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FJM/787485/DTE

31st January 2008

Mr P Seymour
Chairman, Board for Actuarial Standards
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Dear Paul

**Towards a conceptual framework consultation paper November 2007
Lane Clark & Peacock LLP (“LCP”) response**

We are pleased to submit our response to the above consultation document.

LCP is a leading firm of consulting actuaries in the UK with 68 partners and principals and a team of more than 250 employees, based in London and Winchester. The firm has some 80 qualified actuaries providing actuarial advice, including employee benefits, investment, insurance and risk management related advice.

We respond to your specific questions in Appendix 1. Some more general observations are set out below. Most of our comments are made on the basis of our experience as pensions actuaries. However, a number are from the viewpoint of general insurance.

First, we congratulate you on producing a document that is much clearer than that in April with a direction of travel that is now plainer to see. As you are aware, we had difficulties in comprehending your first paper.

In principle, we support your efforts to set a philosophy before going on to draft standards, but we remain concerned about the length of time that this is taking.

It would have been useful to see a clear statement of the benefits of the conceptual framework as you now envisage it, rather than to continue to refer just to the Morris report as the justification. It is clear, from the delays and from your ambition, that there are many costs, such as to users for the additional effort required to comply with extended standards, to the actuarial community in having to wait for standards to be developed and to the public interest should you not be in a position to respond quickly to events.

On an initial read it is hard to object fundamentally to much that is written – and so there is a danger that the framework will get too easy a passage. The paper also contains some home truths on terminology and communicating risk and uncertainty. But when we stand back to see where you are going with the paper and test its contents against what this might mean for the standards that you

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have inherited and those you might write, a number of problems arise, some of which we refer to in our responses to your specific questions. It is not clear to us that you have benchmarked your proposals against the existing guidance notes and so there is a danger that the framework will prove to be over-theoretical. It would, for example, have been very helpful if you had exposed an extract from a BAS-style standard covering material from an existing guidance note. This would have helped us all to understand the impact of your intended framework, including a better understanding of the areas in which there would, in future, be no standard, where one currently exists.

You may also find that the framework, with its focus on Categories A and B, unintentionally makes it difficult for you to develop standards in areas that would serve the public interest. A further difficulty is the technical / ethical divide which will come to the fore as individual guidance notes are converted. This latest paper does not seem to have taken the thinking on this subject any further.

Separately:

- We had hoped to see a summary and commentary on the responses you received to the April consultation. Are you planning to publish this? We note that the full set of responses has been put on your website.
- We had hoped to see a published plan for applying the finalised framework to convert specific published guidance notes into the new regime. Clearly some need earlier (and more urgent) attention than others. We ask you to set a clear timetable for delivery and do your utmost to stick to this.
- There is no indication of any intention to support inherited guidance, in its current guise, in any meaningful way. To date, in the pensions arena, you have concerned yourself solely with minor referencing changes, the communication of which could have been clearer.
- We do not know what process you will employ to create, support and amend a BAS standard. Presumably you will consult on this at some point?

Our general insurance actuaries thought that the paper was tailored towards their colleagues in life and pensions, and the comments we received from them were noticeably different from the points raised by our pensions actuaries. Without considering the views of life actuaries, it seems to us an unnecessarily difficult task trying to make “one size fits all” generic standards when topic-focussed standards would remove the cross-discipline contentions.

We believe that it is absolutely vital that you get good engagement from users of actuarial advice before moving to the next stage. In particular, the proposals in relation to the generic Reporting Standard must be thoroughly tested by the users. We have a concern that whilst the aims and intentions here are laudable, the costs of complying with some of the proposals, particularly in this area, outweigh the benefits. It is also not clear to us why you are now positive that such a generic Reporting Standard is appropriate when in April you seemed to have significant reservations.

Yours sincerely

Fiona J Morrison FIA
Partner

Responses to Specific Questions

Question 1 Following the terminology of Section 3, the BAS has determined that Category A should fall *within* the scope of BAS standards and that Category E should fall *outside*. In that context:

a) Do respondents consider the five categories drawn up by the BAS (defined in paragraph 3.9) provide a meaningful way to determine which areas of work should be within scope and which should not?

