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SESSION 11PD

PROFESSIONALISM AND STATEMENTS OF ACTUARIAL OPINION

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PROFESSIONALISM AND STATEMENTS OF ACTUARIAL OPINION

MR. HERBERT S. WOLF: In most instances, the appointed actuary is an employee of the company for which the opinion relating to asset adequacy is rendered. In some instances, the appointed actuary is a consultant. The economic pressure on the actuary, to the extent that the actuary is an employee, is a very real factor that can influence the professionalism and the impartiality or, as Paul McCrossan would say, "objectivity" needed to arrive at conclusions and render an opinion.

I believe that the professional judgment of the appointed actuary will be questioned if we see another round of insurance company failures similar to those of the early 1990s. There's no requirement, and I'm not suggesting that there should be, that the appointed actuary be independent of the employer. In order to preserve the credibility of both the industry and the actuarial profession, I believe that it should be required that the opinion and supporting memorandum be subject to an independent peer review. In addition to responding to the perception that the appointed actuary may not be objective in arriving at the opinion, the independent review will also give the actuary an opportunity to communicate with another professional who has had a wider range of experience in the area of asset adequacy analysis.

A memorandum is a confidential document according to the laws of most states and is available only for review by the officers and directors of the company to which it applies and by regulators. This condition limits the exposure of the appointed actuary to the ever-valuable interchange of professional experience. The independent reviewer can overcome, to some extent, the limitations imposed by law to the professional growth of the appointed actuary.

In this session, Paul McCrossan will tell us how Canadian actuaries have worked with regulators and public accountants to obtain the right to establish the standards by which insurance company reserve adequacy is measured. He will tell us about some of the differences in the Canadian process compared to the U.S. process, which, in my opinion, leads to a greater public confidence.

After we hear from Paul McCrossan, Sam Gutterman will tell us about the U.S. perspective. He will concede that, in many instances, the appointed actuary is perceived as a necessary evil by the insurance industry and the officers of the companies. This is unfortunate. The function of the appointed actuary cannot be fulfilled in the atmosphere of an adversarial relationship between the appointed actuary and the other officers of the insurance enterprise.

After Sam, Bob Meilander establishes a case for the employee actuary, but Bob is not ready to allow the appointed actuary to establish the reserves without some regulatory restraints.

After we hear from these three presenters, I hope that we will have some information that might enable U.S. actuaries to gain public trust, similar to that of the Canadian actuaries.

Our first speaker is Paul McCrossan. Paul is a Fellow of the SOA and a Fellow of the CIA. He's past president of the Canadian Institute. He also is a former member of parliament. He's past president of the International Forum of Actuarial Associations (IFAA), and he's currently the actuarial representative to the International Accounting Standards Committee (IASA).

MR. W. PAUL MCCROSSAN: How do regulators and the public view the actuary's opinions? Can actuaries form impartial professional opinions? Clearly, I cannot answer these questions from an American point of view. However, I've given considerable thought to the questions. I believe that, unless actuaries can form objective opinions, they will not warrant the confidence of the regulators and their other publics, such as accountants and securities regulators. I further believe that unless actuaries are willing to be held accountable for their work, there will not be great confidence placed in their work.

In my remarks, I'll outline the steps taken in Canada to ensure that the actuary's work will be objective and, hopefully, viewed as objective by our publics. I'll also outline the steps the CIA has taken to ensure that actuaries are seen to be accountable for their work. I'll submit that both steps are necessary in order for the regulators and the public to rely on the actuary.

First, the actuary must be seen to produce first-class, unbiased professional work. Second, the actuary must be seen to stand behind the work product. I believe that as Canadian actuaries have accepted both challenges, they have gradually gained the trust of their key publics.

Here's my conclusion. The position of an in-house appointed actuary, as a member of an insurance management team is a dead end. The in-house actuary does not have overriding public responsibilities, yet remains responsible for the preparation of the actuarial liabilities of an insurer. The public will insist this be changed following the next failures of large life insurers.

Further, I postulate that given the current financial turmoil worldwide, the probability of such a significant failure or set of failures is large and mounting. It is possible that none of these significant failures will be failures of American-domiciled life insurers. However, I believe that if these failures occur, given the increasingly international scope of the life insurance and financial services industry, the move by the financial regulators to develop new international solvency and financial reporting regimes with a great deal of transparency will be irresistible.

