RECORD OF SOCIETY OF ACTUARIES
1993 VOL. 19 NO. 4B

PRACTICE NOTE DISCUSSION

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- What are they?
- Regulators' reactions
- Industry reaction
- Update on Practice Notes

MS. DONNA R. CLAIRE: We thought that considering it is the last session, we would do things a little differently and show that you can have various viewpoints. Tim Harris is a consultant with Milliman and Robertson, and he thinks that practice notes are a horrible idea. After he explains what is wrong with them, I will explain why they make sense. Lauren Bloom, who is the General Counsel of the American Academy of Actuaries, will then explain that no matter what we do, we have to watch our legal liability.

MR. TIMOTHY F. HARRIS: As Donna said, I am a consulting actuary with Milliman and Robertson, and I am also a member of the Life Committee of the Actuarial Standards Board. I have had some exposure to the practice notes, possibly before other people did. And when I was called to speak at this session, I told them that they really didn't want me to talk about practice notes because I would not be too positive. I realize that we need some guidance, but I am not sure the practice notes are what we need. And they called me back a little bit later and said they wanted me anyway. So we agreed that we would debate the issue, or I would raise some of my concerns, and then we would talk about it.

The first is what exactly is a practice note, and what are these random mailings that I get? I don't think I've gotten all of the practice notes. And are these interpretations of the standards, or laws, or regulations, or are these standards of practice? So that's my question – what are these?

The next question is, who produces these? I believe that there is some type of practice note committee out there. I'm not sure how formalized it is, but I've always thought that they were probably written by one person and that these may well express that one person's approach to a specific area. But who reviewed them? Are these reviewed by another person or a committee? And then another question is, does the Academy claim responsibility for the practice notes? Are these an Academy production? Are these a Society of Actuaries production? Who claims responsibility for them? I believe it's the Academy, but I also believe that last year the Academy tried to shift it over to the Society because it was concerned about the appearance of some type of authority or some blessing being given to these practice notes, giving the notes the strength of the standards of practice. But then I understand that the

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Society didn't want it, so I believe it's still now with the Academy under the Committee for Life Insurance Financial Reporting (COLIFR). And I know that as a member of the Life Committee of the Actuarial Standards Board, we're not allowed to talk about the practice notes at the meetings. These things cannot be in the minutes of our meetings. If anything about practice notes is in the minutes of our meeting, it gives authority to the practice notes. It makes the practice notes, in effect, "standards of practice." So there are some things that go on behind the scenes. There may be members of the Life Committee who review practice notes to make sure that they comply with standards of practice, but they can't do it on a formal basis; otherwise, they'll give these more authority than is intended.

And where do these go? Who receives them? Do they go to all actuaries? Do they go to some subgroup of actuaries? As I said, I believe I've gotten random mailings. I know I've seen some that are drafts and some that are finals, and I don't have an index. I don't know if I've received them all, or if I've received only some of them. And if they're mailed to the members of a particular section and you didn't pay that section's dues, even though you might practice in that area you wouldn't get the practice notes. I think that may be what happens. Some of the practice notes are getting mailed to particular people. Let's say that you change your area of practice or you sign an opinion on a small block of business outside of your general area of practice and you're not familiar with the practice notes in that area, again, you've just done something and you haven't seen a practice note on that topic.

And then why? Why do we need these? If actuaries don't know everything about a particular topic, can't they attend seminars and Society of Actuaries meetings? And don't we have the *Transactions* and the newsletters of the various sections to provide a medium for these writings? Perhaps we need an appointed actuary section and a newsletter to get this information to those who need it.

And my real concern here, and possibly more so because of a consulting environment, is the litigation risk. Consultants are more aware of this risk than actuaries who are employed by companies. About a year ago, our outside counsel reviewed a group of practice notes. He had some concerns about the standards of practice, but he had major concerns about the practice notes. He didn't think that they received the same review process as the standards of practice. In a litigation situation, if the actuary hadn't reviewed the practice notes, or hadn't reviewed the appropriate practice notes, that would be deemed some type of malpractice. So let's say you're practicing in a certain area and you didn't know the practice note existed, or you had it and you didn't read it, and a company had some problems and litigation results, you've got a problem.

As an appointed actuary, you really need to make sure that you are named in the company's errors and omissions (E&O) coverage. Generally those coverages will name the covered officers of the company, and as an appointed actuary, you are really at risk.

So, in summary, I think that we're headed down the road to ruin with practice notes as they're presently organized. Cal Assurance is a professional liability insurance company. Although it is primarily an insurer of pension actuaries, it is expanding into

the life and health actuarial area. It sees this as an increased area of business, because we have increased liability.

MS. CLAIRE: As I said, you can't fault us for not allowing varying viewpoints. We do emphasize that practice notes are not standards. We have caveats that are longer than some of the practice notes. They are also not regulations which means they do not have to be followed. What we were trying to do, however, was detail current practices.

I'll give you some of the background: the New York writers had New York Regulation 126. The original version was 98 pages long, because they realized it was a new field for valuation actuaries. As there was no other means to get the regulation across to actuaries, we gave examples of how to do certain things. There are safe harbors in Regulation 126. In general, we were just trying to give examples, like what default risk to use if you're modeling a bond. What's a legitimate alternative? When the standard valuation law came around, most states didn't want to pass a 98-page memorandum, and one of the problems with that is you cannot keep a regulation very current. As new practices emerge, you have to go back and change the regulation.

