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Ethics in Financial Reporting

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Summary: The actuary bears a significant responsibility in assuring that the methods, assumptions and processes used to determine certain financial statement balances adhere to regulatory and professional requirements. This work affords actuaries significant judgment in their interpretation and applications of these requirements to specific circumstances.

This session focuses on how actuaries bearing these responsibilities are creating an environment to ensure the integrity of reported financial results. Attendees understand how actuaries have participated in initiatives for better corporate governance.

MR. DARRYL G. WAGNER: First, we have Neville Henderson, a partner with PricewaterhouseCoopers. He leads the life actuarial practice for PwC in Canada. He has been very active in the profession, serving as the president of the Canadian Institute of Actuaries (CIA). He's also been the general chair of the education and examination committee for the Society of Actuaries (SOA). He's a past member of the board of governors of the SOA and was the chair of the disciplinary committee for the CIA. Mr. Henderson certainly has a lot of perspective to bring to us regarding standard setting. In particular, he's going to talk about the recent work that's been done in the CIA on peer review.

Also, we have Josephine Robinson from Sun Life Financial of Canada. She is assistant vice president and actuary. Her responsibilities include the external peer-

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review process at Sun Life and the dynamic capital-adequacy testing for the company. She serves as the relationship manager for U.S. operations.

My name is Darryl Wagner, and I'm a partner with Deloitte & Touche. I lead our life actuarial practice in the United States. I've been working with both our audit clients and non-audit clients on issues related to Sarbanes-Oxley, and that's going to be one of the things I will talk about today.

Mr. Henderson is going to start the session by talking about the peer-review standards in Canada, in particular. He'll tell us what's happened, what the impetus was, and the implications. I'm going to talk about Sarbanes-Oxley and what that means. Ms. Robinson is going to talk about how this is affecting Sun Life, and how her company is implementing some of these things — touching on both Sarbanes-Oxley and the peer-review standards.

I was in a focus group the other day on the image of the actuarial profession, how we rate ourselves, and how employers and others rate us. And one of the things that was true for both our assessment of ourselves, and of those by our stakeholders is that we are very ethical. In fact, "ethical" was the highest-scored quality, even above problem solving and technical competence. I think having ethical standards is an asset, but we need to make sure that we safeguard it. The world has changed. We're in the post-Sarbanes-Oxley, post-Enron world. I think that there are a couple of lessons that I've learned from that. Even when it seems like things are going OK, it doesn't mean that they are. Even if you're doing your job well, you've got to be looking at the folks that you're associated with — whether it's the rest of an organization, clients, or whatever. There are things that we all need to be aware of. How do we keep ourselves highly rated in integrity? It's not just about fraud. I think that we'd all agree that that's something that we don't have to worry too much about as a profession. But anybody can make mistakes. How do we manage that risk in terms of controls, and not in such a way that it keeps us from completing our business. Those are things for you to think about. Are we ethical? And, from a practical perspective on peer review and Sarbanes-Oxley, what does it mean? How are companies dealing with it?

MR. NEVILLE HENDERSON: In Canada, most regulations are coming through various securities commissions. In Canada, they're provincial, and some of them are fairly draconian. Most of the regulations are aimed at the board of directors, not specifically at the actuary. Right now, the Ontario Securities Commission is considering new legislation. Under that regulation, there is a whole list of things that members of the board have to do to make sure that when they sign off on a financial statement for a company, they've gone through a whole series of steps and are satisfied that those numbers are correct. Once they've signed it, anyone who uses those financial statements could lodge a complaint that there was a misrepresentation. And they are presumed guilty until they demonstrate that they've gone through all of those steps. The result has been good for me. I'm appointed actuary for quite a number of companies. And I find that the board of

directors suddenly realizes the importance of my presentations. And they want to know more about the numbers. They're asking me to explain where they come from. They're more interested in what other companies are doing. This whole process has really started to drive ethics in financial reporting — increased interest in what's being done. I think that is beneficial for the profession.

In order to understand what happens in Canada, you need to have a sense of who is doing the governance and how the whole thing operates because the actuarial profession is somewhat isolated from direct regulations. First of all, there's the Insurance Companies Act. That, fundamentally, is rewritten every 20 to 30 years, however long it takes. It doesn't change frequently, but that's the key act in Canada. It's at the federal level, and it basically controls all of the federally regulated companies. The Office of the Superintendent of Financial Institutions (OSFI) is responsible for administering that act. As you can imagine, because the act doesn't change frequently, there are a lot of changes in financial reporting that must be reflected in the company's valuation. So OSFI will update the act and has additional requirements that the actuary has to respond to.

There are also provincial regulations. If we think of OSFI as the federal regulator that's responsible for financial integrity, the provincial regulators are more interested in aspects of regulation that affect the inhabitants of the province. So things like agent licensing and marketing would be key. There are some companies that are only provincially licensed. And the provincial regulators would review those. They typically use OSFI requirements. The only real exception is Quebec. Quebec has its own sets of financial requirements, and it manages them rigidly. That's the only provincial regulator that is that strong.

