



BOARD FOR ACTUARIAL STANDARDS

FUNERAL PLANS TECHNICAL ACTUARIAL STANDARD

SIGNIFICANT CONSIDERATIONS

FEBRUARY 2011

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1 INTRODUCTION

PURPOSE

- 1.1 The Board for Actuarial Standards (BAS) is responsible for setting technical actuarial standards in the UK: it is an operating body of the Financial Reporting Council (the FRC)¹.
- 1.2 In February 2011, after a process of consultation, the BAS published its Specific Technical Actuarial Standard (Specific TAS) on *Funeral Plans* (the Funeral Plans TAS). Funeral Plans enable plan holders to pre-pay for some or all of the costs of a funeral. Pre-paid funeral plans are excluded from regulation by the Financial Services Authority if the plan provider secures that the pre-payment is either:
 - held on trust until it is required to pay for the funeral and the trust meets five specific requirements (*Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 articles 59 and 60*). One of the five requirements is that an actuary must determine, calculate and verify the assets and liabilities of the trust at least once every three years; or
 - applied towards a whole life insurance on the plan holder's life.
- 1.3 The Funeral Plans TAS applies to actuarial work for funeral plan trusts. Actuarial work for insurers providing whole life insurances which are used to support funeral plans is covered by the Specific TAS on *Insurance* (the Insurance TAS).
- 1.4 This document reviews the considerations and arguments that were thought significant by the BAS in developing the Funeral Plans TAS.

BACKGROUND

- 1.5 In our consultation paper *Towards a Conceptual Framework*, which was published in November 2007², we proposed that our standards would be of two types: generic, applying to a wide range of actuarial work, and specific, limited to a defined context. Generic standards would help to provide coherence and consistency across the range of actuarial work.
- 1.6 That document also set out our proposals that standards be principles-based rather than rules-based, and that they address outputs and responsibilities, with output-based standards focusing on the users of actuarial services and their needs as decision makers.
- 1.7 In April 2008 we published a consultation paper on the *Structure of the new BAS Standards*, in which we set out our proposals to develop a suite of TASs of which three would be Generic TASs on *Data*, *Modelling* and *Reporting*

¹ The Financial Reporting Council is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment.

² All BAS publications are available from <http://www.frc.org.uk/bas/publications/>.

Actuarial Information. There would also be a number of Specific TASs, applying to work in particular areas such as insurance and pensions.

- 1.8 Following consultations, we published our Generic TAS on *Reporting Actuarial Information* (TAS R) in September 2009, our Generic TAS on *Data* (TAS D) in December 2009, and the Generic TAS on *Modelling* (TAS M) in April 2010. We published our Specific TAS on *Pensions* (the Pensions TAS) in October 2010, the Insurance TAS in November 2010, and our Specific TAS on *Transformations* (the Transformations TAS) in December 2010.
- 1.9 In the second quarter of 2010 we consulted informally with major funeral plan providers, the Funeral Planning Authority (FPA)³, and actuaries providing information to funeral plan trustees. We published an exposure draft of the Funeral Plans TAS in August 2010.
- 1.10 We aim to ensure that our standards are consistent with the wider strategic aims established by the FRC including its *Actuarial Quality Framework*, which was issued in January 2009 and updated in June 2010.

FUNERAL PLANS TAS

- 1.11 In developing the Funeral Plans TAS, we considered the responses to the consultations mentioned above. We also held discussions with the FRC's Actuarial User Committee.
- 1.12 The Funeral Plans TAS is the fourth Specific TAS to be developed by the BAS. The structure and style used for the Funeral Plans TAS are reviewed in section 2. Sections 3 to 6 review the development of the content.

³ The Funeral Planning Authority is the self-regulatory body established by funeral plan providers.

2 STRUCTURE AND STYLE

INTRODUCTION

- 2.1 The structure and style of the Funeral Plans TAS (and our other TASs) reflect the objectives and characteristics of our standards that are set out in our *Conceptual Framework*⁴. In particular, our TASs are written in a way which favours principles over prescriptive rules, and each TAS has its own specific objectives.

STRUCTURE

- 2.2 Information including the status of the TAS and its relationship with other TASs and with Guidance Notes is included in a rubric that precedes the content of the TAS.
- 2.3 Part A of the TAS covers its purpose and Part B covers how it should be interpreted. Part C sets out its scope. Part D contains general principles applicable to all work within its scope.