Practice notes are not standards, because standards are meant to stay around for a while. In effect, a standard has a force of law for actuaries, and it explains what we absolutely have to do. Practice notes are meant to tell you what other actuaries are doing.

The original impetus for the Practice Notes Task Force came from the American Academy of Actuaries Committee on Life Insurance Financial Reporting. The members were getting many questions from actuaries and regulators. Examples were, what is a reasonable C-1 risk? What's a reasonable interest rate scenario if you want to do more than the seven that are mentioned in the law? We realized that currently there are no definitive answers to many questions. What we did was create a task force, of which I am the chairperson, of people who had similar concerns. The original task force had about 12 people. They were chosen because they were well recognized in a certain area. For example, when we were doing structured settlements, the original document was written by Steve Smith of First Colony. That company does a lot of structured settlements. He is also quite aware of the industry practices. But also on the committee were members who were with other structured-settlement writers.

At this point, our review committee has expanded to 75 people. Anybody who wants to review these can. It is an evolving process; when there are changes, we really do want input. So we send it to anyone whom we think may be interested. Any comments received are generally incorporated into the next draft. Once a year, they become the "final" for the year.

On the life insurance side, the practice notes have gone through five drafts this year. They are about to go to the Academy for the final review and then be officially released. Last year they went out to all members of the SOA Financial Reporting Section because they paid for that mailing. However, they are also available through the Academy to anyone who calls the Academy office. We figured that most

actuaries are members of the SOA Financial Reporting Section, but if you are not, the Academy does make them available.

The health practice notes are a little behind the life practice notes in the reviewing process. This is the first year health practice notes are being done. Fifty people were on the Health Practice Committee. I think they have done an excellent job. They have divided the notes by products. There is an individual disability income note, there's a group long-term-care note, etc. The "final" draft does get an index.

MR. HARRIS: A nice book is printed.

MS. CLAIRE: They are stapled together. This is expensive to mail. If you notice the numbering system, it is the same as last year's. You probably want to keep last year's set because, although it wasn't the only way things were done in 1992, it does indicate state of the art of the valuation actuary in 1992. Five years from now, what we did last year is probably going to look very basic. However, what was done in 1992 was then state of the art.

Tim asked why no one in the Academy or the Society wanted them. We really do want to make everybody understand that they are not Actuarial Standards Board (ASB) notes. There is an idea that maybe the Society will get involved and publish research that would make these notes obsolete. Much of the information in the practice notes is available from other sources. However, when you are in the middle of testing, you do not want to have to remember that in the summer of 1990 you read something in the *Financial Reporter* somewhere in your pile of literature. We were just trying to make it convenient for people.

I viewed the practice notes project as sort of skunk work. We thought we needed something done. There was really no quick, official way to get it done. But we thought it was information that many actuaries would like for cash-flow testing.

How do practice notes get developed? Questions come directly from actuaries and from regulators. Also, we did a number of surveys. In March 1993, after the end of the 1992 cash-flow-testing season, we sent out a survey to which 140 actuaries responded. The practice notes handed out reflect certain things we found. They also reflect input from actuaries at various seminars who seemed to have many questions. Again, the answers in the practice notes may not be the only answers, but they are answers. Every practice note has been updated for 1993 – this is the process that we would really prefer for the future. In effect, every year as we learn more, as we go to more seminars and more questions come in from either actuaries or regulators, we would like to reflect them.

The final version of Actuarial Statement of Opinion (ASOP) 22 on the Section 8 opinions and memorandum was reflected in the 1993 practice notes. Also, in late 1992 and in early 1993, the NAIC took action that we thought would be a good idea to share. For example, in June 1993, the Life and Health Actuarial Task Force of the NAIC reviewed certain memoranda and its members had specific concerns about ones that they reviewed. At this point, there was no real forum to share that information, so that information is included in the general practice notes under a question of what was the regulatory concerns were in 1992.

PRACTICE NOTE DISCUSSION

Some of the highlights for 1993: The health practice notes will be coming out for the first time. Various drafts are available. If you are interested and have not received a set, Leonard Koloms is the Academy of Actuaries health equivalent of what I am doing on the life side. He is at Benefit Trust.

Now, I am going to give examples of certain things that are covered in practice notes and why they're there. As I mentioned, the regulators' reaction to 1992 opinions and memoranda are included. There are certain things they thought were poor in 1992, and rather than having actuaries continue to give poor opinions and memoranda, we figured it would be nice just to point out certain areas that should be at least looked at, for example, reliances on third parties. Many opinions that the regulators reviewed did not make clear who was being relied on and exactly what was being relied on. Also, in the memoranda many assumption details, like what interest-crediting strategy and what reinvestment strategy were used, were not too clear.

We are still trying to get a practice note written on reinsurance. There are many open issues. We realize that the data on reinsurance are not always good. I have not yet found the person willing to write even the first draft of a practice note on this. This is still legitimately an area of concern. I realize that there are major problems with the data in this area. This also gets into our data quality standard: We are supposed to have good data.

