The Actuary

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The Actuary

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EXAMINING DEPARTMENT EXAMINATIONS

Strengthening The Surveillance System, Final Report to the NAIC-McKinsey Co. Inc., New York.

by George Brummer

Supervision over insurance companies—or, as it is called here, a Surveillance System—is not something that can be lightly dismissed. Insurance is very much a "people" business and, consequently, supervision over it is in the public interest. Moreover, it is in the public interest that any supervision be efficient and, above all, effective.

Insurance supervision in the United States is nothing new. It has been with us for nearly 100 years, evolving and growing with time to its present state. Throughout, a major part of the supervision process has been the regular examination of each insurance company by State examiners under the direction of a State Insurance Commissioner These regular examinations have never become standardized, but have nonetheless been expected to furnish the various state regulatory authorities with sufficient information to enable them to determine the solvency of insurers within their jurisdiction. In recent years, the process has been expanding to include supervision over certain marketing practices, such as advertising. Sometimes this expansion came after prodding by consumerist movements, but more often the impetus came from within the State Insurance Departments.

Unfortunately, the examination system is still not satisfactory. Recognizing this, the National Association of Insurance Commissioners, in 1973, asked McKinsey & Company, a well-known firm of management consultants, to review the system and recommend changes. The results of this review and the recommen-

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EDITORIAL BOARD CHANGES

Pressure of other duties has led Kenneth T. Clark to resign from the Editorial Board much to the regret of his colleagues. Ken has been an active Editor since November 1970 and his scholarly wit has enlivened the duties of the other Editors as well as the pages of *The Actuary*. The Society and *The Actuary* say "Thank You".

We welcome to the Editorial Board, Colin E. Jack who will also act as our Canadian correspondent. We also welcome an addition to the Board, Jonathan L. Wooley.

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20th INTERNATIONAL CONGRESS OF ACTUARIES

The papers submitted by the United States members for the Congress to be held in Tokyo in October 1976 are reviewed by a Committee from the United States section of the International Actuarial Association.

The members of this Committee are as follows:

Newton L. Bowers, Jr.
Thomas P. Bleakney
Melvin L. Gold
T. N. E. Greville
Charles C. Hewitt, Jr.
David G. Halmstad
Paul M. Kahn
William J. November
Jerome A. Scheibl
Donald B. Warren
Robert J. Myers, Chairman

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THE ACTUARY AS A PROFESSIONAL

By John C. Angle

"Those uncertain actuaries," as Fortune Magazine characterized us in 1965, still aren't certain of their identity or professional standards. The words "identity crisis" leap out from Past President Morton D. Miller's program introduction for the 1974 Annual Meeting. And John Bragg's paper reminds us of our forlorn search for an acceptable definition of our profession's brand name, actuary. Mr. Bragg tries again by saying we are experts. I give him credit for a good try, but "What do you do?" will continue to rank among the most difficult questions faced by an actuary.

Our persistent failure to cast a suitable definition of "actuary" can be accounted for, I suspect, by varied roles of today's actuaries. We are, in fact, as fragmented as the French Assembly. Our common bonds are those of a scientific discipline which seems to be breaking into several subspecialties. Our cultural ties are those which unite the graduates of a single institute: only we took our studies by correspondence and wrote examinations in centers stretching from the Philippines to South Africa. But can the unity of education produce a unity of vocation? I will suggest that it cannot. While the president of a mutual life company and a consulting actuary can unite in scientific matters, to suggest that they share identical vocational obligations is to fall into the trap of those who consider alike all insurance men or all Texans or all New Yorkers.

From the birth of the Equitable in London in 1762, a company soundly guided by the work of Dr. Richard Price, to the founding of the Society of Actuaries, "actuary" has referred to an officer of a life insurance company.

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Letters

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Wright and Jeff Liebman letter in the December, 1974 issue of *The Actuary.*

First of all, the Preface by Robert Posnak to *Ernst & Ernst GAAP*—especially the concluding paragraphs — should be must reading for all of us.

The comment on disclosure of withdrawal assumptions is apt in the choice of term, "absurdity", but inept in its application. The absurdity is in introducing withdrawal assumptions into the policy reserves, along with a host of other refinements, and then (since standardization of assumptions was out of the question) requiring "disclosure" — in the expectation that statements would be automatically more meaningful.

I submit that a footnote stating "Linton B lapse rates were used for all permanent plans and 150% of Moorhead R lapse rates were used for term plans"—though admittedly quite specific disclosure—is not even an *assertion* that these assumptions are appropriate.

