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NEW STANDARD VALUATION LAW (SVL)

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The new SVL has expanded the scope of the valuation actuary. How are the actuaries responding to:

- Risk of legal liability?
- Vagueness of actuarial standards related to adequacy testing?
- Reliance on other company experts?
- Consultants versus company actuary perspectives?
- The science versus the art of the process?

MR. DANIEL J. KUNESH: Dr. Dreyfuss, the keynote speaker for this meeting, very eloquently used his wit and wisdom to look into a "crystal ball" to see the future over the next thirty years. Wouldn't it be wonderful if we as valuation actuaries had that same crystal ball? Unfortunately we do not, and we are in the real world, as it stands today, with real problems, inclusive of legal liability.

For several years now, actuaries have been in an era of transition. Passage of the new SVL with its accompanying regulation, which requires rather complete and revealing documentation about our companies, including the valuation procedures we use and our assumptions, has presented us as valuation actuaries with a new challenge. This challenge places us in an unwanted limelight and may even expose us to an unprecedented level of legal exposure; we hope not anywhere close to what the accountants have experienced over the last several years.

We're going to explore some of these exposures and discuss just exactly what the newly expanded scope of the valuation law means to our profession. We are privileged to have three very qualified speakers on the topic. We have an attorney quite familiar with the legal liability issues confronting professional groups and two valuation actuaries from sizeable companies to give you their perspective on various aspects of the process.

Our first speaker is a guest of the Society. However, he is certainly no stranger to us. He has spoken recently to our Fellowship Admissions Course participants. Mr. James Gorsline is an attorney in the bankruptcy and commercial litigation department in the Atlanta office of King & Spaulding. It's the firm that Tillinghast uses when we have a special need for legal assistance. Jim is also a CPA, has received his law degree from the University of South Carolina, and is a member of the bar in Georgia, South Carolina, and I believe, various federal courts. Jim will define professional liability for us, and will tell us what it means to us as actuaries, particularly valuation

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actuaries, in our efforts to comply with this new law. I hope he will also tell us how we can react or behave to limit our exposure to legal liability.

Then we'll move to our second speaker, Karen Olsen MacDonald, the valuation actuary for Transamerica. She will share some of her experiences and perspectives and address the issue of reliances. Karen will be followed by Paul Bell, the valuation actuary for some of the American International Group companies. Paul will also share some of his experiences and perspectives and will focus on the art versus the science of the process. If time permits, I will share some perspectives as a consulting actuary on the topic of legal liability.

MR. JAMES N. GORSLINE: I've spent the better part of the last seven years defending professionals whose judgments are attacked by people who have lost money. I represent mostly accounting firms, including several of the Big Six. I've had several lengthy jury trials involving large accounting firms, and I represent a couple of different actuarial firms and have tried a couple of their cases. Let me say at the outset that my personal experience has been more in the property/casualty side rather than the life side, and I've not had the occasion to represent valuation actuaries. The principal reason for this bias in my experience is that most of the litigation involving actuaries has been on the property/casualty side. That's not to suggest, however, that you won't be involved in litigation in the future and that there is no reason to be concerned.

There are general concepts that apply and some themes that I've seen throughout the cases that I've handled, for both accountants and actuaries, from which we can draw some lessons. I hope they will prevent you from being sued in the first instance, and, if you are sued, will increase the likelihood that you will ultimately prevail in the litigation.

Let me first address the question about whether actuaries should really be concerned about professional liability. Is this something that's worth worrying about? Is it a real threat, or is it just something that fills the time in society? I believe it is a real threat. Even though actuaries have not been subjected to litigation much in the past, the trend is that more actuaries are being sued. It's helpful to look at what has happened to the accounting profession.

Twenty years ago, accountants were where actuaries are today. There were few lawsuits against accounting firms. Today there are few lawsuits against actuarial firms and against actuaries. As you all know, however, we have an overabundance of lawyers in this country, and an attitude prevails that, if you suffer a monetary loss, it's not your fault. It's someone else's fault and someone else should compensate you for your loss. Couple this with the fact that we have a contingent fee system wherein a person who loses money can sue and try to obtain a recovery without it costing him anything. The lawyer "bears" the cost by charging a third of whatever they recover. This system gives people who lose money an incentive to initiate litigation, whether or not the litigation is warranted.

What you're now starting to see is that, whenever an insolvency occurs, litigation is always pursued against the professionals that were involved with the failed company. We've seen it with the savings and loan situation. Who is getting sued? The answer is lawyers, former officers, directors, and the accountants. I suggest that as more insurance companies fail in the future, there's going to be more litigation because, when an insurance company fails, people who lose money, whether they be policyholders, the state insolvency fund, or the investors of the company, all will be looking for somebody to help make them whole. I believe that the plaintiffs' bar is becoming more attuned to suing actuaries, and as time passes, actuaries will find themselves being named as defendants more.

Regardless of whether you're a consulting actuary or work for a company, there are several reasons why you should be concerned about professional liability. First, each of you is a professional, just like doctors, lawyers, and accountants. You're becoming visible in the press, and people are recognizing that actuaries are professionals. The law today is evolving to a point where all professionals are starting to be held liable for their actions. Engineers are being held liable. Architects are being held liable. Anybody with a professional job, like actuaries, is becoming more liable. Ironically, as your profession develops more professional standards, you're going to see more litigation.

Second, plaintiffs are becoming less reluctant to name only entities as defendants in lawsuits. Many of you may be covered by directors and officers insurance. A plaintiff's lawyer certainly does not know. If he represents somebody who has lost money in a failed insurance company situation, he is going to name as a defendant anybody and everybody who he thinks might be able to contribute to a settlement in an effort to gain a large recovery on a jury verdict. The fact that you may be covered by insurance may actually prompt a plaintiff's lawyer to name you, thinking that he can tap into that insurance.

Another reason why you may end up getting sued is that there's a chance that your employer will sue you. Or if your employer is sued, he may set you up as the responsible party and argue that you acted outside the scope of your authority and that your acts cannot make the employer liable. The chances that this may happen may seem somewhat remote, but they do exist.

