

RECORD OF SOCIETY OF ACTUARIES 1977 VOL. 3 NO. 4

THE REALITY OF PROFESSIONAL CONDUCT

Moderator: DALE R. GUSTAFSON. Panelists: DAPHNE D. BARTLETT,
W. JAMES MacGINNITIE

MR. DALE R. GUSTAFSON: Some say the hallmark of a profession is meaningful observance and enforcement of its Guides to Professional Conduct. In this session, you will observe a series of dramatizations. Presenting these scenes with me will be my co-panelists, Daphne Bartlett and Jim MacGinnitie. Actuaries at all organizational levels, both in companies and consulting firms, should identify at least one of these imaginary situations as being close to home. After each small drama, you may be asked to respond to a question or two. You may even be asked to judge relative guilt and innocence.

SCENE 1

Place: The President's Office at the Eat'Em Up Alive Life Insurance Company. A discussion of GAAP interest assumptions in the context of the development of a new portfolio, and the current year's earnings.

Background Setting: Historically, the pricing for this company's non-participating portfolio has involved the use of interest assumptions which approximated the new money yields after tax in the first policy year and graded down very steeply to equal the statutory valuation interest rate at the 20th duration. It was recognized that there was some conservatism in these assumptions, and thus the interest rates used in calculating GAAP reserves were exactly equal to those used in the pricing.

When the new portfolio was developed, it was realized that yields in the past had not decreased as sharply as had been presumed. The actuary who was developing the interest assumptions happened to be very expert in the investment area, and performed very complete analysis, reflecting rollover and policy loan incidence, to come up with a scale of interest rates by duration for use in pricing which used the new money rate for the first policy year, but decreased very gradually over the 20-year period, so that the 20th year rate was significantly higher than the valuation rate.

Because it had always been the practice in the past, the GAAP reserves were calculated using the pricing interest assumptions. Thus, the first year GAAP reserves were significantly lower than those which would have developed had a steeper declining interest table been used.

The outside auditors commented on this, suggesting that the interest assumption was too liberal for GAAP purposes, citing as justification the fact that most other companies with which they were familiar reported using a level interest rate for GAAP reserves, or one which decreased more rapidly. The accountants especially approved of Conservative Life, which uses a level rate. They commented on this in their letter to management. President MacWhirlwind calls his chief actuary (Bowenscraper) and his assistant (Higherprinciple) into his office to discuss the matter:

- MacWhirlwind: What's all this fuss about interest rates, Bowenscraper? If we change these interest rates to make them level, like Conservative Life's, what would happen to this year's earnings?
- Bowenscraper: It would hurt, Sir. Isn't that right, Higherprinciple?
- Higherprinciple: About \$5 a thousand. But we really ought to change. I didn't know that Valuation was going to use those assumptions for GAAP reserves, and there has to be some conservatism. Conservative Life has very good actuaries. If they're using a level interest rate, it's probably the way to go.
- MacWhirlwind: The Sales Vice President of Conservative Life is always complaining about his actuaries padding things. Why do they think a level interest rate is better than the one we're using?
- Bowenscraper: Good point, Sir! If we think our interest assumptions are right, why should we change them just because Conservative Life does it differently?
- Higherprinciple: But theirs are more conservative than ours, and the GAAP reserves are supposed to be a little conservative.
- MacWhirlwind: Well, I know you actuaries. I'll bet you've got a little padding there.
- Bowenscraper: Right again, Sir! Higherprinciple, do you really think that new money rates are going to decrease, as you assumed?
- Higherprinciple: I don't know, but they might.
- Bowenscraper: But maybe they won't, and so perhaps your assumptions really are conservative.

THE END

Questions

1. At this stage, is this a professional conduct question or just a disagreement?
2. Remember earlier in the script Higherprinciple says, "Conservative Life has very good actuaries. If they're using a level interest, it's probably the way to go." Are you comfortable with that easy reliance on the other company's methods?

SCENE 2

Place: A pension consultant's (Betterandbetter) office. He is discussing ERISA compliance with a visiting friend (Hellinahandbasket) who is also a pension consultant.

Background Setting: ERISA requires that the actuary provide his best estimate of the plan liabilities, and that he act for the sole benefit of the participants and beneficiaries. He is, however, engaged by the plan administrator, who is often the plan sponsor. That this leads to some pressure seems inevitable.