These new international solvency and financial reporting regimes will likely recognize that failures resulted from one of two related problems. These problems, which must be addressed in any new regime, that "technical" (formula-driven) liabilities, that do not rapidly reflect either changes in the probabilities of the underlying contingent events, or changes in the value of the assets backing the liabilities, are intrinsically unsound in a volatile world. A once-a-year snapshot of the financial position of an insurer is not satisfactory to protect the policyholders in an increasingly volatile world.

If the life insurer's appointed actuaries are not seen to be significantly objective, I believe that others will move in to fill the void. Either mandatory external reporting of the appropriateness of each company's actuarial liabilities by an outsider or an outside appointed actuary, or the removal of the ability to exercise the appointed actuary's professional judgment, or both will be called for.

Beginning in the early 1980s, the CIA and the Canadian Institute of Chartered Accountants (CICA), which in Canada combines the role of the AICPA and FASB, began to discuss the problem. By the

late 1980s, the Canadian financial regulator, the Office of the Superintendent of Financial Institutions (OSFI), which regulates not only all the insurers, but all banks, all thrifts, many pension plans, and all Social Security plans, was brought fully into the discussions. What emerged was a recognition by the CIA that in order to preserve the role of the appointed actuary as an in-house employee, all appointed actuaries would have to assure their publics that they would act objectively and in the public interest.

During these conversations, the accounting and actuarial professions reached a formal protocol that enabled each of the reporting professionals to use the work product of the other. The regulator, the accountants and the actuaries, came to the conclusion that, if there was the requisite degree of objectivity from the actuaries, the necessity for a prospective regulatory valuation basis no longer existed, and that a single set of financial statements for regulatory and GAAP purposes buttressed by appropriate risk-based capital could be produced and would be desirable.

Finally, I note that two years ago, the Canadian income tax authorities accepted that actuarial liabilities were objectively determined by the actuary. The actuary's professional judgment was found to be acceptable for income tax purposes without any rules whatsoever.

The onus was on the actuarial profession to demonstrate that it would bind its members to a standard of behavior that would be sufficiently objective to satisfy the legislators, the regulators and the accountants. At the time of the adoption of the North American Uniform Code of Conduct, the CIA adopted a different version with respect to the annotations or what you call the precepts. In particular, we adopted annotations to our Rules 1 and 13, which are much more demanding than the annotations to your equivalent precepts in the states. At the same time, we added four additional obligations requiring actuaries to be objective.

The wording of Rule 1 in Canada and Precept 1 in the states differ by one trivial word. In Canada, we use the word *member*; in the states, we use the word *actuary*. The annotation in Canada is significantly different than the annotation in the states. It is the professional responsibility of the member not to be associated with anything false or misleading.

Before you ask why the CIA has set itself up to be holier than the Pope, let me state that virtually identical words occur in the *Rules to Professional Conduct of Canadian Accountants* and other professional codes of conduct in the Commonwealth and in all countries that accept the common law.

Note that the test is not of doing the work, but being associated with the work. It's not whether the actuary knows the work product is false or misleading, but that the actuary *should have known* that the work product is false or misleading.

The wording of Rule 13 in Canada and Precept 14 in the states both impose the obligation to report unprofessional behavior to the appropriate professional body. However, the exemptions to the reporting requirement are much broader in the states, which demands the obligation, "Except where disclosure would divulge confidential information or be contrary to law." With every assignment I make, I sign a confidentially agreement. That eliminates any reporting.

In Canada, the exemption is much more narrowly restricted to "when the member is prohibited by law, or while the member is acting in an adversarial environment." The practical effects are profound. If I'm engaged as a consultant by a company, and I observe unprofessional conduct by one of my client's staff, I have only two professional choices, neither of which is pleasant. According to our rules, the situation must be discussed with the other member. If necessary, an agreement must be reached to ensure that the apparent noncompliance is rectified, or to report the member to the Committee on Discipline.

How frequently does our Rule 13 raise its ugly head? In my practice, which is largely mergers and acquisitions, demutualizations and appointed actuary work, Rule 13 is an issue about once or twice a year. There are terrible situations. However, when viewing my firm as a whole, I find that we virtually never have to report another member to the Committee on Discipline. That is because rectification is the preferred alternative of everyone (ours and the actuaries whose conduct we observe).