The A-E categorisation appears somewhat clearer than the previous information/advice divide and appears appropriate in the context of general insurance work. However:

- We believe that a definition of “actuarial work” to be covered by the standards is needed to enable the categorisation to work. For example, does actuarial work include any work performed by an actuary, or towards the other extreme does it simply relate to calculations that involve assumptions about the future? We also note that many areas of work do not automatically fit into a single category.
- The applicability of the second part of the definitions of Categories A and B (ie that using the phrase “by virtue of a legal obligation to a beneficiary”) is not entirely clear to us. In 3.15 you give the example of release of surplus in a pension scheme, but it is generally quite rare in pension scheme work for a beneficiary to be able to force the trustees to obtain a piece of work from the actuary. Could you give some further examples of where this would apply?
- It would seem that section 179 and 143 (of the Pensions Act 2004) valuations for the Pension Protection Fund fall within Category A and yet it is not obvious to us why this work should be subject to any BAS standards when the work is completely constrained by legislation and guidance from the Pension Protection Fund.

It would have been helpful to have had an extensive (although clearly not exhaustive) list of what work should be considered under each of the headings to ensure the framework is interpreted consistently – for example, categorising the current guidance notes would have enabled us to respond in a more detailed and constructive manner.

In paragraph 3.28, asset allocation and funding strategy advice outside the formal (triennial) valuation are classed as Category C. In relation to funding strategy, there are aspects outside the triennial valuation but within the scheme funding process that should surely be Category A. On asset allocation, there are aspects, such as choosing investments and investment principles (sections 35 and 36 of the Pensions Act 1995) that appear to be in Category B.

There are areas of work that could switch between categories (for instance from Category C to Category A where the results of a relatively comprehensive funding update force the trustees to extend to a formal valuation at that date). This can be acceptable but would have to be well managed to avoid unnecessary duplication of work.

It is not clear to us how a categorisation approach along with generic standards will work. You could well find that you get drawn into correspondence in relation to a particular piece of work as to

whether or not it falls within Category A or B, because if it does it will be at the very least, caught by your generic standards, whilst if it does not, it could be completely unregulated.

b) Which, if any, of Categories B, C and D do respondents consider should be within the scope of the framework?

If the definition of “actuarial work” is narrow (eg it relates to calculations involving assumptions about the future) it seems sensible for Category B to be within scope and be subject to a “Comply or Explain” standard. A wider definition of actuarial work might mean it is no longer appropriate for all Category B issues to be classed as “Comply or Explain”. Could you define actuarial work please?

We agree with your present focus on Category A and B (ie to protect the beneficiary rather than the commissioning entity), so that on the whole, Categories C and D should not have individual standards. But there could be Category C and D exceptions (we do not understand your comment in 3.35 that it is not generally practical to cover Category D). We suggest that you do not finalise the framework in such a way that you unduly constrain yourself from producing a standard addressed to entities in these categories if and when a clear need emerges.

c) The BAS would also welcome feedback, and real examples, indicating whether the non-regulatory element of Category B exists in practice or illustrating any concerns that the definitions are wrongly capturing or omitting areas of work.

Pension scheme rules might require factors affecting an individual’s benefits to be set by the trustees having taken appropriate advice. Appropriate advice does not necessarily mean advice from an actuary, so this might be considered a non-regulatory element of Category B.

We are not sure whether it is valid to limit the scope of the actuarial work that you intend to regulate to that relating to the UK operations of an entity. Although we appreciate your territorial limitations, this will not be of assistance to safeguarding the reputation of the UK actuarial profession in relation to work carried out overseas by its members.

Question 2 The BAS has set out proposals regarding the objectives and characteristics of standards in Section 4. Do respondents agree with them, specifically the proposals:

a) to introduce some generic standards, to provide coherence and consistency across areas of work, in addition to topic-specific standards as is the case now.

The topic is introduced in the abstract. We need to see some topics proposed for generic standards to be able to comment meaningfully on their pros and cons.

Given this, whilst generic standards might in theory provide consistency over many areas of work, we have severe concerns about the cost and compliance risks of their implementation. Further, because of the anticipated exclusion of Category D work from the application of BAS standards, potentially we will end up with “over” regulation of pensions and insurance work (because a generic standard imposes too much on one, where it is needed for the other) and totally unregulated work outside these areas.

As an example of costs and compliance risks, when our pension actuaries complete a valuation report that is GN9 compliant we insist that they place a GN9 “checklist” on the file noting that each section has been complied with or the reasons why that section is not applicable. As all the major

requirements (excluding the high-level Professional Conduct Standards requirements) for that particular piece of work are in a single document, it is relatively straightforward to ensure that the report complies.

