B.A.J. **4**, IV, 689-706 (1998)

FUTURE FINANCIAL REGULATION: AN ACTUARY'S VIEW

A DISCUSSION PAPER BY A WORKING PARTY

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[Presented to the Institute of Actuaries, 22 September 1997, and to the Faculty of Actuaries, 16 February 1998]

The text of this paper, together with the abstract of the discussion held by the Institute of Actuaries on 22 September 1997, are printed in *British Actuarial Journal*, **4**, II, 145-191.

ABSTRACT OF THE DISCUSSION

HELD BY THE FACULTY OF ACTUARIES

The Vice-President (Mr C. G. Kirkwood, F.F.A.): This meeting is in the form of a panel discussion, in which the following topics will be discussed:
(1) What is the objective of regulation and has it been achieved in the past?
(2) Is the form of the Financial Services Authority (FSA) seen as 'progress' or as 'additional bureaucracy'?
(3) How should we define investment advice for the purpose of authorisation and of regulation?
(4) Do we agree with output-based regulation, and should this be underpinned by some form of 'kitemarking'?

The facilitator of the panel is Mr Fishman.

Mr A. S. Fishman, F.I.A. (introducing the discussion): I begin by inviting each of the panellists to say a few words about himself, and then I shall give some introductory remarks as to the background of the Working Party.

Mr R. W. Gibson, F.F.A.: I work for a large Edinburgh-based mutual life company. I work in marketing and have worked in marketing-related activity for most of my career. I have a keen interest in how financial services providers present themselves, particularly in advertising and in marketing material.

Mr N. H. Taylor, F.I.A.: I am a consulting actuary, and I am here because I am Chairman of the profession's Personal Financial Planning Committee. I am also Chairman of the Future of Financial Regulation Working Party, having taken over from Mr Fishman.

Mr W. P. McCrossan, F.C.I.A.: I am a consulting actuary, and am I here in my capacity as Past-President of the Canadian Institute of Actuaries, and as someone who was involved in setting up the regulation of the financial service sector in Canada over the last 10 years.

Mr J. Stretton, F.F.A.: I suspect that I am not here because of my association with another large mutual life insurance company, but as an ex-director of the Personal Investment Authority (PIA), who was involved first on the shadow board of the PIA and then as a director. I left when I found that I

https://doi.org/10.1017/S1357321700000180 Published online by Cambridge University Press

could not accept the direction that was being taken by what was a supposedly self-regulatory body. I did not resign because of an adamant regard for self-regulation, but because I felt that what was being done was not consistent with what was no longer self-regulation.

Mr Fishman: By way of background, the Working Party was established in September 1996 to consider future financial regulation, a topic which, at the time, was certainly very high up the political agenda. Action was expected very soon after the May 1997 General Election. Before the end of May the new Labour government announced its intentions to restructure the whole area of regulation, with the introduction of what, at that time, became known as 'super-SIB' (Securities and Investment Board), with statutory powers.

On being invited to chair this Working Party, I asked a very simple question to begin with: "What was, in fact, the added value which the actuarial profession could bring to this debate on future financial regulation?" The point behind my question was that there had been countless papers from all quarters covering the structure of regulatory bodies, and it seemed to me that one more tome on this particular aspect would have little or no impact on the wider debate. So, what added value can we, as the actuarial profession, bring to the debate?

At the outset the Working Party focused on public interest, and I know that it is a matter of some controversy. It was a core concern to us. From the perspective of the public, we rapidly came to the conclusion that actuaries have much to offer in an area in which our expertise in designing financial products, managing risk and in explaining the process to others gives us a unique voice and a vital role to play.

The Working Party has grasped this opportunity by putting forward for discussion the proposition that regulation should focus on outcomes rather than on the present prescriptive processes. In current political parlance, at the outset we tried to think the unthinkable. From the starting point of: "Are we not putting up something that is impossible?", the Working Party has moved to a position where, perhaps, an outcome-based approach can work.

This momentum has been maintained in a positive fashion by a sub-group of the Personal Financial Planning Committee, chaired by Mr Taylor. In this discussion we are going to examine four separate issues to see whether it is worth pursuing this particular line of thought.

1. *What is the Objective of Regulation, and has it been Achieved in the Past?*

Mr Stretton (opening the discussion on the first question): First, there is no doubt at all that, since the advent of the regulatory system in 1986, standards have improved. Although I cannot prove causation, I think that it would be unreasonable to say that regulation has not played a considerable part in that improvement. However, the question is not whether regulation has done some good, it is whether it has met the standards which were set. The problem with the question is, of course, that the 1986 Act was totally silent about what regulation was expected to achieve — an omission which, I think, was most remiss. It is part of the political job to define what is to be achieved, enabling separation of the executive and the legislative functions. It is part of the politician's job to make choices about what regulation is there to do. So, I have to judge my answer to the question against what people thought that regulation was for. What people thought it was for was based on what Gower said in the papers which preceded the 1986 Act. He said that regulation ought to be there to protect customers, but that we ought to have only just enough regulation to ensure that a reasonable man could not be made a fool of.

What has happened, over the years, is that people have remembered the first part, but have completely forgotten the second. What the public believes, and certainly the press believes, is that regulation is there to protect customers. I think that it is very important for us all to be quite clear-headed on this subject. However nice the sentiment, you cannot protect customers. In an area like savings, investment and insurance, the choice is about what you spend and what you save, what you protect yourself against and what risks you run. Such choices are intensely personal, and cannot be taken away. Pretending that we can protect somebody is entirely counter-productive. Because of this, and because of the way in which the objective has come to be understood, there is absolutely no

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doubt at all that the public thinks that the regulatory system has failed to deliver what it set out to achieve. That is sad, because standards have actually improved.

This is a particularly opportune moment to be looking at the subject, because those who are drafting the new Bill look as though they are going to try to confront this issue, and define what regulation is for this time around.

There is an alternative. Protecting the customer — however nice it sounds — is probably a lawyer's definition, which is not surprising, since Gower was a lawyer. Had he been an economist, he would almost certainly have started from the position of a fair market, and would have tried to define a fair market in financial products. This would have been, in fact, a more normal regulatory approach, looking at the fairness of the market rather than siding with one party in a market against another. We can be equally tough. We can still address all of the issues of competence, of disclosure, and of compensation for failures. We can address the fundamental question: "What does a customer need in order to be able to operate with confidence in a fair market?" I hope that such a question is given consideration as we go into the drafting of this new Bill.

This is not just semantics. The decision on whether you start off with a protection objective and then subtract from it, or whether you start from an objective of a fair market and define what that means, is, I think, fundamental. We can see exactly this sort of issue emerging in the discussion on a fair regulation regime for ISAs and stakeholder pensions. The concepts of benchmarking and of kitemarking are appropriate when establishing a fair market. They give customers a method of assessing whether a particular product is up to standard, and, if it is not, where it is not, and whether that matters to them. That is of great assistance to a customer in making his or her own choice. It does not protect a customer. A kitemarked stakeholder pension can be mis-sold if it is used to persuade somebody to opt out of a good occupational scheme, and the kitemark does nothing whatsoever to prevent such a mis-sale. So, we need to be really precise about what we are trying to achieve, because, if we are not precise, then we will finish up with disappointing our customers yet again.