Let me now turn to the Canadian Rules of Conduct, which have no counterpart in the U.S. These rules came directly out of the discussions with the accountants and the regulators concerning the necessity to be viewed as exercising objective professional judgment.

Rule 17 requires that the member ensure that any calculation or recommendations are, wherever possible, based on sufficient and reliable data, and that assumptions made are adequate and appropriate. The methods used must be consistent with the principles established by precedent or common usage. This rule doesn't prohibit, or even inhibit, innovation; each practice area has its own committee that can give confidential rulings to any practitioner. New insights and methodologies are frequently brought to the practice committees. However, it might be an understatement to say that it's a brave actuary who proceeds with an innovation if he or she has been told that the idea is not consistent with good actuarial practice.

Rule 18 states that when a member is requested by a client or an employer to prepare a study that deviates from principles established by a precedent or common usage within the profession, or is based on insufficient or unreliable data, that member will include in any resulting report, communication, or certificate an explicit qualification of the member's findings. This same rule applies to Canadian accountants. This rule can require an actuary or an accountant to qualify a report prescribed by the government, a regulator, accountants, or any other standard-setting body, to be in non-conformity with generally accepted actuarial principles.

The difference between the Canadian and the American practice was forcefully brought home to me last year. Both the president of the U.K.'s Institute of Actuaries and I believe that an early version of the IASC standard on reporting the cost of pensions and other employee benefits was contrary to generally accepted actuarial principles. The CIA took it to our counterparts, the CICA, and said, "If the IASC goes ahead with the standard, we, the CIA, will oblige our members to heavily qualify the report." The qualification we had in mind was something like, "figures produced in this methodology are frequently misleading." They understood because they had the same rules themselves.

However, when we took it to the Academy, the Academy was equally clear on what their obligations were, but those obligations were opposite from the CIA's. The FASB or the IASC sets accounting rules. If they specify a methodology for calculating actuarial liabilities, which does not conform to good actuarial principles or practice, it's the position of the Academy that any damage to the public interest comes from the accountants, not from the actuaries who conform to the standard. This is an interesting difference.

Rule 20 requires that a member making a report with respect to pensions, employee benefits or insurance companies, or required accounting purposes, perform the services without regard to personal considerations, or to any influence, interest or relationship to the affairs of the member's client or the member's employer. We all see that that objectivity rule is very harsh and is one of the rules for which members are frequently brought before disciplinary tribunals.

There's another interesting rule in Canada. This is a legal rule. It is illegal in Canada for any officer, director, or agent, that includes the appointed actuary or an outside actuary of a company, to authorize or participate in willfully giving the creditor of the company fraudulent or undue preference over any other creditor of the company. The potential punishments on an individual are not trivial. Summary conviction results in a personal fine of $100,000 or a year in jail, or on indictment to a fine; $500,000 or five years in jail. If I, as an independent consultant to an insurer, come to the belief that the company is going to go under and allow sophisticated customers to surrender their policies, or sophisticated debt holders to transfer their debt, I'm guilty of a crime in Canada, just by staying silent.

What's offered as a *quid pro quo* in the legislation? First, both the appointed actuary and the auditor are entitled by law to information and explanations necessary to enable them to perform their duties. The law grants immunity of liability in any civil action to any person who, in good faith, makes a communication to the actuary or the auditor performing their duties.

Second, the act grants qualified privilege to the auditor and the appointed actuary in respect of any oral, or written statement or report made by them under the act.

Third, the act requires the appointed actuary to report directly to the board in person every year on the financial position and expected future financial condition of the company regardless of its circumstances. The actuary is also to make a special report on any matters that, in his or her opinion, have material adverse effect on the financial condition of the company and require rectification. If suitable action is not taken to rectify the matter, the actuary must send a copy of the report to the superintendent and advise the directors that he has done so.

The Annual Dynamic Condition Adequacy Testing, which we call DCAT in Canada, is a privileged document which is only available to the board, the auditor and the regulator. DCAT's American counterpart is dynamic solving testing (DST). However, starting January 1, 1999, the CIA is proposing that the appointed actuary will have to issue a written opinion as part of his annual DCAT report. The opinion will state whether the financial condition of the insurer is satisfactory, which means that the company is expected to maintain the desired risk-based capital (RBC) ratio under the most likely scenario. The opinion will also state that, over the five-year time horizon, it will maintain an excess of assets over liabilities under plausible adverse scenarios.

