SESSION 1

A PERSPECTIVE ON THE ROLE OF THE VALUATION ACTUARY

MR. KENNETH T. CLARK: A perspective implies a point of view. Let me describe mine. It is that of a Canadian actuary, but one who spent his formative years in a U.S. company, one of those large Eastern mutuals which have been the focus of so many examination questions and the brunt of so many jokes. I also lived in the U.S. long enough to acquire the magic forty quarters of coverage under Old Age Survivors, and Disability Insurance and long enough, I hope, to be able to talk eruditely to a largely American audience. I have been a consulting actuary for twenty years, specializing in insurance company work. As President-Elect of the Canadian Institute of Actuaries, I have a first-hand view of the developing role of the valuation actuary in Canada and a second-hand, but vantage, view of it in the U.S.

I have another dual perspective of the role of the valuation actuary, the past-present one, where the present is an age of discontinuity. The role of the valuation actuary, with us since the earliest days of our profession, is now in creative turmoil.

The traditional, and valid, image of the actuary is that of a cautious professional, concerned with financial soundness, careful with his money, and with the public's also. The role has brought us a measure of unpopularity, sometimes warranted, but usually only among those who would like to forever blow South Sea Bubbles. It has brought us a measure of mockery, too, but mockery often tinged with rueful envy. The actuary, it is said, is the "abominable no-man," or "give an actuary an inch and he will measure it." But I like the way my good friend, Mr. Andy Webster, has put it: "The work of the actuary is to preserve the future from the ravages of the present."

We now face a discontinuity, a proposed great leap forward from the past to the future. The objective is the same, financial soundness. The means are different. We are here at this meeting to talk about doing things we have not done before, things which will arouse a different, more explicit, more intense expectation in the minds of the public.

For the basic building blocks of this new role of the valuation actuary, we have to look far across the sea, but not far back in time. In the early 1970s, a rash of life insurance company failures in the U.K. awoke a too lethargic government, and a too complacent profession, to the bitter implications of modern financial turbulence. A Mr. Ronald Skerman published a paper titled "The Work of a Life Office Actuary in the United Kingdom: Recent Developments and a Look into the Future." In reading Mr. Skerman's paper, I felt as I do when listening to the music of Bach: It is masterful, it is the pinnacle of a long development, but it marks the end of an era. For the paper was written before the financial storm and, in a later oral presentation to the Institute of Actuaries, the author mentioned subsequent developments, notably a bill then before Parliament and since passed, radically altering the regulation of the U.K. life insurance business. This bill brought a new explicitness and a new intensity to the role of the valuation actuary, called in the U.K., the "Appointed Actuary."

How striking it is to read the 1984-85 Yearbook of the Institute of Actuaries, which contains the guidance notes on the duties of the Appointed Actuary. No more is the elegant counterpoint of Bach in evidence; now we hear only the stern chords of Beethoven. Some of you may not find it so, for our English colleagues at the Institute have been chary of written professional standards, and our Scottish colleagues of the Faculty of Actuaries even more so, often as a gourmet regards horseradish on an oyster.

Everyone should read the Institutes's guidance notes for Appointed Actuaries. Our British friends have taken a small button and sewn a large overcoat on it. The button is Section 18 of the Insurance Companies Act, which requires merely that the Appointed Actuary report on an investigation into the financial condition of the office, including a valuation of its liabilities. The overcoat is the Institute's requirement that the Appointed Actuary be substantially satisfied at all times, not just at valuation dates, with all items affecting the financial soundness of the company such as premium rates, policy provisions, investments and investment policy, marketing plans, the expected volumes (in particular) and costs of sales, expected expense rates, reinsurance and the amount of surplus. If he is not substantially satisfied with any of these items, his professional duty is to raise hell, but with British decorum.