We cannot have different types of approach to regulation for different types of product. An overall 'moral contract' is, perhaps, the term for it; the way in which customers think about the market and how it will treat them. That has to be the same whether you are talking about small contracts or big ones, and whether you are talking about simple contracts or complex ones. The regulation can be different, but the obligation must be the same, otherwise people simply will not understand. I suspect that we have to decide what the purpose of regulation is before we decide what we are going to do for ISAs and for stakeholder pensions.

We have made progress. Against what people think it was there for, regulation has not achieved its objectives, and there is a big risk that we will fail again if we put the same sort of woolly-minded objectives up for Regulation Mark II.

Mr McCrossan: Regulation in both Canada and the United Kingdom started at about the same time, in 1985-86. In both countries we identified the problems almost identically; but the solutions to the problems have evolved quite differently.

The regulation of the Canadian financial system has been a hive of activity over the last 12 years, particularly so over the last two years. Concerning the objective of regulation and what has been achieved, in Canada we have to deal with the fact that regulation of the financial system is partitioned by sector between the Provinces and the Federal Government. The Provincial Government has absolute jurisdiction over all securities and stock exchanges. The Federal Government has absolute jurisdiction over all banking transactions. Insurers and trust and loan companies, which are the equivalent of your building societies, can choose by which level of government they are regulated. A decision was made in 1986 to establish a single federal agency, the Office of the Superintendent of Financial Institutions, to be responsible for federal regulation of all banks, insurers, trust companies, federal social security programmes and federally supervised employment pension products.

For insurance regulation, power is further divided. The provinces are generally responsible for consumer issues, and the Federal Government is generally responsible for solvency issues. There is, of course, some overlap. Insurance companies have the option to choose either federal or provincial

https://doi.org/10.1017/S1357321700000180 Published online by Cambridge University Press

registration. In practice, all but a handful of Quebec-domiciled life insurers have elected federal registration. Furthermore, while consumer protection is nominally a provincial responsibility, each life insurer or each general insurer must, by provincial law, belong to the National Compensation Corporation, and the standards for risk-based capital to belong to the National Compensation Corporation are established by the Federal Government. All federal insurers, both life and general, are required to have an Appointed Actuary. All life insurers and some general insurers, depending upon their capital strength, are required to investigate the future financial condition of the office, called Dynamic Capital Adequacy Testing in Canada.

The forward-looking period is generally five years into the future for a life office, and a minimum of two years for a general insurer. The actuary is required to stress-test the office for plausible adverse deviations, including mortality, morbidity, persistency, asset mis-match, asset default, new business expenses reinsurance, political risk — that is an interesting category — off-balance-sheet risk, and any other risks that the actuary deems as material to the well-being of the life office. The potential effect on the future risk-based capital levels for all material risks must be examined, and disclosed to the board, the auditor and the regulator.

There is a similar list of 11 plausible scenarios required for general insurance Appointed Actuaries to test.

In the annual statutory filings, the Appointed Actuary is required by law to make an explicit best estimate and an explicit provision for adverse deviation with respect to each material contingency, and to disclose the financial amounts associated with each provision separately and in aggregate.

Commencing at the end of 1998, life offices will be expected to disclose publicly their risk-based capital ratios and the provisions for adverse deviation, so that customers can assess the financial solidity of the office and its exposure to risks, and the Appointed Actuary will be expected to opine publicly on whether the expected future financial condition of the life office is satisfactory.

In the area of consumer protection, there are four key questions which are felt to be pertinent. Is the sales representative a suitable person to assess others' needs and make the sale? Is the product sold suitable to the insured's needs? Does the insured have sufficient information to understand the product? Does the company from which the product was purchased offer suitable solidity?

Through extensive expansion of the role, responsibilities and reporting requirements of the Appointed Actuary, the Federal Government is trying to ensure that both the customer and the agent can access sufficient information to answer the fourth question.

Mr Fishman: This topic is now open to the meeting. We are very interested in hearing as many views as possible on the objective of regulation, and whether people think that it has been achieved in the past.

Mr A. Neill, F.F.A., F.I.A.: In my Presidential Address, in 1991 (*T.F.A.* **43**, 381-398), I bewailed the reduction of independent financial advice. The only answer that I could think of, at the time, was to have legislation that would force banks and building societies to be independent. I just do not believe that bancassurance concepts are at all good for the consumer. I also complained about the lack of education of the general public. People do not understand the difference between deposits, fixed-interest investments and equities. I am sure that boys and girls learn less important things at school.

I am now five years out of date, having retired, but I was involved with the Financial Services Act as a committee member of the Life Assurance and Unit Trust Regulatory Organisation (LAUTRO) and at the Association of British Insurers (ABI). Then we had two Bills with huge significance for life offices at the same time, the Financial Services Bill and the Social Security Bill. Either would have strained our resources for study, representation or lobbying. Both made life quite impossible.

Of course, some of the nonsense in both Bills came from dogma. To have competition in regulation was just silly, and, particularly on the intermediaries side, to have a resulting organisation like FIMBRA was incompetent. Illustrations became regulated and an office had no choice, but when the actual results of policies are less than the lowest figure illustrated — it may happen — who is sued? I know that there is small print, but I think that somebody is going to be sued — SIB, perhaps, or the PIA, or whoever. I just hope that there is good financial backing from the Treasury.

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I have an example. A bank salesman tried, unsuccessfully, to sell my daughter what he called a new account that paid 15% p.a. after tax. After a lot of probing, this turned out to be a unit trust which, the previous year, had gone up by 15%. Some people are not appalled when I tell them this story, but I hope that you are.

Mr C. G. Thomson, F.F.A.: I have three general points. I have very few criticisms of the authors' approach, but I do fear that they may be victims of their time, and, as a result, they have been swayed more than they should have been by political correctness.

First, we are dealing with a human transaction, not with a clinical assessment of right or wrong. The customer is frequently motivated by fear, and sometimes by greed, and will often imagine that the salesman is motivated by greed. Preventing transactions from happening at all might well be the outcome of the approach in Appendix C. It is not necessarily in the customer's interest. A realistic customer may hope never to be ripped off, but does not expect always to get absolutely the best bargain. I do not object to the thrust of the proposals in Appendix C, but I fear that, in reality, we would require new customers — ones with infinite wealth in order to pay for this process, and with infinite patience in order to be able to sit through the revisiting of every step in the decision. To be a little less unhelpful, I do not think that the authors have the wrong solution, simply that it is still too heavy.

My second point is that the structural problems in regulation will always show up. Multiple regulators have proved to be a disaster, generating high costs and high complexities. This was not a new discovery because of the Financial Services Act; we knew it already from pensions regulation. If regulators are ultimately accountable to a single authority, whether that be the Treasury or the European Court of Human Rights, then we should avoid any structure that appears to give separate authority to a body which may have its own particular agenda. We have clear examples of that with individual ombudsmen, the Office of Fair Trading (OFT) and the PIA. Any subsidiary regulator should simply be a facilitator, carrying out the aims of the prime regulator. I believe that the first Insurance Ombudsman was a good example of a subsidiary role of this type carried out correctly. Similarly, regulatory arbitrage needs to be minimised. Separate regulators and separate rules on capital for banks, building societies, fund managers and long-term insurers make little sense when the barriers are crumbling, and I am disappointed that the authors turned away from this in ¶2.2.

