

Inaugural Address

by Gordon M. Bagot

Leader of the Scottish Board of the Institute and Faculty of Actuaries
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1. Introduction

This is an historic occasion. I am in the privileged and somewhat humbling position of being the first leader of the Scottish Board of the Institute and Faculty of Actuaries. This professional body was formed on 1st August 2010 after agreement from approximately five out of every six members of both the Faculty and Institute who decided to vote.

Our previous professional bodies had been in existence for over 150 years as separate entities, but had been working closer and closer together, particularly over the more recent period. Over those many years, our members had fanned out over the world, taking their skills and knowledge into many countries, such that either UK qualification, FFA or FIA, became the accepted qualification in the various practice areas throughout that world. As had to be expected however, governments, regulators and individuals adopted their own actuarial training courses and examinations, modelled essentially on those our two UK bodies had introduced. Our UK Profession now faces competition and thus I am particularly pleased that this new body, the Institute and Faculty of Actuaries, has been formed, in order to maintain and strengthen the UK's reputation in all actuarial matters, from recruitment, training, examinations, CPD, into what now should really be referred to as Enterprise Risk Management. Actuaries should be the leading profession in the business of managing companies. We may not have all the skills (more of which later), we may not be applying our skills in all those possible areas, and we may not be recognised as being fit and able for such roles.

This address outlines my views of the future of the Scottish Constituency and the role of the Scottish Board.

Before proceeding further, I should point out that much of what is in this address is a personal view, formed from many years in the Profession, with many of those years in the investment business, where observation, analysis, interpretation of results, implementation of tactics or plans or strategies, followed by measurement, further analysis and attribution was all par the course. That training and discipline was applicable throughout my career and should form, I believe, the basis of anyone's career – in short, implementation of our new motto, *solutions from experience*.

2. Times are Changing Fast

I do not need to tell this audience that the business environment in which most of us started our careers has changed enormously, and will continue to do so, driven to some extent by the initial and subsequent consequences of the recent financial crisis. For me, the financial crisis was quite an appalling episode when those who had been entrusted with the direction and management of our

major banking businesses were found wanting. Duties were carried out in a superficial or perfunctory manner. My angst was made worse when, at the recent IAA conference in South Africa, Dr Mamphela Ramphele, a former managing director of the World Bank asked a simple question, “Why didn’t we hear your views (that of actuaries) before the financial crisis broke?” As an example, she referred to the defective work of the rating agencies and their AAA assessment of securities which proved to be worthless or almost worthless. That should not have been so pointedly made. It hurt me when I first read it and it still hurts whenever I recall these words. If the managing of financial institutions does not lie in the realms of those in the Actuarial Profession, where does it lie?

The point can easily be made that we have slowly been losing our influence and place in the managing of financial institutions. I would suggest that, with some notable exceptions, we have become technicians. One such exception is the general insurance industry where our members have so ably used their skills and knowledge that they have become recognised as very necessary.

I want to expand on this recent financial crisis a bit further since I believe it may be pertinent to our CPD courses.

I have already noted above that banks’ directors and senior management showed that they did not understand the nature of the risks within the products and services being designed in their investment banking divisions. As far as I am aware, they did not know enough, in some cases, to ask relevant questions of the designers of the products that generated the financial crisis. Their training and any subsequent CPD requirements were, without doubt, totally deficient in re-training or re-equipping them to manage their ever more complex businesses. I do not want such criticism ever to be levied at members of the Actuarial Profession. As a further aside, I believe that if there are areas of a company’s business where at least one senior director or manager cannot be identified as being the expert for the company in that area, then the company should hire that expertise. Moreover, if a board becomes too big to effectively direct a business then those “unmonitored” business lines should be sold.

What, you might ask, do I believe is the most effective number of directors in a board? No more than six or seven, in my view. Such board sizes can work effectively together; they can understand each other’s roles; they can operate if one director misses a meeting. I have seen these numbers in successful companies. I have seen these numbers in successful investment management companies where such a limited number can challenge each other, but can come to collective decisions. Thus, I believe, our banks were far too big to be effectively directed and managed, with the subsequent undesirable consequences for us all, now and for many years hence.