Furthermore, the CIA doesn't prescribe the scenarios, but requires the actuary to identify and test all material plausible adversities. In addition, the act provides that if an appointed actuary resigns or his or her appointment is revoked, which could happen if you write one of these reports, the appointed actuary shall submit to the directors of the company and the superintendent a written statement of his opinion as to the circumstances and reasons behind this dismissal. The act also requires a replacement appointed actuary to request and receive the written statement before accepting a new appointment. If this doesn't happen, the new appointment is void.

What more could anyone ask? The answer is plenty. For the last six years, all appointed actuaries in Canada have had to submit a lengthy written compliance questionnaire to the CIA itself shortly after filing each year-end report. The questionnaire outlines in great detail the steps that he or she has taken to discharge the professional responsibilities of complying with the standards of practice with objectivity, and with the obligations to the auditor.

The CIA now proposes to introduce a new tier two performance review. Starting January 1, 1999, one quarter of all appointed actuaries will be randomly selected each year to be the subject of a performance review by the profession itself. The profession will employ experienced, retired practitioners representing the profession. The costs will be charged to the company. It's expected that the review will last a day or two. The practice review will be exempt from any reporting for discipline since the purpose is to improve reports.

Let me summarize. The regulators, the taxation authorities and the accountants have given the actuary the right to determine the basis on which to determine and value actuarial liabilities. The entire actuarial value section of the insurance companies act consists of one sentence. The actuaries valuation shall be in accordance with generally accepted actuarial practice with such changes as may be determined by the superintendent. So far, the superintendent has never exercised his prerogative to override the profession.

The late Andy Webster used to say, "The work of the actuary is to preserve the future from the ravages of the present." Quite frankly, we in the CIA think that by requiring the objectivity standards we do on the appointed actuary and the directors and officers (D&O) actuaries in all practice fields, we bring benefits to society, our clients, our employers and our profession.

MR. WOLF: Our next speaker is Sam Gutterman with PriceWaterhouse Coopers. He's a Fellow of the Casualty Actuarial Society (CAS) and a Fellow of the SOA. He's past president of the SOA, and he's chairman of the International Association's Committee on International Insurance Accounting.

MR. GUTTERMAN: I'd like to add one other item. I am the SOA's representative on the Joint Committee on Professional Conduct that was set up by all the actuarial organizations in North America. We are currently reviewing the Code of Professional Conduct for each organization. Certainly, we'll be looking at the differences that Paul brought out between the CIA and the rest of the actuarial organizations. If anyone has any thoughts or ideas about how or whether the Code of Professional Conduct should be updated or revised, I would appreciate hearing from you.

In preparing for this session, I had a difficult time, because often the most effective way of learning about professionalism is by looking at case studies and discussing them. This presentation is a bit different. I also have to admit that there are many gray areas. This is not an area of black and white like you read about in a mathematics or actuarial textbook. I will be posing a couple of questions to which I don't necessarily have the specific answer, which many appointed actuaries have to deal with on a day-to-day basis.

There have been many definitions of a professional. I think the first tenet of being a professional is competence, as demonstrated by professional and specialized knowledge. Second is the commitment to ethical conduct and to provide a service for the public good. In my terms, it's providing value with integrity. However, it's possible that the best method for determining whether professionalism has been achieved is measured by trust.

Two aspects of the valuation actuary's role can be considered. The first, financial advisor to the company is not required by any law or regulation. The second, which is required by law, is the development of an actuarial opinion regarding the adequacy of reserves. The latter role gives rise to most of the professional issues in this area, while the former provides most of the opportunities to the valuation actuary to prove his or her value to the firm, and also indirectly to the public.

There are many tensions and potential problems in performing these functions. I saw this quote from a recent CIA list server: "We are viewed by some as an ingrown and suspicious profession with a reputation for being a bunch of bloated and overly expensive practitioners too interested in producing reports full of basically useless information and disclosure as an excuse to gouge our clients with billable dollars." This is pretty extreme, but I've heard something similar from a number of individual users of actuarial services.