The fourth reason why you should be concerned about legal liability is that you have a reputation to protect. You should be concerned about your reputation, even if you are an employee of an insurance company with or without directors and officers insurance, and even if you perceive your own personal financial situation to be such that you don't have enough assets to interest a plaintiff's attorney who is wanting to recover a lot of money. Even though you are not personally named in a lawsuit, you can be dragged into a lawsuit if you get into a situation where there's litigation. So you still need to be careful at all times.

Let me summarize some of the things that have happened in the last fifteen years involving accounting firms. In 1985, accountants spent 1% of their total revenues in verdict settlements and defense costs. Five years later, that figure jumped to 7.7% of total revenues. In 1990, Laventhal, the ninth largest accounting firm, filed for bankruptcy because of its litigation problems. In 1991, the figure jumped to 9% of total revenues, and in 1992 the figure exceeded 12%. You can see that this is a major problem for accountants, and I believe that's where actuaries are also headed.

Let me summarize three 1992 lawsuits involving accountants. In February 1993, a Texas jury hit Coopers & Lybrand in the Miniscribe case for $200 million in punitive damages. That was fifty times larger than the actual damages suffered by the plaintiffs. Coopers eventually settled that case for $60 million, but then another case was brought up by investors. Then the trustee in bankruptcy on behalf of Miniscribe's competitors sued Coopers in bankruptcy court and settled for another $95 million. In May, Price Waterhouse was sued for $338 million. The case is currently on appeal. The claim is 2,400 times the amount of money that Price Waterhouse earned on that audit. If the verdict stands on appeal, it will cost every Price Waterhouse partner over $300,000. Last summer Ernst & Young paid the FDIC $400 million for all of its involvement with the failed savings and loan industry. The government was willing to accept that only because Ernst & Young convinced the government that that's all the money Ernst & Young could afford, not because that's what it was liable for. The next plaintiff that sues Ernst & Young may not be so kind.

There are a lot of other examples, but the lesson that you can learn is that each of these cases resulted from company failure or an insolvency. I believe most litigation involving actuaries will result when an insurance company fails, because when a company fails, people lose money and they look to somebody else to try to compensate them. I could talk about the increases in malpractice premiums, but time is limited.

There are several reasons why I believe actuaries are going to be sued more in the future. The first reason is that the plaintiffs' bar is waking up. Plaintiffs' attorneys are becoming more attuned to anybody who might be a potential source of recovery. Ten years ago, most attorneys didn't even know what the word *actuary* meant. Today they recognize that actuaries may be a potential source of funds, so they're starting to sue them.

A second reason is the scope of this meeting. Recently, there has been more agency rule making. The perfect example is the new SVL that a lot of states are passing. This is an excellent example of how agencies or states are getting into the picture, passing rules and regulations that are going to increase the expectations of what is required from actuaries. Whenever you increase someone's expectations, you have a situation that eventually leads to increased litigation. This has been a problem facing the accountants. The general public thinks that a clean opinion guarantees that nothing is wrong with the financial statements, that they're 100% accurate, and that no fraud exists in the audited organization. That's the public's expectation. Increased rule making leads to increased expectations and eventually increased litigations.

There's increased competition among accountants and among actuaries today. Everybody is going after the same business. Obviously this is more a problem for consultants, but it's a reason why there may be more litigation in the future. At the consulting firms, "rain making" is rewarded. If you bring in clients, you're rewarded, and often you don't have the type of quality control procedures in accepting new engagements that you should have.

Loss shifting by others is a reason why actuaries get sued. I'm representing an actuarial firm right now that's being sued by Deloitte Touche. My client was sued by the state insurance regulator of a failed savings and loan Deloitte Touche's defense has been reliance on the actuary. According to Deloitte Touche, this reliance makes it the actuary's fault, and so the insurance commissioner sued the actuary.

Another reason for litigation is that there's increased third-party reliance. There has been a lot of activity among insurance companies, as many companies are being bought and sold. As part of their due diligence process, buyers are relying on actuarial reports that have been filed with the regulators. Whenever you have somebody relying on your work, if that reliance proves to have been misplaced, it can lead to litigation.

We're now seeing that agencies are suing frequently. Whenever an insurance company fails, the state regulatory agency steps "into the shoes" of the company, operates the company under a receivership or liquidator type arrangement, and ends up suing the actuary.

Another reason is that there are many available experts. There are people who make their living second guessing your work and throwing stones at it, with the benefit of hindsight. The fact that they're available is leading to more litigation. Also, there are many laws that govern conduct. You know more about that than I do. There are tax laws, ERISA laws, securities laws, new accounting standards, and now new actuarial standards of practice.

Then there's the attitude that from a company's perspective, the services you provide are more of a commodity than a service. This type of attitude is going to lead to increased litigation.

Downsizing also affects the relationships that companies have with their actuaries. Finally, you've got the deep pocket theory. When you add all this to the general economic and recessionary conditions in this country, you have a lot of reasons why actuaries may be sued a lot more in the future.

I will now briefly discuss some of the theories that a plaintiff's lawyer can use to sue an actuary. These are legal causes of action. There are five overall areas or theories that you can be sued under, because the law is a malleable enough thing where in the hands of a skillful plaintiff's attorney, if somebody has been injured, you can usually find a way to get that person compensated. So even if your actions may not technically fall into one of these five areas, a good plaintiff's attorney can figure out some way to sue you.

Let's look at the classic causes of action. First there's breach of contract. It's probably the most common claim against an actuary. The plaintiff has to show that the actuary failed to perform material terms under an agreement.

Then you have negligence, which is just a failure to exercise due professional care or failure to follow professional standards. Then you've got fraud, breach of fiduciary duty, and finally various statutory claims.

Your goal ought to be to avoid getting sued. If you will follow some of the following suggestions, I think you can do just that. The first lesson that I've learned from all the cases that I've handled representing professionals is that appearances are vitally important. If something might look suspicious to an outsider, you can assume that most people will believe that those suspicions are well-founded. What that means, if you're a consulting actuary, is that you first must choose your clients with care. Conduct an investigation of them before you accept them as clients. You've heard the sayings that, if you lay down with dogs, you get fleas, and if you run around with pigs, you get muddy. If you're doing work for clients whose operations are not above board, some of that dirt is going to rub off on you.

