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PENSION PLAN PRINCIPLES AND PRACTICES

The passage of the Pension Reform Act points up the desirability of formulating principles and practices for pension plan construction and valuation. A committee of the American Academy of Actuaries is in the process of developing principles and practices. This session will present various views and will elicit audience participation.

CHAIRMAN GEORGE B. SWICK: The topic of our Concurrent Session this afternoon is "Pension Plan Principles and Practices".

As you undoubtedly know by now, I am Chairman of the Academy Committee on Actuarial Principles and Practices in Connection with Pension Plans.

At the New Orleans meeting last October, I presented some of the background leading up to the appointment of this Committee, and the progress of the Committee. It does not seem necessary at this point to review again this background material.

I would, however, merely like to remind you of the purpose of the Committee, and the basis upon which we now function.

The June, 1973, newsletter of the Academy described the Committee as follows:

> "A review of past difficulties within the actuarial profession in publishing 'accepted actuarial principles' and 'guides' for valuation of pension plans made apparent the need for further efforts to achieve these goals. It was suggested that past failures might not be repeated if the questions were to be tackled piecemeal instead of as a single gigantic project. Attention was directed to the headway that has been made in Canada under the aegis of the Canadian Institute of Actuaries. The Board authorized the appointment of a new committee to explore the best method of documenting what constitutes generally accepted principles of actuarial practice as applied to the valuation of pension funds."

The mandate under which the Committee now functions is contained in the following provision of Academy Opinion A-4 of the Guides to Professional Conduct.

> "It is the opinion of the Committee that Guides 4(a), (b), and (c), as amplified by this Opinion A-4, require that the actuary take into consideration the published Recommendations of the Academy's Committee on Actuarial Principles and Practices in Connection with Pension Plans. An actuary who used principles or practices which deviate materially from such Recommendations must be prepared to support his particular use of such principles or practices and should include in his report appropriate and explicit information with respect to such

> deviation. It is intended that such Recommendations, together with this Opinion A-4, constitute what shall be known as Generally Accepted Actuarial Principles and Practices relating to pension plans to the extent that actuarial principles and practices have been promulgated by the Academy; and, if there has not been such promulgation, the actuary must be guided by the sound principles established by precedents or common usage within the profession."

I believe you can assume that, as Chairman of this Committee, I believe it is a worthwhile activity.

The Committee as currently constituted, consists of James F. A. Biggs, Lynd T. Blatchford, Thomas P. Bleakney, Henry Bright, William A. Dreher, Jack M. Elkin, Blackburn H. Hazlehurst, Howard H. Hennington and A. Charles Howell.

The members of the Committee have all been very generous in devoting time and energy to this project. Results never seem to truly reflect the effort expended by the participants.

The work of the Committee was difficult enough prior to September 2, 1974. The enactment of the Employee Retirement Income Security Act added a new dimension. Section 302(c)(3) of the Act provides as follows:

> "For purposes of this part, all costs, liabilities, rates of interest, and other factors under the plan shall be determined on the basis of actuarial assumptions and methods which, in the aggregate, are reasonable (taking into account the experience of the plan and reasonable expectations) and which, in combination, offer the actuary's best estimate of anticipated experience under the plan."

Also, Section 302(c)(2)(A) of ERISA provides:

> "For purposes of this part, the value of the plan's assets shall be determined on the basis of any reasonable actuarial method of valuation which takes into account fair market value and which is permitted under regulations prescribed by the Secretary of the Treasury."

Certainly a multitude of practices can be covered by the words "the actuary's best estimate." We hope the work of the Committee will add some comfort to actuaries operating in this new world of Federal legislation. We also hope that our work will assist actuaries in public relations. One of our primary goals is to prepare Recommendations which will assist the actuary in dealing with non-actuaries, as well as giving guidance to actuaries in their professional capacity.

Our program this afternoon will be a presentation of three perspectives regarding pension plan principles and practices. We hope these remarks will stimulate discussion.

First, we will have Jim Biggs, also a member of the Academy Committee, giving the perspective of the relationship of the actuarial profession with the accounting profession.

Second, Mike Mahoney will indicate the perspective of an insurance company pension actuary.

Third, John Hanson will present his views as an independent consulting actuary.

Following these presentations, I will bring you up-to-date on the work of the Committee, and give you some idea of the material to be contained in the next Exposure Drafts which will be issued in early May. We want to make certain that these will be available in advance of the joint pension meeting in Cincinnati of the Society of Actuaries and the Conference of Actuaries in Public Practice.

For those of you expecting to attend the Cincinnati meeting, there will be a Concurrent Session at 9:00 AM Friday morning, May 23, on this same subject matter.

MR. JAMES F. A. BIGGS: Here I am wearing my green eyeshade and perched on my high stool again. Let me begin with a disclaimer.

I am not a CPA.

I am not a spokesman for the AICPA, the FASB, not even necessarily for PMM&Co. I am not an authority on accounting principles and practices.

I am an actuary - and proud of it.

I am a member of a firm of certified public accountants - and proud of that, too.

In this capacity, I spend a lot of my time helping CPA's understand what I and my fellow actuaries are up to - and this vantage point gives me an opportunity to appreciate the concerns which we share, as well as some areas in which we seem to be at odds.

In approaching this topic, I'll pose a series of questions and then try to give at least partial answers to each of them.

a. What do we mean by principles and practices?
b. For what reasons do we promulgate a specific body of acceptable principles and practices?
c. Are there parallels between the problems we face and those which the accounting profession is facing and has faced?
d. How have they approached a solution to their problems and what can we learn from them?
e. To what extent are the principles and practices of the actuarial profession in the pension area the proper concern of the accounting profession?

a. What do we mean by principles and practices?

Principles I take to mean the fundamental rules or basic laws which guide our conduct, whether it be in personal or professional life. Practices are the methods or techniques by which these principles are carried out. Let me suggest a Biblical analogy:

> "Thou shalt not covet thy neighbor's wife" is a statement of principle. "Pull down the shades and take lots of cold showers" might be regarded as appropriate practices in furtherance of that principle.

The actuarial profession does not lack for either principles or practices. I see the initial task of this Committee - and the profession - as one of **codification** of the principles and practices which do exist - of identifying certain practices which may be less preferable or even unacceptable - and of identifying as prime targets for actuarial research those areas in which principles and practices have not yet been adequately formed.

b. Why do we promulgate a body of principles and practices?

I see four primary purposes:

The first is guidance to members of the profession in the conduct of their practice. The background and experience of actuaries practicing in the pension area varies widely. Our numbers are few, and the opportunity to consult with each other on problems consequently limited. Thus, to the extent possible, it is most desirable to have guidelines to which a member may refer in dealing with new situations, or with unusual aspects of a familiar situation.

The second purpose is to provide assurance to those who rely on our work that it is based on a commonly understood set of ground rules, and to provide assistance to them in understanding the scope and the limitations of those ground rules.