As a result of the requirement put upon us by law and regulation, the question is whether our work and our opinion has turned into a necessary evil. This is obviously of significant and central concern to every actuary in the profession. I'll try to discuss some of the key points raised in that quotation.

The first question is: Are we an ingrown profession? Clearly, we are. In fact, in some cases, we have it codified in law, regulation, and in our own qualification standards. However, this is not necessarily bad, if, at the same time, the profession and the individual actuaries can satisfy the requirements and the needs of their users. In this case, the users are insurance companies and regulators. However, it is clear from countless other examples in the financial and economic environment that monopolistic situations can lead to the opposite situation; a profession becomes more interested in serving itself than the public it is supposed to serve. The profession and its leaders need to stand guard against this potential adverse condition and must continue to innovate, to focus on fundamentals, and to be of benefit to society.

The second question is whether we are overly expensive practitioners. There is no doubt that we can be expensive either as employees or as consultants. However, I contend that as long as we stay within our required scope, this impression will remain. Who wants to pay for something that is not voluntary, that's not deemed to be of value to the company, or to the purchaser of services?

Does our required scope really provide a valuable service to the public, whether that public is defined as policyholders or shareholders? I believe that it does, but if we produce sensitivity analyses that aren't used, if we provide data in our reports that key individuals or decision makers don't understand, then our role is not quite as viable as I would hope. If the practitioners allow other professionals in other areas to overtake them in serving client needs, we will find ourselves holding on to our sacred, monopolistic function without providing the nonrequired role as a business advisor. Only if the valuation actuary is used for other than his or her required function will the user be sure that the expense is worth it.

The third question pertains to useless reports and information. As long as we just provide boiler plate opinions and reports full of numbers relating to what some people view as being unrealistic scenarios, will these deem us to be useless? I think if we take the effort of communicating effectively, we can overcome this concern, but it is not easy.

Does our actuarial opinion provide a false sense of security? I won't repeat what Paul said about the international scene, but volatility of interest rates indicates that we have work to do in order to be prepared for the future. We should be seriously looking at alternative scenarios because, if we don't, we could be heading for a great deal of problems and difficulties in the years ahead. In sum Mary, if we don't provide more value than required by law, the cost for our services will be too much.

These are some issues we must address. Who is our primary audience? Are we advocates? If yes, for whom? That is easy to answer: the truth and the public. We certainly serve the public well, but it's sometimes difficult to recognize who our public really is. Even if we come up with an answer, does this tell us anything about whom we should communicate with and whose perspective we should take?

Two examples of this dichotomy include first our role vis-á-vis the regulator as compared with owners and management. If it is the former, we may be more concerned with solvency risks. If it is the latter, we may be more concerned with providing information to support everyday decisions. The second example is policyholder versus shareholder interest. I'm sure everyone has come across this potential conflict of interest; this is a concern that we all have to live with.

What is the proper role of the valuation actuary in the governance of a company? Paul alluded to some aspects of this issue earlier. We should periodically confirm that our services are of value and meet real needs, but with multiple audiences that may not be so easy.

Are we too self-serving? As long as we are simply performing compliance work and we don't provide overall value, we may be accused of this. Do we communicate our results recommendations and their implications effectively? We need to communicate in an effective and summarized form the risks underlying the financial operations at which we're looking. Does any nonactuary really read and evaluate the actuarial opinion and report? I know some of the members of boards that I report to don't ever read my report. I believe that the valuation or appointed actuary should try to

do a better job of communicating her or his conclusions. To overcome the impression that all we do is fill in boilerplated language, we have to focus on value, focus on communication, and focus on fundamentals of what we're doing and why we're doing it and operate in light of the concerns about integrity.

Two key areas of concern that are important to professional behavior include (1) competence and (2) objectivity. There are a couple of items I'd like to point out in the area of competence. First, competence means taking responsibility for the opinion and reliance on others. There's a need to continually ask questions in this area. We can't continue to accept answers from others that sound good without an appropriate investigation. I emphasize two key areas that we need our care and knowledge: data quality and the investment areas.

Let's focus on the current Asian financial crisis where asset values have come under attack and have not been properly addressed in some cases. I think this is an area an actuary has to be concerned with. It's very difficult for one person to understand all the aspects of a complicated insurance environment, but I believe that actuaries are the best qualified professional to attempt this. Although we aren't auditors, we should dig a little deeper into the sources and information to better assure its validity.