If our British colleagues had not sewn that professional overcoat on the regulatory button, the government would have done it for them. The point is that it was done. Now, you may say:

> That is all very well, it is even interesting, but what has it to do with us? Here in the U.S. we are not talking about that kind of role for the valuation actuary. We have the "Final Report of the Joint Committee on the Role of the Valuation Actuary in the United

> States." It has been liberally sprinkled with holy water by both the American Academy of Actuaries and the Society of Actuaries, which is no mean feat of sprinkling. Discussions at this symposium are bristling with technicalities, in order to figure out the difference in cash flow between a reasonable deviation and a plausible deviation. There is no resemblance between the paneled chambers of Staple Inn Hall in the heart of London and our venue, the rustic, romantic outskirts of O'Hare airport.

I contend that there is a resemblance. In each case, we are dealing with our profession's reactions to financial shock. The modalities may be different, but the pressures, the objective and the discontinuity are the same. I do not believe I exaggerate when I say that the report of the Joint Committee will transform the valuation actuary from a mere multiplier of CSO reserve factors, each calculated to a number of decimal places in accordance with the Specifications for Monetary Tables of the Society of Actuaries, to a professional conductor of true valuations.

For the significance of the word "valuation," I have to cross the Atlantic once again and quote from a recent paper by Mr. Frank Reddington, the last paper he gave us before his lamented death. I quote:

> The word "valuation" may seem to be harmless enough but its misuse has added greatly to the obscurity of the scene. It has the universal meaning of an up-to-date appraisal by an expert. It implies an active, dynamic valuation since we have our possessions revalued for the very reason that the values do change.

This was the guise in which we presented our accounts and in which they were understood by the public. But it was not what they were. Usually assets were on unchanged bases for many years. In effect, liabilities too were at historic cost and therefore were not "valuations." They were actuarial artifacts for calculating surplus. "Artifact" was the correct word...

The misuse of the word "valuation" in the phrase "net premium valuation" is...still a handicap to ourselves and to those who try to understand us.

The Joint Committee report will get us to true valuations. For too long we have made valuations of insurance policies that we have been pleased to call "prospective," but which have been prospective only in an obscure mathematical sense and which, in fact, in the clutches of the past, have been freed only by the deaths of the policyholders.

The details of the report of the Joint Committee are interesting. I see that we shall do a valuation of actuarial liabilities where the difference between assumed and expected experience covers "reasonable deviations" (which seems plausible enough), and a second valuation to cover "plausible deviations" (which seems reasonable enough). Both of these valuations will be performed, I presume, in addition to a third, the GAAP valuation for stock companies, which provides "reasonable and realistic" conservatism. They say that all good things come in threes, but I have to wonder if we are not getting too much of a good thing. Perhaps it would be appropriate to abandon one of the three.

In Canada, we thought we had made our great leap forward in 1978. However, it seems that we have greater heights to surmount. In April of this year, the government of Canada issued its now famous Green Paper titled "The Regulation of Canadian Financial Institutions: Proposals for Discussion." A few days later, the House of Commons asked its Finance Committee to study and report on the Green Paper. The committee has just filed its report.

The House of Commons Finance Committee has not exactly rubber-stamped the Green Paper and indeed, the committee's chairman, in the polished language which is de rigueur in Parliament and which is so refreshing a contrast to the linguistic crudities in Congress, called the Green Paper "a pile of crap."

The committee did its work fast, and had to, because the problem festered even as the committee members strove for solution — a loan company, a trust company, a general insurance company and two banks failed during the short committee deliberations.

For an actuary, the committee's report is exhilarating or intimidating, depending on his point of view. The committee first recommends the creation of the National Financial Administration Agency (NFAA), a superregulatory agency, with responsibilities delineated in subsequent recommendations:

Recommendation 20

That NFAA in conjunction with the Canadian Institute of Actuaries, the Canadian Institute of Chartered Accountants and the Appraisal Institute of Canada be encouraged to develop guidelines and standards for the financial reporting of the solvency of financial institutions.

Recommendation 21

That NFAA require these professional bodies to establish a review committee on the adequacy of solvency standards as applicable to actuaries, accountants and appraisers.

Recommendation 22

That severe disciplinary measure be instituted against professional advisors who fail to observe the established standards and code of conduct.

