



**FINANCIAL REPORTING COUNCIL**

**UPDATE FOR USERS OF ACTUARIAL INFORMATION**

**NOVEMBER 2010**

# 1 Introduction

- 1.1 The purpose of this document is to assist the users of actuarial information to engage effectively with those providing the information. It discusses some of the key issues that governing bodies should consider in the coming months, and includes a list of questions that may act as a useful reminder. Many are the same as in the last two years.
- 1.2 The Financial Reporting Council (FRC), the UK's independent regulator responsible for confidence in corporate reporting and governance, believes that governing bodies, be they directors or trustees, should take special care to ensure that they fully understand the assumptions on which actuarial information is based, and to form a view on how appropriate they are.
- 1.3 The primary purposes served by actuarial information are:
  - To assist governing bodies in making decisions on the actuarial assumptions that should be used in calculations.
  - To present the results of calculations for use in financial statements or determining the amounts of payments to be made or charged.
  - To assist governing bodies in making decisions concerning risk management and capital requirements.
- 1.4 Those who use the information need not understand all the underlying details, but should ensure that they understand the range of possible assumptions and their impacts; the fact that there is rarely a single "correct" answer in actuarial work; and the limitations of the models and calculations. Common sense checks should be performed.

## 2 Key issues

2.1 The current economic outlook is not as depressed or unstable as this time last year. However, significant economic and market risks remain which could present challenges for users of actuarial information. It remains unclear where key parameters such as inflation and interest rates will head, and we have to expect greater volatility than we might have expected a few years ago.

2.2 The FRC has identified three areas of particular concern:

- The need for effective corporate governance controls over actuarial and related work. The FSA's supervisory activities are increasingly focusing on this area, and its with-profits review identified the conflicts of interest faced by with-profits actuaries as an area of particular concern. Governance and use of advisers continue to be major themes of the Pensions Regulator as well as of the FRC.
- In the face of Government austerity measures and a highly volatile economic and market environment, governing bodies should revisit the assumptions concerning business strategy and operations, and the adequacy of their scenario or stress testing. Governing bodies should ask themselves:
  - whether the business model reflects and is being adequately tested against reality;
  - whether it will remain effective under changed circumstances; and
  - whether the behaviour, expectations and needs of policyholders, scheme members or potential customers has changed or will change.

Particular attention may be needed in considering the effects of changes in the basis for calculating benefit increases from RPI to CPI or the effects of the marked softening of premiums in the general insurance market on the adequacy of technical provisions for outstanding claims.

- Given the uncertainties over the economic outlook, governing bodies should consider whether the assumptions concerning investment returns and discount rates remain appropriate. The limitations of discounting should be investigated – small changes in assumed discount rates can have large effects. Governing bodies should consider potential cash flows carefully in order to understand the real implications of discounted values.

### 3 FRC Developments

3.1 The FRC's Board for Actuarial Standards (BAS) has now nearly completed the development of its new set of outcome-focused technical actuarial standards (TASs). The objective of the TASs is that the users of actuarial information can place a high degree of reliance on its relevance, transparency of assumptions, completeness and comprehensibility, including the communication of any uncertainty inherent in the information. However, governing bodies may not yet be making full use of them in monitoring the quality of actuarial work and information.

3.2 Five TASs have now been issued in final form:

- The generic TAS on *Reporting Actuarial Information* (TAS R), which sets out principles for, among other things, the communication of the results of calculations, the assumptions that have been used and the reasons for using them, came into force on 1 April 2010.
- The generic TAS on *Data* (TAS D), which aims to ensure that data on which actuarial information is based is reliable and that any limitations in data are fully understood by users, came into force on 1 July 2010.
- The generic TAS on *Modelling* (TAS M), which aims to ensure that models used to develop actuarial information are fit for purpose, are suitably checked and documented, and that any limitations in their use and the results they generate are fully understood by users, is due to come into force on 1 April 2011.
- The specific TASs on *Pensions* and *Insurance*, which build on the three generic TASs, are due to come into force on 1 April 2011 and 1 October 2011 respectively.