The second concern is objectivity. The perception of multiple users and their interests might influence objectivity. Among these users are owners versus potential owners, policyholders and potential policyholders, management, reinsurers, regulators, auditors and the profession, which is at risk in the event of our adverse experiences. This problem is caused by multiple interpretation and, in particular, multiple perceptions on the future.

Independence. Is the existence of a professional code sufficient? Should it matter whether the valuation actuary is in-house or external? Clearly, there are risks and concerns no matter where an appointed actuary sits. The accounting profession has determined that one has to be external to a

company in order to provide an objective audit opinion. Why are we different? Actuaries pride themselves in being objective with our professional standards, but if you look at the accountants, they have an awesome number of standards to abide by. We're not unique in this regard.

Actuaries worldwide have indicated that an actuary who signs an actuarial opinion can be either internal or external to an insurer. I think our opinion has more to do with historical accident, but I think it can be made to work either way if, and only if, we prove trust in us is warranted. Some have argued that an external actuary cannot understand the inner workings of a company, while others have argued that exposure to multiple approaches and skill sets are a plus. We won't answer this question at this session. It will be discussed for many years to come.

Maybe it is time to segment the role of the valuation actuary into two portions: (1) someone to prepare reserves and justify them and (2) someone to validate them. This may be somewhat similar to the company that takes responsibility for determining financial values, with an external auditor validating the values at which the company arrives.

How many peer reviews are necessary? Currently, they may be done by an actuary in-house, by an actuary employed by an audit firm, and by an actuary around with a triennial regulatory audit (not to mention the possibility at an actuarial discipline board).

The key is to obtain a peer review from someone knowledgeable with exposure to the work of other valuation actuaries, and most importantly, who is willing to provide constructive criticism and not just go back and say, "Yeah, it's a good report." I think that everyone needs peer review. I encourage those who haven't read the Academy's Exposure Report on Peer Review to do so. I think it can add a significant dimension in understanding this issue.

I won't dwell on the international perspective in this area, but I will mention a couple of items. In the United Kingdom, the original requirement for appointed actuaries came into force in 1973. Their appointed actuaries have shown a strong degree of independence, almost to the point of being offended that their judgment is ever questioned. This is undergoing change as the financial services

industry changes in the United Kingdom, but it is significant. They've recently introduced an appointed actuary's certificate to ensure qualification requirements are met. Ninety percent of appointed actuaries in the U.K. are in-house employees.

I won't dwell on the Canadian scene, but, as Paul mentioned, I think there's an awful lot that actuaries in the United States have to learn from the Canadian environment. In particular, the United States need actuarial experiences to work on identifying key risk areas and communicating them to their boards.

In Japan, there's a wide variety of practices with some appointed actuaries actually serving on insurers boards. In Japan, all appointed actuaries are currently employees of companies as they have a very limited consulting practice. But since 1996, appointed actuaries prepare a report for the board covering the soundness of the liability reserves and the fairness and equity of dividends for mutual insurance companies. The Japanese have modified and enhanced their practice significantly over the last several years.

The International Actuarial Association (IAA) has become a force for professionalism due, to a great extent, to Paul's efforts in the worldwide actuarial profession.

The movement towards the appointed actuary is spreading internationally. In order to become a member, the IAA has mandated the existence of a *Code of Professional Conduct* and a discipline process. It is important to note that in many countries, these processes have yet to be tested and practiced. This is going to be a challenge for the future.

Before I close, I'll mention a few of the future professional challenges before the appointed actuary or valuation actuary, all involve enhancing our value, and if executed properly, should improve trust, our perceived value, and enhance our professionalism. This is the most significant way to overcome the impression voiced by the quotation I mentioned earlier.

The first challenge is to enhance the valuation actuary's scope of work. I know you don't need more work, but not much value is added by someone who simply fulfills a regulatory function. The insight necessary to satisfy professional requirements and sign an actuarial opinion should enhance the financial insights of company management. We need to identify and quantify significant risks on a macro level basis. We can't just calculate an actual-to-expected ratio. We must evaluate the risk of a super-preferred pricing and underwriting class on a single newly issued product. The valuation actuary needs to look at the financial impact on the total book of business. Asset adequacy tests are fine to test the business of today, but to provide value to support today's and tomorrow's business decision making, there's a need to reflect new business on an ongoing enterprise basis. This can be accomplished through approaches such as the dynamic financial condition analysis that we've been talking about for the last several years.