My third point is on political correctness. At present, it seems to be commonly accepted that if something goes wrong it must be someone else's fault, and it must be possible to sue. This is just as true for CJD and e-coli as it is for pensions mis-selling. The truth is that the risk is part of everyday life. We need to separate the difference between acceptance of the natural risks and how to deal with the cowboys and the fraudsters. To mix these two different purposes together, as we have been doing, is stupidity, and we should not condone it.

My comments are intended to be constructive. 'Outcome-based' is fine, and is probably the right answer, but not if it is 'hindsight-based', and not if it continues to have so little regard for cost. Do the public know that the current regulatory system costs them as much each year as Robert Maxwell did in a lifetime?

Mr Stretton is right to recall the forgotten words of the late Jim Gower (who is frequently blamed for all of this): "Regulation should be no greater than is necessary to protect reasonable people from being made fools of", and I think that we have forgotten that to the detriment of the system.

Mr R. E. Brimblecombe, C.B.E., F.I.A.: Mr Neill will be pleased that I took his Presidential Address very seriously, because in 1991 I stopped giving tied advice and gave independent advice instead, which I am still doing!

To answer the first question, I think that it depends upon what regime you have had in the past. Like Mr Neill, I was involved with LAUTRO from about 1992 onwards, and I like to think that we had a regime which was pragmatic and was actually achieving quite a bit by way of improving standards. What concerns me is that, since then, we have had the PIA, which, in my view, has been far more prescriptive. You only have to look at its requirements for the pension transfer review to see exactly how much more prescriptive the PIA is compared with what I like to think that LAUTRO

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would have been. If you have a regulator which is pragmatic rather than prescriptive, then the regulation we have had in the past would not have been too bad.

I disagree with Mr Stretton on his suggestion that, looking forward, the same type of regulation must apply to everything. I do not believe that. If we are going to increase the amount of savings and provision for old age in this country, then we are going to have to have a much lighter regulatory regime for delivering small products to the people who are not covered at the moment. The cost of regulation, full regulation, is high — I think one life office said that to sell a personal pension there were full compliance costs of about £600, on average. If you could get away with just simply deciding that the individual wanted the pension, then they felt that they could probably manage with £60. There are other areas — for example, simple products that cover mortgages, contracting out via appropriate personal pensions, and several others, where you could remove a lot of the present prescriptive regime. I should like to see that, limiting the more detailed prescription to people with complex investment products.

Mr Stretton: I think that Mr Brimblecombe and I actually agree with each other. My point was that there ought to be an over-arching philosophy of regulation which people understand as applying to everything. If that philosophy is that customers will be protected (in other words, the industry will only sell you something which is absolutely right for you), that has to apply to everything. We will then finish up with exactly the problem that you described. We cannot deliver this at the top end of the market, and we cannot afford even to try at the bottom.

I feel that we need to get away from that philosophy to one of a fair market, which we can operate effectively and more cheaply across the entire market. When it comes to the detail of regulation, there would be greater controls for the more difficult products, but there would be the same philosophies. Customers do not understand differences of 'moral contact'. They need to have one vision of what the industry will provide.

We probably have more agreement than disagreement.

2. *Is the Form of the Financial Services Authority (FSA) seen as 'Progress' or as 'Additional Bureaucracy'?*

Mr Gibson (opening the discussion on the second question): There is no doubt that the FSA was born out of political ambition. All the way through the pre-election period, in 1996-97, the Labour Party made it clear that it did not trust the self-regulatory organisations, and wanted to move to a form of direct supervision. The forming of their opinion was built up over a number of years, largely driven by Messrs Blair, Darling and Brown, who all, at various times in opposition, held the role of Front Bench spokesperson on Treasury matters, and took a keen interest in financial services.

However, there was probably no more defining moment in setting their views on the need for direct regulation than the point during the Treasury Select Committee examination, in 1995, into the Barings collapse, when the Serious Fraud Office, after discussions with the SIB, stated that they were unsure who was regulating Barings. Was it the Securities and Futures Authority (SFA), the Investment Management Regulatory Organisation (IMRO) or the Bank of England? It was simply not clear who was accountable.

The whole of this affair and the events afterwards, including the Morgan Grenfell fiasco on unauthorised unit trust management, or the copper market scandal involving Sumitomo, were internationally embarrassing, and so became a stick — and there were a lot of them around at the time — with which to beat the Tory Government.

What we have in the Cabinet today is a Chancellor who has flirted with the various factions of the Labour Party at various times, who is an interventionist, who believes passionately that it is possible to break the boom/bust cycle which we have seen affect the U.K. economy since the Second World War, and who wishes to build a platform for monetary stability in the long term. All of his actions as Chancellor that we have seen in the last nine months have really been about putting building blocks in place to achieve this, through, for example, the granting of operational independence to the Bank of England, which now has some of the most open and accountable procedures anywhere in the

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world, and also through the review of corporation tax and through one of the subjects that we are debating here, the overhaul of the regulatory system.

The main problem that the SROs have had is that they have suffered from the perception, particularly among Labour MPs and the press, that the financial services industry has operated a cosy club, and that self-regulation meant self-interest. They have not necessarily suffered from this negative perception from consumers, because, quite simply, consumers did not realise the difference. The point about self-interest, that anybody who has had to deal with the PIA advertising officers will know, is equally nonsense.

So, we now have direct regulation from the Treasury, where, to all intents and purposes, the FSA has replaced the SIB. It seems to have been very easily forgotten that the Self-Regulatory Organisations (SROs) were only able to operate provided that their principles and rules met the strict criteria laid down by the SIB, so that policies were already in force in the SROs within their working model.

However, we should not immediately assume that the SROs have been a failure. We must not assume, just because the political pendulum has swung, that everything that has been created so far has been wrong, and the move towards a central body to exercise control over prudential supervision and the regulation of sales and marketing should not come as a surprise.

There is no question that there have been problems with SROs. They have been expensive to run. There has been a lack of consistency between them, and one can quite easily spot inconsistencies in the rule books of different regulators, and, indeed, there are many types of product, with which we are familiar, which are, surprisingly, not regulated at all; short-term assurances and healthcare are the obvious examples.

Getting common policies across all the SROs has been well nigh impossible. One only has to look, for example, at the differences in the disclosure requirements at point of sale between unit trusts and life bonds. These products have a number of similarities in terms of their characteristics and in their end purpose, but they are still not identical, and it was only about two years after the disclosure requirements for life products were implemented that similar, but not identical, procedures were effected for unit trusts.

Another major problem is that there has been no formal bridge between the prudential supervision and the sales and marketing aspects of regulation. Prudential supervision and marketing are inextricably linked, and this is undoubtedly why the actuarial profession has played such an important part in forming that link for the insurance sector through the Appointed Actuary system. We should not assume that the proposed change is passing comment on that system.

There are five main areas in which there will be statutory objectives for the FSA. These were put forward in two documents, published in 1997, which really spell out what the FSA is trying to do:

(1) to sustain confidence in the U.K. financial services sector;
(2) to protect customers, ensuring that the firms are competent and are financially sound and give consumers confidence in their integrity, but still recognising that they have their own responsibilities for their own financial decisions;
(3) to promote public understanding of the benefits and the risks associated with financial products;
(4) to monitor, detect and prevent financial crime; and
(5) to pursue each of these objectives to ensure that it is done in a way which is cost efficient, does not stifle innovation and takes account of the international nature of financial regulation.