Very often the company actuary has high on his list of projects soon to be undertaken, the accumulation and analysis of data "with which to attempt a quantification of the possible effect on GAAP earnings of his company's lapse experience" — or to gain a little more assurance that his pricing is appropriate.

My recommendation — notwithstanding the eager jump of the SEC — is that you continue to rely on statutory statements and the adjustments derived from your experience. It will be a long time before GAAP statements — even with all the supporting documents that the combined armies of accountants and actuaries can provide — will serve you better.

Considering the wide range of absurdities in the market behavior of stocks in industries other than life insurance (which analysts and CPA's alike would have us believe are more consistently represented in their financial statements), I am tempted to make the hasty and admittedly uninformed judgment that the professional services of analysts — in so far as they affect their clients' decisions — are in approximately the same proportion between semblance and real service as are the professional services of accountants and actuaries; — about which I am somewhat more informed. There is no malice or condemnation in this statement. Obviously, the ratio of semblance to real service reflects the public need.

Since my principle interest outside of my profession is in that field to which the term esoteric was once applied exclusively — and which I would like to see stripped of that concept — it is with genuine mixed feelings that I read the suggestion that life stocks are regarded an esoteric group.

Actuaries and analysts alike are realistic in that their goals are both the reduction of real uncertainty. Accountants, I find, are more apt to seek the reduction of uncertainty *of form* through codification of "principles of accountantancy". It is a moot question whether the principles now canonized in the Audit Guide reflect more the laxity of the analysts or of the actuaries. I suggest it merely reflects the overwhelming strength of numbers — and public recognition — of the accountants.

Uncertainty, however, is the very substance of the insurance business (and the vital essence of the stock market). Nothing is more certain to the experienced actuary than that his assumptions will not be fulfilled in any particular — but he holds to the hope that the net results he predicts will approximate reality. Often, *mirabile dictu,* he proves right. In fact the mature life company often produces more stable and predictable earnings (however defined) than its less esoteric neighbor.

John C. Gould

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A Paradise for GAAP!

Sir:

Baltimore is known as the Monument City — not only for the Washington Monument in Mount Vernon Place, but also for the many statues which adorn her Boulevards, parks, and crossroads. There are monuments to medieval Scottish heroes, the Muses, winged victories, LaFayette (of course), nyads, dryads, and so on *ad proliferatum.* Baltimore is, one might say, a city of almost no statutory reserve.

David Kramer

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Examining Exams

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dations that followed fr : are embodied in the Introduction, c Chapters and three Appendices that comprise their *Final Report on Strengthening the Surveillance System.*

The Report begins with an evaluation of the present system. Based on the premise that the primary purposes of surveillance are (1) to protect the public against insolvencies and (2) to insure fair treatment of policyholders and claimants, the report gives the present system poor grades at achieving either of these.

The deficiencies arise from various causes: statutory requirements are far from uniform; regulatory authorities differ in their examination methods and in their analyses of financial statements and complaints; exchanges of information are slow or virtually non-existent; examinations are infrequent and not scheduled according to need; and manpower, sometimes of dubious quality, is used ineffectively. Furthermore, the present system has not been of too mu help to Insurance Departments in iden fying companies in difficulty or in overseeing the admission of new companies.

To overcome these deficiences, the Report recommends a restructuring. The surveillance system would be composed of two independent yet coordinated parts —one concerned with the company's financial condition and soundness, and the other with its marketing conduct, including its sales and underwriting practices.

The first part would be accomplished through a different type of examination process. Sampling techniques would be used widely and there would be continual monitoring through comparisons of a company's results against established norms and guideposts. Examiners would be more knowledgeable, better trained, and more highly compensated. The more experienced individuals will be experts in specific areas and will enjoy a greater degree of authority and carry greater responsibility in the examination process and in the personnel structure.

Examiners' reports would no long devote considerable space to reciti picayune details, but instead would reflect the examination's concentration and focus on the important issues. The pres-

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ent routine of examining every company every X years would be abandoned in favor of a system whereby a State Insurance Department decides when the examination of a company under its jurisdiction is needed and then proceeds accordingly.

It is anticipated that financially troubled companies and those with high complaint rates will be examined more frequently. Those that are small in size or with a relatively new management will be special targets since the record shows them to have the highest rates of insolvency. The system will provide for a greater degree of coordination and of sharing of information among the interested states, and for a zone examiner to have more responsibilities as an integral member of an examining team rather than as an outsider expected to be a jack of all trades.