Off-balance-sheet items: regulators were concerned about secondary guarantees in contracts. Many actuaries did not necessarily disclose them.

Some of the regulators reviewed all the opinions they received. A subset of these looked at both opinions and memoranda written and did a thorough review. If the regulators were concerned about a company, or you wrote an interesting opinion, a thorough review resulted.

From our surveys, it looks like a lot of sensitivity testing was done, but the regulators could not tell that from what was reported in the memoranda. They would like more detail on what was done and what the results were. So if you did sensitivity testing, they would like to see a summary of the tests in the memoranda.

Checking interim results is an interesting issue. This is one of the areas in which the Life Actuarial Standards Board in ASOP 22 stated that final results should be used, but some regulators would like to see interim results. This is one area in which there is concern by a number of actuaries. As most of you know, California did ask for year-by-year cash-flow testing from all companies. Because of that, 84% of the 140 people responding to our survey did put year-by-year testing in. There is a question as to whether this is a surplus-adequacy test or a reserve-adequacy test. The ASB has said reserve testing is at the end of the period. The practice notes reflect current practices in 1992. Because many actuaries did year-by-year testing, the practice note is going to say the ASOP does not require solvency testing of any kind, but some regulators and some actuaries think it is necessary. Some actuaries think that if in certain lines of business one could wind up in a lapse mortality spiral where, if high interest rates are not credited, lapses will also be high. This may increase mortality and, therefore, result in even higher lapses. They want to reflect that they need

year-by-year results. Therefore, the practice notes state varying current practices regarding intermediate results.

FROM THE FLOOR: Initially, a draft said that the actuaries should at least look at year-by-year results, and it finally got thrown out because of the solvency issue or the surplus-adequacy issue. If the actuary is looking at year-by-year results and some years have a negative result, in that case you are looking at statutory income. Some years will have a negative statutory income, but at the end of the 30-year period, if things are positive, you're going to look at that negative year and say, "Oh well, there's enough surplus to cover that." So you're, in effect, providing a surplus-adequacy opinion. That was the feeling there; they felt that this whole surplus issue is something that the Actuarial Standard of Practice (ASP) can address at this point in time, so they threw out all the verbiage. But the regulators do, however, want to see a year-by-year analysis. I've heard a few of them say that.

MS. CLAIRE: One of the changes that is being suggested is called the Executive Summary of the Memorandum. It would go with your opinion and if you have a very large, intermediate, negative result, that would be included. Rather than take a stand on it, all the practice notes are reporting that actuaries are going to be doing this. But we figured you would like to know that the regulators want to see it either way and that you are to make your own judgment.

The most popular question is, what is passing? The bottom line is that we determined we could not come up with an answer. And, once the regulators who are on the Life and Health Actuarial Task Force understood the point, they accepted that as the answer, that six of seven or seven of seven is not going to be a requirement. I will admit that 10% of the people did put up extra reserves. But legitimately, there are so many assumptions going into those tests that if a regulator or any other actuarial body claimed that you had to pass six of seven, many actuaries would be figuring out how to "pass" and not necessarily show anything constructive to either management or to regulators.

The date used for testing was also an interesting question, and here's another area where right now there is no consistency. About half of the 140 people replying to our survey used data before the end of 1992, and half used year-end data. The ASP does require reconciliation with year-end numbers. The regulators would prefer year-end data being used; there is currently no requirement. That may change in the future, but the problem is that a number of actuaries point out that you do not want to find out in February that you have a problem. There's nothing you can do about it. In fact, you cannot even put up extra reserves, because the annual statement has already gone to the printer. So, by doing the testing on September 30, data seem to make sense and the ASP does specifically refer to that. However, the practice note does point out that certain regulators are going to ask you to use year-end data or make sure you reconcile it to year-end data.

I want to point out some highlights of our practice notes. I'm highlighting some 1993 changes, and some were in all the time, but they probably deserve to be highlighted.

Actuaries do have a choice of accepting or rejecting an appointment. Don't always say yes. If a company is about to go bankrupt, don't say yes. You do not want to be deposed when the company goes insolvent.

There are certain things that follow the ASP, such as, you need good access to data. Also, we have continuing education standards, so you have to be qualified to do opinions. It is a good idea to talk to the prior actuary and, again, this is part of the ASOP. Find out if there are any major problems before you accept a position as an appointed actuary. The ASOP does give you a lot of leeway; perhaps the former actuary should have used a little bit more common sense.

The 1993 practice note has changed to reflect a few things. It always said to not do blind reliance. I think this is one area in which some actuaries did blind reliance on the investment side. You were allowed to do it, but it does not always make sense to do so. In a legal situation, you will not sound too bright saying "We had several scenarios, including scenarios that will pop up 300% and pop down 300%. The investment people said the same bonds would be called in both scenarios, so I used that assumption in testing." The actuary should generally test whether these things make sense.

In 1994, there will be changes to the annual statement. There will be three supplementary schedules, and the supplementary schedules will be audited. The practice note goes into what the supplementary schedules will look like, because with that information it would be nice to know what's correct, such as the assets, the amount in force of all the liabilities, etc. You should make sure that your model tests against the annual-statement-type numbers.

