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6 July 2007

Nigel Bankhead
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Financial Reporting Council
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Subject:

Preliminary Consultation Paper Towards a Conceptual Framework

Dear Nigel

Mercer Human Resource Consulting is the UK's largest employee benefit consultancy, employing nearly 400 Fellows of the Institute or Faculty of Actuaries in the UK, and over 100 more elsewhere in the world.

At this early stage we restrict our comments on the detailed content of standards as they apply to actuaries working in the field of pensions. In due course we would wish to comment on actuaries working in wider fields such as investment, financial risk and human capital, but at this "pre-conceptual" stage we do not believe this would be useful.

In general we believe that the paper is at too early a stage of development to enable informed consultation. We understand that no decision has been reached as to the purpose of the conceptual framework and whether it should apply to guidance drafted by BAS or direct to practising actuaries. However, we have some particular concerns as to the direction BAS seems to be taking. We also address the particular questions asked in the document in an appendix to this letter.

Particular areas of concern

Difficulties with the Conceptual Framework

In principle, we can see that there could be value in having an overarching framework that actuarial standards must fit within. However, we have concerns over how this will work in practice. We understand that BAS is partly following the approach used by the Accounting Standards Board (ASB) in determining its framework for standard setting. The ASB works within a relatively consistent regulatory and valuation regime laid down in Company's Act



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legislation, but there is no similar statutory basis for actuarial work. Various different requirements apply according to the context: valuation methodologies are not always prescribed and where they are the prescription varies (for example, prudence for statutory funding, best estimate for cash equivalent transfer values); the regulatory regime also depends on circumstance with the DWP, the Pensions Regulator and the FSA each operating under different terms of reference and being only some of the parties involved.

Similarly, the ASB has determined that the interests of the users of company accounts are sufficiently aligned that they can be characterised by a single group, the investors, and so accounting standards are addressed to meet the needs of investors. We do not believe that the users of actuarial information form such a homogeneous group that a single report can always be expected to address all their needs.

Thus, we do not believe the single conceptual framework BAS appears to be attempting to develop can be achieved in the current environment. Unless this is recognised, there is significant danger that the resulting combined regime will appear chaotic to users and practitioners alike.

Market related approach

The Chairman's introduction to the consultation document says that BAS, like other parts of the FRC, will 'put trust in the market'. We take this to mean that it believes that there is strength in permitting market forces to be left to impose certain standards and that BAS would only intervene in areas where the market is likely to be weak. However, the main thrust of the document appears to be towards achieving uniform approaches and delivery across the market.

If standards are set to achieve uniformity in approach, there is a risk that any market will become ineffective. Actuarial information and advice will be presented to comply with standards and willingness to provide innovative advice in a variety of formats will be stifled. In particular, it will make it harder for smaller companies to compete, since they have less spare resource to develop products and approaches additional to those required by standard setting.

As a firm, and one of the largest employers of actuaries in the UK, we recognise the need for a certain level of oversight. However, we are concerned at the way regulators and standard setters are becoming involved in increasingly wide areas of our work, not always with the effect of

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creating net benefit to the end user (for example, trustees and scheme members). We welcome BAS's commitment to be 'proportionate and risk based', and hope that it will be able to use this pre-consultation exercise to find and maintain such a stance in the future.

Application of standards

Paragraph 1.2.4 of the consultation document states that BAS's standards (SAPTs) will apply to actuarial information provided by actuaries or by 'entities (using actuarial techniques)'. Elsewhere (paragraph 1.7.3) it appears that 'entities' could also include trustees of pension schemes, for example, if they summarise information provided by their actuary before passing it on to scheme members. The effect of these two paragraphs seems different, so we are not clear what is intended, nor how the application to entities will operate in practice. In particular, we do not agree that this is an appropriate route for BAS to take.

Decision makers and measurers

We believe the consultation document makes difficulties for itself because of the distinction drawn between measurers and decision makers.

