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ADDRESS

BY THE PRESIDENT OF THE INSTITUTE OF ACTUARIES

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THINKING AND BEHAVIOUR

ABSTRACT

In a world of transition for all our disciplines, actuaries can get and keep ahead of the changes by, first, getting our thinking right. Right behaviour and actions will follow. We will think about the needs of our employers and clients and present our findings more in the business context; we will look through their needs to the needs and interests of their employees and customers. We will grasp financial economics and learn banking thinking. The profession will raise issues of public interest and inform the debate.

KEYWORDS

Thinking; Behaviour; Needs of Employers and Clients; Needs of Employees and Customers; Openness; Transparency; Accountability; Business Context; Multi-Disciplinary Schemes; Public Interest; Financial Economics; Banking Thinking; Fair Value Accounting; Appointed Actuary

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Part I. Objectives

1 *Transition*

1.1 We live in troubled times. I do not intend to dwell on them. We are learning our lessons, as are many of our colleagues in other professions and disciplines. The process of learning will continue, as will accepting new realities and adjusting our thinking to demonstrate how we add value in the new environment. We will also contribute proactively to the development of the new environment. My objective, in my Presidential term, is to lead the profession through the transition. Judging by recent experience, the state of transition may itself be permanent.

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1.2 My aspirations for individual members are that we demonstrate that we understand the needs of our employers and clients, their customers and the identified publics they serve; that we demonstrate with openness, transparency and accountability how we make financial sense of the future in both our prudential and our entrepreneurial roles; and that we use our competencies to demonstrate our results in the business context of our employers and clients.

1.3 My goal for the professional body is to support these aspirations. To that end, I expect to see the profession engage in ever closer relationships of mutual understanding with other disciplines and professions, with associations and with government. This will benefit our members and their employers and clients. I intend that we should increase the influence of the profession, and of its members, with selected audiences, so that, through our integrity and our standards, we demonstrate that we deserve the trust of the public we serve. The profession should also be more proactive about raising issues of public concern.

1.4 Let us think about some of these transitions that are taking place at present:

— The presumption of trust in financial transactions is being replaced by a demand for openness, transparency and accountability, coupled with the demonstration of benefit to the customer.
— In the past, we needed to communicate the mechanics of insurance and pensions, by and large, only to those who had grown up in these businesses. We now need to communicate these mechanics to those from other disciplines. In particular, we need to ensure that we communicate the special characteristics of insurance and pensions to those from a banking discipline within the Financial Services Authority (FSA).
— Our employers and clients are making the transition from a world of virtually unrestricted charges and ample estates and surpluses to pressure on margins and on capital.
— Actuaries are making the transition from product focus to more of a focus on customer needs.
— Much of our work will be affected by the accountancy profession's transition from revenue based financial reporting to balance sheet based reporting.

1.5 In all of these transitions, how we behave with our employers, our clients and their customers and with other disciplines, professions, associations and government will determine the perceptions and trust that they place in us in the future. To achieve that behaviour, we need to be thinking from their perspective and to use their language. We are a small profession, and one that punches well above its weight. We can only punch effectively if we adopt the language of the audience we seek to influence. We can use the competencies we have — both technical and personal — to appreciate the needs of others and to demonstrate to them how, truly, to make financial sense of the future.

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1.6 Our influence on the international stage is also important. Our activities with the International Actuarial Association and with the Groupe Consultatif enable us to demonstrate what we do and how we do it. We have contributed significantly to the development of the standards of these international bodies. Associations which are members of these international bodies appreciate our leadership, and model their structures and activities on our standards. In particular, there is a strong appreciation of the benefits of the Appointed Actuary system, which is being copied worldwide. By these and other means, actuaries belong to the first profession to go global.

1.7 I have adopted a process in building my objectives for my Presidential term. I have, of course, paid due attention to the Addresses of previous Presidents and overseas Presidents — what new President would not? I have to say that I have paid significant attention to the views of the employers and clients of actuaries and to the views of regulators and associations. I have conducted some 70 individual and group interviews, and much of what I have to say derives from those interviews. I am very grateful for the time that people have set aside to talk to me. I intend to continue with such meetings in the next two years, to keep my thinking up to date.

1.8 Amongst the many things that people have told me, the following are critical and will be central to the emphasis of my Presidency over the coming two years:

— *Recognising the business context.* Actuaries must present the results of their work in the business context. We, and our employers and clients, know that we have the competence to analyse the implications of our work for everyone involved. We have to deliver the results to our employers and clients, with the implications for the stakeholders affected and with the insights accumulated during the work. This is the single most important issue raised by those I met.

— *Working with others.* In some fields, we are already well used to working in multi-disciplinary teams — in mergers and acquisitions, for example. Where other professionals have responsibilities as well as ourselves, it is doubly important that we present the information we have in a way that all professionals understand. The corollary is that we have to understand much better the way in which other professionals think. A further corollary is that we need to define, with other professionals, what we mean by some words (such as, for example, 'provisions' and 'reserves' and even 'value'). When we use the words at present, we create unintended thinking in the minds of our audience.

— *Integrity.* Nowadays, it is not enough to have integrity, it must also be demonstrated. We do this by the now familiar mechanisms of openness, transparency and accountability, including peer review, adherence to guidance notes, completion of CPD, and so on. These demonstrations must be real, but not intrusive, so that our employers, clients and other audiences not only benefit from our integrity, but can take pleasure in it also. The best demonstrations of integrity do not inhibit our work, nor do they inhibit the actuary from producing a fully entrepreneurial result for employers and clients and others affected by the outcomes of our work. As actuaries, we have a responsibility to look out for each other in maintaining the integrity of each one of us.

— *The correct positioning of the public interest.* For actuaries and for the profession, it is vital that the influence of our public interest commitment is beneficial to all stakeholders in our work. The profession will continue to provide fully qualified actuaries for the public and to raise public interest issues to inform debate. Our public interest stance must not inhibit actuaries from engaging in advice to, and the management of, entrepreneurial organisations.

— *Increasing our influence.* The profession needs to increase its influence with selected audiences. Many observers of actuaries realise that we know more than we let on. We are the thinkers and interpreters of complex financial systems. We need to find ways to ensure that what we know is made more available for the benefit of our employers and clients and the public at large, and not left in the back room.

1.9 In formulating my thoughts in this paper, I have chosen to have in mind actuaries who have qualified in the last three to eight years. This is the group that students are aspiring to join soon and the group that will have qualified under the old education syllabus which, in particular, did not introduce them to financial economics. That is the group that is conscious of the skills they have acquired and must also be conscious that the trials and tribulations of recent years must inform individual actuaries and the profession for the future benefit of all.

2 *We need to Broaden our Thinking*

2.1 In stark contrast to the open-minded and forward thinking I have mentioned above, there were a few whom I interviewed who asked me to "stick to the knitting", "spend less time on those wider fields things", "concentrate on the United Kingdom; we have enough problems here to occupy any President", "preserve what we have", "defend this", "defeat that". All these suggestions define possible approaches. I am convinced that the overwhelming majority of the profession, and our employers and clients, do not want us to pursue such approaches or adopt such attitudes. In taking the broad option, and seeking constructive resolutions, we do need to explore how we can make a real impact with the limited resources at our disposal.

2.2 Some of the areas in which we need to broaden our thinking are determined by the rapid changes in our environment. There is some catching up to do here. Other areas are determined by the need to get ahead of the transitions and proactively set the agenda post-transition.

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2.3 We are judged by our behaviour. It is what our employers and clients see. We can catch up in some of our behaviour by additional training. Being, by and large, a bright bunch, actuaries are able to change their thinking to achieve the required behavioural result effectively, and with permanence. My question is not, therefore, whether we are able, but whether we are willing. It is my intention to pursue the changes in education and ways of thinking that will set us on the right path for the future.

2.4 Paul Thornton laid the foundations for the thinking over the next 20 years by outlining the statement of 'Vision and Values' for the profession. Peter Clark has established the communication processes to get the messages across. I intend to use the valuable work of Paul and Peter, together with our growing external relations, to drive the changes in thinking and behaviour that will shape our work in the future. As the Chinese say: "We have a firm foundation for a great leap forward."

