4.7 Impact of Undue Commercial Pressure

Hotspot Description

The risk that actuaries may be placed under pressure to adopt inappropriate models or unrealistic assumptions to achieve desired commercial outcomes.

Current influences

The continuation of the low interest rate environment may result in financial institutions (in particular, insurance companies and pension schemes), looking for new ways of generating profits. The risk is that this pressure might result in objective and reasoned actuarial judgement (in the actuary's view) being challenged.

Key developments and JFAR member regulators' actions during 2020/21

A significant proportion of actuaries tend to work in commercial environments and are therefore under commercial pressure of one form or another. However, there have been recent developments in the following areas.

Reserving

In some instances commercial pressure from the management of general insurers to deliver improved results may translate into actuarial judgements being challenged disproportionately where there may be areas of potential reserve prudence, with less focus on areas where there may be potential reserve inadequacy. The PRA expects management and boards to be especially vigilant on these issues as they consider the appropriateness of their reserves and solvency positions.[221]

Pricing

Whilst actuaries are not the only individuals involved in the pricing process, they do play an important role in setting the final price. The actuary needs to be aware of the impact the price might have on customer fairness and inclusivity (i.e. less attractive risks being priced out of the market), particularly if machine learning models have a material input into the price.

In September 2020 the FCA published a Final Report on general insurance pricing practices[222] showing that the markets in home and motor insurance products are not working well for certain customers. Certain groups of policyholders are being charged a higher price relative to other groups for a similar product. The final price charged is typically the result of actuarial modelling, commercial considerations, and other factors. The actuary might be heavily involved in some of these factors and little involved in others. Final rules (PS21/5)[223] to address the harms identified were published in May 2021. These included a requirement that, for home and motor insurance, the renewal

221 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2019/letter-from-gareth-truran-pra-current-areas-of-focus-for-general-insurance-firms.pdf
222 https://www.fca.org.uk/publication/market-studies/ms18-1-3.pdf
223 https://www.fca.org.uk/publication/policy/ps21-5.pdf

price offered to a customer must be no higher than the price that would be offered if the customer was new.

This topic is discussed further in Unfair Outcomes for Individuals (Section 4.4, Page 27), sub-section 'Fairness in pricing and product value' (Page 29).

Realistic assumptions for initial expected loss ratios in general insurance business and for planned business and in both life insurance and general insurance business

In the case of insurers that calculate their Solvency II capital requirement using an internal model, the more favourable the assumed performance of the business planned to be written in the coming 12 months, the lower the capital requirement. In the case of general insurers that use initial expected loss ratios (IELR) in the calculation of estimated future claims cost (also known as reserves), the more favourable the assumed IELR in recent accident / underwriting years, the more favourable the published financial result.

Therefore, actuaries working in the areas of insurance capital modelling or general insurance reserving should be aware that there might be an incentive for the business to put pressure on the actuary to agree to assumptions used in the capital requirement calculation or reserves' calculation that are, in the actuary's view, too optimistic to be realistic and are difficult to justify.[224] An example of such pressure could be along the lines "*claims ratios on business planned to be written in the coming 12 months will be lower than historical claims ratios because the book has been completely re-underwritten*".[225]

The actuary should bear in mind that:

- Under the 'Impartiality' principle of the Actuaries' Code[226] an actuary must ensure that their professional judgement is not compromised by the undue influence of others.
- Core provision 8 of Technical Actuarial Standard 200[227] states that "*… any estimates described as "best estimate", "central estimate" or other similar terms shall be neither optimistic nor pessimistic and shall not contain adjustments to reflect a desired outcome.*"

Though the actuary is typically working as part of a multidisciplinary team and might not have the final say on assumption selections, an actuary should not be seen to agree to an assumption unless they are of the view that the assumption is realistic and can be justified.

If the actuary takes the view that assumptions underlying the business plan are not realistic for use in the calculation of the capital requirement or reserves,[228] the actuary should communicate to the business how this situation has arisen and how it might be addressed.

Pension transfers

Pension schemes' trustees are required, by law, to quote cash equivalent transfer values and, before they can calculate them, must have taken advice from their actuary as to the appropriate assumptions[229] to use.

