

Preliminary Consultation Paper towards a Conceptual Framework

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I am a retired actuary with a career in life and general insurance and associated accounting, treasury and investment affairs. My only current actuarial involvement is being part of the Profession's own disciplinary process, where I have had occasion to study guidance notes in the context of making decisions on whether an individual actuary has complied with guidance or not. Thus I am very concerned that the deliverable of BAS is a set of standards, and a process, which limits the scope for misinterpretation. At the same time I recognise that standards should be in both the public interest and in the interest of various stakeholders (other than lawyers etc remunerated by debating ambiguities in the standards). This would imply that the cost of compliance is also a relevant factor. From this perspective I have problems with words such as 'most appropriate' or 'complete'.

I was also a member of the working group on 'value'. The consultation paper does not reflect many of the points that were made in the discussions of that group. Some of these points are repeated in the annexure, which consists of comments on specific paragraphs in the consultation paper and I hope may be helpful in developing the next consultation paper.

My specific comments on the five points where the Board says that they would welcome views are:

1. I would concur with the view that the BAS priority should relate to 'certain financial reporting information which forms part of an actuarial work product'. I have great difficulties over the terminology 'actuarial information'. If the Board were to persist with the term 'actuarial information', then there should be 'scoped-in actuarial information' which relates to actuarial information covered by a standard. This leads to the concept of 'other actuarial information' not covered by a standard. This avoids the confusion of having actuarial information which is not 'actuarial information as defined by BAS'. It also avoids the Galilean religious dogma parallel of denying a discovered truth because it is not according to the standard..
2. This is a somewhat woolly concept given the wide array of stakeholders who may rely on the information. Reliance is a legal term and may exclude certain third parties. The needs of those who rely on scoped-in actuarial information are not necessarily coincident with a perception of a standard-setting body. The public interest, whatever that may mean, is an equally relevant need.

No less important in the development of standards is paying due regard to the needs of clarity for both actuaries generating financial reporting information and individuals (including non-actuaries) involved in the subsequent enforcement

process.

3. As most actuarial information, whether scoped in or not, has a subjective element, words such as *neutral* and *prudent* may develop in the standards which do not align with a more general perception of these terms. Given some version of neutrality, then prudence is the extent to which an additional allowance is made. Prudence is not the decision maker's attitude to risk, but the *degree of prudence* is.
4. Whether or not a SAPT provides a useful means of distinguishing high quality scoped-in actuarial information is a statement of an objective and will in practice depend on the contents. However the word 'distinguish' may be inappropriate as information not in accordance with a SAPT could be of high quality and information in accordance with a SAPT is not necessarily of high quality.
5. It is not clear whether this is a reference to a communication standard on scoped-in actuarial information or on any advice or information that an actuary may give. Any generic communication standard would, because it is generic, cover any communication by an actuary, whether this is a formal written report, letters, e-mails or notes of meetings. Some would argue that 'genericity' also includes oral communications and contributions at meetings might have to be considered. Generic information might be deemed, unless specifically excluded, to cover timely 'rough guesses', as well as possibly less timely formal reports. Communication has a recipient as well as a giver and any generic standard would do well to take into account the circumstances of any communication, including whether it is full and considered. There should be scope for both a full and formal report which covers all six Morris items (probably a very expensive as well as extensive report) and more informal communications (which may assume knowledge by the recipient of previous advice). The BAS could produce a generic template for a 'full and formal' report for exposure before considering the extent to which such a template could be made into a properly scoped standard.

There are two other points that I would like to emphasise.

- The Consultative paper draws parallels to the development of Financial Reporting Standards by the ASB. This parallel understates the magnitude of BAS's task. The accounting standards relate to a specific work product accountants and draws up standards etc for information to be contained within that specific work product. The parallel works if limited to the proposition that standards relate to information. The parallel does not work in that BAS is trying to cover a boundless multiplicity of work products. BAS should recognise that it is breaking new ground.
- There is repetition of a commonly held misperception that reporting and disclosure of information cannot change the outcome. There are several 'exceptions' which disprove the rule. Reporting and disclosure can trigger events, such as runs on a bank. Disclosure of a provision for a GI claim can affect the outcome. Accounting takes place on a normal annual basis,

reporting on financial products priced on a product cycle or contract period of more than a year may produce different behavioural effects depending on the extent to which smoothing is allowed. Changing the incidence of the emergence of profit may generate fiscal effects which substantially changes value.