2.5 *An Example*

By way of example, in the early days of the late Financial Services Act, shareholders, particularly overseas shareholders, were all for "taking action to bring these regulators under control", demanding to know: "Who do they think is running my business, anyway?" To change the thinking of such shareholders to one that admitted that regulators have a legitimate intervention in their business if customers were unfairly disadvantaged, was always going to be a long-term process. In the meantime, their immediate behaviour had to be modified to keep the fines and costs down to a minimum whilst they worked on their thinking.

2.6 So too for our profession, we can have most impact on our behaviour by changing our own thinking. The impact will be longer term and more enduring. It will also keep pace better with the changing mores of our society — both in the U.K. and abroad. If we are really bright, we will allow our changed thinking to determine our behaviour for the good of ourselves, our profession, our employers and our clients, their customers and all the other stakeholders in what we do.

2.7 There is a saying that I value for its wisdom: "The world holds you at your own evaluation of yourself." How we evaluate ourselves, how we think about ourselves, will show in our behaviour, and it is this that the world sees. So, self-esteem is important to enable our good works to be seen and to be accepted by our employers and clients as coming from actuaries of integrity. That self-esteem comes from inside ourselves, from practised competence and the observed value of the work we do.

2.8 In the safety demonstrations at the beginning of a flight, the flight attendant or the video shows how masks appear in the event of reduced cabin pressure. There is then the phrase: "If you are travelling with dependants, fix your mask before attending to others." As applied to the work of a professional, I take that as: "Crisis or not, get yourself competent and in good shape before attending to the needs of others." It is this competence that shows in our self-esteem that shows in our behaviour.

3 *As a Profession, we need to Engage in Closer Relationships of Mutual Understanding with other Disciplines, Professions, Associations and with Government*

3.1 Many of the people I have spoken to since my election as President have remarked on the high regard they have for actuaries. Apart from wishing for a higher profile for the profession, they commented on the quality of their direct interactions with actuaries, on the quality of our meetings and on their increasing willingness to meet with the profession on matters of common interest. Staple Inn, in particular, is regarded as a place both to meet actuaries for their counsel and to meet other professionals and leaders of commerce for a diversity of views. One request I had was for such meetings here at Staple Inn to be more frequent, more diverse and less formal.

3.2 We already have formal structures to maintain relationships with the FSA, the Department for Work and Pensions (DWP) and the accountancy profession. I intend to explore how the Institute can provide a meeting place for the diverse interests in the financial services industry to exchange views at a variety of formal and informal gatherings. I am particularly interested in gatherings of risk professionals to develop the necessary multidisciplinary approach to comprehensive risk acceptance and management in the financial services industry and beyond.

4 *We need to Increase Further the Influence of the Profession*

4.1 The process of increasing our influence must be done in a way that brings those new to our work along with us. There will be occasions where what we do will be challenged, sometimes unfairly from our perspective. We accept that challenges arise from perceptions of what we do, and give us the opportunity to improve the quality of those perceptions. The audiences with whom we will proactively raise our profile will be chosen to be those with whom we can have constructive dialogue to further the interests of our members. Work on prioritising those audiences has been done, and some progress has been made in deciding how to get our messages across to them.

4.2 We need to choose the things we do today to make it easier for our audiences to engage with us tomorrow. Much of today's activity is devoted to meeting, in all sorts of ways, our various target audiences, with the objective, not only of opening dialogue, but also of giving them an incentive to come to us for an exchange of insights as and when they are needed.

4.3 We have done some sterling work in raising our profile in the last few years with selected audiences. I can point to the splendid work on the Minimum Funding Requirement for which Mike Pomery was given a

President's Award. The work of the Life Board in its responses to recent FSA papers on with-profits business was well received by the FSA. The paper by John Ryan *et al.* (2001) on financial condition assessments for general insurance emphasised the contribution that actuaries make to risk evaluation and co-ordination. I can attest to the cumulative effect of these and other, less public, efforts in increasing the level of desire of others to come to the profession for an exchange of views and for insights.

4.4 I have mentioned that I would like to take advantage of this welcome trend. I would like to see us also being the catalyst in bringing together those influential in financial services in the regions, so that the profession is seen to be at the centre of influence in the development of thinking about financial services — both in the retail sector and in corporate finance.

4.5 I have received plenty of requests, too, for raising the profile of the profession in the form of seeing informed comment in the newspapers from actuaries on matters of current interest. This does, in fact, happen quite frequently, and is generated chiefly by press releases from the profession and from actuarial firms and also by good relationships with journalists. Some of the demand for this form of profile is from actuaries, themselves, in a desire to see a good image of the profession and, as a corollary, to have a good image of themselves. Such desires are totally understandable, but misguided. The self-esteem of individual actuaries and our own image of the profession are critical to our success. Self-esteem comes from personal competence and from internal self-confidence, not from multiple mentions of 'actuary' in the press. We shall continue to seek an appropriate level of publicity for the views of the profession and for providing constructive and thoughtful input to debates.

5 *We need Proactively to Raise Issues of Concern*

5.1 It is one thing to raise the profile of the profession by reacting to issues that are already in the public domain, or even to anticipate issues and to prepare our position ready for when they appear publicly. It is quite another matter to raise new issues of concern. There are pitfalls to a public airing which include: that some customers may have already been disadvantaged; that the issue may already have been sanctioned by regulators; or that Practice Boards may be reluctant to take a public stance, because of conflicts of interest; but this does not mean that the profession should shy away from raising the issues.

5.2 At present we have no process for considering the best way, and the best time, to raise such new issues, and with whom. We have to decide whether forming such a process is worthwhile. The mores of society change, to make unacceptable practices that were once considered acceptable. The pace of change may be continuous, which makes the timing difficult for raising the issue. Whenever it is raised, and it is accepted as a real issue, there will already be some disadvantaged customers demanding compensation, and it would have been better to raise it earlier; but, it is important not to be responsible for a self-fulfilling prophecy by raising a concern over something that might have been addressed more successfully away from the public gaze.

5.3 A classic example is the progress of the issue of the selling of endowments to repay mortgages. Evidently, when life assurance premium relief (LAPR) was in force there was a much stronger case for the practice; but the abolition of LAPR, followed some time later by a fall in interest rates and an associated reduction in relief for mortgage interest, the use of endowments to back mortgages became less justifiable. Little is sold today. What is the lesson to be learned from this about timing? I leave this particular example and the need for a process as open questions for now.

6 *Individual Actuaries need to Demonstrate that we Understand the Needs of our Employers and Clients, their Customers and the Identified Publics they Serve*

6.1 Given half an opportunity, I am always keen to press the cause of looking at life from our employer's or client's end of the telescope and, even further, to look at life from the perspective of the customers of our employers and clients.

6.2 My first experience of a customer was of receiving a phone call in the surrender values department of Equity & Law in my first year as an actuarial student. The customer rang to ask to surrender his policy. I had previously worked out that the surrender values of whole life policies increased every year by more than the premium paid after the second year. So I said: "Why would you want to surrender? The more money you put in, the more you can get out.'' It took some doing, but eventually the customer decided not to surrender. That experience was really the beginning of my thinking that has led to 'Client and Customer Needs Focus' being the dominant thought in my professional career.

6.3 I know that I spent the time trying to persuade the customer because I recognised his voice as a famous BBC presenter, and I did not want someone I felt some familiarity with to do what I thought would be against his best interests. Looking back, it certainly should not have taken that extra stimulus to make me do the right thing for the customer. All customers, familiar or not, deserve individual attention to their individual needs. It is what they expect, not just on the sale, but throughout the life of their relationship. There is a cost in proactively satisfying their service expectations — particularly how their benefits are progressing to meet their perceived (and changing) needs. I wonder how many customers, even now, feel they have been offered that proactive service, even at a cost.

6.4 I have written enough in the past on the value and consequences of starting with the employer's, the client's or the customer's needs. Focussing on the customer's needs is different from focussing on the customer. The latter acts on the emotions to persuade the customer of the trade off of the benefits of the product or the service and the cost. It also involves the reprioritisation of disposable capital and income. The former, focussing on customer's needs, is an analytic process susceptible to logical treatment. It has the advantage of requiring relevant data from the customer, so that it is obtained rather than presumed. It focuses the work of the actuary on how to satisfy the variety of individual cases rather than to provide a generalised solution that may fit no individual customer. It has the added advantage of producing simpler results.