STYLE

- 2.4 In drafting the Funeral Plans TAS we have tried to tread the fine line between being clear about the requirements of the TAS and being unnecessarily prescriptive. We consider that, for writing standards, clarity of expression and the substance of the text are more important than the tone in which the text is written. We therefore use the word “shall” to express requirements, and “will need to” to describe the implications of those requirements, in order to provide clarity about what the Funeral Plans TAS requires. The use of these words is consistent with the Funeral Plans TAS’s mandatory nature.
- 2.5 Some of the requirements in the Funeral Plans TAS are for indications or explanations. These terms were chosen because they can be interpreted quite broadly, and therefore the level of detail that they require is a matter for judgement.
- 2.6 The whole of the Funeral Plans TAS is subject to the provision in the *Scope & Authority* that it is only material departures that need be disclosed. There is an explicit statement to this effect in Part B, and the word “material” is therefore used sparingly in the TAS. Similarly, Part B states that the requirements should be interpreted proportionately, and the word “proportionate” is not used in the remainder of the text.

⁴ The *Conceptual Framework for Technical Actuarial Standards*, published in July 2008.

3 PURPOSE OF THE FUNERAL PLANS TAS

PURPOSE

- 3.1 All our standards serve the overall purpose set out in our Reliability Objective, that the users for whom a piece of actuarial information was created should be able to place a high degree of reliance on the information's relevance, transparency of assumptions, completeness and comprehensibility, including the communication of any uncertainty inherent in the information.⁵
- 3.2 Our standards are intended to ensure the quality of actuarial information that the users receive, whoever performs the work. Actuaries performing work that is not designated as being within the scope of our standards may choose to comply with them, and people doing actuarial work who are not actuaries may well be required by others to meet the same standards. The purpose of TASs is to set out requirements that must be met in order to comply with them, not to explain best practice or recommend good practice.
- 3.3 Funeral plan trusts exist to protect a plan holder's money and to provide assurance that, by the time the money is needed, the accumulated amount available is sufficient to meet the costs of the promised funeral. The trustees of a funeral plan trust use information concerning the assets and liabilities of the trust provided by an actuary to support their decisions that aim to enable the funeral plan trust to meet these two objectives. It is essential that the underlying actuarial work is of high quality so that the trustees are able to make good decisions.
- 3.4 The purpose of the Funeral Plans TAS reflects the need for trustees of funeral plan trusts to receive relevant, comprehensible and sufficient information about the assets and liabilities of the trust. We consider that relevant information requires that any calculations required are carried out using measures, methods and assumptions that are fit for purpose; it also requires that any calculations are performed correctly. Any projections of returns from assets and liability outflows are subject to uncertainty and we consider it is important for users that the information provided to them takes this uncertainty into account appropriately (paragraph A.1.2).
- 3.5 As stated in paragraph B.1.7, the interpretation of the Funeral Plans TAS is governed by its purpose. If it appears that any provision in the Funeral Plans TAS conflicts with its purpose, then that provision is being misinterpreted. However, the purpose does not in itself impose any explicit requirements.

⁵ *Scope & Authority*, paragraph 8.

4 INTERPRETATION OF THE FUNERAL PLANS TAS

INTRODUCTION

- 4.1 Part B of the Funeral Plans TAS consists of two sections. The first describes how the TAS should be interpreted and the second defines a number of terms that are used in the remainder of the TAS.

INTERPRETATION

- 4.2 The text in section B.1 of the Funeral Plans TAS is intended to assist practitioners to make judgements about how to comply with the standard. All our TASs are principles-based: they are not intended to foster a tick-box mentality. Awareness of the objectives and spirit of the standard should help practitioners make judgements about compliance.

Materiality and proportionality

- 4.3 Many of the responses to our consultations and the discussions we have had with practitioners indicate that there can be a tendency to interpret our standards as requiring more work and more detailed work than is our intention. In section B.1 we have therefore emphasised:
- the provision in the *Scope & Authority* for immaterial departures;
 - that the standard should not be interpreted disproportionately; and
 - the scope for interpretation in the details of the principles.
- 4.4 We do not consider that it would improve the clarity of the Funeral Plans TAS to repeat the word “material” in every principle. We have therefore explicitly reminded its readers that the standard should be read in the context of paragraph 23 of the *Scope & Authority*, which permits immaterial departures (paragraph B.1.2).
- 4.5 We consider that actuaries (and others complying with our standards) should not act disproportionately, and in particular they should not use BAS standards as an excuse for doing so. We have taken care to ensure that it is not necessary to perform work that is disproportionate to the needs of the users in order to comply with the Funeral Plans TAS, and have explicitly reminded readers of the standard that it should not be interpreted disproportionately (paragraph B.1.3). Proportionality applies to documentation, including work carried out to document compliance with our standards, as well as to information in reports and the work on which the information is based.
- 4.6 There is an important distinction to be made between materiality and proportionality. If a piece of actuarial information is not material, there is no requirement to follow the principles set out in the standard. In this context a piece of actuarial information might be either the result of substantive work performed or information required to be in an aggregate report by our standards. If actuarial information is material, the principles must be

complied with proportionately. For example, in some cases a required explanation might be comparatively brief, or an indication might consist of a short description, while in other cases a detailed explanation or full quantitative analysis might be appropriate.