It is difficult to argue with any of this if it delivers a simpler, more transparent and less costly regulatory regime which must be good for consumer confidence in financial services. It is expected that these objectives will be achieved through the centralisation of policy-making across the various branches of financial services: the banks; the life companies; the fund management groups; etc.; and thus ensure consistency between different providers which, historically at least, have been providers of different types of product.

The way that the FSA says it wants to organise itself is, in true management consultant fashion, a business process of authorisation through supervision through to enforcement and discipline.

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There is no official organisation chart available yet for the FSA, although some senior appointments have been announced. However, from what we know already, each of these main process areas is expected to be responsible for ensuring consistent policy across all of the types of organisation that it regulates. The design will provide a central point of entry to international regulators, should they ever need to do so, or to new players, such as the supermarkets; these organisations want to set everything up at once, the banks, the PEP management companies, the unit trusts, the life offices — there is no natural background, as it were, for them to work from. This set-up lends itself to the supervision of these integrated financial service groups, and further supports the supervision of an increasing number of products which cross over the traditional boundaries — for example, life bonds which perform as banking-type products, and deposit-type products which perform as equities, etc.

Most importantly, through the design there is a single point of entry for the consumer. We are again back to political intentions — the Labour Party set itself up as the consumer's champion, which made the initial proposal of a single compensation scheme, although we learn from the proposals that have now been published that what started out as one scheme now means three sub-schemes: one for each of deposit taking, insurance and investment. Paraphrasing greatly, what the proposals say is that compensation will be paid for by the regulated businesses alone — in other words, not the Treasury, not the Exchequer, and it will not be comprehensive to investors.

The opportunity is there for the FSA to achieve organisational efficiency. It is a simple economic truth that there should be benefits through shared overheads, one organisational structure, one area of central support for all of the basic things which any business needs: the premises; the personnel function; the IT systems; and so on. The whole industry is very much looking towards what the authority does in terms of banking supervision, which is at the vanguard of the setting up of the FSA, and we are due to see the Bank of England Bill come into force in April 1999.

Certainly, from what has been done so far, we should take some encouragement. Mr Howard Davies, the Chairman of the FSA, has an impressive record within business and at the SIB. He has acted swiftly and efficiently in setting up the Authority. Staff are in the course of being moved from the SROs to the FSA, which means that, once the contractual agreements are finalised by the spring of 1998, the FSA will be, effectively, running the SROs. "So successful" — and I am reading from the FSA's own public relations document — "has the planning been so far, to ensure that they are not left behind, that the Building Societies Commission and the Friendly Societies Commission are clamouring to get on board before they were scheduled to do so in late 1999". These moves have meant that they have managed to retain experienced staff, and to retain the experienced Chief Executives that they wanted to, and have not lost them to industry. This handling of the moves bodes well for a smooth transition when the SROs are completely disbanded in late 1999.

There are many other parts of the proposals which are laudable, and desirable. For example, the responsibility which the FSA will take on in playing its part in education on financial services and the likely keeping of the recognition of professional bodies, subject to a review of their operating practices, and in the way in which the authority proposes to interact with consumers and providers.

Mr Davies has also re-stated that the FSA will pick up where the SIB leaves off, and will insist on individual registration of senior managers to take responsibility for their firm's compliance performance. The SFA and IMRO already require individuals to be registered in a way which puts responsibility on senior individuals to adhere to the SRO's rules. For non-compliance, the SRO can take action against the individual. The PIA is currently considering similar steps, and we certainly see this as being a significant and positive move in creating a compliance culture within organisations.

Much of what has been talked about is still at the proposal stage, and, as with any proposal, it is still a paper plan. The proof of whether we have a bureaucracy or progress will emerge over time. Its success will, as always, be in the implementation. We will be able to examine whether we have a bureaucracy on our hands when we understand more about its costs, and make sure that the costs of regulation, both direct and indirect, are proportionate to the benefits. Getting the balance right between sufficient regulation and avoiding excessive regulation will be the key test. No regulatory system can prevent all business failures or ensure universal compliance, and any attempt to do so can only give

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rise to costs which are going to be out of proportion to the intended benefits. This, I would suggest, is a major area that we should examine carefully within the consultation process, when the paper on funding becomes available over the next few months.

However, at this stage we can start to form our own opinion as a profession, and, indeed, respond to the series of papers as they emerge.

In summary, I should like to put forward the pluses and minuses as I see them. In favour of the FSA making progress, we have the opportunity for consistent policy, clearer accountability in three aspects (to consumers; to the rest of the world; and through the accountability placed on individuals within firms), and in operational efficiency. Against, there are fairly major points in terms of management over-stretch, and trying to do too much in too short a time. Late 1999 is when the FSA is expected to be fully operational, and there is much to be done, not least in turning the principles which have been put forward into rules and guidance, and taking account of consumer and professional views as thoroughly as has been indicated is the intent. There is also the problem of conflicting cultures. What we see coming together are the regulators of banks, life companies, fund management companies and intermediaries, along with prudential regulators and regulators of distribution, and all coming together at one time.

However, the point here, even though it is a management one, as anybody who has ever worked in a bancassurer will know, is all about bringing together individuals with different cultural outlooks.

Mr McCrossan: I mentioned earlier that we started out with the same problems, but we arrived at different solutions. As I listened to the presentation, what became clear to me was that the political process was substantially different in the two countries. In Canada, since the latter part of 1995, there has been intense activity on the consumer protection front, both federally and provincially.

In November 1994, the Banking Committee of the Senate of Canada issued a landmark report, entitled: 'Regulation and Consumer Protection in the Federally Regulated Financial Services Industry: Striking a Balance'. This was followed by a Federal Government White Paper in February 1995, called: 'Enhancing the Safety and Soundness of the Canadian Financial System'. The result is that we arrived at where I thought the U.K. was when I worked over here in the late 1960s — a system of maximum freedom with maximum disclosure. The political process through which we arrived at it appears to have been significantly different. When we started this process in 1985 we had a three-party Parliament. The members of the Finance Select Committee of the House of Commons decided that, if we were going to devise a regulatory framework that had both regulation of financial solidity and consumer protection that was going to last, it had to be done unanimously. Therefore, the Members of Parliament embarked on a pledge to each other, as we started out, that we would listen to each other, and that whatever report we produced would be produced unanimously. Indeed, for four years, as we re-regulated the Canadian financial sector, all three of the parties subscribed to the regulations. That occurred in both the House and the Senate.

The principal federal initiatives that were adopted were an early intervention policy — that is, all financial institutions have the right to fail, but they do not have the right to lose customers' money. They are perfectly free to go through their capital and their surplus. The point of intervention should try to be as close as possible to the point where they have used up their capital and surplus, so that the customer proceeds are protected, and the business is allow to fail. So you have the balance with commercial freedom.