6.5 I advocate the approach of focussing on customer needs, even making it one's dominant thought, especially in the current environment. Some obfuscations of the past are being swept away by the Association of British Insurers' (ABI) Raising Standards Initiative in life assurance. Taking the employees' perspective makes a strong case for defined benefit pension funds and better informs the necessary accommodation between the pensioner's need to cover reasonable and reasonably fixed expenditure in retirement and the employer's need to cut costs and accounting volatility in the face of increased longevity, lower interest rates and FRS 17. The behavioural consequences of FRS 17 closing down defined benefit schemes could not — at least, I hope they could not — have been foreseen by the accountants in the early drafting, although our briefing statement of November 1999 is clear that FRS 17 would discourage the continuation of such schemes.

6.6 Closer to the work of the individual actuary, I am aware of the temptation to say: "Well, I cannot start until I have the data.'' Would it not be valuable to use the intervening time to check thoroughly with the boss or the client more precisely how the results of the work will help the resolution of the real problems. This may well happen at a senior level, but I question whether the results of that discussion are passed on to other actuaries in the team. This involvement with the resolution of problems, rather than the mechanical production of an actuarial result, is critical to the development of young actuaries, who, in turn, should demand to be more involved.

7 *Individual Actuaries need to Demonstrate with Openness, Transparency and Accountability, how we make Financial Sense of the Future in both our Prudential and our Entrepreneurial Roles*

7.1 The typical process of a traditional actuarial piece of work is one of input applied to a methodology with some assumptions, followed by output with demonstration of the sensitivities to changes in the assumptions. What do we have to do differently to take on board the requirement to demonstrate openness and transparency? We have to show, not only what we have done, but also how it was done, why it was done that way, why the assumptions and methodology are appropriate and why the range of results is reasonable.

7.2 To enable actuaries of the future to demonstrate more openness and transparency, the 'why' and 'how' will feature very strongly in the new education syllabus currently under development. We will also be encouraging actuaries to be more open and transparent with themselves as they acquire competencies during their working lifetime. We will be requiring students to keep a logbook of their work and skills learned to demonstrate their progress to becoming an actuary. We hope and recommend that every actuary keeps such a logbook beyond Fellowship to demonstrate lifelong learning.

7.3 At the professional level, the paper by Graham Clay and his working party (2001) on the transparency of with-profits business is a demonstration of the recognition that actuaries should abandon the mystique card and expose even these most complex of animals to the scrutiny of management, the board and the regulators.

7.4 On the other hand, it has been said that we have avoided attracting too much attention over recent failings, because observers do not know what we actually do. This, it is said, makes us difficult to target, so we should maintain our mystique as a protection. Frankly, I do not believe this is an option. This may (and I stress 'may') keep us safe from criticism in the short term, but the negative impact would be all the stronger in the long term. If observers do not recognise what we do, they will be more inclined to impose unworkable proposals upon us. It is only by being recognised and acknowledged that we can carry influence.

7.5 So, we had better get used to openness, transparency and accountability — and fast. This may seem counter-cultural to actuaries, but it does not conflict in any way with our familiar professional criteria of integrity, competence and rigour. Nor is there any conflict with the objective of satisfying employer and client needs. It is a lot to get used to, but it is do-able — with practice — and we need to get there soon. Whilst advocating this path, I recommend we do it with our eyes open. The context and consequences are admirably set out in the 2002 Reith Lectures by Onora O'Neill, 'A Question of Trust'. She explores the rather passive activities of openness and transparency, and advocates, rather, the active limitation of deceptions.

7.6 Contrary to popular belief, actuaries are once again occupying some of the most senior executive positions in financial services organisations. Five of the largest financial services organisations in the U.K. are now headed by actuaries — who, as far as I am aware, are happy to acknowledge that they are where they are, at least in part, because of their actuarial background.

7.7 I think that one of the consequences of openness, transparency and accountability is that we will have to think harder in our work about what is advice and what is a decision. This is not just an issue for consultants. It is especially critical, for example, to the recommendation of bonus rates on with-profits funds. Taken together with the increasing awareness of the need for directors to understand the process and to exercise control and to demonstrate the exercise of control, it is important that directors know what implicit decisions have been made in such recommendations.

7.8 More generally, we will be better actuaries and be better contributors to our employers' and clients' businesses if we are more aware of the advice and decision processes we use and can communicate how they work. Such enhanced self-awareness also equips the actuary to take on entrepreneurial roles. As ever, decisions are easy, it is living with the consequences that is difficult.

8 *Individual Actuaries need to Use our Competencies to Demonstrate our Results in the Business Context of our Employers and Clients*

8.1 I have long been impressed with the easy presumption of integrity in the work of actuaries and of the profession. This presumption has been hard won by the behaviour of all actuaries every day with their employers and clients. It is not lost by the behaviour (or alleged behaviour) of one or two actuaries that the profession might regret. The presumption is dented, and it places our employers and our clients on a higher level of alertness to our integrity and standards of behaviour. That, of itself, is no bad thing. It does require us to be sensitive to that heightened alertness. Daily demonstrations of integrity, high standards and appropriately resisting pressure are the most valuable forms of public relations that the profession has at its disposal.

8.2 I have already mentioned the need for actuaries to express their results with greater clarity. Ever greater responsibility is also being placed on the shoulders of shareholders and trustees, for them to demonstrate their grip on their operations. So, it becomes more incumbent on actuaries to ensure what they say is clear and presented in a way that employers and clients can use, as directly as possible, in the discharge of their responsibilities. To that end, in the new education syllabus, we will be emphasising the need to demonstrate results in the business context.

8.3 I also see a need for greater sensitivity when working in multi-disciplinary projects — a sensitivity that will follow naturally, as actuaries gain a greater knowledge of the mind-set of other disciplines. I see an increasing need for actuaries to know how lawyers, accountants, regulators and bankers think, in order for us to convey the project results with clarity and to persuade and influence the recipients.

8.4 It is clear to me that, during the course of our work, actuaries become aware and alert to many business issues and their implications beyond the original scope of the work, but there seems to be a reluctance to impart this extra knowledge. Our employers and clients also suspect that actuaries have discovered a lot about the business organisation as a by-product of their work, but those we serve do not know how to dig this information out from us. It may be that the additional insight has not been

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blessed with the rigour of the main work. It may be that time pressure prevents the development of the implications. For whatever reason, actuaries will do themselves and the profession a valuable service if they all grasp this opportunity to show our good works as part of any project.

8.5 By way of encouragement, I repeat a description of an actuary that was sent to me by one of our members:

"An actuary:
— brings a commercial financial outlook that pure mathematicians don't have
— thinks creatively in a quantitative context that accountants aren't familiar with
— brings many different perspectives to a financial model, including demographic, economic and social, that economists don't embrace
— has a mindset to think in the space of uncertainty — even if the underlying parameters are also uncertain — that statisticians are uncomfortable with."

8.6 The profession's by-line, 'Actuaries make financial sense of the future', was chosen deliberately. If we had wanted to say only that actuaries make financial *models* of the future, we could have done so. We have adopted the by-line. We must live up to it.

8.7 My marketing adviser talks in terms of a 'signature behaviour' of an entity. This is a behaviour that is associated (often uniquely) with the entity. How many people, for example, associate The Body Shop with products that are not tested on animals? The answer is probably everyone who has ever stepped into a Body Shop, and many, many more besides. Other examples are John Lewis ('Never knowingly undersold') and Goldman Sachs (all new recruits are flown to New York for their induction into the Goldman way).

8.8 I would like the placing of the results of a project in the business context to become a signature behaviour of the actuarial profession. I would like to be able to say that, when an actuary has done a piece of work, he or she will, at the minimum, add an informative coda on the business implications of the results and any other value added insights obtained during the project.

8.9 Over time, the business coda should permeate all of the actuary's thinking, and the whole document will be steeped in business issues, not just the closing; but I recognise that there is a learning curve; we should not expect too much of ourselves too soon. I just ask that we do not take too long!

8.10 I urge all actuaries to adopt this signature behaviour of the demonstration of business implications and value-added insights to the point where it becomes recognised, and, indeed, expected, of actuaries in presenting their results. I also call upon employers and clients to assist by demanding this service from their actuaries.

