

November 2018

Consultation:

Actuarial Statement of Recommended Practice 1: Financial Analysis of Social Security Programmes

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1 Introduction

- 1.1 The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting transparency and integrity in business. It issues and maintains technical actuarial standards for actuarial work in the UK. The Institute and Faculty of Actuaries (IFoA) requires its members to comply with standards issued by the FRC for technical actuarial work.

Background

- 1.2 The FRC published revised Technical Actuarial Standards (TASs) in December 2016, with an effective date of 1 July 2017. During the review supporting the revision, we identified that technical actuarial work related to Social Security Pensions represents a high level of risk to the public interest. We considered including this work in the scope of *TAS 300: Pensions* but considered that a more appropriate approach was to adopt the model standard, *International Standard of Actuarial Practice 2: Financial analysis of social security programs* (ISAP 2 (2017)) issued by the International Actuarial Association (IAA) to support the application of *TAS 100: Principles for technical actuarial work* to this work¹.

Purpose and audience

- 1.3 The purpose of this public consultation is to seek views on:
- the approach that we are proposing for setting a standard for technical actuarial work supporting UK Social Security Programmes (SSPs);
 - the proposed scope of the standard; and
 - the changes that we have proposed in the adoption of ISAP 2 (2017).
- 1.4 We set out the rationale for the scope, structure and content of the proposed standard in this paper. We also include an impact assessment and a list of questions. The annexes of this consultation contain the exposure draft of the proposed standard and the published model standard ISAP 2 (2017).
- 1.5 Our consultation has been written for those carrying out or reviewing technical actuarial work on SSPs, and those who rely on such technical actuarial work.
- 1.6 The FRC's Actuarial Council has provided advice to the FRC in the development of the proposals in this consultation. In addition, various stakeholders have provided valuable input during its preparation. We are grateful to all those who provided input to us.
- 1.7 We welcome responses from interested parties.

¹ FRC Consultation: Revised Specific TASs, May 2016, paragraph 3.7

2 Format, Compliance and Commencement Date

Introduction

- 2.1 International Standards of Actuarial Practice, ISAPs, are model standards of actuarial practice published by the International Actuarial Association (IAA). They are not binding on any individual actuary unless they are adopted in some form by the actuary's local professional or standard-setting body.
- 2.2 The IAA published the current version of *ISAP 2 (2017): Financial analysis of social security programs*, in 2017. We have agreed that the adoption of ISAP 2 (2017) is the most appropriate approach to setting a technical actuarial standard in the UK for this work. We propose adopting ISAP 2 (2017) with minimal change to the model standard.
- 2.3 We set out in this paper our approach to adoption and the minimal changes we have made to ISAP 2 (2017). In our approach we wish to ensure that the actuarial work on social security pensions is treated no less seriously than the regulation of private sector pensions. We believe that the combination of TAS 100 together with this Statement providing specific "comply or explain" requirements does achieve that. As noted in paragraph 2.13 below, we propose that a compliance statement should always be required for work within the scope of this Statement.

Form of adoption of ISAP 2 (2017)

- 2.4 The *FRC's Framework for developing Standards, Statements of Practice, Codes and Guidance*² sets out the hierarchy of authority and the categories of FRC's policy publications.
- 2.5 Documents issued under the category for policy publications which are on a "comply or explain" basis are typically called Statements of Recommended Practice (SORPs). The level of compliance required and the prescriptive nature of ISAP 2 (2017) mean that a SORP is the most appropriate form of adoption. ISAP 2 (2017) uses "should" statements throughout which are on a "comply or explain" basis rather than a mandatory "must" basis. It also provides illustrative examples as non-mandatory guidance using "may" statements.
- 2.6 Additionally, the style of ISAP 2 (2017) is more prescriptive and detailed than the principles-based approach and style of the TASs. This style is helpful for a document that expands a TAS for application in a specific practice area which is the role of SORPs.
- 2.7 We considered whether we should strengthen the provisions of ISAP 2 (2017) to mandatory requirements and remove the explanatory guidance to include some additional provisions in TAS 300 for this work. However, on balance we decided that this "gold-plating" was not necessary as this is a narrow area of work and the supporting detail is helpful to practitioners in applying TAS 100.
- 2.8 Therefore, we intend to adopt ISAP 2 (2017) as an Actuarial Statement of Recommended Practice (ASORP). We intend to include the prefix "Actuarial" to make

² [FRC website](#)

it clear that it is issued to support the TASs and for the avoidance of confusion with accounting or auditing SORPs.