Recommendation 78

That professional associations including accountants, lawyers, appraisers, actuaries and representatives from financial institutions and trade organizations be consulted in drawing up a list of prohibited transactions.

Recommendation 119

That the NFAA review the present role of the valuation actuary in consultation with the Canadian Institute of Actuaries and broaden this role to include an appropriate responsibility for the continuing financial condition of the company along the lines of the Appointed Actuary in the United Kingdom.

<u>Recommendation 122</u>

That property and casualty insurance companies be required as soon as possible to appoint a valuation actuary and include with their financial statements a report by the actuary certifying that the provisions for unearned premiums and unpaid claims are adequate.

<u>Recommendation 124</u>

That the review of the role of the valuation actuary recommended by the committee for life insurance companies also be applicable to property and casualty insurance companies.

There are several other recommendations, but these are the highlights.

I could have called this talk "The Age of Discontinuity." In the U.K., actuaries have not only bitten the bullet, they have swallowed it. Their digestion is normal, with no symptoms of lead poisoning. In Canada, we are dancing the two-step, one step in 1978 and the other step in 1986. The most exhilarating scene is here in the U.S. where the great leap forward is most overdue and taking place with breath-taking rapidity. I am reminded that the U.S. did not put the first sputnik in the sky, but did put the first man on the moon.

There is, however, the introspective, much whispered question: "Are we ready for all this?" With the decisiveness characteristic of my entire professional career, I unequivocally answer "Yes, and no."

If by "ready" you mean that the principles are defined and the techniques are ready then, no, we are not ready. But by a similar definition of "ready," no one can be ready to be a spouse, a parent, or President of the United States. Consider principles for example. The Society's Committee on Life Insurance Valuation Principles is grimly struggling to articulate a consensus. So far (I say this as a spent member of that committee) without success. But did not someone say: "An ant can't move a rubber tree plant?" As regards techniques, this symposium is helping us learn how far we have yet to go, not only in the development of techniques, but also in their dissemination among practicing actuaries.

In another and, I think, more meaningful sense, I say: "Yes, we are ready." We are ready because we have to be ready, and we have to be ready because the need is there. The challenge and the stimulus are bringing forth the principles and techniques.

For the benefit of the skeptical, the timid and the too traditional, I have assembled some wit and wisdom of the ages in support of that thesis.

From poetry:

A man's reach should exceed his grasp.

(Browning)

<u>From my schoolboy latin:</u>

Palma non sine pulveris.

(You can't win a prize without getting some dust on you.)

<u>From analogy:</u>

Faint heart never won fair lady.

(I admit the analogy is thin between a fair lady and the standard valuation law.)

<u>From Harry Truman:</u>

If you can't stand the heat, get out of the kitchen.

(He was thrust unprepared into the Presidency of the United States, but he coped and did a creditable job, as we shall).

<u>From prose:</u>

Until we require actuaries to go beyond the statutory formulas in valuing life insurance companies, it is unlikely that the necessary energies will be devoted to the task of developing valuation principles.

(By an unknown ghostwriter for the Joint Committee on the Role of the Valuation Actuary in the United States, worthy of Gibbon at his best.)

I therefore appeal to you to joyfully accept the discontinuity, the leap forward, the challenge of the new role for the valuation actuary. I am making a double appeal in this. The first is to your patriotism and public spiritedness. The fact is that, in spite of our professional shortcomings, neither the U.S. or Canada will operate as well without valuation actuaries as they will operate with them. I also appeal to your ego and your pocketbook. The new role for the valuation actuary will provide a challenging and stimulating job, and it will be highly paid.

I have already said that I could have called this talk "The Age of Discontinuity." I also could have called it "The Loss of Innocence." The choice is ours. We can reject the discontinuity and maybe retain our innocence, going on in the old way. Or we can accept the discontinuity, indeed seize it, for the public benefit and for our own.

I end with a apt verse from Dryden:

> "Charge, charge, ..."
>
> (That is not, as you might think, a motto for consulting actuaries. Let me finish it, for it crystalizes my perspective on the role of the valuation actuary.)
>
> "Charge, charge,
> 'Tis too late to retreat."