Actuarial work

- 4.7 The term “actuarial work” is used in paragraph C.1.5. There is no universally accepted definition of “actuarial work” and we consider that it is not possible to provide a precise definition, especially as the actuarial profession evolves and the range of work that it performs changes. We also consider that what constitutes actuarial work is a matter of perception and common sense, based on the nature of the work, the way it is presented and the expectations of users. The key test is whether it is reasonable for any of the intended users to expect the work to involve the application of actuarial techniques (paragraph B.1.5).
- 4.8 In the context of work for the trustees of funeral plan trusts, we consider that the work performed by an actuary in order to determine, calculate and verify the assets and liabilities of the trust is actuarial work. This is because regulation requires funeral plan providers to have this work performed by an actuary and because the trustees expect the actuary to act in a professional capacity as an independent expert in the performance of the work.

Explanations, descriptions and indications

- 4.9 Throughout our standards, including the Funeral Plans TAS, we have used words such as “indicate” and “explain” in order to avoid being prescriptive about the type of analysis or level of detail that is required. In paragraph B.1.4 we have emphasised that the level of detail is a matter for judgement. Where possible, we have illustrated the principles in the Funeral Plans TAS with examples, in order to convey the intention behind the principle.

DEFINITIONS

- 4.10 Section B.2 defines a number of terms used within the text of the standard. Many of the definitions appear in the Generic TASs and also appear in other Specific TASs.

Materiality

- 4.11 We have adopted the same definition of materiality in all our TASs and in our *Scope & Authority*.
- 4.12 Our definition makes it clear that the judgement of materiality must take place within the context in which the work is performed and reported. The context includes the time when the activities take place, so that there is no element of hindsight, but it is not limited to either the time when the work is performed or the time when it is reported (which are not always the same). The definition also introduces an element of reasonableness into the judgement.

Measures and methods

- 4.13 The terms “measures” and “methods” are used throughout our standards. The distinction between a measure and a method was discussed in Appendix A of our *Conceptual Framework*. In actuarial literature relating to the assessment of liabilities, the term “valuation method” is often used to refer to a measure of the liabilities rather than to the method of quantifying them. When the language is used in this way, given the same data and the same assumptions, two different valuation “methods” will (deliberately) arrive at different outcomes. For example, in the context of pension schemes, the method of valuation known as “projected unit” takes into account prospective future salary increases which the method known as “current unit” ignores (by design).
- 4.14 This use of the word “method” is quite different from normal business parlance, in which two different “methods” of valuation would normally be intended to produce similar results. For example, a deferred annuity could be valued either by discounting all future cash flows or by multiplying the pension amount by an annuity factor and then discounting the result. Both approaches would produce the same result but are different methods.
- 4.15 We consider that the use of the term “method” to refer to a measure confuses users and reduces clarity. We encourage practitioners to be consistent with normal business usage and to draw a distinction between “measures” and “methods” as we do in the TASs.

Users

- 4.16 In many cases the use of and reliance on actuarial information are not confined to those paying for its preparation. Regulation⁶ requires that, in order to be excluded from regulation by the Financial Services Authority, the funeral plan provider undertakes to secure that the assets and liabilities of a funeral plan trust are, at least once every three years, determined, calculated and verified by an actuary. The FPA requires registered plan providers who have established a funeral plan trust to provide it with the results of an annual determination, calculation and verification by an actuary of the assets and liabilities of the funeral plan trust. We consider that the trustees of the funeral plan trust and the FPA are intended users of this information. We consider that all the intended users, regardless of their commercial relationship with those responsible for preparing the report, should be able to rely on the information.
- 4.17 The definition of “users” deliberately refers to those who are intended to be assisted by the actuarial information. Those who may have access to the information are not necessarily users. It is only those for whom the report is specifically intended who are users of the information it contains for the purposes of compliance with our standards.

⁶*Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 art. 60.*

5 SCOPE OF THE FUNERAL PLANS TAS

INTRODUCTION

- 5.1 Part C sets out the scope of the Funeral Plans TAS. The scope includes actuarial work that supports the purpose set out in paragraph A.1.2.

GENERAL COMMENTS

- 5.2 Some work might be within the scope of the Funeral Plans TAS by virtue of more than one paragraph. For example, work concerning the determination, calculation and verification of assets and liabilities of a funeral plan trust that is required by the *Financial Services and Markets Act 2000 (Regulated Activities) Order 2001* to be performed at least once every three years is covered in both paragraph C.1.2 and paragraph C.1.5.
- 5.3 The scope of the Generic TASs is set out in the Schedule to our *Scope & Authority*. The Generic TASs apply to all work that is within the scope of any Specific TAS, and so they apply to the work that is within the scope of the Funeral Plans TAS (paragraph C.1.1).