Third, such guidelines furnish support for members of the profession in resisting pressures for inappropriate techniques or inadequate disclosure.

Finally, the member who has conducted his practice in accordance with the established standards of his profession will find them a helpful defense if his work should be challenged, whether by regulators or by legal action.

c. What parallels do we find in the accounting profession?

There are similarities, and there are differences as well. Many of the differences may be largely differences in timing, reflecting the current stages of structural evolution of the two professions. Accountants have - and have had - the same fundamental needs as we do. The four primary purposes outlined above are equally applicable to them.

One of the major differences is a matter of size. The AICPA has approximately 80,000 members. The Society of Actuaries has 5,000. To put it in slightly different perspective, the Academy admitted 115 new members last year. My firm alone admitted 114 new partners. This greater size obviously produces massive problems of communication and control.

This is particularly so because a central role of the CPA in our economy is the task of informing both the investing public and the general public. This task is accomplished through the medium of the financial report - and, if the financial report is to fulfill its purpose, it should be informative, it should be reliable, it should be consistent with prior reports of the same entity, and, to the extent possible, it should be consistent with similar reports of other entities. This requires the existence of a body of principles and practices which are understood and observed by all practitioners, and a control procedure to monitor compliance.

CPA's perform two separate and distinct roles in this process. As a corporate officer or employee, the CPA is responsible for preparing the financial statement, and in this role he is governed by a body of accounting principles and practices. The auditor, on the other hand, is not responsible for preparing the statements. It is his role to examine the statements and express an independent, impartial opinion as to whether they fairly present the financial condition of the entity under examination. He must be concerned with generally accepted accounting principles and practices, since one aspect of his opinion is to state whether they have been followed in the preparation of the statement. But he must also be concerned with a second set of rules, which are known as auditing standards. These fall in three major categories - General Standards, Standards of Field Work, and Standards of Reporting. These standards are designed to assure the reader of the statement that the audit has been conducted by people who are competent to do the job, who are independent of the entity examined, and who have exercised due care; that the investigation has been thorough; and that all necessary disclosures have been made.

How comparable to these are the problems of our profession?

Here is where we come to the timing difference I mentioned earlier. Suppose we view the accountant's role in three phases - the first, in which he is preparing financial information as a guide to management decision making; the second, in which he is preparing financial statements for the information and guidance of the public; and the third, in which he is serving as an independent auditor of those statements.

Most actuaries in the pension field have functioned principally in phase 1. The principles and practices with which they were concerned were those related to getting costs and liabilities properly determined and making appropriate disclosures to their client. If, for example, the client chose to adopt an actuarial cost method and assumptions which were consciously designed to produce an escalating pattern of costs, and he clearly knew what he was doing, the actuary may have felt no responsibility to call attention to this in his report. APB#8, and the close scrutiny which it brought to the actuary's work, started to move the actuary further into phase 2, and ERISA and the current consumerist climate which it typifies may complete the process. The actuary today must be deeply concerned, not only with the quality of his work, but with the adequacy of disclosure of the implications and consequences of what he has done. ERISA may even have nudged us into phase 3. Some actuaries have suggested that it is now necessary to have two actuaries for each plan - one to make the calculations and advise management, and a second to review and express an opinion on the work of the first. I hope we haven't reached that point. But we may move toward an intermediate point. For example, many of the key assumptions which we make are in areas where the actuary has no unique competence or omniscience. These certainly include investment returns and future salary increases, and perhaps employee turnover and retirement patterns as well. The selection of these assumptions even now is often a joint effort of the client and the actuary.

Why shouldn't these be specifically identified as the client's assumptions, which he adopts in writing, and which the actuary accepts as part of his opinion? We already have some precedent in the area of negotiated plans with a fixed benefit and a fixed contribution, and the principle may be equally valid in the unilateral plan area.

d. Now, how have the accountants gone about meeting these problems?

Here, again, the matter of size comes into play because it gives them a much larger manpower pool from which to draw, and a large academic community to involve. From 1959 to 1972, accounting principles were enunciated by the Accounting Principles Board of the AICPA. One of the Institute's publications stated that the Board has produced, "Four Statements, 21 Opinions, and a thousand critics." Those of us on the Academy's Committee on Principles and Practices can certainly see a parallel there. The Board was a part-time, all-volunteer body. Its opinions were issued only after approval by at least two-thirds of the Board, and then only after circulation to the members of the Institute for comment and criticism. Institute members are required to disclose departures from Board Opinions, in the notes to the financial statement or in the auditor's report, where the effect on the statement is material. The burden of justifying any such departure is on the member.

This system was changed in 1972 by the creation of the Accounting Research Foundation and the Financial Accounting Standards Board. This change served two purposes. The task of directing and conducting research, and of promulgating new rules of practice, is now a full-time assignment for people who do not have the simultaneous responsibility of conducting a business or practice of their own. And, from the standpoint of public perception, the reporting standards are now being set by an independent group who have no current ties to the corporations or the accounting firms who must live by their precepts.

In the auditing area, a similar process has been followed, but it hasn't gone public. Auditing standards are promulgated by the Auditing Standards Executive Committee of the AICPA. This process traces all the way back to a "memorandum on balance-sheet audits" which the Institute prepared in 1917 at the request of the Federal Trade Commission. From 1939, when the more-or-less current structure was adopted, to 1972, a total of 54 Statements on Auditing Procedure have been adopted. These have been codified by the Institute, and are available for reference by Institute members at any time by simply opening the book. The Institute's Code of Ethics requires adherence to generally accepted auditing standards, and further requires that members be prepared to justify any departure from the published Statements.

e. In what respect are the principles and practices of the pension actuary a proper concern of the accounting profession?

The accountant must rely on the actuary in all three phases of the accountant's role which I mentioned earlier. He needs sound answers and sound advice in preparing reports and recommendations for management. In preparing his financial statement, he needs information which is meaningful to the reader on the costs and obligations which the plan entails. And, as an auditor, he needs to know that the actuarial information used in preparing the statement has been determined in a manner consistent with generally accepted accounting principles. In all of these roles, the accountant must be able to comprehend, at least conceptually, what the actuary is doing. We have all heard critics who place the communication capabilities of the actuary somewhere between inarticulate and unintelligible. Such criticism usually tells us more about the critic than about the actuary. But there are members of our profession who seem to regard their work as being so terribly complex and mysterious as to be beyond communication. Just possibly, if we can't explain the concepts of what we have done to a reasonably intelligent, informed business man, it may mean that we didn't understand the concept in the first place.

Accountants in business are concerned with these matters. We've had responsible officers of major corporations come to us and say, in effect, "Look, I know my actuary has a fine reputation and I'm sure he's good. But, dammit, this is my company, and I've got to do the financial planning, and he hasn't helped me to understand what he's doing or where my pension cost is going."