Structure of ASORP1

- 2.9 We have adopted a similar structure to the TASs which ensures that ASORP1 is clearly aligned with the overall framework for technical actuarial standards in the UK. Therefore, ASORP1 consists of the following sections.

Purpose

- 2.10 The purpose of ASORP1 is to promote high quality technical actuarial work in relation to SSPs. It supports the application of TAS 100 to this scope of work.

Scope

- 2.11 The scope of the SSP is technical actuarial work supporting the financial analyses of SSPs. This includes when actuaries are performing or reviewing, advising on, or opining on the financial analysis of a SSP. We have amended the scope of ISAP 2 (2017) in its application to the UK. We discuss this in Sections 3.3 – 3.6 below.

Compliance

- 2.12 Technical actuarial work related to SSPs is covered by TAS 100. The exposure draft makes clear that this remains the case. This new ASORP does not replace TAS 100 for this work, rather it is supplementary to TAS 100. The exposure draft also makes it clear that in the event of a conflict between ASORP1 and the requirements of TAS 100, the latter should be followed.
- 2.13 As ASORP1 supports TAS 100 for an area of technical actuarial work identified as high risk to the public interest we have included a requirement for a compliance statement with TAS 100 and ASORP1 for technical actuarial work falling within the scope of ASORP1. This is consistent with the approach for work in scope of TAS 300.
- 2.14 We have proposed a commencement date of 1 September 2019 for the application of ASORP1 in the expectation that the introduction of this ASORP will not require a significant level of initial preparatory work. This assumes an expected publication date of the final standard of end May 2019 and a three-month implementation period.

Appropriate practices

- 2.15 Our intention is to adopt ISAP 2 (2017) with minimal change. The changes we propose are changes such as formatting and structural changes to achieve consistency of style and language with the TASs, an amendment to the scope for application in the UK and removal of some requirements where they are covered elsewhere. The changes that we have proposed are set out in Section 3 and in Annex 3 of this paper.

1. Do you agree that a compliance statement should always be required for work within the scope of ASORP1?
2. Do you agree with the commencement date of 1 September 2019?

3 Adoption of ISAP 2 (2017) for application in the UK

Introduction

- 3.1 Our intention is to adopt ISAP 2 (2017) with minimal change. There are some changes that are required to adopt the ISAP for application in the UK and to ensure consistency with the style and language used in the TASs. The changes that we have made are set out in the following paragraphs. A detailed explanation of the changes is set out in Annex 3.
- 3.2 We have also retained a requirement in ISAP 2 (2017) related to both unfunded and funded schemes and we are seeking views on this decision in this consultation.

Scope of Application

- 3.3 SSP is defined in ISAP 2 (2017) as a programme primarily for provision of benefits in old age which satisfy a set of criteria (see draft Glossary entry in Section 3.16 below). Other benefits are included in scope only if they are subsidiary to this primary objective.
- 3.4 A unique feature of the UK system is the existence of the Pension Protection Fund (PPF) and other compensation programmes. The definition of SSP contained in ISAP 2 could be interpreted to include the PPF and possibly some other compensation schemes. We consider that the scope of ASORP1 should be restricted to cover social security benefits on retirement which are paid for by taxation. We have therefore decided to amend the definition of SSP in ISAP 2 (2017) to require that eligibility for such programmes depends on National Insurance Contribution payments or credits.
- 3.5 We will consider whether changes or additions need to be made to the TASs to reflect technical actuarial work done in relation to compensation schemes, including the PPF.
- 3.6 We have considered whether the definition of SSP includes other social security programmes or auto-enrolment and have concluded that such work is not within the scope of the definition of SSP in ISAP 2 (2017) and we don't consider there is a requirement to extend the definition.