If actuaries are to rise to the challenge of Dr Ramphele, it is essential that we widen the scope of our services, learn new skills, and apply these and our traditional ones so that the actuarial skill set is properly understood and appreciated by current and future clients. Our profession has already taken great steps in that direction with the development of the internationally recognised risk management qualification, Chartered Enterprise Risk Actuary (CERA). Actuaries in Scotland have been at the forefront of the development of CERA and I believe we are in a great position to really drive forward in this area. Traditional areas of actuarial work are changing, not declining, partly because of new regulatory and reporting requirements and partly because the wider public should and wants to understand the costs, risks and reasonable expectations from their individual savings and pensions products. If there is a common theme to all these changes and developments, then it is this:- everybody (however you want to define this word) wants and needs the Profession and its members to work in the public interest.

3. A Radical Change to CPD

We have our CPD requirements and our President, in the September 2010 edition of “The Actuary”, referred to them as representing minimum standards. They also need refining and adapting for the much wider roles which actuaries are now undertaking. I concur with the President when he expresses concern about CPD being a burden for those working in non-traditional areas. We need to recognise this problem, we need to tackle it. He and I want those non-traditional actuaries to remain within the Profession, since some of those will be identifying possible future directions for many more actuaries. Thus our CPD courses need re-designing and improving for all in the Profession, no matter the area in which they work. If, as suggested, we work in the public interest then I believe our CPD reporting needs changing while, at the same time, there is an unnecessary burden on our secretariat staff to monitor the CPD status of approximately 12,000 members in the UK and world-wide.

Concerns have already been voiced about the time and cost of regulation, particularly effecting participation in quality and relevant CPD. What is apparently not raised is some source for the public or end-users of actuarial services to check that sufficient and effective regulation is in place and CPD has been undertaken by actuaries who are providing the services to them. No mention either has been made, it seems, of the regulation of the Profession and its members providing services to clients who are not UK resident, though this latter group can submit to a partial regulatory regime if they so wish. What is apparent is that the evolution of the regulation of the Profession, whether by member or firm, is difficult. It will not satisfy all – it will be incomplete however hard we try. Witness the failure of the FSA and SEC. And all the time it is the client who suffers from regulatory failure of any profession or any service or product supplier.

So, may I suggest a solution to our President’s concerns about CPD? Turn the regulatory approach on its head and examine the issue from the client’s perspective. The client provides the information for the regulation of actuaries, through the completion of a “Client Satisfaction Questionnaire”. This form would be returned to the overall regulator of the Profession with only a copy to the client’s actuary or firm. The actuary or firm would have to send the questionnaire to its clients, these clients selected in a completely random way, but over 10 years, for example, every client within one firm would have had to complete the form at least once. For small firms, with fewer than 10 clients, the form would need to be completed 2 or 3 times within a decade.

Only those actuaries actually signing forms and reports to clients, only those actually meeting clients where matters are discussed and agreed, would be named on the Questionnaire.

All other actuaries doing “back-office” work, i.e. not producing and signing letters or forms or reports for external use by clients and not meeting clients, would not be named in a Questionnaire. Such actuaries, it is presumed, have their work regularly reviewed by their superiors, with all necessary and relevant CPD being “encouraged” so that the individual continues to perform to the necessary standards and aspires to and achieves progress. If all this is not an ultimate responsibility of the senior partner or chief executive officer, one doesn’t know what is.

Why have I raised this issue of CPD? I am concerned that following the merger of the Faculty and Institute and the imposition of tighter external regulation that a blanket approach is taken, which makes compliance difficult or impossible for those working on a self-employed or small partnership basis. Further, here in Scotland at least, more actuaries work in one or two person partnerships,

i.e. small firms, than all those working in the larger, more well known firms. These small partnerships tend to be in businesses that don't fall into one of the recognised actuarial silos. They are out in "new fields", where current regulation may be somewhat less relevant, where peer reviews are almost impossible, or where their work may be considered as Intellectual Property (IP), with no or limited explanation to other possible competitors. It is not that these practitioners are not regulated—they are by their clients. A good job leads to recommendations to other similar clients, a poor job report could brutally finish the business. These small practices are at the sharp end, potentially leading the profession into alternative areas.

