

# MANAGING ACTUARIES' PROFESSIONAL RISK

By MW Lowther and JWT Mort

## ABSTRACT

This paper describes a new concept, of vital importance to actuaries, which the authors have named 'managing actuaries' professional risk'. Much has been written on the constituent elements of legal causation, risk management, indemnity insurance and professional conduct standards. This paper envisages an integration of these elements using the profession's own guidelines for risk analysis and management for projects (RAMP). Actuaries are experts in risk applications for clients—in an increasingly litigious society, they need to apply their expertise in their own back yard.

## KEYWORDS

Professionalism; professional risk; risk management; professional indemnity insurance

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## 1. RISK MANAGEMENT

*Risk arises as much from missed opportunities as it does from possible threats*  
—Darlington, Grout and Whitworth

1.1 Among the many writings on the subject of risk management, Darlington, Grout and Whitworth (forthcoming) provide a useful overview. Notable is their distinction between 'traditional' risk management practices and the more recent trend of 'enterprise-wide' risk management.

1.2 As could be guessed from its title, the Guidance Note GN30 'Compensation for Professional Shortcomings' (Institute of Actuaries, 1997) is an example of 'traditional' risk management. In a 'traditional' analysis, according to Darlington, Grout and Whitworth (*op. cit.*), risk management is not considered in the strategic decision-making of a business enterprise, so that protection is focused on the book value of tangible assets rather than economic value.

1.3 The Actuarial Society of South Africa (ASSA) has no equivalent guidance note to GN30. Thus, local actuaries with United Kingdom qualifications are bound by GN30. At 1.3, GN30 reads:

It is the professional responsibility of all actuaries to consider the potential for clients to suffer loss as a result of any breach of their duty of care and to ensure that appropriate arrangements are maintained, firstly to minimise the risk of breach of their duty of care, and, secondly, to provide compensation for loss in the event of any breach.

'Appropriate arrangements' for minimising risk are then suggested, and include operational policies and practices, seeking risk-management advice, and contractual limitations. Similarly, 'appropriate arrangements' for providing compensation are seen to include the firm's resources and professional indemnity insurance.

1.4 Since GN30 is a regulatory document and not an office-management one, it may be entirely appropriate that it is conceived in the traditional paradigm. However, it would be interesting to predict how 'enterprise-wide' risk management would tackle the task. Let us defer to the self-proclaimed experts:

Recently, the skills which have enabled insurance companies and pension funds to prosper for over a hundred years have been applied to all manner of business projects. For problems as diverse as decommissioning nuclear power plants to setting lending criteria for a clearing bank, the actuarial assessment of risk has enabled project sponsors to make informed investment decisions. ... Some of the most up-to-date thinking in this area has been harnessed by the actuarial and engineering professions in a methodology known as RAMP<sup>1</sup> (Risk Analysis and Management for Projects)—just one example of the very essence of actuarial thinking: making financial sense of the future for business.

This excerpt comes from 'Financial Sense', a marketing brochure of the Faculty and Institute of Actuaries (undated). This could perhaps be paraphrased as 'of all people, actuaries understand that taking risks can be profitable'. 'Project' need not only refer to a capital project—the RAMP handbook gives examples of its application to soft projects such as a major public company's pensions administration department. In the sociological sense, 'project' can also refer to loose associations of people with a common purpose—for instance when Larson talks of the project of a profession (quoted in Bellis, 2000).

1.5 The RAMP methodology first attempts to identify risks. It then considers strategies for mitigation. Briefly, the identification process involves listing risks by type, cause, intensity, timing, consequences, and relation to other risks. This may be achieved a priori, in brainstorming groups, and by the use of handy checklists. The evaluation of intensity is made by a graph plotting likelihood against severity, since statistical information will rarely be available.

1.6 The mitigation process considers various ways of dealing with the identified risks. These include:

- reducing or eliminating a risk (for example by training, design or transparency);
- transferring a risk (for example by contract or insurance);
- avoiding a risk (for example ceasing that aspect of the business); and
- absorbing and pooling a risk (for example using margins or making partnerships).

Each option for mitigation may then be evaluated by assessing the likely effect on the risk compared with the feasibility and cost of implementing the option. Residual risks will probably remain after mitigation measures are taken. Practical measures regarding feedback and monitoring should also be put in place.

1.7 ASSA offers a course in 'professionalism' to newly qualified actuaries. This is derived from a similar course presented by the Faculty and Institute of Actuaries in the UK. The original stimulus for this paper came from feedback from South African delegates regarding the perceived lack of guidance in the course on the subject of management of professional risk. The paper also constitutes a response by the authors to a request by the council of ASSA for an investigation into the feasibility of creating a group indemnity insurance scheme for South African actuaries.

1.8 As a first step, during June 2001, ASSA provided the authors with a list of all the small South African actuarial enterprises. These 32 firms were approached, of which 24 subsequently provided the authors with the information set out in Table 1 with regard to their risk-management practices. Compliance with GN30 may be observed as somewhat tenuous—although it should be noted that these results reflect the practices of small firms only. Since risk-management practices are likely to vary significantly from large to small firms, the results should be considered in that context.

TABLE 1. Responses to survey of actuarial enterprises

Question 1: What is the legal structure of your business?					
sole proprietor	8	limited company	8	close corporation	8
Question 2: In which fields does your business specialise?					
life	8	investments	2	employee benefits	9
				health	2
				legal	3
Question 3: Has your business ever explicitly analysed its exposure to professional risk?					
yes	7	no	17		
Question 4: Does your business have explicit strategies for mitigating professional risk?					
yes	18	no	6		
Question 5: Does your business carry any professional indemnity insurance?					
yes	9	no	15		
amount of cover		number of respondents		premium (% of cover)	
R1m		3		0,50%	
R2m to R5m		2		0,11%	
R80m		1		0,10%	
Question 6: Would your business be interested in participating in a group indemnity scheme?					
definitely yes	11	maybe	9	definitely no	4

1.9 As one would expect, the professionalism course (Faculty & Institute of Actuaries, 2000) problematises the eponymous concept. One suggested definition for professionalism is 'knowledge and practices that require the unique exercise of learned

judgment for each new situation'. However, the management of the legal risks involved with this project is not discussed in depth. For example:

We have a disciplinary procedure if things go wrong—members of the public do not have to rely on the courts

With respect, members of the public may prefer to have their day in court—and more and more are doing so—when large sums or multiple interests are at stake. Furthermore, as discussed in Section 6 below, the primary function of a disciplinary code (as can be deduced by its powers of reprimands, fines and expulsion) is to maintain standards and not to get involved with compensation.