Contrast that with the structure you propose. The same compliance check would require at least a checklist of:

- the generic reporting standard;
- any other applicable generic standards;
- all the topic-specific standards that are relevant (from your example in section 4.4a, which implies a standard specific to technical provisions, the implication is that you may produce more than one standard covering the scheme funding process); and
- the relevant ethical guidance from the actuarial profession.

It is also a concern that, if the generic standards are to include substantial material that will not be applicable/appropriate to many areas of our work, there is an increased likelihood of the important points being lost. The danger of the important issues being buried is exacerbated by the suggestion in 4.9 that standards should be written so that lay people and non-experts can understand them; whilst a worthy notion the extended standards would increase compliance costs. A separate “easy-to-understand” version of each standard, or notes for non-experts, would limit the costs whilst maintaining non-actuarial understanding.

b) that standards be principle-based, rather than rule-based; respondents are asked to identify any advantages or disadvantages that they consider may flow from this approach; and

Generally we welcome your intention to use primarily principle-based guidance, though note that many of the current pensions guidance notes are built upon regulations that are rules-driven (hence in the pensions arena the recent interest in moving to principle-based regulation).

A clear disadvantage will be that of similar standards being applied to the same type of work: the interpretation of principles will allow much more flexibility. Potentially this will, in effect, lead to individual firms becoming sub-regulators as they develop in-house standards as to the practical interpretation of the principles.

In your discussion on principles versus rules we note that in paragraph 4.11 you envisage that standards will address the exercise of judgement by actuaries in a variety of ways including assumption setting. It therefore seems strange that you are not intending to provide any topic-based guidance on cash equivalent transfer values, when the trustees are required to obtain actuarial advice and will be reflecting on that advice when they set their assumptions. But as the actuarial work required is Category A, it will presumably be caught by your generic standards?

c) that standards address outputs and responsibilities, as now, with output-based standards focusing on the users of actuarial services and their needs as decision makers?

On the basis that “outputs” here includes “inputs” and “processes”, we are generally happy with this focus. However, there are increasingly areas of work where the actuary’s role is advisory and the final decision is made by another party (such as in setting technical provisions, where the assumptions are the responsibility of the trustees or in company accounting work where the responsibility for the assumptions rests with the directors). Where another party makes the decisions

it is not clear how an outputs concept can work. There would appear to be a danger that you end up regulating the entity which we assume is not intended.

It is not clear from 4.16 how a BAS standard can address the responsibility of post-holders without crossing the technical/ethical boundary. This is an important area and it would have been helpful if you could have given it more attention in the consultation document.

Question 3 Do respondents foresee any practical issues or problems that they consider should be addressed in relation to the enforceability of standards, as set out in Section 5, in order to ensure the efficient functioning of the enforceability proposals?

We agree with the general principles of Compulsory (subject to reasonability override) and Comply or Explain. However, we are concerned that the current definitions of Categories A-D leave it open to interpretation what level of enforcement is appropriate for similar pieces of work (see also our responses to Question 1 above).

For example, pension scheme commutation factors that have to be set by an actuary are Category A and would therefore be subject to all generic standards and any topic-specific standards subject to the reasonability override. If the trustees were free to choose their own commutation factors, it would appear that no BAS standards would be applicable. For enforcement depending on categorisation of work to be effective, Categories A-D will need to be well defined. There could also, as perhaps a direct result of your standards, be cases where the entity changes modestly its legal framework, so as to remove much work from the scope of BAS standards (eg the wording of pension scheme rules relating to the setting of actuarial factors).

We have a slight concern that BAS standards do not apply if a non-actuary signs off the work in case this produces a workaround for those who wish to omit a critical part of the standard.

We are concerned by the suggestion in 5.18 that non-actuaries could assert that information they produce “complies with BAS standards”. The training and experience requirements necessary to qualify as an actuary are designed to ensure actuaries identify and consider all the relevant issues that could affect calculations. Further, BAS standards form only part of the whole picture for actuaries who will be bound by the Actuaries’ Code and actuarial professional standards. Our concern is that non-actuaries could claim compliance (which would in fact only be partial compliance) without fully understanding the implications/application of the guidance and without, of course, the potential sanction of a disciplinary case.

