Institute and Faculty of Actuaries

LIFE CONFLICTS OF INTEREST CASE STUDY 2013

Case Study: Actuarial prudence v. shareholder pressure

Lear Company is a proprietary life insurance company listed on the UK stock exchange. Its in-force portfolio comprises a range of conventional without profits and unit-linked products, including a large portfolio of level immediate annuities which are mainly backed by UK corporate bonds. You are the Actuarial Function Holder of Lear Co.

In late 2008 credit spreads on UK corporate bonds widened significantly as a result of the global credit crisis. For the year end 2008 valuation, you recommended a very low valuation rate of interest for the annuity portfolio. This reflected a high expected credit default assumption, an additional allowance for the risk of mis-estimating this allowance, and a further margin for prudence.

Your recommendation was adopted by the Board and as a result, Lear Co. incurred a substantial loss during 2008. The share price fell dramatically and the company received adverse publicity which was more negative and damaging than the Board had anticipated.

It is now late 2009 and credit spreads have narrowed to some extent. The corporate bond manager in the investment department of Lear Co. has indicated that she believes that the credit default allowances in the valuation basis are now too large.

A group of major shareholders of Lear Co. has approached the Board of directors. The shareholders believe that the basis used at year end 2008 was unnecessarily prudent and are demanding a significant release of reserving “margins” in order to reduce the cost of capital, support the 2009 profit statement and allow the share price to recover.

You have received a communication from the Board explaining this position and asking you to reflect it in your valuation basis for year-end 2009.

However you strongly believe that there is still considerable uncertainty about the economy and that it is too soon to release more than the absolute reduction in credit spreads that has occurred over the year.

How should you proceed?

Life Case Study: Discussion Points and Suggested Answers

1. Who is your client? To whom do you owe duties of confidentiality and disclosure?

(a) Lear Co is the direct client.

(b) The Board of Lear Co are responsible for setting the basis for the valuation, taking account of the AFH's recommendation. The AFH carries out the valuation and sets the reserves on that basis.

(c) Legally, the Board is the AFH's client. However, the term "client" in the Actuaries' Code definition of a conflict of interest should not be read too narrowly here. Immediate commercial interests may not be fully aligned with the interests of all parties, especially policyholders who are not clients but depend on the integrity of the AFH. You also need to take account of the public interest and, of course, all applicable regulations.

2. Can the Board ask you to tailor your recommendation?

The Board is entitled to ask you whatever they like; for example, they might ask you to take investment advice on spreads. And it is certainly not inappropriate for them to question your assumptions. There will be a range within which a reasonable basis can be recommended. That does not mean, however, that in recommending a basis you can follow the Board's direction rather than exercising your professional judgement.

3. Do you have a duty to protect the policyholders? Might they also be considered to be your client?

The security of policyholders' benefits depends ultimately on adequate reserving and therefore the protection of policyholders' interests depends on the advice that the AFH gives. In assessing conflicts of interest you should have this in mind rather than just thinking about who your direct client is.

4. Do you have a personal conflict?

Yes, Lear Co are your employer and they can advance (or not) your career and salary prospects. So you might feel that your own personal interests will not be best served by recommending an appropriately prudent reserving basis.

5. What might you do to ensure your independence?

You definitely must ensure your independence and objectivity; that is part of your role as a member of a profession.

You could seek the views of other actuaries in the company who have relevant knowledge and experience. You could also take external advice.

You will want to take account of discussions with your Reviewing Actuary, but it would be inappropriate to rely on his opinion and you must be personally satisfied with your recommendation. If there is a Reserving Committee or similar you will want to ensure that you fully discuss the issue with it.

Who you approach will inevitably depend on what your relationships are like within the firm and with the Board and the support mechanisms available to you. If a satisfactory resolution proves difficult you might feel it appropriate to raise the matter with a Senior Actuary, the CRO or a NED.

6. **What steps might you take before making your recommendation?**

   You will want to understand the basis of the corporate bond manager's views and could seek the views of another investment manager on spreads. You will want to understand wider actuarial thinking about the issue.

   You might wish to demonstrate your willingness to re-consider but you need to do appropriate due diligence and be appropriately satisfied why you would/would not consider changing your opinion. You must not be influenced by concern that your reputation may rest on the stake that you've already put into the ground with your previous advice. What matters is that you are confident that the advice you give is well-founded.

7. **What additional considerations might arise if your remuneration package includes a bonus which is directly linked to profit and/or you hold share options in Lear Co.?**

8. **What steps might you take if others perceive that there might be a conflict of interest regarding your remuneration package?**

   Looking at 7 and 8 together, your bonus is linked to the company's profit so there's a direct financial interest. Ultimately, though, your professional obligations have to rise above this.

   Nevertheless perception matters here, perhaps more than anything else. You will want to be satisfied that any bonus arrangements are not inappropriately out of line with market terms.

   It will also be helpful if the process by which bonuses are determined is appropriately transparent, and separated from others as part of the governance structure.