The second part concentrates on a company's marketing conduct, including sales, underwriting, rating and claim practices. A review of the treatment of the policyholders would use similar approaches such as sampling techniques and examinations by experienced examiners as needed.

The stress that the McKinsey Report places on this aspect of a surveillance system is proper and fitting. After all, one of the primary reasons for the existence of a State Insurance Department is to assure the fair treatment of policyholders. Some Departments perform this function better than others, probably because not all of them investigate complaints with the same degree of throughness. The same is true of companies, some of whom exhibit a proper degree of public consciousness while others almost ignore it.

And, recently, consumerism has entered the arena, although its emphasis has generally been along the road of information rather than of rectifying complaints. Still, in the final analysis, the Insurance Departments are the ones in the best position to determine whether the public is indeed being treated fairly, something the public does not always know, and even more rarely recognizes or appreciates. Nevertheless, the public deserves and Insurance Departments must be given the means, in terms of both methods and manpower, to assure fair treatment.

Changes in structure and examination approach are not, however, the only ones needed. The present system of having the company being examined pay the cost of its examination may, for example, put it in an even worse position if it is financially troubled. The report suggests a financing sytem whereby a state's expenses of financial condition examinations are covered by assessing its domiciled companies on the basis of earned premiums. The cost of market conduct examinations would be spread among all companies, both domestic and foreign, doing business in the state, on the basis of premiums each shows as written in the state. The Report also amplifies further on the strengthening of examining staffs and calls for higher qualifications for employment, higher standards for promotion and higher salaries.

The Report also makes several references to CPA audits, findings and working papers, and suggests the use of such material by Insurance Department examiners wherever practical, as long as one does not blindly accept the word of the other. This reviewer, not being a state examiner, is hardly in a position to comment, but it does look as though the same job is being done twice. For that matter, the same could be said with respect to some of the services being rendered by a consulting actuary.

Finally, the Report concludes with an outline, including recommended timing, for implementing the numerous changes, and with brief descriptions of the examination procedures followed in other industries and nations.

Having covered so much ground in so few pages, there are bound to be some defects. A more prominent one is the inclination to oversimplify. For example, to concentrate emphasis on companies that are prime candidates for insolvency while paying much less attention to those that are just poorly run but in no danger, means that the public will continue to suffer. The abandonment of comprehensive examinations in favor of sampling and comparison tests may well result in many important items being overlooked.

The Report seems to envisage a future regulatory model for all states. Examiners in all states will be highly skilled and highly paid even to the extent of competing successfully with private industry. Examinations will be efficient and identical from state to state and any one state will trust unequivocally the judgment of another. This suggests to the reviewer an ignorance of the current practical operation of State supervision.

The other glaring defect, although perhaps a more chauvinistic one, is the very sparse mention of actuaries and the complete absence of any reference to any actuarial organizations or professional designations. Yet actuaries are the only group who have considerable knowledge and familiarity in more than just one or two of the areas listed in the Report as being essential to investigate. Actuaries are the only ones who feel at home with computer records, financial statements (including assets, liabilities, profit and loss, etc.), statistical comparison tests, sampling methods, statutes and regulations, underwriting procedures, premium development and rating practices, surplus distribution, and all the other features of insurance company organization and operation. CPA's are mentioned throughout the Report—why no mention of MAAA's, FSA's, FCAS's, etc.

All in all, the Report provides food for thought for everyone involved in the examination process, for both examiners and examinees. Responsible State Insurance Department officials should work more diligently and more quickly toward the implementation of a truly coordinated nationwide regulatory system despite the elected or appointed commissioners, whose tenure is often too short to have any effect, and despite those Insurance Department staff members whose inclination is to resist any kind of change.

Similarly, companies, being in the forefront of those suffering from the inadequacies of present examination procedures, should not only support improvements in the surveillance system, many of which are long overdue, but should also anticipate them by adapting themselves to changes even before they become a reality. They certainly should not sit still.