WORK WITHIN THE SCOPE OF THE FUNERAL PLANS TAS

Reserved Work

- 5.4 Our *Scope & Authority* defines Required Work as work carried out in order that the entity commissioning the work complies with regulations, or with some other legal obligation, that require the entity to have the work carried out (or make certain outcomes conditional on the work having been carried out). Reserved Work is defined as Required Work for which the regulations or other legal obligation require the entity in question to commission the work from an individual who holds a prescribed actuarial qualification (usually Fellowship) from the Institute and Faculty of Actuaries.
- 5.5 Regulation⁷ requires that, in order to be excluded from regulation by the Financial Services Authority, a funeral plan provider who has established a funeral plan trust undertakes to secure that the assets and liabilities of the trust are, at least once every three years, determined, calculated and verified by an actuary. This work is Reserved Work.
- 5.6 Reserved Work may also arise as a result of terms in the trust deed governing the funeral plan trust or other contractual arrangements concerning funeral plan trusts.
- 5.7 By its very nature Reserved Work is important to the trustees of a funeral plan trust and so should be reliable. Reserved Work concerning funeral plan trusts is therefore within the scope of the Funeral Plans TAS (paragraph C.1.2). This work is already within the scope of the Generic TASs⁸.

⁷*Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 art. 60.*

⁸ See the Schedule to the *Scope & Authority*.

Determining, calculating and verifying assets and liabilities

- 5.8 Trustees might request that the value of the assets and liabilities of a funeral plan trust are investigated at more frequent intervals than required by regulation. For example, the FPA requires each registered plan provider who has established a funeral plan trust to hold pre-payments to obtain a report from an actuary on the assets and liabilities of the trust at least once a year. This report is part of the information that the FPA relies on when deciding whether or not to renew the plan provider's registration. We agree with the FPA that the regular assessment of assets and liabilities provides important information. The information assists the trustees in managing the trust to meet its twin purposes of keeping client monies safe and to be in a position to meet the costs of funerals as they fall due. We therefore consider that the work should always be reliable. Work to determine, calculate and verify the assets and liabilities of a funeral plan trust is therefore within the scope of the Funeral Plans TAS (paragraphs C.1.5 and C.1.6).

WORK NOT WITHIN THE SCOPE OF THE FUNERAL PLANS TAS

- 5.9 The scope of the Funeral Plans TAS is limited to the determination, calculation and verification of a funeral plan trust's assets and liabilities. It was suggested to us that it should also include work to support the development of a statement of investment principles to be followed by the investment manager appointed to manage the assets of the trust.
- 5.10 The TAS requires reports including an estimate of the value of liabilities to include a quantification of the liability cash flows expected to arise in each of the first ten years following the effective date of quantification (paragraph D.4.3).
- 5.11 TAS R requires reports on the liabilities to state the nature and significance of each material risk or uncertainty faced by the entity in relation to those liabilities (TAS R paragraph C.5.5). The Funeral Plans TAS also requires that these reports indicate the effect of uncertainty on the estimate of the value of liabilities by considering adverse scenarios (paragraphs D.4.6 to D.4.8).
- 5.12 We therefore consider that the report on the value of liabilities provides useful information to trustees to support the development of a statement of investment principles.
- 5.13 Other useful information for the development of a statement of investment principles concerns the expected returns from assets and the risks and uncertainty associated with those returns. This information might be obtained from actuaries with the appropriate competencies or from other investment professionals. We consider that the principles in TAS R are relevant to this information and we would encourage trustees to require their investment advisers to comply with them. However, because this work is not reserved to actuaries and, in other fields, might not normally be provided by actuaries, we have decided not to include this work within the scope of the TAS.
- 5.14 We will review the scope of the Funeral Plans and other TASs regularly.

6 GENERAL PRINCIPLES

INTRODUCTION

- 6.1 Part D of the Funeral Plans TAS contains general principles that apply to all work within the scope of the TAS.

Judgement

- 6.2 Because the Funeral Plans TAS is principles-based, judgement will be required in order to apply it. We consider that such judgement should be reasoned and justifiable (paragraph D.1.2).
- 6.3 Judgement might be needed on many matters when complying with the Funeral Plans TAS, including the measures to be used to determine the value of the assets and liabilities, and how the assumptions are derived including in particular the rates at which funeral costs inflate (paragraph D.1.3). When making such judgements it is important to be guided by the spirit and reasoning behind the principles in the TAS, as well as by how they are drafted (see paragraph 20 of the *Scope & Authority*).
- 6.4 We consider that requiring a justification of all judgements would be unduly onerous, and so require only that it is possible to justify them, rather than requiring justifications to be documented (paragraph D.1.4). We consider that proportionality should apply to the work done in order to demonstrate compliance with the TAS as well as to work done in order to comply. We therefore consider that documentation of compliance should be proportionate to the scope of the work (see paragraph B.1.3).