BAS assumes that 'decision makers' are not necessarily the same people as the 'clients' who may have commissioned and paid for the actuary's work. (where 'client' could be the employer or another part of the same company). It defines 'decision makers' very widely – as anyone who might reach a decision based on the content of a report – and its intention is that SAPTs will be directed towards the provision of information to decision makers. However, as the consultation document recognises, a great many stakeholders, or 'decision makers', will have an interest in some actuarial information. This is likely to preclude presenting information in a manageable format that will be useful to its intended recipients.

Although it might appear desirable, it will not always be possible to present standardised advice meeting the needs of all potential stakeholders. The next best alternative, which we believe BAS should adopt, is for advice to be presented to clients in the way that meets their needs most appropriately, and for its limitations with regard to other stakeholders to be noted.

For example, in Appendix 5 BAS assumes that scheme members should be considered decision makers when preparing an actuarial valuation report. This would require the report to include

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information on each member, based on an assessment of the overall value of his or her overall remuneration package including the pension, and would turn the report into something much more complex than at present. However, individual members should not expect to make decisions based on a report to trustees, since it does not (and cannot) cover their particular circumstances. The report should be treated as just another piece of data they can take to their adviser, who will provide them with other information so they can make their decision.

We appreciate that most scheme members will not have access to financial advice. However, BAS should not pretend that it can address this weakness in one area of the market by imposing unrealistic standards in another area.

Existing guidance

BAS adopted the technical standards from the actuarial profession over a year ago. Rather than reviewing these standards to see if they are fit for purpose, it has chosen to concentrate its resources on developing its conceptual framework. Although we agree that there is value in having a robust framework, we are also conscious that some of the pensions related standards inherited from the profession would benefit now from revision and updating. We encourage BAS to put resource into this area. Not to do so puts at risk one of BAS's key objectives – to support 'high quality actuarial practice'.

Reviewing standards would not only benefit practicing actuaries. Doing it alongside the conceptual framework's development would give BAS the opportunity to engage more closely with the profession (individual members as well as the organisation) and might provide a more tangible context in which the framework could develop.

The fact that BAS is prepared to consult widely on a working document gives us confidence that its future outputs are likely to take into account the concerns of all stakeholders. We would be happy to meet with you to discuss the content of this letter and to find a way to work together in the future.

Yours sincerely

Deborah Cooper

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Appendix - Specific questions posed by BAS

1. The Board would welcome views on whether the BAS priorities should be to focus on standards that relate to actuarial information, over the other issues discussed.

We understand this question as asking whether we agree that BAS should first issue standards to do with areas of ‘actuarial information,’ as defined in the first bullet of paragraph 1.2.1, and only then move on to SAPT in areas to do with ‘actuarial advice’, as defined in the second bullet. Our best interpretation of these definitions is that the former – ‘information’ – appears to be viewed by BAS as traditional actuarial work, such as valuing a set of liabilities. The latter appears to be more general work, such as product design.

We believe this separation is specious.

The ‘information’ referred to usually follows the provision of advice around the nature of the financial product being valued and the assumptions and methodologies that might be most appropriate for its valuation. Often there is no standard approach, but in other cases the choice might be partly driven by regulatory requirements (specifically listed under ‘advice’); the provision of this ‘information’ is then often followed by ‘advice’ on how the product can be revised to make the ‘information’ more acceptable.

Guidance notes produced by the Profession were based around issues, rather than attempting to compartmentalise the nature of the services provided by actuaries. This approach was followed largely because actuarial guidance was reactive, but also because (as discussed previously) different regulatory requirements apply in different areas. The issues covered were the responsibility of different Boards, albeit with some central oversight, and this is likely to be one of the reasons the Morris review found the Profession’s Guidance to be inconsistent.

There is no reason for BAS to duplicate the separation between practice areas that developed within the Profession. It should be possible for BAS to take a unified view to the information presented by actuaries to assist financial decision making and this should enable its standards to become more proactive. Indeed, we would see this as the purpose of the proposed communication standard – setting out broadly what basic information should be presented to support the final commentary prepared by an actuary on the matter in hand.