3. Do you agree with the proposed scope of ASORP1?

Consistency of style with the TASs

- 3.7 We have adopted the style of the TASs in the adoption of ISAP 2 (2017). The structural changes have been set out in Section 2 above. We set out the changes related to style in the following paragraphs.
- 3.8 The TASs are written in the passive voice setting out the action required. We therefore changed the structure of the sentences in ISAP 2 (2017) to reflect this but without changing the substance of the requirement.
- 3.9 ISAP2 (2017) makes several references to an actuarial report. The TASs include requirements related to "Communications" without specification of the format of those communications. We have therefore changed references to reports in ISAP 2 (2017) to requirements for Communications in ASORP1.
- 3.10 We have set out key requirements in the opening paragraph of each section 2.1 to 2.4 of the exposure draft in emboldened text. We have introduced this formatting to

improve the clarity of communication and to provide consistency with the style of the TASs. The remainder of the requirements support these key requirements.

4. Do you agree with the drafting changes in ASORP1 to ensure consistency with the TASs?

Glossary

- 3.11 The adoption of ISAP 2 (2017) has introduced three new terms to the Glossary: financial analysis, financial stability and Social Security Programme.
- 3.12 The term used throughout ISAP 2 (2017) to refer to the technical actuarial work in scope of the model standard is “financial analysis”. We considered whether we should change this term to “actuarial valuation”. However, we understand from our stakeholder engagement that the term “financial analysis” is more appropriate as it includes the broader activities undertaken. These may include a valuation discounted to a specified date or alternatively projected cash flows or determination of a contribution rate.
- 3.13 We have therefore retained the term “financial analysis” and the following definition will be added within a Glossary to ASORP1.

“Financial Analysis

Any formal actuarial analysis. What constitutes a formal actuarial analysis is a matter for the practitioner’s judgement but might include work required by law and work requested by the user to inform decisions. A financial analysis might include but is not limited to:

- Determination of discounted point in time values,
- Projection of cash flows and associated fund values, and
- Determination of future contribution rate(s).”

- 3.14 ISAP 2 (2017) also introduces the term “financial sustainability” and we have adopted this term unchanged in the Glossary as follows:

“Financial Sustainability

Financial sustainability of a **SSP** relates to its continuous capacity to support the benefits offered by the **SSP** when considering the applicable financing rules and the future demographic and economic environment in which it will operate.”

- 3.15 ISAP 2 (2017) also includes a definition of a Social Security Programme. As noted above we have adapted the definition of SSP from ISAP 2 (2017) to require eligibility through the payment or crediting of National Insurance Contributions. The italics in point 2 below indicate where we have made changes to the ISAP 2 (2017) definition.

- 3.16 We have therefore added the following term to the ASORP1 Glossary.

“Social Security Programme

A programme with all the following attributes regardless of how it is financed and administered:

1. Coverage is of a defined segment, or all, of the population, often on a compulsory or automatic basis;

2. Benefits are provided to, or on behalf of, individuals *with eligibility for benefits dependent on the payment by (or crediting to) the individual of National Insurance Contributions*;
3. The programme, including benefits and financing method, is prescribed by law;
4. The programme is not financed through private insurance;
5. Programme benefits are principally payable or delivered upon old age, retirement, death, disability, and survivorship, and the following benefits (if provided) are only ancillary to the principal benefit(s):
 - i. Unemployment benefits;
 - ii. Medical expenses;
 - iii. Benefits provided due to work-related injuries, work-related death or occupational diseases;
 - iv. Short term social assistance benefits (e.g. food stamps);
 - v. Benefits provided for disaster relief (e.g. insurance, or recovery funding, for flood, drought, hurricane/typhoon, earthquake/tsunami); and
 - vi. Financial insurance or financial guarantees (e.g., for loans, bank deposits, pension payments, financial securities, insurance payments from insolvent insurers).”