The CIA is the main body. And we're a bit more fortunate in Canada than in the States. Everything is in one body. So the property and casualty (P&C) people, life people, pension people, etc., all report through the same body. All of the rules are consistently drafted. And a lot of effort has been put into coming up with what we call "consolidated standards of practice," which tie all of the core practices that actuaries need into one framework. That applies to everybody, regardless of your discipline. The other pieces are the practice-specific pieces. Those have been separated. The SEC, though it's not that active in Canada, has tremendous influence. The reality is that most of the large Canadian companies are SEC-registrants. SEC registrants own a lot of other Canadian companies. So Sarbanes-Oxley and other SEC regulations significantly affect us.

I will talk just a bit about the Insurance Companies Act, to let you know how the actuary is perceived in Canada and the strength and weaknesses of our position. I'm going to talk about some of the implications of these things. First of all, all federally licensed companies must comply with the Insurance Companies Act. The Act defines the actuary. We are defined bodies in Canada. We are accepted, on a regulatory basis, in the federal and all the provincial regulations. We are expected to apply what, according to the act, is generally accepted actuarial practice. And it

defines that as the standards of the CIA, plus what other requirements the OSFI might impose. So we have a well-defined body of actuarial practice. It states that if an actuary does comply with the Act and makes a statement, he is not subject to civil liability, which is an important aspect of the job. I think that most appointed actuaries in Canada view the job as fairly high risk. There are a lot of requirements and there is a lot of responsibility. And you are, of course, subject to the discipline process. The act always has enabled OSFI to look at the actuary's work and demand a second opinion, if they want it. If they feel that the actuary hasn't looked at all of the appropriate factors or that the valuation is not copasetic, they can demand a review. They can appoint another actuary to do that review. The company pays for it. And that enablement, under the act, is one of the things that drove this whole need for peer review.

OSFI, as I mentioned, controls the Act. They administer it. They can order a review of an actuary's work if they so desire. They also issue an annual memorandum to the appointed actuary, outlining what additional requirements they want in the evaluation. OSFI examines companies every year. So OSFI has a preconceived notion of how companies are doing, how strong the valuation is and where they think there may be weaknesses in the valuation. So whenever we deal with a company, we go to OSFI and try to find out what the sensitivities are. Because when you're doing your appointed actuary work, you want to make sure that you cover those. If you don't, they're going to come back to haunt you during the audit. OSFI also has played a fairly significant role in driving the CIA in developing standards.

The CIA is the body that sets standards. I explained to you how all of these various practices are tied together. There are three key elements of the codes of professional conduct. We have general standards of practice, and that takes priority. That applies to every actuary in Canada, regardless of discipline. And then there are the practice-specific standards. So for life insurance and P&C insurance, for example, there are a set of standards that tell you how to narrow the general standards down to apply to that type of work. There are similar things for pension actuaries and for workers' compensation actuaries. It's all broken down by discipline.

Having standards is one thing. And back in the early 1980s, when we wrote the role of the appointed actuary into the legislation, there was a significant concern that we had to manage and insure that our members applied the standards. That led to the development and strengthening of our discipline process. There's been quite a bit of activity in that area during the last couple of decades. It led to the development of compliance questionnaires, to make sure that actuaries were applying the standards. They asked questions regarding the valuation of various choices of assumptions, choices of methods, whether experience studies were used — just to make sure that the actuary had actually considered those things and confirmed them. That, more recently, has moved to what we call peer review or independent actuarial review.

The SEC, though it doesn't have direct control over all companies in Canada, does have control over U.S. registrants. Our finding is that most Canadian companies are applying pieces of Sarbanes-Oxley, especially their audit committees, even though they're not necessarily forced to do that. They're typically viewing adoption of the regulations as good practice. So we are seeing significant implications of SEC guidelines in Canada.

As past president of the CIA, I think that we've done some wonderful work and a very good job of developing standards. But the reality is that we have been a volunteer body. And I think that, like any volunteer body, developing something new takes a supreme amount of work, and there is an awful lot of pressure from one's employer to do other things. So I am the first one to admit that we haven't necessarily been the fastest in developing standards. But we have a fairly comprehensive and thorough body of standards in place at this time.

In the 1980s and 1990s, there were several insolvencies in Canada. But there were also a number of other companies for which, although they were solvent, their asset-liability management was such that a significant change in the economic environment could have impaired their financial solvency. So there was concern that there were a number of companies out there that may be potentially insolvent if the economy turned any further downward. So that was their primary concern.

The other concern was the standards of practice. Because companies are different, we define our best-estimate assumption without bias. And then we add a margin for adverse deviation. There's a significant range around that margin for adverse deviation. Now, there are guidelines on how you would select that, but there is a fairly significant range. OSFI reaction to that was that it was too broad. I can remember sitting in meetings with the superintendent of insurance, back in the late 1990s. He basically said, "Look, you have two actuaries. They take the data from one company and apply standards of practice. One is more liberal than the other is. One can say that the company is solvent. The other says that it's insolvent. Whom are we to believe?" Furthermore, there are a lot of companies out there that aren't even observing your standards of practice. You've got these compliance questionnaires, but they're obviously not giving you accurate feedback. They are not complying. Now, we went after OSFI to find out who those were, because we could prosecute them under the discipline process. But they wouldn't review it, because they didn't want to ruin their relationship with the various companies that gave them information. So we're at a bit of a standoff on the issue.