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Rather than prioritising ‘information’ over ‘advice’, we believe that BAS should prioritise producing such a communication standard, since this would ensure that limitations in other areas are made apparent to users. Provided it is clear that not all requirements will apply in every case, and content can be directed at the intended user (who must be defined) we believe that this would be the best way to meet BAS’s objective to support ‘high quality actuarial practice’.

See question 5. for further comments on the proposed communications standard.

2. The Board would welcome views on whether the needs of those who rely on actuarial information should be the primary foundation on which actuarial standards are developed as discussed.

We agree that actuarial standards should be produced with the needs of those who can be expected to rely on the information covered by the standard in mind. However, in some cases, as BAS recognises, different groups may have access to, and rely on, the information provided. We do not believe it is possible to develop good standards that try to address the needs of all the parties with access to a single piece of work.

The table in Appendix 5, which attempts to categorise ‘actuarial information’, distinguishes between ‘Measurer’ and ‘Decision-maker’. If, as the consultation document suggests in paragraph 1.4.1 the ‘primary consideration for the BAS standards is the needs of the decision makers ...’, then BAS must be very clear what it means by ‘decision maker’ (eg trustee who makes decisions on prudence and contribution demands and/or member who makes decisions on transfers or continuing to accrue rights).

Without commenting on the table in detail, we are not comfortable with the distinctions being made between ‘measurer’ and ‘decision maker’, nor with the entries under each categorisation. In the pensions field, the ‘measurer’ is the person who is likely to have commissioned the piece of work referred to – that is, the ‘client’. The client role is a key piece of information, both to the actuary and to other users of the ‘actuarial information’.

People other than the client may rely on the information and their needs must be considered. However, the advice given during the preparation of the ‘information’ will have been addressed to the client and any conclusions about that advice that have been reached in the report will have

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been made as a result of decisions taken by the client. Consequently, we think the distinction between the 'client' and other users should be made clearer.

We note that the ASB's Statement of Principles for Financial Reporting skirts the problem of multiple users by making the investor the 'proxy' for all users. We do not believe a similar approach will work for actuarial information, because the different groups can often have quite different needs or objectives. Either a different conceptual framework is required for different actuarial 'products' – such as SFO valuations or transfer values – or a much higher level and lighter touch conceptual framework is needed.

Instead, we would propose that 'actuarial information' should be addressed to the client and the needs of the client should be the primary foundation for actuarial standards. However, because other people can be expected to refer to the report, any limitations this gives rise to in their regard should be noted. This is consistent with the aim proposed in paragraph 1.4.6 of the consultation document, that 'decision makers should understand any limitations that apply'.

The alternative, of trying to prepare information that is helpful to all possible users, risks making the information either too bland, or too involved, to be helpful to anyone.

BAS clearly recognises this difficulty, mentioning (in paragraph 1.4.18) concerns about the different levels of competence of some end users. It believes that actuarial standards can mitigate the problems caused by lack of understanding, but we do not believe this is always possible, or necessarily desirable. If a piece of actuarial work must be relied on by 'decision-makers' with materially different levels of understanding, the work must be addressed at the lowest common denominator. In some cases, this will mean that sections of every report will be redundant to some users. We do not see how this meets measures of 'decision usefulness'.

If information is to be fit for purpose, it must be directed to the end user, not to the end user and every other stakeholder who might have access to a copy. If a piece of information is material to the end user then it should be produced specifically with that user in mind – actuarial valuation reports and summary funding statements seem to us a good example of this practice.

This more directed approach will make it easier to reconcile the apparently conflicting statements (both of which we have some sympathy with) in the consultation document:

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- Paragraph 1.4.9, which says that information used in decision making ‘should not contain implicit assumptions about decisions of a management nature and effectively usurp decision makers’; and
- Paragraph 1.7.18, which says that BAS will consider when information doesn’t need to be disclosed – and so effectively becomes ‘implicit’.

