

Actuaries and Governance

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Abstract

This paper discusses the role that actuaries can and should play in the achievement of sound and sustainable governance practices within the organisations which use the actuary's services, whether as a client or as the actuary's employer. It is not about the governance of the Profession, although it may provide some pointers to what good governance means in the context of the Profession.

Keywords

Governance; corporate governance; standards; Combined Code; dominance; trustees; directors; communication; Morris Review; reputational risk; risk management; discipline; transparency; advice; relationships; terms of engagement.

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1. Introduction

This paper discusses the role that actuaries can and should play in the achievement of sound and sustainable governance practices within the organisations which use the actuary's services, whether as a client or as the actuary's employer. It is not about the governance of the Profession, although it may provide some pointers to what good governance means in the context of the Profession.

2. What is Corporate Governance?

The corporate governance "industry" in the UK has its roots in a report on the subject by a committee chaired by Sir Adrian Cadbury in the early 1990s. The trigger for this report was a series of corporate financial scandals in the 1980's whose origins could be traced to poor financial controls, dominant individuals, weak company boards and so on.

Cadbury defined corporate governance as "the process by which companies are directed and controlled." Cadbury's primary focus was the interests of shareholders. Over time the interests of other stakeholders – employees, customers, suppliers and the wider community for example – have been drawn into the corporate governance framework. And it has been recognised that the principles of corporate governance apply to all manner of organisations and institutions, not just to companies.

There has been much debate in the UK about the extent to which good corporate governance creates added long-term value. What is widely accepted is the converse – that bad corporate governance practices are very likely to destroy value in the long term. That is a sufficient reason for corporate governance to be at the heart of business planning and processes.

3. The Combined Code

The Cadbury report, together with a number of successor reports, have resulted in a set of principles and rules (the Combined Code) with which listed UK companies are expected to comply as a condition for their listing on the London Stock Exchange. Failure to comply with a rule is acceptable provided that an explanation satisfactory to the shareholders and the listing authorities is given.

The following are some key features of the Combined Code:

- a) The Company should be headed by an effective Board that should lead and control it.
- b) The Board should have a balance of executive and non-executive directors, bringing an appropriate level of independence, skills and challenge.
- c) There should be a formal, rigorous and transparent process for appointing new directors, and appropriate induction and ongoing training programmes.
- d) The roles of chairman and chief executive should be undertaken by different people to avoid dominance by one individual.
- e) The Board should be supplied with information that is timely, relevant and transparent.
- f) Executive directors' remuneration should be determined by formal and transparent procedures and incentives should be framed so as to align the interests of directors and shareholders.

- g) Financial reporting should present a balanced and understandable assessment of the company's position and prospects, including the attendant risks.
- h) The board should maintain sound systems of internal control and risk management to safeguard shareholders' investments and the company's assets.
- i) Companies and major shareholders should each be ready to enter into a dialogue based on a shared understanding of objectives, and shareholders have a responsibility to make considered use of their votes at Annual General Meetings. Life assurance companies are interesting in this respect – many are both listed companies and major shareholders.

4. Pension Fund Trustees

The role of the Trustee Board of a UK pension fund is similar to that of a Company Board in many respects, and the principles of good governance can be read across:

- a) The Trustee Board should avoid dominance by employer or member representatives.
- b) Its members should have the skills and experience necessary to absorb and challenge the advice (often complex) from external experts.
- c) Under new regulations in the UK, the Trustee Board has much stronger powers to negotiate funding agreements with employers. As a result, senior company executives are finding it increasingly difficult to serve as trustees.
- d) To an increasing extent, independent persons are being asked to chair Trustee Boards.
- e) The requirements for transparent financial reporting, including an assessment of the fund's future prospects, apply equally to pension funds, as do the need for sound internal controls and risk assessment.
- f) Pension funds are major institutional shareholders and are expected to behave accordingly in terms of dialogue with investee companies and voting policies.

5. Actuaries, Insurance Companies and Pension Funds

In more recent years governance failures have hit institutions where actuaries play a central role – Equitable Life, Independent Insurance and the Maxwell pension funds for example. In the wider financial world, Long Term Capital Management and Split Capital Investment Trusts come to mind.