Finally, when the CIA introduced these consolidated standards of practice in 2002, that was the final straw. Although we talked about a consolidation, there were, in fact, some liberalizations that occurred in the margins. And there were some other definitions that would have allowed the actuary somewhat greater latitude in selecting assumptions. OSFI saw that as a very significant negative. Their reaction was that in that environment, those compliance questionnaires really don't make sense. You have to have a better methodology. The only way that you're going to

reduce the range of practice is to get out there and look at the work. Have someone review it and agree that the assumptions and the methodologies are appropriate, and that standards of practice have been applied in calculating the reserves. So there was fairly significant pressure to change the entire environment.

Now, CIA has been slow in developing a peer-review process. In the late 1980s, the CIA had started a committee to look at compliance issues. And even back then, the thought of a peer review had come up as a secondary method. There were two that were being looked at — compliance questionnaires and peer review. I don't mind telling you that the membership was extremely negative about the concept of peer review. They saw that as a "big brother," communistic kind of thing. And they didn't like it. They said, "We've got standards of practice, we should be applying them." So there was a tremendously negative reaction. There wasn't a positive reaction to compliance questionnaires, but it was the lesser of the two evils. So compliance questionnaires were the first things that were put into place.

The CIA treats the review like a very formal process. The first reviewer is generally the appointed actuary. In most instances, at this point, we're talking about the evaluation. Though the first actuary may choose the reviewer, because he's got a sense for what the capabilities of the reviewer are, the engagements are through the individual's firm. The competence tests for the reviewer are almost the same as those for the appointed actuary. There are expertise and experience requirements, but they're not terribly onerous. There is a requirement of objectivity by the CIA. It has a whole bunch of ethical guidelines. And fundamentally, it would say that if you've got two actuaries in the same consulting firm, one has done this valuation, the other one's never worked on it or worked with this client (they are totally independent), the independent actuary could do the peer review. That would be acceptable under CIA standards. That would not be acceptable under OSFI standards.

If this process is going to work, and you're going to continue to improve knowledge, you should cycle the reviewer every couple of years. Two to three cycles are what the CIA recommended. A cycle is basically three years. Finally, they have a sample engagement letter that clearly specifies the respective responsibilities between the two parties.

The review is supposed to be congenial, with full cooperation. It is confidential. There is a written opinion. The expectation is that the written opinion will be adequate at least to confirm that methods and assumptions are reasonably consistent with standards of practice. But the actuary doesn't have to go to the same depth of work that the original actuary did. It doesn't mean that you have to recalculate all of the numbers. On the other hand, if you're the reviewer, and you've come across something that looks suspicious, or if some of the numbers don't look appropriate, and you're going to prepare a written report, you are going to start checking those numbers in much greater detail. There are other requirements, like how much you investigate the various contracts with companies.

The suggestion is that you don't go that deep. As long as you confirm that the actuary has taken account the major aspects of those contracts, you should be able to accept that and write your report.

The appointed actuary, who is providing the information, is expected to help the reviewer as much as possible. Providing the appropriate documentation, explaining why the different assumptions were taken, how he's managed his asset-liability-management process, etc., are all critical. He should identify all of the processes that he's used in making sure that his reserves are accurate. If they were not accurate, the actuary would probably start recalculating.

OSFI views the peer-review process or external-review process from a different perspective. The standards are much stronger than what they want. Their objective is clear. Everyone would agree that it's a laudable role, including strength and confidence from the public, management, directors and regulators. I think that it's important that the other two bodies feel the same way. They're not as aware of the issues as OSFI has been, so OSFI's really the driver on this. The key objective all along with OSFI has been to narrow the range of practice. They've made no bones about that. They talk a little bit about improving the quality of the appointed actuary's work. One of the issues that came up is that they've had some appointed actuaries who've been in the role for a long period of time. They don't know what's happening in the rest of the industry. So this process will give them exposure to what's happening at other companies. And maybe there are some processes that they could learn from. So professional education is one of the focuses of OSFI.

On the work that is to be reviewed, OSFI is more specific, because they're really talking about valuation. So the year-end report, the valuation report, the valuation work, and the development of the appointed actuary's report are all critical. For federally regulated companies, the appointed actuary in Canada has to overview the calculation of the required capital. So OSFI wants that reviewed. Canadian regulations are focused on protecting the rights of our policyholders. So anything to do with dividend allocations is expected to be reviewed in greater detail and commented upon. And, of course, the future-financial-condition report is to be reviewed and commented upon. Those are the elements that have to be looked at.

The review is to confirm, first of all, that the work of the appointed actuary is in the range of accepted actuarial practice, and that means CIA standards of practice. It also means whatever additional requirements OSFI may have promulgated. So in each and every company, there could be additional work that needs to be done. Up until recently, we often looked at assumptions and methods and said, "Well, they're within standards of practice." Now they're asking us to state that the assumptions and methods are appropriate — a whole new level of work. It certainly has increased what we used to call an audit review in this whole independent review process. It's a stronger process. Because a written report that goes to OSFI and to the board of directors is produced, actuaries are a lot more careful in preparing that report and in carrying out the underlying work.