ASSUMPTIONS

- 6.5 Section D.2 sets out principles concerning the selection of assumptions.
- 6.6 Actuarial work concerning funeral plans involves assumptions about many matters, including:
- asset returns;
 - discount rates;
 - mortality rates and changes to those rates;
 - future levels of inflation applying to the costs of funerals;
 - plan surrender rates; and
 - running costs.
- 6.7 We consider that there are some general principles that should be applied when selecting any assumptions for work concerning funeral plans, and these are covered in paragraphs D.2.1 to D.2.8. There are some assumptions, concerning discount rates and mortality rates, for which we consider more specific principles will ensure more reliable information, and these are in paragraphs D.2.9 to D.2.15.

- 6.8 The principles in paragraphs D.2.1 to D.2.8 are the same as some principles in the Insurance and Pensions TASs. It is possible that some of them might at some time be consolidated into a Generic TAS.
- 6.9 However, it is not necessarily the case that a principle that is capable of being applied to other areas of actuarial work should be so applied. It is possible that a principle that is proportionate in one field of work would be disproportionate in another. The Generic TASs apply to a broad range of actuarial work, and even principles that are both applicable and proportionate to work in insurance and pensions might be inapplicable or disproportionate to work in other areas. The appearance of a principle in more than one Specific TAS does not therefore imply that it should be in a Generic TAS.

General considerations

Overall approach

- 6.10 The Funeral Plans TAS is principles-based, and does not prescribe particular assumptions to be used in specific circumstances, or ranges within which assumptions should lie. Although it has been suggested that more prescription would provide greater consistency, we consider that the most important outcome is that assumptions should be appropriate for the context in which they are used.
- 6.11 In contrast to much work in insurance and pensions, actuaries are responsible for choosing the measures and assumptions used in determining and calculating the assets and liabilities of a funeral plan trust rather than providing information on the basis of which others choose the measures and assumptions to use. We consider that actuarial standards should not limit the measures and assumptions that are chosen but that they should lead to users being in a position to challenge them. We consider the best way of ensuring that appropriate measures and assumptions are used is to ensure that users are well informed, understand the rationale underlying the measures and assumptions used, and understand the implications of those measures and assumptions on the results.
- 6.12 We consider that any prescriptive rules or ranges might not apply in all circumstances, and that they should be based on appropriate research. As our TASs come into operation we will monitor their effect, and keep under review our approach to assumptions.

Selection of assumptions

- 6.13 For the work concerning the calculation of the value of the assets and the liabilities of a funeral plan trust that is required by regulation and that has to be submitted to the FPA, the assumptions are set by the actuary who performs the work. However, users might request additional information in order to understand the sensitivity of the results to changes in assumptions or the funeral plan trust deed might require calculations to be performed using prescribed assumptions. In these cases an actuary performing such work may not be in a position to ensure that the assumptions meet all the requirements of the Funeral Plans TAS and so is not required to (paragraph D.2.1).

- 6.14 Paragraph C.4.9 of TAS R requires that if the assumptions are considered to be materially inappropriate by the person responsible for a report then the report will need to include a statement to that effect, or other explanations.
- 6.15 Different assumptions are appropriate in different circumstances and for different purposes. The reliability and relevance of actuarial information depend on whether the assumptions on which the information is based are appropriate (paragraph D.2.2).
- 6.16 TAS R requires an aggregate report to include sufficient information to enable its users to judge its relevance to the decisions for which they use it (paragraph C.3.1 of TAS R). We consider that the assumptions on which information is based affect the relevance of that information: if the assumptions are inappropriate, then the information is less relevant.
- 6.17 An important factor in judging whether assumptions are appropriate is the evidence on which they are based. We consider that basing assumptions on sufficient relevant information will help to ensure that they are appropriate, but recognise that sufficient information is not always available (paragraphs D.2.3 to D.2.6).
- 6.18 Assumptions should reflect the state of the world at the effective date of the calculations in which they will be used. For work within the scope of the Funeral Plans TAS, it is usual for a number of months to elapse between the effective date of the calculations and the date when the work is performed and decisions made. Material events after the effective date might affect those decisions. Examples of such events include falls or rises in asset values and changes in the economic outlook. For some of the work, accounting or other standards might determine how material events after the effective date should be treated. For other work, if there is a significant period between the effective date of the calculations and the date the work is performed, it might be appropriate to adjust some assumptions to reflect more recent information if it is material (paragraph D.2.7).
- 6.19 TAS R requires a report to indicate any material changes or events that are known by a person responsible for the report to have occurred since the effective date of the data and other information on which it is based (paragraph C.3.13 of TAS R).
- 6.20 There have been instances where one assumption is adjusted in order to compensate for a shortcoming in another unrelated assumption. For example, the discount rate used to value liabilities might be decreased as a proxy for reducing future mortality rates instead of incorporating an explicit assumption for future mortality improvements. We consider that adjusting one assumption in order to compensate for a shortcoming in another unrelated assumption makes information less transparent to users, and is inconsistent with the achievement of our Reliability Objective. Paragraph D.2.8 forbids this practice.
- 6.21 We recognise that there are circumstances in which there may be practical difficulties in determining a material assumption or modelling its impact. For example, there may be insufficient information from which to determine an assumption or a model might not include proper allowance for a particular assumption. Examples of the latter include a model not allowing for the term structure of interest rates. In such circumstances it might be disproportionate

