



Our response to the Morris Review of the
Actuarial Profession: Interim Assessment

February 2005



Mellon

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1. Introduction and overview – the importance of proportionality

The Human Resources & Investor Solutions division of Mellon welcomes the opportunity to comment on the contents of the Morris Review of the Actuarial Profession: Interim Assessment. As an employer of over 30 qualified Actuaries providing actuarial and related advice to trustees and sponsors of pension arrangements and other employee benefit plans, both in the United Kingdom and overseas, we are regularly and intimately involved in issues concerning the workings of the actuarial profession.

We are not involved in the workings of insurance companies, so our comments relate exclusively to the work of actuaries in the context of advice and other services in respect of occupational pension schemes. Our detailed responses below therefore concentrate on some key issues that we regard as critical to the market in which we operate.

As the Interim Assessment correctly notes, there is currently widespread concern that the population's long-term savings are substantially below the level required to meet the population's needs. With State-provided benefits in the UK at one of the lowest levels of any country in the European Union, the importance of "private" arrangements is correspondingly increased. Given the close involvement of actuaries in such arrangements to date, it is understandable that some people consider the current overall position of historically low scheme funding ratios and reduced benefits that can be bought by funds actually held (by schemes in wind up) to have been largely a result of a failure of members of the actuarial profession.

However, it should be remembered that pension schemes are long-term undertakings, and one should be careful about drawing too many conclusions about the general state of schemes and the role played by any one group, based on a view of the position over a relatively short period – especially when that period has seen an unprecedented convergence of negative factors affecting schemes. We agree that there are criticisms that can be made about the contributions to the position by some aspects of the profession, but we would urge that any resulting recommendations made by the Review are proportionate to the true role of actuaries, based upon a judgement of the true contribution made by them in the past, and likely to be made in the future.

Under the concept of proportionality, it should be noted that the shortfalls in the amount of assets needed to meet the cost of securing annuities and deferred annuities found in a large number of pension schemes going through a wind up process would still exist (albeit to a different degree) had:

- scheme funding been on a stronger basis (with greater employer contributions)

- scheme sponsors, trustees and members recognised (to a greater degree) the lack of guarantee inherent in defined benefit pension schemes
- the Government not removed the tax credits on UK equity dividend payments
- longevity not improved
- no compulsory increases to benefits applied; or
- there been a more plentiful supply of bulk annuity providers.

As well as actuaries contributing to the present situation of low funding ratios and underfunded schemes on their wind up, we trust that suitable consideration is given (and appropriate weight applied) to the part that the Government and sponsoring employers have played. For example:

- the flawed Minimum Funding Requirement (MFR) legislation led to both a perception that schemes were adequately funded and provided a funding yardstick that was inappropriate. Suitable changes were not made quickly enough following the removal of tax credits on dividends, nor were changes made when it was recognised that mortality improvements were greater than anticipated, or that we were in a sustained “low inflation” environment. The whole process for changing the MFR to an appropriate standard has taken far too long
- some of the disclosure requirements such as the content of benefit statements have led to a false sense of the security of benefits
- the priority order on the wind up of pension schemes was inappropriate and only recently changed to be more generous towards deferred members; and
- ultimately, it is generally sponsoring employers that set contribution rates to pension schemes.

In addition, recognition needs to be given to the poor and often misleading reporting by the press of the facts of cases, which has helped lead to a lack of confidence for savers.

We caution that proper consideration be given to the practical implications of any changes that might be recommended by the Review. There has been a persistent trend over the past decade to pitch the level of pensions-related regulations at “absolute best practice”. Whilst this is a fine standard to aim for, there are important cost implications from such an approach. The result is often that only the largest schemes are able to absorb these additional costs comfortably, and consequently the costs exacerbate the funding difficulties currently faced by other schemes. Only those regulations that are an absolute requirement for good governance should apply. This is an important issue, given that approaching 90% of defined benefit and hybrid schemes have fewer than 1,000 members, and over 60% have fewer than 100 members.