3. The Board would welcome views on whether prudence should be regarded as decision-makers’ attitude to risk ... and is not an element of measurement ...

The application of ‘prudence’ has become central to the measurement of pension scheme liabilities under the application of Part 3 of the Pensions Act 2004. Although no consensus has emerged as to what it means in this context, it seems to be interpreted as incorporating a degree of cautiousness.

Prudence, can also be interpreted as the exercise of sound judgement, in which case we agree that ‘prudence’ need not be part of the measurement process but instead refers to the actions decision makers take having received their ‘actuarial information’.

In that case, measurement must be made on a range of bases, to enable decision-makers to understand the consequences of different choices. This is consistent with one of the requirements Morris suggested (sensitivity analysis) for good communications.

Regulators from the top down have been careful not to define prudence and we do not see it as BAS’s role to attempt any comment or definition in this area.

4. The Board would welcome views on whether the concept of SAPT will provide a useful means of distinguishing high quality actuarial information

Actuarial guidance notes were intended to give people confidence in work prepared for them by members of the Actuarial Profession, although it seems they did not entirely succeed in this respect. However, it is not the existence of guidance (or SAPTs) per se that is important, but the expertise of those that rely on the information presented, the way guidance takes this into account and the way it is used to present the profession to its end users.

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The best guidance in the world will not avoid a strong minded person overcoming weak minded interrogation. If the guidance itself is unclear – whether because it is overcomplicated, poorly targeted, or just poorly drafted – then this will only exacerbate the problem.

We agree with the principles set out in paragraph 1.1.2, that SAPTs should be risk-based and proportionate. We also agree that SAPTs should only refer to the measurement process and not seek to control the actions taken by decision makers.

However, apart from those very high level principles we are left with no clear view from the consultation document as to what the ‘concept of SAPT’ will be. We find many aspects confusing.

Example A:

The discussion of ‘neutral measurement’ and ‘prudence’ appears contradictory. In particular the following statements are confusing in this regard:

- paragraph 1.5.5 states ‘Measurements ... are neutral processes.’
- paragraph 1.4.15 states ‘prudence should not be regarded as an element of measurement’;
- paragraph 1.6.2 says ‘we do not currently see a role for BAS in setting standards for decision making’; but
- paragraph 1.4.16 says ‘... we envisage developing standards for the measurement and communication of different levels of prudence.’

If, as suggested in paragraphs 1.4.15 and 1.4.13, and the consultation papers question 3., prudence is part of the decision making process, how do you reconcile these statements?

Example B:

Similarly:

- paragraph 1.7.15 says that actuarial information is ‘relevant’ if it has the ability to ‘influence’;
- paragraph 1.5.2 implies that actuarial information is concerned with ‘measurement’; and
- previous paragraphs suggest that ‘measurement’ is ‘neutral’.

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But information cannot both be 'neutral' and 'influential'. 'Neutral' measurements can be used to inform decisions taken in context of decision makers own preferences; if measurements 'influence' then they change decision makers' preferences and so are not neutral.

Example B illustrates an interesting dichotomy BAS will face, partly because of its statement in paragraph 1.5.5 that measurement should be a neutral process. However, when the measurement is constrained by a standard and has to follow particular criteria, it is no longer neutral and it can affect all of the points that paragraph 1.5.5 claims should be left unaffected.

If the references to the 'neutrality of measurement' were replaced with 'limitations of measurement' – which is what is concluded in paragraph 1.5.11 – we would find it easier to agree with this section and it could also resolve the earlier dilemma.

If, as stated under question 3., BAS considers prudence to be part of the decision making process, and if BAS is not to get involved with standards for decision makers (a point of principle that we support), then it would seem inappropriate to develop standards that relate to 'different levels of prudence'. However, as suggested earlier, we do agree that measurements should be presented using a range of assumptions, each of which might have a different likelihood of being realised. Whether these are more or less prudent will depend on the view of the end user.