to find more information on which to base the assumption or to develop a new model for the exercise being performed. Rather than attempt to compensate for the shortcoming in information or the model by adjusting an unrelated assumption, we consider it would be more transparent to allow for the assumption as best one can and make an adjustment to the output from the model to reflect either the increased uncertainty or the limitation in the model.

- 6.22 For example, if it is not proportionate to reflect the term structure of interest rates then an average interest rate might be used. An adjustment might need to be made to the output from the model to compensate. TAS R requires that a report shall indicate the nature and extent of any material uncertainty in the information it contains (paragraph C.5.2 of TAS R). TAS M requires that a report which includes information derived from models shall include explanations of any material limitations of the models that have been used and the implications of those limitations (paragraph C.5.8 of TAS M). In the circumstances described, if the shortcoming is material, it should be explained together with its implications and any adjustments made.
- 6.23 We do not intend that paragraph D.2.8 should prevent margins to allow for adverse risk and uncertainty in a set of actuarial assumptions being contained in just one assumption such as the discount rate.

Discount rates

- 6.24 Discount rates are often among the assumptions that have the most significant effect on the results of the work that is being performed. We therefore consider it especially important that users understand the nature and characteristics of the cash flows to which they are applied, how they are derived, and the implications of adopting them (paragraphs D.2.9 to D.2.12).
- 6.25 To enable users to challenge a discount rate, they should be made aware of the nature and characteristics of the cash flows being discounted. For example, the liability cash flows for a funeral plan trust include refunds of pre-payments, funeral costs and running costs. Characteristics of the liability cash flows include the term over which they occur and uncertainty concerning their amount and timing (paragraphs D.2.9 and D.2.10).
- 6.26 The choice of discount rates might depend on the purpose of the exercise for which they are selected. To enable users to challenge a discount rate, we consider that reports should be transparent about the rationale for the discount rate chosen (paragraphs D.2.9 and D.2.11).
- 6.27 The discount rate used in the calculation of funeral plan liabilities might include an allowance for the fact that their liquidity is not the same as that of assets generally traded in financial markets. Plan holders usually have the right to a refund of their pre-payment subject only to a small penalty to allow for administrative costs. Therefore it might be judged that funeral plan liabilities are liquid. On the other hand, there is an implicit penalty if there is no allowance for interest on the pre-payment. This implicit penalty increases the longer the plan remains in force, which might lead to the judgement that funeral plan liabilities are increasingly illiquid. The debate about the validity of allowing for an illiquidity premium when discounting insurance liabilities applies equally when considering the discounting of funeral plan liabilities. In addition, there is uncertainty over the determination of illiquidity

premiums that are implicit within various market instruments. We therefore consider that, to enable users to challenge the discount rate assumptions, transparency concerning any allowance for illiquidity is particularly important as understanding, application and market practice continue to develop (paragraph D.2.9).

Mortality rates

- 6.28 Future rates of mortality depend on both current rates of mortality and the way in which those rates are expected to change in the future. As we explained in our discussion paper on *Mortality*, we consider that these two factors are very different in nature: in principle it is often possible to obtain reliable information about current rates of mortality, whereas it is impossible to know what the future holds in terms of changes to mortality rates. We therefore consider that separate assumptions should be used for base mortality rates and subsequent changes, as the uncertainties in the two are so different (paragraph D.2.13).
- 6.29 In addition, we consider that, although both current mortality rates and future changes to mortality are likely to depend on the makeup of the plan holders in the funeral plan trust under consideration, it is not possible to determine the way in which the make up of the plan holders might affect future changes. It is, however, possible to assess the effect on current rates of mortality, and so we consider that the plan holders of the funeral plan trust should be taken into account when deriving assumptions (paragraphs D.2.14 and D.2.15).
- 6.30 If the funeral plan trust is large enough, and has been operating with a similar membership profile for a long enough period, it may be possible to use its mortality experience in the derivation of the assumptions. Otherwise, adjustments will have to be made to publicly available mortality tables, or mortality rates will have to be derived from a wider base. Information that might be used to adjust standard tables includes the place of residence and the socio-economic profile of plan holders if known.

