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# The Actuarial Ethicist:

## Responses to “Ahead of the Curve”

by Frank Grossman



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### THE CASE STUDY

Briefly summarized<sup>1</sup>, Neil the FSA and chief actuary of his insurance company invested considerable time and resources in the development of his staff and their models over the past four years. His company was subsequently purchased by a larger competitor, and a new CEO, Roger, was transferred from the parent company and became Neil’s boss.

The parent company has considerable expertise with long term disability products and in markets similar to Neil’s LTD lines. Their claims experts conducted a detailed review of all large outstanding LTD claims at Neil’s company and their final report highlighted substantial opportunities to close, reduce or settle a sizeable number of claims with long tails.

Roger met with Neil and observed that his LTD reserves appeared to be overly conservative, and asked what could be done about that. Neil eventually agreed to revise his LTD claim assumptions for the cohort of claimants targeted by the review, partially reflecting the anticipated impact of more efficient claims management practice, which decreased year-end claim reserves for the LTD lines in question by approximately 10 percent on average.

Following year-end, Bruce the auditor challenged the appropriateness of the reduction in LTD reserves, and asked Neil, “How can you defend your change in assumptions?”

### READER RESPONSES

Your comments and suggestions dealt largely with tasks Neil ought to have performed before Bruce contacted him, including careful evaluation of the claim experts’ report and assembly of good documentation. Responses have been edited for space considerations.

#### Similar, Yet Not the Same

Neil appears to be a diligent chief actuary. “*Four years is enough time to establish his focus as chief actuary and not be a drone. The fact that he has*

*developed his staff and improved his models indicates some level of maturity in his role.*” One reader specifically noted that “*Neil needs to be qualified to render opinions and be current on his continuing education credits*” echoing the SOA’s Code of Professional Conduct.

COPC Precept 2: An Actuary shall perform Actuarial Services only when the Actuary is qualified to do so on the basis of basic and continuing education and experience and only when the Actuary satisfies applicable qualification standards.

The case describes the acquiring firm as a “larger competitor” with “considerable expertise with LTD products and in markets similar to Neil’s LTD lines.” Note, however, that the case does *not* say that the acquiring company’s body of claims experience was more credible than Neil’s firm’s data. One sharp-eyed reader observed that “with LTD products and in markets similar to Neil’s LTD lines” meant of the same type but not necessarily the same products or markets. Several readers nevertheless concluded that the acquiring company’s LTD experience was more credible, and their LTD lines were exactly the same as Neil’s.

#### Assumption Setting Rudiments

One actuary defended Neil’s approach. “*There will, in practice, be several sets of experience taken into account:*

- *the experience underlying the base table;*
- *inter-company termination study reports for the industry, leading to adjustments to the base table; and*
- *own company termination studies of the experience of the actual block of business, used to confirm or further adjust the termination rates.*

*The rates will be set by the actuary by giving levels of credibility to each of these sets of experience. On occasion, one or more additional factors will be taken into account if the actuary has good reason to believe that they will influence the future experience.”* A change in assumptions may be triggered

by “an argument that an external factor, namely the claims management process, has changed or is about to change.”

Another anticipated a corporate desire for consistency in LTD assumptions. “Once the two companies merge, then it’s probably reasonable for the reserve assumptions for the two companies to be consistent (using the combined data of both companies). The parent’s reserves might go up to offset if blended experience is used. Alternatively, Neil might be able to just use the parent’s assumptions, if he could point to the implementation of clear process differences.”

The first actuary also considered the asset side of the balance sheet. “Part of the reason for settling long-tail claims may be reduction of financial risk rather than reduction of expected value. For example, long-tail claims carry additional financial risk because they cannot easily be closely matched by fixed income investments. If the purpose of the settlements is to remove these risks from the portfolio, the settlement basis may be as generous, perhaps even more generous, than the computed expected value of future payments and still be beneficial from the insurer’s point of view. In that scenario, future settlements may not augur lower claims costs.”

A third mentioned the risk of potential policyholder lawsuits, due to overly aggressive efforts to close, reduce or settle claims, and their attendant legal costs—something else for Neil to consider.

### Tea for Two

That Neil “eventually agreed” to lower his LTD claim reserves suggests that this was not an immediate response. Neil set his assumptions after the claims experts completed their final report, but before his meeting with Roger. One might fairly conclude that the chief actuary was aware of the claims experts’ findings and considered them when setting his assumptions. The relevant Actuarial Standard of Practice [ASOP] says as much.

ASOP 5 (Incurred Health and Disability Claims) §3.2.1  
Health Benefit Plan Provisions and Business Practices (in

part): The actuary should consider the health benefit plan provisions and business practices ... that materially affect the cost, frequency, and severity of claims.

(A Health Benefit Plan is defined to include a disability income plan.)

And yet the case study is silent on the process or criteria that led Neil to “eventually agree” with Roger. One wonders what Roger might have said that prompted the chief actuary to revise his assumptions. Readers offered a range of interpretations. One actuary wrote plainly, “I never thought, based on the write-up, that Neil did something arbitrary just because his CEO asked.” Another concluded that Neil had indeed been railroaded by Roger. When confronted by ambiguity, what do good actuaries do? Make an assumption! And this is exactly what a third reader did: “I’m going with the theory that Neil didn’t bend to pressure, but used professional judgment and relied on the experts who said the costs can be lowered.”

### People Who Need People

The acquiring company’s claims experts clearly provided Neil with additional, new information. “The parent company has expertise that is considered improved and different claim management practices.” Another reader noted, “Neil is relying on the claims expert in the new company and can do that as long as he has analyzed and reviewed the new methods and agrees with them.”