3.3 Early adoption of TAS M and of the Pensions and Insurance TASs is encouraged. Exposure Drafts have been published on proposed TASs on *Transformations*, and *Pre-paid funeral plans*, discussing principles that should be followed in those specific areas. It is expected that the TASs will be issued by early 2011 and will come into force by the end of 2011.

3.4 The FRC and its operating bodies have taken a number of other actions in recent months that are relevant to the challenges faced by users of actuarial information:

- In May 2010, the FRC issued a new edition of the *UK Corporate Governance Code*, which includes a clearer statement of the board's responsibilities relating to risk. The organisation's business model should be explained and the board should be responsible for determining the nature and extent of the significant risks it is willing to take.

- In June 2010, the FRC revised its *Actuarial Quality Framework*, which is designed to support effective communication between actuaries and the users of actuarial information about the quality of actuarial methods and communication; technical skills, ethics and professionalism of actuaries; and the working environment for actuaries and other external factors.
- In July 2010, the Professional Oversight Board's *Annual Report to the Secretary of State for Business, Innovation and Skills* was published – the commentary on the Actuarial Profession's progress and priorities in regulating its members focused on standards, guidance and education in support of the new Actuaries' Code, competence requirements for actuaries, and ways of improving actuaries' quality controls, including features of their working environment.
- In July 2010, the FRC published the *UK Stewardship Code*. As part of their responsibilities as stewards and for mitigation of risk, pension fund trustees and other owners (including insurers) should have appropriate arrangements for monitoring the companies in which they invest.

Questions that users of actuarial information may find useful when considering issues in these areas are set out in the Appendix. Trustees and directors should also be aware of the responsibilities placed on them by the Pensions Regulator and the Financial Services Authority, and should take full account of any regulatory guidance.

## A Appendix: Questions

This appendix sets out some questions that members of governing bodies might like to consider as they make decisions based on actuarial information. Not all the questions will be relevant to all governing bodies, although they may suggest useful parallels.

- 1. Actuarial quality controls**

Do your quality control and corporate governance arrangements ensure that you are able to take decisions and report to your stakeholders on the basis of high quality actuarial information and advice?

*Quality standards*

Do your actuarial work and the actuarial information produced by or for your organisation meet the new Technical Actuarial Standards (TASs)?

Have the key judgements on matters such as materiality been agreed?

Is your organisation using the FRC's Actuarial Quality Framework to assess the overall quality of its actuarial work and information?

*Use of actuaries*

Are your actuaries' terms of reference adequate to ensure they provide the actuarial support you need and to reflect best practice?

Are they encouraged to challenge or validate the existing models, data and assumptions? Who has taken responsibility for these matters?

Have your actuaries been encouraged to express their own opinions and concerns? Has their advice been adequately documented and reported? Are other parts of the organisation such as risk management, paying sufficient attention?

*Conflicts*

Is the objectivity of your actuaries threatened by conflicts of interest or other undue pressures?

Do your actuaries have other interests or responsibilities which might affect their perceived objectivity, such as giving advice to scheme trustees and sponsoring employers? Are any such conflicts adequately managed?

*Review*

Do your actuaries have adequate processes for internal review and quality assurance in place?

Do they need external support or review?

How is compliance with TASs and other legal, statutory and professional standards being monitored and reported?

**2. Business model** Do your general assumptions about how the business is run, or how the pension scheme or its sponsor operates, remain valid in current conditions? Have they been revised in the light of recent events?

*Business* What supports your assumptions concerning matters such as:

- volumes of new business or numbers of new members?
- rates of salary increases, expense levels and so on?
- rates and amounts of insurance claims?
- future actions taken by management?

How are these likely to be affected by changed economic and market conditions, such as lower premium rates or increased rates of fraud?

*Options* What supports your assumptions concerning the decisions customers, scheme members and beneficiaries make about how they exercise options, such as surrender values, cash commutations, transfer values and so on? Is the financial effect of exercising the options reflected in the model?