MODELS AND CALCULATIONS

- 6.31 Section D.3 contains a principle concerning models and the results of calculations.
- 6.32 We recognise that some actuarial information is derived from old models. Documentation of these old models might be incomplete or lost as might be details of the checks that were carried out when they were first developed. The objective of documenting and testing models is to ensure that the model is fit for purpose (TAS M paragraphs C.3.5 to C.3.9). The amount of detail required is a matter of judgement, which should be exercised in a reasoned and justifiable manner, having regard to the context.
- 6.33 TAS M does not require all possible checks to be performed every time a model is used. A model that has been used many times over a long period is likely to require less checking than one that has not been used before. Similarly, TAS M does not require all checks that have ever been performed on a model to be documented. It requires only those checks that are performed in compliance with TAS M to be documented (*TAS M: Significant Considerations* paragraph 5.20).

- 6.34 One way of demonstrating fitness for purpose of old models is through comparison of actual results with those projected by the model over a period of time. We consider that the requirements in TAS M for constructing, performing and documenting checks in order to determine an existing model's fitness for purpose might be met in large part by such a comparison.

Changes in measures, methods and assumptions

- 6.35 Most work within the scope of the Funeral Plans TAS is repeated at regular intervals. Regulation⁹ requires that the assets and liabilities of a funeral plan trust are determined, calculated and verified at least once every three years in order for the plan provider who has established the trust to be excluded from regulation by the Financial Services Authority. The FPA requires registered plan providers who have established a funeral plan trust to have this work performed annually.
- 6.36 TAS R requires the results of two similar exercises to be compared. The comparison covers assumptions, results and other material matters. The comparison of results should include a reconciliation of the results (TAS R paragraph C.5.17).
- 6.37 We consider that, as well as being provided with a comparison, users should be provided with a rationale for any changes. We also consider it important that they understand the impact of the changes on the results. We have included a principle in the Funeral Plans TAS which requires an explanation of any changes and a quantification of the overall effect of all the changes (paragraph D.3.1).
- 6.38 The TAS does not require a quantification of the effect of each change if more than one change is made.
- 6.39 If the previous exercise was carried out by another practitioner it may not always be possible to determine the rationale for the selection of the assumptions. If so, an explanation of the position will need to be given.
- 6.40 We have added the constraint that the exercises should be related because we recognise that there are occasions when work is performed for a similar purpose but the work is not related. We consider that consecutive exercises performed in a regular cycle of such exercises are similar and related (paragraph D.3.2).
- 6.41 We do not consider that the change in the nominal value of a parameter is always a change in assumptions requiring an explanation and quantification of its impact. In some models, assumptions might be linked directly to an externally observed variable. For example the discount rate used in setting annuity prices might be directly linked to an interest rate index. We consider that the assumption is the link to the variable rather than the nominal value of the assumption. Therefore if the externally observed variable changes from one exercise to the next which drives a change in the nominal value of one of the assumptions used by the model we do not consider this to be a change in assumptions (paragraph D.3.3).

⁹ *Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 art. 60.*

REPORTING

- 6.42 Section D.4 contains principles concerning the reporting of the value of assets and liabilities.
- 6.43 It is important that actuaries communicate the results of their work clearly so that trustees of funeral plan trusts and other users can make good decisions concerning the management of the trust. Actuarial work should not be seen as a “black box”. TAS R requires that the style, structure and content of reports are suited to the skills, understanding and levels of relevant technical knowledge of users (TAS R paragraphs C.6.1 to C.6.3).

Liabilities

- 6.44 Regulation of pensions requires trustees of pension funds to choose the economic and actuarial assumptions used in calculating technical provisions prudently. Current prudential regulation of insurers requires an insurer to set mathematical reserves using prudent assumptions. The Solvency II directive will require an insurer to add a risk margin over and above the best estimate of future cash flows in estimating its technical provisions. The International Accounting Standards Board has proposed that insurers should add a risk adjustment to a neutral estimate of the present value of future cash flows in the measure of insurance liabilities in financial statements¹⁰. There is no such requirement for prudence or a margin for risk laid down for the estimation of the value of the liabilities of funeral plan trusts.
- 6.45 We consider that, in estimating the value of the liabilities of a funeral plan trust required to be calculated by the *Financial Services and Markets Act 2000 (Regulated Activities) Order 2001*, judgement should be exercised in order to determine an appropriate allowance for adverse risk and uncertainty concerning the liability cash flows. In exercising this judgement, actuaries should consider the purpose of the exercise and the information that would enable the trustees to make good decisions about the management of the trust.
- 6.46 We also consider that similar judgements will be required in making analogous estimates of the value of the liabilities such as the estimate prepared annually for submission to the FPA.
- 6.47 The TAS does not prescribe whether or how such an allowance should be made nor how big any such allowance should be. Any allowance will be a matter for judgement and might depend on factors such as the nature and term of the investments of the trust, uncertainty concerning mortality improvements and funeral cost inflation and the relevance of the regulatory requirements required in the other situations described in paragraph 6.44. Possible methods include adding provisions for adverse deviation to the assumptions used to project and discount liability cash flows and adding an explicit margin for risk to the present value of an unbiased probability-weighted estimate of the liability cash flows. An explicit margin could be based on a Value at Risk measure or a conditional tail expectation measure. In the interests of transparency, we consider it important that aggregate