5. Do you agree with the proposed Glossary terms?

Changes to the requirements of ISAP 2 (2017) in adoption for UK

3.17 In adopting ISAP 2 (2017) for application in the UK, we have excluded the points related to the independent expert review and the actuarial opinion. We set out our rationale for our approach below.

Independent Review

3.18 Paragraph 2.5 of ISAP 2 (2017) sets requirements relating to an independent expert review of the technical actuarial work undertaken. The first two sub paragraphs simply define the possible nature of the review and impose no specific requirements on the practitioners who have performed the work. The third sub paragraph contains a requirement for the actuary who prepared the financial analysis to cooperate with the independent expert.

3.19 These paragraphs do not place any technical requirements on either the actuary who has prepared the financial analysis, or the independent expert. Therefore, we consider that this is not a matter for a technical actuarial standard and have excluded it from ASORP1.

3.20 A further consideration was the concern that the requirement for co-operation could result in an unintended consequence as there may be circumstances when it is not

appropriate for the practitioner to share data and calculations with independent reviewers.

3.21 We have therefore excluded Paragraph 2.5 of ISAP 2 (2017) in drafting ASORP1.

Assumptions and Methodology Mandated by Law

3.22 Paragraph 2.6 of ISAP 2 (2017) requires the actuary to apply assumptions mandated in legislation as though the assumptions were “prescribed by the principal or another party”. Paragraph 3.5 of TAS 100 already refers to assumptions set by others and further requires the actuary to comment if the assumptions are not considered to be reasonable.

3.23 We have therefore excluded Paragraph 2.6 of ISAP 2 (2017) in drafting ASORP1.

Communications

3.24 Paragraph 3.2 of ISAP 2 (2017) sets out a specific requirement for a formal actuarial opinion. We have removed this requirement because our view is that the content of this opinion is already included in the Communication requirements of TAS 100, supplemented by the Communication requirements of ASORP1. There is therefore no need to specify a requirement or format.

“Neutral” assumptions

3.25 Paragraph 2.3 of ISAP 2 (2017) specifies that assumptions chosen by the actuary should be “neutral assumptions” and defined this term as “*Neutral assumptions are such that the actuary expects that the resulting projection of the SSP experience is not a material underestimate or overestimate.*”

3.26 As part of the revision to the Specific TASs we removed the term “neutral” and use the term “best estimate” instead without definition. We have therefore adopted the same approach for ASORP1 and have replaced the term “neutral” with “best estimate” and removed the definition.

3.27 Paragraph 2.3.5 of ISAP 2 (2017) covers the situation where the assumptions contain margins. This ASORP requires the actuary to identify margins compared to the best estimate assumptions and explain (but not necessarily quantify) the level of prudence in the results.

6. Do you agree with the proposed changes to ISAP 2 (2017) in adopting it for the UK?

Other ISAP 2 (2017) specific considerations

3.28 We have retained the remainder of the requirements from ISAP 2 (2017). There are two of those requirements where we are seeking views.

Consistency of the method of financial analysis with the funded status of the SSP

3.29 Paragraph 2.4 of ISAP 2 (2017) comments on consistency of the method of financial analysis with the SSP financing method. This paragraph covers both unfunded and funded SSPs. In the UK the State Pension is unfunded and therefore much of this paragraph is redundant.

3.30 We considered removing this paragraph, however after consideration and consultation with stakeholders we decided to leave the paragraph intact. This was because it has no effect while state pensions remain unfunded and therefore there is no cost of leaving it extant. Further, it provides for the possibility of the introduction of a future state pension which is pre-funded.

Margins for prudence

3.31 Paragraph 2.3.5 of ISAP 2 (2017) requires that if margins are included in the assumptions that the basis and rationale for the margins are communicated and that the relationship between the result both including margins and best estimate assumptions should be explained.

3.32 TAS 300 includes a provision for technical actuarial work related to Scheme Funding that requires communication of sufficient information to enable the user to understand the level of prudence in the assumptions and the resulting actuarial information.

3.33 We have therefore retained this requirement in ASORP1 as an equivalent requirement for financial analysis related to SSPs.