When advising on aspects of defined benefit transfers actuaries need to remember that different parties have different needs and motivations. The pension scheme member is likely to want the transfer value to be as

[224] See also PRA's letter to Chief Executives of general insurers dated 31 May 2018 on subject Market conditions facing specialist general insurers: Feedback from recent PRA review work (key findings 2 and 5 in particular); and PRA's supervisory statement titled: Solvency II: Calculation of Technical Provisions and use of internal models for general insurance (SS5/14)

[225] See also PRA's supervisory statement titled: Solvency II: Calculation of Technical Provisions and use of internal models for general insurance (SS5/14) - paragraph 3.12 on improvements in performance: "Firms should not assume an improvement in performance relative to that seen in the past unless such an improvement has been clearly justified, in line with the expected Delegated Acts. For example, it would not be realistic to base the internal model on a business plan which assumes improved underwriting results unless the measures taken have been shown to be effective."

[226] https://www.actuaries.org.uk/upholding-standards/standards-and-guidance/actuaries-code

[227] https://www.frc.org.uk/getattachment/c866b1f4-688d-4d0a-9527-64cb8b1e8624/TAS-200-Insurance-Dec-2016.pdf

[228] See also PRA's supervisory statement titled: Solvency II: Calculation of Technical Provisions and use of internal models for general insurance (SS5/14) – paragraph 2.8 on premium provisions: "Many firms use business plan loss ratios to set the level of premium provisions. Using optimistic business plan loss ratios for this purpose is not realistic, and will not produce a best estimate as required by Article 77 of the Directive."

[229] http://www.legislation.gov.uk/uksi/1996/1847/regulation/7B

high as possible. The sponsoring employer may desire that a transfer occurs. The pension scheme's trustees need to protect the position of the pension scheme's members who remain behind, in addition to their fiduciary duty to the pension scheme member to whom they give a transfer value. Although the actuary has a main user to whom they provide advice there are wider public interest issues that need to be considered. In advising their client the actuary may need to bring to the attention of their client any impact on the wider stakeholders. Under the 'Impartiality' principle of the Actuaries' Code an actuary must ensure that their professional judgement is not compromised by bias or conflict of interest.

Commercial pressures may mean that communication to pension scheme members might over-play the merits when transferring from an existing scheme to a different scheme, or under-play the benefits of guaranteed lifetime income when commuting some of that income (i.e. if commutation rates are materially lower than a true best estimate). Particular care needs to be paid to avoiding the provision of 'advice' to pension scheme members: FCA / TPR guidance[230] indicates that information which is not generic or factual is likely to be advice. The actuary should resist any pressure that might result in pension scheme members receiving information which could steer them toward or away from a transfer.

The scope for harm arising from an unsuitable decision to transfer a defined benefit pension is significant. This has led to various initiatives by industry and by the FCA to ensure that advice given is in the pension scheme members' best interests.

If an actuary feels that their professional judgement is being compromised by undue influence of others or by conflict of interest, and considers that they might need support to avoid breaching the 'Impartiality' principle of the Actuaries' Code, the actuary should seek assistance from the IFoA's Professional Support Service.[231] The JFAR has considered the roles that actuaries fill with respect to pension transfers to ensure that all the JFAR member regulators are acting consistently and in full knowledge of the actions of other regulators.

This topic is discussed further in Unfair Outcomes for Individuals (Section 4.4, Page 27), sub-section 'DB to DC transfers' (Page 31).

Accountability of Senior Managers

The Senior Managers and Certification Regime[232] (SM&CR) regime was introduced in 2019 by the FCA and the PRA, meaning there is a single regime for identifying the most senior decision-makers in all regulated financial services firms including banks, insurers, and major investment firms, and setting requirements on them. This clearly establishes the link between seniority and accountability. The SM&CR both strengthens individual accountability and reinforces collective responsibility among boards.

The regime defines specific senior management functions (e.g. Chief Risk Officer (SMF4), Senior Independent Director (SMF14), Chief Actuary (SMF20), With-Profits Actuary (SMF20a), Chief Underwriting Officer (SMF23)). Actuaries holding any of these functions need to consider their responsibilities within the regime. These responsibilities may well include not focussing solely on the commercial outcome above everything else.