8.11 I have been considering why it might seem difficult for actuaries to absorb business conditions alongside their education and experience. It struck me that one of the characteristics of actuaries is that they feel

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comfortable only where there is little that they know that they do not know. In other words, an actuary, presented with some new data or methodology that might be relevant to his or her work, will, by and large, react by making a considerable effort to get familiar with that data or methodology. Another consequential behavioural reaction is that actuaries may not proactively seek new data or methodology that may actually assist their work.

Part II. Two Specific Issues that need to be Addressed — Positioning the Public Interest and Financial Economics

9 *Positioning the Public Interest*

9.1 It will come as no surprise to those who have attended previous Presidential Addresses that I raise the issue of the public interest. The first line of the objects of the Institute, set out in our Charter from 1884, requires the profession: "in the public interest, to promote knowledge and research in all matters relevant to actuarial science and its application.'' This requirement is quite specific and limited to promotion, i.e. to something that the profession initiates. The profession also initiates the education of students to become qualified actuaries, so that actuarial work is done to a standard set by the profession.

9.2 Recently, the profile of the public interest has increased significantly, and the profession has struggled with how broad an interpretation to accept. As a consequence, the public interest issue causes much confusion for individual actuaries. In our profession, the confusion is perhaps of special significance to the group I identified as those I have particularly in mind, three to eight years' qualified — and with good reason. We ran some focus groups last year that exposed this confusion. In particular, those actuaries who have joined the profession in the expectation of developing the entrepreneurial skills for senior management have been confused by the concentration on, and the intensity of, the public interest commitment placed on them by the profession.

9.3 It is my ambition to relieve individual actuaries of the yoke of a presumed requirement to act in the general public interest when it is, in fact, not required.

9.4 I have already commissioned a group, under the auspices of the Communications Committee, to consider the aspirations of entrepreneurial actuaries and to reconcile those with the public interest stance of the profession. The aim of this review is to deliver a statement of the positioning of the 'public interest', and to do so in a way that can be understood by all those who are concerned with, and influenced by, the work of actuaries.

9.5 That review is not yet complete, and my further comments on this very important issue should be regarded as statements about work in progress. I have deliberately separated the positioning of the public interest into that relevant to the profession and that relevant to individual actuaries. They are obviously interconnected, but it helps clarity to consider them separately first.

9.6 Two documents relevant to this issue are the Consultation Document, *Protecting the Public Interest* (2002), from the Review Board of the Accountancy Foundation, the new independent regulator of the accountancy profession, and the response from the Institute of Chartered Accountants in England and Wales. The Consultation Document is largely about procedures; the accountancy profession's response asserts that the public interest is difficult to define and that the public is a collection of groups of individuals with different interests. The Consultation Document does not distinguish directly between the appropriate approaches of the profession and of individual members. The accountancy profession's response expresses a similar concern to that of our young professionals about "the apparent presumption ... that accountants should at *all* times have a responsibility to the community as a whole.'' Also, from the response: " ... it seems invidious to impose an obligation on qualified accountants alone to take into account responsibilities to everyone in the community, in every activity they carry out.''

9.7 Ironically, the young actuaries in the focus groups had a misconception that, when accountants 'leave the profession' to work in industry, they somehow leave their professional and public interest responsibilities behind. For the avoidance of doubt, they don't!

9.8 There may be some lessons for us from the accountancy profession in the separation of the setting of standards and ethics from the main boards of the profession.

9.9 *Public interest issues for the profession*

Perhaps the most basic form of public interest is anything that the public is interested in. That can vary from matters of extreme importance, whether globally or personally, to rather trivial matters, such as the private lives of famous people. These are matters which have been of some debate in recent months, and the courts have had to make judgments on the extent to which the public is entitled to be kept informed at the expense of discomfort by those who wish to keep matters private. Plainly, it is not always the case that information that the public is curious to know is information that it is necessarily the public's entitlement to know. And yet, both of these are, in ordinary English parlance, matters that can be described as 'in the public interest.'

9.10 For the actuarial profession as a whole, the public interest dilemma can often revolve around information that may be in the interest of the general public, as consumers, to know, but may be not in the interest of the actuary's employer or client to make public. If the profession required

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actuaries to place a duty to the public above their duty to their employers and clients, will this not simply lead to actuaries being left out in the cold, whenever it is permissible to do so? It is not merely actuaries who would be disadvantaged in such a scenario. It is difficult to see how the public would benefit in the long term if financial services organisations abandoned actuaries, whenever possible, in favour of advisers who put their customers' interests first and foremost.

9.11 The profession issues briefing statements on matters of public interest. Not surprisingly, the briefing statements currently on our web site include topics of wide interest, such as the Minimum Funding Requirement, the impact on savings of a low inflation economy and the availability of personal lines general insurance. These are issues on which we can state our view or, at least, inform the public debate.

9.12 Our briefing statements also cover topics such as annuity guarantees and the inherited estate, which are inherently controversial, because they impact on the competing interests of different groups. Typically, the more controversial statements have taken a long time to develop, and have the look and feel of a committee compromise. I would like the profession to feel able to be more forthright on public interest issues and be prepared to put out such statements more quickly.

9.13 Taking positions on issues of public interest is entirely consistent with raising further the profile of the profession with selected audiences. This is because it is in the public interest for actuarial opinions to be better disseminated, and because of the benefit to the public in making them known. As an aside and for the avoidance of doubt, I would like to say that I regard shareholders as part of the public. It would be surprising if it were any other way.

9.14 Airing issues is one public interest activity of the profession. Whilst important, the main public interest activity of the profession is to produce qualified actuaries who have been through sufficient education in actuarial science to reach our exacting standards. A corollary to this is the maintenance of the competence and standards of qualified actuaries as research brings new techniques and the financial environment produces new or unexpected results.

9.15 The new education syllabus will bring us up-to-date in the education of our students. We have all the opportunities for qualified actuaries to keep themselves up-to-date if they are so minded. Of course, actuaries with practising certificates must complete their CPD. For those not formally required to demonstrate CPD, the profession will look at what positive encouragement it can give to actuaries to do and to demonstrate their CPD. I suspect that, in the near future, there will be a need for the profession to provide an acknowledgement that CPD records are adequate. I am particularly concerned at the current low level of understanding of the basics of financial economics in some of my selected audience and in more senior actuaries.

9.16 *Public interest and the individual actuary*

The relationship between the individual actuary and the public interest has always been more tricky. I believe that individual actuaries, in their day-to-day work, must act only in the interest of the person who has commissioned the project and any other parties that the actuary and the person commissioning the work have identified (including, always, those parties to whom the actuary of the client owes a statutory or regulatory duty).

9.17 To take an extreme example, it may be that a forest is about to be sacrificed for the sake of thousands of de-mutualisation prospectuses that few people will ever read. With the agreement of the client, it is legitimate to consider the environmental consequences of destroying such a forest and the burning of the prospectuses unread; but, just as those considerations will be put in their proper place in the project, so the interests of other affected stakeholders must be put in their proper place. It is not for the actuary to bias his or her work to reflect the interests of one or other specific group to the detriment of the client who has commissioned the work.

9.18 As a corollary to that proposition, the individual actuary does not need to be confrontational in raising a public interest issue with the employer or client. The resolution of a public interest issue is part of the business solution. It should be self-evident that an actuary who does a proper professional job, taking into account the interests of employer, client and identified stakeholders, automatically satisfies the public interest.

9.19 There is a continuum in the realisation of potential additional liabilities arising from a public interest issue. It creeps up on you. There used to be a maxim: 'Plan for the best, provide for the worst', or: 'Price for the median expected, reserve for the worst end of expected.' During the period from the realisation of the existence of an issue to the determination of whether it is real and, if so, its severity, the actuary has the power to recommend reserving for the 'worst end of expected'.

9.20 It is in this way that the actuary can express, from his or her skills, the implications for the client or employer of delay in acting against a trend that may become a public interest issue. Whether the client wishes to commit the additional capital to cover the contingencies until the issue is resolved is a financial consideration for the client, which the actuary can also help to control.

