Case Study G4 — Reserve ranges

You are the Company Actuary at a general insurance company, reporting to the Finance Director. Each year-end you produce a reserving report in accordance with GN12. The Directors will set the reserves at the level recommended in your final report which will, therefore, directly affect the company's declared profit for the year.

You are discussing your draft report with FD, who comments that the reserves as recommended in your draft report will mean that the company's profits will be below market expectations and might lead to the rating agencies downgrading the company with a consequent effect on business for the following year. He says that your predecessor as Company Actuary explained to him that actuarial reserving is not an exact science, that the actuary uses his judgement to a great extent and that the result is subjective. Furthermore he says that he is aware that the actuary sets the reserves slightly above the mid-point of an implicit range of values and that the actuary would be comfortable with any figure within the range. He asks you to re-consider the report and see if you can recommend reserves within your range but nearer the lower end.

What should you do?

Would this be any different if you knew that a "good" result this year would lead to a hefty bonus for you, or if you had shares (or options) that could be exercised?

Discussion points

You are giving your opinion of the reserves in your capacity as Company Actuary. The report will be made available to auditors and the Revenue. As with any opinion, your conclusions should have clear justifications.

You have a professional duty not to produce a misleading report. The recommended reserves should be reasonable in your opinion.

The Actuary needs to have a good ongoing relationship with the company's management. Before reaching any conclusions about whether you are unable to re-issue the report or not, consider the following:

- How much conservatism have you built into the reserves?
- Are there any issues or events that have happened since you issued the draft report that may have a bearing on the recommended reserves?
- Is the FD right in assuming that the recommended reserves are slightly above the mid-point of an implicit range of values? Even if the FD is right, is your recommendation a best estimate?
- How much difference is there between your recommendation and what the FD thinks?

A possible option is for you to re-issue the report with a reasonable range for the reserves. GN12 does allow a report to be produced with an acceptable range of reserves rather than a point estimate. The size of the range will be directly affected by the perceived uncertainty in the eventual outcome of claims. The responsibility of selecting a point estimate for the reserves in the accounts will now rest with the Directors. If the Directors are relying on you to recommend a point estimate for reserves, then any departures in your recommendation from your best estimate should be clearly stated as such, including any additional risks to the financial soundness of the company.

A point estimate for reserves which is slightly lower than a best estimate is probably acceptable for the accounts. You will need to apply your judgement as to what is acceptable without compromising your professional responsibilities. As the report is being prepared in regard to reserves for statutory accounts, you should give due recognition to the relevant accounting principles and statutory requirements. One of the accounting principles is that there should be consistency over time unless there is a good reason for a change. Therefore, you should also consider what implications there may be in future years of your recommendations.

If no agreement can be reached with the FD, then it would be advisable to raise the issue with the other directors before issuing your final report. You will need to make clear why your recommended reserves cannot be at the level the FD wants, and explain that your professional responsibilities, therefore, preclude you from producing a report that supports the FD.

What if you knew that a "good" result this year would lead to a hefty bonus for you, or if you had shares (or options) that could be exercised? This should not affect your deliberations, though it would certainly raise the stakes! You will probably have greater credibility with the Directors if they know that you are paying for giving the advice.

Case Study G5 — Data quality

You are the consulting actuary to a medium sized insurance company that has grown rapidly in recent years. Part of your engagement is to provide an actuarial certificate confirming the adequacy of the claims reserves. This certificate is included in the published Report & Accounts.

Over the past two or three years you have become concerned about the quality of the data. You have also heard market rumours that the company is suppressing case reserves in order to improve results. Staff turnover in the claims department is abnormally high. Two months ago the company's founder resigned as CEO “to spend more time with his family”. You have raised your concerns with the company who have assured you in writing that the data are accurate. You have spoken to the auditors who have also confirmed in writing that they are happy with the data.

The incurred claims projections give reserves consistent with those the company wishes to book.

The Finance Director has just phoned to remind you that he needs your certificate by the end of the week.

What would you do?

