SESSION 3

THE FUTURE ROLE OF THE VALUATION ACTUARY

MR. W. PAUL MCCROSSAN: Bob Hammond has outlined to you the current role in Canada of the valuation actuary, including the very important legal accreditation actuaries have in Canada. Wayne Bergquist has outlined research on the C-1 to C-3 reserves and on the development of capital and surplus standards in Canada. Both of the previous sessions covered the standards that valuation actuaries must now use and will be expected to use in Canada. However, I believe that we are likely to see a significant extension of the role of the valuation actuary in Canada toward the professional responsibilities imposed on appointed actuaries in the United Kingdom.

Tomorrow morning Judge Estey will table his report into the collapse of two small Canadian chartered banks. Naturally, no self-respecting politician would admit to having read his report before he tables it. Let's put, then, what I have to say today under the category of "informed speculation."

First, Judge Estey will likely report that, in his opinion, both of the banks were insolvent by 1983, and both insolvencies resulted from unsound business practices. He will also likely find that there were actions taken by the auditors of the banks that in practice inflated both the assets and the earnings of the banks in their final three years. With this in mind, I expect Judge Estey to recommend the immediate establishment of an advisory committee between the auditors, the banking community, and the Office of the Inspector General to create a formal standard for bank financial statements. There will also be recommendations with respect to minimum qualifications of auditors before they

can accept an appointment as a bank auditor, together with a provision for exit interviews should auditors, senior management, or directors resign.

The Finance Committee of the House of Commons also studied financial regulations and powers in Canada last year and recommended a major restructuring of the regulatory environment in Canada. Twelve of our recommendations deal directly or indirectly with the valuation actuary. The most important of these recommendations is number 119, which states that the supervisory authorities should "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."

In addition, recommendation 21 states that the government should "require the supervisory bodies to establish a review committee on the adequacy of solvency standards as applicable to actuaries, accountants and appraisers" and continues in recommendation 22 "that severe disciplinary measures be instituted against those professional advisors who fail to observe the established standards and code of conduct."

In addition, the committee recommends that valuation actuaries with similar powers and responsibilities be required within five years for property and casualty companies.

As you can see, I anticipate the thrust of each of the principle House of Commons recommendations with respect to the valuation actuary to have an explicit analogue in Judge Estey's recommendations with respect to bank

accountants and auditors. It would not surprise me if the minister were to announce within weeks of the tabling of the Estey report, or indeed tomorrow afternoon, that he has instructed his officers in the Office of the Inspector General and in the Office of the Superintendent of Insurance to begin negotiations immediately with the accounting, auditing, and actuarial professionals in Canada to establish these advisory committees and to significantly broaden the professional responsibilities of the valuation actuary and the auditor.

Those of you who have heard me speak in Canada over the last four years know that as a past vice-president of the CIA, I pushed for such an extension in professional responsibilities, and that as a legislator, I have been actively pursuing this issue. However, for those who are not familiar with the U.K. approach and the considerable burden it places on the appointed actuary, I thought I would spend some time outlining this role, as well as speculating on what it would mean for valuation actuaries. I encourage everyone at this meeting to get copies of the British Institue of Actuaries' Yearbook, in which the duties of the appointed actuary are spelled out.

Allow me to quote several sections that outline asset matching, concentration of risk, capital, and surplus:

> Article 6.7. The appointed actuary must also pay regard to the relationship between the term of the assets and that of the corresponding liabilities. The importance of this will vary widely from one situation to another, but experience suggests this can be an area of particular danger.

Article 6.8. At one extreme for example, for a company with a large portfolio of long established with-profit business, and where the company is transacting (and seems likely to continue to do so) a steady volume of new business which is small in relation to the existing business the possibility of insolvency arising from mismatching of assets and liabilities may be minimal.

Article 6.9. At the other extreme for a company transacting a volume of non-profit new business which is very large in relation to the existing portfolio and which has only a small free estate, matching of asset proceeds to liability outgo may be critical to solvency. The dangers are increased if there are alternative guarantees or options which could, in certain circumstances, require a different distribution of assets by term.

Article 6.10. The appointed actuary must decide whether in his judgment the investment policy pursued by the directors is or could become inappropriate having regard to the nature and term of the company's liabilities. If this is the case, he must advise the company of the constraints on investment policy necessary to protect the position of the policyholders.

Article 7.1. It is apparent from the foregoing that most of the problems with which the appointed actuary is concerned are not capable of precise assessment but are, rather, matters of judgment. In some circumstances, this judgment may be appropriately based on the actuaries' estimate of the

probable outcome.... If, however, judgment is required in a matter which may affect the solvency of the company, more rigorous standards must be applied by the appointed actuary.