But most of our mutual concern relates to the audit process.

When an auditor is required to express an opinion on financial statements taken as a whole, he must satisfy himself of the reasonableness of all material items in those statements. Although he must place reliance on the opinions of others in reaching his conclusions, he cannot state that reliance in a manner which purports to disclaim responsibility with respect to those items. This inability, which certainly came across as an unwillingness, to state reliance on the actuary provoked a major controversy with respect to the proposed Audit Guide for Pension Funds. There may be a way out of this dilemma in the audit of the plan, if the AICPA and the Department of Labor are willing, and that is a clean division in the annual report between the financial information (on which the auditor expresses an opinion) and the actuarial information (which is covered by the actuary's certificate).

The employer's financial statement poses a more difficult problem. If the pension items are deemed to be material, the auditor must satisfy himself as to their reasonableness. In the past, the test of materiality has commonly been based on the relationship of the pension cost to some measure such as the employer's earnings, and this frequently showed non-materiality. With ERISA and the 30% test, materiality may be more common and the auditor's concerns correspondingly greater.

The auditor doesn't want to check the actuary's work. He wants to place reliance on the actuary's opinion. In doing so, he wants to be able to determine that the actuary is presumptively qualified for the work he has performed, that he has employed acceptable methods and practices, and that the results are adequately and meaningfully disclosed.

If there are no generally accepted principles and practices for pension actuaries, if there are no standards governing the disclosure of material information, and if the same words and the same certification format may mean many different things, then the ability of the auditor to rely on the actuary's certification is diminished, and the necessity for him to inquire deeply into the actuary's procedures is correspondingly increased. Thus, the existence of a body of generally accepted actuarial principles and practices can contribute to an increase in understanding and a lessening of tensions between the professions.

MR. MICHAEL J. MAHONEY: As has been indicated, my comments will be confined to the viewpoint of an insurance company pension actuary. No attempt will be made to delineate the specific provisions of the Act, since it is assumed that most of you are familiar with the wording of the law.

My remarks will center on those provisions of ERISA which will affect administration and valuation. Also some reference will be made to Title IV and the provisions governing the Joint and Survivor Option. Obviously, time does not permit an in-depth exploration of all the items.

Administration

Historically, insurance companies have been recordkeeping companies and, in our opinion, one of the major problems resulting from ERISA is that extensive revisions will have to be made in our existing data systems to produce the information required by the new law.

Records will be needed to determine service to be credited for (a) vesting, (b) benefit eligibility, and (c) participation, with "service credit" subject to the definitions prescribed in the new law. Since eligibility and participation may be based on different definitions, provision must be made for the calculation of required service credit. Furthermore, break-in-service requirements will make it necessary to maintain records on terminated employees.

Records will be needed to calculate vested benefits. Special recordkeeping will be required for contributory plans as employee contributions vest immediately while employer contributions may vest over different periods of time. In those instances where employees withdraw their contributions and later seek reinstatement, the "buy-back" provision of the law will require the calculation of hypothetical employee-purchased benefits. Finally, if a participant is at least 50% vested, he can withdraw his contributions and still retain the vested employer-provided benefits.

Records will be needed to prepare an annual report of accrued benefits to employees. This report must be furnished upon written request of the plan participant and must indicate the vested portion of the accrued benefit. Since we anticipate that most employees will take advantage of this privilege, we are making preparation to produce this information on a regular basis for our customers.

Records will be needed to prepare the annual report to the employer and to the Departments of Labor and Treasury.

Finally, there is the completion of EBS-1 and the preparation of employee announcement material.

Obviously, all of these recordkeeping requirements will increase the administrative costs of the plan. How much it will be -- only time will tell.

Valuations

With respect to the actuarial valuations performed for small firms, we are not too dissimilar from the consulting profession in that our assumptions, procedures, and reports are somewhat standardized. However, for the larger more sophisticated customer, we tailor our estimates to meet the particular situation.

As you are all well aware, ERISA requires that the actuarial assumptions must be "reasonable in the aggregate" and represent the actuary's "best estimate of future anticipated experience." In general, we have interpreted these requirements from the point-of-view that

(a) the funding of a pension plan is a long-term proposition

and

(b) there is an advantage to maintaining contributions at a level percentage of salary, or at least reasonably consistent from one year to the next.

In most instances, the two assumptions which have the greatest impact on estimated plan liabilities are the interest rate and salary scale. Historically, the noninflationary trend of interest has been about 3 - 3½%, and that of salary scales approximately 2%. Admittedly, we have recently experienced double-digit inflation, but how much of this can be reasonably assumed to continue into the long-range future? Based on past experience, we believe that a reasonable recognizable estimate of long-term inflation to be about 2½% to 3%. Obviously, if the present high levels of inflation continue, our recognizable estimate would have to be adjusted upward.

Thus, after giving effect to the anticipated inflationary trend, our actuarial valuations are based on an interest rate of 5 - 6%, and a salary scale of 4 - 5%. Another element we consider is the maintenance of a 1½ - 2% differential between the interest rate and salary scale (e.g., a 6% interest assumption with a 4½% salary scale). Of course, this philosophy must be consistent with the fund's investment earnings.

Lately, there has been increased discussion concerning the (a) communication of actuarial assumptions to plan participants and (b) whether these assumptions should be "realistic" or "most probable" as opposed to "conservative." Personally, I am a firm believer in communication; but I think we should exercise some caution in the dissemination of technical information to a large group of individuals, many of whom lack the necessary knowledge and expertise to adequately understand its full import. Consider the effect of publicizing a 6% or 7% salary scale. Will this lead to employee dissatisfaction if in fact salaries are only increased 5%? Similarly, suppose an employer has in the past periodically increased benefits to retired lives. Suppose further, that there is no formal commitment to continue the practice in the future, but the employer has the intention to do so. If the valuation is to be based on "most probable" assumptions, shouldn't there be some provision for an "anticipated" increase in retirement benefits? If so, isn't it possible that the retirees might be led to a greater expectation? -- one that might never materialize.

Two final points on the ERISA provision affecting valuations. First, we believe that the insurance company can continue to provide actuarial valuation services. We have made valuations in the past, and they are part of the regular services which we have made available to our customers. Secondly, it is our opinion that the insurance company pension actuary should be included in the definition of enrolled actuary -- if for no other reason than that there is a scarcity of qualified pension actuaries.

Plan Termination Insurance

All qualified defined benefit pension plans are required to participate in an insurance program administered by the Pension Benefit Guaranty Corporation (PBGC) for the purpose of protecting participants and beneficiaries against the loss of benefits. There are some limitations on the maximum amount of monthly benefits insured under the program and some "phase-in" controls affecting newly-established plans and benefit liberalizations.

In order to meet its obligation, the PBGC is authorized to charge a premium based, initially, on the number of participants. Included in this definition are retired employees and their beneficiaries who have fully insured benefits, as well as terminated employees who have fully-insured deferred annuity benefits. Based on our discussions with the Labor Department, it was our understanding that no premium payments were required with respect to these categories -- and this is still our position.