What supports your assumptions concerning decrements such as lapses, withdrawals, early or ill health retirements and so on? Are the decrement rates likely to be affected by the current economic situation, through its effects on customers, scheme members or employers?

*Data* Does the data that has been used in setting assumptions cover previous economic downturns, or does it cover only the recent past?

**3. Discounted values and investment returns** Do you consider projected cash flows as well as discounted or other present values? Are there limitations on cash flows within the organisation that are hidden in discounted values? Are there peaks of cash demands or troughs in the availability of cash that need to be recognised?

How sensitive are discounted values to the discount rates that have been used? What is the relationship between the discounted values of assets and liabilities? Are the assumptions used for assets consistent with those used for liabilities?

Are your assumptions regarding investment returns consistent with the returns that can be generated from the existing assets and the current investment strategy?

*Rates of return* What rate of return is required from each type of asset, such as equities, gilts, cash and so on, to support the assumptions? How likely is it that these returns can be achieved?

How do these rates of return compare to each other and to the assumed rates of return from low risk assets such as gilts? What is the justification for the differences between the assumptions?

Are any illiquidity premiums that are used in models and calculations justifiable? Do any assumptions contain implicit margins to compensate for other factors? What is the impact of any such margins and do they reveal any potential risks?

*Investment strategy* Are your assumptions consistent with any anticipated changes to the assets that are held, such as a move into bonds as the liabilities approach maturity?

If the investment strategy includes financial instruments such as derivatives, how is that reflected in your assumptions?

*Reinvestment* How is the effect of reinvestment on uncertain terms reflected in the assumptions, for example the investment of future dividends or interest received, or the proceeds of assets that mature before liabilities become due?

**4. Risk reduction and transfer**

How is the success of risk mitigation actions monitored?

If you have taken actions to reduce risk, such as changing investment strategy, increased monitoring of investee companies, reinsurance or hedging, who now holds the risk? How are any changes reflected in actuarial assumptions or models?

*Residual risk* How effective have risk reduction measures been and what residual risks have been retained? For instance, assets may not mature at exactly the same time that liabilities become due, or there may be differences in terms and conditions between reinsurance and the business it covers.

Have other organisations that are similar to yours identified risks that might still be unrecognised in your organisation?

Do actuarial assumptions and models reflect the retained risk?

*New risks* If risks have been transferred to others, what other risks (such as counterparty risk) have arisen? Do actuarial assumptions and models reflect the new risks? Are the new risks affected by the current economic conditions?

Are you taking on risks that might be difficult to mitigate if the conditions encountered in 2008/9 occur again?

**5. Scenario analysis and stress testing** Do you have the right models in place to enable you to examine the impacts of actuarial assumptions and adverse circumstances? Are the methods that are used robust, particularly in the light of recent events?

*Scenarios* How extreme are any scenarios that have been analysed? Has the probability of the scenarios been assessed? What supports the assessment of the probability?

Do the scenarios cover the full range of adverse effects on the business or pension scheme? Has the range of plausible scenarios been revisited in the light of recent events? Have the possible effects of extreme events been reassessed?

Are the scenarios internally consistent, taking into account knock-on effects? Do they allow for two or more separate adverse events to occur simultaneously? Have the assumed correlations between risks been reassessed?

Are there any scenarios in which, despite positive discounted values, cash flow would be inadequate?

*Stress tests* What supports the choice of the stress tests that have been considered? Do the stress tests cover the full range of material assumptions? Has the need for stress tests in the areas of credit risk, and possible defaults by counterparties in hedging and reinsurance transactions, changed? Has the need for stress tests covering the behaviour of policyholders or scheme members changed?

How extreme are the stress tests that have been applied? Have they been revised in the light of recent events? Has your view changed of what a 1 in N year event might be? If stress tests are relative, for example looking at a percentage fall in markets, have they been run in the context of current circumstances, and is the relative change still at the desired level of extremity?



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