1.10 This paper aims to initiate a debate concerning a risk management framework that could be offered to actuarial enterprises in South Africa—particularly the smaller businesses but also the employed actuary. Section 2 traverses some of the issues around legal causation—what makes a claim win in a South African court. Section 3 presents an example of a risk-mitigation exercise. Sections 4 and 5 concentrate specifically on the mitigation strategies of office procedures and professional indemnity insurance. In Section 6, the interaction between two concurrent systems of governance, the law and the professional guidance, is discussed and some proposals are made *inter alia* for South African guidance to replace GN30.

## 2. IDENTIFYING RISKS

*'For an actuary to claim that his judgment is incontestable is a challenge to the ingenuity of lawyers'*

—successful South African attorney and businessperson

2.1 How do we identify the risks to which actuaries may be exposed? The fundamental premise in South African law is that damage rests where it falls. In other words, each person must bear the damage he or she suffers. However, it is accepted that the responsibility to make good the loss suffered as a result of such damage may shift to a third party. This shift arises when a loss is suffered by someone, caused by another person, for which such other person is liable in contract or delict. The four components of loss, causation, liability and contract or delict are vast and intricate areas of South African law to which justice cannot be served by this brief résumé. But an understanding of the basic aspects of these components is vital to any strategy aimed at avoiding or minimising professional risks. Each component is dealt with below.

2.2 The loss suffered is a fact which, like any other element of a cause of action that any person may bring against an actuary, must be established on a balance of probabilities (legalese for saying that it is more likely than not that the loss was suffered). Once the loss is established a court will do its best to quantify that loss even if this involves a degree of guesswork. Furthermore, a distinction must be drawn between past loss on the one hand and future loss on the other: future loss being that which has not yet materialised. It is perfectly possible to obtain an award for a future loss. A loss in the context of the actuarial

profession would be for financial loss and not, for example, the loss of an amenity of life (such as may arise when someone suffers some bodily damage in a car accident or in respect of some type of property).

2.3 There must be a link between the loss suffered and the conduct of the actuary (whether by act or omission) whom it is sought to hold responsible for the loss. This causal link exists as a fact or it does not. Essentially an actuary will be held responsible if it can be found that, were it not for what he or she had or had not done, the loss would not have been suffered. This is not as simple as it may seem, because it is not always easy to show, where there is a whole series of consequences flowing from one particular act or omission, that it was the consequence of the actuary's act or omission that led to such a series of consequences. For example, in a 1996 UK case<sup>2</sup> against a firm of consulting actuaries, the purchaser of an insurance company suffered a loss of several hundred million pounds. The actuaries had allegedly not alerted the purchaser to the potential losses that might arise as a result of an outstanding claim from an oilrig disaster. The defendants were successful on the basis that they had satisfied the relevant standard of care and no part of the loss was caused by their negligence. Of course, no one can depend upon some of the difficulties of proving causation as a basis of escaping responsibility.

2.4 Liability means essentially that the person causing the loss had a responsibility in law in respect of which he or she has no defence. In South Africa, as discussed in Neethling *et al* (1990), it is generally held that the person causing the loss will be held liable only for such loss as such person should reasonably have foreseen. A duty of care is therefore owed by the actuary to those persons who may suffer loss that is reasonably foreseeable as a result of the actuary's conduct. In assessing liability, the court will not look to the standard of the reasonable person in the street, but at that of the reasonable actuary. What constitutes the reasonable actuary is discussed below. What is reasonably foreseeable flows from how the reasonable actuary is defined. Other than that the loss could not have been reasonably foreseen, the main basis for avoiding liability would be on the grounds of some or other incapacity by the actuary, but the authors doubt that this could ever be of application.

2.5 All work undertaken by an actuary will be on the basis of contract, whether written or oral. The express terms of a contract, again whether written or oral, do not present a problem; what is more problematic is where terms of such contract are tacit, or implied. This may flow from the professional relationship the actuary has with the client, and reliance might be placed on the profession's code of conduct (as discussed in Section 6 below). Essentially though, to the extent that an actuary does not perform what is required in terms of the contract (whether it is performed incorrectly or not at all) the actuary will be held responsible for any loss that may flow from this, provided such loss is reasonably foreseeable. In simple terms, a liability in delict will follow even where there is no liability in contract, and liability in delict may apply even if there is a contractual relationship between the parties and there is no liability in contract for the loss suffered.

Typically it will be easier to hold an actuary liable for failing to act professionally under the heading of delict than in terms of contract, such as where an actuary allows him- or herself to be in a situation where there is an undisclosed conflict of interest<sup>3</sup> and continues in that situation with the result that the client suffers a loss.

2.6 In the light of these four criteria for holding an actuary liable for loss, what standard does a court expect from an actuary? And is there a higher standard expected where there is a loss suffered by the actuary's client than where a loss is suffered by a third party? It has been stated in the Supreme Court of Appeal that the work of an actuary should reflect the professionalism and skill peculiar to this field. It follows that the typical obligations of a professional to perform the task required of him or her, to show good faith (including the obligation to avoid a conflict of interest) and the duty to exercise care, skill and diligence apply. As the Pension Funds Adjudicator has recently emphasised<sup>4</sup>, it may not be an adequate defence to claim that 'everyone else does it'. It also follows that if an actuary undertakes to do work in a particular field, he or she should have sufficient competence to perform the work required. If the actuary is not adequate for the task, the client should be told—in the same way that the family doctor should not undertake open-heart surgery without telling the patient that he or she has no expertise in that area of medicine.

2.7 The Supreme Court of Appeal made an important judgment in a recent case<sup>5</sup> where an actuary had been required to make an assumption in order to determine a transfer value, which assumption was subsequently found to be incorrect. The use of assumptions is essential to much of the work of an actuary. No liability attached to the actuary since the court found that he had acted reasonably at the time because he had used an actuarial methodology that was not disputed.