Although it must be correct to aspire to the highest level of protection for scheme members, it must also be accepted that it is simply not practical (or even possible without Government

underwriting) to guarantee absolute protection in all circumstances. Once the cost of attempting to do so passes a critical point, the goodwill of scheme sponsors, which is vital to the continuation of the non-State provision required to ensure adequate overall provision in the UK, will be lost. The consequences of such an eventuality would be both disastrous and far-reaching.

We therefore urge that every proposal for change be carefully focused on achieving a clearly-defined objective, and tested against the benchmarks of proportionality and effectiveness for its defined purpose.

2. Responses to the Review's suggested options

We have used the Chapter headings as set out in the Interim Assessment.

Chapter 2 – The market for actuarial services

Increasing competition

The Interim Assessment provides information on the share of actuarial appointments to the 750 largest UK occupational pension schemes. We do not believe that the number of firms serving this market (25) should be a concern in itself. However, the market share of the top three does show a lack of appropriate diversity in service providers which, in other business areas, would be regarded as potentially unhealthy.

We do not believe that the availability of professional indemnity insurance cover (Option 1) has been a significant barrier to entry or choice to date, but the position could change in the future. Nor do we agree that the unbundling of the provision of advice related to statutory roles from other types of advice would open up the market to greater competition (Option 2). For all but fully insured Defined Benefit schemes, there is presently the option of unbundled advice – the market has simply chosen not to take it on the whole. Indeed it should be noted that many of the “Actuarial firms” employ those with wide-ranging investment skills and experience in their investment consulting practice – not just actuaries. Presently there is no good reason why non “Actuarial firms” should not carry out much of the investment consulting and advisory work.

However, we do believe that conflicts of interest (see our response to public interest and accountability – pensions) and improved Scheme Governance (see our response to greater scrutiny of performance) will lead to a redistribution of providers of advice. Time will tell whether it is simply a recycling of business between the largest three providers or will decrease their market share.

Increasing market testing

a) Greater scrutiny of performance

We agree that there is a problem with the level of understanding by many trustee bodies of the advice given by their actuary. We also agree that this lack of understanding has been a contributory factor (although not perhaps as important as the Review document suggests) in the problems currently being faced by some schemes and their sponsoring employers.

Although undoubtedly there is always room for improvement in actuaries' communication abilities, the problems are by no means entirely due to the actuarial profession. The issues that actuaries have to take account of in the course of their work are by their nature complex

and are difficult for many lay-people to understand. This is demonstrated by the difficult and lengthy training that actuaries have to undergo.

In addition, the cycle for actuaries to review and report to trustees – particularly in respect of small and medium-sized schemes, which generally tend to have less frequent dialogues with their actuaries than the trustees of the larger schemes – means that in many cases when the actuary arrives to present his or her report and recommendations to the trustee board, board members will have changed since the last formal report, and those that have continued in post have lost much of the detailed understanding they acquired the previous time; this means that the education process required from the actuary effectively has to start afresh. Given these facts, it is a testament to the advances made in the actuaries' overall communication abilities in recent years that the current level of understanding is as high as it is.

The proposals for contact with trustees through the requirement for annual certification of the scheme's continued compliance with the new statutory funding standard due to be announced later this year, should further help trustees to maintain their knowledge of actuarial matters.

It is not clear to us, however, that this lack of understanding of the actuarial processes is of itself causing a lack of effective competition for actuarial services, thereby prejudicing schemes' abilities to meet expectations. In respect of the options set out in the Review paper, therefore, we consider that peer review (Option 4 – which we take to mean external, since peer reviewing already takes place within a firm) would lead to unnecessary expense for most schemes. The concept of “performance measurement” is superficially attractive, but it is difficult to see what criteria would be used here; nonetheless, if suitable criteria could be devised, then encouragement (but not compulsion) of their use might be helpful in some schemes.

Clearly, increased education/expertise of users (Option 1) should always be sought. We anticipate that this will be addressed to some extent by the new trustee knowledge and understanding requirements under the Pensions Act 2004. We suggest that the Review body works closely with the new Pensions Regulator, who is currently drafting a Code of Practice on this subject.