It is true that some small practices are in areas recognised as silos, but the work is being conducted for small companies not normally a client of the larger consulting firms.

Excessive or, perhaps more pertinently, inappropriate regulation is not what is wanted in these alternative businesses, nor in these difficult economic times.

I am a member of the Scottish Constituency of the Institute and Faculty of Actuaries and I have felt moved enough to voice my concerns to the Professional Regulation Executive Committee (PREC) on this issue of quality assurance. I want Scottish voices to be heard as the Profession moves from pre-merger into a hopefully formative stage. I have raised this as an example that, if you don't shout, it will be assumed that all is well north of the border and with all former Faculty members working abroad.

4. Training of Actuaries

I am particularly concerned that the more senior amongst us could be accused of not understanding the course contents of those who have just completed the latest set of examinations. As Stewart Ritchie first commented in his address four years ago, the Profession needs to design and offer re-training courses to longer qualified members to bring their knowledge up to the same standard as those just qualified. And this does mean that time will need to be spent – a week, two weeks, maybe more – on courses that maintain their knowledge and then enhance it. Horror of horrors – some of these courses will have to be examinable before accreditation could be given. Further, our knowledge, use and development of Enterprise Risk Management (ERM) and all its applications should, I believe, be at the core of that enhancement. In addition, there are other professions, which, as part of their training programmes, supply courses in topics which could be of quite some value to members of the Actuarial Profession. I am thinking about basic courses in the legal aspects of managing a multi-national enterprise, courses in Human Resources, courses in Financial Accounting, courses in Marketing, courses in Communications, courses in Behavioural Finance. If members of our Profession aspire to managing, from a senior level, our financial institutions and many of the other large enterprises, then properly designed training and re-training courses are required. It is thus quite some change I am suggesting. You may accuse me of being a retired member who won't have to undertake such courses, but I can assure you that I would relish them if I was 20 or 30 years younger.

To further convince of the need to widen and re-learn our skills, I recall my early days in investment management. After qualifying as an actuary in 1973 I was transferred to the investment department of my employer, an Edinburgh-based life assurance and pension society. I thoroughly enjoyed that time, encompassing, as it did, roles in equity and gilt management. What were the features of that time that have stood me in good stead? First, I had an exceptional mentor, who, by example, showed the way to review portfolios and investigate potential securities for purchase and then

reasons for sale. Second, those reviews recognised that there was more than one party involved in a successful company – it wasn't just the equity shareholder, as seems to be the norm today, who was concerned about a company's progress. There were three other interested parties: the suppliers of the goods and services, the management and employees of the company, and the customers of the company's products or services. While security screening systems were becoming more readily available – risk modelling in today's language – other knowledge and skills were needed. Company directors and senior management were met, also their suppliers of goods and services, and customers watched – the early days of Human Resources or Studies in its wider application. I still do this customer watching today when outside high street stores. I note the names on bags from other stores as potential customers enter a particular store, I estimate what proportion are leaving with a shopping bag from that store in question, and who and what trucks are delivering products at the back door. This was an early and basic aspect of Behavioural Finance! Then back to the office to review the company, its prospects, its accounts and its competition – possibly now referred to as the application of Financial Reporting. We have changed the terms or names but the underlying skills and knowledge still have to be learned, still have to be kept updated. If I was still in employment I would be undertaking all the relevant courses to keep my investment management knowledge right up to date.

5. The Scottish Board

So, where does the Scottish Board with its constituency fit in?

First, we need a definition of the 'Scottish Constituency'. The Scottish Constituency comprises all former Faculty members, including students, in Scotland and beyond and those former Institute members who live or work in Scotland and elect to join the Scottish Constituency.