¹⁰ ED/2010/8 *Insurance Contracts July 2010*.

reports explain how the estimate of the value of liabilities allows for adverse risk and uncertainty (paragraph D.4.1).

- 6.48 We consider that it is important that trustees understand the degree of any allowance for adverse risk and uncertainty that has been included in any estimate of the value of the liabilities. Without this understanding, it is unlikely that the trustees will be able to make good decisions concerning the management of the trust. It is equally important that any change in the allowance is explained to them. The TAS therefore requires that trustees are provided with a neutral estimate of the liabilities. It also requires an explanation of any change in the relationship to the neutral estimate between consecutive exercises (paragraphs D.4.2).
- 6.49 The trustees of a funeral plan trust usually have the discretion to apply any surplus arising of the value of assets over the value of liabilities to increase amounts payable from the trust to meet the cost of funerals. This provides protection to the plan holder from the impact of inflation on funeral costs in the period between the date of the pre-payment and the funeral the pre-payment purchases.
- 6.50 We consider it is important that trustees understand what allowance has been made for such discretionary increases in any estimate of the value of the liabilities of the funeral plan trust (paragraph D.4.1).
- 6.51 TAS R requires reports to indicate the nature of any future cash flows being quantified, including their timing (TAS R paragraphs C.5.10 to C.5.12). To assist the trustees in their development of an appropriate statement of investment principles to be followed by the investment manager responsible for managing the assets of the trust, they should be provided with a quantification of the actual liability cash flows expected to arise. This will also enable the trustees to monitor the appropriateness of the assumptions and any allowance for risk and uncertainty used to calculate the estimate of the value of the liabilities by comparing the cash flows actually emerging against those that were expected to emerge. This comparison should enable them to challenge the assumptions used in the calculation of the value of liabilities. The TAS therefore requires that the trustees are provided with a quantification of the cash flows expected to arise in each of the ten years immediately following the effective date of the quantification and an explanation of how the estimate of the value of the liabilities is derived from the expected liability cash flows (paragraphs D.4.3 and D.4.4).

Assets

- 6.52 In common with our view on measures and assumptions used to calculate the liabilities of a funeral plan trust, we do not consider that our standards should require that particular types of measures are used to estimate the value of the assets. However it is important that the trustees are provided with an explanation of the measures used and the reasons for their selection so that they can effectively challenge any actuarial judgements made. The TAS also requires that if the measures used are not fair value measures, then the trustees should be provided with an estimate of the fair value of the assets (paragraph D.4.5).

Risk and Uncertainty

- 6.53 TAS R requires reports to indicate the nature and extent of any material uncertainty in the information they contain (TAS R paragraphs C.5.2 to C.5.4). It also requires that, for each material risk or uncertainty faced by a funeral plan trust in relation to work being reported on, reports should state the nature and significance of the risk and explain the approach taken to it (TAS R paragraphs C.5.5 to C.5.7).
- 6.54 For work concerning funeral plan trusts, we consider that additional information on the impact on the trust of adverse scenarios will provide useful information to trustees enabling them to make better decisions concerning the management of the risks to which the trust is exposed. The TAS therefore requires that the effect of uncertainty should be demonstrated by considering the impact of adverse scenarios (paragraphs D.4.6 to D.4.8).
- 6.55 Risks faced by funeral plan trusts include:
- increasing longevity extending the duration between the receipt of the pre-payment and the date of the funeral, increases the exposure of the trust to the inflation of funeral costs which might not be matched by asset returns;
 - if the plan provider no longer sells funeral plans, the trust is exposed to the risk that expenses absorb an increasing proportion of the income received from the trust's assets. Assets might also have to be sold to meet claim payments potentially exposing the trust to market risk;
 - a pandemic unexpectedly requires a liquidation of assets exposing the trust to market risk; and
 - if the trust invests in other than risk free assets the trust is exposed to the risk that returns might be lower than expected.

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