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31 January 2008

The Director
Board for Actuarial Standards
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Dear Sir

Towards a conceptual framework: consultation paper

Thank you for the opportunity to respond to this consultation paper. This response has been prepared by the Benefits Practice of Watson Wyatt and therefore primarily reflects pensions-related issues, but the firm's Insurance and Financial Services Practice has reviewed the comments we have made and is happy for the response to be regarded as from Watson Wyatt as a whole. Watson Wyatt is a global consulting firm with particular strength in the area of UK pensions. We advise over half of the 100 largest corporate pension schemes, and the firm as a whole employs over 300 qualified actuaries in the UK.

Generally, we are happier with this latest document than with the 'preliminary consultation paper' published in April 2007. We welcome the acknowledgment of the fundamental differences between accounting and actuarial work and between the insurance and pensions fields, and the acceptance that different approaches (in particular, different 'valuation' measures) are appropriate for different situations. We are also pleased that the earlier critical distinction between 'information' and 'advice' has been modified.

There is a lot more detail than in the preliminary document and it is therefore not as difficult as it was before to envisage how the standards might end up. However, we still think that it would have been much better if some specific examples of specimen draft guidance had been included, to provide a better understanding of how the principles would be applied in practice. We were pleased to infer from a recent consultation meeting that the BAS is intending to include a sample of the first actual standard at the next stage of the process (the exposure draft of the framework), and look forward to seeing this.

We are concerned that the BAS still seems to be some way from producing any actual standards, including (other than some recent very modest corrections) updating or otherwise amending the standards transferred from the Profession in May 2006 and April 2007. Some of these 'Guidance Notes' are now in urgent need of revision. We also think that it would have been a good idea for this consultation paper to set out the process for developing and revising standards, to clarify this aspect for the benefit of others (unlike us) who have not been fortunate enough to have the opportunity to have it explained to them separately.

There is nevertheless one area in which the BAS is offering very detailed proposals – the generic Reporting Standard. Unfortunately, however, we consider that the specification for this comes across as far too detailed for a generic, principles-based standard.

Detailed comments on the consultation paper, on a section-by-section basis and including our comments relevant to the specific questions posed in section 9 of the consultation document, are attached below.

We would be very happy to meet with you to discuss any of the points raised in this response. If you want to take up this offer, please get in touch.

Yours faithfully

C G Singer

Senior Consultant

Towards a conceptual framework: November 2007 consultation paper

Section 2

Whilst there is clearly benefit in having a sound framework underpinning a standard-setting regime, the BAS must ensure that ‘the tail does not wag the dog’. When actual standards are drafted, it will inevitably be discovered that not everything fits neatly into the framework, which therefore must not be adhered to too rigidly.

We welcome the clarification (in 2.10) that the framework will not be a standard itself, and suggest that this is explicitly acknowledged in the final version.

We have doubts as to whether the confident statement at the end of 2.12 “...the boundaries between technical and ethical should not cause a problem” is fully justified. Our understanding is that the distinction has already caused some practical difficulties and it will require a concerted effort in dialogue between the BAS and the Profession for these to be satisfactorily resolved.

Section 3

We think that these five categories are an improvement on the advice/information categorisation in the preliminary paper.

It appears to us that if the BAS is indeed (with few or no exceptions) going to restrict its standards to Categories A and B, where the work is required by regulation or by a legal obligation to a beneficiary, the scope will be quite limited compared with the full range of actuarial work – a limitation of scope which we generally welcome. For example, funding advice to an employer (which currently falls under GN9, albeit that the steps needed to comply are not always obvious) would fall outside the BAS standards, unless it is made a specific exception under Category C.

However, some more clarity is still needed in defining the scope. It has been explained to us (in private conversation) that actuarial work in connection with accounting for pensions under FRS17 and IAS19 is ‘within scope’, although this wasn’t clear to us from the paper itself. And asset-liability studies remain a grey area; in general, they are not required by regulation or other legal obligation, but are often used in conjunction with regulatory requirements (such as drawing up a statement of investment principles or giving funding advice) – would such uses bring them under Categories A and B?

We are surprised that 3.28 indicates that funding advice other than the formal (triennial) valuation would normally fall into Category C, given that documents such as the statement of funding principles, annual reports and the schedule of contributions are all required to be obtained (with actuarial advice) under the Pensions Act 2004.

Care needs to be taken to ensure that the definitions (or absence of them) do not bring some tasks inadvertently into scope. For example, unless ‘actuarial work’ is appropriately defined, an actuary advising on a Trustees’ Report (with the Accounts) may fall within Category B, which would not be appropriate.

Section 4

We are in favour of principles-based standards, as opposed to rules-based standards. However, we have no illusions about the difficulty of producing effective principles-based standards which avoid the risks of being perceived as too weak and/or creating too much uncertainty for the user.