All former Faculty members are automatically enrolled into this Scottish Constituency but I encourage all former Institute members living or working in Scotland to join. We want a thriving community of actuaries in Scotland, a community which feels and knows it has a purpose, a purpose which is recognised by all actuaries in Scotland and well beyond. By building on the heritage of the Faculty and the excellence of our academic institutions, I know we can achieve this. The role of the Scottish Board will be to champion and develop the actuarial community in Scotland.

A "triangle" was recently defined by the new President of the Institute and Faculty of Actuaries. This triangle consists of the profession, academia, and business. We have a geographically close community in Scotland in which this triangle can be developed and flourish. The triangle represents the opportunity for the Profession and its members to review the skills it needs, to review who can undertake such re-training and then identify where and how it can be applied. I believe that much research has already been undertaken in universities, particularly in the fields of, for example, financial economics, ERM, behavioural finance. This research, with some possible re-working, could find application within our Profession. Again, the Profession could and does offer resources, (i.e. money and mentoring) into areas of particular interest. Recently, for example, the Management Board agreed the funding of two major projects. It is worthwhile noting them here:-

The call for proposals invited bids in three areas:

- *How should firms define and use "risk appetite", but with the emphasis on the need that outputs should be practically grounded and expressed?*

- *How should firms identify and assess the hard to define risks – what techniques are available and how do they work in practice? This topic could possibly be linked with practical techniques for reporting on emerging risk and strategic risks, to mirror text from the recent Walker Report.*
- *How should firms report and communicate tail dependencies and correlations to stakeholders including senior management, the Board and regulators? This includes mechanisms for reporting, and the need for effective communication.*

It was felt that progress in any of these three areas would be of significant benefit to the UK Actuarial Profession. The resulting review of all the bids led to an award to Milliman/Universities of Bristol and Bath for the first two topics, while the University of Kent was awarded the third.

I particularly want you to note Milliman's response to the question of Intellectual Property (IP) rights. I am delighted with it and I commend it to you all: -

We (i.e. Milliman) have absolutely no desire to withhold any output from this research. Based on research to date and observing trends in other disciplines, such as economics, we are convinced that the use of complexity science is almost inevitably going to be at the heart of risk management in the future. We feel it is important for the Profession to be seen as one of the leaders in this area and are therefore prepared to bring the benefit of our previous work to help the Profession claim that thought-leadership position.

As I said, we have a geographically close community in Scotland in which this triangle of training, research and application can be developed and flourish. Some steps have already taken place.

- i) The Profession is a founding member of the Scottish Financial Risk Academy. Amongst its activities, the academy carries out research into risk management topics, runs training and re-training courses for interested parties (for example ERM courses for actuaries). Fuller details are available on its website, www.sfra.ac.uk
- ii) Scottish actuaries have been actively involved in the design and launch of the internationally recognised CERA qualification.
- iii) We are organising an informal meeting in Edinburgh with representatives from academia and business, including the Director of the Scottish Financial Risk Academy, the Head of Mathematics at Edinburgh University, and the Chief Executive at Scottish Enterprise. This will include a discussion on the use of risk management techniques in larger firms and possible application to smaller firms.
- iv) We would like to encourage actuaries to volunteer to act as mentors on research projects at both Heriot-Watt and Edinburgh University. I realise and the Profession realises that actuaries in today's workplace do not have the same time to participate in research groups as once was the case. However, the present and future research need is as great if not greater than in the past. It is thus important to encourage universities to lead that research, with our members acting as advisers or mentors just as outlined above in the recent Management Board awards. If you are interested, please contact the Profession's research manager. The Scottish Board, with collaboration or agreement through the Profession's research manager, can also sponsor research that meets our needs and the needs of the wider Profession, but through universities in Scotland.
- v) A range of events and activities, including meetings and forums, will continue to be offered to members in Scotland. If you have an idea for a topic or an event, please contact the Profession's secretary to the Scottish Board.