In all of these, as well as governance issues of the kinds already described – particularly dominance and lack of challenge at senior levels – there has been (to varying degrees) a failure to understand and communicate the nature of financial risks. In the Equitable Life case, for example, Lord Penrose criticised the actuarial profession for having standards that were ambiguous, not tough enough and not set independently. But he also questioned the ability of the non-executive directors to understand and challenge the complexities of the reserving and pricing policies followed by the executive management. Sir Derek Morris, in his recent Review of the UK Profession, highlighted the asymmetry of understanding between actuaries and non-executive directors of insurance companies/trustees of pension funds. Actuaries advise in complex fields and this brings added responsibilities for rigorous analysis and clear communication. It also brings with it the risk that the adviser is, by default, taking decisions which are not his or hers to take.

6. Actuaries and Corporate Governance

With that background, it is clear that actuaries have much to offer in the Corporate Governance space, and they will face serious threats if they ignore it.

- a) There is a clear reputational risk for individual actuaries and for the Profession if there are failures in the institutions that employ, or are advised by, actuaries.

- b) On the other hand, actuaries should be comfortable in a sound corporate governance environment, as indeed should other professionals. We are used to having a code of conduct, a disciplinary scheme and professional and technical standards (which will be greatly strengthened in the UK following the Morris Review). We are also used to operating in areas that are subject to strong external regulation, through the Financial Services Authority and The Pensions Regulator.
- c) Where the skills of actuaries and the demands of corporate governance converge is in the field of risk management. In response to the corporate problems that spawned the corporate governance industry and the growth of the regulation industry, organisations of all kinds have put the identification and management of risk at the heart of their operational models. Enterprise Risk Management presents an exciting opportunity for actuaries to adapt their core skills to wider risk problems and to organisations far beyond insurance companies and pension funds. Actuarial associations around the world, and the IAA itself, are at various stages of developing strategies to address this opportunity. They need to move quickly.
- d) Transparency and clear communication are key features of good governance. Both present challenges to actuaries, not least because of the complexity of the products and risks on which they advise. But there can be other, less acceptable, forces at work. The providers of financial products have tended on occasion to obscure the risks inherent in certain products, for marketing reasons, to the detriment of consumers and ultimately to the detriment of the providers themselves arising from reputational damage and the costs of making good customer losses. Similarly, employers have been reluctant to

point out the risks to members of defined benefit schemes with mismatched investment policies. Could actuaries have done more to prevent these problems, if they had been more independent of the providers and employers concerned respectively? Possibly not, but there are lessons to be learned.

7. Some Necessary Conditions

It is clear to us that actuaries can add considerable value to their employers and clients in corporate governance. However, there are some conditions that will need to be satisfied.

- a) There needs to be a clear distinction made between advice and decision taking. Actuaries as advisers have a particular responsibility to help decision-makers understand fully the implications of their advice for all stakeholders, to make well-informed decisions and to analyse the implications of the decisions actually taken for all stakeholders.
- b) The relationship between the actuary and his or her client or employer needs to be defined clearly as part of the terms of engagement or contract of employment. This will cover inter alia the scope of the work (bearing in mind a) above), the reasons for it, the timescales, and the remuneration. The client or employer needs to understand and accept the code of conduct and standards within which the actuary is required to operate.
- c) There need to be regular reviews of outcomes compared to expectations with an appropriate commitment to corrective actions where necessary.

8. Conclusion

That actuaries have the technical skills to add value in corporate governance is we think, very much the case – although of course to maintain that position it is essential for the profession to be at the forefront of innovative thinking and research. Whether, as a group, actuaries have the communication and business skills to apply their technical skills to maximum effect is more open to debate. This leads to a much wider debate about education, about widening the range of people for whom the profession is seen as an attractive option, about working more collaboratively with other professionals, and, ultimately, about the sort of profession we all want to be part of.

Questions for Discussion

- a) Major companies (both of financial and commercial) have failed through the dominance of an individual or a small group or a culture. How do you tell the difference between the dominance by an individual or culture that is likely to lead to failure and dominance that creates an entrepreneurial organisation for the benefit of all stakeholders? What is the role of systems and controls in keeping a dominant culture on track? What is the responsibility of employed or advisory actuaries in exposing a dominant individual who does not pay adequate attention to what their systems and controls are telling them?
- b) Should the professions publish precedents for the terms of engagement of consulting actuaries and the terms of employment of employed actuaries?
- c) Should the professions publish guidance on best practice in the relationship between actuary and client or employer, including documentation and audit trails, style of report and follow up on unresolved issues?

- d) Should the professions seek to exercise some guidance over firms of actuaries, for example in their terms of engagement and internal conduct standards?
- e) Under what conditions should a firm be permitted to advise both trustees and sponsors of a pension fund?
- f) Who should regulate the influence of firms on individual actuaries?
- g) How should actuaries doing 'non-actuarial' work be governed by their profession, if at all?