Another element is making sure that the appointed actuary's report clearly describes the assumptions, and that those assumptions were used in the calculations. This is one of the first times that they're concerned with avoiding misrepresentation in financial statements and ensuring that there's nothing in the report that would be misleading. The boards come down on this. They really want to know how they can be sure that these things are transpiring and that there is an accurate description. They expect the actuary to review all processes and procedures, make sure that everything's covered and that there are no major holes that could result in significant errors in their report. And, finally, produce a written report. OSFI wants the work to be done triennially. I've mentioned that it artificially started doing a triennial review of companies back in the mid-1990s. It is possible to subdivide the work. Some firms do that. One year, the reviewer will look at individual life, the next year group life and health, and the third year the wealth or accumulation products. The actuary would then repeat that cycle during the next three-year period. It is possible to do it that way.

There's a preference that all of the work be accomplished prior to releasing the report. The worst that could happen, of course, is that the reviewer doesn't really agree with assumptions. Now you have a big problem. You have a financial report out there that the reviewer doesn't agree with. You get into issues of misrepresentation of the financials and significant implications for the appointed actuary because this is a discipline process. This isn't done to the exclusion of other professional standards.

OSFI accepts that it may be impossible to complete the process in the given time frame. They will allow a three-month overage, but that's not their preference. They would like it all to be done prior to the report being issued. And finally, if an audit firm is doing it — in our case, for example, we've got to have our review completed prior to the opinion being signed. So we've got to do it quickly. It goes to the board of directors of the company; it also goes to OSFI on a confidential basis.

Just to give you a sense of the seriousness of the report and how much the reviewer is committing himself professionally, it must clearly describe the extent of the work. If it's not appropriate, OSFI may request another review, so you better be sure that it's done in appropriate depth. It must make conclusions regarding the compliance of accepted actuarial practice. There are a number of other requirements that OSFI may have. They may have looked at this company in the past and been worried about lapse assumptions or some such thing. So you have to make sure that you're aware of those, that you look out for them and specifically comment on them. If there are any changes in methods or assumptions, those need to be identified. You have to address any differences between the appointed actuary and the reviewer. I once wrote a review that said that I disagreed with the choice of assumption; it wasn't that big, and the difference was immaterial. OSFI then, of course, wanted to look at more sets of calculations than you could shake a stick at, just to prove that it was immaterial. So you have to be very careful in how

you write these reports. You can create a lot of extra work.

OSFI has similar requirements to the CIA's requirements, in terms of selecting a reviewer. They basically share the same qualifications as the appointed actuary. And in OSFI's eyes, if that appointed actuary died, this reviewer could do the work. They also have a stronger experience requirement. They really want the reviewer to have done this for more than one company and have a broad range of experience, so that they can bring some learning to the appointed actuary and help them to look at different methods or approaches to specific issues. They're also much stronger in terms of objectivity. There are a number of guidelines, such as no prior relationship, etc. Most of them are quite obvious. They cannot be an employee or have served as the appointed actuary within the last three years. They can have no financial interest. If the appointed actuary is a consultant, the reviewer cannot be from the same firm. That's been inconsistent with CIA standards, but that's how OSFI has stepped up that standard. Once the reviewer has gone through and suggested that there should be changes, either to methods or assumptions, the reviewer can't be involved in implementing those changes. They must maintain their independence after that. OSFI states that the reviewer must change every two cycles, every six years.

There's been a lot of reaction to peer review, and it's been across the board. I mentioned earlier that when we first started looking at the process, there was a negative reaction among the membership. That continued for a long time. There still is a bit of that negativism in some segments. We have fairly comprehensive standards of practice. There are some actuaries who feel that other actuaries are looking over their shoulder. On the other hand, there are a number of actuaries who recognize that there are significant consequences to signing a year-end statement. They're relieved to have someone confirm that the assumptions and methods are consistent with practice, and that someone is supportive of the way that they've done their valuation. The expense of the process is large, especially to the smaller companies. The old audit reviews were fairly inexpensive, but a peer review can get quite expensive. When you start looking at smaller companies, they tend to make more approximations; they tend to have more manual intervention. All of that causes more work for the reviewer to satisfy himself or herself that the methods and assumptions are appropriate and reflected in the actual valuation.

The job is difficult for sole practitioners. There are a number of practitioners out there who were valuing one or two companies. Under the new standards, you can do a peer review, but you're on fairly thin ice if you're working only with a couple of small companies. You're doing those valuations; the standards are changing. You're now going to have to have a peer review. You have to find someone to do that peer review for you. It's gotten onerous. Many small practitioners who don't have a large body of valuation work are walking away from the process.

Finally, one of the big issues is that the reviewer is not exonerated from Rule 13. So if there's something wrong with the work, Rule 13 kicks in. There's a process for

dealing with that. If there's an honest difference of opinion, the two parties will discuss it, narrow it down and come to some agreement on what the assumption or the method should be. As long as all of that transpires and there's final agreement, the report is issued. However, it wouldn't be inconceivable that it couldn't be a significant difference of opinion around application of a specific standard or assumption. That could result in some sort of discipline complaint.