Betterandbetter is in his office reading, when he hears a knock at the door. He opens the door and admits Hellinahandbasket.

Betterandbetter: Hellinahandbasket, how are you, what a pleasant surprise? To what do I owe this?

Hellinahandbasket: I just finished a rough session with the benefits and financial people over at Punch-n-Chisel. That client has caused me more difficulty than all of the rest put together.

Betterandbetter: What's the trouble this time? Contribution level?

Hellinahandbasket: Is it ever otherwise? Last year it was the salary scale, this year the interest rate. It is particularly intense this time, too. They want to improve the benefit levels, and they really should to keep themselves competitive in their labor market. But, earnings haven't been very good, and they say they just can't stand an increase in contributions. So they want me to raise the interest rate assumption.

Betterandbetter: What's so bad about that? Interest rates have been rising, you know.

- Hellinahandbasket: A little bit, perhaps, but I was already near to the upper limit of what I would call a best estimate and the recent increases have only made me feel a little less uncomfortable. The other thing that bothers me here is that the benefit improvements they want to make will reduce the benefit security ratio of a lot of their lower priority employees.
- Betterandbetter: I have a client with a similar problem. But it seemed to them, and to me, that increasing the interest assumptions and holding down the contribution helps the company prosper and in the long run that can only help the employees and improve the real security of their benefits.
- Hellinahandbasket: You don't have to give me that argument too. I heard it, in various guises, all during today's meeting. And there is some truth to it. But I end up saying that I can't go any further this year on the interest assumption and still say that it is my best estimate. Just last month I signed off on a plan that is very comparable, both in benefits and portfolio, and the interest assumption was less than I am already using here. There is no way I could justify both that and what they want me to do here as my best estimate.
- Betterandbetter: Why not? As long as the assumptions aren't unreasonable, and the administrator says that is what he wants, I say it is a best estimate. The Society's Guide 4c even goes so far as to tell you how to qualify reports that use unreasonable assumptions. So what is wrong with using the client's assumptions so long as they are not unreasonable?

THE END

Questions

1. Is it possible that two valuations using significantly different assumptions on comparable plans can both be best estimates?
2. Was Hellinahandbasket justified in discussing his client's problem with Betterandbetter identifying specifically the client?
3. When should a client be allowed to specify assumptions? Does Guide 4c conflict with ERISA's best estimate requirement?

Mr. GUSTAFSON: In preparation for the next question let me read to you from the Guides to Professional Conduct of the Society of Actuaries.

- 4b) "The member will exercise his best judgment to ensure that any calculations or recommendations made by him or under his direction are based on sufficient and reliable data, that any assumptions made are adequate and appropriate, and that any methods employed are consistent with the sound principles established by precedents or common usage within the profession."
- 4c) "If nevertheless, a client or employer requests the member to prepare a study which in his opinion deviates from this practice, any resulting report, recommendation, or certificate submitted by him will include an appropriate and explicit qualification of his findings."

Also let me read to you the following:

The Constitution of the Society of Actuaries refers to five levels of misconduct. The first three levels are identified with the words warn, admonish and reprimand, and specify that no public identification of the offender may be made. The toughest two levels call for suspension or expulsion from membership and, obviously, the action will be published. Perhaps it will be helpful to characterize these five levels this way. These are my definitions:

Warn: You really have done wrong, but you weren't aware that what you were doing was wrong. Don't do it again, now that you understand.

Admonish: You have done wrong and didn't realize your action was wrong, but you should have realized it. Don't repeat the action and be more aware in the future.

Reprimand: You have done wrong and you know that what you did was wrong. Your action was inexcusable, but not serious enough to call for public censure.

In all three of these levels it would be made clear that continued violation would be considered much more seriously.

Suspension: The wrong doing was flagrant enough to call for public censure and serious punishment. The period of suspension could be short or long.

Expulsion: The offense was serious enough to call for permanent removal from membership, although reinstatement is theoretically possible through Board action, with confirmation of the reinstatement by a vote of the Membership at a meeting.

DISCUSSION—CONCURRENT SESSIONS

Now another question . . .