Second, avoid conflicts of interest. I can't tell you how much plaintiff attorneys love to find conflicts of interest, because most people, particularly those in the political arena, just assume that conflicts of interest are always bad. Even if you disclose them at the front end, they look bad to people, and they will invariably cause problems.

The third suggestion is one that applies equally to consulting actuaries. I've had lawsuits where there have been "to do" lists left in the workpapers that we've had to produce to the plaintiffs, and it was messages like "Did Todd check with the client to make sure the incurred triangle for accident year 1985 is correct?" There was no evidence of any effort to clear the list. You just have this open "to do" note in the file that you have to turn over to the enemy. I can't tell you the damage that it does to your case. You have to clear those open notes, otherwise it creates the appearance that you didn't do everything that you needed to do. This one really speaks for itself.

Another suggestion involves the major premise that hindsight is 20/20. What I mean by this is, judgments that each of you make on a daily basis as actuaries are second-guessed if things don't turn out exactly as planned. When you recognize that hindsight is 20/20, there are a couple of recommendations that I would make to help you reduce your litigation exposure. First, before you finish an engagement or before you sign the opinion that's required by the new SVL, look at the big picture. Second, don't apply your rules mechanically. Sit back and actually think about the whole thing before all you do is run a bunch of spreadsheets, add up the numbers, and say this is what it is. Never lose the forest for the trees. Look at the big picture, and don't apply rules mechanically.

Another suggestion applies equally to consultants and to the folks that work in-house. Document all of your judgment calls. Litigation is always after the fact. You're not going to be sued today on the report that you filed yesterday. You're going to be sued three years from now on the report that you signed yesterday, and if there were major assumptions that went into that report, make sure that you document them (i.e., why you picked 8% instead of 6%). Document all of your judgment calls, so that, when somebody second-guesses them later, you have a reasonable explanation as to why you did what you did. Get your work peer reviewed, and finally avoid armchair advice. If somebody walks in your office and asks your advice on a matter, avoid giving advice if you haven't had time to thoroughly look at everything.

Finally, realize that there is an expectation gap between actuaries in the public. This is a term that's used in connection with the accounting profession, and it applies to actuaries as well. What I mean by this is that there is a difference between what you do as an actuary and what a jury is going to understand you to do. You have to remember that the 7th Amendment says that, if you're ever on trial, you're entitled to have a jury of your peers. However, you're not going to be tried by 12 people sitting on a jury, each of whom is an actuary. You're going to be tried by 12 people, each of whom may never have even gone to high school. I've tried some cases for accounting firms where I didn't have anybody who had a college education, and they're the people who have to decide whether this professional failed to exercise due professional care.

You have to remember that there is an expectation gap, and with that in mind, here are a couple of suggestions to reduce litigation exposure. Clarify your duties and responsibility with an engagement letter that defines and limits exactly what you agree to do. It can define the audience for whom the work is being done; it can set forth a contractual standard of care; it can give you indemnification; and it can define the client's responsibility to you. If you're an in-house actuary, instead of clarifying your duties with an engagement letter, clarify your duties and responsibilities with the opinion that you sign. You have enormous flexibility in adding language to that opinion. Tell what your limitations and concerns were. Put it all out if you can. Maybe the state won't accept it; maybe it will ask you to make some changes, but go ahead and try.

The second thing is make sure that your data are good. I recognize that there are times when you don't look at all the data needed in a review, and you're asked to assume that it is good. However, you can't close your eyes to data. If you know that data are bad, be very careful because you can be held liable if you rely on it. Think about who's going to rely on your work and plan accordingly. Also, examine your client's motivations and agenda.

One last point, a lot of lawsuits involve situations of an insurance company sale. I've had three instances where all the buyers wanted was the liquid assets of the purchased company. They looted the company, left it in insolvency, and disappeared to some other country. Be very careful if you're a consulting actuary or if you're an in-house actuary. If the owners of the company that you work for change, be very careful, because new owners may "skip town," and then your work is going to be put under a microscope by the regulators because it's an insolvent company.

MR. CHARLES D. FRIEDSTAT: I think it would be helpful to the group if you can, while maintaining client confidentiality, give some specific examples of cases where actuaries have been tried, just giving some of the fact patterns. I think it might be enlightening for all of us.

MR. GORSLINE: Let me tell you about one that I'm involved in right now that illustrates a couple of these points. It is a case that's been brought by an insurance commissioner who is the receiver for a failed property/casualty company. The thing that I find interesting about the case is that the company is in receivership because its assets were looted by the folks that bought the company. The receiver (who is the insurance commissioner) is in an unusual position because he is operating an insurance company in a manner to protect the policyholders without dipping into the state insolvency fund too much. He also recognizes that the company is in an insolvency situation because of its problems on the asset side of the balance sheet.

Nevertheless, in this situation, the insurance commissioner as receiver of the company has sued the former officers of the company saying that they knew they were selling to looters. They've sued the company's former accountants saying, notwithstanding the fact that the final straw that broke the camel's back may have been a looting of assets, that the company was losing money because of their failure as accountants to help the company set a proper rate structure. And they sued the company's former actuaries, my client. The accounting firm and actuarial firm would never have been sued if this company had not gone into receivership. Even though the company is in receivership because its assets were looted, the insurance commissioner has put the work of these professionals under a microscope and, with the benefit of hindsight, has stated that some of the projections the actuary made five years ago are not entirely accurate and the company could have done better. The company might not have had as many losses, and so on.

The only reason the work is being second-guessed is because the company is in receivership, and it's not in receivership because of the work of the actuaries or the accountants. It's just that easy to second-guess somebody else's work. My client has been sued under RICO as well, which is the Federal Racketeering Statute. I think we're going to get that claim dismissed, but it's very hard to get a claim of negligence dismissed pretrial against an actuarial firm. To do that, you have to show that there's no disputed issue of material fact and whether or not the actuary exercised due professional care.

It's hard for me to come up with examples where an actuary has been sued in a situation other than a failed insurance company. There are a couple involving sales of companies between one company and another where things like pension benefits were not properly valued and so the liability assumed by the acquiring company was more than the acquiring company thought the disability would be, so the acquiring company sued the seller. I hope a lot of those are resolved by arbitration where you have two companies, neither of whom is insolvent just arguing about whether or not they paid too much for something.