Thus, we see that the PBGC has entered into the business of insuring guaranteed benefits, i.e., benefits already guaranteed by an insurance company. An obvious question to ask then is what effect, if any, will this have on the insurance industry? Will there be a tendency away from insurance company guaranteed benefits?

Another aspect of Title IV is the employer's contingency liability equal to 30% of his net worth. How will this provision affect the pension business? Will it encourage the deferment of plan improvements, limit the growth of new plans, and/or cause a shift to defined contribution plans? As for the growth of new plans and the deferring of plan improvements, obviously, the employee market place will have an effect on the ultimate outcome. As to the latter, we have noticed a shift to profit sharing and savings type plans. Their popularity, however, may be more attributable to the attractive interest rate guarantees currently being offered than to a trend away from defined benefit plans.

Title IV may also have some effect on our profession re the determination of actuarial assumptions. Under the Act, termination insurance premiums for plan years beginning 24 months or more after the date of enactment may be based on both the present value of basic benefits and on the unfunded value of basic benefits. Since the PBGC will be bearing the risk, they probably will want to have some say as to the determination of the above liabilities and to actuarial assumptions employed. Is there a possibility that this will lead to a narrowing of our "reasonable assumptions"? Will the individual actuary have to justify or explain where his assumptions differ from those of the PBGC?

Joint And Survivor Benefit

For plan years beginning after January 1, 1976, the Act requires qualified pension plans to provide for a Joint and Survivor Annuity. Since most pension plans already have this benefit on an optional basis at retirement, this requirement is nothing new for the post-retirement period except that now it is automatic, unless the employee elects otherwise. The main problem is how this requirement will be administered and costed during the pre-retirement period.

A participant can elect this option ten years prior to normal retirement date or after the plan's earliest retirement age, whichever is later. Since the employer is not required to bear the additional cost, it is permissible to reduce the participant's eventual retirement benefit. The question arises, "should the full reduction be reflected immediately at the time of election or on a year-by-year basis throughout the pre-retirement period?" Certainly, the former would be easiest to administer, but should this be the sole criterion? If the participant or spouse dies while active, then a charge would have been made for coverage after the date of death.

If the survivor benefit is subsidized and is included in the pension plan as opposed to being funded through group life, there is a distinct probability that it will be subject to the vesting provisions of the Act. Thus, the beneficiary of a vested, terminated participant would also have this coverage.

One final point on this optional benefit, for the sake of administrative ease, we favor the use of uniform joint and survivor reduction factors.

MR. JOHN HANSON: In 1966 the Board of Governors of the Society of Actuaries requested the Society Committee on Pensions to provide a guide for pension actuaries "somewhat analogous to the generally accepted accounting principles of the accounting profession." In my 1972 comments on the committee's discussion paper, I reviewed with some admiration the approach of the accounting profession which has been and is, in brief, to first outline its problems in terms of the purpose and objectives of financial statements and second to assign to an appropriate committee the task of narrowing differences in existing reporting procedures. I understand the accounting problems and the legitimate need for the narrowing of differences in the annual financial reports of corporations.

In those comments I also noted the very important essential differences between the actuarial and the accounting professions and I suggested that our profession should organize its discussion of solutions around an agenda of the problems that we face.

Changing Problems

The impetus for establishing "generally accepted actuarial principles" has come in the past in large measure from actuaries who have felt that the profession needs public recognition and/or the added responsibility that would flow from the need to certify as to the adequacy of pension plan funding.

Such public recognition and responsibility along with substantial potential personal liability are now the lot of the pension actuary who becomes an "enrolled actuary" under the Pension Reform Act. In this new environment my views have necessarily changed substantially from those expressed in 1972. However, I continue to believe that the proposed rules and ethical guides for the pension actuarial profession should be formulated from and on the basis of an agenda of the problems faced by pension actuaries.

Exposure Draft

The work of the Academy committee that produced the recent exposure draft on present values began early in 1973 at a time when a draft of H.R. 2 (later to become the Pension Reform Act) indicated that all actuarial calculations were to be made in "conformity with generally accepted principles of actuarial practice." From a procedural standpoint I believe this committee and the Academy are making two serious mistakes:

1. The above language is not included in the law and in fact the law includes many provisions and requirements dealing with the subject matter of the committee's work. I do not believe the committee and the Academy should be moving ahead without careful reconsideration of the purpose and need of the recommendations in light of the radically changed environment created by the Pension Reform Act.

2. More disturbing to me personally is that the exposure draft not only would cast doubt (without explanation) on some customary uses of the unit credit and other methods -- i.e., the committee attempted to "narrow differences" in the manner of the accountants -- but the draft also suggested as a standard a new value that heretofore has to my knowledge never been suggested, discussed, or computed in practice, i.e., the committee innovated a "generally accepted practice." (This new value is one that the committee chose to call the "present value of total accrued benefits.") In effect, this committee would strike out at practices of pension actuaries in a more authoritative manner than the Accounting Principles Board has ever struck out at the practices of auditors.

It would appear that the committee is rushing to complete an assignment that has never been clearly defined by the actuarial profession, that their charge is in effect "to do something," and that they feel compelled to move ahead even if the actions of the committee may, as a result of the Pension Reform Act, be detrimental to the members of the profession and of no apparent benefit to the public.

Liability

I doubt if the intent of the Pension Reform Act is that the actuary is responsible to the fund as a fiduciary for experience losses under actuarial assumptions. However, the actuary is to be retained on "behalf of the participants" and the actuary is to be a fiduciary to the extent that he exercises discretion with respect to the "administration" of the plan. When and if he acts as a fiduciary, the actuary is required to act "solely in the interests of the participants."

Although there is currently no clear understanding regarding the extent to which the actuary will act as a fiduciary, there is general agreement that actuaries will be included in future lawsuits filed against the plan and fund on behalf of beneficiaries who may expect more out of the Pension Reform Act than it in fact provides. For example, it is entirely conceivable that beneficiaries will sue at plan termination to obtain non-insured pension benefits, and that the actuary will be defending his assumptions which could, even if reasonable, have resulted in experience losses from salary increases and investments over a period of several years.

The certifications to be required of the enrolled actuary are certifications to the effect that the assumptions and methods adopted by the actuary offer his "best estimate of experience under the plan." This raises, it seems to me, a number of questions that need to be resolved before the profession promulgates rules that could be utilized in a lawsuit against practicing actuaries. For example:

1. If the actuary uses methods or adopts assumptions permitted by the law that are not the preferred method or assumptions of the committee, what are the implications with respect to the liability of the actuary in a lawsuit?

2. How can an actuary make "his best estimate" as an individual if he must abide by the preferences of this committee in order to retain his professional standing?