Also adopted were greater disclosure of financial data, so that customers can assess solidity, developing a stronger prudential framework, which implied increasing the powers of the boards of directors *vis-à-vis* management, and measures to reduce systemic risk in the system. At the same time the provinces were becoming quite active. Beginning in 1995 with Ontario, each of the provinces began requiring mandatory continuing professional education for life insurance agents. By 1996, Ontario was the first province, followed by the others, to move to establish insurance ombudsmen and to require each company to establish and communicate a complaints handling protocol, with one contact person designated in each company. The industry association, the CLHIA, sponsored the development, by one of Canada's leading law firms, of a series of six legal volumes on insurance

https://doi.org/10.1017/S1357321700000180 Published online by Cambridge University Press

distribution, including one volume, quite a thick one, devoted entirely to market conduct issues, including the establishment of a comprehensive compliance framework for each company to follow. Finally, between 1 July 1997 and 1 January 1998, three new sets of industry guidelines have come into force. The first of these guidelines covers: who can be hired as a life agent; what sort of behaviour should be looked for; what you should be looking for in terms of early indications of unprofessional behaviour; and moving unsatisfactory agents out quickly.

There are also guidelines on life insurance illustrations which require pagination, complete policyholder signatures, disclosures of alternative dividend scales, alternative options, and the information that the customer requires to assess the product. Customers may choose not to read it, which is their choice, but the information must be disclosed. There is a similar set of guidelines for variable insurance contracts or unit-linked contracts.

In 1997, three of the major provinces (Ontario, Quebec and British Columbia) decided to permit class action suits. Many large Canadian life insurers were hit by major class action suits relating primarily to market conduct, particularly dividend and universal life transactions made in the 1980s, as interest rates began to decline. The issue before the courts has been whether sufficient policyholder disclosure of the risks inherent to the policyholders from declining interest rates took place. These suits, the first of which are now being settled, have led life offices to a much greater degree of disclosure at the point of sale, including written acknowledgement of receipts, of sales illustrations and warnings of what can and cannot happen.

What we have not done in Canada is to head in the direction suggested in this paper, sampling policyholders to find out whether the sale was proper or not. What we have gone to is the idea of maximum freedom and maximum disclosure, and if you fail to disclose, you do so at your very considerable legal peril.

Mr Stretton: I like the Canadian approach. Also, I do not normally go much for organisation. I think that what you try to do, and how you try to do it, matter much more, but there are limits. If you do not describe closely what is to be done, and you let loose what was originally supposed to be a self-regulatory structure, but was actually a five-tier structure with the Treasury, the Board of SIB, the Executive of SIB, the Board of the PIA and the Executive of the PIA, four of which are not really accountable, then you have a recipe for disaster.

What is proposed for the future does not guarantee that we will do any better, but it gives us a chance of doing so.

Mr G. M. Murray, C.B.E., F.F.A.: It seems to me that individual registration has the potential for bureaucracy running wild. While I have every sympathy for accountability at the top level, I believe that the move towards registration of individuals below that level will get bogged down in the morass of legislation. We have seen what happens with unfair dismissal legislation, and how companies have to deal with it. The way that individual registration is scheduled to be dealt with is not quite along these lines, but we may soon get bogged down in civil actions.

Mr Gibson: I agree. I think that there is a danger of individual registration being taken too far within organisations, and it is creating an overhead all of its own. I must admit the bit that I liked was that it very definitely focused the mind. When you know that you are individually accountable, you are going to make sure that the compliance systems within which you work are going to be adhered to.

3. *How should we Define Investment Advice for the purpose of Authorisation and of Regulation?*

Mr Taylor (opening the discussion on the third question): I read the Financial Services Act this morning, thinking that I might get a quick description of what investment is, but it was so complex. I then turned to our own rules as a profession, where, of course, it is the Institute which is the Recognised Professional Body (RPB), not the Faculty. We are moving to slightly more practical rules from the very large encyclopaedia of rules by which we have to abide. I would imagine, when it comes to investment advice, that those who are regulated by the PIA have a similar approach.

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What our rules do is to list activities which are regarded as a normal part of actuarial practice. In broad terms: we can give advice on pension scheme funding; we can give advice on asset allocation, and that, in turn, means matching liabilities, strategy, fixed interest versus equities, options, warrants, amongst other things; we can give advice on the choice of investment managers; we can sit on investment committees; we can advise on different types of pension plans — occupational, personal, buy-outs, annuities and transfer payments; we can advise on life and health contracts; and we can advise on the valuation of pension funds and of insurance offices for mergers or sales or, in a pension fund case, when parent companies are being sold or merged.

Those are all regarded as normal actuarial practice, and not strictly investment. There is a caveat, as there always is in anything actuarial. In many cases, the advice has to be generic rather than specific, and there is also a difference between talking to individual investors and to business or professional investors. There is a cross-over point. Those of us who try not to give investment advice can find ourselves slipping, very easily, into giving something which, under the Financial Services Act, would be investment advice. Therefore, you go for what is known as precautionary authorisation.

Perhaps one of the best examples is about membership of an investment committee. The moment you talk about individual shares rather than straightforward investment policy or strategy, you are getting straight into the area of investment advice. I now produce some other examples of where one can stray across the border or where it is not clear whether you are straying or not. Some of them are mine; some are ones that other people have fed into the profession and have been passed on to the Treasury as part of our consultation.

I was asked by a policyholder about the merger terms involving an office with which he had a policy, and whether he was being treated equitably. It was a one-off type of contract. Should he go to the High Court, as he was entitled to do, to complain? I do not know whether the advice I gave him was investment advice or not — I certainly felt competent to give that advice.

Choice of investment managers is a real problem, and one that will affect those who are in life offices. It is fine for us, consulting actuaries, to give a choice of investment managers, but if one wants to go for a managed fund company, then we are into packaged products. The consultant then has to be authorised. Yet that business is straight pension fund management business under the Insurance Companies Act, so we have a position here where my view is that the definition of investment advice is not wide enough.

What about advice to a policyholder who takes a large sum of money out of his unit-linked pension fund, and causes the price to change that day, asking whether his reasonable expectations are met or not? Is that investment advice?

I now consider traded endowments. I am involved in that market, and I can certainly advise on the structure of the portfolio and the terms on which purchases should be made for a professional fund, but again, I am not sure when I advise on one-off purchases whether it is investment advice. I am fairly comfortable, because the advice is given to a professional investor, but it could be investment advice if it was given to a private investor.

You can see from these examples why consulting actuaries go for precautionary authorisation.

We now have a bit of a worry. There is a chance that the new authority might put our regulatory fees up substantially. The big firms might cut back, and just authorise a very limited number of consultants to give investment advice. Those of us who are in the smaller partnerships or sole traders might just say that we are not going to give investment advice. If we can get the definitions widened as to what is, and what is not, investment advice, based on what we would regard as our normal practice, then we can withdraw with impunity. If we do, then the FSA will lose their fees. They might not be very happy about it. So they have a conflict of interest.

One of the problems that we have is that the role of the profession, or particularly the Institute, as an RPB, must be questionable. We certainly do not really know what the FSA has in mind for the professions. There must be a worry, in that they do not really understand our problems. We are quite small, and therefore the problems of other professions, which are much bigger, will be addressed in priority to our own. I am certainly very concerned by what I see as the very strong banking, and thus short-term, background of the senior people who are currently making their mark in the FSA. I

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wonder whether they will be able to make the transition to understanding long-term advice, with which we are concerned in our profession.