Second, we need to integrate testing and other functions of the company with, hopefully, one basic system and one database for pricing, financial projections and for reserving. I believe an integrated focus on risk analysis in many of the functions that touch actuaries will be increasingly important as time goes on.

The third challenge is communication. We need to do a better job of communicating our conclusions and insights to boards and upper management.

Note that I have not mentioned technical skills or competence. I mentioned this briefly when I discussed the definition of professionalism. I assume that this will continue to be enhanced over time. This is a given.

MR. WOLF: Our third speaker is Bob Meilander. He's a vice president and corporate actuary with Northwestern Mutual. Bob tells me he considers himself a newcomer to the valuation actuary scene. He says he has only been active in this area for three years, but in view of how it has developed and how it is still developing, I think he is probably as far along as virtually everybody in this field. We're all still learning.

MR. ROBERT G. MEILANDER: For starters, I'd like to point out I'm not the expert on this panel. We have a former president of the SOA, a former president of the CIA, and a former member of parliament. It's humbling to be part of this panel.

In order to get ready for this presentation, I spoke to a number of practicing actuaries on the topic, and what I have for you is a collection of some of my own thoughts and a lot of theirs.

My goal is to represent the in-house actuary and to help focus some of the issues of professionalism as it relates to statements of actuarial opinion. What I want to do is to say what most of you might say if you were up here.

I have a collection of thoughts for you to think about. I wanted to do something like Letterman's Top Ten List, but I'm not quite as thoughtful as he is, so I only came up with seven.

The first basic thought is the actuary is a professional. Almost all the folks I spoke to pointed this out. They do think of the actuary as a professional. I'll give you just a hint of the kinds of things they said.

One individual stated that signing his name to a report meant he had pride in his work, and it meant he took responsibility for his work. So that was one view. A second view was that a professional is going to make judgments. They're going to decide what they will do and what they won't do. Note the professional judgment aspect of it. This is contrasted with an employee who will do what he or she is told.

Another aspect of professionalism is that professions police themselves. It has been suggested by some that the regulators ought to require an outside review of actuarial statements of opinion. I guess my personal belief would be that, if there's a need for that kind of an outside review, and we are a profession, it should come from within the profession. We shouldn't have to ask the regulators to make us do that. My first point is that the actuary is a professional.

The second point is that perfect is the enemy of the good. Our current system is not perfect. There are issues. There are things that are being done that maybe shouldn't be done. Herb pointed out some of those in an article in *The Financial Reporter* a while back. The question isn't whether we have a perfect system. It's more, how do we deal with those imperfections? Much of what I'm going to have to say from here on is going to deal with that question.

One of the advisors I spoke with stated, "We have a good system." In this person's mind, 98% of the assets of the insurance industry are owned by companies that have the resources and time to do a good job of asset adequacy analysis and are, in fact, doing a good job.

His concern was, "Do we want to design a system around the other 2%?" I think the point is that we need to be careful that we don't do damage to a good system in an effort to make it perfect. If there is a need for any revision, it's for fine tuning, not for massive reconstruction.

The third point is why replace a hired gun with a hired gun? Again, someone suggested that an outsider review or do the actuarial opinion. This is an interesting concept. It may improve the situation, but it isn't perfect either. For starters, an outsider isn't plugged into the company. They're not part of the planning process of the company. They're not part of the culture. They're not part of the day-to-day operations of the company. As a result, the outsider is going to be dependent on the insider for information. I would ask the question, "Is the report based on insider information that is much better than a report prepared by an insider?"

A second comment on the same point is that an outside review has a cost. If you pay enough to get a good review, it's going to be expensive. You're going to pay twice because you're going to pay the insider and the outsider. You have to wonder if independence isn't going to suffer on the part of the outsider. That independent outsider is not going to be as dependent on one employer for income as the insider would be, but you still have to wonder.

In addition, there are potential conflicts created by other consulting services. Will a company hire a firm from management consulting that gives it a bad actuarial review? Regardless of whether they would or they wouldn't, how will the consultant feel about taking that chance? The point is, would an outside review be better than the current situation?