MR. DAVID LEVENE: We've gone to great pains to make sure that we can only be sued on the cash-flow-testing issue by regulators or our own insurance company. Do you think by making a big fuss over this issue that we actually avoid the suit by the third party, or will the third party come after us no matter what we do?

MR. GORSLINE: What I think you're referring to is the language in the new model SVL that says that, when you sign one of these opinions, your liability is limited only to the regulator, except in cases of fraud or gross negligence. The question is, will this insulate you from liability from third parties? My answer is, having that language in the statute certainly can't hurt you, and it may help. However, that's not going to stop a plaintiff's attorney who wants to see a recovery from at least naming you in a lawsuit. While that language is good to have in the statute, it's full of holes. For example, it specifically says that the state regulator can sue you. What about the example I just gave you where the state regulator can wear two hats: one as a state regulator and one as receiver for a failed insurance company? Does the statute apply to the state regulator when he is standing in the shoes of the company as the court-appointed receiver? I could make an argument that it doesn't, but then again I can make an argument that it does! That's an ambiguity that I hope will be resolved under litigation in favor of the actuaries.

The law also makes an exception in cases of fraud. We think of fraud as being bribes in a smoke-filled room. However, in the hands of a skillful plaintiff attorney, they can take ordinary negligence and make it look like fraud. If you don't do something that they think you should have done, they'll say it is evidence of fraud, "He intentionally did not do that test because he knew that, if he did, he would get a bad answer and he knew he didn't want that answer." So the plaintiff attorney will take some sort of inaction on your part, something that probably at best is evidence of a shortcoming, and they'll characterize it as fraud. You may say it's not fraud, but the very fact that the attorney says it is and you say it isn't means it's a disputed issue, and the plaintiff attorney probably can get to a jury on that. So while I think that such efforts are good, I don't think they are going to prevent you from getting sued. Ultimately it may help you, but it certainly wouldn't stop you from getting sued.

MR. KUNESH: If you work for a large mutual company or well-capitalized stock company, it's clear that you are not free from the risk of being sued. This idea of having an engagement letter also can work inside the company wherein you clearly outline the scope and limitations of your work to your senior management team, so that there's a clear understanding. You may want to look at a consulting firm's engagement letter as an example. Second, if you think your company is well-capitalized, you can still get caught up. I can think of a couple of situations. One is a demutualization where you are the valuation actuary. The issue involves one of the actuarial guidelines where you take the more liberal interpretation and your state is "wishy washy" on determining whether or not the guideline should be applied. It is likely that, during the demutualization, it would come out that you underreserved in the eyes of some people. It could also be the other way. You could be deemed to have been too conservative, thus taking away policyholder value.

In the second situation, a class-action lawsuit was filed wherein a claim practice that was permitted by the state insurance department was challenged successfully in court, and the actuary is being called into question as to why he didn't recognize the possibility that this practice might be deemed inappropriate. How far can we go? How far should we go?

MS. KAREN OLSEN MACDONALD: What I decided to do was to raise several issues that I've been thinking about as a result of going through the exercise of preparing the reserve opinions for our companies at year-end 1992. I've dubbed my issues here the "wise whys," and when we get to the discussion, maybe some of you will have some further insights.

The first one is, if asset adequacy testing is demonstrating that your reserves are sufficient, then why keep formulas, and why are the formulas getting even more complicated? The second one relates to the issue of Section 7 opinions and why they're easier than Section 8 opinions. The next issue is reliance and why it is forbidden under the current law. The next one is more of a why not than a why, but why not limit the professional liability of the actuary? Finally, a subtler issue has to do with the degree of proof required of the actuary who's providing the judgment as to reserves.

The first one is the issue of formula reserves. By way of background, for years our profession mastered calculating fixed reserves. There was little or no requirement to assess asset quality, do asset/liability matching or anything beyond, had you mechanically followed the formula reserve requirements that were in effect in your state. There were obvious flaws with this, which became more prominent. During the 1980s when companies went to interest sensitive products, the dynamic valuation standards that were in use during the 1980s were an attempt to help, and they did help somewhat but probably didn't go far enough.

We have now a new SVL, which is an attempt to get at this problem. The intent here is to alleviate the problems with formula reserves by placing the responsibility on a knowledgeable, professional actuary to come to a judgment as to the adequacy of the assets backing the reserves. All this sounds fine and good, but the problem is that the regulators didn't stop at that. They said, "If formula reserves used to be good and if asset adequacy testing is even better, let's just go to a 'greater of' standard. Let's have the best of all possible worlds."

This whole situation is further complicated by the proviso in the new requirements that not only do you have to meet the "greater of" standard in your state of domicile, but also you must do so on each and every state that you file in. So we've got the asset adequacy plus additional formula reserve requirement. On top of this we now have an interest maintenance reserve that clearly seems redundant. If you're doing asset adequacy testing, then I don't see why you need to hold another formula rigid reserve that doesn't take into account the specific nature of your liabilities. So it seems to me that the regulators in their zeal to get the job done have gone overboard, and my own view is that cash-flow testing does the job or it doesn't. If it does, then I don't know why we need to continually develop formula reserve requirements, including the "this state" problem.

One way to go would be to use formula reserves only for those types of contracts where there isn't any significant asset liability risk. This whole area is one that needs more discussion by the profession, going forward.

One of the current topics on formula reserves, which is an area of interest to our company, has to do with the proposed NAIC Actuarial Guideline situation -- the idea that even greater reserves are needed for term life insurance. There have been extensive discussions going on about this topic and considerable uncertainty for companies that are out there selling these products. Yet cash-flow testing can demonstrate that the reserves that we're currently holding can withstand considerably more mortality fluctuations. I have a bit of a problem seeing what the point of all this excess is.

The second topic may be more controversial since I notice there are a number of actuaries representing smaller companies in attendance at the meeting. The new SVL basically exempts smaller companies from the requirement of doing the asset adequacy testing. They allow them to file a Section 7 opinion. Larger companies on the other hand, have to file a Section 8 opinion, which requires asset adequacy analysis. We have within our group, companies in both situations. Certainly for our major companies we've filed Section 8 opinions. We also have a couple of Section 7 companies. I've wondered about this because in my experience I've found smaller companies to be, if anything, perhaps more vulnerable, certainly not less vulnerable, than larger companies to fluctuations in experience with respect to mortality, asset defaults, and so on. Certainly by number there are more insolvencies among smaller companies. Perhaps the reason that they were exempted is because it was felt that the process is too expensive for smaller companies.