And actuaries, some 75% whom are affected by the surveillance system through their association with insurance companies, should take a much more ac-

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Actuary as a Professional

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technique is powerful, Professor Kuhn calls scientific education narrower and more rigid than that of any other course of instruction save that of seminarians in orthodox theology. Furthermore scientific education proceeds from textbooks (read *Study Notes*) to concentrate the student's attention on the development of highly refined, particular skills. Little time is spent giving novices any insight into the premises of the field. Textbooks and even scientific papers are prepared according to the advice attributed to Louis Pasteur: "Make it seem inevitable." This may explain why scientists, actuaries included, find it more difficult to explain their work or relate it to other fields than to apply it to a problem.

In the debate over "Professionalism," the term "professional" seems to be defined to emphasize a practitioner's relations with clients and is undoubtedly stimulated by the ethical problems of consulting actuaries. The analogue for this sort of "professional" seems not to be that of the scientist but of the public accountant. The public accountant, it seems to me, is a sort of financial referee who can give investors, lending institutions and governments an independent, unbiased opinion about the accuracy of a firm's financial statements. In this role of financial referee, he abides by rules of statement presentation established through a quasi-judicial process within the accounting profession. Conformity to these rules rather than creativity seems the byword in accountancy.

Somehow I find the rule making of professionalism the antithesis of the scientific ethic which encourages all members to untrammeled debate over the quality and objectivity of any scientific work presented by a fellow scientist. At the heart of the scientific ethic, according to Jacob Bronowski, lies an almost religious worship of the value of truth. From this ethic, according to Bronowski, flow such other values characteristic of scientists as independence, originality, dissent, tolerance, freedom, justice, honor, and respect.

Not only are professional-vocational rules of conduct likely to stifle the iconoclastic spirit needed by a good actuary but they are apt to curtail his venturesomeness. After all, our science is not explicit enough to cover all situations in which an actuary gives advice. Often we must reason by analogy from the simple models of life contingencies to the complexities of a large insurance company. In creating new coverages or new financing provisions our experience and mathematical skills may be all that we have to bear upon the problem.

Among all company officers the actuary seems uniquely insulated against that ultimate manifestation of unpopularity, the pink slip, by the apparently limitless demand of the marketplace for more actuaries. E. J. Moorhead suggested several years ago that actuaries cultivate a readiness to sacrifice. He recalled the words of George King who said, when accepting the Gold Medal of the Institute of Actuaries:

> "Four times in my life I was out of a job, without knowing where I could earn the next sixpence, just because I would not accept conditions that seemed to me to be dishonorable or perhaps worse. I wish every person to know, the younger men especially, that I was never a penny the worse, and those whom I left were those who suffered most . . . My advice would be that a man should be sure that his position is right, and then go forward boldly with no fear of what might happen to him."

I conclude that the heritage of actuaries is the maverick-like freedom of thought characteristic of Dr. Richard Price rather than in the catechisms of some orthodoxy of practice. Attempts to put actuarial practice in a mold will be as doomed to failure as are business plans which take no note of changing times and consumer wants.

Furthermore, attempts to specify modes of practice are made more difficult by the balkanization of the actuarial profession in North America. Rather than creating a need for some new generalization, such as professionalism, I believe the situation cries for enough organizational fragmentation to stimulate new scientific theories, new debate and new extensions of our science to meet the needs of the actuaries of today.

The above is part of Mr. Angle's discussion of John M. Bragg's The Future of the Actuarial Profession as Viewed in A.D. 1974. □

Actuarial Meetings

Feb. 11, Central Illinois Actuarial Club

Feb. 13, Baltimore Actuaries Club

March 3, Boston Actuaries' Club

March 12, Hartford Actuaries Club, Springfield, Mass.

March 13, Actuarial Club of Indianapolis

March 13, Baltimore Actuaries Club

March 14, San Francisco Actuarial Club

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tive part in the deliberations regarding changes and in assisting regulatory authorities in the examination process itself, steps that should be possible through the formation of committees and panels of professionals by one or more of our organizations. We have the knowledge and the expertise, and we should make it available to assist in the outcome and to influence it to move in the right direction. Perhaps, through such participation, coupled with the strong support of actuaries in general, we will not find ourselves being once again in the position of onlookers that later must follow the dictates of others who played more active roles. It happened with the accounting for pension costs and the presentation of life insurance company financial results. The trend threatens to continue as economists become more heavily involved in social insurance programs and as cost accountants and various Federal government functionaries enter the pension arena. The actuarial profession must assert more leadership.

Our contribution must become more effective and our participation more influential. Whenever we can, we must speak instead of merely being spoken to. The McKinsey Report, its proposals and its recommendations provide just such an opportunity. □

Death

Valentine Howell