view of how past experience feeds into assumptions for the future. Past experience should not be mechanically projected into the future. Technicians can do that but it is not professional actuarial work. In analysing past experience thought should be given to the decisions and circumstances in which that experience occurred and its relevance to the future. Assumptions do need to be made about how changing management behaviour (or consumer behaviour) may affect the outcomes. Indeed this is fundamental to the professional skill of actuaries.

10. The concept of actuarial measurement is used extensively throughout the consultation paper and should perhaps be explained or defined more clearly. We do have some concerns about the way in which the measurement concept is used and doubt whether it is really an appropriate word for much of what actuaries do. Measurement has a clearly defined meaning in the accounting profession, in relation to measuring assets and liabilities on the balance sheet. In many cases this would refer to items which are measurable or countable, at least in principle. Actuaries are mostly concerned with making estimates and projections of future cash-flows or transactions. There are some examples of where actuaries may be providing estimates of present values of liabilities to be used to inform decisions about provisions in the context of balance sheets and in these cases the accounting concept may be applicable. However, recognition should be given to the fairly restricted scope of such work in an actuarial context.

11. We are concerned that the paper appears to jump to somewhat simplistic conclusions about the appropriate approach to determining the present value of amounts payable on future contingent events. There is a long history of development of actuarial science, which cannot just be laid to one side. Discounted cash flow models have a strong and rational intellectual foundation and may be completely appropriate for many actuarial applications, just as market-consistent approaches may be relevant to other applications. It is clear, for example, that market-consistent considerations have less relevance in unfunded social security and pension systems and may not be at all appropriate from the perspective of government liabilities. It would certainly be inappropriate for BAS to require all actuarial work to be carried out in a market-consistent



framework, or to lay undue emphasis on this as an approach (other than for particular applications where it is required by the regulatory or conceptual framework).

12. We have a concern that BAS may be underestimating the difficulty of developing a conceptual framework for the whole of actuarial work. Furthermore, whilst it is logically sensible to develop a framework before moving on to the development of specific standards, the fact that this sort of exercise has never been attempted before in relation to actuarial work will make it a difficult and probably quite lengthy process. Moreover, the BAS is embarking on this process before it has had any experience of dealing with live current issues or with what is involved in standard-setting.

13. It may be helpful for making some progress if the initiative of setting a conceptual framework were given somewhat narrower terms of reference. In other words, BAS should not try to cover all facets of actuarial activity at once, at least for a start, but should instead focus on the conceptual framework needed in order to move forward to set standards for certain key areas of actuarial activity, in particular in relation to reserved roles.

14. In due course the standard-setting process will no doubt be extended more broadly, and a broader conceptual framework can in time be developed to accommodate this. However, there is clearly less of a rationale for BAS involvement when it comes to non-reserved roles.

15. There are a great many points on which we might be tempted to comment but we have limited ourselves to a few detailed comments in the Annex. We will no doubt have further comments when the work evolves to a more developed phase.

16. In Section 3 of the Consultation Paper the Board asks in particular for views on five issues or statements. Our views are as follows:

1. The Board should have its primary focus on the way actuarial information is presented and actuarial advice is given, rather than on the substance of that advice, which is the proper preserve of regulations or regulators, or, in many cases, the responsibility of the actuary's client. BAS should identify at an early stage what actuarial information it is seeking to address as a matter of priority. Presumably, as in the case of the parallel body, the Accounting Standards Board, standards will only be issued with a clearly defined focus and many areas of actuarial advice (just like many aspects of what accountants do) will not be subject to BAS standards at all.
2. Agreed in principle, but adequate emphasis needs to be given to the needs of all stakeholders, including regulators and government, members of pension schemes and policyholders, as well as trustees and Directors of insurance companies. The Consultation Paper as it stands does not address the issues involved with actuarial advice to government and more generally in the public sector.
3. We do not agree that prudence should be precluded in all cases, particularly where there are no applicable standards of practice. It would also be inappropriate to exclude prudence in standard fields of actuarial advice to trustees and as the actuarial function holder or with-profits actuary, where the client is asking for the actuary's advice on prudent technical provisions. The client in these cases does, of course, need to be able to understand what level of prudence is incorporated and whether this meets their needs. It seems to us that whether there is prudence or not depends on the application and the circumstances. BAS

- should be cautious about laying down any general presumptive ruling on this point, although it may be appropriate to include reference to this in standards for particular purposes.
4. This remains to be seen, depending on the nature and content of SAPTs. BAS will need to have proper regard to the regulatory framework which already exists in some areas of actuarial work and should coordinate activities carefully with the respective regulators.
 5. We are not sure that it would be a sensible use of resources for BAS to try to develop a generic communication standard at this stage. It might be a longer term objective but, in the short term, it will be more important to focus on improving communication in relation to specific actuarial roles.

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6 July 2007



Annex

Detailed comments on the Consultation Paper

Sections 1.4.12 to 1.4.16 The paper seems to us to be unclear about what it means by the word risk and somewhat inconsistent in its usage of the term. In a number of places in the Consultation Paper the word is used where in our view the correct word should be uncertainty or variability. Risk is usually defined in terms of failing to meet some specific and measurable future objective. We do not agree with the proposal in the Consultation Paper that it is always appropriate to set general actuarial standards based on the concept of neutrality (leaving aside whether it is always possible to define what that means).