The question of the impact of these recommendations on potential personal liability should be studied by actuaries individually and as a profession before rushing to publish or agreeing to innovations or recommendations narrowing differences of the type proposed in the recent exposure draft on present values. Such study should provide a mature understanding of the law, and of lawsuits and court findings regarding individual liability in the other professions, and of the impact of the standards of such professions on these matters.

Present Problems

My view over the years has been that the principal problem facing the actuarial profession has been the lack of credibility of the actuary in the eyes of the public. As a result of the Pension Reform Act, actuaries now have recognition and important responsibilities under the law. Aside from the potential personal liability of the pension actuary under the Pension Reform Act, is not the lack of credibility of the actuary the single important problem now facing the profession?

My View of the Pension Actuary

Before outlining the credibility problems I feel we face, I would like to give my view of the work of a pension actuary which, I believe, differs fundamentally from the work of many of the actuaries on the governing bodies of the existing professional organizations.

The pension actuary is in essence a problem solver. Since accountants and other laymen have not mastered life contingencies, I have never viewed them as a threat to the actuarial profession. Opinion No. 8 expanded and enhanced the scope of our work in that we necessarily came to grips with and learned to distinguish accounting problems as opposed to funding problems.

There are now new problems to solve as a result of the Pension Reform Act that will require the use of actuarial techniques within the framework of the regulations to be established under the Act.

I am convinced that the importance of the pension actuary will grow over the years as long as there are problems to be solved using our expertise in the area of life contingencies. The ability to exercise judgment, in my opinion, is the hallmark of the work of a qualified pension actuary. I am concerned with and opposed to restrictions on the use of life contingencies where such restrictions are artificial and unnecessary since such restrictions limit the exercise of judgment and therefore lessen the usefulness and professionalism of our work.

The Actuarial Credibility Gap

Some of the situations that give rise to the lack of credibility of the actuary in pension work are discussed below. It is clear to a person involved full time in this work that in many instances the lack of credibility results from matters that have nothing to do with actuarial science or life contingencies.

1. A major cause of the lack of credibility of actuaries has been the failure of the profession to utilize terms that are understood by laymen. The best example is the use of the term "accrued liability" or "past-service cost" over the years under both the unit-credit method and the entry-age-normal funding method even though such values differ fundamentally under these methods and the difference can be explained by an actuary. A close runner-up is the definition of "total accrued benefits" by the Academy committee in terms that are contrary to the understanding of all laymen and most actuaries.

2. Actuaries have utilized different valuation methods in parallel situations resulting in substantially differing cost levels. It is my belief and conviction that all of the valuation methods commonly in use have useful characteristics and that they have advantages and disadvantages that are understood by knowledgeable laymen. The choice of methods is or should generally be the result of a choice by an employer with respect to the accounting question of whether the incidence of contributions should be increasing, decreasing, or as nearly stable as possible. It is completely inaccurate to believe that one of these methods can be preferred over the others on the basis of actuarial considerations. In fact, should the Academy adopt the recommendation that some of these generally accepted methods not be "accepted," it is my firm belief that this suggestion would not be accepted by the accounting profession or by industry and obviously not by the legislators.

   In the past, some actuaries dealing with the accounting profession and with legislators have been reluctant to explain the differences between methods because they felt that these laymen would decide to choose one method in preference to the others. It is important to observe that both the auditors and the legislators have recognized the fundamental value of the range of methods, and I submit that all the methods available both for accounting purposes and under the Pension Reform Act have inherent uses that the practicing actuary must be able to utilize in his work.

3. Under many plans there is no single cost possible because of the plan provisions. The best illustration is a plan provision permitting employees with 30 or more years of service to retire regardless of age and receive full unreduced benefits. There is simply no way that the actuarial profession can dictate the correct retirement assumption under plans of this type. There is also no way that misunderstanding about the cost of such plans can be completely avoided. The actuary must continue to explain the underlying problem that exists in this and similar situations.

4. The credibility of actuaries is questioned when an actuary representing a union develops costs that are only a fraction of the cost developed by an actuary retained by an employer. It has always seemed to me that this problem should be resolved by the actuarial profession on the basis that such actuaries should be professionally obligated to reconcile their differences. This reconciliation should result in an agreed explanation of the reasons for the differences. There may, at the present time, be need for action by the profession with respect to this problem; however, the Pension Reform Act requires an "enrolled actuary" to be employed "on behalf of the participants" and to utilize a "best estimate" that is based in part on experience under the particular plan in question. Thus, the Pension Reform Act appears to provide a substantial part of the answer to, if not a complete solution to, this problem.

5. Actuaries use different assumptions, and the credibility of actuaries has been questioned because of differing results flowing from conflicting approaches to matters such as the use of inflation in connection with some or all of the assumptions. Clearly the approaches are conflicting not only because of differing actuarial techniques but also as a result of differing fundamental views about budgeting costs in an inflationary economy. In this regard, the obligation of the actuary, in my judgment, should be to interpret to laymen the present and future implications

of using or not using assumptions with respect to future inflation.

6. Individual actuaries use alternative assumptions for alternative purposes. For example, in the past some actuaries have used differing assumptions for purposes of minimum and maximum deductible contributions. Clearly, the pension actuary under the new law must make his "best estimate" and it is intended that the same estimate apply for virtually all purposes. It would therefore appear that the credibility problems in this respect should be reduced somewhat.

An Alternative Approach

An approach that I could support, subject to a clear understanding of the impact of the Pension Reform Act on the personal liability of the actuary, would be a series of recommendations by the profession that would have as its focus the need to come to grips with the credibility problem facing the pension actuarial profession. It is my view that there is no other justification for these recommendations. As such, the recommendations or releases would be formulated on the following basis:

1. The alternative practices in use would be described with a clear explanation given of the reasons for the use of each such approach, with such explanations developed by practicing actuaries who use and believe in the approach.

2. The release would summarize the advantages and disadvantages of each practice and interpret these advantages and disadvantages in terms of accounting, benefit security, economic, actuarial, and other considerations.

3. The release would include findings as to whether the differing practices were inherent in the terms of the plan instrument or fact situation, or were the result of differing views of accounting, benefit security, economic, actuarial, or other considerations.

4. The release would express a preference for a particular practice over another only when the differences clearly did not result from non-actuarial considerations.

Thus, an effort would be made to close the present credibility gap by explaining differences that do not result from actuarial considerations. The only special burden placed on most practices would be whatever burden would result from any deficiencies that would be obvious from the description of the accounting, economic, or other aspects of the particular practice.

Although most of our differences are not essentially actuarial in nature, there would, in my opinion, be some differences resolved on the basis that the difference resulted fundamentally from differing views of strictly actuarial considerations. In my judgment, recommendations prepared on this basis would be useful in developing regulations under the Pension Reform Act, and would be useful not only to pension actuaries but also to the general public.

