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The Role of the Actuarial Profession's Social and Ethical Mission

By

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Let me of first of all welcome overseas members of the Association to Hong Kong. The Colloquium's theme is an extremely apt theme for these times, as the world continues to grapple with the financial excesses of the past decade. Time and tide, as the proverbial saying goes wait for no one. It behoves us all therefore to consider what we can do to build sounder foundations for the future. I congratulate the Association for a most interesting slate of topics for the Colloquium. My attempt at contribution to this slate is to try to put in context, the role of the Actuarial Profession in its social and ethical mission.

The actuarial profession grew out of deeply felt and important social needs. From antiquity there have been mutual insurance associations in all communities. So long as risks have been felt, societies have found ways to ensure that the burdens of risks do not fall on persons unable or unwilling to bear them, and in so doing, individual societies have been able to advance themselves through commercial interchange with other communities. But, such risks were by no means restricted to commercial ventures. Ancient societies have formed mutual aid societies to take care of the poor and the sick, for the provision of decent burials and the creation of public monuments. In time, business organizations and methodologies were developed to ensure that families could be provided for in the event of the demise of the bread earner or that a person may be assisted in making provision for his own retirement or the needs of a loved one.

Schemes for insuring risk should not be allowed to fail, as the very essence of insurance is that it should be there, when it is needed. The mathematical and statistical advances of the eighteenth century enabled the insurance industry to flourish by bringing to bear information gathering, mathematical and management techniques, which identified the character of the information which gave rise to the risks, assessing the probabilities of the contingencies insured against and pricing the

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contribution which is required for the insurance of these contingencies. Whilst mathematics formed the intellectual roots of the actuarial profession, it was the social needs of communities which formed the ethical roots of the profession.

The Amicable Society (also known as the Amicable Society for a Perpetual Assurance Office) was founded by William Talbot, the Bishop of Oxford and Sir Thomas Allen, who in 1706 obtained its Royal Charter. Its motto was "Prudens Simplicitas" (Simple Prudence). Contributions were shared among the widows, children and heirs of its contributors in accordance with the shares they owned. In 1762, a Royal Charter was granted to the "Society for Equitable Assurances on Lives and Survivorships" (later referred to as simply "The Equitable"). Building on the work of Dodson, Halley and De Moivre, the Equitable was the first to offer for fixed premiums, policies on single or joint lives or survivorships, or for any term, for anyone and for any state of health, although over time, more sophistication was introduced into the design and pricing of policies. Both the Amicable and the Equitable were owned by their members (mutual societies in present day terms). The members elected their officers in the expectation that they had the expertise to manage the businesses of their societies and the integrity to ensure that all members would be fairly treated.

The social importance of insurance was recognized by the Life Assurance Act 1774, which outlawed the taking up of insurance on the lives of persons in whom the beneficiary had no interest (leaving insurance of ships, goods and merchandise out of the ambit of the Act). At about the same time as the accounting profession was taking shape by the formation of professional bodies in England and Scotland, the actuarial profession also formed professional bodies in England and Scotland. The middle of the nineteenth century saw the corporate form of business organization beginning to flourish and the consequential entrustment of management of businesses to managers. The "agency problem" (as it later came to be known) had to be policed. The regulation imposed relied primarily upon the integrity of financial reports to the stakeholders of the corporation. Accountants took on the role of auditing accounts of a company by publicly giving an opinion that the financial statements were true and correct (later in latter half the last century, changed to "true and fair"). For insurance companies, a heavy onus was placed on their management to make the right judgments as to what amounted to profits which could be prudently divided among policy holders in a business which depended on the value of income, assets and liabilities extending well into the future, so that adequate reserves may be built up to deal with the vicissitudes of future claims and the returns on investment from the markets. This kind of judgment depended on the skills and body of knowledge which we have now come to call the actuarial sciences. From the

nineteenth century onwards, insurance companies have depended on and could not effectively function without persons learned in the actuarial sciences.