ANNEXURE

Chairman's introduction

1. Is it true to say that the accounting profession has ploughed a path over the past decades on the development of a conceptual framework of the concepts and principles underlying the work of accountants? They have chosen to develop concepts and principles which apply to a particular piece of work by accountants, viz the production of financial reports as required by Company Act and similar legislation. They have chosen to give the term 'financial reporting' a specific and narrow meaning. Actuaries produce financial reports, sometimes more extensive and sometimes more specialist, than the accounting profession's so-called financial reports. Producing a conceptual framework for all work undertaken by a professional body of people is breaking new ground and not following a well trodden path. The proposed SAPTs may be less of a parallel to GAAP than is implied in the third paragraph.
2. Whilst agreeing that the prime role is to issue high quality standards to enable wise decision making and regulation to flourish, an equally important aspect is that they should be drafted in such a way as to make it very clear when a standard is being breached and whether any such breach could be construed as 'material' (whatever that may mean, or not. It may equally be important not to set standards where the compliance costs could outweigh the benefits.
3. I would hope the FRC would only believe that markets which are deep and liquid are effective 'regulators', although that term may need clarification. Actuaries may be concerned with products where there is no market, other than occasional transactions, or two markets (e.g. the market places for individual insurance policies and that for novations or reinsurance of portfolios of policies).

Body of report

4. (para 1.2.1) 'actuarial information' is a novel phrase which I will comment on later. My perspective is that it is difficult to identify anything uniquely actuarial, when other disciplines (statisticians, financial economists, accountants, etc) can undertake equivalent work and may have common techniques. To me 'actuarial information' is information provided by actuaries. If the suggested more restricted definition is adopted, how clearly will actuarial reports have to distinguish between actuarial information and non-information? For instance, will a report on GI claim reserves have to make clear that case estimates are not actuarial

information but other information, including intermediate information in calculations, is actuarial information?

Can 'actuarial information' only be information produced by actuaries?

Is 'actuarial information' just information which appears in an actuarial report and which is not covered by a 'reliance on others' statement? There are many instances where an actuary is given information by others but should apply some 'common sense' checking process. Is such information then actuarial? The process is not an actuarial principle (or is it?) or technique.

5. (para 1.2.1) 'actuarial advice'. This appears to be re-phraseable as 'any advice given by an actuary in a professional report'. For compliance purpose, there should be a clear dividing line as to what would not be actuarial advice.
6. (para 1.2.3) What is the coverage of the BAS responsibility in respect of actuaries whose work product and principle are not based in the UK?
7. (para 1.2.4) Does this mean standards for all the so-called actuarial information (which would differ substantially from ASB standards) or for a limited number of standards for specific work products? For the latter, is the approach a 'one size fits all' or should the standards be 'sufficiently 'fit for purpose' for a specific work product? It is not clear how a standard relating to the output from using stochastic methods would ensure the techniques used were to an appropriate standard.
8. (para 1.4.3) 'the most appropriate choice' implies that one choice is more appropriate than others. This is not necessarily the case other than for a given utility function of the decision maker (or the underlying risk takers; this may be substantially different). In either case, the utility function may be unknown or subjective.
9. (para 1.4.4) again 'most appropriate' could be an inappropriate phrase.
10. (para 1.4.5) There is a secondary issue on the volume of information which has to be given; for certain users, too much information descends into the great unread and is produced substantially for the benefit of liability protection. Consideration should be given to the balancing point between the rock and the hard place.
11. (para 1.4.60) One could envisage a large number of highly unlikely risks which are not factored into the so-called actuarial information. There are also some likely ones, such as retrospective legislation or court decisions. What liability would be established against the actuary if he/she had not listed all the unlikely risks?

12. (para 1.4.8) One would not want ‘accepted’ measurement standards which impeded developments in measurement techniques.
13. (para 1.4.9) This raises the question as to what explicit assumptions on management decisions should be given and, unless the report was voluminous with alternatives, why such decisions were assumed.