6. What does this mean for you?

Whether you are a former Faculty member or student, in Scotland and beyond, or a former Institute member who lives or works in Scotland, I hope you will feel part of the Scottish constituency and get involved in the range of activities on offer.

To help foster a sense of community for the Scottish Constituency, we've set up an online community so that members of the Scottish Constituency, regardless of where they live and work, can share news and information and discuss actuarial ideas and topics. You can view and join the discussions by logging in to the Profession's website, going to the Communities section and clicking on the Scottish Constituency button under "Other communities".

Furthermore, the Scottish Board cannot develop training courses or encourage research on its own. The Board needs to hear the views of its Constituents, and not just those in Scotland but those who live and work overseas. An alternative way of saying this: I cannot lead this Board and I and the Board cannot undertake work on Constituents' behalf without knowing what our Constituents want.

Actuaries in Scotland have traditionally "punched above their weight" on actuarial committees and working parties in the development of the Profession. I would like this to continue but it is already becoming clear that Scottish actuaries are becoming few in number on Practice Executive Committees and their sub-committees. Unless Scottish actuaries actually take part in these committees, get involved, and record views then any distinctive, formative role for us will disappear. All Board members, elected and co-opted undertake further work for the Profession but we cannot undertake it all. I want other Scottish Constituents to volunteer – make your voices heard and your interests known, initially through our online community website.

It is in all our interests for Scotland to continue as a centre of actuarial excellence. The Scottish Board can only do this with your input and support. I want the Profession to thrive and expand. But we have to engineer it. I look to you for support, encouragement, and direction.

By working together we can create bright futures for all.

Synopsis of the ensuing discussion

The President chaired the discussion following the Inaugural Address by Gordon M. Bagot, Leader of the Scottish Board of the Institute and Faculty of Actuaries. Opening the first meeting of the merged profession in Edinburgh, the chair pointed out that this is an opportunity for Scottish actuaries to have their say in what they think the Scottish Board should be doing to help them in their professional life.

Professor Robert Clarkson, after congratulating Gordon on opening the debate, expressed concern that the Actuarial Profession over the past few years had been caught up in structural reorganisation to the disadvantage of looking at what was happening in finance. Many will recall his scepticism of the basic tenets of financial economics, voiced when presenting papers both to the Faculty and Institute, and he now feels the financial crisis provides much more evidence of its fatal flaws. This was not the place or the time to go into detail but he promised a paper within the next couple of months on a better way forward for the theory of finance that takes into account some aspects of actuarial science. In the meantime, he recommends Benoit Mandelbrot's last co-authored book, *The (Mis)behavior of Markets*.

One speaker, suggesting that though not young he was reducing the average age of the audience this evening, asked how the Scottish Board plans to get the student population and newly qualified actuaries to engage in forums like this and to engage more generally with the Profession in Scotland. Mr Bagot agreed that it is a priority. Part of the plan, as evidenced in this evening's proceedings, is to create a more informal form of sessional meetings to encourage the younger members to raise their views and comments, alongside the traditional more formal paper presentations. He also wanted to engage younger members by supporting their career development through the structured courses he mentioned in his address. Actuaries, he noted, have most of the skills to rise to the highest level in the largest companies and a few have already done so. But why, he wondered, have not more done so? Perhaps some need extra skills and he believed that it is part of the Scottish Board's role to support such aspirations. But, he pointed out, this cannot be done unless young actuaries make known their needs.

Mr Malcolm Murray asked what might be considered the ideal mix between executives and non-executives on a board. Mr Bagot thought nine or ten was about right – six or seven executives and three suitably qualified and experienced non-executives. He explained that he came to this view from studying successful investment management houses. If the board gets much bigger then it becomes too big to know what is going on down in the engine room. A board small enough to know what is going on is required for successful management of a business. It is not the size of the company that is important, it is the lines of business that it is involved in and a good company maintains focus on a relatively few lines of business.