4. If Hellinahandbasket gives in at Punch-n-Chisel, and provides the increased interest rate as requested and gives an unqualified opinion, is he in violation of the Guides to Professional Conduct?
5. Think for a moment - you are a member of a disciplinary committee hearing this offense. Would you think this offense calls for a warning, admonishment, reprimand, suspension, or expulsion?

SCENE 3

Place: This is a Society of Actuaries Disciplinary Hearing. A charge has been brought by an insurance department actuary against an insolvent company's group actuary for establishing Group Health claim reserves on the basis of a commonly used table even though the company's own credible experience appears to call for substantially larger reserves.

Background Setting: The portfolio of Insolvent Life consisted mainly of group life and health coverages, and some individual life insurance. Most of the group cases in force were small pooled cases, but there were also several very large experience-rated cases. Insolvent Life had recently undergone an insurance department examination at which questions had been raised about the adequacy of the claim reserve and the table used for valuation. They had been answered to the apparent satisfaction of the examiners. The Company stated that:

1. The poor experience was, in general, attributable to the experience-rated cases, and it was planned to reduce the refund on those cases.
2. Rate increases on all cases were in the process of development and would be imposed shortly.
3. The reserves on the Ordinary Life line were conservative, and, thus, in aggregate, the company's reserves were adequate.

Now that the Company is, in fact insolvent, the Insurance Department Actuary (Departmentacturius) has been asked by his Commissioner to defend his actions. His response is to bring charges against the Company's group actuary, Groupisgreat. The hearing officer (Ineversinned) begins:

Ineversinned: Groupisgreat, why did you use the commonly used table when you knew your experience was worse?

- Groupisgreat: Well, we were planning on these rate increases to help us out. Also, our poor experience may have only been a fluctuation. And third, it was blessed by the Insurance Department in the examination.
- Departmentactuarious: Wait a minute, I didn't "bless" the use of that table. I considered all the arguments you gave me, and decided that some of them made sense. I had intended to conduct another examination the following year to see if you had followed through, but the Department didn't have enough personnel to do it. I consider that it is the actuary's responsibility to set up adequate reserves whether or not the Department puts pressure on him to do so, and you certainly didn't do that!
- Groupisgreat: Well, as you know, I was hoping that all these rate increases would go in, and that we could reduce our refunds. But there was all this competition. We would have lost a lot of our big cases if we'd reduced the refunds as much as I wanted to. We did put in a rate increase, but again, for competitive reasons, we couldn't go as high as I would have liked.
- Ineversinned: When you knew all that, why didn't you increase the reserves the following year?
- Groupisgreat: I really did feel I had some implicit blessing of the table I had been using from Departmentactuarious. Also, our experience had improved a little, and so I convinced myself that, in the long run, the table was correct. And of course, you all are aware of the management pressure on the actuary when setting claim reserves. I couldn't prove that a higher reserve was necessary, and management didn't want to impact earnings by the amount of increase that would have been required.
- Departmentactuarious: I think it's just terrible the way you company actuaries can't resist management pressure.
- Ineversinned: I'm not sure you're completely innocent in this matter, Departmentactuarious. It is difficult for actuaries to resist pressure in circumstances such as these. Groupisgreat could, perhaps, have used your help at the time of the examination.

THE END

Questions

1. Is this a professional conduct question for Groupisgreat? And at which of the previously mentioned five levels?

2. Is this a professional conduct question for Departmentactuaribus? And at which of the previously mentioned five levels?
3. Is it ever proper to set reserves lower than experience would indicate?

SCENE 4

Place: In a major mutual company, a dividend scale increase is under consideration. There is controversy about the relative increase in dividends for the company's leading sales plan, the Wonderful Wizbang, and the rest of the individual policy portfolio.

Background Setting: The time is September, 1977. It has been decided that a dividend scale increase for 1978 will be recommended to the Board of Directors at its meeting in a few weeks. The general amount of the increase that will be recommended has been determined. Most of the details of the dividend scale have been worked out. The only factor still under question is the mortality differential between The Wonderful Wizbang and the other plans of insurance. The Wonderful Wizbang was designed to be especially attractive to the very competitive, financially sophisticated market. It was introduced seven years ago. The Wonderful Wizbang has a high minimum size, and while it is not underwritten specifically as a preferred risk policy, it was expected at the outset that the high average size and the sophistication of this market would produce significantly lower mortality than for the company's other plans. The initial pricing assumed a 10% better mortality than the other plans of insurance in designing the initial dividend scale.