For interest rate models, a major change in 1993 to the practice notes was the added section on yield-curve normalization. That is probably going to be added to the standard valuation law. At the end of 1992, the yield curve was particularly steep, and many actuaries thought it was particularly steep. It is not always going to look like that. After two years the yield curve might be normal (or less steep). Again, there are a number of ways to do yield-curve normalization. We did not go into particular details. We just said that this is an item to consider.

Asset valuation reserve (AVR) and interest-maintenance reserve (IMR): The IMR must be included in the testing. However, regulators currently will only allow the IMR to be positive or zero. You cannot have a negative IMR. Many people are questioning why it must be included in the testing. It's because the theory of the IMR should have allowed it to go negative. It's just that the regulators right now won't allow it.

MR. HARRIS: So you could include a negative IMR in the testing but not in the annual statements. Isn't that the way it is?

MS. CLAIRE: Correct. The AVR can be used within testing for defaults. That was another question people asked.

MR. HARRIS: Nothing else?

MS. CLAIRE: Nothing else. The AVR can only be used for defaults. It cannot be used for extra reserve.

Regarding default risk, one possibility is to relate the factors to the risk-based capital (RBC) factors. This is one area in which a couple of the regulators wanted to see more sensitivity testing, especially if you had junk bonds or low-grade commercial mortgages. One thing that Larry Gorski added was if you have concentration in a single asset, like if one asset makes up 5% of your portfolio, it should have special attention. You should have sensitivity tests on that asset. The practice note reflects that.

The mortgage and real estate C-1 list refers to certain other sources of information. I think the most useful thing in this note is that it tells you where else you can go for further information. It goes into the prepayments and defaults on these things, and it also gives you sources of data that are useful for knowing where else you can go for information.

The practice notes go into a little bit more detail on collateralized mortgage obligations (CMOs) than last year, but work is going to be continuing throughout the year, so it really won't reflect the final information on CMOs. As a number of you have already found out, the regulators are interested in your CMO portfolio. The practice notes give some examples of what you may want to show in your actuarial memorandum as to what you looked at regarding CMOs. They also refer to the work of the Invested Asset Working Group, which is still meeting, so the 1993 practice notes will not reflect the final work of that group.

For C-2 risk, according to the survey, many did sensitivity testing, particularly on excess lapses. Also, some mortality and morbidity tests were done. A number of other things were tested, and the practice notes tell the percentage of people from our survey who tested certain things. If you tested them, you probably didn't include them in the memorandum if you found out they did not significantly affect the results. The regulators would like to know what was looked at. One does not have to show 6 million numbers in the memorandum. A statement like "Excess lapses going up 50% were tested, and the reserves still wound up to be adequate" is probably sufficient.

There are also two special practice notes: One on group annuities and one on structured settlements. The group annuity one is short, but I still have not received any comments on it. The structured settlement note is long. I have not received any comments on that one either, so there are no major changes in it this year.

I want to point out that actuaries are not lawyers and actuaries have a tendency to say and do things that can get them into legal trouble. In particular, with cash-flow testing, we did have Lauren write legal notes that list certain things you may want to consider when writing in your actuarial opinion, even though they are not the words in the regulation. This is to maybe protect ourselves a little bit more.

We want to cover additional areas in the future, such as reinsurance. As I said, we realize it is a problem. But nobody who was willing to give any good answers. We are also getting some questions from our regulators and actuaries on how to make

expense assumptions. Again, there is no one way to do it. We want to give certain alternatives. The majority of actuaries did not reflect shareholder dividends in their final testing. All regulators who I spoke to wanted it included in the cash-flow testing, but, enough work wasn't done on it this year to have it included in the 1993 practice notes.

We have one new note for 1993, notification of reserve misstatement. It's a requirement that if the reserves are materially misstated, the actuary has to either rerun the test or notify the regulator. Or if there's a problem, the actuary must notify the company lawyer and let him or her deal with it. But somebody has to be notified.

We hope the process of producing practice notes gets better. If anybody has any questions or comments, or you would like to write a note, please contact me at my *Yearbook* address.

MS. LAUREN BLOOM: Often it's a real pleasure to speak third in a setting like this, because it marks the concept of thesis and antithesis, and I'm supposed to provide the synthesis. And I think that's certainly true here, because as I'm sure it has become apparent, there are very strong feelings on both sides of the practice note issue, if you will. In an effort to try to stem some of those problems, at its October Board meeting, the Academy adopted a document called, "Guidelines for the Development of Practice Notes." Those guidelines are specifically intended to address many of the questions that Tim raised in his presentation.

Let me start with one that I think is the most basic. Why practice notes? The reason for practice notes is that sometimes new areas of practice come up, or actuaries are asked to do things for which there is not a lot of exciting scholarly literature. A compliance guideline, or a new statutory requirement, or something else might suddenly require the actuary to do things that perhaps he or she wasn't required to do before, or the actuary might be asked to do them in a new way. When there is a shortage of that kind of literature, we get requests from our members for more guidelines, and that's exactly what happened with the Standard Valuation Law and the practice notes.