2.8 Any basis for holding an actuary liable by a third party will be on the basis of delict, and this will depend upon whether the harm that was suffered was reasonably foreseeable. An obvious situation is where an actuary is obliged to give certain advice to the trustees of a pension fund and does so incorrectly, with the result that a loss is suffered by the fund and therefore by the members of that fund, who would be entitled to sue the actuary if the trustees of the fund should fail to do so. The Court might, however, be reluctant to award unlimited liability to a large number of claimants, or place an excessive burden on the profession as a whole.

2.9 It should also be remembered that a person's right to be compensated for a loss may, through the passage of time, prescribe. Naturally this is not a defence that any actuary should expect to be able to rely on. The actuary should also remember that prescription can be interrupted, and that in respect of a claim for damages, prescription begins to run only when the person who suffered the damages first becomes aware of his or her loss or should have become aware of that loss.

2.10 This is a brief résumé of South African law, which, it should be noted, is undergoing significant development as a result of the bill of rights in the Constitution. The work of the actuary may be affected *inter alia* by the right to equality and freedom from discrimination, the right to privacy, the right to fair labour practices, the right of access to information, and the right to just administrative action. The precise impact of the Constitution on these areas of law is still in the process of being determined.

### 3. RISK-MITIGATION STRATEGY

*'You're not in business if you don't have a few P.I. claims on the go.'*  
—successful South African actuary and businessperson

3.1 Let us imagine Ms Nana Mkhize, who runs a small actuarial practice in South Africa. Her main work is pension-fund valuation and consulting. She also acts as an independent trustee for a life office's umbrella pension-fund venture, as well as doing the occasional Road Accident Fund damages claim.

3.2 Paging through the guidance notes, as she was encouraged to do on her professionalism course, she re-reads GN30 regarding professional indemnity insurance. She has always considered insurance unnecessary on the grounds that it would be very difficult for a court to dispute an actuary's judgment—but what about clerical errors? When she started out, she had enough time to check the work in detail, but with growing success she now merely looks for reasonability in the figures produced by the employees she has trained. Insurance is so expensive, she has heard, and there's all that small print. All business involves risk. Should she just accept whatever risks there may be? Will Nana grow rich and famous? Will she end up in Court?

3.3 As expressed so succinctly in the opening quote to this section, claims against professionals are an unfortunate fact of business. Any significant reduction to this threat should be welcomed since, even if the claim is unsuccessful, 'the time and effort involved in contesting a claim involves diverting otherwise productive resources from the main business of the professional' (Hooker & Pryor, 1987). Actuaries, along with other professional advisers, can be soft targets for potential claimants in the area of financial services. The primary defendant may be unavailable or intractable or have no resources. Claimants will be more likely to sue where there is a good prospect of recovery—such as professional indemnity cover. (The converse, as more than one professional told the authors from experience, is that having no indemnity cover may discourage potential lawsuits.) As long as the trio of loss, cause and liability can be proved against the actuary, the claim does not have to be apportioned between all potential wrongdoers—the actuary can be required to make good alone.

3.4 Based on the RAMP processes discussed in Section 1 and the professional risks outlined in Section 2, the results of a mitigation exercise, done with Nana's participation, are shown in Tables 2 to 4.

TABLE 2. Risk mitigation for a pension-fund valuator and consultant

Transaction	Statutory valuation		Transfers		Conversions	Mergers & acquisitions	Cross-selling	rules	Consulting	
	liabilities	assets	individual	bulk					benefits	assets
Duty of care	statutory	statutory	statutory	statutory	high	high	moderate	high	high	high
Provable loss	yes	yes	yes	yes	yes	yes	maybe	yes	no	yes
Provable cause	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes
Likelihood	low	low	medium	low	medium	high	low	medium	medium	high
Severity	low	high	low	medium	high	high	high	medium	medium	high
Cash flow	high	high	low	low	high	low	low	medium	medium	high
Utility	high	medium	necessary	necessary	medium	low	low	high	high	medium
<b>Strategies</b>										
Reduce by office procedures (1)	x	x	x	x	x	x	x	x	x	x
Avoid (2)						x	x?			
Transfer by contract (3)										x
<b>Residual risks</b>										
Absorb							x	x	x	x
Transfer by insurance (4), (5)	x	x	x	x	x					
<b>Notes:</b>										
(1) It is beyond the scope of this paper to discuss all the possible underlying causes of clerical risk (such as lack of training, poor computer programming or testing, etc. and the management thereof). However, some comments on procedural duties of care are made in Section 4.										
(2) This work is of high risk and is not a major source of income to the business. Avoid it.										
(3) Because it is not a statutory duty, it is possible to include a disclaimer about investment performance.										
(4) Because it is a statutory duty, it is not possible to limit damages to a fixed amount or include many disclaimers.										
(5) Insurance required for (4) will also reduce the other risks, for which it would otherwise not have been really necessary.										

3.5 The first step was to eliminate areas where there is no duty of care, or loss is unlikely to occur, or causation is unlikely to be proved. Then, the likelihood of wrongful acts in each area of work was assessed together with their expected financial severity. For a small actuarial practice, high severity must be managed even if it has low likelihood, since its occasional occurrence would otherwise be a financial disaster. Noting the opening quote to Section 1, these quantified risks were compared with the value that the area of work has for the business.

3.6 Areas of work with high risk and low expected cash flow were flagged as having low utility for the business, and it was suggested that the provision of services in such areas should be stopped. For the areas with greater utility, appropriate strategies for risk mitigation were suggested.

3.7 As regards the work of a pension-fund valuator and consultant (Table 2), asset consulting has high risks, but it is very profitable, so Nana made an informed decision to stay in the business, and put in place the mitigation strategies suggested. Mergers and acquisitions are equally risky, but since they do not occur that often, Nana decided to withdraw from that field. It seems that she really needs cover for the statutory part of her business. The other precautions and strategies are still necessary as other risks, such as excesses, cover limits, and costs of claims, remain. These are discussed in Section 5.