9.21 By resolving public interest issues as part of the business solution of the problem, the actuary can engage fully with an entrepreneurial client, with no need for concern about any further duty to the public interest. All that is necessary is for the actuary to be familiar with, and act upon, the relevant guidance notes and the Professional Conduct Standard (PCS).

9.22 I hope that the work in progress on this issue will deliver to our young members the right attention to the public interest in their day-to-day work, so that they can deliver of their best to their employer or client.

The full resolution will also need to consider an understanding of the relationship of actuary to employer or client, and how much of the general role of the actuary is advisory or contains delegated executive powers. The resolution should also opine on the extent to which an actuary, seemingly in an advisory capacity, is actually making implicit decisions in reaching recommendations.

9.23 *Help is at hand*

When an actuary is in any doubt about his or her professional responsibilities, the second option is to seek advice on the matter from the Professional Guidance Committee. The first option is, of course, to seek to resolve the issue with a senior actuarial colleague. Typically, there is a wide range of possibilities to be explored to resolve the issue, varying from advice to the actuary that the matter is really not such a big deal after all, through to full support from the profession in raising the issue with the employer, client or appropriate regulator. I find it also helps, first, to answer the question: "Whose problem is it, anyway?"

9.24 I want all actuaries to know that this avenue is open and available to them, and I want to encourage them to use it. It benefits the actuary to get advice before an issue escalates out of control. It benefits the employer or client for the same reason. It benefits the profession, because we get to know what is troubling actuaries in their day-to-day work, and, from there, we can identify issues that are common to many individual actuaries. Please contact Michael Scott, Secretary to the Professional Guidance Committee, at the Faculty office in Edinburgh, with any such issues.

10 *Financial Economics*

10.1 It is vital that actuaries can engage with clients and their advisers who use, implicitly or explicitly, the constantly developing science of financial economics to price transactions and value assets and liabilities. The rules and formulae are being used every day, and we need to understand the principles behind them, both to help with our own evaluation and to be able to add clarity to our work that involves prices and values derived from them.

10.2 One of the standard textbooks of financial economics, written by Brealey & Myers (2001), is used as a primer in business schools. It is a comfortable read, and provides an easy introduction both to the language and to the science of modern corporate finance and financial economics, with plenty of summaries, quizzes and questions to aid assimilation. Much of it is very familiar to actuaries; what is interesting is what is familiar, but expressed differently; it is that difference that gives us clues to what is really worth learning. This is an easy action point for all actuaries to take to demonstrate our acceptance of a world to which we must pay more attention. I recommend all actuaries, who have not already done so, to read Brealey & Myers. As a minimum, I recommend, from the 6th edition, the sections on 'Risk' (Part 2), 'Dividend Policy and Capital Structure' (Part 5), 'Options' (Part 6) and 'Risk Management' (Part 8), as well as the chapters on 'Corporate Financing and the Six Lessons of Market Efficiency' (Chapter 13), 'Valuing Debt' (Chapter 23) and 'Conclusions' (Chapter 35).

10.3 I shall be asking the CPD Committee to establish courses on financial economics (with an optional exam for those actuaries who want evidence that they have satisfactorily completed the course). I shall be the first to take the course.

10.4 Financial economics and actuarial methodologies are complementary. They work together to inform our processes and our results. It seems to me that financial economics informs us from its observations and formulae, derived top-down from prices of entities whose stock trades in deep liquid markets where the techniques of financial economics are most advanced. Actuarial methodologies inform us from observations and models derived more bottom-up, from diversifiable risks inherent in the entities.

10.5 So, it appears to me that the thinking behind each of these disciplines can inform the other. As financial economics informs values where there is no market, and actuarial methodologies seek to reproduce market values, we have a lot to learn from each other. It can be, truly, a both/and world of mutual understanding.

10.6 The space in which actuaries excel is where there is no market or where there is discretion in the benefits. I think it is incumbent on those espousing financial economics to respect where actuarial methodologies are valuable. It is incumbent on actuaries to open their ears to the science of, and the lessons from, financial economics.

10.7 Are there financial economists whose advice would have been valuable in anticipating recent financial services failures? We know the impact that financial economics is having on the financial planning of pension funds — whether one agrees with its conclusions or not. Similarly, could not actuarial thinking and control systems have been instrumental in anticipating problems in Long Term Capital Management (LTCM), Enron and split capital trusts?

10.8 Those who are both actuaries and financial economists have been having a frustrating time lately. They have espoused and evangelised the cause to their fellow actuaries, many of whom have responded with closed ears. Now is the time for learning, for co-operation and for reconciliation. Reconciliation is needed, both in relationships and in the results that financial economics and actuarial methodologies deliver. Once reconciled, we can work together to place our more powerful findings in front of our employers and clients in their business context and in their language.

10.9 I know that this co-operation and reconciliation is happening on the ground faster than it appears within the profession. It does not help to espouse actuarial methodologies as all embracing, with financial economics as a young, upstart subset that requires demonstrably invalid assumptions to work. Nor does it help to espouse financial economics as describing everything, with actuarial methodologies as a passé subset that creates misleading values.

10.10 I think that values derived from actuarial methods should, at least, be not inconsistent with those derived from the principles of financial economics. Some of the best work of actuaries is in the space of uncertainty, of diversifiable risks, of the drivers of value and of the control systems that use values as tools.

10.11 *Fair value accounting*

If financial economics has crept up on traditional actuaries and imposed itself on a hitherto largely reluctant profession, fair value accounting has done something very similar for accountants. The major characteristic of this movement is that it is balanced sheet based, rather than revenue based. The story is an interesting one, because it has instructive parallels for our profession.

10.12 Historically, accountants have been very focussed on the company law requirement that only *realised* profit can be distributed to shareholders. The emphasis has, therefore, been on accounting for realised profit only. The balance sheet was the financial dustbin into which the non-profit and loss debits and credits were placed. No one seriously asserted that the assets and liabilities in the balance sheet represented, in any sense, a 'valuation' of the business in any market place. Indeed, it is not at all controversial to say that, at times, the component parts of an accountant's balance sheet have often been based on very different measurement principles (something which is totally alien to actuaries, who have always produced 'valuations' that were internally consistent, even if they were not in the least bit consistent with market economics).

10.13 Various commercial pressures led the accounting profession to re-visit basic accounting principles. The International Accounting Standards Committee (IASC) Framework, first promulgated as early as 1989, recognised that the elements directly related to the measurement of financial position are assets, liabilities and equity. It defined income and expenses in terms of the enhancement and depletion of assets and liabilities. It defined assets and liabilities in terms of future economic benefits and obligations. None of this thinking has (yet) removed the concern shared by many accountants that published profits should not be greater than the amount which can lawfully be distributed, and that the switch to balance sheet driven accounting models is not, *per se*, going to bring about truly market value based accounting, where profits reflect all unrealised gains.

10.14 With this trend to balance sheet accounting and with the international framework in place, the industry, nevertheless, went through the exercise of building the accruals basis for life assurance accounts. The basis was derived from the operations of a company, such as a dam construction company, to take profits in proportion to risks borne and work performed. We are through that exercise — hopefully the last of the new revenue based systems — and can now work with the balance sheet — the actuary's natural home.

10.15 So, accountants will be getting used to the balance sheet as the new starting point for accounts. This is a tremendous opportunity for actuaries. The blend of market value based expertise with the ability to cope with discretion and cash flows for which there is no market should put actuaries in the forefront of providing opinions on values in accounts.

10.16 We must, however, not be blindsided by the current concentration on valuation. The work of the actuary, besides the regular annual valuation for statutory purposes, has always concentrated on the management of the financial organisation. Pricing, control systems, surplus distribution and investments are domains where the actuary's work is critical. We use values as tools, not as ends in themselves.

10.17 To an actuary, the word 'value' was never intended to be synonymous with 'economic value'. To most economists, a value that is not an 'economic value' looks highly suspicious. This is one of the reasons for the confusion and disagreement I alluded to above. To be useful as an actuarial management tool, a value does not always have to be consistent with the amount realisable in the market place. This is, however, a confusing concept for many outside our profession, especially business people, amongst whom the awareness of financial economics is growing fast. If we can present our conclusions using market consistent values, employers and clients will understand us more easily, which means they will be better served.

