A BIRD'S EYE VIEW OF PENSION FUND ACTUARIES

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SUMMARY

Pension funds in South Africa operate under the supervision of a Registrar of Pension Funds. Actuaries to such funds are required to submit valuation reports to the Registrar at least triennially, as well as reports whenever members are transferred between funds.

The Registrar favours less rather than more regulation, and generally leaves actuaries free to keep their own house in order professionally. Unfortunately some actuaries have taken advantage of this situation.

The author, on retirement from practice as a consulting actuary, joined the Registrar's staff with the responsibility inter alia to study valuation and transfer reports lodged by pension fund actuaries. He established specific objectives and check-lists for the purpose of this task, and the paper describes the results achieved.

While many reports were exemplary others were not. The author describes "acceptable" and "unacceptable" reports, and defends his reasons for considering certain reports unacceptable. Examples of unacceptable action are:

(a) No attempt to prove the completeness and accuracy of the valuation data.

(b) No analysis of the financial progress of the fund from one valuation to another.

(c) An arbitrary basis of valuing the fund's assets, and no reference to the suitability of the assets relative to the liabilities.

(d) No motivation of the valuation methods and parameters.

(e) Indications of succumbing to client pressure to produce a palatable result.

In the final section of the paper the author considers the courses of action open to the Registrar in dealing with unacceptable reports. The author indicates that corresponding experiences in other countries would be of great interest to him.

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For over thirty years, in my capacity as a private sector pension fund actuary, I have been at the receiving end of regulatory control over my work by way of Acts of Parliament, regulations under such Acts, directives and similar forms of persuasion.

In the South African context this control has essentially come from two sources, namely the Inland Revenue authorities and the Registrar of Pension Funds. The former has concentrated upon laying down the conditions that have to be fulfilled before a pension fund, its members and the sponsoring employer can enjoy tax relief; whereas the thrust of the latter's activities has been to ensure that funds are managed soundly and "in the public interest". This paper confines itself to the regulatory supervision exercised by the Registrar.

The Registrar (who is supported by a small staff of actuaries, lawyers and administrative personnel) is on record as favouring less rather than more regulation. In particular, in carrying out their statutory functions pension fund actuaries in South Africa are generally free to determine their valuation methods and parameters as they see fit; there is no stipulation, for example, that an "aggregate" method is to be used, or that any particular "real" rate of return is to be adopted. The Registrar looks to the actuarial profession to keep its own house in order professionally, and the Actuarial Society of South Africa publishes guidelines on various topics (such as valuations of pension funds) in an endeavour to support the Registrar's confidence in the professional integrity of the members of the Society.

There are really only two directives from the Registrar that have some effect in restricting the actuary's freedom. They are:

(a) In setting his parameters, the actuary must provide for the "reasonable benefit expectations" of contributors, paid-up members and incumbent pensioners.

(b) The valuation method must inter alia determine and compare the value of the accumulated assets of the fund with the value of the fund's obligations to its members in respect of pensionable service already rendered (the so- called "accrued service actuarial liabilities").

    If the comparison reflects assets less than the said liabilities, then remedial action must be taken within a specified period to correct the situation.

The aforesaid freedom of movement brings with it the responsibility for actuaries to "play the game", both in respect of their duty to the regulatory authorities and in respect of their duty to the actuarial profession. While many actuaries do indeed fulfil their responsibilities in this regard, I regret that during my private sector career I have occasionally encountered actuarial reports that in my view fell below this standard. This is of particular concern where there is suspicion that the actuary has succumbed to pressure from his client to "modify" his professional standards, say where the fund in question initially failed the requirement in (b) above.

In this latter regard, a further source of pressure upon pension fund actuaries to modify their standards can arise from the vehicle through which the actuary practises. In essence there are three such vehicles in South Africa, namely as a consulting actuary in an organisation existing solely to provide actuarial advice; as the actuary employed by a life office; or as the actuary employed by a firm of pension brokers/consultants. It is a sad fact that, although one would like to believe that the actuary would apply the same high level of professional integrity irrespective of which of the three situations applied, there have been instances where actuaries appear to have fallen from grace and been influenced by the nature of their employment.