Now there is also a concern here, too. When you're in a new area and, particularly, in an area that is heavily regulated, there is concern that if the profession does not try to thrash out some ways of dealing with new issues, it will suddenly find itself buried in a 98-page regulation. Those regulations are, of course, binding upon you as a matter of state or federal law, depending on the responsible jurisdiction over the area in which you're working. It makes it less necessary for the regulators to step in with defining constraints. But there are a couple of reasons to do them. However, it's been quite rightly pointed out there can be problems with the status of practice notes.

What exactly are they intended to be? Now this question is important, because as Tim also pointed out, actuaries do face a risk of litigation and the appropriateness of actuaries' work can come up in litigation in a whole variety of settings. It can come up in rehabilitation hearings for failed insurance companies. It can come up in malpractice action. It can come up in bankruptcy proceedings. And as Donna pointed out, having your work challenged in a deposition or in court is absolutely no fun at all.

Now, I do want to point out that I think there's a misapprehension floating around the profession, and I want to correct it. Standards of practice do not create liability. Neither do practice notes. What creates liability is loss. Somebody somewhere is injured in some way. Something as simple as a head-on collision with two trucks, something as elaborate as failing to have insurance can cost a lot of people a lot of money. It is the loss that triggers the litigation. Then the question becomes, who is responsible for it? You as professionals are very likely targets for litigation. That has not been true until recently, and even now the actuaries enjoy a relatively low level of lawsuits. But I do think that is likely to change, because both the insurance industry and the pension industry are going through a real upheaval, and the people associated with those industries are much more likely to find themselves in litigation.

Now the good news is, the courts do not require professionals, be they attorneys, doctors, or actuaries, to be perfect and to do everything perfectly or in the best possible way all the time. What they do require professionals to do, and this is where we start getting into the area where standards and practice notes are important, in the case of actuaries, is to have generally accepted actuarial practices. Now how is a court going to figure out what those things are? It is going to look at many things to try to determine what is generally accepted practice in a given area. It seems to me, and I think it seems to M&R's attorney and to other people, that the standards of practice are likely to be very compelling evidence of what constitutes good practice in areas where standards exist. With the data-quality standard, I can tell you there will almost always be at least one from now on, and in many instances, probably two or more. Where there are standards and you elect to depart from them, you do so at your peril, because the odds are pretty good that courts are going to look at those standards and say, that's probably what generally accepted practice is.

As Tim also pointed out, the practice notes are different. At the SOA we talked about possibly undertaking the writing of practice notes. We were not trying to create additional standards of practice. We were trying to create a document that would have the effect of a piece of actuarial literature. That is to say that it would be helpful, it is someone's expression of a way to do things, but it would not necessarily have the same binding, evidentiary weight in court that the standards of practice have. And part of the reason that the standards are going to have so much weight is that they are promulgated by a nationally recognized body. They go through extensive writing and rewriting by the committees and then by the Standards Board. They then go out for notice and comment to many people and come back to the committee for more rewording before the ASB pulls them apart again. They may go back to the committee yet again and even be exposed again before they are finally adopted, if they are at all. So, many procedures are in place to try to make the standards as clear a reflection of generally accepted principles as possible.

The practice notes are not intended to be that. The practice notes are intended to be a supplement to available actuarial literature. They are not interpretations of standards, they are not standards that have failed to go through the process. They are by definition informal, and that's one of the reasons they don't come in those neat, little booklets. We don't want them to have the same weight that the standards do. What have we done to try to avoid that? Well, the first thing we've done is develop those guidelines I was telling you about for the development of practice. They are now being produced, at least in the Academy, through the practice councils. They

will undergo review by the practice council chair, and the chair of whatever task force or committee drafted the practice notes. I'll make sure that they're not inconsistent with the standards of practice and don't impose unreasonable requirements. We've also required that every practice note begin with a little paragraph that explains what they are and what they are not. What it is intended to do is make clear that these are available as advisory guidance for actuaries, but that actuaries are not required to follow them.

Now will that work? I don't know, because we haven't yet seen it go through a court of law. Most of you are familiar with that old joke about the umpire who says it's not a ball or a strike until he calls it. By the same token, the evidentiary weight that's going to be assigned to a particular kind of document is something that we can only try to project, if you will, or anticipate. We won't really know until probably more than one court, or administrative law judge, or someone makes some kind of ruling on it. For this reason, these guidelines were developed and adopted for only one year. If we find out that the practice notes are being misused, and we may want to reconsider whether to undertake the project at all. Nevertheless, we have been told by our members that they have value.

You are right, they do get mailed out. At least the standard valuation law practice notes were mailed to a group of people whom we thought were going to be most likely to be interested in seeing them. We do make them available at no cost on an as-requested basis to anybody who calls the Academy office and asks for them. So we try to make them available to people, but, by the same token, not to stuff them down anybody's throat.

We do anticipate that the Academy Board will revisit the issue of practice notes next year. We do want to see to it that they are as useful as they can be without operating as undue constraint on our members. In the meantime, I hope they are of assistance to you. Ken did make the point that you might find yourself someday in a situation where an attorney is saying to you, "Well, you didn't follow this practice note, did you?" You could also end up in a situation, frankly, where you're on the stand and the attorney says, "Well, you didn't follow the approach that was taken by Professor XYZ in this article, did you?" It is our intent, and what we hope we have achieved, to have the practice notes have about that same level of authority; not the same level of authority as a standard, but the same level of authority as a piece of respected actuarial literature. It's there to give you advice on what other people are doing and approaches that other people have found helpful, without requiring you to take the same approach. After all, if there's one thing I discovered about actuaries in the last few years, you folks are very creative people. We really don't want to interfere with your ability to build a better mousetrap, particularly when you're working in an area that is new and there's still a lot to be discovered.