The professional bodies of the accounting and actuarial professions have over the last 150 years been mindful of the important social roles played by their respective members and have in their structures for entry and discipline tried to keep with changing social expectations and the skills needed to perform their socially important roles in light of the changing financial structures and economic environments. Recognizing the social roles played by actuaries, insurance regulation around the world has assigned specific statutory responsibilities to actuaries. In the United Kingdom, insurance companies have since 1973 been required to appoint an Appointed Actuary (many countries in the British Commonwealth follow this system, as does Hong Kong, though a different name may be used – such as Valuation Actuary in Canada) who is relied upon to give a certificate as to integrity of key financial figures of the insurance company – such as solvency, divisible profits, and embedded values. The PRC has also followed the British regulatory system in requiring an Appointed Actuary. The United States requires insurance companies serving clients under the Federal Employee Retirement Income Security Act to appoint an "Enrolled Actuary" and the various states, taking the advice of the National Association of Insurance Commissioners, require insurance companies to have an "Appointed Actuary".

The lingering question is whether the professions have been sufficiently fleet of foot in responding to changing social expectations. At the close of the last century, two highly publicized cases of corporate failure placed under the microscope of public scrutiny, how practitioners in both professions had failed in their socially important roles.

The first case was the failure of Enron, which showed that the auditors and management fell short of what was expected of their important role of ensuring the integrity of the financial reports of the corporation. The regulatory response was the Sarbanes Oxley Act ("SOX"), which strengthened the oversight of auditors by the creation of the Public Company Accounting Oversight Board ("PCAOB"), imposed a requirement for the company's board to examine the company's internal controls and to confirm that they are satisfied that the internal controls are sufficient to ensure the integrity of the financial reports and for auditors to give an independent opinion that this is so, with independence assumed to be assured by rotation of auditors and prohibition of consultancy work by auditors for the company for which they acted as auditors.

Other countries have emulated the same approach by placing the conduct of accountants under the oversight of statutory Financial Reporting Councils

in addition to the oversight of their own professional bodies (something which the European countries have long instituted). Equally, SOX type requirements have been imposed upon public companies and auditors.

The second was the fall of the venerable Equitable in the United Kingdom. The tipping point in this fall was the House of Lords decision in the Hyman case. The case, as is well known, dealt with the narrow question as to whether the Equitable's directors had right to exercise a discretion conferred on them by Article 65 of the company's Articles of Association, to use profits of the company to pay general policy holders a discretionary bonus thereby depriving part of the benefits of policy holders who had guaranteed annuity policies. The House of Lords (as the country's final court of appeal) ruled that the directors of the Equitable cannot use their discretionary powers to cut down the contractual rights of the guaranteed annuity policy holders. This immediately created a shortfall of 1.5 billion pounds sterling for the company and tipped the company into crisis.

The Penrose Report (published in 2004) observed that: "Superficially, claims of £1.5 billion should not have brought down a Society with funds of £32 billion" (2/113). The Penrose report outlined how the Appointed Actuary (who was also the Chief Executive) between 1991 and 1997 did not inform the Board of "the risks to which policyholders not entitled to annuity guarantees were exposed by policies and practices" (19/126) and "brought the Society to the position of weakness in which it found itself in 2000 and 2001 without full knowledge and understanding of the developing position" (19/88). The Penrose report also observed that: "the Board never at any stage got fully to grips with the financial situation faced by the Society: information was too fragmented, their collective skills were inadequate for the task, and there were no effective arrangements for ensuring that there was detailed examination of, and onward reporting to the Board on actuarial reports"(20/50). The report also found that there was "Serious omission in communication to policyholders of relevant information about their prospective interests" (19/24), and failed to properly inform regulators of "a series of particular valuation practices of dubious actuarial merit"(19/240(5)), and thereby, "the Society was able to over-allocate bonus beyond available assets at market value, and in particular to make payments on claims that exceeded the available assets at the time (18/49).

Subsequent reports by the European Parliament and the UK Parliamentary Ombudsmen pointed out that UK regulators were too focused on solvency alone and did not take a sufficiently holistic view of the organization, including its communications with policyholders and corporate governance. A compensation scheme for policyholders is still being discussed by the UK Government. The regulatory response so far has focused on the conflicting role

between the Appointed Actuary and the Management and the role which the board should play as well as the institution of peer review of the work of actuaries through the Financial Reporting Council. This is consistent with what is happening as the EU with amendments to EU's Life Directives and the implementation of Solvency II.