So this gives you a sense for the background, how we got to where we are and some of the consequences.

MR. WAGNER: I'm going to spend a few minutes talking about Sarbanes-Oxley. Just to put in context, Sarbanes-Oxley deals with risk, specifically financial-reporting risk. There's a lot of discussion about risk management today, enterprise-risk management, etc. Sarbanes-Oxley is focused on the risks associated with financial reporting and disclosure. It's important to keep that in mind. Do we need to apply Sarbanes-Oxley to the pricing process, because the pricing process develops the products that ultimately require reserves? You have to figure out what financial reporting risk includes and what it doesn't include. It obviously impacts a lot of people — the issuers, the companies themselves and the auditors. Financial statements must be informative and accurate. It's a challenge for actuaries because often what we do is so complex and has so many variables and dimensions to it. How do you disclose that and convey that in a way that not only is understood within the organization, but outside as well?

The Sarbanes-Oxley Act has 13 sections or titles. I won't talk about each of them, but they deal with independence of auditors, white-collar crime, etc. They also deal with enhancing financial disclosures. Sarbanes-Oxley created the Public Company Accounting Oversight Board (PCAOB). You may be hearing more about PCAOB. My firm had to register with PCAOB to be recognized as an accounting firm. So any firm that's going to do auditing work has to register. That includes a fair amount of due diligence on the company and its people.

Section 404 of Sarbanes-Oxley is about disclosure. Section 404 is the one section within Title 4 that is creating most of the work. The big deal is that each financial report must include an assessment of the internal control structure and processes. In other words, the company itself has to assess those internal controls that your auditor shall attest to and report on it. What we're seeing with most companies is that they are preparing themselves to be able to do this. They may have an adviser to help them do that. And their audit firm is satisfying itself that they'll be able to do this as well. Obviously, it's a joint effort. There are two levels of assessment. Sarbanes-Oxley is the law. It's implemented through regulation. The SEC has a rule related to Sarbanes-Oxley, which prescribes more specific guidance.

This is kind of the endgame of Sarbanes-Oxley 404. In your financial statement, you'll have something that says that you assessed the controls and believe that they're effective, including maintenance of records on those transactions. You have

to figure out what controls are significant. Really, even before that, you have to figure out what risks are significant, what business units are involved. Are those controls effective? Also, the documentation is a big deal. For those of you involved in this, you probably learned that. You basically have to identify the risk, set the controls up, and be able to say that you think that those controls are going to adequately manage that risk. But the documentation of all of that is just as important. Absence of sufficient evidence to support that evaluation could be a material weakness, which basically means that it could lead to a qualified opinion. As an actuary, I was speaking to somebody the other day, and I said, "Do you have a report on this?" And he said, "I'm an actuary, I don't do documentation." One of the challenges that I've seen for actuaries in dealing with this Sarbanes-Oxley issue is the terminology around controls. Which is not to say that we don't have controls and haven't had controls on what we do. But I think that we've typically not described them in the same way that the accountants do. So this might bridge that language gap. Hopefully, having accountants understand what we do and how it's controlled has some value. There are some things that we can learn from looking at other types of controls and other kinds of processes.

Non-routine transactions, estimates — these are the kinds of things that an accountant or an auditor is going to highlight. For us, it's business as usual. We have to make adjustments and estimates all the time.

We're going to focus in on just one item of the Sarbanes-Oxley financial statements: premiums coming through the income statement on lapsed policies, or lack thereof (one subset of one line on the income statement). What's the risk? Well, the risk is that when I record the premium on a lapsed policy, I must make sure that all of the policies that I get premiums on are valid. How am I going to do that? I've got some kind of application that's only going to let the bill go out if the policy is in force. I'm going to test that by sending some lapsed policies through. As an actuary, you would develop comparable analysis for things like reserves and deferred-acquisition costs.

What we do is unique in that it is difficult and judgmental. We are finding, in implementing Sarbanes-Oxley, that insurers' disclosure committees are involving claims, underwriting and actuarial groups that have not been a core part of a financial disclosure team. It sounds like most of you are becoming involved in this at your companies. But if you're not, you should really get involved, because it's important. It's the right thing to do, and this is going to start happening whether you're a part of it or not. If you're a part of it, you can make sure that it's going in the right direction and doing the right thing.

These are the four big categories of a top-down actuarial control structure. No. 1, setting the methods and assumptions — because of the judgmental nature of the work, this is an important step in the process. No. 2, data integrity — there area a lot of data involved. How can we make sure that that data is good? No. 3, calculations — we do a lot of calculations with the data, how do we make sure those

calculations are accurate? And No. 4, disclosure — how does all of that work its way into the final document?

What should the documentation include? What control am I documenting? What are the risks? When and how often does it happen? Who does it? What are the characteristics? It should be formal, up-to-date, clearly described. You can definitely leverage things that are already there, but it needs to be put together and identifiable. It doesn't have to be all in one computer or in one desk, but it should be identified.