3.8 As regards the work of an independent pension-fund trustee (Table 3), the analysis seems to indicate that the popularly perceived risks of trusteeship may be contained by appropriate mitigation strategies. The situation must be monitored for changes arising out of legislation, court judgments or Pension Funds Adjudicator rulings. Insurance rates (and therefore, presumably, claims) are increasing in more regulated environments such as the UK. Because of the potential long delay between the cause of a claim and the report thereof, insurance and indemnity must cover past trustees who are no longer serving. The above would also apply to an employed actuary serving as an employee- or employer-representative on his or her staff pension fund. For a comprehensive analysis of the risks faced by South African pension-fund trustees, the reader is directed to Hunter (for example, as quoted in Asher, 2001)

3.9 As regards the work of an expert witness (Table 4), a validly held opinion cannot be a wrongful act. However, even the disclaimers will not protect Nana if she has not made herself aware of the conventional procedures for reports. This does not mean that she cannot pioneer her own methods with adequate disclosure, given the inherent uncertainty in what Robert Koch has dubbed 'the utility of a life plan'. Nana decided to find an experienced practitioner who might be prepared to oversee her reports. Had this been her only field, insurance would not have seemed necessary.

3.10 Lost income is often valued on an after-tax basis. South African tax law is becoming more and more complex. Nana realised that she needed access to a tax expert.

TABLE 3. Risk mitigation for an independent pension-fund trustee

Transaction	Fund accounts	Fund administration	Fund investments	Marketing material	Death benefit distribution	Member investment choice	Fund valuation	
Duty of care	statutory	statutory	statutory soon	high	statutory	high	high	
Provable loss	no	yes	maybe	yes	yes	maybe	yes	
Provable cause		maybe	yes	yes	yes	yes	maybe	
Likelihood		high	low	high	high	high	low	
Severity		low	high	medium	low	high	medium	
Cash flow			single fee for all services					
Utility			All services are necessary.					
<b>Strategies</b>								
Reduce by office procedures (1)	x	x	x	x	x	x	x	
Avoid (2)								
Transfer by contract (3)	x	x	x	x	x	x	x	
<b>Residual risks</b>								
Absorb								
Transfer by insurance (4)	x	x	x	x	x	x	x	
<b>Notes:</b>								
(1) This will have to cover both the trustees' and the administrator's procedures.								
(2) Resignation will be essential if (1), (3) and (4) are not in place.								
(3) The trustee needs a watertight indemnity from the sponsor and the fund.								
(4) The trustees must obtain appropriate insurance for the fund; check the small print.								

TABLE 4. Risk mitigation for an expert witness on the assessment of quantum

Transaction	Getting accurate data	Legal knowledge	Reports	Court appearance
Duty of care	high	medium	high	high
Provable loss	yes	yes	yes	no
Provable cause	maybe	no	yes	
Likelihood	high		low	
Severity	medium		medium	
Cash flow	Extra fee can be negotiated		high	
Utility	necessary		high	
<b>Strategies</b>				
Reduce by office procedures (1)	x (1)		x (2)	
Avoid (2)				
Transfer by contract (3)	x (3)		x (4)	
<b>Residual risks</b>				
Absorb	x		x	
Transfer by insurance				
Notes:				
(1) It is often impractical to get complete information				
(2) The usual checklist items relating to data processing are relevant; mentoring will also be needed.				
(3) Will a disclaimer override the Code of Conduct requirement for accurate data?				
(4) Disclaimer that calculations are based on information received and assumptions made.				

3.11 The above illustration of a risk-mitigation programme has necessarily been shown in a somewhat abbreviated manner—particularly the segment regarding the pensions valuator and consultant, where transactions could be broken down into smaller units for analysis. Nevertheless, the principles are illustrated. A risk management expert could develop these further.

3.12 A similar analysis could be done for an employed actuary, whether or not he or she is performing statutory duties. The liability for a loss caused by an employee who acts in good faith in the normal scope and course of his duties normally shifts from the employee to the employer in South African law. A bona-fide mistake by an employee would still be in the normal scope and course of duty. The employer, of course, still has a right of recourse against the employee, including the provision in the Pension Funds Act allowing losses to be recouped from the employee's pension. Nevertheless, the employed professional is, by definition, someone who will from time to time be required to apply

professional skills and duties to his or her work. Thus, at some point between negligence and recklessness, the actuary could be held not to be acting in the normal scope and course of duty, and to this extent, the employed actuary will be exposed to the direct risks of loss as discussed in Section 2. For this reason, it is common to find both the professional and his or her employer cited as respondents in damages claims. The primary mitigation strategy for the employed actuary is usually an indemnity from the employer, both for external claims and claims by the employer itself. This indemnity needs to continue beyond the date of the actuary's leaving service in respect of claims subsequently reported but arising during such service. Apart from the above, the employed actuary who errs may suffer the indirect risk of loss of reputation and therefore future earnings potential.

3.13 In the June 2001 survey of small actuarial practices (set out in Table 1 above), only 7 out of 24 respondents had ever explicitly analysed their exposure to professional risk. However 18 of the 24 indicated that they did have at least some risk-mitigation strategies in place. These were:

- peer review (9);
- consistency checks;
- job assessment;
- indemnity insurance (9);
- computer backup;
- electronic trail;
- client assessment;
- joint signatories;
- recording of discussions;
- paper trail (5);
- care;
- standardised filing procedures; and
- limitation of advice to stated assumptions given by the client.

#### 4. GOOD OFFICE PROCEDURES

*'And it seemed to me that you lived your life like a candle in the wind'*

—Elton John

Good administration is a risk-mitigation strategy that is likely to turn up in any risk-management programme. Consequently, many of the authors' sources gave checklists, from which the following was synthesised.

##### 4.1 DOCUMENTATION

Documents are likely to be the most significant evidence if a claim arises. Meetings and conversations need to be noted, as well as correspondence and reports. Documents need to be preserved for many years, since claims may be reported very late. Wherever possible, a contract, or terms of appointment, should be confirmed by the client, setting out the scope of the work. This should also identify the client and the

delegates with whom the actuary is authorised to work. On the other hand, there is a danger of creating new documents damaging to a case. Early notification to underwriters of a potential claim will permit them to attempt to contain this sort of damage. It is possible to make use of without-prejudice communication, but in any event an apology or admission should not be made until legal advice is obtained.

