

ACTUARIAL STANDARDS AND REGULATION - FINAL PROPOSALS ON FUNDING THE NEW REGIME

Introduction

The Financial Reporting Council (FRC) is the United Kingdom's independent regulator responsible for promoting confidence in corporate reporting and governance.

Following the Morris Review of the Actuarial Profession, published in March 2005, HM Treasury asked the FRC to take on new responsibilities for setting actuarial standards and overseeing the regulation of the actuarial profession. The purpose of the new regime will be to enhance the quality of actuarial reporting and to promote the integrity, competence and transparency of the actuarial profession – to the benefit of all those who rely on actuarial advice.

Information on the FRC's role in relation to actuarial standards and regulation is available on its website at www.frc.org.uk, which also gives details of its present funding, governance and accountability, including its Regulatory Strategy and its Plan & Budget for 2006/07.

In line with the recommendations of the Morris Review, the FRC is:

- Establishing an FRC Board for Actuarial Standards (BAS). From April 2006, the BAS will take on responsibility for the technical standards with which actuaries must conform. It will have a Board of senior individuals, representing the users and providers of actuarial advice. The Chairman of BAS and the FRC's Director, Actuarial Standards have already started work.
- Extending the remit of the FRC's Professional Oversight Board for Accountancy (POBA) to cover the actuarial profession.
- Extending the remit of the FRC's Accountancy Investigation and Discipline Board (AIDB) to cover public interest matters involving actuaries.

In October 2005, the FRC published a consultation paper inviting views on the arrangements for funding the new regime.

This paper:

- provides feedback on the issues raised in response to the consultation paper and sets out the FRC's policy for implementing the arrangements for funding the new regime; and
- proposes the specific funding arrangements which will apply in 2006/07.

The total funding requirement for the new regime will be £1.7m in 2006/07.

Comments on the proposals are invited by 30 April 2006.

1. Feedback on consultation and policy decisions

Funding the new arrangements - the FRC's initial proposals

The FRC's October 2005 consultation paper explained that the FRC had taken as its starting point the basis envisaged in the Morris Review. The costs the FRC incurs in relation to its actuarial responsibilities should be met by the main beneficiaries of the new regime - life and general insurance companies, pension funds and the actuarial profession.

The Morris Review framed its recommendations largely in terms of the quality of actuarial advice by members of the actuarial profession to life and general insurance companies and the trustees of pension funds.

The BAS will account for the largest element of the FRC's costs in relation to its actuarial responsibilities. It will take on an independent role in establishing and improving actuarial technical standards and ensuring that they are coherent, consistent and comprehensive.

When the arrangements commence in April 2006, the standards set by the BAS will apply to members of the actuarial profession working in the UK. However, the quality of actuarial standards and compliance with those standards are not matters that affect only actuaries. BAS standards will also be relevant to users of actuarial advice - notably the directors of insurance companies and the trustees of pension funds - who will be making commercial judgments on the basis of advice from actuaries who are subject to BAS standards. The BAS membership and approach to standard-setting will reflect the importance to insurance companies and pension funds of high quality actuarial standards.

The BAS will work closely with the Financial Services Authority (FSA) and the Pensions Regulator to ensure that its standards provide, where appropriate, the necessary basis for actuaries advising insurance companies or the trustees of pension funds to provide advice in a form which enables those entities to comply with regulatory rules and guidance. Such rules and guidance may also include a general requirement to conduct the work in a way that is consistent with BAS standards.

The other elements of the FRC's role in relation to actuarial standards and regulation will also provide benefits for those who rely on, as well as those who provide, actuarial advice by promoting high quality actuarial practice and the integrity, competence and transparency of the actuarial profession.

The FRC hopes that the new arrangements can be funded through non-statutory arrangements, on the basis of an understanding with the insurance and pension sectors and the actuarial profession that takes into account the benefits the new regime should provide for these groups in particular.