But I'm here to tell you I think it's too expensive for larger companies as well. It's a much more complicated job. With all the liability concerns today, I felt that I had to do a fairly thorough job of documenting our work, of doing due diligence with respect to the assumptions and of getting it peer reviewed. It cost a lot of money, and I'm not sure that we can afford to spend $500,000 on this any more than a smaller company can afford to spend $50,000. I think this issue also deserves further discussion.

The topic of reliance is the third issue. I work with Transamerica Life Companies, which is a multiline company. In the past until 1992, we had multiple signers of our reserve opinions. Our structured settlement actuaries signed for those reserves, our reinsurance actuaries signed for those reserves. Similarly, we had a life actuary, credit actuary, annuity actuary, and pension actuary. We probably had ten different signers on our reserve opinions. We never had any central review of the reserves. Then along came 1992 and the new valuation law. We read the law, we looked at the regulations, and the law appeared to require a single signer.

Can anybody in a multiline company be equipped to be a single signer? I know we didn't have anybody who wanted to be a single signer. Recognizing it had to be done, I was the corporate actuary, so I got the job. The way that I ended up doing it is, I decided that our line actuaries who had always done the work were clearly the experts. They understood their liabilities, their assets, all the special quirks of their lines of business, and they were the experts, so they had to continue to do the work. However, to come to a single opinion, we needed some degree of consistency with assumptions. We needed some central review so that somebody could responsibly sign off on it. We used an integrated approach, whereunder the primary responsibility for the work was with the people who had always done it. However, they had to meet certain standards and were subject to review at my level. While it worked reasonably well, I would feel a lot more comfortable if I was allowed to state reliances on these other actuaries in the opinions.

As the law now stands regarding the opinion, you're not allowed to rely on other actuaries. You can express reliances in the memorandum, but not in the opinion. This is a real limitation. Anyone who has worked in a major company knows that no one person can be the expert in all lines of business. It's naive not to allow reliance within the opinion itself. If the actuaries you're relying on are qualified, then you ought to be able to rely on them in the opinion.

A shortcoming of not being able to rely on other actuaries is trying to figure the degree to which you need to audit their results. These actuaries tell me they followed the assumptions that I gave them; they tell me these are the results; and I sign the opinion. But how do I know they followed my instructions? How much due diligence can I possibly do? At some point there's got to be a "leap of faith." You can only do so much due diligence. I think the regulators should to be encouraged to correct this problem. I would be interested in your thoughts as to how much reliance within the memorandum really protects you when you can't express reliances in the opinion.

MR. GORSLINE: I'm glad I'm not in your shoes, although I think you probably work for a strong company. My advice would be that you include in the opinion everything you did to make yourself comfortable and who and what you relied on, and actually have the state kick it back if they believe that the opinion is unacceptable. I would try to do something like that, because I think it would help to protect you in that situation.

MS. MACDONALD: So even though it says you can't rely, you'd rely and let them come back.

MR. GORSLINE: Tell exactly what you did and where you were not able to do it.

MS. MACDONALD: It's worth thinking about. Let's move to the liability issue. The new valuation law requires the actuary to sign a statement that says:

> The reserves and related items when considered in light of the assets held by the company with respect to such reserves and related actuarial items, including but not limited to the investment earnings on such assets and the considerations anticipated to be received and retained under such policies and contracts, make adequate provision according to presently accepted actuarial standards of practice for the anticipated cash flows required.

In the future in the event of failure, I'd like to know what types of different interpretations attorneys could reach about opinion phrases like "according to presently accepted actuarial standards of practice." It's clear that there is immense room for a difference of opinion on that point, and that this is a sensitive item. Actuaries cannot control the future. It's very unfair to put them in the position of being subject to 20/20 hindsight. Five years from now attorneys are going to know what, in their opinion, we should have known about that future.

I propose that the standard be changed to put a maximum period on professional liability expense. I propose a period such as two years for the statute of limitations. The purpose would be to minimize after the fact, second-guessing if things go wrong in the future. In addition, it ought to be enough if you draw an analogy with the incontestable provision on life insurance policies. Two years allows regulators enough time to review and question the actuarial memorandum. What more do they need? This perpetual open-ended liability is just not reasonable.

The final topic is an emerging issue. The issue relates to how regulators are going to interpret and review the results. We're going to have to see what happens here as they are first starting to review 1992 results. Through various correspondence received by most of us prior to year-end, certain regulatory actuaries (John Montgomery of California, Larry Gorski of Illinois) indicated the kinds of things they will be looking for. I noticed the dangerous tendency for them to push numerical tools that they could use to interpret opinions, things that might point to inarguable regulatory actions. Montgomery wanted positive surplus at all durations. There was other talk about how many scenarios you had to pass. I don't believe the valuation actuary concept lends itself well to this type of review of the results. The whole point of the valuation actuary was to place responsibility on a knowledgeable professional to arrive at a judgment. If you're doing that, then you have to let the professional come to his or her judgment without placing arbitrary constraints on his or her work.

U.S. regulators unfortunately have a rather closed mind-set. I dread having questions come in like, "Why didn't you assume this? Our consulting actuary says you should have tested that scenario." You could have a process that goes on forever, and I'm waiting to see what happens. My view is that regulators should be barred from requiring extensive retesting or extensive correspondence unless they demonstrate that there's some reasonable likelihood that the reserves are inadequate or that there's some problem with the opinion. We'll have to wait and see what happens on that one.

MR. PAUL S. BELL: Dan's instructions to me were to share with you how it feels to be a valuation actuary. It obviously feels great! Somewhat like Karen, I became a valuation actuary because my company looked around and said, "Well, who went to the course and who is qualified? Who satisfies the twelve hours of continuing education requirements?" The curious thing here is, we're actually having a meeting just before the postmortem, so this must be the pre-postmortem. If you think of this as being the pre-postmortem, think of your actuarial memorandum and opinion as some little guy. Envision hundreds of auditors surrounding him, picking on his almost lifeless form, firing questions at you like, "Why did you do this and would you run three more scenarios?" State auditors! The SEC! My own external auditors! Everybody is looking at these things, so I hope soon, after all this, the valuation actuaries can finally have an opportunity to relax.