#### 4.2 ADMINISTRATION PROCEDURES & ERRORS

The professionalism course includes a dramatisation in which an auditor is interrogated over the office procedures behind an inaccurate audit. The advocate's arrows find their mark because, *inter alia*, the audit partner:

- was not personally involved in much of the work;
- selected only junior or unqualified staff for the work;
- did not plan the work, or did not keep a record of the plan;
- did not have regular briefings on progress;
- did not ensure that the team understood the client's business;
- did not check the reasonableness of the results; and
- did not comply with professional guidance.

Small businesses may be better able to track errors than the valuation factories of large offices. However, even with the right procedures, errors can still be made by the actuary, an actuarial worker, or a typist. For example, errors can be in arithmetic, transcription, spreadsheets, inappropriate approximations, or inaccurate wording.

#### 4.3 DISCLAIMERS, LIMITATIONS & INDEMNITY

Whilst it is not possible to limit liability to a third party (for which the only remedy is some form of indemnity), it is common to find in many professional relationships an agreement excluding or limiting liability. Such a disclaimer could also limit liability in delict as well as in respect of any contractual liability. However, as Midgley (1995) discusses, although there does not appear to be any settled case law on the topic, it is probable that a clause excluding the duty to exercise care, skill and diligence will not be enforced. Obviously, such exclusion clauses convey an inference that the service given may not be reliable and is of reduced value. Statutory duties cannot be avoided by disclaimers. However, liability for other work could potentially be limited by a qualification that it is not to be used by third parties, or for purposes other than described. One can state that the accuracy of the information provided has been relied on. However, this may not overturn an actuary's duty to check for reasonableness. In the same circumstances, one can also come to an agreement with the client that damages will be limited—e.g. to twice the agreed fees. The ultimate limitation is an indemnity from the client, such as that which an employed actuary should get from his immediate client, the employer.

#### 4.4 PEER REVIEW AND COMPLIANCE WITH PROFESSIONAL GUIDANCE

Practical aspects of peer review were discussed by McGaughey (2001). It appears that peer review will become compulsory for statutory tasks in the UK. The Canadian Institute of Actuaries has made similar proposals. These are part of a thrust to ensure

compliance with professional guidance. In practice, though, for smaller businesses, there may be difficulties in finding an appropriate peer-reviewer. The right person must, *inter alia*, have the necessary skills, be independent (or at least objective), accept the liability that comes with approving the work, and not use the originator's intellectual capital in their own work. Peer review will add to the costs of an assignment, particularly if the reviewer takes insurance for this low-utility work (i.e. high risks incurred for only a few chargeable hours). It goes without saying that compliance with professional guidance is an effective risk-mitigation strategy.

#### 4.5 DISCLOSURE

Transparency and disclosure will go a long way towards the avoidance of misunderstandings. In practice, however, it may seem unnecessary extra work. There may also be reluctance to disclose office hiccups, and the authors acknowledge the potential contradiction of this advice with the exhortation in ¶4.1 not to admit liability before taking legal advice. According to Brindley & Shelley (2000), poor communication by the Equitable in the UK to its guaranteed-annuity policyholders possibly created the benefit expectations that eventually led to the demise of the company. In South Africa, the Pensions Adjudicator has repeatedly emphasised in his adjudications that 'good faith is procedural'. In other words, justice must be seen to be done.

#### 4.6 AND MORE

Information technology and its security risks, which include breaching confidentiality, corrupting data and opportunities for fraud, is a huge area. Legal advice can always be sought. However, the actuary should ensure that the chosen attorney is an expert in the appropriate field. The wording of indemnities and insurance could well be subject matter for an expert opinion. Providers of claims-management services hold that using their services dramatically cuts the cost of claims. The first response to an alleged error or claim is crucial, and must be made with a plan of campaign in mind. Good project management should also include a sign-off from the client at critical stages such as completion of the project plan and the various deliveries.

### 5. PROFESSIONAL INDEMNITY INSURANCE

*'It surely will get back to you, somewhere along the line'*

—Billy Joel

5.1 Nine of the 24 respondents to the June 2001 survey carried professional indemnity cover. The reasons why the other fifteen did not do so included the following:

- haven't got around to it (4);
- indemnified by client (3);
- business too small (2);
- too expensive (2);
- minimal exposure to third parties;
- 'claims occurring' cover unavailable;

- difficulty of deciding on amount of cover; and
- not doing pure actuarial work.

Eleven respondents were 'definitely' interested in some sort of grouped insurance arrangement, while four were 'definitely not' interested. Of the six respondents who provided details of cover limits, three carried R1 million cover. The others had R2 million, R5 million and R80 million respectively. Reinstatements were not specifically mentioned, but most policies that the authors saw allowed for only one, after which cover fell away.

5.2 What exactly is professional indemnity insurance, and why is it unpopular with the small South African actuarial enterprises surveyed? To answer these questions, the authors first examined examples of insurance policies effected by larger institutions in the general financial-services industry. In the authors' opinion 'a jungle of impenetrable small print superimposed over crevasses of exclusions waiting to swallow up the unvigilant' might be an apt description of some of these documents.

5.3 Allowing for what seems like a great deal of overlapping, financial institutions might have at least fidelity, 'D&O', and 'E&O' cover. Fidelity covers the institution against employee dishonesty, as well as against direct losses. D&O (directors and officers) covers the employees against negligent acts, and is usually combined with company reimbursement, which covers the costs of the institution indemnifying such employees. Then there is E&O (errors & omissions) also referred to as 'malpractice' or 'professional indemnity', which covers the institution itself for a similar set of negligent or wrongful acts.

5.4 Jess (1982) defines professional indemnity cover as  
an insurance which indemnifies the professional's negligent act, error or omission which causes loss to be suffered by his/her client or a third party

The insurance generally covers the costs incurred by the professional in defending the claim. Professional indemnity for services can be likened to product liability for goods.