Discussion points

Which Guidance Notes is an “actuarial certificate” subject to? (Probably none.) Does the certificate need to be backed up by a GN12-compliant report, as required for Statements of Actuarial Opinion under GN18/GN20/GN33?

In general, it is reasonable to rely on or utilise the work of other professionals (GN12 6.1). But to what extent can you rely on the work of other professionals (e.g. auditors) if you think they’ve got it wrong? Is it enough just to draw attention to the shortcomings in the actuarial report (GN12 6.3)?

GN12 6.2 says you can use imperfect data if you think the results appear reasonable. The implication is that you can’t use the data if you think the results are unreasonable.

How can you tell whether the results look reasonable? Is it enough that the projections of incurred claims (which incorporate the suspect case reserves) give reserves consistent with those the company wishes to book? No. The fact that the company has come up with similar figures is not an independent check on the reasonableness of the incurred claims projections. You could conduct projections of paid claims — which are unaffected by case reserves — and see if the answer is consistent with the incurred claims projections. (This point is a bit technical but it cuts to the core of data reliance.)

Is it practicable to draw attention to the data issues in the actuarial certificate? Not without your own evidence: you cannot write derogatory information in a professional opinion based on market rumours and gut feelings (both the company and the auditors wrote that they were happy with the data). If you were concerned enough, you would have to refuse to provide the certificate and face the consequences in respect of the client relationship and your fees.

The Morris Review recommended that the FSA should require general insurance companies to get advice from an approved person, not necessarily an actuary. If the approved person was an actuary and had to prepare an annual report on the financial condition of the company as part of the company's annual supervisory return, would this have helped in this case?

If the Case Studies finish before time is up:

Other contentious public-interest issues

The first case study dealt with conflicts in a commutation situation. Was it implicitly assumed that an actuary will give a different report on the same issue depending on which side he/she was acting for? If so, is this “professional”?

Extended warranty business with loss ratios of 20% — should the Actuarial Profession point out that these things are a waste of money? (Arguably, the Actuarial Profession should have said this about personal pensions — were we in the pocket of our paymasters?)

Should we be pushing for certification of the reinsurance to close of Lloyd’s syndicates (as a sessional paper recommended in 2000)?

Case Study G3 — Another actuary’s work

You are employed by the Acquisitive Insurance Group, negotiating the purchase of an insurance operation, a subsidiary of Divestment Re, another Insurance Group. Part of the documentation you have seen is an actuarial report prepared for the insurance subsidiary by another UK actuary.

(a) On reading the report you see that although it complies with GN12, the assumptions are somewhat unrealistic. What should you say and do?

(b) Suppose that on reading the report you see that it does not comply with GN12, although there is no indication that the underlying work was deficient. What should you say and do?

(c) Suppose that the underlying work was incompetent, for example by using methodologies unsuited to the classes of business under consideration, or using inappropriate data without adjustment. What should you say and do?

Would your answers to the above questions differ if you were a consultant?

Discussion points

(a) PCS 8.1 says that you can criticise if properly reasoned and you believe it to be justified. Therefore you can voice such criticisms of the other actuary's assumptions to your employer/client. But you need to acknowledge that other members may quite properly hold different professional opinions and that special circumstances may exist in any particular case (PCS 8.2).

(b) *First you would ask the author of the actuarial report why GN12 was not complied with. It might be that what you have seen is an interim report, a work in progress or part of a larger report.*

(Can fail PCS by e.g. not giving enough detail to allow the client to judge whether the recommendations are appropriate and what their implications are — PCS 3.5.)

(c) There may be grounds to report the other actuary to the professional body. The PCS suggests that you try to resolve the matter with the other actuary first, but if this fails and the matter is material, then subject to confidentiality you have a duty to refer the matter to the professional body (PCS 4.4.5). *You would probably consult another actuary before doing any of this.*

As a consultant, your interests are no different from those of your client, except that you are limited by the scope of your assignment – an employee would be less constrained about exceeding his or her scope. So all of the above should apply. It is likely that a consultant will be more circumspect in criticising another actuary – an employee is likely to feel able to speak more freely.