We can see some merit in the concept of regular formal reviews of advisers (Option 2). Although the Combined Code on Corporate Governance gives no direct guide on the regularity of review of advisers, many organisations do have programmes in place to ensure that reviews do happen. There is no compelling reason why such reviews cannot also take place for pension scheme advisers. It may be appropriate for the new Pensions Regulator to have a role in issuing appropriate guidance on the subject. However, the large cost of reviews (both in terms of time for trustees and for advisers, which ultimately will be passed on to schemes) should not be overlooked in setting appropriate standards.

We believe that with a continuing move toward the appointment of separate advisers for the employer and the trustees (driven by higher standards of corporate governance and the recent Pensions Act) we will see much greater scrutiny of advice as the employer challenges or questions approaches suggested by trustees.

b) Improving user understanding

This issue has been largely dealt with by our comments in the section immediately above. Clearly, especially given that this is already a requirement of the Pensions Act 2004, we favour Option 1 (increasing user knowledge and understanding, provided the requirements are proportionate).

There is no objection to making the profession's guidance notes generally available, although the potential benefits from such an action may not be achieved in practice, since we suspect that most trustees (for a variety of reasons) would not invest the time and effort needed to read and understand them.

In the future there is likely to be an increase in the use of professional trustees, so Option 3 will probably happen anyway as part of a natural process, driven to some extent by market forces where appropriate, leaving no need to introduce any specific new requirements in this respect.

Improving clarity of advice

In view of the points made above, we think that leaving the matter to market forces made more effective by the improved understanding of trustees (Option 1), will be sufficient, and provide the most appropriate and cost-effective solution.

It should be recognised that progress is being made with regard to improved communication (Option 2) and clearer disclosure of actuarial advice (Option 3) with changes in the profession's training and education process and the introduction of a Code of Practice on Scheme Funding under the Pensions Act.

Chapter 5 – Public interest and accountability

Reporting and whistle-blowing

There is certainly a lack of clarity in some circumstances as to whether a Scheme Actuary has a duty to whistle-blow. One of the reasons for this is the breadth of the issues that the duty potentially covers. This lack of clarity is unacceptable, considering the (personal) penalties on actuaries for failure to comply. It is also unacceptable from the perspective of scheme members (and the public at large) who would expect that where a whistle-blowing duty exists to protect member interests, it will actually achieve that objective in practice.

However, the type and extent of such a duty should be set with its wider consequences in mind. The greater the duty, and the wider its area of responsibility, the greater will be the involvement that the actuary will need to have in respect of the scheme – with obvious cost consequences.

If accountants and others already have a wide remit in these areas, there seems little point in expanding the whistle-blowing duty of the actuary. Also, in view of our comments in the next section below about conflicts of interest, and the need to separate in the following section, the whistle-blowing duty should properly reflect the role that each particular actuary plays in respect of that scheme.

It follows therefore that we do not consider Option 3 to be appropriate. Option 2 appears to contain inconsistencies between the tests of the actuary's actual or imputed beliefs that may cause practical difficulties. Option 1 therefore seems to be the most appropriate approach to coping with the problems currently faced by actuaries in this area; it is also the option that fits most closely with the flexible, less prescriptive regulatory approach to be adopted by the new Pensions Regulator from April 2005.

It should be recognised, though, that whatever process had been in place for whistle-blowing to date, it is unlikely to have avoided ongoing pension schemes being underfunded or schemes in wind up with insufficient assets. Therefore, the references to proportionality mentioned earlier are particularly pertinent here.

Pensions

This section essentially concerns conflict of interest considerations, and is rapidly developing into one of the most important areas affecting the actuarial profession's work going forward. We believe that the most common current position will no longer be tenable: that is where the actuary normally acts for both the trustees and the sponsoring employer, with the proviso that, if an obvious conflict situation arises, the actuary will give up one of the appointments (usually the company one where the actuary is appointed as the trustees' Scheme Actuary).

There are already many situations where the actuary has a potential conflict of interest, and these will increase with the provisions of the Pensions Act 2004 (for example, in the area of setting contributions). However, the greatest potential problem is posed by the fact that in many instances the actuary will find him or herself in a conflict situation before they are able to do anything about it. That will place them in an impossible situation.

