Speech to Biennial Dinner of the Society of Actuaries in Ireland

8 February 2007 - Colm Fagan

Honoured guests, colleagues and friends.

It is my great pleasure to host this biennial dinner on behalf of the Society of Actuaries in Ireland.

The dinner comes towards the end of my two-year term as president. It is an opportunity to thank government and industry, regulators and members of other professions, for engaging constructively and openly with the Society of Actuaries in Ireland and with individual members of the actuarial profession on matters of mutual interest. It is also an opportunity to thank the many individuals – actuaries and non-actuaries - who have helped the profession during my term as president, from serving on disciplinary bodies, chairing committees or working groups, serving on government bodies, contributing to the profession at European and international level, etc. Thank you all.

I do not intend to impose on you this evening. However, I cannot let the opportunity pass without expressing my views on a number of important matters affecting actuaries, especially as I have a captive audience consisting of some of the most important and influential people to our profession. I do promise however that I will only take a few minutes of your time.

Risk is the theme I have chosen for my talk.

According to the old joke, an actuary is a cross between a bookie and an undertaker. In the light of recent improvements in life expectancy and its financial impact on pension liabilities, some of my colleagues may feel that the actuary should be redefined as a cross between a bookie and a gerontologist. More seriously, the profession has now spread its wings from its traditional home of mortality, to include much wider aspects of risk and finance. Whatever the definition, an understanding of risk and how to manage it are key parts of the actuary’s tool-kit.

For people living and working in Ireland, the last few years have been good from a risk point of view. Stock markets and real estate markets have shown positive returns; interest rates have remained low; the economy has performed strongly. There is even a perception in some quarters that the dragon of risk has been slain or at least has been substantially tamed.

It would be rash to believe that risk has been conquered. When risk returns, as it most surely will, it will expose the weak underbelly of the economy and will lay bare practices that have evolved in the good times but which cannot stand up to the stress of turbulent market conditions. As Warren Buffet said, it is only when the tide goes out that you discover who's been swimming without trunks.

When the tide next goes out on the Irish economy, I fear that many people and institutions will discover that they have been swimming without trunks.

Risks in products offered to retail investors

Irish investors' love affair with property is a particular source of risk. The average Irish investor has a much greater exposure to property, both direct and through collective schemes, than investors in most other countries. This lack of diversification, often geared up through high levels of lending, carries risks which the strong returns of recent years have masked.

Of particular concern are individual buy-to-let investments, often overseas, which are completely unregulated and which are not subject to the normal statutory protections afforded to people who invest in regulated products. For example, investors in such products do not benefit from full disclosure of charges and sales remuneration, which applies to most retail regulated products. In addition, some of the claims made for future performance are very misleading, and the commission paid to the salesperson or intermediary, which does not have to be disclosed, can be particularly high.

It can be difficult for the consumer to spot that some of these property funds are unregulated, given that they may be promoted by entities that are regulated for other related activities. In other cases, the unregulated property fund may be "wrapped" inside a regulated product, such as a life assurance policy or a pension. While both, the "wrapper" and the promoter, may be regulated, the underlying property investment is often held in an unregulated vehicle such as an exempt unit trust, shares in private companies, co-ownership arrangements, etc. This can lead to risks which most investors are unaware of, including potential problems in realising the investment, transparency on costs and valuations, etc. Added to this, virtually all invest on a substantially geared basis, often in just one particular property located in a foreign jurisdiction.

Anyone investing in overseas property should ascertain whether the underlying investment vehicle is regulated; they should check out the costs and be aware of the additional risks that gearing and lack of diversification can add to their investment.

In November last, the Society wrote to the Minister for Finance to express our concerns about unregulated investment products. I understand that the Department and the Financial Regulator are looking carefully at how such abuses can be curbed. I recognise that it won't be easy, especially as some of the top legal and tax brains in the country have often helped to construct some of these schemes. As one of my former bosses used to say, if these problems were easy to solve, they wouldn't have to employ people like us on high salaries to solve them.

Risk in the insurance business

Risk is at the heart of the actuary's "home ground", insurance. Good progress is being made towards the introduction of a new risk-based solvency regime for European insurers, called Solvency 2. I am pleased to see many of the people who are active in planning for the introduction of Solvency 2 in Ireland here this evening. They include officials from the Department of Finance and from the Financial Regulator, people from other sections of the industry and of course many of my own actuarial colleagues.

It will be at least 2010, and possibly later, before Solvency 2 comes into effect. In the meantime, the Financial Regulator has to develop some rules of thumb to allow for the fact that the current Solvency 1 regime overstates the true risks in some areas and understates them in other areas. Unfortunately, the approach being taken, of applying a flat 50% or 100% safety margin to the existing Solvency 1 rules, magnifies the deficiencies in the current regime and doesn't really address the underlying problem. The problems caused by adding a safety cushion to Solvency 1 capital requirements are coming to a head in the context of the current fraught discussions on health insurance, but they also cause severe problems and arbitrage risks in other parts of the insurance business. Senior officials in the Financial Regulator are aware of the issue and I am confident that they will address the problem to everyone's satisfaction.