Mr McCrossan: In Canada, investment and securities are a provincial jurisdiction. Therefore, a life insurance salesperson or an actuary may not give such investment advice. Our firm's professional liability coverage says that it is void if we give investment advice. One can, of course, as an actuary, give investment advice if one becomes registered with the Securities Commission and obtains a professional designation of Chartered Financial Analyst, and many actuaries do so. It has reached a point where the Chartered Financial Analysts in the Canadian Institute of Actuaries are now co-sponsoring one meeting a year for the joint membership, in which we talk about asset/liability matching issues on the one hand and securities selection issues on the other. The demarcation issue is quite clear. As an actuary, as a life insurance salesperson, you may not give investment advice with respect to selection of any security unless you are registered. So, inside the life insurance agent's organisation we are seeing a role developed for a Chartered Financial Planner, who is recognised as dealing with State tax and financial planning, and that sort of thing. Inside securities selection you need a Chartered Financial Analyst. Many people are going for both designations, but you can only offer investment advice if you are registered under the Securities Act.

Mr Fishman: So, how we should define investment advice for the purposes of regulation? Are we happy with what we have got? Are we happy with what might be suggested? Should we influence the debate? Are we restricted in any way?

Mr Brimblecombe: I think that this is a major issue for those of us who work both in insurance companies and in the consulting field. One of the problems with the Financial Services Act is that any contravention of the Act is dealt with as a criminal offence rather than as a civil offence, because it is unauthorised selling. One or two professional bodies have suggested to the Treasury that if the new Financial Services Act, or whatever it is going to be called, can deal with transgressions under civil law rather than criminal law, there will be less need for people to have precautionary authorisation. Mr Taylor has certainly given a whole list of areas where people in the financial services industry are worried in case they stray, and therefore they need to be authorised.

My firm wrote to the FSA on this very issue. Let us assume that XYZ consultants are consultants to a pension fund of £300m. Advising the Trustees on which investment house to use is not investment business under the Financial Services Act, and up until now the Trustees have, say, five separate managers. Suddenly the Trustees decide, for whatever reason, that they wish to place £10m out of the £300m in a fund investing in South Korean small companies. The only investment house offering such a facility happens to be a managed fund with the ABC insurance company. Technically, in order to give that advice, the individuals employed by the consulting firm have to be authorised under the Financial Services Act, because it happens to be a packaged product. That is an obvious nonsense.

Given that we have quite a considerable number of people in this particular practice area, the regulation seems to be an over-kill. It should be noted — and this is a more technical point — that we could give advice on the suitability of the ABC insurance company as an investment house if we were suggesting an investment management arrangement with them, but not a managed fund.

I think that there are a large number of areas here where the expense is totally out of all proportion to the benefit. We are talking here about advising large corporations, not individuals, and I should like to see the profession push for, perhaps, a narrowing of what is deemed to be investment business under the revised Financial Services Act.

Mr C. D. Daykin, C.B., F.I.A.: This is an area which is not at all well defined. Right from the start I have been worried with the Financial Services Act that deposits were not counted as investments. It seems to me just as much an investment for somebody to decide to put money in the building society or the bank or to buy a National Savings Certificate as it is to buy any of the products which insurance companies sell.

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So, at one end we have the problem that many of the financial products which men and women in the street buy are not covered, whereas, at the other end, we have uncertainty as to whether the advice that actuaries are giving to pension funds is covered by the Financial Services Act or not.

It seems to me that the generic investment advice on asset/liability management which actuaries give to financial institutions is nothing to do with the Financial Services Act, and that this should be made clear. Actuaries should be able to provide investment advice to pension funds without specific authorisation of the sort that we are talking about.

Authorisation under the Financial Services Act, and through the new FSA, should cover financial advice to individuals, which should include deposits and risk protections. It should, therefore, include temporary assurance, permanent health insurance, critical illness insurance, contents insurance on your house, and other general insurance products for individuals. In other words, it should cover the whole package of products which individuals need for their financial protection. A completely different sort of investment authorisation should then be available for people who are giving advice on a wholesale basis, such as fund managers, on whom pension fund trustees might want to rely to carry out their investment.

Mr J. H. Webb, C.B.E., F.I.A.: I comment on what Mr Taylor had to say about the Institute rule book, and point out that we authorise only a minority of consulting actuaries, because there is a completely illogical distinction which relates to whether a firm is self-owned or not. If you are not in a self-owned firm, then, at the moment, you have to go to one of the other regulatory bodies. We also have a growing third category of our members who are working in accountancy firms, and who are authorised by another profession.

I think that there is some possible improvement in consistency, in that, if the whole of the authorisation procedures and the rule book are going to be determined by the FSA, then at least we have a better chance of a level playing field across the various classes of consulting actuarial firms than we have at the moment.

There has been reference to the uncertainty about the future of professional bodies in an authorisation context. It seems fairly certain that all authorisations will come directly from the FSA. What is to be negotiated, and where we are uncertain, is what delegated powers the FSA will be prepared to give to professions which supervise their member firms. We shall be in very close consultation with the FSA on this matter.

4. *Do we agree with Output-Based Regulation, and should this be Underpinned by some form of Kitemarking?*

Mr Fishman (opening the discussion on the fourth question): I remind everyone that the current procedures do not test the outcome of the process. Currently, regulated firms monitor the processes, it is true, and there are other indicators, such as complaints and persistency levels, but current procedures do not test the outcome. Just to be absolutely clear, the outcome is the sale itself. We are not talking about the eventual out-turn of the contract purchased.

We believe that, perhaps, there is not such a huge gap from the current prescriptive basis, which has not worked too well, to an outcome-based approach. We now have 'key features' and 'reason why' letters, which are audited by firms and by regulators to check that sales are compliant. It does not seem to me that it is much of a step to use the reason why letters and the fact finds as a basis for checking the outcome of a sale directly with the investor in a focused way. If we were to adopt this approach, we would then come to a tricky issue. Since the equivalent discussion at the Institute (*B.A.J.* **4**, 145-191), there has been some adverse publicity on what we would actually do under an outcome-based approach. How would we test this? Would it be by sampling or by some other method? Purely for discussion, we talked about carrying out checks by telephone, by direct visit or by letter. One or two press articles were not too kind when we suggested that this could be conducted by telephone. We can see that promotion of this particular concept has to be handled very carefully.

Of topical interest, as an example based upon the background information available, it should be possible, in the case of personal pensions, to establish whether or not an investor is clear about his

https://doi.org/10.1017/S1357321700000180 Published online by Cambridge University Press

costs, affordability, the absence of a company scheme, the possible effects of a change of job, and, perhaps, a change in family circumstances. We discovered this rather late on in the process, but, *perhaps, the implications of bankruptcy somewhere down the line also needs to be made clear.* These are all risks which could be pointed out if one looks at an outcome-based approach, which may well not have been covered in the selling process itself.