To the extent that Neil’s assumptions were influenced by their analysis—either before or after meeting with Roger—this “reliance on others needs to be documented and it probably would be good to have the claims experts sign a reliance statement regarding the information they are supplying.” This view was echoed by another actuary who suggested, “Since Neil didn’t actually do the claims analysis and he is relying on someone else’s word/analysis that the new company will manage the claims differently, he should state that explicitly via a reliance letter.”

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### Timing is Everything

It's possible that Roger had a valid point. Actuaries are generally a pretty staid lot, and maybe Neil's LTD reserves were too heavy. One reader suggested, *“It actually sounds like Neil should have been incorporating some degree of claims management improvement into his valuations before meeting with Roger ... Was he being overly conservative before the acquisition?”*

But the sticking point is when exactly should Neil reflect the impact of the parent company's more efficient claims management practice? *“Claims handling practices have to be taken into consideration, but I suppose that this could be taken to say that the expert analysis in Neil's case could only be applied after the change in practice occurs.”* A second actuary cited practical considerations. *“From an acquisition standpoint, just because you buy another company, that doesn't mean you can roll out your claim payment practices on Day 1. Sometimes it takes months or years for the ‘better’ practices of one company to take hold in another company. So, if the claim payment practices weren't going to be*

*operational until, say, three years down the road, Neil needs to take that into consideration and not assume they happened on Day 1.”*

A more skeptical attitude was reflected in another response. *“In terms of basing a reserve reduction on a review of opportunities, that's probably not justified. If the opportunities are real, then when acted upon—and the claims are closed—they will naturally lead to the reserves coming off of the books. If I were Neil, I would allow the reserves to come off through the targeted actions, rather than assume the targeted actions were effective in advance.”*

### Tell and Show?

Several actuaries mentioned pitfalls that Neil should take care to avoid. One observed that the influence of an external factor on termination rates may be weak or contrary, for example if *“the new claims management process has already commenced and the opportunities to close, reduce and settle claims have already been taken advantage of.”* It may be worth noting that the case does not spell out whether the “substantial opportunities to close, reduce or settle a sizeable number of claims with long tails” were ever acted on. *“Such claims reviews, while valuable and useful, cannot usually be repeated to the same effect and typically produce diminishing returns. If on the other hand the revised claims management process has yet to be applied, the impact on future claims expenses may be mixed.”* Perhaps that's why Neil only “partially reflected” their anticipated impact.

A canny actuary mentioned, *“Another issue is to what extent did Neil look for potentially offsetting factors when he put the assumption change through. Was he aware of any such items, yet ignored them, effectively allowing the CEO to cherry pick the obvious and available positive impacts to current period financials?”*

The first actuary also mentioned, *“Hopefully, Neil has not applied the time-honored actuarial technique of ‘tell me what answer you want, and I will*

*show you how to get there'. In that case, it might be difficult for Neil to convince Bruce that the assumption change was justifiable."*

### **A Routine Call**

Several actuaries mentioned the importance of having one's documentation in order *before* the auditor calls. This would include *"the experience data and reserve assumptions of both firms"* taking care to spell out the material changes made to these assumptions for year-end. *"Neil should have a package ready to share with the auditors when changing assumptions has a 10 percent impact on the reserves, including a complete list of the reasons underlying the changes and their supporting logic."* One actuary specifically noted that not only the credibility of claims data but its relevance (i.e. consistency with claims practices going forward) ought to be described and disclosed. And providing evidence of process controls that were in place to ensure that the desired assumption changes where those actually implemented couldn't hurt.

The case mentions that the auditor's post year-end call was routine, but there was no indication whether Bruce had audited Neil's work previously, or that he was a new external auditor. In this vein, one actuary wondered, *"Was Neil's original company privately held or otherwise subject to a different audit standard than the parent company?"* The first year-end under new top management might mean a new audit process for Neil as well. If this was indeed the case, then a little proactive information gathering (e.g. What's different about our new audit standard?) and advance preparation (e.g. What do I have to do now that I haven't done before to meet this standard?) on Neil's part would have been a good idea. Another actuary specifically mentioned a need to *"discuss the auditor's threshold for materiality."* Neil could have taken the initiative and called Bruce first—maybe even prior to year-end!

One actuary noted that, *"An equally valid question from the auditor would have been 'How can you*

*defend no change in assumptions?"* which serves as a reminder that a decision to make no revisions to one's assumptions may need to be buttressed somehow. Another reader wrote, *"When updating assumptions, even if that means no change from prior assumptions, documentation of the experience study used and any changes in process (new, more efficient claims management practice) should be prepared."*

While there may be innumerable ways to come up with a wrong answer, a sage actuary noted there may not necessarily be a single right answer. *"Bruce as an auditor likely thinks in terms of there being a 'correct' liability. Some actuaries think that way too. In fact, there is no 'right' number for a liability of this sort, involving as it does both probabilities of payment and time value of money. Probabilities of payment are based on experience, and depend upon the experience selected and the credibility assigned to that experience."* Amen to that.

## **CONCLUDING THOUGHTS**

A sincere thank you to all who contributed their comments and suggestions about Neil's next move. And special thanks to John Hadley who co-authored the case with me.

The contents of this article should not in any way be construed as a definitive interpretation of the various actuarial guidance documents referenced within the article. This hypothetical case study and its discussion are intended for the personal use and (possible) edification of members of the Management & Personal Development Section. ●

### **ENDNOTES**

<sup>1</sup> See the February 2011 issue of *The Stepping Stone* for the complete description of this case study.

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