Also we do not believe that the distinction between a principles-based and a rules-based standard is as clear-cut as is often suggested – in practice, there is a continuous spectrum between the simplest of principles and the most detailed of rules. In relation to reporting, we would contend that a very simple overarching principle is neatly encapsulated by paragraph 3.5 of the Actuarial Profession's current Professional Conduct Standards: "*Advice must include sufficient information and discussion about each relevant factor and about the results of the member's investigations to enable the intended recipient of the advice to judge both the appropriateness of the recommendations and the implications of accepting them, including, where the advice relates to an insurance company, a Lloyd's syndicate, a friendly society or a retirement benefit arrangement, any material implications for the policyholders of the insurance company or syndicate, the members of the friendly society or the beneficiaries of the retirement benefit arrangement, as the case may be*". However, that doesn't necessarily mean that anything which goes beyond that cannot be described as 'principles-based'.

In general, we would not expect that it would be appropriate to produce much in the way of generic technical standards. As the BAS has acknowledged, actuarial work is very diverse. As already mentioned, we have significant concerns about the current 'generic Reporting Standard' proposals set out in section 8, which did not appear to us to be 'principles-based'.

Section 5

We note that this document is based on the position that the BAS only has jurisdiction over actuaries, and not (in general) entities, whereas the preliminary document appeared to suggest that the BAS standards might be more widely enforceable.

The 'reasonability override' for compulsory (Category A) standards seems sensible (and similar to the current position under the Profession's 'Practice Standard' Guidance Notes). Its application should, however, not be relied upon to allow out-of-date standards to remain in force unamended – we are concerned to see the override described in 8.27 as a 'protection' in the event that numerical limits on assumptions become inappropriate, as few actuaries would feel comfortable about ignoring such a limit unless the BAS had formally indicated that it need no longer be applied.

If the fact that BAS standards apply only to actuaries undertaking Category B work is a deterrent to using actuaries, we are not sure that the 'comply or explain' approach will help much, because of the additional work required. A better option would seem to be for the BAS to seek a widening of its jurisdiction to encompass non-actuaries.

There are likely to be practical problems in determining whether or not an actuary is "in overall charge of the work" for the purpose of the application of Category B standards. For example, some reports may have two signatories – an actuary and a non-actuary – and there is no sensible answer to the question of who is 'in charge'.

Given that the BAS does not intend to produce ‘recommended’ standards, we wonder what will happen to the ‘Recommended Practice’ Guidance Notes transferred from the Profession. Will they be made compulsory, or instead returned to the Profession for it to decide what to do with them?

Section 6

This section contains some helpful discussion of the various different methods for and philosophies behind the quantification of liabilities.

Although we understand the underlying point you are making about ‘measures’ and ‘methods’ in 6.10, we would point out that the Current Unit Method and Projected Unit Method are more than just a measure of liabilities, incorporating also the determination of future service contribution rates (hence the description ‘method’). However, we do not think that this is a very important point to worry about.

We agree that a distinction may be drawn between ‘valuations’ and calculations for planning or target-setting purposes. However, we do not think that the distinction is necessarily as clear-cut as indicated – the description of the latter in 6.15a is remarkably similar to the statutory definition of ‘technical provisions’ for a pension scheme (a measure which is elsewhere in the document regarded as firmly in the ‘valuation’ category).

In the example in 6.20, we agree that the view in 8b) is not valid for the premise stated at the beginning of the example (to produce a ‘central estimate’).

Section 7

We thought that this was a useful discussion of the theory of risk and uncertainty (and the difference between the two), although where it leads practically speaking in terms of actuarial output is less clear.

Paragraph 7.7 suggests that longevity estimates may have moved from one of the ‘risk’ categories to the ‘uncertainty’ category. We think it is worth drawing a distinction here between the ‘actual’ and the ‘perceived’. It could certainly be argued that it used to be thought that these outcomes were statistically quantifiable but that more people now regard them as unquantifiable, but that does not mean that they were correctly regarded as (sufficiently) quantifiable before. Related to this, our answer to the second question posed in 7.23 would be ‘no’, ie that mortality projections cannot now be made with the level of confidence that has been ascribed to them in the past.

We agree that probabilities (and the inferences which may be drawn from them) are difficult to communicate effectively and actuaries have not always been successful in doing this in the past. The consultation document itself illustrates this communication difficulty in 7.29 – the conclusion that a result of 50:50 (heads and tails) becomes more likely as the number of tosses increases assumes that the aim is to be relatively close to 50:50 in ‘percentage of tosses’ terms rather than relatively close to 50:50 in absolute terms, but this precise nature of the ‘aim’ is not discussed.

The development of the distinction between the two types of probability in 7.28 to 7.32 does not always seem to work. The probability of an individual member dying before retirement age presumably falls under 7.32b and is an inherent part of the calculation of a cash equivalent transfer value, which is surely (contrary to the assertion in 7.32) regarded as a ‘valuation’.

One other small point from 7.26 which highlights how difficult it is to get communication right: past experience on mortality is still a guide to the future, but it is now acknowledged to be a less reliable guide than had previously been thought.