Summary

The Pension Reform Act provides recognition and important responsibilities for the pension actuary, and both the Pension Reform Act and the auditors have recognized the inherent value of a wide range of alternative methods.

Because of the nature of our work we will not always be able to provide laymen with the simplistic answers they sometimes seek. However, I believe actuaries should continue to learn **how to explain and interpret alternative** approaches, and that a committee action to prefer one approach over another, that might be explained for example in accounting terms, represents an admission of failure in the ability of the profession to communicate, or perhaps to understand, the legitimate uses of actuarial values. In my view, efforts by actuaries to eliminate differences that exist because of non-actuarial factors are misdirected and destructive. We should not give up in our efforts to understand and communicate.

I also believe that recommendations attempting to narrow differences without justification are a disservice to the practicing actuary attempting to work with clients within the legal framework, in that the profession will have created a presumption of error in the minds of laymen that could result in financial liability to the practicing actuary as a result of the fiduciary responsibility requirements of the Pension Reform Act.

CHAIRMAN SWICK: I indicated previously that I would give you some idea of the work of the Committee since the first Exposure Draft was presented in August of last year.

The next Exposure Draft will cover two topics. First, a second Exposure Draft on the Determination of Actuarial Present Values under Pension Plans. Second, there will be a first Exposure Draft dealing with the question of Inflation.

Following the mailing of the first Exposure Draft, the Committee received about 50 written responses. For the most part these comments were constructive, and gave the Committee encouragement to continue.

Extensive debates within the Committee on many basic issues have delayed the finalization of the second Exposure Draft.

Nomenclature has caused us great difficulty. We are pleased that the Society Pension Committee is currently tackling this issue. We have kept in contact with this Committee through its Chairman, Preston C. Bassett, and we hope we have not strayed too far from the thinking of this Committee.

As previously indicated, ERISA has caused us great concern. The somewhat loose wording of the Law makes it difficult to anticipate its regulations, and we have had many discussions on the intent of the Law.

Now, what were the comments on the first Exposure Draft, and how did we deal with them?

There were six basic criticisms:

1. The Exposure Draft does not present any significant actuarial principles and practices.

2. References to actuarial cost methods were insufficient.

3. The restatement of present practices will stifle the development of new ideas and procedures.

4. There is evidence of a lack of research.

5. Criticism of the specified approach for computing the present value of accrued benefits under an active plan **was made.**

6. Finally, the accountants complained of our suggesting the identification of accountants who may have audited data and/or asset valuations.

Furthermore, at New Orleans, the Chairman of the Society Pension Committee suggested on behalf of that Committee that we promulgate a Recommendation that the accrued benefit method not be used for final average salary plans.

The Committee believes that it has dealt effectively with these comments.

I believe that the best means of indicating to you how we have dealt with these comments is to read to you selected portions of the next Exposure Draft.

First, let me point out that there will be 12 specific Recommendations in the new Exposure Draft; some which may seem relatively minor and others which we believe will have major consequences.

One general comment has been added which might be of interest:

> Section 1.2 reads "It is recognized that the great growth of American pension plans has occurred since the Second World War. During this period actuarial procedures and techniques have been in a constant state of development. As a result, this Recommendation is intended to be applicable on a prospective basis only, effective upon its adoption by the Board of Directors of the American Academy of Actuaries."

In line with current thinking of the Society's Pension Committee, Section 2.3 reads:

> The term "supplemental present value" is preferred by the Committee as a designation for the quantity variously referred to as "accrued liability," "past service liability," and "supplemental liability." The Committee believes that the term "supplemental present value" best describes the present value of future contributions to the plan in excess of future normal costs, and therefore recommends the use of this term in lieu of those previously used. In some actuarial cost methods, "supplemental present value" is not a direct present value of specific benefits, but instead is an amount derived from other present values (e.g., an amount equal to the excess of the present value of total projected benefits over the present value of expected future normal cost).

The discussion of Actuarial Cost Methods has been simplified, and Section 4.2 now reads, in part, as follows:

<u>Actuarial Cost Methods</u>

Actuarial cost methods generally fall into two broad categories:

(a) Projected benefit method

(i) individual level cost

(A) entry age normal cost with supplemental present value
(B) level cost without supplemental present value

(ii) aggregate level cost

(A) entry age normal cost with supplemental present value
(B) attained age normal cost with supplemental present value
(C) level cost without supplemental present value

(b) Accrued benefit method

(i) unit benefit cost

(A) one year current cost with supplemental present value

New procedures have been given greater attention. In the projected benefit method area, the following language appears in Section 4.2:

> Projected benefit methods have, in the past, generally been applied to the existing population of plan participants without allowance for replacement of terminated employees, or changes in the size and structure of the workforce. However, the Committee recognizes and accepts projected benefit cost methods based upon projections of the existing workforce adjusted for expected new hires and expected future changes in the nature of the workforce.

While in the accrued benefit method area, the following new language appears in Section 4.2:

> The accrued benefit method has, in the past, generally been based upon units of benefits accrued to the determination date using historical records. The Committee recognizes and accepts the accrued benefit method under which retirement benefits are first projected to expected retirement on the basis of relevant actuarial assumptions, and the current cost is then based upon an appropriately pro-rated portion of that total benefit. To determine the total projected benefit at retirement, actuarial assumptions may be made with respect to salary scale, prospective entitlement to early retirement benefits in excess of those having equivalent actuarial values to the accrued normal retirement benefits, projection of Social Security benefits and taxable earnings, etc. As used in this context, the accrued benefit method has some of the attributes of a projected benefit method.

Much criticism of the handling of one-year term cost led to changes to emphasize stability as well as magnitude. Section 4.3 reads:

> In conjunction with any of the above actuarial cost methods, it may be considered appropriate to determine the current annual cost of ancillary benefits (such as disability and pre-retirement death benefits) by applying the one-year term cost method, provided that the developing annual cost for such ancillary benefits is expected to remain relatively stable, or where the cost exposure is relatively minor in relation to the cost of the entire plan.

Recognizing the statement of the Society's Pension Committee regarding the accrued benefit method, the following Recommendation is included (Section 4.5):

> Where the accrued benefit method is used with respect to a plan benefit formula related to compensation in the years immediately preceding retirement or other termination, the actuary should base his calculations on the pro-rata portion of benefits projected to expected retirement or other termination date.

However, an overriding Recommendation is included, which emphasizes the disclosure nature of the entire document. This is, perhaps, the most important Recommendation included, and will also appear in the Recommendation on Inflation. Section 4.7 reads as follows:

> The extent to which benefits should be funded in advance of the date when they must be paid is a decision to be made by the plan sponsor, with the assistance of the actuary, in light of many factors, including regulatory requirements, collective bargaining considerations, financial practices, accounting considerations and alternative uses of money. If the funding pattern differs from the long-term pattern consistent with the Recommenda-

tions set forth herein, the actuary should disclose the trend of the funding pattern, and should indicate, at least approximately, the impact of such funding pattern on future pension contributions.