At the same time, the International Accounting Standards Board is pushing ahead with the revision of IFRS 4. The revision seeks to bridge an important gap between reporting for regulatory purposes and the financial reporting.

All countries are studying the unfolding of the EU Life directives and Solvency II as well as the revision of IFRS 4. All of these efforts focus on the interaction between the accounting and actuarial professions with management and board of an insurance company, and seek to define each role from the perspective of its social importance.

Social expectations have drastically changed since the financial crisis of 2008. Since then the media has been replete with unflattering comments about practitioners in the finance industry. The distrust of financial professionals and in institutions have in the last few years reached one of the lowest points in history. The global regulatory response has been the result of this distrust.

The Preamble to the Dodd Frank Act states:

> "To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes"

The United Kingdom has had to bailout a number of major banks and embarked on a slate of regulatory reforms, in which it is said:

> "In addition to dealing with operational failings of the system introduced between 1997 and 2000, the Government believes that the reform of the regulatory framework must address a number of fundamental issues"[2].

As a result of the Consultation Paper, the United Kingdom Government has committed itself to a "Twin Peaks" type of financial regulation, with separate agencies dedicated to prudential and business conduct regulation and creation of a central authority for systemic oversight. The UK Government has also announced that it would implement the recommendations of the Independent Banking

[2] A New Approach to financial regulation: judgment, focus and stability. Consultation Paper on Financial Regulatory Reform of the Coalition Government.

Commission, which sought to separate retail from wholesale banking, something which the Dodd Frank Act also seeks to do.

The European Community have responded in similar fashion with a re-examination of the MiFid (Markers in Financial Investments Directive), which is will soon be promulgated as MiFiR (Markets in Financial Investments Regulation), a piece of directly applicable regulation.

The international community in the form of the G20 Group of Leaders, the World Bank, the IMF, and all international financial standard setters have banded together and have now for two years embarked on a global financial regulatory agenda of historic proportions, identifying common frameworks for regulation of markets and the supervision of internationally important financial institutions, identifying 30 G - SIFIs. The IAIS has launched work to building a common framework for the supervision of internationally active insurance groups directed at some 50 insurance groups which are said to meet the criteria.

This avalanche of regulation that has been instituted since 2009 is clearly symptomatic of the distrust felt by Governments and electorates alike around the world. This distrust assume that those who have been engaged in the financial services, particularly their leaders, have been responsible the creation of the mess, and are either incompetent or untrustworthy, if not downright dishonest. Books such as "Too Big to Fail" (Andrew Sorkin, Allen Lane, 2009) depicting in graphic detail, the last days of the fall of the giants of Wall Street, fictions (with the ring of truth) such the Big Short or Liar's Poker by Michael Lewis, provide a glimpse into the workings of the financial work which does little to inspire confidence and without doubt, the massive bailouts and the consequent diversion of public resources for doing this, add fuel to the assumption of incompetence or untrustworthiness. The separation of retail and wholesale banking and the Volcker Rule in the US is reminiscent of the firewall approach of the Glass Steagall Act of 1933 which forebade commercial banks from underwriting the issue securities. The new capital requirements and the clearing of derivatives through clearing houses, all of which will add to the cost of financial services, also stemmed from distrust that those in the financial services could not be trusted to properly manage their risks. The regulation on executive pay in the financial services is again a result of suspicion that executives were feathering their own nests while ignoring the interests of their shareholders and clients.

Then what can the financial professionals do? In a 2009 study by Jackie Wells and Mary Gostelow (updated on 18 March 2011) for the FSA on consumer trust of investment professionals, takes as a starting point the following definition of trust:

"(Trust is the) undertaking of a risky course of action on the confident expectation that all persons involved in the action will act competently and dutifully" (Lewis and Wigert)[3]

Lack of trust was identified as the result of the following conditions:

- Fear, intimidation and coercion.
- Corruption, deception and dishonesty.
- Inappropriate legislation.
- Too much information;
- Too much insistence on rights but too little recognition of responsibilities.