Risks in Pensions

Moving now to consider pensions, another of the actuary's "specialist subjects", the Society's position is clear: greatly improved life expectancy and low interest rates mean that good pensions do not come cheap.

No amount of tinkering around with funding standards or talk of a state annuity fund will alter that basic fact.

As an aside, while increased life expectancy represents a challenge to the financial position of pension schemes, I am among those who see it as a wonderful development, something that we as a society should be celebrating. I am very pleased to report that the Society of Actuaries in Ireland has taken an important initiative in this area. We are in the process of contacting other organisations that are facing the challenges of an older society and what it entails, with a view to pooling our efforts to make the most of the valuable resource that older people represent. One of my actuarial colleagues, who was active in the campaign for equal treatment of women in the workplace in the 1970s, recently made the perceptive comment that some of the explicit and implicit discrimination against older people at the present time has echoes of the discrimination that women faced in the 70s, and needs similar radical thinking. I have great hopes for that initiative.

State annuity fund

A second aside in relation to the cost of pension schemes is that a state annuity fund has been mooted in some quarters as one of the solutions to the cost problem. In this regard, the government could well heed what happened 199 years ago. In 1808, its predecessor, which was then the government of Great Britain and Ireland, was looking for new sources of debt finance. It decided that it would be a good idea to raise money by selling annuities and sought advice from the actuary of Equitable Life. As a result, it mis-priced the annuities and lost a fortune. As observers of recent developments in the UK financial sector will know, 1808 wasn’t the last time that an actuary from Equitable Life caused problems for Her Majesty’s Treasury.

Security of promise to pay a defined benefit pension

Under a defined benefit pension arrangement, the employer promises the employee a pension for life equal to a percentage of salary. The security of that promise is very much dependent on the amount of money set aside specifically for that purpose. Almost without exception, the amounts set aside fall far short of the amounts that would have to be set aside if the same promise were being made by an insurance company or bank. It is a simple fact that the promise of a defined benefit pension does not have the same backing and security as a contractual commitment from a financial institution such as a bank or an insurance company.

Even in the soundest of pension funds, there is always a risk that the promise won't be delivered. I believe strongly that employees and pensioners should be told clearly and explicitly the extent of that risk.

Risks to the actuarial profession

Moving on now to look at risks facing the actuarial profession itself, my colleagues and I on Council are keenly aware that the profession is exposed to a number of risks. Perhaps surprisingly, one of the biggest risks we face as a profession derives from the fact that government and regulators place so much trust in us.

Legislation and associated regulations stipulate that a Fellow of the Society of Actuaries in Ireland must pronounce not only on prudential reserves and solvency for insurers and pension funds, but also on matters as diverse as the content of sales projections for individual savings plans or the appropriateness of investment strategies for PRSA arrangements. There is little or no independent external monitoring of the technical and professional standards that actuaries are supposed to adhere to when discharging their responsibilities in these areas, or of their compliance with the standards set by the profession. It is generally assumed that the Society of Actuaries in Ireland, as the professional body for actuaries practising in this country, will set standards that satisfy sound objective criteria and that it will also ensure that actuaries act professionally, with the minimum of external oversight. We are very pleased and honoured by the trust that government and regulators have placed in the profession, but we don't think that it is necessarily the best way to run a modern financial economy. I am reminded of the sign you sometimes see in pubs: "In God we trust; everyone else pays cash." We actuaries may think we're gods, but we don't necessarily expect others to think the same.

I am pleased to report that we have started constructive dialogue with government, in the form of the Department of Finance and the Department of Social and Family Affairs, and with the Financial Regulator and the Pensions Board, on how best to address this potential weakness in the supervisory system.

Concluding comments

As I come towards the end of my term as president, I am very pleased to report that the actuarial profession in Ireland is going from strength to strength.

The number of actuaries has increased ten-fold in the last twenty-five years. Despite this phenomenal increase in numbers, demand still exceeds supply and the prospects for the increasing numbers of new actuaries qualifying each year are excellent.

The profession's opinions are sought on a wide range of issues and the views expressed are highly respected by government, regulators and both sides of industry. There is high regard too for the quality of actuaries' technical training and knowledge. More important by far, however, is the need to ensure that actuaries can be counted on to act professionally and with integrity.

As professionals, we gain a lot from the trust that society places in us. In return, my colleagues and I recognise that we have a responsibility to act in the public interest and not to abuse that trust.

As I look around this room, I see among our guests many individuals who have shown goodwill to the profession but who have also challenged us to live up to our ideals of serving the public interest. During my term as president, I hope that we have not let you down. Thank you all for that supportive challenging.

I would now like to ask my fellow actuaries to please stand with me while I propose a toast to our guests.