One of the interesting things that happened after the Institute discussion was that I received quite a lot of phone calls. There were many from independent financial advisers (IFAs) who were delighted at the concept of an outcome-based approach, because, for smaller IFAs, the cost of regulation is a very large burden, particularly when FSA business forms only a very small part of their work. This also applies in large firms. Certainly, in the case of the smaller IFAs, the cost of regulation bears very heavily indeed. They cannot afford a full-time compliance officer. Apart from the direct costs, there is considerable indirect cost as well. This causes the smaller IFAs very great concern, and maybe the OFT might have something to say about this one day. For small firms, there may be very few FSA-regulated events in a particular period. There might be none at all. Under outcome-based regulation systems, those with no relevant business in a particular period could simply provide a nil business return and be absolved from detailed record keeping. We must not forget that, as well as rather larger organisations, there are many hundreds — maybe thousands — of small organisations.

I have given some thought to the question of kitemarking. This is a topical matter, because we are about to get stakeholder pensions, which, I think, will be introduced sooner rather than later. Kitemarking initially seemed to me to be an extreme example of an outcome-based approach. On reflection, I am not so sure. I am not sure that kitemarking, as we have already heard from one of the panellists in this discussion, is necessarily a guarantee that investors will understand the outcome. At the same time, of course, kitemarking is intended to be a substitute for prescriptive regulation, because stakeholder pensions are going to have to be a fairly cheap sort of product.

I am very interested in hearing others' views on the whole concept of outcome-based regulation. I know that it starts off as a very difficult concept, but we must try to think the unthinkable. There will be practical issues. Has the Working Party been barking up the wrong tree completely? Do we seem to be crazy to be thinking about this, or is it worth pursuing, in particular by reference to the introduction of stakeholder pensions? In a sense, this is the core of our Working Party paper and subsequent discussions.

Mr Stretton: One of the troubles with prescription of the methods that you must use is that it makes matters very difficult to change. As customer needs change, there is a severe danger that the established practitioners in the market who go through this current form of regulation get left behind. They cannot move fast enough to change to meet current customer needs. So, whether or not we think that output-based is preferable *per se*, it has some considerable long-term advantages in making sure that we do not get marooned.

Mr McCrossan: The question was asked: "Should the profession make representations?" I am sure about your ability to make representations to the relevant political bodies, but, beginning in 1983, the Canadian Institute of Actuaries decided that it would seek the opportunity to make political representations on any subject before Parliament of interest to actuaries. It also decided that any representations that it made should not be advocating solutions. We had a unique opportunity, as a profession, to advise Parliamentarians on the pros and the cons of various alternatives, and we should try, as a profession, to advise the politicians as dispassionately as possible, because the CIA represents all regulators who are actuaries or consultants, all life insurance actuaries, etc. What we found was, by following that line consistently, not advocating any solution, but merely offering ourselves as a teacher or speculating about the consequences of various actions and alternative actions, that the CIA became the witness of choice to the Finance Committee on virtually any issue. The currency of Ottawa is knowledge, and virtually everyone who comes to a Parliamentarian has a vested interest which they actively promote. So, if one can establish the standard of coming as a friend of the court, if you will, and live up to that standard, then it is a marvellous way of increasing the profession's influence on public policy.

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Mr Gibson: I have some comments on the proposed approach for outcome-based regulation. My thoughts are that it would be very difficult to see it applied practically, and that there could be many different interpretations of what was a satisfactory outcome. In ¶4.4.5 there is a call for a clear outcome framework to be defined. That takes one back to needing more rules and more guidance on the framework itself.

Another area where I see difficulty is that the appropriateness of the outcome is dependent on a series of risk-based models being defined, so that risk assessment can be understood, at least, by advisers, and this assessment is then eventually passed on to consumers. I know the difficulty that advisers have in passing on an interpretation of the concept of risk at the moment. To take this to a stage further, where there are actually metrics within these models, the issues become even more difficult to communicate.

The other point of criticism that I have is that the test, or the audit, can really only come after the event. As a marketeer, I see further problems down the line if the audit has to take place, even with a telephone follow-up call which has been suggested. In my view, it is not a practical proposal.

Mr R. K. Sloan, F.F.A.: I back the idea of kitemarking. If we think of the parallel of motor cars, for instance, it would be quite unthinkable to be able to buy a motor car which might not turn the corner when you turned the steering wheel, yet we have had financial products which have been ridiculously expensive. Contracting-out has been operated with products which had high front-end charges, and which made it very difficult for good advice to be given. So, I believe that certain elements of a product should, indeed, be kitemarked. That does not mean that you can necessarily identify an appropriate product for any customer, but at least it means that you can justify that the quantitative side, the actual cost, is at least reasonable.

I have been involved quite a bit in advising on some of the mis-selling scandals, and feel that one should be careful about how much blame is attached to the salesman. The benefit of hindsight has been mentioned. It is most surprising how clearly some customers remember exactly what it was they intended to do at that time, yet they signed proposal forms which appeared to achieve exactly the opposite.

I am not sure to what extent the adviser might be able to get a disclaimer. We have talked about execution-only contracts. I would like to see the situation where, if one had given all the correct advice on possible outcomes, and so on, and if the client, at that point, were to sign an appropriate disclaimer confirming that he had understood everything, then that would be the end of it. Unfortunately, we do not distinguish adequately between getting the wrong answer for the right reasons and getting the right answer for the wrong reasons. It appears that only the latter would be condoned by the proposed outcome-based approach, which might be unfortunate.

Mr T. W. Hewitson, F.F.A.: As a member of the original Working Party, I throw in one further suggestion. In Appendix C we have suggested, among other things, that the salesman should identify the needs of the customers, their various circumstances, and the concerns that the customers may have, It occurs to me that one possibility might be to have a system whereby the salesman goes through this process with each customer, identifying their individual needs. What are their concerns? What are their current and likely future circumstances? Then, having done that, the salesman can advise them on the most suitable product and write some sort of letter which explains to the customer how this product is intended to meet their needs, and to satisfy the various constraints identified in the initial interview. This letter would, of course, have to be customer focused rather than product related. In principle, you might then have a satisfied customer at that stage. Of course, you would also have something in writing, given both to the policyholder and kept in the company's own records, which could be audited, perhaps on a sample basis, at a later stage. Again, at least in theory, you might have much less need to go back to the customer, or for the regulators to go back to the customer, to ascertain whether this was a good sell.

Mr D. G. Robinson, F.F.A.: I was attracted to Mr McCrossan's idea of the way in which the profession should represent itself to government. It seems a very sensible way for the profession to

https://doi.org/10.1017/S1357321700000180 Published online by Cambridge University Press

raise its profile with legislators and regulators, and is something that the profession ought to pay attention to.

Outcome-based regulation has a lot of appeal. However, it needs the right regulatory touch. Many of us who have had contact with people doing regulatory audits know that those responsible appear to want to go by a rule book rather than to adhere to a set of principles, so the regulatory audit approach will need to change to reflect the outcome-based approach.

I disagree with Mr Sloan on kitemarking. I think that kitemarking has some fundamental, but superficial, appeal. However, the concern that I have with kitemarking is that it will tend to stultify product design. I agree that consumers' needs will change over time, although I have a concern that the products that the industry produces in response to customer need will get stultified by the kitemarking. We may get to the situation that we are in, for example, with critical illness products, where we have a huge list of illnesses which you could say are the industry's kitemark for critical illness products. However, that is not what customers necessarily want. Customers do not want to know whether they are covered for a particular set of illnesses, they want to know if this policy will pay out if they develop a serious medical problem which will affect adversely their future life style. However, the way that the industry solves it, at present, is by having a list of 30 or 40 illnesses which purport to be the industry kitemark. There is certainly superficial attractiveness in kitemarking, but we have to be very careful that we do not tie ourselves down in a way so that we are not able to respond to changing customer needs.