One clear example of this is if the actuary to a defined benefit scheme that is not funded to the full buy-out cost level is approached by the sponsoring employer and asked what the effects would be if the employer were to stop benefit accrual under the scheme. At that moment, the actuary has a dilemma. Part of his or her advice to the employer must be to consider the ways

of avoiding the buy-out liability falling immediately, yet at the same time he or she must inform the trustees that he or she is advising the employer on this issue, and advise the trustees on how to counter this advice to the employer. The situation is exacerbated in cases where the same individuals are both trustees and financial decision-takers for the employer.

Although we recognise that the appointment of separate actuarial advisers to the trustees and employer will increase costs to the company of running schemes, we nevertheless believe the issue to be so fundamental that it will become a necessity in certain circumstances. At the same time, we also recognise that it will take some time to effect the change across the entire range of schemes, so this must be done gradually. This means that at the moment Option 1 is maintained as a temporary measure, with a movement through to Option 3 as soon as practicable. Option 4, although a preferred route from a purist's point of view, is simply not workable for smaller schemes and therefore may be a good practice approach only.

We do not believe that Option 2, whereby the trustees decide whether there is a conflict, is workable, since they may not always be aware of the work a Scheme Actuary is carrying out for an employer, and would be reliant on the Scheme Actuary passing them information.

Chapter 6 – Education and CPD

The syllabus and governance

Given the size of the profession, we believe that Option 2 would introduce too great a cost burden, which would ultimately be passed on to pension funds. Option 1 is our preferred solution.

Examinations issues

Our preferred solution is to have some reform of the existing governance structure (Option 1) but with the involvement of an independent oversight body. We do not see the need (nor is it financially viable) for the continual involvement of such an oversight body in the setting and marking of exams. However, that does not mean that the profession should be slow in seeking external advice or additional help both in setting and marking exams. For example, there is no reason why some of the subjects need be marked by qualified actuaries alone – members of the teaching profession may be available to help. Option 2 is not financially viable.

Broadening actuarial education provision

We see no reason why there should not be a wider provision and accreditation of degrees that grant exemptions, nor post-graduate fast-track conversion courses. The market-place should be the driver, because ultimately it will be up to commercial employers to decide whether individuals with such training are a valuable resource to them. Of course, such “post-

graduate” individuals would potentially have to accept that the return on their study investment may take some time to emerge through earnings levels.

Continuing professional development

We believe that an amalgam of the options mentioned for both the CPD Scheme and its monitoring is appropriate. For the scheme itself, it needs clearer definition and not to be a box-ticking exercise. Additionally, greater CPD for reserved role-holders should be required and also some external involvement to ensure a more outward-looking approach is in place. Overall, Option 1 should apply where the profession sets out the objectives, but the strengthening envisaged under Option 2 is appropriate, as is the link with other disciplines required (Option 3) and some sort of overview by a mixed group of individuals to ensure varying views to that of actuaries alone is taken (Option 4).

In terms of monitoring, the profession should have responsibility, with the changes currently envisaged (Option 1). However, it will be good practice for the profession to seek some independent review of their monitoring procedures to ensure that they are appropriate.

Chapter 7 – Standard-setting

Actuarial standard-setting

In the area of standard-setting, it is important that the responsible organisation contains appropriate representation from outside the profession. Such representation needs both to be and to be seen by those outside the profession as effective. We also believe that the profession itself, with appropriate outside representation, is best placed to set and maintain actuarial standards that are appropriate to the work performed by its members, and conform to the reasonable expectations of the public.

In addition, we consider that, given the relatively small number of actuaries (as recognised in the Interim Assessment document), standard-setting by a group within the profession best accords with the theme of *proportionality* running throughout our response. We therefore favour Option 1, a quasi-independent Actuarial Standards Board.

Chapter 8 – Scrutiny and discipline

Scrutiny of actuaries in pensions

Once again, there is a clear issue of balancing costs against benefits here. Actuaries are highly-experienced and highly-qualified professionals, with in many instances a personal responsibility for the consequences of their work. In considering possible new provisions for scrutiny and discipline, it is necessary first to be clear as to the intended aim of such provisions, which in turn first requires agreement as to the aspects of actuaries’ practice that

are currently deemed unsatisfactory; it also requires an assessment of the overall monetary cost of those unsatisfactory practices.