This is despite the fact that the letter from the Registrar approving an appointment as the actuary to a registered fund stipulates inter alia that "he is to act in his personal professional capacity and this office relies on him to exercise the high standards expected from a member of his profession regardless of his present connection with his employer. "

In short, therefore, the authorities have a problem. While they favour minimal regulation, and would prefer to rely on the actuarial profession to keep its own house in order, there are disturbing indications that this trust is occasionally being abused.

This paper discusses the problem in more detail, in the South African context. Particularly in the light of the development discussed in the next section of this paper, I must emphasise that I take full responsibility for the thoughts and opinions expressed herein.

POACHER TURNED GAME KEEPER

In November, 1993, I retired from practice as a consulting actuary and took up a consultancy appointment with the Registrar of Pension Funds. My task is inter alia to scrutinise documents submitted by private sector actuaries in the fulfilment of their statutory duties relating to pension funds, and to report to the Registrar on the results of my scrutiny in a manner that would enable him more effectively to carry out his regulatory function (and hopefully to resolve the problem described earlier).

There are essentially two types of statutory document submitted by pension fund actuaries. One consists of actuarial valuation reports on pension funds, which must be provided at least once in every cycle of three years, and the other is represented by "schemes" prepared in terms of Section 14 of the Pension Funds Act.

To clarify this latter reference, Section 14 deals with transfers of assets between funds registered under the Act, and provides that before any such transfer may take place a "scheme" must be prepared by the actuaries to the funds involved, setting out the details of the proposed transaction, and sent to the Registrar for approval. The purpose of this requirement is to ensure that the transfer is not to the detriment of either the transferring or the residual members.

As stated earlier, the thrust of the Registrar's function is to ensure sound financial management of funds. In broad terms I have taken this to cover the following procedures:-

* The Registrar must be satisfied that pension funds operating under his jurisdiction are financially sound, failing which he must institute remedial action and have the authority to enforce it.

* The Registrar must be satisfied that the periodic reports presented on the results of actuarial valuations represent sound communication between the actuary and all the other relevant parties (the regulatory authorities, the trustees, the sponsoring employer and the members), failing which he must once again be in a position to institute remedial action.

* In the case of Section 14 schemes, the Registrar must be satisfied that the terms of the rules of the funds concerned had been observed, that the actuarial aspects were professionally sound, and that the proposed transactions were equitable to all concerned, before granting his approval of a particular scheme.

It was clearly necessary for me to establish in some detail the standards against which I would compare reports and Section 14 schemes, when advising the Registrar on the aforementioned matters.

My test of financial soundness inter alia covers the following matters:-

(a) The data upon which the valuation was based should be examined for completeness and accuracy.

(b) The method used to place a value upon the assets of the fund should not be dependant upon the fortuitous state of the investment market at a particular point of time.

(c) The valuation method applied must be appropriate to the circumstances of the fund.

(d) The parameters applied in placing a value upon the obligations of the fund towards its members (the "actuarial liabilities") should be in line with current and expected future experience; and where applicable sound reasons must be given for any changes made to the previously existing parameters.

(e) The assets and the liabilities of the fund should be shown to be suitably matched to each other; alternatively, and recognising that a period of mis-matching is occasionally justified, if there is such a mis-matching the extent is quantified and the justification for such a situation being allowed to continue is soundly argued.

(f) While the valuation clearly must as a first step be based upon the obligations of the fund as set out in its registered rules, account must also be taken of ancillary benefits of an ex-gratia nature, such as a track record of granting pension increases at a given level or (if there is no track record) any reasonable expectations of contributors about future pension increases.

(g) An analysis of the financial progress of the fund between the previous valuation and the current one should be made and set out in the valuation report, and its implications discussed relative to the valuation parameters adopted and the likely future financial development of the fund.

(h) There should be minimal dependence upon future contributions to enable the fund to fulfil its obligations relating to service already rendered. (Strictly speaking there should be no such dependence, in view of one of the Registrar's directives, but it was recognised that circumstances could arise when a measure of such dependence was unavoidable).