MR. FRANKLIN C. CLAPPER, JR.: I'm going to deal with something you just finished talking about. If the intended status is to be like a piece of actuarial literature, why don't you just publish it as a piece of actuarial literature in something like the *Financial Reporter*, instead of saying in big, bold letters **PRACTICE NOTE**. Maybe part of the problem that Tim is referring to is the format. It looks like a standard, so it's going to be used as a standard, even if you don't intend it to be a standard. And related to that he said, "same status as a respected piece of actuarial literature." I had an

experience dealing with a tax issue in which the major issue was what current practice was as of 1982 in determining reserves. About $50 million was riding on this question. Though all the evidence was in expert-witness reports that cited actuarial literature, the only problem was, the literature started in 1940 and went through 1990. So the question wasn't clear as to what should have been current practice in 1982. So I don't know.

MS. BLOOM: The last one sounds more like an anecdote than a question.

FROM THE FLOOR: No, it's to point out that this can assume the status of the actuarial standard, whether you intend it to or not.

MS. BLOOM: Certainly any document can assume evidentiary weight in court, as can the opinion of an expert witness. How much weight will be assigned in a given instance is going to depend on the circumstances, on the relevance of the particular piece of literature to the case, frankly, and on the degree to which witness presenting it does a credible job. Now there are several approaches that could have been taken here. Everything from "no, we don't want to publish these, go write an article and get it published someplace," to, obviously, "we need to add more to the standards of practice so we'll start writing appendices and give these the same kinds of notice and exposure that standards receive." A decision was made by the Academy leadership to take this middle ground. And, as I say, we've attempted to find ways to limit the evidentiary weight that will be assigned to these documents, but unless and until such time a judge actually rules on it (and probably more than one judge will, given that we've got 50 sets of state courts and many circuits in the federal system and there are all the various administrative courts where it could come up), we really won't know whether our efforts have been successful.

MR. JOHN S. TILLOTSON: My question is similar. I'm not a lawyer, so I'm kind of an amateur here, but the law abhors a vacuum. Now this is all new, so maybe this year the court would rule that there are no standards. Because it would seem to me that maybe in three or four years you couldn't go into a court and say that there are no accepted standards. We're not ever going to have them. Everybody gets to do whatever they want, and the court and the judicial system will assume that a standard exists, and so then they will start looking for them. So if this is all that exists at that time, the practice notes, regardless of how you qualify them, or expert articles, will fill the vacuum. Now, if in the meantime the regulators come out with many detailed rules, that will solve the problem and create other problems as well.

MS. BLOOM: You say create other problems. I think this is why the Academy has chosen to watch it for one year watch it and see what happens with these documents. It may well be that in another year or two, I don't want to put your committee out of work here, Donna, but as literature develops in this area, the practice notes will cease to be needed.

I guess the point that I would like to make here, to quote from my favorite author, Dr. Seuss, "Remember that life is a balancing act." No one is more expert in the existence of risk than actuaries. In this instance, a decision was made, again, by the Academy leadership, not by me. I'm an employee, but a decision was made that the benefit of having this material available to actuaries was worth undertaking some risk.

Yes, it's very possible that they may be misused. On the other hand, it is also just as possible that five years from now an actuary will be seated in a witness box saying, "Yes, but I followed current practice as reflected in this practice note." Remember that evidence can be used both ways, not just against an actuary. So it is possible that we will find that they have been more helpful than harmful, and it's also possible that they'll never be used at all.

MS. CLAIRE: It is a new area for many people. However, when I was deposed, it was right after my practice notes came out. They were not referred to, but specific speeches that were given at valuation actuary symposiums three and four years ago were referred to, people said X, this particular actuary didn't follow it, and the question was, why? So we have a lot of legal liability as it is. I admit we're not trying to add to it, but we're really trying to give you a place to find a lot of information.

MR. CLAPPER: You responded more to my second question than my first, and maybe Tim would think about this. I used to work for a consulting firm, and consulting companies and big-six firms are very good at doing surveys. Really that's essentially what you're trying to do here. So let me ask the question more directly. Why wouldn't you want to take a less risky route, which is available by publishing these things in actuarial literature? I'm reminded of a survey that Ernst & Young did. First, many firms published guidance of *FAS 97* when it came out and that was their opinion. Generally, their opinions were all the same at the time and they left a lot of open-ended questions. And a few years later, some of them did surveys as to what was current practice, which was very informative, and that's exactly what you're talking about. And those things were published, but they would not carry the same weight as these practice notes, I guarantee it.

MS. BLOOM: That was actually one of the problems we had. Where could they be published to get distributed quickly enough to be useful? Yes, there are *Transactions,* et cetera. That's actually a three-year publishing process. And three years from now you don't want to know what you should have done.