As mentioned earlier in this response, we do not believe it fair to lay all the blame for the current plight of UK pension schemes at the door of actuaries. There are many other parties involved and, at the end of the day, the Scheme's Actuary is only an adviser and cannot direct how the scheme will be run, or what contributions will be paid. Therefore, the compulsory inclusion and auditing of the long-term liabilities within the scheme's financial statements (Option 2) would appear to be inappropriate, involving, as it would, further cost and potential for conflict through differing views of members of different professions. However, included in the scheme's financial statements is the Actuarial Statement for the purposes of Regulation 30 of the Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996. No audit of this statement takes place, but it does show that the Scheme has had a valuation of long-term liabilities carried out by a suitable professional. Following the introduction of the Statutory Funding Objective (SFO) in the Pensions Act and a requirement for annual funding assessments, it should be possible to either slightly amend the scope of this Statement to include the annual reassessment, or alternatively replace it with some information required under the disclosure requirements of the SFO. We await drafts of the Code of Practice being issued by the new Pensions Regulator.

There is always a clear case for some degree of peer review, since even the best professional will benefit from the fresh view of another. To be most effective, though, the review should be focused and conducted by someone with clearly relevant experience and qualification. Given the specialist nature of their work, in the case of actuaries, this suggests review by other actuaries.

However, the basis of any such review will be limited, since by definition the parameters within which the review is set will be determined by the practices set out by the profession itself. It is not therefore cost-effective to have an extensive review by a peer who effectively replicates the work done by the first actuary – which could be the result of Option 4.

Consequently, we believe that the peer review of the Scheme Actuary, as envisaged by the profession (Option 3) represents the best choice here. Of course, as with CPD, it will be good practice for the profession to seek some independent review of their proposed process and monitoring procedures to ensure that a sufficiently robust and appropriate process to meet the demands of today's society is in place.

Discipline

Overall, we consider that the profession's new disciplinary process, when combined with the new peer review and standard-setting procedures, should give sufficient control over the standards of actuaries' work.

However, we also recognise the importance of maintaining the confidence of those outside the profession in the work of its members. In view of this and of current thinking in respect of other professions, as highlighted in the Review, we believe that it is necessary in the current climate to demonstrate that the disciplinary process for actuaries is comparable to that for members of other professions. Consequently, we would support Option 2, the accountability of the disciplinary scheme to a suitable independent oversight body. It should be noted that significant changes are being made to the disciplinary process (which we support) and we would not see the role of the independent oversight body as being to change the process, but to make sure the system works as proposed. We do not think that the existence of this procedure will add significantly to the cost of actuarial work.

3. About Mellon

The Human Resources & Investor Solutions division of Mellon is an employee benefit and actuarial consultancy operating through 63 offices around the world. In the UK we have over 30 years' experience, advising on all aspects of the provision and implementation of employee benefits for staff in corporations, local government departments and non-profit making institutions.

We employ consultants of the highest calibre. They are innovative business professionals who specialise in the key areas in which we operate, namely retirement planning, pension scheme administration, investment, employee communications, health & welfare, rewards and HR advice.

Our ability to understand our clients' needs, concerns and aspirations has enabled us to successfully provide creative solutions to the challenges they face.

Founded in 1916, we changed our name from Buck Consultants and Buck Healthcare in October 2003, and are a leading provider of HR consulting and outsourcing services in the world.

As the legislation affecting individuals and employers becomes increasingly complex, our international presence provides multinationals with the reassurance that we can advise on benefits and remuneration policies for staff anywhere in the world. With headquarters in Pittsburgh, USA, our international network spans offices across North America, South America, Asia Pacific and Europe.

As a member of the Mellon Financial Corporation, we draw upon extensive resources through our internal expertise and through our extensive corporate partnerships. With more than 5,000 professionals to serve our clients, we help employers provide for the health, welfare and financial security of an estimated 15 million men and women worldwide.



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