The role of the actuarial profession's social and ethical mission is to ensure that society is well served. Without trust being placed in the profession it cannot perform this function. To promote trust in the profession, actuarial societies around the world have introduced ethical programs into training and examinations as well as in continuing professional development. Codes of Ethics have in recent years been promulgated by all societies and all societies have instituted systems of professional discipline and sanctions. These are all highly laudable efforts. But at the end of the day, ethical standards are only tested in situations of stress, when a professional is asked to compromise his standards as has been done in Enron and the Equitable.

I would caution the profession to take note of the following trends, each of which would add a further level of stress when ethical standards are tested:

- First, the concepts and tools of financial regulation are converging into the three pillars - Capital soundness as Pillar One, Soundness of internal governance and risk management as Pillar Two, and Adequacy of transparency and accountability as Pillar Three;
- Second, as regulation becomes more complex, it would be necessary to comply adequately and sensibly;
- Third, as the financial markets become increasingly complex and global, an increasingly heavy burden is placed on professionals to

[3] Lewis JD and Wigert A (1985), 'Trust as a Social Reality', Social Forces, 63, 971, as quoted in the 'World Database of Trust'.

guide lay managers and directors in the making of decisions based on complex facts.

The first of these trends will mean that actuaries must see themselves as an integral part of the businesses in which they are employed. They would to involve themselves in the work of the organization to ensure that all three Pillars put in place do serve regulation as well as the business and its stakeholders.

The second of these trends will mean that actuaries must be expert translators of regulation into the business processes of the businesses in which they are employed. Regulation in future will tend to be pitched at higher level than before if only there is going to be much more and there is little time to devise the bright line. There is also the belief among regulators that bright line regulations tend to elicit avoidance tactics where practitioners tend to game the system. High level regulation means that principles would have to applied to specific situations. It makes the environment less clear but it also makes financial professions think more deeply about the purpose of the principles expressed in the regulations. Actuaries must work with the rest of the organization to make sense of regulation and implement them in a way which maximizes the value of the business. Yet regulation will mean higher costs to the business and this would conflict with the need to bring in adequate returns.

The third trend makes integrity of information systems and understanding of the informational needs of all stakeholders paramount in all organizations. All of these trends place upon actuaries and other financial professionals within the organization the burden of truly understanding the business and the merits and limitations of each of their disciplines. They place upon all professionals the burden to co-operate and communicate effectively, but most important of all, these places a continuing burden on all that truth must be sought from facts, and that unpalatable truths cannot be withheld from the final decision makers and stakeholders of a business. Such are the assumed objectives of these regulatory trends.

Whether more regulation will actually restore confidence in the financial services or ensure that those in the financial services can now be competent and trusted remains to be seen. The continuing economic problems in Europe, the still fragile economic situation in the United States continue to be a source of deep concern to the whole world. The economies of the emerging markets are slowing down due to the lack of impetus from these two major economic blocs in the world, and it will take time even for the BRIC countries to develop robust domestic economies less dependent on the consumption of these major western economic blocs. It must be remembered that regulation is imposed by Governments and when regulation is published as a cure for incompetence and untrustworthiness, it is not unreasonable for

the governed to measure the regulation promulgated against the conduct of those in Government. That conduct has not been exemplary in many countries, and for rules and regulations to find legitimacy and trust, those in Government must play their part in restoring trust in the processes of Government and the people who govern, just as those in the financial services should play their part in restoring confidence in their profession.

Restoration of trust must come with the assumption by all players of the responsibilities intrinsic in their public roles. Just as those in Government should abide the basic principles of public office, recognized[4] as selflessness, integrity, objectivity, accountability, openness, honesty and leadership, so must those whose activities affect the public and therefore, have a public role to play, abide the same principles[5].

The actuarial profession has its ethical roots in deeply felt social needs and therefore, the profession has an undoubted public role to play. In an increasingly complex world, it is only too easy to lose one's way, and one needs a ready compass to guide the difficult and often tortuous path that one has to trod. I would commend these six principles as a compass to guide all members of the actuarial profession, as it is only when a member of the profession is activated by proper principles, that the profession can claim to fulfill its role in service to society.

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[4] First proposed by Lord Nolan in the Nolan Report of 1995, which later came to be known as the Nolan Principles of Public Life.

[5] This was proposed by Baroness Onara O'Neill in the 2002 BBC Ruth Leith Lecture.