As an aside, we are very much of the belief that actuarial standards should focus on what, given the commercial realities and the state of actuarial science, we “can” do rather than necessarily what entities or regulators ask that we “should” do. When producing the standards we ask that you bear in mind that if these enforceability requirements are to be respected, the requirements cannot be too onerous or optimistic. We believe the standard of work will be higher with a simple set of standards fully adhered to than a complex all-singing set of standards that are adhered to “when possible”.

Question 4 Do respondents agree with the proposals in section 8 for:

a) the *general* principles set out in paragraph 8.2;

Broadly, yes. We have no specific comments to make here.

b) the *quantification* principles set out in paragraphs 8.3-8.30;

We believe it would be most useful to add an additional ingredient to those listed in 8.3: materiality. Particularly for smaller entities, the costs of fully complying with actuarial guidance can outweigh the benefits. We believe in certain cases an explicit exemption from certain parts of actuarial standards in immaterial cases would be appropriate.

Section 8.16 recommends that actuaries disclose undiscounted cashflows separately, a concept built upon in 8.37-8.41, but with no clearly stated rationale or indication that the users of actuarial reports require this or what they will do with it. We believe that this proposal would result in a non-trivial increase in costs and could be very detrimental to our clients' understanding of our work. Although illustrating projected cashflows can have its place, care is needed in its interpretation. Reliance on the inflation assumption used, rather than the relationship between inflation and another assumption, is one obvious difficulty. You will also be aware of the Government's recent use of undiscounted figures that gave the impression the Financial Assistance Scheme was far more generous than it actually was.

It might be that this concept of undiscounted cashflows has been built on the notion in 7.24-7.25 that the users of actuarial reports are a "self-selecting group of intelligent individuals, willing to devote time and energy to grapple with the complexities". As may be, the issues we are trying to convey are very complex. With the vast array of figures we already have to provide to clients, we do not believe it is sensible to always be required to provide undiscounted figures.

There is an assertion in section 8.21 that a deterministic calculation effectively ignores the risk of a stock market crash if the discount rate is positive. We do not understand this; in, for example, the context of a cash equivalent transfer value calculation, the discount rate will be chosen to reflect the fact that crashes and periods of high growth are likely to occur over the period, then will be averaged accordingly. As this document is aimed at the users of actuarial guidance as well as actuaries, we are concerned by the potentially harmful "none of your historic actuarial valuations or transfer value calculations have allowed for the possibility of stock market crashes" message this could send to pension scheme trustees.

In 8.29 you say that it would be a proper exercise of your functions to specify how prudence is to be achieved in a given context. It would seem better for you to lobby the body who issued the regulation so that they make their intentions clearer. It is not obvious to us that were you to seek to constrain actuarial judgment that the actuary could safely advise on this basis if he or she disagreed with the constraint.

c) the *generic reporting standard* set out in paragraphs 8.31-8.55?

Our thoughts on generic standards are outlined in our answer to Question 2 above, and the concerns regarding cost and compliance hold equally here.

Instead of a generic reporting standard, we would much prefer a reporting conceptual framework from which no requirements flowed, with all the topic-specific material included in topic-specific standards. Whilst many of the proposals contained in the generic reporting standard seem reasonable when applied to "flagship" actuarial reporting such as pension scheme funding valuations, they seem to be inappropriate, at least to the extent envisaged, for other areas of actuarial work, such as:

- reporting on day to day actuarial calculations (such as transfer value bases and the approach to commutation factors);

- completely constrained reporting such as that for section 179 and section 143 (of the Pensions Act 2004) valuations for the Pension Protection Fund – as we mention earlier, we do not see the need for such calculations to be subject to any BAS standards; and
- processes that require actuarial thought but where there is little, if any calculation work undertaken (for example certifying bulk transfers and giving section 67 certificates).

There is also the danger that those calculations that are within scope suffer a costly compliance report, whilst very similar ones outside do not – for example a slight change in the wording of scheme rules regarding commutation factor setting could push this from a Category A event, requiring full reporting, to a Category C event with few reporting requirements.

Conversely there is a danger that a standard is interpreted as setting a sufficient marker for advice – if the standard is too brief this could have unfortunate consequences. We hope actuaries will be encouraged sufficiently to tailor each piece of work to their clients’ needs and consider all the surrounding issues – not just those within a standard.