5.5 Addressing the then Students' Society, Hooker and Pryor (1990) gave a good analysis of professional indemnity cover, both as consumers of the product and as vendors. Much of that detail is still relevant today. Some of the main points to be aware of include the following:

- Cover is usually on a claims-made basis. This means that cover extends only to claims first reported or becoming known during the period of cover. The alternative, more expensive, option (if available) is claims-arising cover. However, 'tail cover' may be purchased by those ceasing to practice, and more recently, some insurers are offering case-by-case claims-arising cover for large contracts.
- Looking backwards in time, there will be a retroactive date after which the wrongful act must have occurred. This is often set at inception of the business, but it can also move with time. As discussed below, pensions actuaries in the UK are currently having difficulty obtaining retrospective cover.

- Each insurer will have its own set of exclusions, but dishonesty and insolvency are always excluded. As in any contract, definitions should be carefully studied. In one example studied by the authors, the trustees of a commercial pension fund run as a business venture by an insurer believed they were covered, whereas the trustee-extension definitions restricted ‘trustee’ to an officer of the staff pension fund.
- The insurer may have the right to take over the management of the claim. This can include requiring the insured to admit liability. This can have painful consequences to one’s professional reputation, as well as possible disqualification from directorships and trusteeships. The admission can be required even when the insured and his profession are convinced that the conduct was not negligent—this happened to a medical professional known to one of the authors.
- The insured is required to agree to pay an excess, which should not be insured elsewhere.

5.6 The claims experience of professional indemnity insurance business is long-tailed, low frequency, and very skew. In other words, not many claims occur, but they are reported late, and of the claims many are small, but a few are substantial. Underwriting considerations are therefore relatively simple. A South African actuary would probably merely be asked about his or her qualifications, period of experience, volume of work, and pro-forma client contract. Any indication of past good behaviour would probably be regarded as statistically not credible by the underwriters.

5.7 The Institute of Actuaries in the UK no longer arranges professional indemnity cover for its members. Instead, it refers members on enquiry to a preferred brokerage firm. Current practice in the UK seems to include the following:

- It is generally small firms that seek out the services of the preferred broker. Larger firms will have their professional indemnity cover packaged with all their other insurances.
- Over the last three years, there has been a marked move by small firms to take cover, particularly because of the costs of defending claims, even spurious ones. Also, many clients now require that cover be held. It would appear that the majority of small firms now have cover.
- Claims experience has deteriorated in the past three years. Claims have been made equally for alleged poor judgment and poor office procedures. Just the cost of defending a simple claim can easily run to £30 000.
- Underwriters have hitherto not discriminated between different actuarial fields with their potentially different risk exposures. However, there is growing concern about the risk exposure of pensions actuaries and trustees. Some underwriters will no longer accept sole-practitioner pensions actuaries for cover. The underwriters’ concerns have arisen from additional fiduciary duties imposed by the 1995 Pensions Act, particularly with regard to actuarial monitoring of investment management.
- All the business of the preferred brokerage is placed with one insurer, so there is a de-facto group insurance arrangement. However, there is no compulsion on the insurer to accept applicants, nor any on actuaries to apply.

- Premiums average 1% to 2% of fees, depending on limits selected. There is no easy way of working out an appropriate cover limit; by default, the decision will be made on grounds of affordability.

5.8 The actuarial profession in the United States is large and diversified, although some professionalism issues are regulated by the Actuarial Board for Counselling and Discipline of the American Academy of Actuaries. It is therefore difficult to report on any standard practice. Nevertheless, there are some preferred brokerages, which report the following experience:

- There are de-facto group insurance arrangements because of the grouping for risk purposes by the preferred brokerage.
- Issues of actuarial judgment have proved difficult for courts and clients to understand. However, the comfort of having cover is primarily to have something to fund the defence costs, which are more predictable.
- As with other professions, claims experience is of low frequency but high amount.
- The preferred brokerage encourages risk-management practices, including the need for contracts with clients and peer review.
- Many older actuaries do not have cover, whereas the younger ones are now becoming insured. More and more clients demand cover.
- Tail cover is available, and can even be seen as insurance after the event because increased limits will apply to old claims.
- Cover limits are often \$1 million to \$5 million, and premiums 0,5% to 1% of fees.

5.9 In the UK and the USA, there are group schemes—sometimes even dedicated cell captives or mutual insurers—that attend to the professional indemnity needs of various professions, including doctors, lawyers, accountants, architects and engineers. However, the authors have not come across any group schemes for actuaries. This is possibly owing to the relatively small size of the profession, as well as to the disinclination to share risks with contemporaries.

5.10 The Institute of Actuaries of Australia recently adopted resolutions requiring all members offering advice to external parties to be covered by suitable professional indemnity insurance arrangements by January 2002. In their view, it was clearly important that all members providing actuarial advice to external parties were adequately covered by insurance against such contingencies. It was stated that this would bring actuaries into line with all other professions, enhance sound professional practice and help reinforce the importance of continuing professional development (CPD); and that it was expected by the public. A voluntary group policy has been facilitated by the Institute, with a special provision for low-income earners.

5.11 In South Africa, professional indemnity insurance is offered by a handful of companies. Larger covers can also be placed offshore. There are specialist risk brokerages that arrange the cover, but commission can be quite high, such as 20% of the

premium. In return, the insured may negotiate for the broker to add value not only by assisting in risk management as discussed above, but also in managing the claim. One broker that the authors interviewed reported his experience that most claims will 'go away' if properly managed.

5.12 How much cover is appropriate for a South African actuary? is a commonly asked question, to which the authors are unable to give a satisfactory reply. They have heard of a 'minimum' recommendation of £250 000 in the UK and A\$4,5 million in Australia and noted the US experience of \$1 to \$5 million. Because actuaries deal with large amounts of liabilities, it is likely that if a big claim is made, it will exceed any affordable level of cover. Indeed, it was pointed out to the authors that the actuarial profession in South Africa may be able to influence, directly or indirectly, as much as half of the national savings.

5.13 The only rule of thumb that the authors can usefully suggest, therefore, is that the determination of the level of cover should start with the amount deemed sufficient to pay the defence costs, particularly where spurious claims are involved. The only financial-services area where the authors found a widely accepted aggregate cover formula was for indemnity (together with fidelity) for South African pension-fund trustees. Their 'honesty index' is 2% of the total of assets and annual contributions, subject to a minimum of the highest death benefit payable.