Section 8

General principles

We agree with the need for the framework and standards to recognise different quantification approaches for different contexts. Whilst we would agree that market value would normally be the appropriate measure for the assets, we consider that the BAS needs to keep open the possibility of other valuations in specified circumstances, with a key need being to ensure that asset and liability values are derived consistently.

Quantification principles and calculations

The list in 8.24 of matters that may be specified in BAS standards seems reasonable. However, there may be considerable practical difficulties in specifying some of these in the way that the BAS might wish. A particular example relates to the determination of ‘prudent’ technical provisions (as mentioned in 8.29), where the legal position is that this is (in most cases) the responsibility of the trustees and not the actuary and so the standards would normally have to apply to the actuary’s advice on the methods and assumptions rather than to the calculations themselves.

In any event, we are not convinced by the BAS’s view that to specify how prudence should be achieved would be a proper role for the BAS, given that the EU, the Government and the Pensions Regulator have all declined to do this.

In 8.26 to 8.30, the possible ways in which limits on assumptions may be set are discussed. We expect that the BAS is already well aware of the dangers involved in prescriptive bases when the world is perpetually changing, but mention the point again here to ensure it is not overlooked.

In 8.10, the suggestion is made that a margin be added for data uncertainty, to avoid a ‘misleading presentation’. This begs the question of what is ‘misleading’ – incorporating a margin (or bias) in the results seems to us to be potentially ‘misleading’ (regardless of the motive), especially if it is “within the results” rather than “within the range of possible results”.

Generic reporting standard

As already mentioned, the proposals in this document came across to us as far too detailed and prescriptive for a generic standard (although we understand from a private meeting that we may have inferred considerably more detail and prescription from the consultation paper than the BAS had intended). We observe that a lot of the proposed content is similar to what is currently required by GN9; this is not very surprising, but it needs to be remembered that GN9 largely relates to the most formal actuarial reporting document in the field of pensions, and applying in full its principles to all other reports would be excessive.

Examples of actuarial ‘reports’ relating to pension schemes where a generic reporting standard of the type proposed could significantly increase compliance costs without any obvious benefit could be section 179 valuations, section 67 actuarial equivalence requirements, bulk transfers without consent, and non-standard individual transfer values.

The key to producing a workable generic standard would appear to be to ensure that items listed in 8.34 to 8.51 do not have to be included (or even mentioned as ‘not included’) where not relevant to the circumstances. The preliminary consultation paper contained an important concept of ‘decision usefulness’ and it is crucial that this principle is applied (whether by that or some other name) here. Where, rather than a one-off calculation or certificate, a process is involved (as will normally be the case for scheme funding advice), it is important that the reporting standards allow for the relevant information to be given at the appropriate stage of the process (ie when it is needed for a client decision at that stage) and then not duplicated unnecessarily at later stages.

We are not convinced of the benefit of requiring an undiscounted cash flow disclosure of the type described in 8.37 to 8.41 (the proposals for which would seem to us to be contrary to the concept of principles-based standards). Whilst this information is sometimes helpful in explaining and amplifying other results, it also has considerable potential to mislead and confuse. Where inflation assumptions are involved, the undiscounted figures will often be considerably more subjective than the discounted figures (there being more uncertainty about the actual rate of inflation than about the net rate of return). And in many actuarial calculations with ‘long tails’ (reflecting a few people living to a very long age), highlighting the very long period over which payments are expected to be made may detract from the important point that the payments are heavily weighted towards the early years of the period. Our colleagues in insurance have additionally commented that cash flow reporting would be especially inappropriate for unit-linked business.

On risks (8.42 to 8.47), an actuary will not normally be aware of, let alone be able to comment on, all the various risks faced by an entity – he or she will normally only be able to comment on the relatively narrow area of the pension scheme. Paragraph 8.47 confirms that for some calculations the full list of risk disclosures would not be appropriate, but as currently drafted it leaves a lot of uncertainty as to how much of this sort of analysis the BAS is envisaging will be carried out in a wide range of scenarios.

Like the cash flow disclosure discussed above, the proposal for a specific probability assessment looks likely to create costs and practical problems without necessarily achieving its objective. We can see the attraction of encouraging statements of the type “the assumptions for the technical provisions have been set at a level which it is believed have a 75% chance of being met or bettered over the next ten years”, or “the basis for determining the member’s transfer value is intended to give a 50% chance that its amount will exceed and a 50% chance that it will be below what it would actually have cost to provide those benefits if they had remained in the scheme”. However, we are against any attempt to force such disclosures by stipulating general rules for the calculation of a specified probability. Such probabilities would often give a spurious impression of accuracy and would almost always rely on significant assumptions as to the variability of certain factors – for example, any assessment as to the variability of outcomes for future mortality improvements would be highly subjective.

In summary, the ‘probability of sufficiency’ concept and a disclosure of cash flows (although not usually a single aggregated figure) can both, in some form, be a useful part of actuarial reporting in certain

circumstances. But an attempt to require specific such disclosures in all cases would, in our view, be a serious mistake.