10.18 In the coming years of the assimilation by accountants of the balance sheet as the starting point, I suspect that the focus will be on correcting for perceived undervalued liabilities or overvalued assets. I suspect that less attention will be paid, initially, to overvalued liabilities or to undervalued assets, and especially not to assets that are currently not valued at all, in particular internally generated goodwill. The natural corollary of this understandably cautious approach will be the understatement of earnings for the next few years, before more realistic values and intangibles get a look in. In this transition period, accounts will have to be regarded, more than ever, as sources of information for analysts and actuaries to derive more realistic values.

10.19 I regard FRS 17 as a prime example of this phenomenon. Its introduction is entirely consistent with a desire not to overstate the net worth of a company by bringing the current deficit in a pension fund onto the balance sheet. There is nothing objectionable in that, *per se*, nor in the valuation of tradable assets at market value, but it is only half the story.

Even on a look-through basis to the pension fund, FRS 17 does not value the associated discretions that are in the power of the employer to exercise. There is the power to increase contributions and to reduce benefits and even to discontinue the scheme. FRS 17 does not value the option for an employer to ask the employees: "If the worst comes to the worst, do you want a pension or a job?'' There is a concession in valuing the liabilities at the AA corporate bond rate rather than at a risk-free rate, but, at present, whether that concession values the options properly is anyone's guess. The pace at which employers are exercising the discontinuance option suggests that it is undervalued.

10.20 FRS 17 presents us with an opportunity to demonstrate how the objectives of the way in which actuaries have, for example, managed pension fund contributions over the long term have served the employers and employees well. The arrival of a new reporting standard does not alter the need for long-term funding of long-term liabilities. The opportunity is to explain the valid objectives and how they may be achieved in the language of the present.

Part III. Thinking and Behaviours in Current Issues

11 *With-Profits and the Appointed Actuary*

11.1 The timing of writing this address could not have been worse to allow comment on the fast moving developments in the with-profits business. This paper was put to bed in mid-May, just as the FSA was revealing its hand. This paper is, therefore, too late to influence the FSA's deliberations and too soon to opine on the results. I shall just comment on the aspects of the review that relate to the themes of this paper: thinking, behaviour, advice and decisions and the international dimension.

11.2 The fifth consultative document from the FSA raised the question of whether the role of the Appointed Actuary diluted the responsibilities of the board. The perception is that the board delegates too much to the Appointed Actuary, that the Appointed Actuary was comfortable with taking that level of delegation and, despite that, the Appointed Actuary system has served the companies and their customers well in the management of with-profits funds. It struck me, from the tone of the consultation, that all that is needed is for the level of delegation to be lowered so that the board can demonstrate directly that it is making the decisions. The response of the profession suggested that this is already happening; that boards are regarding the Appointed Actuary more as adviser than a decision maker.

11.3 As in any work of an actuary, it is important that the relationships are established at the outset and that any decisions that are implicit in the actuary's work should be revealed. For example, in the recommendation of bonus rates, the Appointed Actuary will make decisions about the relative

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sharing of surplus between generations of policyholders, between classes of policy, between sizes of policy. The bonus recommendation process is a mixture of decision and advice. In revealing the process of the determination of the recommendations, the actuary will reveal what are decisions for ratification by the board and what is advice. It will take more time, but more time is needed, to allow the directors to demonstrate their greater level of understanding and decision making — as the profession's response envisages.

11.4 As I have mentioned in debates on the paper by Guijarro & Hare (2002), 'Corporate Diversity and the Provision of Financial Services', the role and management of the estate, as the difference between assets and asset shares, would be served by a report by an actuary whose sole responsibility is to the owners of the estate, whoever they are. Would the report differ if the estate were owned directly by the shareholders?

11.5 The international insurance community is watching with keen interest as the U.K. digs up the roots of a system that has served customers well in the U.K. and abroad, and is adopted, or about to be adopted, more widely. It will be important that the principles of any new system adopted in the U.K. are well defined and communicated, so that the beneficial results that are seen to be part of the current Appointed Actuary system are demonstrated to be part of the new. It would help the communication of the continuation of those benefits if the title of Appointed Actuary were to be retained.

12 *The FSA and the With-Profits Review*

12.1 I have three concerns about the progress of the recent FSA consultations leading to the next round of regulation. One is about thinking, the other two are about behaviour. I have mentioned them all already to the FSA, and I understand that they have been received and understood. I have also received support for these concerns in my interviews.

12.2 There are few actuaries who can be said to be expert in banking. There are few who speak banking language. I would like there to be more; we have a lot to offer. In my experience, there are few bankers who are expert in insurance or speak insurance language. This is all quite understandable; the two businesses are quite different.

12.3 To over-simplify:

— Banking risks are generally short term, and bankers seek to match those risks — even avoid or offset them, when possible.
— Banks balance their books daily.
— There is no or little discretion in bank contracts, once agreed.
— Banks have credit committees to assess pricing, and profit is measured as margins in interest rates.
— Banks' liabilities are relatively straightforward. It is their assets to which they need to pay special attention, for example, to default and early repayment risk.

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12.4 In contrast:

— Insurance seeks, accepts and pools both short and long-term risks.
— Insurers use their capital to cover mismatches.
— They balance their books maybe monthly, or yearly.
— Insurance uses discretion in contracts to smooth risks or to provide cover that could not be provided without the use of discretion.
— Insurers have Appointed Actuaries. They measure profit as value added. Insurance also assesses behavioural risks in pricing its products.
— Insurers' assets are relatively straightforward. It is their long-term liabilities that need careful valuation — including the valuation of the customers' interests.

12.5 Such differences point to a different regulatory regime for banks and insurers, except, maybe, for risk based capital requirements for demonstrably similar risks.

12.6 I understand that the majority of FSA staff is from a banking background. The draft *Integrated Prudential Sourcebook* seems to have been written from a banker's point of view. We therefore need, as a matter of urgency, to acquire the understanding of banking thinking and language in order to communicate with the FSA and to extol the virtues of insurance and long-term risk and savings in banking language. At the heart of these virtues are the needs of customers to secure the benefits that can come only from pooling their risks, from discretion and from the provision of benefits in which there is no market.

12.7 My second area of concern is the manner of supervision of any new regulations. My experience of the last round of new regulation was that the actions required by the policymakers, as interpreted by management and passed down the management chain, was different to the actions required by the supervisors as a consequence of inspections on the ground. To help the better understanding of what is actually required on the ground by the next round of regulation, I would advocate that the FSA publish their training manuals and instructions to their supervisors before regulatory visits. I think this action would dispel much concern and demonstrate openness, transparency and accountability through the chain of understanding of what is required.

12.8 My third area of concern is with the expressed desire that regulation be based on principles rather than on rules, the 'less is more' concept. In the past, regulators have demurred from letting firms know if they are doing something right, only letting them know if they have transgressed a rule in the view of the supervisor. If we are to move to principle based regulation, then firms will need to know if their interpretation and execution of the principles is the same as that of the policymakers and of the particular supervisor who will be making the visits. As yet, I see no process for allowing firms to get positive feedback on their plans as compliant before they execute them.

12.9 I have always believed that change is more effective when it is initiated from the ground up; we observed that the late Financial Services Act had little impact until supervisors inspected the documentation relating to real sales on the ground. I surmise that we may be in the same situation again, and experience a hiatus in change until rules are brought in to document the principles. I suspect lawyers might prefer that too.

12.10 There is, as ever, a beneficial spin-off to the reviews of the with-profits process; it causes actuaries and regulators to think more deeply about the nature of the beast. One result was the paper, 'Transparent With-Profits — Freedom with Publicity', by Clay *et al*. (2001), mentioned in ¶7.3.

12.11 A question I have is whether financial economics can support the with-profits concept. For example, in the case of a simple long-term downside guarantee, it would seem plausible that, the later the cost of the guarantee is charged to the customer, the more information would accumulate about the nature of the guarantee, the nearer one would be to the exercise of the guarantee, the narrower would be the likely spread of the cost and the cheaper it would be. That suggests a positive answer to the question: "Can financial economics demonstrate that discretion benefits customers?" If that is right, it supports the methodology of discretionary with-profits pricing that removes some of the upside gains in the underlying assets in the smoothing process.