What can you do? It's important to participate. There's some dialogue out of this that would be healthy, in terms of improving controls and having other people understand what we do. We talked about being ethical. Are you ethical, and are you perceived as ethical? I know that there's a perception that actuaries can do anything that they want with the numbers. There's the stereotype of two plus two can add up to whatever you want it to be. There's this belief that actuaries can bend data to produce any results that they want. Perhaps this process can help people understand better how it really works, and the fact that there are controls around it. We all have to be thinking about the reputation of the profession. You know that you are ethical. You know that your colleagues are ethical. That doesn't necessarily mean that everybody else understands that. Now, I don't think that we've seen any evidence that people think that the actuarial profession in any sort of collective way is unethical, but there are things that aren't very well understood.

There are benefits of following Sarbanes-Oxley. You get to stay listed with the SEC; you develop structure and restore confidence.

MS. JOSEPHINE ROBINSON: I'm going to talk about the external review process that we underwent at Sun Life this past year, and our internal peer review process. When I talk about peer review, of course, it's valuation-related.

I'll give you a little bit of background about Sun Life so you can understand what framework I'm coming from. We're an international company with operations in Canada, the United States, the United Kingdom and Asia. Within Asia, we operate in Hong Kong, the Philippines, Indonesia and, recently, China and India. We have about \$340 billion (CAN) in assets. We have a corporate office in Toronto, and that's where I work in the corporate actuarial area. There's a chief actuary in the national operation that is responsible for valuation. The valuation work is decentralized and done within the business units. By business unit, I mean individual annuities, group life and health, etc. The asset-liability-management function is done in the national operation. The corporate national operation or corporate investments often prepare asset cash flows. Liability cash flows are done by the business unit and the Canadian asset-liability methods (CALM) within the business units. For those of you who are not familiar with the Canadian method, it's a cash flow method that links both the assets and the liabilities, so that when you're done, you have enough assets to cover your liability cash flows.

What are the goals of the external peer review? Narrowing the range of practice, quality of work and education, and better understanding, by everyone involved, of what's going on with the reserves. Maybe I should explain the role of the appointed actuary in Toronto. He signs off for the Canadian actuarial liabilities worldwide. He has to have confidence in the work that's being done. I'll talk a little bit later about the controls that are necessary in a decentralized environment.

What is reviewed? All of the items on which the appointed actuary provides an opinion — actuarial liabilities, the minimum continuing capital and surplus requirements, allocations and compliance with the Insurance Companies Act. (That's the board's responsibility, but the appointed actuary gives the board assurance that the company is in compliance.)

The scope of the external review — once we receive it, we look at all of the recommendations that our peer reviewer had given us, and insert under every single recommendation our management's response. So where there were differences of opinion, we mention it and then insinuate what our plan is. And we think that will be a good way of tracking how we deal with those recommendations.

One of the other points that I wanted to make is that the external peer reviewer does do a high-level review of the overall reasonableness of the results. But the reviewer does not sign off that the amount of the liabilities is appropriate. The other thing that they do not do is reproduce the work or do any detailed calculations.

At Sun Life, the first review was based on 2002 year-end. We provided the peer reviewer with the 2001 appointed actuary's report. This way, they could start looking at our methods and assumptions. Where we weren't planning on making significant or material changes, they could get up to speed on our approach. At year-end, if you work in a business unit and you're doing valuations, you don't want to be asked questions on why you did something. It's very busy, so we try to do work in advance. We establish our assumptions before year-end, so that there is a minimal amount of information that has to go to the peer reviewer. They still have to review the year-end results, but they've done a lot of work beforehand. Plus, we know in advance of year-end if there are any issues that are going to cause problems. We want to make sure that we deal with those as soon as possible. The last thing that we want is a surprise, like finding out that what we're doing is non-compliant in their opinion.

Unfortunately, we were trying to do a pre-release review, which means that it had to have been done by the end of February. Because it was not mandated this particular year, we submitted it in April. We submitted a report to the board. And that report is a summarized version. It was about three pages, as opposed 30 or 40 pages. Basically, that report tells the board the highlights. They don't care what your mortality assumption is. They care about the appointed actuary's compliance. What are the key findings? In this process, one of the benefits that came out was

increased interest, on the part of senior management, in the business group. If you're going to give something to the board, senior management wants to see it, too. So now they are interested in actuarial work. They can start to become more knowledgeable about what we're doing. In addition, there's educational value. It's significant, especially for those areas outside of Canada. Obviously, the Canadian actuary is going to be more of an expert. They go to the meetings, they go to seminars, and there are a lot of benefits to the operations outside of Canada. But I think that there are even benefits to those in Canada. I mean, there are some negative things. Some people have different reactions to having their work reviewed. Some don't like it. The number of questions that they are asked frustrates them. But other people view this as a very positive thing. They like the idea of someone confirming that what they're doing is good.

Some of the suggested changes were practical. For the most part, they were not difficult to implement. Some of the recommendations supported changes that we wanted to make. So we were able to appeal to a third-party expert. There were things that we wanted to have done that weren't that important, but we thought that they were best practices or insured consistency across all the operations. We were then able to implement that more easily. Compared to other reviews that we have done in the past, when we demutualized, we had to have an audit of the closed block. When we acquired a company in Canada, we were reviewed at that time. And we were satisfied with the work that was done. We felt that the recommendations were very reasonable.