FROM THE FLOOR: The *Financial Reporter* comes out every other month.

MS. BLOOM: Yes, it does, but with a long lead time. In fact, our original thought was to put it in the *Financial Reporter*. We needed a four-month lead time, which would have been completely useless. The same thing is going to happen this year because of the health practice. That's just not there at the time and that's why they are being sent to the financial reporting people and being made available.

MR. HARRIS: I wanted to follow up on that. One of my concerns is that these practice notes don't always express the common practice. They may express the practice of a subgroup of people. We don't know what the size of that subgroup is. At one of the sessions, I heard that Robert Callahan indicated that practice notes suggest some deviations from the valuation law. Someone made a comment to me that the practice notes sometimes indicate an area in which a person may have gotten away with a specific practice that may not be acceptable in all jurisdictions. And I was also involved in a situation in which a group of actuaries in a certain type of company talked to me about their concerns of some valuation requirements and

the fact that their company might not be able to meet or didn't want to meet these valuation requirements. They thought they might write a practice note to allow them to circumvent these requirements. This practice note would say that this is what people generally do, even though it doesn't comply with the valuation law. And this is my concern. There are hidden agendas here in some of these practice notes. One that Donna mentioned is normalization of yield curves. I personally don't believe in normalization of yield curves. I'm not sure where that comes from, but I don't buy that theory. If there's a practice note on it and I have to follow that, I don't believe that presents a problem for me.

MS. BLOOM: This is why the practice notes are written in permissive rather than mandatory language, and we are very careful about that. We have people look at them to try to be sure that they are consistent with the standards of practice and the Standard Valuation Law. And, finally, it is why the preamble to every practice note that is prepared by the Academy contains the explicit statement that actuaries are not bound in any way to follow practice notes.

MS. CLAIRE: And, by the way, if anyone has a differing approach, let me know. It will be in the next draft of practice notes.

MR. HARRIS: I can understand the desire to get these out quickly and to everybody, and that's one of the reasons you did it this way. I also appreciate all the safeguards you've built in there, the legal-type safeguards. Despite all the language, it looks official. It's unsigned. It looks like a standard of practice.

MS. CLAIRE: Well, the final one will have committee names on it, and last year's did include the names of the committee members.

FROM THE FLOOR: So do the standards of practice.

MR. HARRIS: Make it an article as opposed to something like the standards.

FROM THE FLOOR: I can't imagine that would be hard.

MS. CLAIRE: None of the practice notes has a single author. As I said, the first practice note probably has an equivalent of about 50 authors.

MR. HAROLD J. DEUTSCHER: You addressed one issue there in terms of stockholder dividends, implying that they should be included, or some regulators think they should be included. As I read the instructions, we're supposed to concentrate on Exhibits 8, 9, and 10, and the stockholder dividend does not fall under that category at all. We also kind of closed the company down and worked with the in-force business, with no new business coming in. So there's inconsistency as I see it, including dividends. But if we open it up to dividends, what about other types of real contracts a company has – employment contracts with officers, long-term leases, pension plans not funded by the company – that could trigger a lot of vesting costs in the pension plan? I've considered those outside of the scope of the valuation actuary. Yet, if we have a practice note or anything that says to include provisions for dividends, which I would challenge, would I also challenge these others?

MR. HARRIS: That's in the regulatory hidden agenda. The regulators want that.

MS. CLAIRE: The reason we did not address that was because we could not adequately, in the time allotted, put all the different viewpoints in. You have a very good point. The practice note would state that the majority of the industry thinks that, except under special circumstances, and special circumstances being one in which the fact that the subsidiary has to give certain things to the parent, stockholder dividends shouldn't be included. That's probably what the practice note would get into.

Tim is implying that the regulators are hidden in laws or whatever. The regulators are one of the groups, a very important group, that review these. In a number of places we will state that, yes, these are what the regulators are asking for, and in some places, like with intermediate-year results, we will state in the practice notes that the ASOP takes a different stand. But it is not a hidden agenda. We thought people should be aware of what regulators though about certain issues.

FROM THE FLOOR: I guess I first should admit I haven't thought a lot about this. I didn't really know what a practice note was until I walked into this room, but from something Donna said when she was talking about her litigation, I'd just like to bring a question out for food for thought. Now, which is more dangerous, something written that we've had a chance to read and decide whether we agree with, or something that might be brought up in a court of law that you never heard of before?

MS. BLOOM: I appreciate you making that point, because there are many sources of evidence of what constitutes good practice. Things are said at valuation symposiums, things are said at the various professionalism courses, and things are said in house at some company seminars that are held over lunch. Many companies do them, they're good, and they're worthwhile. But, by the same token, someone may come in and express a point of view. One thing I have learned in the last two years is that not only are you folks very creative, but also you disagree a lot. It is often the case that there are two, very well thought out, well-articulated, beautifully reasoned, well-argued, diametrically opposed points of view about how to do something. And, at that point, it becomes a question of dueling experts. Who do you believe? It may well be the case that there's more than one good way to do things. You are not required to do things that way. You are required to do them in a way that is generally accepted practice. And so because of that, the existence of one set of articulated ways to do things does not necessarily preclude alternative approaches.