There was much criticism of the specified method for computing the present value of accrued benefits under an active plan. This has been revised to a disclosure procedure as follows (Sections 5.6 and 5.7):

The committee recognizes that actuaries have varying opinions as to the best measure of the present value of accrued benefits under an active plan.

Under many pension plans, benefits accrued to the determination date are directly computed on the basis of historical employee records. In such cases the most common procedure currently in use is to calculate the present value of accrued benefits on the basis of such directly computed accrued benefits.

A substantial number of pension plans, however, contain features such that an actuary may wish to employ an alternative calculation. Examples of such plans are:

(a) plans with maximum credited service provisions

(b) plans with Social Security offset provisions where credited service used to compute such offsets is limited to a shorter period of credited service than that used to compute the gross pension benefit

(c) plans providing early retirement benefits with an actuarial value greater than the value of the accrued benefit to which the participant would be entitled commencing at normal retirement date

(d) plans with automatic cost-of-living increases.

RECOMMENDATION

The procedure used to determine the present value of accrued benefits under an active plan should reflect the actuary's best judgment as to the most meaningful figure of the actuarial present value of benefits accrued to date under such plan. In presenting his results, the actuary's report should clearly indicate the treatment afforded to the following:

(a) the manner in which benefits are calculated in the case of a plan which limits the number of years that may be credited

(b) whether a projection of future earnings was applied in determining benefits accrued to the determination date

(c) whether the projection of future earnings or of future benefits included any explicit or implicit allowance for future inflation

(d) whether recognition was given to any benefits which, if an employee continued in employment, could become payable before normal retirement age with an actuarial value greater than the value of the accrued normal retirement benefit

(e) whether benefit increases scheduled to occur after retirement were recognized

(f) whether Social Security benefits, under an integrated offset plan, were reflected in full or pro-rated

(g) whether average Social Security covered earnings, if applicable under an integrated step-up plan, were related to past service only, or projected to normal retirement

(h) whether the actuarial assumptions used for this purpose are different from the assumptions used to determine total pension plan costs or contributions, and, if so, indicate the reasons for and the effect thereof.

As regards the accountants, we have eliminated the references in the first Exposure Draft. As you are aware, there is a liaison group of Academy members and members of the AICPA. It is my belief that this group will be successful in satisfactorily defining the relative positions of actuaries and accountants, particularly with respect to complying with ERISA. Nevertheless, the new Draft contains the following Recommendation (Section 10.3):

In preparing calculations for the purposes of determining actuarial present values, the actuary should give adequate recognition to the responsibilities of other professions and to the requirements of clients in dealing with such other professions. He should, in accordance with Opinion A-3 of the Opinions as to Professional Conduct, furnish all actuarial information pertinent to such responsibilities and requirements.

I have asked Ed Farb, our Recorder, to distribute at this time a one-page summary of the Recommendations on Inflation. Please bear in mind that this represents the conclusions. The actual document will contain back-up material, and will also deal with transitional problems.

I would also call to your attention the presidential address in New Orleans last October. You will recall that Ed Lew made a strong plea for actuaries to come to grips with inflation.

Also bear in mind that, during the period 1953 - 1973, the period of greatest growth in the American pension scene, inflation ran at a compound rate of less than 2% per annum.

I would like to read to you the four Recommendations on Inflation, copies of which you now have.

Recommendation 1: The actuary should take into account any material effects of inflation, and other economic factors such as productivity gains, upon his determination of actuarial present values and pension plan costs. The anticipated effects of inflation, and other economic factors, should be explicitly recognized in every actuarial assumption they affect.

Recommendation 2: If the effect of inflation, and other economic factors, is recognized only implicitly, by the use of altered actuarial assumptions such as offsets in the investment return and salary scale assumptions, the actuary should take particular care to report the effect of such approach upon the valuation. Such disclosure should include the reasons for using an implicit method and a discussion of the implications of not using an explicit technique.

Recommendation 3: Whether the allowance for inflation, and other economic factors, in the actuarial assumptions is explicit or implicit, the actuary has an obligation to disclose his assumptions regarding inflationary effects. If future inflationary conditions are not anticipated on a basis that seems realistic to the actuary, he has a further obligation to indicate approximately what results would be obtained if more realistic inflationary allowances were to be made.

Recommendation 4: The extent to which benefits should be funded in advance of the date when they must be paid is a decision to be made by the plan sponsor, with the assistance of the actuary, in light of many factors, including regulatory requirements, collective bargaining considerations, financial practices, accounting considerations, and alternative uses of money. If the funding pattern differs from the long-term pattern consistent with Recommendations 1 - 3, the actuary should disclose the trend of the funding pattern, and should indicate, at least approximately, the impact of such funding pattern on future pension contributions.

I believe there is little I can add at this point in time. I hope we have stimulated discussion. I believe the most valuable contribution of Exposure Drafts is the discussion which they elicit. We welcome your thoughts at any time.

MR. THEODORE J. KOWALCHUK: The Committee is to be commended for the preliminary recommendations distributed today. I am looking forward to the Committee's final report.

It is highly desirable that the Academy promulgate actuarial principles to be observed in the valuation of the liabilities and assets under pension plans. The principles should provide sufficient flexibility to permit the actuary to select appropriate actuarial assumptions, taking into account the fact that past and anticipated experience among various pension plans may differ considerably. Appropriate guidelines should be adopted by the Academy to minimize the need for specific IRS regulations in this area.

The Academy should also act as a self-policing organization with respect to any abuses that may occur. I would prefer to see the Academy do an effective job of handling possible abuses by any member so the Treasury and/or Labor Departments will not find it necessary to do the policing job for us.

Many of the pension plans with relatively few participants are not currently being serviced by members of the Academy. It would be desirable to have the Academy's principles also apply to such plans in order to protect the interests of the public. I hope that consideration is being given by the Committee as to how this might be accomplished, if in fact it can be.

MR. JOSEPH GOLDBERG:* I am presenting a letter which I sent to the General Counsel of the Pension Benefit Guaranty Corporation on February 28th regarding my original letter. Needless to say I am still without a response.

*Mr. Joseph Goldberg is a Fellow of the Conference of Actuaries in Public Practice, a Member of the American Academy of Actuaries, and is an independent Consulting Actuary

February 28, 1975

Mr. Henry Rose, General Counsel
Pension Benefit Guaranty Corporation
P. O. Box 7119
Washington, D. C. 20044

Dear Mr. Rose:

I enclose for your edification a copy of letter which I wrote to the Corporation on November 22, 1974, and which I referred to in my question to you at the Bar Association meeting yesterday as not having been responded to.