We accept that it may well be appropriate for a 'best estimate' approach to be adopted in standards for certain specific purposes but, since it is unlikely that standards will be issued to cover every type of advice given by actuaries, it would not be appropriate to lay down any general presumption against prudential margins being included in actuarial estimates or projections. As recognised in places in the paper, there are also some important areas of actuarial advice (scheme actuary, for example) where the requirement of the client is for advice on prudent technical provisions.

We remain unconvinced that it is appropriate for BAS to envisage developing standards for the 'measurement' and communication of different levels of prudence, since the meaning of prudence will differ according to the circumstances and should be a matter for the actuary to discuss with the client, taking into account the interests of the stakeholders and the decisions of the client, where charged with the responsibility for deciding on prudent assumptions.

Section 1.5.1 We are not sure what is meant by the use of the term 'financial products'. On the face of it this would not seem to be an appropriate concept for much of actuarial work. We are also unhappy about the use here (and elsewhere in the document) of the term 'actuarial forecasts'. Actuaries do not generally make forecasts. Actuaries make projections of outcomes on stylized models and assumptions, in order to help clients to take appropriate decisions. It would be misleading to the recipients of advice to label these as forecasts.

Section 1.5.7 We do not accept that there is any basis for this assertion. Forecasts, and indeed all types of measurement, and in particular, accounting measurements, directly affect the outcome of future events. Sometimes that is a deliberate intention – to affect future behaviour by making a forecast that makes people take notice. Sometimes it is purely a question of unintended consequences.

Section 1.5.8 'Exposure to risk' does not appear to be the correct term to use here, when what is referred to is risk severity. Exposure does not relate to the consequences but to the canvas over which risk events may occur. It might be a more appropriate term for what has been labeled the 'source of the risk'.

Section 1.5.11 Actuaries do not predict future events, which might be considered to be the province of fortune-tellers or astrologers. Actuaries make projections of future outcomes in accordance with soundly based models and professional judgement about appropriate assumptions.



Section 1.6.1 We are not convinced that it would be sensible for BAS to seek to draft standards which apply to entities. As far as we understand it, BAS (and the FRC) have no jurisdiction (in general) over entities in the actuarial field. In our view BAS should confine itself to drafting actuarial standards within its field of direct competence, namely in relation to individual actuaries.

Section 1.7.6 Recognition should be given to the fairly frequent circumstances in which actuarial advice is confidential to the client and is not intended for use by third parties. Even when advice may be made available to third parties, it is very common (and indeed appropriate) for it to contain caveats limiting the extent to which any party other than the client should rely on it.

Section 1.7.7 This lacks clarity in relation to references to clients and stakeholders. Clients are clearly free to commission reports; many stakeholders are not. Does the BAS intend to consult with stakeholders, i.e. members of pension and social security schemes, members of the public, policyholders, regulators, government and Parliament or is it thinking more about consulting with the main client groups for actuarial advice?

Section 1.7.8 We are not convinced that it has been demonstrated evidentially that there is a serious general need to address actuarial communications, although clearly there are examples of poor actuarial communication to be found. Nor are we sure that a generic standard on communication would necessarily be the answer. Development of a generic standard on communication will clearly be a difficult task, and perhaps impossible, as communication requirements differ so much between different types of actuarial advice and different clients and circumstances. However, developing standards in relation to communication in particular situations would appear to be a task which BAS should address.

Section 1.7.16 We are concerned that the concepts in this paragraph are over-simplified. The outcome of future events is certainly unknown. However, the idea that the future might be modelled using assumptions derived from the past is a hypothesis which may or may not be realistic, according to the circumstances. A major difference between a professional actuary and what one might describe as an 'actuarial technician' is that an actuary is able to apply judgement in deciding what assumptions to make for the future, having regard to, but not slavishly following, the experience of the past. Uncertainty arises from the inherent variability of outcomes (even if the future distribution does follow past experience), from changes in the distributions which cannot be inferred from the past and from the inevitable limitations of our ability to model the relevant processes.

Section 1.7.18 We agree with the first sentence, but are doubtful whether it follows that the BAS should be taking a view at a generic level on what might be regarded as material or not material, or indeed whether this is practical or sensible. Materiality will surely depend entirely on the needs of the client and should be their call.

Section 1.7.20 As has already been argued earlier in the Consultation Paper, responsibility for assumptions will often now lie with the client, e.g. for the technical provisions for a pension scheme or for an insurance company. It will not be appropriate for BAS standards to seek to override, or even necessarily to influence, this responsibility of key decision-makers. In these areas standards will need to be more to do with process and presentation rather than with substance in relation to the setting of assumptions.

Section 2.4.3 Risk is usually defined in terms of probabilities of not meeting objectives, so it focuses on the downside. The corresponding up-side potential may be better described as opportunity rather than risk. There is nothing inherent in risk analysis or management which precludes analysis of upside as well as downside and exploration of the probabilities of exceeding objectives. It depends on the focus of interest of the client. In practice it is often not so much of a worry to clients if their objectives are exceeded, so simple utility theory points to the need to place more emphasis on failing to meet objectives.

Section 2.7.1 In our view actuaries do not forecast mortality. We would suggest that mortality is too extensive a subject to be addressed properly within a document having such a broad scope. Although important, mortality does nevertheless need to be kept in perspective with the many other assumptions that have to be made by actuaries.

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