Whitaker-Henderson is responsible for mortality investigations for the company and also for the mortality factors in the dividend formula. He has always been concerned about that assumed 10% differential in mortality, and as a part of his most recent mortality investigation for the company, he ran a separate study on the mortality experience on The Wonderful Wizbang. Of course, this experience was quite small and included only the first five policy years, but nevertheless he was somewhat comforted to observe that the mortality ratio was only 70% of the corresponding ratio for all of the company's other plans. However, the experience was so small that standard statistical analysis indicated that the difference was not statistically significant.

As we enter the scene, the Sales Vice President, Sellensellensell, is speaking to the Chief Actuary, Smoothrunningship and his assistant, Whitaker-Henderson.

- Sellensellensell: ". . . and I am so pleased that your mortality investigation confirms that we are indeed experiencing better mortality on The Wonderful Wizbang. When you reflect that 30% result in improved dividends for The Wonderful Wizbang, our sales enthusiasm and sales results will be a marvelous thing to behold. I just can't wait to start announcing this good news to the field."
- Whitaker-Henderson: "But wait a minute. It is not my intention to reflect that small sample 30% result in actual dividends. I am just pleased that this little experience shows that there is some mortality difference. I am content to continue with the 10% differential we originally assumed."
- Sellensellensell: "What? Here you have got real spectacular results, and I suppose you want to wait another five years to make another one of your studies before we can take advantage of this wonderful piece of work that our marketing and underwriting people have accomplished. It is just like you actuaries, carrying things out to the tenth decimal point without regard to the important opportunities and extreme value these results provide for the company."
- Smoothrunningship: "Let's not get excited. I am sure we can work this out. As I view this situation, it really is a judgement call. In considering the implications of the mortality investigation, sales potential, and the strength and satisfaction of our very important field force, it may well be that we have a very important synergistic effect at work here.
- "You are certainly correct, Whitaker-Henderson, in pointing out that our mortality experience on The Wonderful Wizbang is limited. However, it is also true that however limited, the results are very good."
- Whitaker-Henderson: "You mean, Sir, you want my report to the Board of Directors recommending the mortality factors for the 1978 dividend scale to include a 30% differential for The Wonderful Wizbang.
- Smoothrunningship: "Yes. I think it would be appropriate for you to include a general, layman's description of the mortality investigation, including some reference to its relatively limited scope. However, the specific technical statistical tests for significance are probably a little bit too complicated for the Board to understand, and besides I am not entirely sure they are really valid for our purposes."

Whitaker-Henderson: "I want to think about this a little more. I believe I will be able to prepare my report along the lines you have suggested, Sir, but I am afraid that I will remain quite uncomfortable with it."

Sellensellensell: "I can see that you two have reached a good agreement. I am quite sure that none of us will ever have any cause for the slightest regret for this very forward-looking, constructive decision."

THE END

Questions

1. Is it okay for Whitaker-Henderson to give in this easily about not referring to statistical significance in his report?
2. If prepared as described, will Whitaker-Henderson's formal report comply with the Guides to Professional Conduct?
3. At a disciplinary hearing, could charges be brought against Smoothrunning-ship?

SCENE 5

Place: Billing\$, a consulting actuary for Factor and Value is in his office. His assistant Nervous Nellie Backroom is at her desk calculating values and entering them on a worksheet.

Background Setting: Goodclient is the financial vice president of a moderate-sized, rapidly growing company that markets through franchised dealers. His company has been a client of Factor and Value, consulting actuaries, since the beginning of its pension plan several years ago. The relationship has been a good one for both client and consultant.

Billing\$: (Hanging up phone, then checking watch):

Finished that just in time. Goodclient is due here any minute. He didn't say what he wanted, but probably is interested in discussing an improvement in the benefit structure.

(A knock is heard at the door, and Billing\$ answers, welcoming Goodclient.)

Billing\$: Good to see you.

Goodclient: Nice to be here.