Your reference to the statute which calls for "premium" on all participants appears to be inconsistent with the definition of the word. The word "premium" as used in the statute represents a payment for an insurable interest. Obviously, where no insurable interest exists such as in the case of an annuity purchased before September 2, 1974 it would seem that no premium is due. Had the word "charge" been used rather than "premium" the above discussion might not have ensued.

Very truly yours,

J. Goldberg, FCA, MAAA
Actuary

November 22, 1974

Pension Benefit Guaranty Corporation
P. O. Box 7119
Washington, D. C. 20044

Gentlemen:

At a meeting of the Educational Conference at the New York Hilton on November 19, 1974, Mr. G. Davey made a statement to the effect that premiums payable to the Pension Benefit Guaranty Corporation are to include former members of a plan for whom an annuity had been purchased on a fully guaranteed basis from a third party insurance company.

This statement is in direct contradiction to the third paragraph of the Instructions regarding line 10 on page 5 which states, "retirees receiving or who are eligible to receive benefit payments from the Trust, and deceased participants whose survivors are receiving benefit payments from the Trust." A person receiving a benefit from an insurance carrier is not receiving benefit payments from a Trust and is no different than an individual who retired and elected a lump sum distribution.

Definition #7 of Section 3 of Subtitle A of Title 1 of the act states:

> The term "participant" means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.

Specifically, this definition states, "eligible to receive a benefit of any type from an employee benefit plan". A person who received a lump sum payment, or on whose behalf a lump sum was transferred to an insurance carrier, or a savings bank for periodical distribution, does not, in my opinion, represent a person eligible to receive further benefits from the plan.

It is our interpretation that the payment of premiums applies to plan participants, active or retired, who are subject to the insurance provisions of the Pension Benefit Guaranty Corporation. In view of the deadline for payments, we propose to compute premiums with respect to such bona-fide participants and identify such former participants who have ceased to be either active or retired under a plan. If, upon subsequent clarification of the law, your department still insists that premiums be paid with respect to such former participants, our clients will be obliged to make payment of premiums trusting that their non-payment was made in good faith, and, therefore, not subject to any penalties.

I believe that your interpretation is correct with respect to those participants who elect lump sum or annuity purchases after September 2, 1974 which payment could represent dilution of the assets of a fund to the extent of resulting in a possible liability to the Pension Benefit Guaranty Corporation. In such event, a one-time charge of say $15, representing a life expectancy of 15 years might be the acceptable premium method.

Your earliest response and consideration will be appreciated.

Very truly yours,

J. Goldberg, FCA, MAAA
Actuary

MR. EDWARD H. FRIEND: I would like to submit a copy of my response to a November 18, 1974 letter from John Hanson with which he enclosed a paper submitted to Don McNamara for the Transactions.

December 2, 1974

Mr. John Hanson
Actuary
The Wyatt Company
Suite 4545
One First National Plaza
Chicago, Illinois 60670

Re: Your Letter of November 18 Discussing Problems Faced by the Pension Actuary and Enclosure: "Matching Solutions to Problems in the Pension Actuarial Profession"

Dear John:

I have read your paper with considerable interest and feel that you make some very convincing arguments, which should be considered seriously by the Committee on Actuarial Principles and Practices in Connection with Pension Plans. The following observations and comments would seem pertinent.

It would be wrong to require an actuary to justify results obtained on the basis of a "practice" which differs from "generally accepted practice," when the "different practice" may be more appropriate under a given set of conditions and circumstances than the "accepted practice." Nevertheless, it would not be burdensome to require an explanatory discussion of the circumstances which make the "different practice" appropriate. With such a discussion, there would be no need for qualification, or quantification, of the impact of the use of the "different practice."

You ask two compelling questions:

1. If the actuary uses methods or adopts assumptions permitted by the law that are not the preferred method or assumptions of the committee, what are the implications with respect to the liability of the actuary in a lawsuit?

2. How can an actuary make his 'best estimate' as an individual if he must abide by the preferences of this committee in order to retain his professional standing?

In answer, I would hope that the Swick Committee would not regard itself as the actuarial counterpart to the Accounting Principles Board, and, hence, not fall into the trap of promulgating "preferred" practice. I would hope that it would not set up standards with respect to methods or assumptions. However, I can accept guidelines for their selection, guidelines which provide the basis for selection under "often-encountered" circumstances, but which guidelines make it very clear that "often-encountered" does not mean "usually" and that other choices may be equally good or more appropriate under given circumstances. If asked for a label, I would suggest that the results of this effort be identified as "Principles and Guidelines for Actuarial Practice under Often-Encountered Circumstances." I would hope that the only impact on the qualified, enrolled actuary who deviates materially* from guideline practice would be the requirement that he offer an explanatory discus-

Mr. John Hanson
Page Two
December 2, 1974

sion of how the circumstances differ from those with respect to which the guidelines were developed; not qualify, not quantify, but merely discuss. In addition, and so that there would be no sanctity associated with the guidelines, when the guidelines are followed it would be appropriate to require a positive assertion to the effect that the "often-encountered" circumstances are present and, accordingly, guidelines are being recognized. (Clearly, it would not be unusual to have situations in which following the guidelines would be wrong or inappropriate, but some other course of action would be correct or appropriate.)

You raise the question: "Aside from the potential personal liability of the pension actuary under the Pension Reform Act, is not the lack of credibility of the actuary the single important problem now facing the profession?" You follow with the opinion that "the ability to exercise judgment is the (I prefer 'a' to 'the') hallmark of the work of a qualified pension actuary." You then discuss several kinds of situations that exacerbate actuarial credibility and follow with a proposed alternative approach in which you suggest promulgation of a "series of recommendations."

I am not opposed to your proposed alternative approach, although I believe it would be much more difficult to develop than "principles and guidelines for actuarial practice under often-encountered circumstances." Consider the difficulty in getting a committee of actuaries to agree on "the advantages and disadvantages of each (actuarial) practice and interpret(ing) these advantages and disadvantages in terms of accounting, benefit security, economic, actuarial, and other considerations."

In response to your closing remarks, I would hope that the development of "principles and guidelines for actuarial practice under often-encountered circumstances" would not be a disservice to the practicing actuary, but would instead (i) close the credibility gap, (ii) help eliminate incompetent, inadequate, or purposely deceptive actuarial practice (to the extent that it may still exist) and (iii) provide benchmarks, deviations from which would be regarded as acceptable and quite often appropriate, although each such deviation would have an associated explanatory discussion. All three objectives are interacting. The credibility gap is closed by the benchmarks. The benchmarks are not mandatory standards, but, nevertheless, confront the incapable, improperly prepared, or purposely deceptive actuary. And the opportunity for casting aside the benchmarks (so long as there is an associated explanatory discussion) upholds the integrity and the dignity of the qualified actuary who is exercising his judgment.

Sincerely,

Edward H. Friend

*The words "material deviation" introduce a degree of weakness not found in the expression "inconsistent"; accordingly, it may be well to substitute the words "whose practice is inconsistent with the guidelines."