There could be exceptions to the view on the withholding of information where there are a number of stakeholders and the provision of information could be to the detriment of one party and the advantage of another. Disclosure may mean that reporting is not neutral. This already exists in some accounting information. For example, disclosure of the allowance for specific disputed GI claim provisions would reduce the probability of a favourable settlement to the insurer.

14. (para 1.4.14) It may be desirable for the measurement of risk to be neutral, but the word ‘must’ may be impractical in many cases found in actuarial work products.
15. (para 1.5.1) One would want an ‘exhaustive’ definition of ‘actuarial information’. Information may be provided to a principle with a proviso that it should not be used by anyone else without the consent of the actuary. The user may then include the information, say insurance provisions, in a financial report subject to audit. There may be no requirement for all the actuary’s report to be included in the condensed financial reports, long form or short form. Any standard should clarify the position regarding the indirect use of the ‘actuarial information’.

It is slightly misleading to not refer to the actuarial assessments of solvency which relate to a portfolio of financial products or liabilities covered by a portfolio of assets

The phrase ‘appropriately standardised measurement’ implies a single appropriate method. There may well be disputes on what ‘can be measured’.

16. (para 1.5.3) This does not imply that past data specific to a product has to be used. Certain actuarial techniques involve adaptive control.
17. (para 1.5.5) ‘Measurement of value or risk.....are neutral processes’. This makes an assumption on what is meant by value; whatever that assumption is, it is not universally appropriate for all valuations which an actuary may undertake. Value depends on what is being valued, for whom it is being valued and by whom. For example, an actuary may be involved in the valuation of a large GI claim which depends on both whether or not liability is established by a court and what the amount of any award would be. The valuation needs an estimate of probability and amount (or possibly distribution functions for those parameters). The calculation might require or rely on legal advice and the experience of claim assessors. Any estimate made is not neutral in that it is ‘subjective’ and a

‘subjective estimate’ cannot be neutral.

In general, there are relatively few instances where information can be ‘impartial and objective’ (para 1.5.6), although that is a desirable objective. The old adage is that it is better to be roughly right than precisely wrong. (para 1.5.9-11) would reinforce the view that measurement of ‘risk’ is not a ‘neutral’ process.

18. (para 1.5.7) This statement is not universally correct. Divulgence of measurements to third parties can lead to a change in the outcome, for example indicating how much has been provided for a disputed claim.
19. (para 1.5.8) These definitions of *risk* and *exposure to risk* may be at variance with other usages of those terms and cause confusion.
20. (para 1.5.9) Mervyn King’s observations are not entirely original. I would however go one stage further and say that the statistical tools which analyse past numbers may also have a measure of non-robustness in terms of their application. They may be subjective in terms of the choice of population on which they are based and the period over which they have been collated and the accuracy of their collection. If there is to be a distinction within ‘risk’ between variability and uncertainty, then these factors are not alternatives; variability itself is uncertain.
21. (para 1.5.10) The use of the word ‘reliable’ is debatable in that it has a number of interpretations, including a specific accounting definition which may not be universally appropriate for actuarial calculations.
22. (para 1.6.1) There are no standards for ‘accounting information’, only for reporting under certain specific circumstances. The proposals on actuarial standards would be breaking new ground in ‘accounting’ parallels.
23. (para 1.7.2) ‘Complete and reliable’ are judgemental words and are best avoided unless they can be better defined.

In practice one would want some guidance on non-material departures from any SAPT. Accounting parallels show that this is a fuzzy area.

24. (para 1.7.4) If different stakeholders make their decisions in different ways, then the ‘actuarial information’ cannot be consistent with all of these decision-making processes.
25. (para 1.7.4) ‘complete’? A very difficult word when it comes to its interpretation in any disciplinary process. What does this mean when decisions have to be taken on partial information? Again should it be consistent with the way in which stakeholders make decisions or ‘ought, in the view of BAS or the disciplinary process, to make decisions’?