5.14 In South Africa, therefore, it does not seem worthwhile to pursue the creation of a formal group vehicle for actuaries' professional insurance. One local underwriter required a minimum of 100 members, generating a premium of at least R100 000 a year. (It would appear that part of the problem is that South African actuaries are seen as good risks with resultant negligible premiums.) Rather, the model of a preferred brokerage, as used in the countries mentioned above, has the potential to add value to actuarial practices. This would not only be from group purchasing power, but also (and more importantly) from advice on risk management issues both related to insurance and with respect to alternative or complementary risk-mitigation strategies.

## 6. PROFESSIONAL GUIDANCE VERSUS THE LAW

*'We have a disciplinary procedure if things go wrong—members of the public do not have to rely on the courts'*

—Professionalism Course Handbook 2000/2001

6.1 It is one of the characteristics of a profession that there should be a code of conduct for its members, and that a disciplinary process should exist to police the code. However, as discussed in Section 2 above, the law must make up its own mind as to the influence or relevance of a code in a particular legal matter. The above quote therefore seems to miss the point that a disciplinary process has little directly to do with compensation. Rather a disciplinary process exists to bolster a profession's claim to a particular field of expertise, and its powers are reprimands, fines and expulsions.

6.2 For instance, Midgley (1992) quotes from the Tennessee (lawyers) Code of Professional Responsibility (1978) that 'this code does not undertake to define standards for civil liability of lawyers for professional conduct'. However, Midgley adds that it must be accepted that the code constitutes some evidence.

6.3 Nevertheless, the profession should bear the courts in mind when settling on codes of conduct and related guidance notes. Even statements marketing the profession (such as 'making financial sense of the future') might be quoted by plaintiffs as having established certain qualities for actuarial advice in the eyes of a reasonable person.

6.4 As an aside, it is noted that, in terms of normal legal procedures, deliberations by an investigating committee or a tribunal of ASSA may be subpoenaed as evidence in a court case. It appears to be up to the committee itself to decide whether to suspend proceedings if a court case in the same matter is instituted.

6.5 GN30 is classified as 'practice standard'. This means that a material breach is of itself a ground for complaint under the UK disciplinary procedures, and would amount to strong *prima facie* evidence of misconduct. In passing, at 1.2, GN30 somewhat gratuitously commits the profession at practice standard level to:

a duty of care (that) includes working to appropriate professional standards at all times, considering how advice may be interpreted by third parties who can reasonably be expected to rely on that advice and communicating any significant uncertainty or risk.

It is beyond the scope of this paper to speculate whether this statement has created an onerous legal duty for the profession. Suffice to say that the subsequent exposition of 'traditional' risk management is elevated to obligatory behaviour, and thereby any breach is offered to complainants as a potential course for legal action. (It may, of course, be a pointless activity to sue a penniless actuary for not having taken out insurance.) At the same time as this paper was being written, the UK actuarial profession published Exposure Draft 45, in which a change was proposed to Section 6 of the Professional Conduct Standards (Institute of Actuaries, 2000) for similar reasons. The authors recommend that, for this reason, any South African guidance on this subject be made recommended practice rather than mandatory.

6.6 GN30 is not the only professional guidance note needing review from the viewpoint of creating potential legal liabilities. The Guide to Professional Conduct (ASSA, 1995) has, at 3.3, a sweeping statement about actuaries' duties to third parties, as follows:

If a member has reason to believe that any advice that he (sic) gives will be transmitted in whole or in part to a third party he must take all reasonable steps to ensure that his authorship and responsibility are acknowledged to the third party, that any implications of the advice to which he has drawn attention are stated and that his advice is not presented in a way likely to give a misleading impression. Moreover he must be aware of a situation where advice that he formulates in the interests of his client can be presented as if it were necessarily the advice that he would have given to another interested party.

Whilst this is laudable, it has already been pointed out to the Society by a leading advocate that this somewhat vague wording potentially sets up enormous legal liability for actuaries—particularly in the pensions field where third parties abound.

6.7 A related issue, as raised in the notes to the professionalism course (Faculty & Institute of Actuaries, 2000), is the debate in the profession regarding the extent to which written guidance should be prescriptive. Some actuaries feel that it would be better (and safer) if written guidance left very little scope for individual judgment. The other view, which has so far prevailed, is that actuaries are trained to use judgment and should be free to do so, and that it is usually impossible to cover all possible scenarios in the guidance.

6.8 The opening quote to this section seems to reflect the good old days when professionals (and their clients) saw themselves as bountifully dispensing their pearls of wisdom to the grateful public. Bellis (2000) has recorded some more modern understandings of the professional relationship, such as that of Larson (1979), who suggests that the 'project' of a profession is to capture a field of enterprise for the self-enrichment of the members. The attributes of professionalism—such as standards, discipline, risk management, monitoring compliance and CPD—serve this self-interest. It follows that professional bodies must steer a careful way between claiming enough expertise to make a viable source of income-generation and claiming so much expertise that client expectations are unlikely to be met.

6.9 Thornton (1999) noted that the most recent president of the Chartered Accountants of England and Wales put the emphasis on the members' rather than the public interest. The barroom rivalry between accountants and actuaries has changed recently from jokes about who has the greater lack of personality to the surprise of finding an accountant prepared to sign any statement at all. While the accountants head for cover (in both senses of the phrase), the actuaries are moving in the other direction, with broad undertakings such as 'making financial sense of the future' and 'acting in the public interest'.

6.10 Thornton did, however, concede that it was problematic to require an individual actuary to act in the public interest:

... it is eminently possible to replace an individual actuary who has spoken out against the interests of his client. One actuary says that he cannot think of a single person who has 'whistle-blown' on his employer and remained with that employer for more than two years.

Thornton also noted that we have continually to revisit the subject of the public interest as the nature of the society in which we live changes. It is the authors' opinion that such a revisit is now due, to cover the legal implications not only of broad liabilities such as acting in the public interest, but also of specific guidance such as GN30 'Compensation for Professional Shortcomings'.