The Company Law Reform Bill currently before Parliament will provide the FRC with immunity from liability in damages for the performance of its actuarial functions and provides a power for the Secretary of State to make regulations enabling the FRC to recover its costs. Should a voluntary approach prove unsustainable, use of these statutory powers would be invoked.

The FRC's October 2005 consultation paper invited views on four questions:

Q1 - Is it reasonable that the actuarial profession should contribute 10% of the cost of the new arrangements?

Q2 - Is it reasonable that the costs of the new arrangements that do not fall to the actuarial profession should be split equally between the insurance and pension sectors?

Q3 - Is it reasonable that the amounts payable by individual insurance companies and pension funds should be calculated by reference to the FSA regulatory fees and the Pension Regulator's general levy respectively?

Q4 - Is it reasonable to meet actuarial investigation and disciplinary case costs from a fund that is replenished as necessary to meet the actual costs incurred?

In response to the consultation, some respondents also raised the question as to whether there should be a Government contribution to the cost of the new regime.

The responses to the consultation and the final policy decisions

The responses to the consultation document are summarised below together with the final policy decisions on funding the FRC's actuarial responsibilities.

Government contribution to the cost of the new arrangements

The FRC consultation paper noted that HM Treasury endorsed the principle that the costs of the new regime should be met by the main beneficiaries and not from public expenditure.

Analysis of responses

Some respondents suggested that there should be a Government contribution to the costs on the basis that there is a public interest in actuarial standards and regulation. The FRC has drawn HM Treasury's attention to the suggestion that there should be a Government contribution to the costs of the new regime.

HM Treasury has advised the FRC that it acknowledges the wide range of interests in the quality of actuarial standards and regulation, but remains of the view that it is appropriate for the main beneficiaries of FRC oversight to provide the necessary funding rather than for this funding to come from general taxation. This is in line with the way that the Financial Services Authority is funded.

Final policy

The FRC's funding proposals are based on the Government's policy that it will not contribute towards the costs of the new regime.

The FRC consultation paper explained that it was proposed that the costs of the new arrangements would be recovered from the actuarial profession, insurance companies subject to the FSA's regulatory fees and pension funds subject to the Pensions Regulator's general levy. This remains the basis for the FRC's funding proposals.

Contribution from the actuarial profession

The FRC invited views on the proposition that the actuarial profession should contribute 10% of the costs of the new regime. The FRC believed that its proposal was reasonable in the light of the overall recommendations of the Morris Review and the benefits the FRC's new regime will provide but that would not discourage actuaries from retaining their membership of the actuarial professional bodies.

The new actuarial standards and the arrangements for independent investigation of public interest matters affecting actuaries will only apply to individual actuaries who are members of either of the two actuarial professional bodies. Although some professional actuaries are required by law to be members of one of the professional bodies in order to provide specific actuarial services (eg the Actuarial Function Holder for insurance companies and the Scheme Actuary for pension funds), this is not the case for the majority of actuaries.

A reduction in the number of actuaries who retain their membership of the professional bodies would have a number of consequences which would not be in the public interest, including a reduction in the effectiveness of the new regulatory arrangements.

Analysis of responses

All respondents supported the proposition that the actuarial profession should make a contribution to the costs of the new regime. Some respondents argued that the profession should bear more than 10% of the costs.

The FRC has considered carefully the arguments for a larger contribution from the actuarial profession but remains of the view that 10% is a reasonable level taking into account:

- the danger of a creating a disincentive to membership of the profession if a larger proportion of the costs were allocated to the profession which is of a small size.
- the benefits for the other proposed funding groups - insurance companies and pension schemes.

Any increase in the percentage payable by the profession would result in a negligible reduction in the amounts payable by the other funding groups but would increase the risks that the new regulatory regime would be ineffective.

Some respondents argued that the costs of the new regime should be borne entirely by the membership of the actuarial profession (and the Government), accepting that members of the profession would in turn pass on the costs incurred to their employers and their clients.

The FRC believes that this proposal is less attractive than its initial proposals because the majority of the costs are likely to be passed on to the insurance industry and pensions sector as actuaries' clients, but with a reduction in the transparency of the basis of cost recovery.