Case Study L5 — Low performing endowments

Actuaries working in life companies are responsible for the current underperformance of endowments, both with profits and unit-linked, by not being involved enough in the projection process, and by non transparent pricing hence causing misery and disillusionment to many. True or false, and should The Actuarial Profession take on a more general role to whistle blow when we see possible future general problems in areas where it is accepted we have knowledge (particularly life and pensions business)?

Discussion points

No **discussion points** given, ideal for use as role play, with one group agreeing the statement, the other disagreeing.

Actuarial Function Holder

Case Study L6 — Distribution of profits

You are the With Profits Actuary of a proprietary composite office. You report directly to the Finance Director and the arrangements are that you attend Board meetings along with the Actuarial Function Holder when certain matters relating to life insurance are under discussion. Generally this is restricted to the annual Board discussion setting the various bonus rates. None of the Directors, including the Finance Director, is an actuary.

The Company's constitution is such that "any profits arising from participating life business are allocated 90% to policyholders and 10% to shareholders and further any profits arising from nonparticipating business shall be allocated to policyholders at the discretion of the Company". An increasing proportion of unit-linked business is now being written. All the life business is written in a single fund with one group of assets, but separate revenue accounts are kept so that premiums, claims, expenses etc. (but not investment income) can be analysed separately for without profits and with profits business.

It has been the company's practice for many years to allow all the profits from the fund, those arising both from participating and non-participating business, to be included in the 90:10 calculation. Thus the participating policies have enjoyed surplus arising from non-participating policies. Owing to increasing pressures on the non-life side of the business, the Board wishes to exercise its right to restrict the 90:10 calculation to the participating business only.

You are concerned that the reasonable expectations of existing with profits policyholders may be reduced. Discuss the issues that need to be addressed and what action, if any, you should take

Discussion points

1. It is essential to be prepared in terms of identifying the financial effects of the proposed changes both in the last few years and the way in which they may affect future bonuses. The analysis would need to include a test for sensitivity since, particularly in the case of the analysis of future development, wide divergences could take place depending on, for example, levels and mix of new business, investment performance, etc.
2. The practical way in which the changes would be allowed to affect bonuses over the next few years would need to be addressed. Dramatic changes in bonus league tables are generally to be avoided.
3. Care would be needed to take legal advice including external advice. In particular you should consider commitments and implications of prospectuses or advertisements in the past. Further, advice about any constitutional issues raised by the matter — whether the articles and

Memorandum allow what is proposed and whether there are any practical legal difficulties. Particular points may arise in terms of implications given in the Principles and Practices of Financial Management (PPFM). This needs to be checked both from the point of view of the existing PPFM and how any changes would be reflected in the next version.

4. How should policyholders be dealt with? What form of consultation should take place, if any? Is there a need to consult formally the policyholders before going ahead? Inter-related with this area, what publicity should be given to the matter? In particular the treatment of the press and the trade press.

5. In matters of this kind it can be very helpful to have an opinion from an independent party. Thus, whether or not an independent actuary is involved, a second opinion from a major firm of consulting actuaries can be particularly helpful. They are also more likely to have experience of how best to approach the authorities.

6. The FSA should be consulted.

7. The overall requirement on the With Profits Actuary is to draw attention not only to the financial implications of the proposed step but also the ethical ones. Although the policyholders are undoubtedly losing a privilege, if not a right, is it one to which they are reasonably entitled, given the change in business mix? It is vital that the Board of Directors has its attention clearly and unambiguously drawn to this matter. This guidance to the Board should be written, not simply oral, and you should attend the Board discussion of your report.

8. Treating customers fairly must also be considered.

Case Study I2 — Conflicts in a sale and purchase

You are a qualified actuary practising as an investment consultant. You have a particular pension fund client, the Scheme Actuary for whom is employed by another firm of consultants.

You receive a call one day from the Finance Director, who is not a Trustee, advising that there is to be a management buyout. The Finance Director will become the Chief Executive of the new company and Chairman of the Trustees of the new company's pension fund. He comments that the Trustees of the current Scheme always talk highly of you and he would like you to act as investment consultant to the new Scheme.