The test of sound communication is that the report should anticipate all questions that the parties reading it are likely to ask; must motivate all conclusions reached by the actuary, particularly in respect of valuation parameters and methods; and must generally indicate to the reader that the actuary has endeavoured to carry out a comprehensive, professionally responsible task.

As far as Section 14 schemes are concerned the test would be whether they fulfilled the matters on which the Registrar requires to be satisfied.

RESULTS

In the course of my work along the foregoing lines I have encountered many exemplary reports on the results of actuarial valuations.

Typical features were that they took the reader through a logical process of reiterating the result of the previous valuation; listing any changes to the rules and/or systems and/or regulatory requirements in the interim; summarising the current membership and showing what steps had been taken to ensure the completeness and accuracy of the current data; summarising the fund's income and expenditure account for the intervaluation period, and ensuring that only audited financial statements were used; listing the assets of the fund and their values for valuation purposes (as well as discussing the basis of and motivation for the said values); discussing and motivating the valuation method and parameters used (the parameters seeking to be realistic and responsible, erring if necessary in the direction of caution, and taking account of all factors likely to have a bearing upon the future financial development of the fund); setting out the valuation result in clear terms, with due regard to the regulatory requirements of a comparison between assets and accrued service actuarial liabilities; comparing the current valuation result with that at the previous valuation and hence quantifying the change in the financial condition of the fund; analysing the change into its components; discussing the implications of the information disclosed by the said analysis; commenting on the suitability of the investment portfolio relative to the liability requirements of the fund; indicating the likely trend of the fund over the foreseeable future; and summarising the essential results of the valuation. These reports were furthermore usually accompanied by annexures setting out greater detail in respect of certain items that would otherwise burden the main report.

There were however also other reports that fell short of what I considered to be responsible standards of reporting, before even considering the scientific standards adopted. Examples of the deficiencies encountered were:

(a) No link with the previous valuation by way of an analysis of the change in financial condition; sometimes the result of the previous valuation was not even given.

(b) Little if any demonstration of the completeness and accuracy of the data on which the valuation was based.

(c) An arbitrary basis of placing a value upon the assets of the fund, with little or no attempt to justify it.

(d) No motivation of the suitability of the valuation parameters used, even when they differed from those at the previous valuation.

(e) Explaining the implications of the valuation result in terms of generalities ("the fund significantly improved its financial position because of superior investment performance") instead of specifics. Sometimes no attempt was made at all to explain the implications of the valuation results.

(f) No reference to the suitability or otherwise of the investment portfolio relative to the liability requirements of the fund.

(g) A fund with 80 pensioners and 8 contributors was valued in the same manner as one with 80 contributors and 8 pensioners, with no attempt to allow for or even discuss the dangerous "gearing" implications of the overweight pensioner situation.

(h) Generally, no attempt to avoid the impression that the valuation had been churned out by a clerk and simply signed by the actuary; or that the method and/or parameters used had been such as to produce a result likely to be palatable to the client (this was a particularly disturbing feature).

It seemed furthermore that poor reporting standards often went hand in hand with a cavalier attitude towards scientific standards. Developments in actuarial thought, as set out in papers published in actuarial journals for several years past, have indicated a number of new approaches to the scientific process of determining the financial condition of a pension fund. The relative advantages and disadvantages of the "aggregate" method versus the "projected unit credit" method; a fresh look at the "emerging cost" approach that promised to become popular some years back; the various techniques for placing a realistic value upon the assets relative to the liabilities; the whole trend towards regarding asset/liability management as a comprehensive whole; the insidious and misleading implications of "contribution holidays"; all of these appear to be conveniently forgotten when

one encounters a valuation report where, for example, the projected unit credit method was adopted without any discussion on its suitability for the particular membership involved; no provision was made for post-retirement pension increases despite the fact that this was historically an established feature of the management of the fund; and the assets were blindly valued at 85 % of market value, again without motivation.

In view of the sensitivities involved I have deliberately not indicated the relative proportions of reports that I have encountered that are acceptable and unacceptable. Suffice it to say that there were several reports crossing my desk of the unacceptable nature described above, and I believe this to be an *untenable situation whatever the proportion they represent.*

As far as Section 14 schemes are concerned, once again there were exemplary cases (clear, concise, professionally sound); and others that to say the least were casual (almost implying contempt for the Act requirement), and often indicative of bowing to client pressure.