Final policy

The FRC will seek an annual contribution from the actuarial profession of 10% of the total costs incurred in relation to its responsibilities for actuarial standards and regulation.

Contribution from insurance companies and pension funds

The FRC invited views on the proposition that the costs of the new arrangements that do not fall to the actuarial profession should be split equally between the insurance and pension sectors.

Analysis of responses

Those respondents who supported the proposition that the insurance and pension sectors should contribute to the costs of the new regime argued that the costs should be allocated to the two sectors in proportion to the work required in each area.

The FRC agrees, in principle, that the proportion of the FRC's costs which is not paid for by the actuarial profession should be divided between the insurance and pension sectors on the basis of the relative proportion of the FRC's activities which are relevant to the two sectors. However, a substantial proportion of the work is likely to be common to both sectors and the costs involved in establishing a reliable basis for allocating the remaining costs are likely to be disproportionate to the amounts involved.

It is not easy to identify measures of the size of the two sectors which are wholly comparable, but the available data (summarised in the consultation paper) suggests that the two sectors are of the same order of magnitude.

The FRC regards it as essential to ensure that the insurance and pensions sectors are appropriately represented in the new regime, including on BAS and on the FRC's Council.

Final policy

The FRC will seek annual contributions from the insurance sector and the pension sector, each equivalent to 45% of the total costs incurred in relation to its responsibilities for actuarial standards and regulation

Calculating the amounts payable by individual insurance companies and pension funds

The FRC invited views on the proposition that the amounts payable by individual insurance companies and pension funds should be calculated by reference to the FSA regulatory fees and the Pensions Regulator's general levy respectively.

Analysis of responses

Most of the respondents who commented on this proposition accepted that it would represent the most cost-effective basis for allocating costs to individual insurance companies and pension funds.

One respondent queried whether the costs would fall disproportionately on poorly funded pension funds which would be least able to afford them. This comment reflects a mis-understanding of the FRC's proposal which is to base the allocation to pension funds on the Pensions Regulator's general levy which, unlike the PPF levy, has no risk-based component.

The pension levy group will comprise pension schemes subject to the Pensions Regulator's general levy. The FRC levy will be set each year as a proportion of the general levy, subject to a de minimis level.

The FRC believes that it will be sensible to introduce a de minimis level in relation to all schemes below which the levy is judged to be uneconomic to collect. The extremely skewed distribution of pension funds (ie a relatively small number of very large funds and a very large number of small funds) means that the net increase in costs to those funds required to pay the levy will be very small.

Final policy

In implementing the arrangements for the proposed levy the FRC will define two “levy groups”:

- **the insurance levy group will comprise life and general insurance companies which are required to pay the relevant FSA regulatory fees.**
- **the pension levy group will comprise pension schemes which are required to pay the Pensions Regulator’s general levy, identified on the basis of information on scheme membership provided to the Regulator in its scheme returns.**

The arrangements for 2006/07, based on this approach, are set out in part 2 of this paper.

Actuarial investigation and disciplinary case costs

The FRC invited views on the proposition that actuarial investigation and disciplinary case costs should be met from a fund that is replenished as necessary to meet the actual costs incurred.

Analysis of responses

In general, respondents accepted the need for a fund. Those who argued that the actuarial profession and the Government should meet the entire costs of the new arrangements were by implication arguing that the profession should meet the costs of disciplinary cases. Other respondents supported the proposition that the fund should be established and replenished from the overall funding arrangements for the FRC’s actuarial responsibilities.

Actuarial investigation and disciplinary case costs will depend on the number and complexity of cases and cannot be subject to firm budgetary limits. This means that it will be difficult to quantify at the start of each financial year how much should be raised. In addition, given that - as proposed above - there will be many organisations which will contribute to the costs of the new regime, it will not be cost effective to issue supplementary invoices part way through the financial year.

The FRC has not yet come to a firm view as to the appropriate level for the actuarial investigation and discipline fund. This will be kept under review in the light of experience of the number and size of cases.