- Billing\$: You remember Ms. Backroom, I'm sure. I asked her to join us since she's just been working on your valuation.
- Goodclient: I'm glad that you did. With new problems, three heads are always better than two. I came to see you about a problem that we've had for some time now that has become so bad that we're being forced to do something about it. Both our dealers and ourselves have had our premiums for products liability coverage raised unreasonably in the last few years, and now the underwriters are refusing to renew our coverage at any price. Our actual experience looks pretty good, at least to me. Last year the losses were only about \$200,000, but the premium was well over \$1,000,000.
- Billing\$: Gee, that sounds pretty unreasonable alright.
- Backroom: Were those losses reported, reserved or what, Mr. Goodclient?
- Goodclient: That's what they paid. Insurance companies set up enormous reserves on every claim notice they get, but they never pay them. As a good finance man, I watch the cash transactions. Anyway, we've pretty much decided to set up our own captive insurance company to handle this, and we need some actuarial work to get it started. Since you people are good actuaries and have given us good service in the past, I wanted to come by and see if you couldn't do the work for us.
- Billing\$: Wonderful! Always happy to be of service. What do we need to prepare for you?
- Goodclient: Well, the lawyers say we need to have rates, forms, five-year financial projections, and your recommendation as to capitalization, retention and reinsurance.
- Billing\$: Great! Fine! Shouldn't be any problem at all.

(Phone rings. Billing\$ answers, then turns to Goodclient)
- Billing\$: It's your office.
- Goodclient: Must be the lawyers; I told them I'd be here.

(While Goodclient is on the phone)
- Backroom: Mr. Billing\$, I'm afraid this is over our head. We don't know anything about production liability.

DISCUSSION—CONCURRENT SESSIONS

- Billing\$: Products Liability, Backroom. But we can always figure it out. From what I hear, nobody else does either.
- Backroom: There must be some consultants who could help. We could refer him to them or maybe even joint venture a subcontract.
- Billing\$: The last time we did that we lost a good pension client to the other firm. Nothing unprofessional, mind you, just a case where they liked the other firm better after they got to know them. Besides, getting another consultant in would be expensive and time consuming. He needs some answers fast, and we can help him as well as anyone. We can use our contacts to fill in the gaps in our knowledge, and we already know how to do the financial projections.

THE END

Questions

1. Was Billing\$ justified in his reluctance to bring in another consultant?
2. Does Backroom have a professional conduct question in the offing?
2. Are there circumstances where accepting assignments in unfamiliar areas is justified?

SCENE 6

The final part of this program is a taped interview with an individual who has been subject to a severe professional conduct process as well as both civil and criminal actions. Because there are still some issues outstanding, the individual will not be identified.

I must tell you that I am very impressed with this person's generosity in being willing to take part in this program. This is not going to be a rehash or rationale for what happened, but rather our purpose is to try to find insights in what happened to increase your sensitivity to professional conduct, and perhaps better prepare you to avoid troublesome situations.

This interview is presented in a question and answer format.

- Q Can you identify the beginning of your involvement in this situation?
- A Yes I can, Gus, but before I do, I would like to reiterate something you stated before this tape was started. That is, I am here to discuss reasons for my involvement. What I did was clearly wrong. I recognize that now and I recognized it when it was happening. I am not going to try to justify what I did, but rather I hope to give you some insight

as to the thought process that was involved. In answer to your specific question, at one point I was asked to do something which, while not clearly unprofessional or criminal, was somewhat of a strange practice. At the same time it was implied that there were some problems which existed in the parent company. When I agreed to the request, I became involved, not so much because of the act, but because of a vague awareness of problems which existed elsewhere.

Q Do you think that you would have been less likely to get so deeply involved if you had had a greater awareness of the Guides to Professional Conduct?

A I really don't think so. I have read the guides several times, not only when I was Fellow of the Society, but during the criminal proceedings I went through, and also just before we met for this interview. I know what I was involved in was wrong and I view the codes of conduct as simply very specific statements of what is right and what is wrong or what is ethical and what is unethical.

Q Were economic pressures an ingredient in your becoming involved and continuing to be involved?

A I would say yes to the extent that when I first became involved, I was a young and struggling family man. I had three children, heavy mortgage payments and no money in the bank. As a result, there definitely was a fear of the loss of my job.

Q What are the things that kept you involved and kept you with it as it developed?