12.12 Such a piece of research would show where the risks and rewards are in back-end pricing, and for whom. It could express more clearly how the with-profits concept copes with offering long-term benefits for which there are not enough data to offer them on a guaranteed basis. It could also support the discretions implicit in defined benefit pension funds.

13 *Maxwell, Equitable, Independent, Long Term Capital Management, Enron and Split Capital Trusts*

13.1 I shall not comment directly on the progress of the Equitable or the Independent investigations. Tom Ross, President of the Faculty, and I will consider, during our terms, the appropriate actions for the profession to take as a consequence of these unhappy events. One could reach the conclusion that these two events, together with the Maxwell affair of a decade ago (one in each of our main disciplines) have some similarities of a behavioural nature. It is not in the province of the actuarial profession, *per se*, to opine on behavioural matters, but I suspect that actuaries may have an interest in tracking more than the financial levers affecting our employers' and our clients' bottom line by identifying behavioural or agency effects as predictors of potential problems.

13.2 I personally know little of the causes of the collapse of LTCM, Enron or split capital trusts beyond what I read in the papers. I wonder if, for similar reasons, actuaries and behavioural psychologists could offer some insights into the analysis of such failures. I do think regulators could legitimately pay more attention to the behavioural causes of failure. The skills of actuaries to analyse the real drivers of solvency, coupled with an analysis of the way in which those levers are pulled, would, I think, be a most powerful combination to provide a most fruitful outcome. Another example was the dot-com boom and bust. With hindsight, it was difficult to come up with any calculated value from identifiable cash flows that came close to market values.

13.3 The demise of Enron has clear lessons for actuaries and firms of consulting actuaries. Taking assets and liabilities off balance sheet may be effective for accounting purposes, but does not affect value or the volatility of value, *per se*. Indeed, tax and other incidental effects aside, value reduces by the cost of doing the deal. Firms of consulting actuaries will need to demonstrate greater separation of their regulatory roles and advice from general consulting. There are moves afoot in the United States of America to decline to hire firms that seek to limit their liability on assignments involving statutory roles.

14 *Education*

14.1 The new syllabus review is well into the implementation phase under Nick Dumbreck. I was privileged to be involved in the strategy development, and I am keen to see the implementation of the core applications syllabus that we identified in the strategy. There are major prizes to be won in the dissemination of what we have done internationally. Let me say, immediately, that we have borrowed many ideas from the Australian Actuarial Control Cycle (2002) in the formation of the core applications syllabus, but, as they borrowed the idea from us in the first place, I think the debt is settled.

14.2 We have a meeting of minds over the internationalisation of the core technical syllabus with North America and Australia. I am very hopeful that we will have a similar meeting of minds over the core applications syllabus. The development of the designation of quantitative risk analyst (QRA) for all of the core technical syllabus, bar the subject of actuarial mathematics, is a welcome development to get the basics of any financial services training into one designation, with the stamp on it of the actuarial profession. I am very pleased that we have moved the subject matter of financial economics to earlier in the course, to recognise its growing penetration into our syllabus.

14.3 We are still heavily involved in the development of the syllabus in North America, and the work we have done there, in the International Actuarial Association (IAA) and in the Groupe Consultatif, is at the core of creating a global profession.

14.4 One issue that needs to be addressed is that some employers would prefer to see more specialist and nation-specific material earlier in the course, for example, as part of the Associate designation, with wider concepts left to the Fellowship. We can see the commercial pressures that lead to this preference, but we are of the view that actuaries should learn general concepts before taking on the detail of their chosen specialism. We believe that an actuary is better equipped by having a broad awareness of all the actuarial concepts before learning to specialise than by acquiring only the Core Technical knowledge and in-depth technical and country-specific knowledge of one speciality.

14.5 Closer to home, I have had a request that we explore the possibility of providing courses and certificates for data technicians, that is the people who are the first to get their hands on raw data and manipulate them to get the best results in terms of homogeneity, trends and patterns. We may also explore the possibility of providing courses and certificates for mathematicians in investment banks to allow them to demonstrate the skills they have acquired. Neither of these can be developed during the creation of the new syllabus, so I shall leave these ideas for my successor to consider.

15 *Competition*

15.1 There are some features of the financial services industry that work the wrong way under the force of competition. Jim Anderson, in his 1959 paper, implied that it is in the public interest for a provider of capital to expect to achieve a return of at least the cost of that capital, otherwise the provider will not provide the capital and the public will be worse off because of the reduction in diversity. More explicit, in Jim's paper, was an understanding of the virtue of sharing the profit before commission between the provider and the intermediary. The logic was that competition would determine a price, and hence the profitability. If the intermediary demanded commission of an unreasonably high proportion of the profit, then the provider would take his capital elsewhere. This was an early recognition that unconstrained commission is not in the interest of any stakeholder, including, ultimately, the intermediary, when capital chooses to get its return elsewhere.

15.2 That logic seems to have evaporated, and we are now seeing that competition serves to increase commission. The life industry has made attempts from time to time to redress this tendency. In the early 1970s, the then Life Offices' Association and the Association of Scottish Life Offices attempted a maximum commission agreement that did not survive. More recently, the Register of Life Office Commissions (RoLAC) was mooted, where a life office had to disclose if it paid more than scale. This reappeared in the later LAUTRO commission scale, which was deemed anti-competitive by the Office of Fair Trading. It would seem to me that it is in everybody's interest to find an appropriate permission for the life assurance industry to enter into a maximum commission agreement. In my interviews for this

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address, I have had an almost universal support for such permission as a sensible counter to the unintended consequence of competition.

15.3 I understand that commission for larger cases is often rebated to customers who negotiate with their intermediaries, which is fine for those customers. It seems that it leaves a relatively unfair result for those customers who are not aware that negotiation is possible. In advocating such a permission, I do recognise the other side of the coin, that intermediaries need fair pay for the work that they do.

15.4 There is a quite separate situation where competition is inhibited from doing its job because of an inappropriate legal structure. When a customer buys a policy from a mutual life company, unless he or she is deliberately carpet-bagging, the chances that the customer places much value on the ownership rights conferred by the policy are small. Nevertheless, it is this mechanism of membership through policy ownership that creates the opportunity for a few policyholders to disrupt the original intentions of the many. So, the legal structure of a mutual does not express the original intentions of the vast majority of customers, nor of the original providers of capital, nor of the directors and management in the deal with the customer. If the estate is there to provide working capital and cover for guarantees, it needs to be held over for the benefit of safeguarding the guarantees of existing policyholders and for the benefit of future policyholders. One of the frustrations is that the estate has to belong to someone. The legal structure grants the power to own the estate to existing policyholders, and ignores the interests of future policyholders and, indeed, the interests of existing policyholders in increments under their policies or in taking out new ones. Only when the legal structure for a mutual denies the activities of the carpet-baggers will market forces operate to distinguish the relative values of mutual and proprietary forms of company.

16 *Simplification in Retail Products*

16.1 Many of the regulatory issues we are faced with today arise from the complexity of the products and the systems devised to provide benefits to customers and employees. Now that the era of obfuscation is over, the directors of a financial services company are replacing the presumption of trust with openness, transparency and accountability, and it is now in the interests of providers to make products and schemes as simple as possible for the retail customer.

16.2 In any sale there will always be some trust. Trust begins when the customer can absorb no more and covers all the remaining information that could have been given. Replacing trust with openness and transparency only goes as far as the customer's ears are open. The rest is now not trust, but accountability. Actuaries and life companies have spent some time on openness and transparency — there is more to do — but little time yet on accountability. How do firms demonstrate that what they did would have been deemed to be open and transparent if the customer had had the time and inclination to listen? How do they demonstrate that what they would have communicated would have been acceptable by a customer with open ears? How do they document the demonstration so that, if the outcome still disappoints, they can show what the customer would have heard? I fear we are in for some pitfalls in the sphere of future accountability. One route to limiting the scope of accountability is to simplify products.

16.3 In 1998, the profession took on the role of challenging the assertions about the likely performance of multi-index bonds sold by U.K. companies. These are bonds backed by derivatives designed by the investment banks, presumably with appropriate counter-parties. They promise high-income returns with potential loss of capital.