What are some of the other benefits? Before we did the peer review, we started building a documentation database. This effort in answering questions through the peer review has to be documented. So you start to populate a documentation database. We all hate documenting, but it's critical that we do so. I guess the more turnover you have, the more critical that becomes. It introduces a more disciplined process to the valuation process. Responding to questions provides opportunity to learn more about the business. This is really valuable to someone in the corporate office. We're twice removed from the business unit. The business unit looks at this as a "make work" project, but there is the benefit of sharing best practices. There was a criticism in one business group on the closed-block valuation, and there was no criticism in another group. So we asked, "What did you do to satisfy the peer? What were your efficiency tests?" I expect it's going to be an easy thing for this other operation to adopt what is learned.

Another thing that I found valuable was that, in the United States, there's a new product, the no-lapse guarantee. Essentially, that's like a term-to-100 product that's been sold in Canada for more than 10 years. There are lots of risks with it. I was able to supply the valuation actuary with a lapse study that the CIA had done. What we are hoping to learn from this is not to make the same mistakes that were made by Canadian life insurance companies. We'll see if that really happens.

We started the second review for 2003 year-end. We did that a little differently this

year. We learned something from last year's process; we must create a schedule. We had all the business units buy into that schedule. It's just more structured. The other thing that we learned was to increase the number of meetings between the peer reviewer and the business group, to make sure that communication was very clear. When you get a written report or set of questions from a person, you're not really sure if your response is going to be two pages or two sentences. So by having frequent verbal discussions, you can cut to the chase. So the person who has to do the work doesn't feel like he's doing the work for nothing. I think that type of communication is really important.

As part of the Sarbanes-Oxley process, we were asked to look at our method and assumptions process. What's important? What do we have to do? What are the key controls when the national operation changes their method of assumptions? And they do so every quarter. First, they send the report to the chief actuaries, and that goes to the corporate office. It includes the assumption changes that they want to make and why, the pre-tax impact on the reserves, after-tax impact, and bottom-line impact. The key control, in this case, was the appointed actuary. The relationship manager reviews and questions the methods and assumptions. If we see something that we don't like or we want increased sensitivity testing, it goes back through the loop. At the end of the day, we have to approve the methods and assumptions.

Everything that we're doing is connected, and all of the reviews support each other. Are we overdoing it? I don't think so. If you ask the business units, they may think otherwise. But the internal reviews allow us to investigate work more thoroughly. It can reduce the work effort of the consultant. So during this process, we're looking at the system, we're looking at the data, we would like to do a seriatim valuation. That doesn't get done at the level of the external review. And the time frames for some of these are a little longer; a systems-review check might take three to five years.

In terms of our organizational structure — I mentioned that after demutualization, we decentralized. And afterward, we thought that we needed some controls. It is really important that whatever structure you have — whether you're decentralized or not — there's not a right or wrong, you just better have everything set up and in support of the organization.

There was one benefit that became evident when Sarbanes-Oxley was introduced. It was a common complaint among valuation actuaries that the data that they were receiving from administration or claims areas was untrustworthy. The benefit is that now those people are responsible for ensuring that their data is accurate. I think that should be very reassuring to valuation actuaries. The kinds of things that they may not have coded properly — sex, substandard or not, age — are important criteria that we need to have.

In conclusion, valuation actuaries and other users of actuarial financial information should have more confidence in the work that we're doing. When you bring your car

in to be repaired and you don't know anything about it, how do you know that you're not getting "snowed"? Senior management probably feels the same way about us. Having an external reviewer gives them some assurance that we know what we're doing, and we follow the standards. These processes should provide an opportunity for continuous improvement.

FROM THE FLOOR: If you have a company that has a large number of people that are given incentive to do the wrong thing, and the banks are in cooperation with that, and perhaps the auditors are in cooperation with that, do you feel that Sarbanes-Oxley would lead to fundamentally different outcomes? It seems that we've always had ethical issues. We've always had responsibilities to do the right thing. When we sign off on the actuarial opinion, it is something that all of us or many of us take very seriously. And whether Sarbanes-Oxley is with us or not doesn't really change my view of my responsibility in signing. In your understanding of Sarbanes-Oxley, how would that have changed something like Enron?

MR. WAGNER: It's certainly a good question. It gets at the issue of fraud, as opposed to the issue of mistakes. I've heard it said that if somebody really wants to "put one over," and they do it little by little, they're probably going to be able to do it. Is Sarbanes-Oxley going to stop that? I think that we'd have to say, "no." I think that if somebody really wants to try to perpetrate fraud, they're going to know the system and try to trick the system. I think that Sarbanes-Oxley is putting up a number of protective barriers, if you will. Some of which were there, some of which are becoming more formalized. There's a piece of this that affects investment bankers, there's a piece of this that affects auditors, and there's a piece of this that affects management. And if every one of those guys is in on it, probably one of them doesn't want to be in on it. And maybe Sarbanes-Oxley will be enough to cause that person to object.