Mr David Martin noted that the Faculty had a good reputation for research and it was the expectation when he qualified that every newly qualified actuary would join one research group or other. He thought that it is through academia that we are going to move forward and he asked Mr Bagot to elaborate on the research going on in Scotland, and also the way that actuaries here might be able to give support in different ways.

Mr Bagot responded by saying that the traditional model of working parties of actuaries producing research papers is no longer tenable, given the demands of the day job. He saw the modern model as one where specialist research work is contracted out to universities. They have the skills, they have the staff, they can call upon senior staff to help out and to train students in research methodology.

One way to engage with universities is to sponsor students to undertake some research project—some firms in Edinburgh sponsor and support MSc students, especially through Heriot-Watt. However, this is not the best way to get quality research due to two drawbacks: data appreciation and emphasis. First, he has found, when with Wood Mackenzie and WM and providing data to universities to do some backup research, that the use of data and the selection of data by university students left a lot to be desired—in many cases they ignored large slices of the data because they did not understand it. Second, some of the papers coming out of universities were good but could have been much better, with a much wider application within the Profession, if the work had been done in a slightly different way, or had been done with a different emphasis. So, perhaps a better model for engaging with universities is that actuaries give direction to students' research – and mentoring is a lot less time consuming than actually writing research papers.

Mr Bagot reminded the audience that actuaries are actually mathematicians and some problems, such as modelling the risk posed by tail dependencies, require us – in conjunction with, say, the renowned Mathematics Department at Edinburgh University – to identify and manage these key risks that can cause ruin.

He mentioned other initiatives such as the Profession's role in the Scottish Financial Risk Academy and organising colloquia that can help at the big picture level. He concluded by pointing out that young actuaries, who may not be far away from the disciplines of learning and training, are best placed to develop the collaborative research agenda with the universities.

Mr Tom Ross, admitting that he did not lower the average age in the room, welcomed the new approach of concentrating energies in Scotland on research and development and not the administrative paraphernalia that goes around running a profession. He opined that younger actuaries in the room will be doing something totally different in work to what it is they are doing today. That is why it is so important to keep developing the Profession and it is primarily in the interest of younger members that that is done. The Profession, because of its disciplined approach to these issues, is at the forefront of developments.

He went on to suggest that there is another research field which, because of the close community in Scotland, ought not to be ignored. The world of economics and finance is obviously extremely important but so too, he pointed out, is the social sciences and issues of longevity, and so on. There is, because of Scotland's particularly small community, a mass of very valuable data which, in the right hands, can provide very important insights. He urged a proper analysis of it, especially as times are going to be a bit tough in the future, particularly for the poorer sections of the community. He thought that it is important that the Profession lends its skills to the analysis of the data that are available on health, lifestyles and well-being of people in our society and to use that to enable more informed decisions to be taken in some of those important social areas.

Another speaker suggested that, while the terms of reference of the Scottish Board will be the ultimate criterion on which to decide its success or otherwise, his one measure of success is the building of a vibrant community of actuaries and actuarial students in Scotland. In this regard, it might be helpful for the Scottish Board to consider itself a customer of the executive team down in London. The Board, as a customer, should demand high-quality interactive sessions of different styles for different segments of the community – for actuaries at all stages of their careers.

Mr Crawford Taylor, who still considers himself a younger member, confessed that he could not have imagined how enjoyable the work of an actuary could be and encouraged the Scottish Board to try to get that message out to young graduates and to get more of the great Scottish thinkers and inventors of the past into the actuarial profession. He was surprised that more young actuaries were not here tonight and, because of that, there is a challenge to re-engage them with the Profession.

Mrs Irene Paterson supported the view that the triangle of Business, the Profession and Academia is the way forward for actuaries. There is competition within the risk area from other risk professionals. Regulation really demands our skills. Solvency II focuses on credit risk, liquidity and market risk. It is challenging how these risks should be managed, as well as the traditional risks that we have always advised on.

The chair, conscious of time, drew the meeting to a close by asking everyone to join him in thanking Gordon Bagot once again for a stimulating and encouraging address.