The author's view of the activities of his former private sector pension fund actuarial colleagues is therefore a mixture of admiration at the work of some and embarrassment at the results produced by others.

ALTERNATIVE VIEWPOINT

I have branded certain behaviour described above as "unacceptable". There are some who would beg to differ. They argue that:-

(a) The client is interested only in the bottom line; he is not concerned with a comparison between the latest result and that at the previous valuation, nor with an explanation of why the actuary selected a particular technical approach and set of parameters.

(b) The client wants to know the cost implications of his fund based upon the minimum obligations of the fund; and also does not want the actuary to charge fees for "additional investigations" such as an analysis of financial progress between valuations and the taking out of experience (e.g. in respect of withdrawals) in order to test the continued suitability of the valuation parameters.

(c) The client will understand a valuation of assets by reference to market

value; he will not understand a method such as capitalization of expected future cash flow.

(d) The client is a busy person in his own area of activity, and therefore only wants a brief report (this in turn restricting the contents largely to the bottom line results).

Leaving aside for a moment the question of pride in one's professional work, are the foregoing contentions valid? While they are persuasive I submit that they suffer from the following deficiencies:

(1) They assume a lot of things about the client's views and wants; I wonder how often the client is actually asked what his views and wants are?

(2) They assume the client only wants to know the minimum costs, and to pay minimum actuarial fees, with the obvious consequences for professional standards. Has the client ever been asked about these?

(3) They assume the client cannot understand anything beyond simple concepts. Is this not a particularly high handed attitude?

(4) They overlook the fact that there are other parties having an interest in the financial progress of the fund, such as the members and the regulatory authorities.

(5) In any event, which should take priority: satisfying the client or satisfying one's professional conscience?

Overhanging all these points of detail is the standing of the profession in the eyes of the non-actuarial world; a world that has frequently shown itself all too ready to seize any opportunity to downgrade the actuarial profession.

To my mind adopting the approach in (a) to (d) carries the great danger of portraying the actuarial profession as being populated by people more interested in maximum rewards for minimum work. I for one would not wish to be associated with such an image, and for that reason I make no apology for describing the said behaviour as "unacceptable" and carrying out my supervisory duties appropriately.

REMEDIAL ACTION

If I encounter a valuation report or a Section 14 scheme that I consider to be unacceptable, measured against the standards described above, I advise the Registrar appropriately and he has then to decide upon remedial action. Courses of action open to him are (in theory at any rate) the following:-

(a) Legislate all aspects of the functions concerned, so that the actuary becomes no more than a calculating machine and the question of acceptable or unacceptable conduct does not arise.

Some countries effectively follow this course of action. It is significant that actuaries from those countries, on hearing of the minimal degree of regulation in South Africa, have advised us to do all we can to preserve our approach.

(b) Report all unacceptable reports to the Actuarial Society of South Africa.

The Society issues guidelines, as previously mentioned, but as yet none of those in the pensions sphere are mandatory. This means that even if the Society becomes aware of, or suspects, substandard activities of its members, it can really only take action if and when a complaint is lodged. If however, a complaint is lodged then the fact of non-compliance with the guidelines becomes a relevant factor in following out the disciplinary procedures of the Society's Constitution, and the guidelines can have some impact.

(c) Reject the report or scheme, giving reasons for rejection, and requiring the document to be resubmitted after addressing the offending items.

(d) Deal with the matter informally, verbally or in writing as appropriate.

The Registrar prefers that procedure (d) be followed whenever possible. If persuasion is unsuccessful then procedure (c) comes into play, with the trustees and sponsoring employer of the fund concerned being informed of the action.

Referring a matter to the Actuarial Society would normally only occur if there had been an apparently serious breach of professional conduct, in the opinion of the Registrar. I am glad to say that none of the "unacceptable" reports that I have dealt with thus far fell into that category, although one or two came very close. Procedure (a) is not currently being considered, as it would run counter to the Registrar's philosophy on regulation.

It would be of much interest to me, and indeed to our regulatory authorities, to learn of corresponding experiences and practice in other countries.

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