MR. HENDERSON: I work with an audit firm, and that's a big issue with us. We talk about it all the time. The reality is that if a company really wants to commit fraud, or there are individuals in a company that really want to do it, they can. And it's pretty difficult to catch. On the other hand, with all of the focus placed on it right now, it's likely to help the situation for a while. But I don't think that anyone is under any illusions that this is a panacea. In the long run, as people get more accustomed to dealing in the current environment and things settle down, we're going to see it again. It's cyclical. It may be a negative attitude, but that's the way that we see it. And certainly, some companies recognize that just stepping up this process in the short run is really very expensive. There's some question as to whether it is going to help them in the long run. It's almost like it's a political reaction.

I've heard some of the speeches from politicians on Sarbanes-Oxley. It was based on prior regulation. There were a number of things in it that really weren't clearly defined. They were rather flabbergasted that it was put in place as quickly as it

was, having been in the mill for about three years. They knew that there were holes in it. But once Enron hit, they had to react. There are some pieces of legislation that are good, but there are some weak pieces in it as well.

FROM THE FLOOR: I think that once the business gets too big, you really can't centralize controls very well, because all of the work comes at once and you have to have an enormous corporate staff to do all the functions. We have a function very similar to Sun Life. Each of our business groups has its own actuarial area, and it all "feeds up" to the corporate offices. Corporate sets out all of the standards. Their GAAP documentation process is 300 or 400 pages long. We send formal GAAP memos. Mine's about 70 pages long. They go up to corporate with an official peer review. We have off-line discussions. And to centralize that may be efficient, but corporate would be so large, and all of the work would come at the same time; it would be very hard to have a centralized function there.

MS. ROBINSON: For U.S. regulatory purposes, if you were operating in a country in which you didn't have actuarial expertise, it is better to decentralize. The people who are in the business units know the risk. The U.S. operations or the Canadian operations own the bottom line. That's a good thing, but I spoke to a fellow who worked for a U.S. operation for which everything was centralized. Obviously, the benefit of that is lower operating costs. So it depends on what your goals are and what you're trying to achieve.

FROM THE FLOOR: Is peer review something that could come to the United States or should come to the United States?

MR. HENDERSON: British actuaries are looking at it. And likely, something will be implemented there. I had mixed emotions about the whole thing. I was present at the time when the issue came up with OSFI. And I got into "fisticuffs" with the superintendent of insurance at the time. He said that the range of practice was wide. One actuary found the company solvent, the other found it insolvent. I said that the solution to that problem is not necessarily a peer review. The solution to that problem might be taking a look at our standards and tightening those up. It seemed to me that would have a more permanent effect than just having two people look at the same body and discuss things between themselves. I really wasn't convinced that it would have a huge effect.

The key issue with them really was that it took them so long to get standards in place that refining standards at this point would take so long that there would be nothing in place in time to help with the current problem. You're bringing up consolidated standards of practice. Those, in fact, open up the range of practice, not narrow it. Therefore, you have to do something fast. In the back of their own minds, they had the example of the accounting profession, which does do peer reviews. They have hired people within the accounting board that review the auditor's work on a periodic basis. They were thinking that the CIA would implement the same thing.

I still am of mixed emotions about it. I can see some benefits. I've been peer-reviewed myself. I don't think that I got an education out of it. It was a very expensive process. The long-term solution to narrowing the range of practice is to analyze and fix standards. In Canada in particular, there's a lot of protection for the appointed actuary. There are a lot of things in place that allow independence. So the Insurance Companies Act and the way it's set up forces independence, professional standards of practice on compensation, and makes sure that the appointed actuary is not given incentive to do the wrong thing. So there are quite a number of stops and checks in place. And I'm not entirely convinced that the peer review solves those, but there are some benefits to it. I don't know if it's worth the cost, but there are some benefits to it.

FROM THE FLOOR: Since the external reviewer is not affiliated with the firm, was there any concern that a trade secret might be learned along the way? Was there any concern raised with that kind of exposure if someone comes in to look at your books, and suddenly they know more about your company than you want them to know?

MR. HENDERSON: I usually have to sign a confidentiality agreement. When I send an engagement letter out, I specifically step up to those points and confirm that we won't be revealing any proprietary information, nothing that's relevant to that client that's not already public knowledge will be made public knowledge. I know that it's a weakness, but the only exception to that is that the report goes to OSFI. If they choose, they certainly can react to anything that's in that report. Now, that wouldn't make it public, you wouldn't be revealing any confidential information from the company, but it could get the appointed actuary into deep trouble.

FROM THE FLOOR: Obviously, it is a pain in the neck to comply with Sarbanes-Oxley, but I saw value is that there were a lot of functions that were done in the company without people thinking about it as much as they should. As an example, there are some things that might be done by one person with nobody officially looking over it. Sarbanes-Oxley is making us document what they're doing — somebody signs off as having done it and somebody else signs off as having reviewed it. So nothing has come out of our reviews that indicated any real issues, but it's made us all more conscious of what we are doing. That is good. People are supposed to be creating financial statements that are accurate, and that's what we all think we were doing, but the fact that you now have to sign it and say you did it, just makes you sure.