26. (para 1.7.5) 'most useful'? Who is to say what is most useful, especially with hindsight? The requirements for the information to be most useful to [all] stakeholders and also in a format prescribed by BAS (para 1.7.6) may be inconsistent requirements.
27. (para 1.7.6) There is reference to reliance on actuarial information by a third party. This raises issues which I will not comment on other than to say these issues should be thoroughly covered by the Board and be consistent with any relevant legal requirements.
28. (para 1.7.7) There are many types of reports and I suspect in practice 'standard reports' cannot be developed by the Board for every conceivable commission. The actuary should be able to consider whether any 'standard format' is appropriate for such 'non-standard commissions'.

There may also be an issue about 'one size fits all' with, taking parallels with accounting standards, different rules for small clients.
29. (para 1.7.9) third indent. This may be in conflict with some people's views on the understandability of information.
30. (para 1.7.10) 'best estimate' I have seen many interpretations of this phrase and considerable care is needed to ensure consistency and that a particular interpretation is understood. For communication purposes, it may be best to avoid use of these words!
31. (para 1.7.13) The fact that a marginal value (in a deep and liquid market!) is an objective and practical measure does not mean that it is an appropriate measure other than for certain limited situations.
32. (para 1.7.15) This raises serious issues on how stakeholders take decisions and the extent to which they have to ignore risks. The issues are complex, but historically there have been many examples of ignoring what were considered at the time remote risks because all competitors equally ignored such risks. Such decisions may, inter alia, be linked with economies of scale, attitudes of the fiscal authorities and consumer dissatisfaction with large equalisation or fluctuation provisions or reserves being built up to cover cyclical variations over time periods greater than a year.
33. (para 1.7.6(b)) 'assumed' rather than 'expected'.
34. (para 1.7.17) After something has 'gone wrong' and in the post-mortem world of analysing reports and their adherence to guidance, words such as 'reliable' and 'represent faithfully' will take on different hues. In particular what does reliable mean where judgement (actuaries, lawyers, claims assessors, etc) is the essence of

the information?

35. (para 1.7 18) There must be materiality principles for both calculations and disclosure. The issues will be complex. For example, in modelling a portfolio of life policies, small and obscure policy categories could have a disproportionate effect which is not always known until the modelling is complete. The Board may find it difficult if not impossible to develop tight and consistent rulings.
36. (para 2.3.1) 'forecasts'. Is this the correct term? It is in the sense of a 'conjectural estimate of something future. They are not predictions or prophecies, which is an alternative dictionary definition of the word.
37. (para2.3) The word 'value' is an imprecise concept with many interpretations. Adjectives may (must) be used to describe what sort of 'value' is being considered and reflect the philosophy underlying calculations (if a number can be put on value) of such a 'value'. The issues facing actuaries are complex and market consistency may just be a theoretical concept (see final sentence of 2.3.3). For example, there are two markets for private car insurance policies, that between authorised insurers for exchange of portfolios of policies and that between an insurer and policyholder. There is no single price for a policy and different insurers charge different rates for identical cover. Moreover a single insurer may charge different rates for the same product or may continually vary the price as a tool for the diversification of risk etc.
38. (para 2.4.1) Profit and losses of course arise from other sources, such as the volume of sales covering fixed costs. Value as a mid-point of a payment distribution may depend on subjective and conjectural estimates on sale volumes. Where there a number of distributions involved in making conjectural estimates, a single range of outcomes may be insufficient for a complete picture.
39. (para 2.4.3) A good example of the problems of using a word like 'risk' or 'value' without an adjective (or adjectival phrase). If one is talking of the 'risk of loss' then the 'traditional' (whose tradition?) view is appropriate. The Board are right to say that upside potential should be considered as well as downside potential, but many observers would be confused by the concept of a 'risk of profit'.
40. (para 2.4.4) Does the Board consider stress testing to be outwith actuarial science?
41. (para 2.6.2) Forecasts can change the future where forecasts (conjectural estimates) are built into valuations for specific purposes. Such forecasts may be instrumental in determining views on, for example, the viability of current trading and consequential decisions thereon or on the timing of tax payments. Different conjectural estimates may change behaviour which itself changes estimates; a 'run on the bank' is the most obvious example of induced behavioural change. Forecasts which result in the enforcement of changes in investment policy may

effect retention levels and change the future.

42. (para 2.7.2) The final sentence is contentious and probably wrong.