6.11 The Institute of Chartered Accountants and the Public Accountants and Auditors Board recommend professional indemnity cover to their members, but it is not

compulsory. In the opinion of one leading accountant, compulsory insurance would require guidelines to be laid down, and if those guidelines turned out to be inadequate, the profession as a whole could be liable. Liability for audit opinions cannot be limited, but other reports almost always come with limitations such as use for internal purposes only, not for third parties, and compensation limited to double the fees.

6.12 One can register as a professional engineer without professional indemnity insurance, but the South African Association of Consulting Engineers requires insurance to be carried. Most clients, in any event, demand indemnity cover. Liability can be limited, for example to double the fees. Municipalities, who employ a number of engineers, generally self-insure their risks, which often means that these employees are uninsured.

6.13 According to the Law Society, there is no requirement for attorneys to carry professional indemnity insurance. However, a practising attorney is automatically covered by the lawyers' fidelity fund. It is compulsory to contribute to this fund, which reimburses clients for theft of trust funds by attorneys. In addition to the fidelity cover, attorneys have professional indemnity cover rising from R1 million for sole practitioners to R1,8 million for large partnerships.

6.14 The legendary shoemaker's child went barefoot even though his father was an expert in covering up such exposure. The actuarial profession is also expert in exposures, although actuaries call it 'making financial sense of the future'. And like the aforementioned family, actuaries have tended to ignore using their expertise at home. The following proposals may go some way to remedying the situation.

6.15 South African actuaries with UK qualifications are bound by GN30 'Compensation for Professional Shortcomings', because the Actuarial Society of South Africa has not issued local guidance on this subject. Most small South African actuarial enterprises surveyed in June 2001 did not appear to comply with the guidance note. With due respect to its authors, GN30 appears to have the following weaknesses:

- the note does not sufficiently emphasise the need for a dynamic risk-management programme;
- ¶1.2 tries to encapsulate all the professional conduct standards, and in so doing, goes further than the standards, and imposes potential legal burdens on actuaries;
- ¶1.3, in making insurance a duty, does not protect the client in any additional way, but adds a potential legal burden to the profession as a whole;
- ¶2.1.3 is unrealistic, since actuaries are unlikely to get cover for the full amount at risk in many of the funds with which they deal; and
- ¶3, giving information about insurance, is inappropriate in a mandatory guidance note.

6.16 It is not, of course, being suggested that actuaries' duties of care should be trivialised. At issue is appropriate draughtsmanship for South Africa in the current

decade. The authors therefore recommend that ASSA issue guidance along the following lines:

- the title should be ‘Managing Actuaries’ Professional Risks’, or similar;
- the guidance should be best practice, not mandatory;
- there should be a statement that the Code of Conduct does not undertake to define standards for civil liability of actuaries for professional conduct;
- there should be a statement that professional conduct and discipline is set out in the Code of Conduct, without further recapitulation here;
- there should be a statement that, in any profession, errors and other breaches will happen from time to time; that actuaries should maintain a risk-management programme to minimise both the risk of breach and the amount of loss;
- there should be a statement that a risk-management programme includes analysing the likelihood and severity of risks; a risk-mitigation strategy; and a regular review of the programme; and
- common risk-mitigation strategies could be listed (such as indemnity insurance, compliance with professional guidance, peer review, etc.).

6.17 A glance through the South African Code of Conduct (ASSA, 1995) shows a number of statements that seem to place unnecessary legal burdens in the path of South African actuaries. For instance, at 1.1, actuaries are obliged to provide ‘the best possible service and advice’—not, for example ‘appropriate advice’ or ‘what the client wanted’. And at 1.6, the Code assists the courts by declaring that ‘as a matter of law his duty of care can extend to persons or organisations whom he can reasonably expect to rely on the advice’.

6.18 Lest they be misinterpreted, the authors repeat that they are not seeking to lower the professional standards. The issue is elegant draughtsmanship that does not bestow gratuitous rights on potential claimants.

6.19 A task team of the Institute of Actuaries recently reported on methods by which the profession could monitor compliance (Institute of Actuaries Working Party, 2000) with professional guidance. The various practice boards in the UK are currently considering how these should be implemented. In South Africa, a compulsory form of a risk-management strategy should be developed.

6.20 This paper has recorded the complexities of professional indemnity insurance, which perhaps is one reason for actuaries not taking it. A group insurance scheme does not seem feasible, both from approaches to local underwriters, and from reviewing overseas practice. A useful step would be the appointment of a preferred professional indemnity broker, who would become familiar with the needs of actuaries, and be able to advise (after consultation with Council) on the many important facets. This broker could create a de-facto group scheme by placing all the business with one underwriter. This arrangement exists in the UK and the USA.

## 7. CONCLUSION

7.1 The authors have attempted to merge elements of legal causation, risk management, indemnity insurance and the professional conduct standards into the concept of 'managing actuaries' professional risk'. By so doing, it is hoped to stimulate debate on an aspect of professional practice that may require more and more of the attention of actuaries as our society becomes more and more litigious.

7.2 The topic could also form a section in the professionalism course, both in South Africa and elsewhere; indeed, it was the delegates to a professionalism course who, questioning this lacuna, were the authentic stimulus for this paper.

7.3 Sections 2 to 5 offer practical suggestions on making risk management a profitable addition to an actuarial practice. Section 6 examines differences between the functions of professional guidance and legal review. ASSA is encouraged to set up a framework under which each actuary could decide on his or her risk appetite, and then put appropriate risk-mitigation strategies in place.

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### NOTES

- 1 An unfortunate acronym for a risk manager in South Africa, since 'ramp' means 'disaster' in Afrikaans.
- 2 NRG vs Ernst & Young, Bacon & Woodrow, UK 1996.
- 3 The complex question of conflict of interest is currently under discussion by ASSA. Actuaries are often faced with such conflicts. The Code of Conduct provides that work may be undertaken, despite the existence of a conflict, if all the parties have indicated their agreement. The authors understand that, in the UK, claims might be raised by the public against employed actuaries on grounds that they should not have issued the investment approval required by the Pensions Act 1995, when the assets of the pension fund were managed by the actuary's employer.
- 4 Quarterly Address of the Pensions Adjudicator to the Pensions Lawyers Association, June 2001.
- 5 Le Roux *et al* vs AIPF, SA 2001.

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