Requirements for 'prudence' occur in many statutory and quasi statutory publications, including accounting standards. However, no regulator or standard setter so far has attempted to define what prudence means in each context. This is, in fact, the prudent approach, since (as the consultation document recognises) prudence is a relative term that can be interpreted differently in different situations.

Because of our uncertainty about what you are proposing here, we find it difficult to comment further in a helpful way, but we would be happy to meet with you to clarify our concerns.

5. The Board would welcome views on whether BAS should develop a generic communication standard as well as detailing specific communication requirements and standard reports in each SAPT standard. If so, which of the six items from the Morris listing are applicable to every report containing actuarial information.

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We do believe it would be helpful if there were a generic communication standard that set out the general information commentaries on 'actuarial information' should be expected to include. The six items listed by Morris, and referred to in the consultation (A1.14) cover the sorts of matters this would include.

The requirement to set out the relative importance of risks and the capacity of the client to bear them (the sixth bullet) points to information being directed towards a particular user (the client we referred to above) rather than being completely general, since it would often be impossible to determine the risk capacity of all end users.

Rather than guess at the requirements of every report that will be covered by a SAPT, we would prefer an approach that is normally inclusive of all six points, but allows individual opt outs depending on circumstances. Where reports depart from the 'normal' requirement, this should have to be justified in the individual report.

In general, we do not believe it necessary for individual SAPTs to include specific information requirements, although from time to time there may be good reasons for them to do so.

In his introduction to the consultation document, the BAS Chairman states that BAS believes the 'market is an effective regulator' and in most cases we would support this view. However, mandatory standards are, necessarily, a constraint on market practices. Actuarial guidance was often introduced retrospectively to reduce the ability to abuse process, where the risk of this had been identified, and Morris criticised this retrospective approach. BAS intends to take a more proactive stance, but this implies publishing guidance in circumstances where previously there would have been none, thereby affecting market practice. The more comprehensive or prescriptive SAPTs become, the less effective the market will be, since it will become increasingly constrained.

Similarly, we do not believe it is BAS's role to issue standard reports. Organisations should be able to determine the way they want to present information and provided the information presented contains the background necessary to comply with the appropriate SAPT, the format and language used should not be further constrained. Clients can then use the market to source the approach that they find most appropriate for them.

Comment on section 2

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Comment on section 2 of the consultation document was not explicitly sought. However, as it has been included in the document it seemed unwise to ignore it entirely. Very briefly, we have the following comments:

- Paragraph 2.4.1 states that 'value' could be regarded as the 'mid-point' of a distribution. Whilst this might be true in some cases, it will not be true in all.
- Paragraph 2.4.4 implies that BAS will be surprised to conclude that actuarial science has limitations. One of the issues Morris surfaced in his review of the Actuarial Profession was its insularity. Mercer has been a cross practice and mixed professional firm for many years and we have been aware that actuaries can often only contribute partially to the answer to a problem. We hope that BAS appreciates this as well, and that its SAPTs are prepared with this in mind.
- We do not agree that 'forecasting' or 'mortality' are 'key conceptual issues'. Mortality is a 'risk' that can be modelled and forecast, and forecasting is a technique.
- We do not think that BAS should recommend particular forecasting methods (although there might be circumstances in which it considers a model to be inappropriate). Different models apply in different situations and frequently several will be appropriate to a particular task, although each may have certain different limitations. It should be the responsibility of the user to determine which is most appropriate given the circumstances of the task in hand.

It is wrong to say (paragraph 2.7.2) that, in examining mortality, actuaries have largely focused on age. For some time CMI has investigated experience based on sex, product and amount, and individual companies have looked at lifestyle. Within companies, there is increasing emphasis on more detailed analysis as more data, and data analysis tools, have become available and the market has begun to appreciate the importance of understanding its exposure to longevity risk. If BAS appears to be behind the curve in the guidance it issues, it will undermine its relevance in the new regulatory regime.