One thing that being a valuation actuary has taught me is that we have to use many disclaimers. I'm a valuation actuary for five insurance companies. I've spent almost my entire career doing financial statements. I have been employed by large stock companies, and I've also been an auditor. I have many biases and often also rather strong opinions. Let me also indicate to you that I operate in the state of California. I have companies domiciled in California, Delaware, and New York, and all of these state regulators are wonderful people, their actuaries are quite talented, and I'm having three-zone exams and I don't want any problems.

Dan was quite wise, he didn't bother us a great deal because you know that valuation actuaries during the months of January and February are rather grouchy. Before preparing for this session, I was very fortunate to attend the Philadelphia Actuaries Club meeting that Mr. Metzak ran and was able to assemble many opinions of other valuation actuaries. Therefore, the opinions that I state here and some of the examples that I give are totally unrelated to my company.

Let's start with the first thing that every valuation actuary was concerned with this year. We have access to a wonderful book. It is called *The Life and Health Valuation*

Actuarial Manual. In ranking it among the most boring piece of material that you've ever read, there are actually two pieces of material more boring, *Sources and Characteristics of Mortality Tables* and *The State Insurance Laws* of the various states.

The *Manual* is actually a tremendous piece of work. The gentleman who prepared it should be greatly complimented. We all became far more aware of what the state differences actually were.

The Saturday Evening Post in 1940 defined the typical actuary as a man past middle age, wrinkled, intelligent, passive, noncommittal, and with eyes like cod fish. I was impressed at the valuation actuaries meeting in Philadelphia to find many very young actuaries there. I looked around and asked, why, because I knew in particular they weren't signing. Perhaps the answer is in what one company's valuation actuary said, "If I have to sign, every one who's helping me must also sit through these hours of meetings." A commendable concept! In fact, I've asked for an increase in my budget to do the same. This is a highly responsible job, and we have to encourage the younger actuaries who still don't know debits from credits to learn this field.

I'm tempted to think that the whole valuation actuary concept was created by the computer software chip people, because if we didn't have these 286, 386, and now 486 computers, how could we do this job? And that doesn't mean I'm sending them a thank you note. Unfortunately, we just bought a new computer that will do it faster, so now I can respond to these questions more quickly.

Among the people in Philadelphia, software was the greatest concern. They didn't know how their software worked; they didn't know what the black box was necessarily doing; they didn't know how to get data to it; they didn't know what to do once the data came out of it; and in many cases, it took hours and hours to run one scenario. In our own case, we have one scenario that takes over six hours to run. In that case, it's very difficult to run a hundred statistical scenarios.

Then we came down from reading our book, and we had to make some decisions. We had to determine how we were going to file these memorandums and what we were going to do about all the state requirements. When we discovered that many of these requirements were different than what we expected them to be, some of our actuaries filed opinions that totally ignored the state of domicile issue. Some actuaries even filed their opinions admitting that, if they were filing in another state as their state of domicile, they might have filed reserves a bit differently. I'm sure there must have been one or two actuaries out there who used the most conservative of all 50 states and filed that way. I'm glad they have that much surplus. This is going to create a severe problem in the future. I believe it's a severe problem for the industry if we require so much surplus to comply with the most conservative of the 50 states. This would drive our surplus down, drive away investment dollars, and eventually hurt our industry.

Then we started writing the memorandums. We had to deal with the issues of failing at least one test. What do we do when we fail a test? Many of us did fail a test, some may have failed two tests. The question becomes what do I do, how do I say this, how do I handle the New York seven as opposed to the Chicago seven, what do I do when I'm applying the information to a situation which is entirely different? In the case of our company, we have interest rates in some of our territories at 15%, in other territories at 4%, and in some territories at 35%. How can you apply the New York seven, be a responsible Academy member, form an opinion, and write creatively in situations like that?

Let me touch upon my concerns about reliances. In our case we have to deal with many investment officers located throughout the world. "Tell me what your investment goals are going to be, what is your investment concept, what's going on out there, and what should I assume for my future interest rates?" They always seem to come back and say that interest rates are at a bottom right now and are going to go up! So how do I put that in my opinion? These are the same guys who, a few years ago, said interest rates would never be the same again, would never go below 10% in the U.S. Do I rely on that? How do I rely on the accounting data that they provide me?

Auditors in our Philadelphia meeting brought up an issue about missing call information on bonds. This caused us to go out and research call information. If you see that such information is obviously missing, how do you deal with this? I would suggest to you that the easiest way to find out how many of your bonds are callable is to first look in Schedule D under the sections called Sold and guess how many of those were actually called. Then go see if your call information is correct. I believe all of us are willing to let the investment department tell us what's going to happen to run the best scenarios we can. However, we cannot get away from our responsibility to put an "actuarial twist" to their projections.

Various assets will always come under question. Mortgages, particularly balloon mortgages, are a good example One of the auditors at the Philadelphia meeting reported the results of a recent poll which indicated that over 65% of mortgage balloons refinance. This gives you some pause to think if you're using balloon mortgages as cash outflows for certain liabilities, especially if you expect them to be material.

Then there are collateralized mortgage obligations (CMOs). CMOs are the most wonderful invention in the world. It's the only way you can take 8% mortgages, pay a large amount of money to a broker, split it up in 450 different ways and have everyone earn 9%.

How do you deal with it? Do you turn it over to one of the actuarial software firms? Do you ask an investment house to give you an evaluation (and these are the same investment houses that are telling you you're earning 9% on an 8% mortgage)? Do you use one of the other mechanical software facilities available? How many of us are aware of what the prepayment speeds really are?

I'm aware of one discussion with an investment officer where he thoroughly explained that there was no prepayment risk at all if interest rates fell 200 basis points. The rather heated discussion that followed came to almost an abrupt end when one of the actuaries in the room said that over the last three years we've had interest rates drop 200 basis points. He then asked how many people in the room had refinanced their mortgages. Everyone in the room had except for the investment officer.