16.4 These have now re-emerged from offshore companies, and there are some onshore look-alikes that return, in total, at least the invested capital; one is offered by National Savings. I understand that all these bonds have passed an FSA test, but I must say they still cause me concern for the customers' full understanding of what they are getting into. When customers are *promised* a return above the risk-free rate, do they realise that they may have all (or more than all) the income clawed back on maturity if the underlying assets do not perform?

16.5 To my mind, such a claw-back is really a loss of capital by another name. Being backed by sophisticated derivatives carefully priced, I am sure the expected loss of capital is well known to the designers. I believe that such products advertising, say, 11% income should also have a wealth warning of the expected loss of capital at, say, 7%, allowing for expenses as well as expected return. Such a warning would put the gamble more into perspective. It is particularly revealing that intermediaries advertise these products in the tabloids, but eschew the broadsheets. Perhaps I was, after all, a little hasty in writing that the era of obfuscation is over!

16.6 On the other side of the simplification coin is the cost of the industry to the consumer. I have been tracking the cost per household of the U.K. life assurance industry for some time. It reached over £500 per U.K. household in 2000, and was growing at 15% p.a. from 1996 to 2000. I am sure much of this increase is down to market conduct compensation and compliance administration. I would welcome any investigation into the identification of the sources of additional costs, so that we can track the future benefits of simplification as they come through.

17 *Projections*

17.1 I support the move to illustrate pensions from money purchase schemes in real terms. I believe it is important that the eroding effect of inflation on the income they draw is brought to the attention of employees and customers. Such attention can be drawn by illustrating the initial amount of an inflation-adjusted pension or by showing the purchasing power of money in the future. I prefer the former, as it brings home the level of expenditure and the standard of living that can be afforded and sustained.

17.2 I do understand that, in practice, expenditure in real terms will decline as one grows older; but to say that one can offset the effects of inflation and the decline in real terms lacks a sophistication that we can provide. I trust that the report by the Actuarial Review of Retirement Income Working Party, following up the Extending Retirement Choices report, will open up the debate to the design of pension payments that are better customised to the needs of the pensioner. In the meantime, I think every quotation of a pension that is not inflation-adjusted should show the inflation-adjusted initial annuity with an encouragement to save the difference against the future ravages of inflation. I would similarly support projections in real terms of the benefits from life policies and other savings vehicles.

17.3 There is another piece of information that could help customers to understand the underlying volatility of the investment they have chosen. If customers are shown a projection using the best estimate return, they could also be shown the return that is expected to be produced with at least, say, an 85% probability. The gap between the best estimate return and the 85%+ likely return will help customers, by means of a few numbers, to appreciate the risk inherent in the underlying investments and in the illustrated return, in order to supplement their decision to invest in high, medium or low risk vehicles.

18 *The Work of the Profession in Transition*

18.1 The relationships built up during the Presidencies of Paul Thornton and Peter Clark are critical to the transition to new ways of thinking and working. The Life Board is, and will continue to be, particularly heavily burdened with work on the Tiner project and related consultations, on the development of fair value accounting, the '2005 Accounting Project', and the implications of the latest mortality reports.

18.2 The Pensions Board's major activities will be in the development of the next stage of reform of the Minimum Funding Requirement (MFR) through its representatives on the Consultation Panel of the DWP and in the continuing debates on the choices of annuities at retirement including statutory money purchase illustrations.

18.3 The General Insurance Board attracted significant praise for the work done following the events of 11 September 2001. It will be tackling the issues of peer review, financial condition reports and structured settlements. The Board will also address the need to train more general insurance actuaries to meet the demand for actuarial services and the development of financial condition modelling and of Lloyd's statutory opinions. I hope the Board will also be monitoring the developments in alternative risk transfer and the replacement of traditional sources of risk capital by long-term debt instruments with repayment guaranteed by reinsurers. Understanding the hunt for inversely correlated risks must be a fruitful field for general insurance actuaries.

18.4 The Finance and Investment Board will have its own 300 series exam from April 2003, as one demonstration of the importance of this Board in furthering the demand for, and supply of, actuaries in their new areas of work through research and external influencing. There is a lot more to be done by this relatively new Board to ensure that the actuarial profession recovers lost ground in the field of funds management, and becomes, once more, a leading light in this area. The Board also has the important responsibility for spearheading the development of the profession into an ever-widening range of businesses, as called for in 'Vision and Values'.

18.5 The Finance and Investment Board's twin sister, the Social Policy Board, after its highly successful conference on 'The Ageing Population' in Edinburgh in January, is pursuing its remits on damages, genetics, health and care, pension provision and personal financial planning. It is extending its remit to embrace environmental issues.

18.6 The Professional Affairs Board has carried a heavy burden in getting the PCS into shape and recommending improvements in the disciplinary processes. The Professional Guidance Committee of the Board is one I regard as one of the most important links between the profession and its members. As explained in ¶¶9.23 and 9.24, the Professional Guidance Committee is needed at critical times by members when they are confronted with ethical and practical dilemmas. It is a sign of a healthy profession that its members approach the profession to discuss current issues and that the profession provides guidance in times of need.

18.7 The Education and CPD Board continues the development of the new syllabus, and I have commented already on its highlights and issues. CPD will become more important for all actuaries over the next two years and beyond. I have mentioned the need to get up-to-date in financial economics. The new syllabus will include the requirement for students to keep a log of the progress they make in the acquisition of competencies, which, we hope, will become a habit that students will continue beyond qualification as a record of lifelong learning. The Careers Committee carries an onerous responsibility to attract the brightest and best to the profession, and is extending its reach into schools and colleges. University links will become more important as the benefits of concentrating the actuarial education process become more apparent.

18.8 The Accounting Liaison Group and the FSA Co-ordination Committee are setting examples of how to build and maintain relationships with other bodies. The work they have done has led directly to the increased influence of the profession, and is to be emulated with other bodies.

18.9 The International Committee continues its liaisons with the International Actuarial Association and the Group Consultatif, and supports the sterling work done in the assistance to countries developing their own professions and education systems. Our chief partners in this endeavour are the North American associations and the Institute of Actuaries of Australia. All these bodies work together with the Hong Kong Actuarial Society, through a joint office in Hong Kong for the South East Asia region, and in joint committees on the development of world-wide education syllabuses. The strong belief that we can achieve a global syllabus and, perhaps, a global exam is driving us to find ways to make it happen.

18.10 The Communication Committee was established a year ago to give substance to the main theme of Peter Clark's Presidency. To recognise its importance, this committee is now upgraded to a Board. It has appointed a marketing professional from outside our profession to add valuable expertise to our deliberations. I recommend that other committees and boards consider bringing non-members into their deliberations.

18.11 There is a need for short-term urgent research to permit the profession to arm itself with the necessary data and implications to comment on topical issues. I support the initiative of the Finance and Investment Board for a panel to commission original research, both internally generated and in collaboration with external organisations.

19 *Closing*

19.1 I would like to offer my thanks to those who have helped me in the run-up to this address. Jane has been a constant support. I thank her for that and, in advance, for the continued support that she has promised me in the next two years. My thanks also to Simon Carne for helping me put this paper together and to those who have contributed content and comment.

19.2 I am very conscious of the speed of change at present, and the need for the profession to take on a role of proactively encouraging change as well as reacting to change instigated by others. In particular, I am conscious that developments will occur between the writing of this address in mid-May, the delivery on 1 July and the discussion at the Sessional Meeting on 23 September.

19.3 I hope I have been true to my audiences, in particular (but not only) the audience of actuaries of three to eight years qualified. You have some great role models in actuaries who are entrepreneurial and thinking and successful. To emulate them, you must recognise that the education you have has taken you only so far. You will have to learn new skills, from financial economics to interpersonal skills, and learn to present your work in the business context of your target audience, whether employer or client, and earn the opportunity to get involved in the business. The President and the Council of the Institute are here to develop the characteristics of the profession that suits the needs of actuaries and, through them, their employers and clients. Tom Ross, at

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the Faculty, and I have established email addresses in the names of askjeremy@actuaries.org.uk and asktom@actuaries.org.uk for you to help us direct the development of the profession over the next two years. Please use them and any other method of communication to let us know how we are doing. I look forward to playing my part in bringing the Institute and the profession through the transitions to concentrate on serving our employers and clients and their employees and customers.

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