Our thoughts on undiscounted cashflows are set out in our response to Question 4(b) above.

Given that actuarial advice in relation to cash equivalent transfer values would appear to be Category A, we are concerned with the implication of sections 8.46 and 8.4 that figures should always be accompanied by the nature and origin of the risk, together with an explanation of the link between the risks and assumptions made. It is difficult to imagine the benefits of providing such additional information will outweigh the costs of doing so in this and other cases.

In passing we do not believe the implication of paragraph 8.42(c) that the cost of a hurricane is measurable to any credible extent.

We have some concern on 8.55 which leaves the clear impression that you do not want to get into the quality of an actuarial report in terms of it addressing the implications of the results. Implications are essential when advising an entity. If you choose not to address this issue, you may inadvertently send out the wrong signal.

d) the proposal set out in paragraph 8.48(d) for actuarial quantification of liabilities to include an assessment of the probability that the assets held by the entity at the valuation date will be sufficient to meet those liabilities; respondents are asked to focus, in particular, on:

- **any practical problems in assessing the probabilities which the proposal calls for; and**
- **any limitations on the usefulness of the information if one or more of the probabilities has to be omitted from the assessment.**

It is not clear why you are proposing this substantial addition to compliance costs. “Sufficiency” would also need to be defined – for a pension scheme, does it mean sufficient to buy out remaining benefits at some future time (if so, what time), or does it mean running out of money before the last benefit payment is made?

We assume that paragraph 8.50 is intended to exclude the following scenarios in addition to the stated cash equivalent calculation example:

- most General Insurance work (generally the focus is on liabilities rather than assets);

- section 179 and section 143 valuations; and
- section 75 debt on the employer calculations.

In this one aspect of the proposed generic reporting standard there are a number of obvious exceptions. Without a definitive list of to which areas of work each aspect of a generic standard relates, actuaries will be forced to seriously consider every aspect of every generic standard for each piece of work undertaken.

Focussing again on the probabilities, where there is an attraction to the user in obtaining this assessment, there is a danger that the methodologies that are necessarily employed will not be able to give the user information that is at all valuable – indeed it could be positively misleading. Certainly in the world of pensions, there is at present, no current regulatory requirement to give such statements.

We are concerned about the implications of paragraph 8.49 – particularly in the general insurance field, the risks faced are unknown. By differentiating between those risks that have derived probability distributions and those that have not, there is an implication that the derived probability distributions are “correct”. Our experience in the general insurance field is that derived probability distributions are often known to be quite wrong, but are the best available. Requiring detailed disclosures about unknown probabilities will only cause embarrassment and loss of confidence when the experience is inevitably different from the initial estimate. Bear in mind that actuaries do not always know the right answers, but they are often in the best position to guess.

The proposal in 8.48(d) needs first to be tested for technical feasibility. We suggest that the proposal will be much better suited to inclusion in appropriate topic-specific standards. Only if it is feasible and the information is relevant to users should you consider its introduction – and then only after full consultation given the significant increase to costs and complexity that will arise. In this regard we welcome the comment in 8.51 that an Impact Assessment will be carried out. We believe this to be essential to ensure proportionality, as will be obvious from our comments.

You also asked for feedback if respondents believed any of the material in sections 6 or 7 is ill-founded. We believe the following paragraphs contain errors or could be misleading to users of actuarial work:

- 6.5 paragraph 4 states that the value of liabilities in company accounts for General Insurance should be “sufficiently prudent to cover future (incurred) claims”. In fact, our experience is that clients are interested in best estimate rather than prudent figures.
- 7.25 states that the trouble with comprehension of probabilities is not to do with the user’s intelligence but that the information has been presented in a way that has been prone to confuse users. Whilst we accept that actuarial advice has not historically been totally user-friendly, the concepts are very complex and should not be trivialised. We are aware of several examples of highly intelligent individuals not understanding relatively basic statistical concepts (such as the High Court judge who dismissed evidence because he could not grasp the concepts of your footnote 22 on page 50).

Although we found much of the content of section 7 of interest, we felt that it was necessary for it to come to some conclusions before your proposals in section 8 could be fully developed. We found your three-way subdivision of risk and uncertainty in paragraph 7.2 of interest, but are of the view that much General Insurance work is in the camp for which there is little or no basis on which to assign probabilities.