MS. CLAIRE: But, again, it does give you some assistance. Any comments I received with alternate approaches were incorporated in the practice notes. But I cannot know everything. There are many creative people out there, and the only way I can tell other people about it is if I know about it. So if you write to me about any of the things in the practice notes or have any other questions, your comments will be included, because we really are trying to serve the actuaries doing the testing. We are trying not to have any hidden agendas.

MR. FRANK J. LONGO: I may be looking at this fairly simply, but I accept the fact that the practice notes are being produced primarily for convenience. I think that's a good thing, because I've not attended a valuation actuary symposium, although other

people at my company may have. There's never perfect communication among groups of people. You know that all the information does not get transmitted to other people in the company perfectly. So, in that sense, I view the practice notes as primarily a convenience, but it also strikes me that there's also probably not good or perfect communication between actuaries and their attorneys at their own companies. I was wondering, is it desirable to have any parallel communication that goes to attorneys at companies where appointed actuaries will practice to make them aware that this subject is rising in importance and that it's just something that they ought to be looking out for?

MS. BLOOM: That's an interesting idea, and it's not something that's been suggested before. I don't like to react to things definitively without thinking about them first. Probably any attorney who looks at a final practice note with the disclaimer that's on every first page would understand what we were attempting to do and that those issues are out there. Nevertheless, that is an interesting idea, and one that I'll take back to the Academy for discussion.

FROM THE FLOOR: Another thought I have is that actuaries are getting to the point where they're being held accountable for an accountability that had always been there, but it seems like it's being more clearly focused. That's how I view all of this. I'd like to ask you, Lauren, from your couple of years' experience with the Academy in dealing with the actuarial profession, how do you see actuaries in terms of their capability of accepting that type of responsibility?

MS. BLOOM: Well, actuaries are like any group of people. People's attitudes about these things vary tremendously. I think it's unpleasant for the profession as a whole. Not that the liability wasn't always there; I think you make a good point there. Whenever you undertake to provide a specialized service for someone else, and that's everything from delivering a baby to fixing a car, and you hold yourself out as an expert in some way, then you're expected to behave like a reasonably prudent expert in your field. So that obligation has always been there, but I think that actuaries have tended to work in industries that up until now were very stable and involved relatively little litigation and loss. Unfortunately, there's a lot of turmoil in both the pension field and in the insurance industry these days, and I think that's creating commensurate turmoil within the profession. The other thing, too, is that I know you folks make a career out of minimizing risk. So suddenly finding that risk is increasing has got to be very uncomfortable.

MR. WILLIAM J. BRIGGS: I think practice notes are a good ides. Donna Claire has been intimately involved with the development of Regulation 126 and has a whole network of people that she can talk to on any conceivable issue. But some of us out here in the real world have 87 other things to worry about and find ourselves inexorably dragged into asset/liability matching problems by the appointed actuaries of our company. I'm not there yet, but Donna has assured us that reinsurance will soon be there. I work in reinsurance for the Equitable. And, frankly, I'm not sure reading Regulation 126 would enable me to understand all the issues involved. So having something quick and dirty, relatively speaking, but actually of a high professional quality, is helpful for those of us who don't have all the time in the world to worry about this. Now, is the Health Practice Note ready for release?

MS. BLOOM: No, but it's coming. It's currently with the staff at the Academy office. For anyone who wants draft copies, contact Christine Nickerson at the Academy office. The health practice notes go through a fairly rigorous procedure, and that bothers me. It's good and bad, compared with the standard of practice. They do go through more processes than I realized, which makes me feel better, but it also gives me some concern, because really they're going to be like ASOPs.

I would appreciate it if Donna would talk about the problems of reinsurance.

MS. CLAIRE: Virtually any type of reinsurance is a problem, but giving you some of the background from the regulators' point of view, if you're assuming reinsurance, in effect, you have to rely on the ceding company giving you clean data. Not only that, you cannot rely on the actuary. You probably have to look at the actuarial report and memorandum and make sure everything is done properly, et cetera, to make your official opinion. But even with simple reinsurance like YRT – you know you reinsured all of these people, and, theoretically, you know that that's a female, aged 53, $100,000 – all data may not meet the data-quality standards, so it cannot be relied upon.

With ceding companies, you have the problem of making sure that the reinsurer is going to be fine and around to pay. But, again, certain companies may not meet the rigorous standards. As a ceding company, theoretically, just by using reinsurance in your testing is sort of certifying that you think that it is OK. How much study have you really done of your reinsurer? This could also be a problem.

The more you get into reinsurance the more questions arise. All of these issues have to be addressed, because if reinsurance is reflected in cash-flow testing, there are standards on reinsurance and data quality that should be followed.

MS. BLOOM: I do want to add one point, too, on this review issue. Practice notes, like articles, like standards, and like many other resources that are at the disposal of actuaries, are only going to be of any use to you at all if they're right, or at least if they offer approaches that seem to make sense that are helpful to you, that improve the quality of the work that you do. Now, I don't know how we can deal with some of the other concerns that I heard you raise, Tim, including the notion that they put forth minority views, or views that perhaps aren't reflective of good practice, if they don't go through at least some kind of review.

MS. CLAIRE: Officially, COLIFR reviews them.