You comment that you are clearly very pleased to have been asked and would be delighted to accept (you have never won new business so easily)!

You proceed to provide the necessary investment advice on appropriate arrangements for the new Scheme. Everything is agreed pending the bulk transfer payment from the old Scheme (for whom you still act as investment consultant). Some months pass and then you receive a letter out of the blue from your new client, stating that the bulk transfer value has now been agreed and could you make the necessary arrangements to transfer the monies. The letter encloses a copy of the Sale Agreement, which you have never seen before — indeed you have not been involved in any way with the buy-out and had not envisaged having to be.

The Sale Agreement is not, in your opinion, particularly well written. In particular, the wording on the cash and alternative in-specie payment is very ambiguous. You are of the view that the wording could be interpreted a number of ways and you would certainly advise your two Trustee clients concerned differently.

How would you deal with the situation?
What mistakes did you make?
What professional issues arise?

Discussion points

How would you deal with the situation?
What mistakes did you make?

The “apparent” problem is that the consultant feels he has a conflict of interest. In particular, he feels he should be advising his two clients differently in relation to the Sale & Purchase document. However, the mistake is in thinking that this is the problem. The consultant's clients are the Trustees of the two funds and neither is party to the Sale & Purchase document. The consultant's advice to both Trustee clients should be that there is an ambiguity and that this should be referred back to the two Companies and their advisers to sort out. Only after this ambiguity has been clarified will he be able to progress the transfer. The consultant's mistake was in not understanding who his clients are.

The other mistake was in not considering whether any conflicts may arise and discussing the matter with the clients. Given the relationship between the two clients i.e. the management buy-out had not yet completed, there remained plenty of scope for conflicts to arise. The consultant could become privy to information from one client that, if he were able to disclose it, may effect the advice given to the other.

What professional issues arise?

The ambiguity within the Sale & Purchase document raises a question over the competence of whoever drew it up. Even if the Actuary was heavily involved, you need to be very wary of criticising him/her in this case. The Sale & Purchase document is the result of extensive negotiations in which you were not involved. You may well find that whilst the wording was ambiguous there was a clear understanding

between the two companies. In addition, a number of parties are likely to have provided input on the wording and the Actuary may not have been involved with the sections that give you concern. It is only if the two companies disagree on what was intended that you should really start to consider the Actuary's role in this.
From your own perspective, you have been asked to make the necessary arrangements to transfer the monies. You need to ensure you have the relevant knowledge and experience to deal with the transfer or have access to someone that does. Unless you have been delegated discretionary authority by the Trustees and are approved by the FSA to Manage Investments you should not instruct the Vendors scheme on how the monies should be transferred. Rather, you should write to your client with your recommendations and the rationale behind them, giving the necessary risk warnings that apply to a transfer of this nature.

Case Study I4 — Eavesdropping

You are the investment consultant to the Trustee of a UK pension scheme, the size of which is not immaterial relative to the size of the sponsoring company. You are on your way to meet with the Trustee to present the results of an investment strategy review that has just been completed. Initial discussions on the findings of the strategy review have already been held with the Investment Committee, which includes two company appointed Trustee directors, the Finance Director and the Human Resources Director.
You travel to the meeting by train and as usual are minding your own business sorting your emails out on your Blackberry. You notice two people get on the train, one of which you recognise as an actuary from a meeting you went to many years ago. Neither of the individuals recognises you and proceed to sit on the chairs immediately behind you. The two individuals strike up a conversation and whilst talking very quietly it is difficult not to hear what is said given their proximity. The conversation is somewhat cryptic but every so often they give clues away as to what they are talking about. The more you hear the more you become convinced they are talking about a deal involving the sponsoring company of the client you are on the way to visit. In particular, from what they are saying the proposed transaction would involve selling off what you understand to be one of the most stable (from a revenue and profit perspective) parts of the business.
What professional issues arise from the situation you find yourself in?
How would you deal with them?