7. Do you agree with the rationale for retaining these requirements in adopting ISAP 2 (2017) for the UK:
- a) reference to both funded and unfunded SSP's?
 - b) requirement to disclose margins for prudence and their rationale and to explain the difference in results both with and without margins?

4 Impact Assessment

Introduction

- 4.1 In this section we consider the impact of the proposed introduction of ASORP1 and consider both the benefits and costs.

Benefits

- 4.2 There are over 30 million people employed in the UK and therefore earning eligibility for state pensions through the payment of National Insurance Contributions. In 2013 there were 12.6 million people in receipt of state pensions. The current number is expected to be higher. The financial analysis supporting these pensions is the subject of this standard.
- 4.3 The revised framework for technical actuarial standards is proportionate and risk based. The proposed statement supports this framework in a proportionate manner. It will benefit users by setting a minimum standard of recommended practice which can be expected for all technical actuarial work related to SSPs. We have identified that technical actuarial work related to SSPs poses a high degree of risk to the public interest.
- 4.4 From a practitioner perspective, the benefits from these changes is to support them in their application of TAS 100 in this area of work.

Costs

- 4.5 Actuarial work on SSPs in the UK is performed almost exclusively by the Government Actuary's Department (GAD). In discussions with representatives from GAD, we understand that their current processes are broadly consistent with the requirements of ISAP2 (2017).
- 4.6 In establishing ASORP1, we have made minimal changes to ISAP 2 (2017) and therefore we expect any impact to be minimal. We therefore do not expect that the transition cost will be material. We estimate that the initial costs to review internal processes and to provide training and time for embedding in practice to be less than £20,000. We estimate that additional ongoing costs will be minimal.

8. Do you agree with our impact assessment?

9. Do you have any other comments on our proposals?

5 Invitation to comment

Questions

5.1 The FRC invites the views of those stakeholders and other parties who wish to comment on the content of this document. In particular, we would welcome responses to the questions below. Please provide reasons for your response where appropriate and provide an alternative approach where you disagree with our proposals.

- 1 Do you agree that a compliance statement should always be required for ASORP1?
- 2 Do you agree with the commencement date of 1 September 2019?
- 3 Do you agree with the proposed scope of ASORP1?
- 4 Do you agree with the drafting changes in ASORP1 to ensure consistency with the TASs?
- 5 Do you agree with the proposed Glossary terms?
- 6 Do you agree with the proposed changes to ISAP 2 (2017) in adopting it for the UK?
- 7 Do you agree with the rationale for retaining these requirements in ISAP 2 (2017) in adopting for UK:
 - a) reference to both funded and unfunded SSP's
 - b) requirement to disclose margins for prudence and their rationale and to explain the difference in results both with and without margins?
- 8 Do you agree with our impact assessment?
- 9 Do you have any other comments on our proposal?

Responses

- 5.2 A template for responses is included on the [FRC website](#).
- 5.3 Comments should be sent electronically to ASORP1@frc.org.uk. Comments may also be sent in hard copy form to:

The Actuarial Policy Team
Financial Reporting Council
8th Floor
125 London Wall
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- 5.4 Comments should reach the FRC by **31 January 2019**.
- 5.5 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes

(these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 2018 (DPA) and the Environmental Information Regulations 2004). The FRC will process any personal data in accordance with the DPA. Information on the FRC's privacy policies are available at <http://www.frc.org.uk>.

- 5.6 All responses will be regarded as being on the public record unless confidentiality is expressly requested by the respondent. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure. We do not edit personal information (such as telephone numbers or email addresses) from submissions; therefore, only information that you wish to publish should be submitted. If you are sending a confidential response by e-mail, please include the word "confidential" in the subject line of your e-mail.
- 5.7 We aim to publish non-confidential responses on our website within ten working days of receipt. We will publish a summary of the consultation responses, either as a separate document or as part of, or alongside, any decision.

6 Annexes

Annex 1 Exposure Draft

Annex 2 International Standard of Actuarial Practice 2 – ISAP 2 (2017)

Annex 3 List of changes between ISAP 2 (2017) and ASORP 1

Annex 4 Consultation Response Form



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