Many actuaries had to deal with stocks in their asset adequacy work. How do you build unrealized capital gains on stocks into your actuarial opinion or do you build it in? Many of us will associate common stock with the surplus account to avoid the issue.

Finally, at the end of the day, we sit there and say, "It's time to sign my name." Again, in the case of my company, I had to sign my name some 500 times. We have to all take a responsible position. We can't rely on many other people. We have to have in our files the tests that we ran, the conclusions that we came to, and we have to do a responsible job for each of our scenarios.

We have some awesome responsibilities now, and we have a lot of teamwork to be done, and it's the teamwork that counts. The more education that we get and the more people we bring into the process, the better off we are.

MR. KUNESH: I'd like to talk briefly about two things. One involves the consultant's perspective of the valuation actuary role, but it applies to you as company valuation actuaries as well. First I'd like to share some thoughts in dealing with regulators. Always be prepared to demonstrate your qualifications, your knowledge of the subject, and those on whom you rely. I refer you to *Professional Actuary Specialty Guide I-1-92*. It gives you a reference list of sources that you can refer to in your certification process, and it's helpful. You don't want to have been asked by an attorney if you're familiar with the *Guide* and say no, because it's a fairly comprehensive list, and it's impressive.

Second, cooperate with the state, even though it may not respond to your letters and concerns. Also cooperate with the state on a timely basis. Larry Gorski of the Illinois Department tells me that, if your opinion is rejected, you are subject to a five-year exclusion clause, whereunder you cannot sign another opinion for five years. So he's going through pains to caution actuaries, asking them questions. Respond to the regulator's questions, make sure that you clear all exceptions with the departments.

A few states are looking at actuarial opinions and memorandums fairly closely. Illinois, California, New York, and Florida are examples. These are states that have already passed the law, and there's going to be many more next year. We already heard about documentation. Document well, and if you have an assumption that is not clear or it's arguable, don't hesitate to state that it is not clear, but give the basis for the choice of an assumption. Uncertainty happens all the time. Sometimes, we don't have good experience data. In these cases, explain this fact carefully, because it will come to your benefit.

I was told by Larry Gorski that in Illinois they are reading the actuarial memorandum of every single domestic company this year. Next year, they're not going to require the memorandum except from specific companies. So if you're asked to do so in Illinois, you want to be very careful. I mention Illinois because that's where I'm from.

Also, reconcile values in the memorandum to the annual statement. There's nothing more embarrassing than to have reserves that don't add up to what's in the annual statement, and this has happened. Also document company practice regarding reinvestment strategy, indicating whether or not this strategy was used in your testing and if not, why not. If your assumptions bear no resemblance to the investment strategy of the company, you're not going to fool most learned regulators. If they review your memorandum, they are going to be asking for your investment policy, and they are going to be asking you questions if there is no resemblance. You may be able to explain your way out of it, but maybe not. The same is true about experience data. If you have it, use it. If you don't, explain why and what you used. Respond on a timely basis and be thorough in evaluating your results in the memo.

I've seen a number of these memorandums, and they are very weak in saying why they came to the conclusion they came to. I can tell you that, if I was an attorney, I'd love it because I'd have plenty of meat. You need to explain how you came to your conclusion. Explain why the results of a given scenario are invalid in your mind.

I'm going to go over quickly some of the problems that trouble consultants – namely, gaining access to appropriate data, data quality, reliances, time (both timing and the time needed to get the job done right), variations in the state valuation requirements, and interpretation of actuarial guidelines. Gaining access to appropriate information is probably more a consultant's problem than it is a company problem primarily because you're coming in from the outside. You may not know what is available. You have to ask. You have to know what you want, and you have to ask.

Concerning data quality, it all relates to what data you need and how you are going to use them. You're all familiar with the proposed standard on data quality. My ideas here come from that proposed guideline, and they apply specifically to you as a valuation actuary, because you need data. If you know what data you need, ask for them, ask for them early, and know how you're going to use them. Once you have the data, you must determine if they are appropriate for their intended use. Are you going to get a lot of data you don't need, are you going to have "dry runs," are you going to get information that's inaccurate? No doubt you will need to do some due diligence on the data. You simply can't rely on others, thinking that if these data came from the CFO, they have to be okay. That's not good enough.

Consider accuracy and comprehensiveness. There are ways in which you can get to the heart of the issue if you're a consultant. You ask questions, you do some auditing. If there are limitations to data and many times there will be (such as with claims data), determine what required modifications and assumptions you have to make so that you can measure the biases that may result from imperfect data. You should confirm the reliability of the source of the data. I don't believe you should be relying on anybody less than an officer of the company, because at least then you have a fighting chance that this person has the necessary experience and knowledge to assure accuracy and comprehensiveness. Then disclose the sources of your data and any existing bias. Measure the bias to the extent possible. If that is not possible and the bias may be material, explain how you arrived at any adjustments that you made, and disclose any reliances you make.

On reliances, I want to make one additional comment beyond what has already been said. I believe that CPA firms will not allow you to use their names as a reliance source in the opinion or memorandum. I believe this is one of their standards of practice. So you have to rely on a company person, and smaller companies often have a problem in coming up with reliable data for the actuary. Make sure you get their statements of reliance! Don't forget that. Also make sure you understand their credentials and expertise, because the states are asking about them.

On time, this applies to a company actuary as well. Don't underestimate the data collection process and review process that you need. Verify that experience data are available and accessible, and if they are not, determine early what you're going to do. Some people "punt" and use pricing assumptions. That's largely unacceptable even if that's all you have available. You need to do some analysis of experience, albeit very small companies may have a logical excuse for not doing so because the data may not be credible.

Plan for problems in asset modeling. You will have problems. Paul mentioned some with CMOs. How do you do it, how do you handle liquidity issues with private placements, any number of things? There are issues related to asset problems and time needed to do multiple runs and reruns. I understand there were a couple of states that held firm on the March 15 deadline. Was it California that wanted to have a March 15 submission date for the memorandum? If you wait until the last minute, you're not going to write a very good document. At the end of February 1993, I talked to one actuary who needed to do a Section 8 opinion, and he was just going to begin his valuation actuary work. It doesn't work that way. That actuary obviously is going to have some problems with his company's state of domicile.