It is obvious to anyone who looks at the problems that emerged with SPDA products in the United States as offered by Baldwin United and its subsidiaries that the products were intrinsically not sound in a volatile investment market, given the high guaranteed cash values. It is also obvious that there was an asset immunization problem in these companies as a result of equity investments in related companies, or in the case of the New York subsidiary, almost complete investment in short-term money market products. Furthermore, in retrospect, it was unsound to have concentrated business risks and exceptionally rapid expansion, given the strength of the company.

I think the U.K. actuaries have anticipated the problems of Baldwin United rather well, and I doubt very much whether such a situation could have developed in the United States had the actuary of the company been following the procedures outlined by the Institute of Actuaries.

Let us consider other policy types referred to by Bob Hammond, such as lapse-sensitive products, reentry term, and nonsmoker policies. There has been a significant amount of discussion in the CIA about the relationship between the pricing actuary and the valuation actuary, and whether the valuation actuary is ultimately responsible for pricing or whether the valuation actuary is merely in the position of making sure that appropriate reserves are set up, bearing in mind the nature of the contract. No such confusion exists in the United Kingdom. Once again, I quote the Institute of Actuaries' Yearbook:

Article 5.1. (with respect to premium rates and policy conditions) A prime responsibility must lie with the appointed actuary to satisfy himself that the premium rates being charged for the business are appropriate. That is to say they should be sufficient to enable the company in due course to meet its emerging liabilities, having regard to (the premium rates on in-force and new business; the nature of contracts in-force; the existing investments and continuing investment policy; the marketing plans, in particular, expected volumes and costs of sales; the current and likely future level of expenses; the extent of the company's free estate; and the reinsurance arrangements).

Article 5.2. In exercising his judgment he must pay particular attention to the company's surplus position.

Article 5.4. Even though the new business premium bases might be commercially justifiable if it involves significant new business strain the actuary must be prepared to set limits on the volume of new business that may prudently be accepted.

So far the CIA recommendations have not been to direct the valuation actuary specifically to satisfy himself that a premium is adequate for a new product or to direct the valuation actuary to consider placing limitations on new business, bearing in mind the size of company surplus. To some extent, the development of valuable surplus and capital requirements discussed by Wayne Bergquist will reduce the need for actions limiting business. Nevertheless, I believe there are circumstances where the valuation actuary should have the power to curtail new business, even though I cannot imagine one single company president being

satisfied with such a request. That's why the British actuaries and the Finance Committee recommended giving considerable protection to an incumbent appointed actuary.

The British Institute of Actuaries' recommendation 2.2 requires a potential appointed actuary to consult with his predecessor "to discover whether there are any professional reasons why he should not accept the appointment. He should make this clear to his prospective principal and seek his permission to hold such consultations. If such permission were withheld, it would be a material factor which would be relevant to the prospective appointee's decision as to the propriety of accepting the appointment."

There remains an additional question. What happens if the Superintendent of Insurance has sufficient doubts about the soundness of the valuation actuary's work, but not sufficient evidence to lay a formal charge? In most cases, the superintendent asks the valuation actuary to discuss the problem, and as Bob Hammond indicated, he expects to be listened to. However, it is obvious both to the Finance Committee and to Judge Estey that there must be recourse to a professional advisory committee in cases of an unresolved problem. In Canada, we currently have a CIA review committee to handle such inquiries. However, to the best of my knowledge, the process has not yet been invoked with respect to a valuation actuary.

The final point I wish to highlight is the obligation imposed on the appointed actuary that "Although, as a statutory requirement, an investigation is to be made only at specific intervals, the profession regards it as the appointed actuary's duty to take all reasonable steps to ensure that he is, at all times,

satisfied that if he were to carry out such an investigation, the position would be satisfactory."

What, then, do I expect in Canada? I expect that before the year's end, negotiations will be under way between the CIA and the Superintendent of Insurance with respect to formal professional obligations in Canada on valuation actuaries similar to those imposed on the appointed actuary in the United Kingdom. I expect that the valuation actuary will ultimately be elected as an auditor is elected at the annual meeting, and that he will have automatic recourse to the Board of Directors if he views that the proposed actions or continuation of actions could jeopardize the solvency of a company. I believe that there will be a professional obligation imposed to alert supervisory authorities to a dangerous situation after a valuation actuary has tried to take steps to terminate that situation.

These additional judgmental professional responsibilities will be onerous. However, it is obvious that the public will be much better served. I also believe that the profession will be much better served, since the biggest threat to the continued accreditation of actuaries has been, and remains to be, that irresponsibility or negligent acts leading to insolvency that cast doubts upon the integrity, character, or professionalism of actuaries. I have no doubt that many company presidents or controlling shareholders will oppose the extension of responsibilities I foresee. However, I for one am prepared to engage in a public discussion with these naysayers in the Finance Committee of the House of Commons, should they wish to explain why their policyholders should not have the protection that government policy indicates they should have.

These are exciting days for all professionals connected with the financial service industry as we restructure the powers and obligations in the business as the next century approaches.