Mr H. Taylor, F.F.A.: My view on the desirability of kitemarking is that it really all depends on what you mean by it. There is muddled thinking and language around the topic. There often seems to be confusion with the related, but distinct, process of benchmarking. When benchmarking, you must first decide whether you are measuring performance on specific criteria only relative to what product providers are actually offering in the market place, or whether all providers are measured against absolute targets which would constitute a good product for the consumer. The 'relative' and 'absolute' approaches need to be considered if benchmarking is to be part of the kitemarking process. The other decision is selecting the set of the particular criteria for kitemarking; that is how many components of the product and its interaction with the customer will be covered. Will it include some measure of investment performance or risk? Is it some overall measure of the total effect of charging structure, or the way that charges are taken and in what circumstances? Will it say which features must be excluded from the product as well as those which may or must be included?

Sometimes you can illustrate problems by looking at extreme examples. For kitemarking, this could be where every aspect of the product, the charging structure, the product provider and the customer process had to meet certain 'absolute' minimum standards. That would lead to both a commoditised product and a standardised product across the whole industry. This would ultimately act to the detriment of the customer. At the other extreme, with no kitemarking or controls whatsoever, there are risks of mis-selling bad products. There is merit in kitemarking, but the thinking around exactly what we mean and the role of benchmarking need to be thought through carefully. There is the core of a good idea. I think that the actuarial profession should have a part in helping to influence what ultimately emerges as kitemarking, otherwise there is a risk that it may become a marketing gimmick, which would be bad for customers and for the industry.

Mr Daykin: I would like to distinguish between the three different channels of regulation with which we are concerned. One of them is the role of the salesman or the intermediary. I agree very much with what Mr Hewitson said in this respect; one needs to focus on the role of the intermediary in dealing with the customer, advising on comparisons and alternatives, understanding the individual's financial needs, and so on. That is one aspect which is quite separate from the kitemarking problem. Kitemarking seems to be addressing what I regard as the next type of regulation with which we are concerned. This strand runs all the way through from the design of the product, through the mode of marketing, transparency to the customer, how much disclosure there is, and then, ultimately, to its delivery through the fulfilment of policyholder reasonable expectations.

It seems to me that this is essentially an actuarial area, or ought to be. It is not necessarily so at

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the moment. The actuary has some role in the disclosure aspect, and certainly a role in the aspect covering delivery of policyholder reasonable expectations. However, the actuary does not necessarily have a role in the design or how the product is marketed. Such a view is something towards which the Americans are now moving. They have had a much more constrained process up to now, with controls on the nature of products, a requirement to have guaranteed surrender values, and so on. The proposals which now seem to be emerging are for each product to be the subject of a plan, signed by the actuary, which covers the design of the product, the way in which it is going to be disclosed and marketed, and how that will be carried through to the final stages of delivery.

That is the sort of kitemarking which the actuarial profession could support, being essentially in the professional area, something which actuaries would control. The person might be someone other than the Appointed Actuary, so as not to load too much onto the Appointed Actuary, who has probably got enough on his or her plate already. We want to avoid it becoming a sort of prior product control arrangement, which is now banned under the European Directives. So, I do not think that we can have kitemarking in the sense that the product has to be approved in advance. It may mean that products have to meet certain standards. Some of those could be generic standards, as in British Standard arrangements; but some would be under professional control, and would be signed off by the actuary in question.

The third area of regulation is the obvious one of financial soundness and the continued ability of the provider to meet the liabilities.

Mr W. B. McBride, F.F.A.: I am a consulting actuary, and my work is mainly with small friendly societies. I want to tell the panel that, contrary to an impression that they might have got at the Institute discussion, small societies find the burden of current regulation very severe. Mr Boléat said: "If we ask the compliance managers for their views on regulation, they want more of it...the bigger the rule book, the better". Regulation means that they no longer need to take decisions. More or less the exact opposite view is taken by small friendly societies. They are groaning under the weight of regulation.

As one example, I have knowledge of a transfer between a small friendly society to another, not very much larger, one. When the transferee society realised the scale of the Commission's fees for their valuable services in supervising this exercise, they withdrew; whereupon the trustees of the smaller society promptly resigned, leaving the society without management. The last that I heard of this was that the Commission were trying to sort out the mess.

However, on perhaps a more important note, I attended the Association of Friendly Societies' Annual Conference, in October 1997, where Mrs Liddell, a Treasury Minister, gave the keynote address. She expressed full support for the friendly society movement in all its aspects, and generally developed a theme of encouraging us. In the discussion, I asked her how she reconciled this positive attitude with the withdrawal of tax credits on equity dividends for tax exempt business, they being the mainstay of many societies. Amazingly, she seemed to think that this was a hostile question. The tone of her reply was largely along the lines of taking out anomalies in the tax structure and encouraging investment, which, of course, completely avoided the question.

I wrote to her subsequently, trying to point out how helpful I was really trying to be, and eventually received a letter from an official in the Treasury enclosing a copy of a statement that Mrs Liddell made to the House in November 1997. In that statement she was mainly having a go at pensions mis-selling, but she did say that this Government was not going to set people up to be cleaned out, or some such expression, as had happened before. However, her entire tenor was negative insofar as the savings institutions were concerned. It was really quite depressing. It made me think of what Mr Thomson said, that there is not enough acceptance by regulators of the natural risks, and that separating out the goodies from the cowboys is simply not being done.

Without a change of heart on the Government's part, in this respect, I would not hold out much hope for Mr Stretton's laudable ambition of a proper definition of objectives being installed instead of the present prescriptive regulatory regimes.

Mr N. H. Taylor mentioned fees for smaller firms and sole practitioners. For some 25 years of my exile in England I managed to resist the blandishments of the Institute, but when I joined my present

https://doi.org/10.1017/S1357321700000180 Published online by Cambridge University Press

colleague I was seduced into becoming an Affiliate. The reason behind this is simply that we are the two directors of a small company which is regulated for investment by the Institute, All directors who are so must be members of the Institute in one fashion or another, which is no great burden, because I found that the Institute's Affiliate fees are very modest. However, as a relevant person under the Financial Services Regulations, the fee is quite monstrous. The difficulty is that I have absolutely no intention of giving any investment advice, leaving that aspect to my colleague. Yet, to all intents and purposes, I am lumbered with this fee. It is galling to have to pay so much for, in effect, nothing.

The Vice-President (Mr C. J. Kirkwood, F.F.A.): We have had a very interesting and educational meeting on a most important subject. I should like to thank the panel: Mr Gibson, Mr Taylor, Mr Stretton, Mr McCrossan and Mr Fishman, for all the work that they have put in to producing this paper. It is interesting, in particular, to see the Canadian view of regulation. I should especially like to thank Mr Fishman for the way in which he has controlled the panel and made my task so much easier. I hope you will join me in a hearty vote of thanks.

https://doi.org/10.1017/S1357321700000180 Published online by Cambridge University Press