Finally, consider the use of an interim valuation date. How many have used data other than December 31? The vast majority. I think that's good, but Larry Gorski indicated to me he's going to be looking very specifically for the things that might have changed from the valuation date to year-end. I hope you are also making sure that you can reconcile to the year-end data as necessary. For you consultants out there, be careful how you price the job, because you might be grossly underbidding. If you're not careful, you'll end up doing a lot of charity work. That's probably not a bad idea this first major year of the valuation actuary concept, because we need to make sure that we're covered in all areas.

MR. ROBERT H. DREYER: We've kicked back and forth the reliance issue with regard to multiline companies. Has anybody done anything different about relying on the reinsurance credits they accept from the reinsurer?

MS. MACDONALD: We had several major reinsurance arrangements for which I received reliance statements regarding the reserve calculations from the reinsurer, and I included them in the actuarial memorandum. Again, I couldn't include them in the opinion.

MR. BELL: The only issue I had with reinsurance was, how do I deal with all 50 states in filing a state of domicile? It was found to be rather problematic, presuming that some states have different unauthorized levels.

MR. JAMES W. PILGRIM: Karen, we didn't have many client companies ask us for reliance statements. Most of our business comes from companies who administer the business themselves. In some situations, we act as a third-party administrator, and we provide them with the information. They control it, and we're serving as their data processing facility. So we didn't get many questions.

It seems to me that we're painting ourselves into a corner when we get notices from state departments saying you can't use a date prior to September 30, for example, or "I'm going to make sure that your September 30 information reconciles with December 31," and then have to complete our work by March 1 or March 15. I propose that we should take a cue from situations in other parts of the world. We're a U.S. subsidiary of a German parent. In Germany, reinsurance companies file their financial statements by June 30, with the prior December 31 as the as of date. Granted, a lot of their business is property/casualty versus life, so it cuts down on making estimates for incurred but not reported (IBNR) claims and so on. However, it sure would help the situation in terms of the time crunch, because no matter how much advanced planning you do, it's always a fire drill to get it done and get it done right within the time allowed.

Second, while I won't say I am a proponent of federal regulation, when you think about all of the state variations that we had in 1992 and more to come in 1993 and after, you have to say to yourself, if we just had one set of regulations to comply with and not federal regulation in addition to state regulation, wouldn't things be a lot simpler, and at the same time, a lot better in terms of quality and timeliness?

MS. MACDONALD: Let me mention one update on the state valuation issue that you may be interested in. The NAIC Life and Health Actuarial Task Force met recently. One of the issues raised was the fact that this state thing is practically very onerous to comply with, and it is putting actuaries in a tough situation, because they really couldn't comply. On the other hand, they don't want to sign their names to something that says they did something that they didn't do. The regulators at the meeting had some sympathy for the problem. They were particularly sympathetic to the issue of reflecting timing problems regarding compliance with the new valuation standard. They've created a small technical group that is supposed to draft language that could be used to amend the SVL to perhaps alleviate part of this problem. It's something you want to watch.

MS. ESTHER H. MILNES: I'd like to mention two other developments from the Life and Health Actuarial Task Force meeting. The regulators are concerned about the way people have been complying with the SVL. One concern has to do with this timing issue that has just been discussed. The regulators are fairly sympathetic to requests for extension of the deadline, provided those requests come in fairly early. They're not at all sympathetic with requests that they receive on February 28. They were complaining quite vehemently about people who talk to them on February 28 or March 1 and ask for an extension. They did grant a lot of extensions to people who came and talked to them in January and explained what their plans were for completing the work and their desire to do a quality job in a reasonable amount of time. I think they're fairly sympathetic to that, and you should consider this as you try to deal with this law.

A second concern was with reliance on investment officers. They are interested in taking the reliance provision away. Right now in your opinion you can rely on your investment officer for the investment cash flows. Their concern is not with the investment data. They feel that the data quality standard provides enough assurance that the actuary will have looked at the data. What they're concerned about is the assumptions that go into projecting investment cash flows. They feel it's inappropriate for the actuary to rely on the investment officer for those assumptions. Again, we're getting into a catch 22, where investment officers are the people with the knowledge to make investment cash-flow assumptions. However, the regulators say that the investment officers have no professional standards.

Thus they have no recourse to investment professionals. They prefer to have the actuaries make the assumptions. These two areas warrant our attention in the next few years as events unfold.

MR. ALLAN W. RYAN: I gather from your comments that, if a company does fail, it's just about automatic that the accounting firm will be sued as well as the valuation actuary. Is that basically the case? My question concerns the role of the actuary, which I do a lot of in support of an audit, where in order to come to an audit opinion, the audit firm relies on actuaries to do some of the work as "experts." Do you see an actuary in this role having as much exposure to legal liability? Would the suit typically be against the accounting firm, or would they name an actuary in the accounting firm specifically as well as the valuation actuary?

MR. GORSLINE: Either could happen. I have represented accounting firms before where only the firm was named as a defendant. I have represented accounting firms where both the firm and the audit partner who signed the opinion were named as defendants. My experience is that typically your role is to assist an audit partner who actually signs the opinion. Prior to the litigation, a plaintiff lawyer's perspective is going to be that he doesn't know of your existence until he gets into discovery and he determines that the audit partner actually used Deloitte's in-house actuarial expertise. I think it would be unlikely that you as an actuary be individually named in a lawsuit.

There are countervailing considerations to naming individuals. On the one hand, there might be some additional insurance, but on the other hand, we've been able to defend professionals who are individually named to really play on that with the jury. It's a lot easier for a jury to hit an entity that does not have flesh and blood with a large jury verdict for punitive damages, than it is to actually hit an individual. The jury members recognize that, if they return a verdict of a couple hundred million dollars or something, that they have destroyed an individual's entire life. It's easier to do that to a faceless entity, and so that is why some plaintiff attorneys will not name individuals when they can name the firm. Having said that, a lot of them will name individuals as well. I rarely represent accounting firms that actually utilize other experts. In situations where accounting firms do that, where it's not just the audit partner making these assumptions, but some other expert, they generally have less concern. It's a lot easier to defend an accounting firm that has actually done that.