A As I stated earlier, I didn't feel that the first thing which occurred was unprofessional or criminal. However, when it got beyond that point, when it got to the point where I knew that what was happening was clearly wrong, then there were several things which contributed to my staying. The major factor was the issue of economics which we discussed earlier. I felt that I just could not afford to simply walk out and be unemployed for some period of time. Secondly, the first clearly wrong thing done with my prior knowledge was advertised as something which was going to be done just once in order to cure problems which had been created prior to the time I joined the company. My attitude was that if it was going to be only once, and if in the long run it was going to benefit the company and its stockholders, I would not object strenuously. Needless to say, the things which happened didn't occur just once, there was a massive snowballing effect.

Another factor was the substantial number of good things going on in the company. For example, the company was doing some very excellent research work in the area of new product development. Although the financial reporting posture of the company became untenable, I tended to bury my head in the sand so to speak and look at only the positive side, hoping that the negatives would go away. Lastly, there was the issue of loyalty to the company. To a certain extent, I felt that the company was paying me a salary and, therefore, senior management had a right to expect me to do what it thought was appropriate.

Q I know this seems like an obvious question, or the answer to it seems obvious, but I want to ask it anyway. If you had it to do over, what might you do differently?

A I guess in a sense the question is obvious. Simply, I would leave the minute I sensed improprieties. However, I don't think that you intended the question be that simple. If I had it to do over again, I would fight top management harder than I did. I think that I also would attempt to seek outside counsel.

Q By outside counsel, you don't necessarily mean a lawyer, you mean just someone that you could confide in and discuss the situation.

A Right, preferably another actuary, in whom I could confide in order to get some objective answers rather than answers or opinions which were derived from my own possibly nonobjective viewpoint. In the event these actions resulted in the conclusion that the situation was wrong, then immediate resignation would be in order. The economics in the final analysis were not all that important. I should have known that at the time when I could have gotten out and still had a profession, the actuarial profession, to stay in. This is one of the most significant things I learned from the experience. In spite of the fact that I was fired and forced to leave the life insurance industry, I was able to succeed. I was able to support my family, and build another career.

Q I think this is going to be my last question, and you have given parts of the answers as we have gone along, but I would like you to try to pull together here - all in one piece - from this experience that you have been through, what are some of the signposts or earmarks of situations that might lead to trouble?

A In answering your question, I will try to give you several signposts I should have seen along the way or before I knew there was something clearly wrong. I don't believe any one is necessarily a negative all by itself. However, if several of these items are present in combination, then there may be a problem worthy of consideration. The first thing I probably should have paid more attention to was difficulties with various insurance departments and the SEC. I am not talking about a fine once every ten years for issuing a policy on a form which hasn't been approved because of a clerical error. However, excessive problems every year I think is a pretty definite signpost.

I also don't believe there is any such thing as being a little bit pregnant. If management starts demanding small things in order to improve profits, then it strikes me there is every risk that the next time the request will be a little bit greater and the next greater and so forth.

Another key indicator may be detection of difficulties or unprofessional or criminal conduct in one but not all divisions of the company. This situation is like a cancer which will spread to all parts of the corporation.

I think another significant factor is the company's overall attitude toward not only its policyholders, but its employees. If a company has a basically fair attitude toward these two groups of people, the chances are greater that the same attitude will prevail toward preparation of its financial statements.

The final point I would like to make relates to companies which create emphasis on bottom line results. In these situations, the question always arises as to what lengths the company is willing to go in order to achieve a satisfactory bottom line result.

MR. WALTER STEFFAN: That interview suggests an ethics question. If you were the actuary with whom another actuary sought confidential conversations regarding a professional conduct question, presumably you would suggest he report the incident to the proper people. If no action was taken, is there a professional conduct question for the member holding that confidential information?

MR. DANIEL F. CASE: If the Society wants its members to consult with other members when they are faced with a professional conduct question, then I think it needs to be clear that the member who is consulted does not need to report anything that is revealed to him in the consultation. On the other hand, if a member learns something independently about questionable actions by another member, then I think he has a duty to the Society whether or not the other member is a personal friend. There might be combinations of these two situations, wherein a member would consult with another member in confidence and the other member might subsequently become aware through independent channels that the first actuary was doing something questionable. In such a situation, I think the second member could report any of the first member's actions which came to his attention independently without being considered to have violated the confidence.