The IFoA's Practising Certificate[233] regime includes a requirement for IFoA Members that hold the senior management functions of Chief Actuary (SMF20) or With-Profits Actuary (SMF20a) to have a relevant IFoA Practising Certificate. The regime is designed to ensure that IFoA Members who hold these functions are assessed as having skills and experience to

230 https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/tpr-fca-employers-trustees-financial-matters-guide.ashx [especially Pages 9-11]
231 https://www.actuaries.org.uk/upholding-standards/professional-support-service
232 https://www.fca.org.uk/firms/senior-managers-certification-regime
233 https://www.actuaries.org.uk/upholding-standards/practising-certificates

allow them, amongst other things, to withstand different pressures. The FRC's Guidance for Boards and Board Committees[234] includes guidance related to financial reporting.[235]

Insurance capital models

Actuaries at insurance firms (working as part of a multi-disciplinary team) may face internal pressure to calculate a capital requirement that the actuary and others might regard as insufficient given the company's risk profile. Where this pressure arises, it may come in the form of 'model drift' (also known as 'model creep'). This is where year-on-year assumptions are changed marginally so the change in the capital requirement from one year to the next appears not material, but over time the capital requirement drifts down to a level at which it is no longer appropriate for the risks faced by the business. Therefore, when the actuary is considering changes to an assumption, they should also consider recent changes to that same assumption or recent changes to similar assumptions.

An example in both life and general insurance is where actuaries may be under pressure to assume unduly high diversification effects between components of the business being modelled (particularly in the tails of the marginal distributions modelled). Diversification is an area of modelling where small tweaks can have a significant impact on the capital requirement. Actuaries are expected to fully understand the dynamics of this.

Actuaries 'speaking up'

Actuaries face a challenging environment for experts and are reminded of the standards expected of professionals acting in the public interest. The Actuaries' Code[236] includes 'Speaking Up' as a stand-alone principle, in order to emphasise its importance. The FCA has also called for cultural change[237] within some organisations, to deliver good consumer outcomes. The PRA has published information on this under the subject 'whistleblowing' [238] including a written notice[239] to the Society of Lloyd's dated 23 December 2019 on whistleblowing at the Society of Lloyd's. Lloyd's itself notes[240] the importance of employees feeling that they can speak up without fear of adverse consequences.

The IFoA provides a Professional Support Service[241] to IFoA Members, providing assistance with ethical or technical professional issues that they are facing, including matters that may require them to 'speak up'. This service includes: access to an independent confidential helpline operated by the charity Protect and speaking up guidance[242] for IFoA Members.

Further Reading

- https://www.fca.org.uk/firms/remuneration – FCA requirements for firms' remuneration
- https://www.fca.org.uk/firms/senior-managers-certification-regime – with links to larger papers and reports, and podcasts
- PRA annual report for the period 01 March 2019 to 29 February 2020 (published June 2020)
- Paper presented to the JFAR (December 2019): The role of actuaries in DB to DC transfers (Section 5, Page 53)

234 https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code/frc-guidance-for-boards-and-board-committees

235 https://www.frc.org.uk/getattachment/d672c107-b1fb-4051-84b0-f5b83a1b93f6/Guidance-on-Risk-Management-Internal-Control-and-Related-Reporting.pdf

236 https://www.actuaries.org.uk/upholding-standards/standards-and-guidance/actuaries-code

237 https://www.fca.org.uk/news/speeches/leading-way-regulation

238 Whistleblowing and the Bank of England; see also PRA's supervisory statement titled: Whistleblowing in deposit-takers, PRA-designated investment firms and insurers (SS39/15); see also PRA Rulebook / SII Firms / Whistleblowing

239 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-action/written-notice-from-the-pra-to-the-society-of-lloyds.pdf

240 https://assets.lloyds.com/assets/pdf-culture-dashboard-the-foundations-of-a-high-performing-culture-at-lloyds/1/pdf-culture-dashboard-the-foundations-of-a-high-performing-culture-at-Lloyds.pdf [Section 4, sub-section: Trust]

241 https://www.actuaries.org.uk/upholding-standards/professional-support-service

242 https://www.actuaries.org.uk/upholding-standards/speaking