The contribution that will be required to maintain the fund at an appropriate level will be reviewed each year. If in one year case costs exceed the annual contribution the additional cost will be recovered in the following year from insurance companies, pension funds and the actuarial profession in the same proportion as their contributions to the FRC's other costs in relation to the new arrangements.

Any fine income received or legal costs awarded to the FRC in relation to disciplinary cases will be used to replenish the fund. Should the fund exceed the target level the excess will be used to meet the FRC's actuarial operating costs, thereby reducing the costs to the funding groups.

Final policy

The FRC will establish an actuarial disciplinary and investigation case costs fund.

2. Proposed funding arrangements for 2006/07

The FRC's actuarial costs for 2006/07

The FRC Plan & Budget for 2006/07, published on 21 December 2005, explained that the FRC expected to incur the following costs in 2006/07 in relation to its new responsibilities for actuarial standards and regulation:

- **Actuarial operating costs**, which will cover the BAS (likely to be the largest element of the operating costs), the additional work undertaken by POBA and the AIDB, and a proportionate share of the FRC's overheads. These costs will be subject to firm budgetary limits.
- **Actuarial investigation and disciplinary case costs**, which will depend on the number and complexity of cases, and cannot be subject to firm budgetary limits. The FRC is proposing to establish a fund to cover these costs, with an initial contribution of £250,000 in 2006/07.
- **Recovery of set-up costs**, arising from the need to establish the new arrangements and recruit new operating body members and a small number of additional FRC staff during the course of 2005/06. Since the budget was published the set-up costs have been re-assessed and are now expected to be in the order of £450,000, somewhat lower than originally allowed for. The FRC intends to recover £150,000 of these costs in 2006/07 and the remainder in 2007/08 and 2008/09.

The total cost of the new arrangements in 2006/07 is expected to be as follows:

	£m
Actuarial operating costs	1.30
Initial contribution to the actuarial investigation and disciplinary case costs fund	0.25
Recovery of set-up costs	0.15
Total	1.70

Funding for 2006/07

The FRC will seek contributions to these costs as follows:

	£m
Actuarial profession	0.17
Insurance levy group	0.77
Pension levy group	0.77
Total	1.70

Contribution from actuarial profession

The FRC will seek a contribution of £170,000 (10% of total costs) from the actuarial profession in relation to its responsibilities for actuarial standards and regulation in 2006/07. It will be for the actuarial profession to decide how the profession's contribution should be recovered from individual members of the profession.

Insurance levy group

A FRC levy of £765,000 (45% of total costs) will be collected from insurance companies in FSA fee-blocks A3 and A4. It will be allocated to individual insurance companies in the same proportion as the FSA regulatory fees and charged to insurance companies on the same invoice as the FSA fees.

The FRC levy on insurance companies will be an amount equivalent to 1.4% of the FSA's proposed regulatory fees for Fee-blocks A3 and A4 for 2006/07 (£56m).

Pension levy group

A total FRC levy of £765,000 (45% of total costs) will be collected from the pension levy group in 2006/07 on the basis of information on scheme membership provided to the Pensions Regulator in its scheme returns. The FRC levy will be collected by the agent used by the Pensions Regulator for collecting its general levy and the Pension Protection Fund levy.

The FRC intends to collect a levy of £2 per 100 members on pension schemes in the pension levy group.

The FRC levy on pension schemes will be an amount equivalent to 2.4% of the the Pensions Regulator's expected general levy for 2006/07 (£32m).

Part 1 of this paper set out the principle that there should be a de minimis level in relation to all schemes below which the levy is judged to be uneconomic to collect. The extremely skewed distribution of pension funds (ie a relatively small number of very large funds and a very large number of small funds) means that the net increase in costs to those funds required to pay the levy will be very small.

For 2006/07, the FRC intends that this level should be set at £20. This will have the effect of including within the scope of the levy those schemes with more than 1000 members - around 2000 schemes, representing approximately 85% of the total membership of pension schemes.

**FRC
1 March 2006**