The next point: Sunshine helps. A former CEO at Northwestern used to say, "Never do anything that you don't want to see on page one of *The New York Times*." That's a pretty high standard. Perhaps some public review of the actuary's work may be appropriate. As an example, note how balance sheets were changed and cleaned up as a result of risk-based capital requirements.

Here are some ideas on how we might bring a little sunshine to the situation. We could make the scope of the actuarial review and its general assumptions (like trend lines) public. We wouldn't necessarily have to make the results or the detailed assumptions public, but we could make the generalities public. This would help other actuaries see how the work was done and would help identify the key issues that need further discussion. This is much like what Herb has done in *The Financial Reporter* article. This would address the issue of what is normal.

As a second possibility, one actuary has hired an outside firm to do a peer review of their work. This is something we could all do. Another way of dealing with this same situation would be to rotate staff people (if you have staff people that you can rotate). Rotating staff people in and out of the valuation actuary positions gives your company a new set of eyes each time you do it. The point is that, with some review, actuarial reports improve.

The next point is that the feedback loop is a big issue. One individual stated, "I don't know if there's a problem with what I'm doing unless someone tells me." I'll give you an example. As part of our own work at Northwestern, we file a segmentation plan in New York. Segmentation plans are required in New York if a company separates assets by product, and they have to be filed. Segmentation plans are confidential, so we don't see anybody else's and others don't see ours.

I was recently told by someone from New York that our plan was the most complicated he had ever seen. I found that rather interesting. By the way, he didn't have a problem with that; it was just his observation that it was very complicated. We weren't aware of any particular complications and, frankly, I was a little surprised by the comment. We tend to think of ourselves as a fairly simple company. I think this points out that with things like this, it isn't obvious until you say it.

Other issues related to this particular discussion are what is a good job and what is normal practice? It's very difficult to figure those things out. Regulators, for the most part, won't say because, if they do, it becomes the minimum. If they quantify what is acceptable, then acceptable is all they're going to get. I can understand that viewpoint. On the other hand, companies may be doing less than the regulators want because we're not exactly certain about what it is they want. They may be feeling they're getting inadequate stuff, and we don't know about it.

A way one individual put it is that the current system is pass/fail. You file the report. It's approved or it's disapproved. Maybe letter grades would be better. So the issue here is what's the best way to let the actuary know if he or she is doing a good job.

The next point is trust within limits. I saw a quote the other day that's related to this. It was, "No one can be faulted for staying entirely within the rules." Interestingly enough, that was a quote by Donald Fehr regarding Mark McGuire's use of the performance enhancing dietary supplements. No one can be faulted for staying entirely within the rules. Or can they?

I'm willing to trust the actuary, but I still think some standards for reserves are appropriate and needed. I realize I have spoken out of both sides of my mouth. I said the actuary is a professional, and now I'm telling you that I don't want to give him or her total control of valuation. It's a confusing situation, but perhaps we do need to follow some stated valuation principles. I don't necessarily mean the rule-oriented system we have today, but I think there has to be some set of standards for the actuary, if for no other reason than to provide a floor to protect guarantee funds. At this point, maybe we need some standards to make it easier to trust the actuary.

My last point is: state your opinion. You can't afford not to. There are lots of things going on right now. There are changes to Regulation XXX. There's discussions of the unified valuation system, market value accounting, and professionalism discussions such as this one. Things are going to change out there whether you're involved or not. Others will make the decisions for you if you let them.

The valuation actuary has an important job. We're not just dealing with numbers. We're dealing with people's lives. We're dealing with the future of this industry. If you think about it, we have nothing to sell if not the promise to be here when people need our product. So it's an important job. We deal with a system that's not perfect, but it works pretty well. Regardless of whether you're an insider or an outsider, you still have to grapple with the issues. One of the keys is, if you need help, go get it. If you need a peer review or an outside consultant or whatever, go get it. In the final analysis, the key to whether or not this stuff is done right is the character of the individual and not necessarily whether they're in-house or out of house.

MR. KERRY A. KRANTZ: I'm from the Florida Department of Insurance. I wish we had the Canadian system. I think that the actuaries there flourish under it.

Since we don't, and since the United States has a different culture than Canada does, I'm wondering if having two kinds of actuaries as envisioned by Bob Wilcox's committee's would be a solution. There would be an appointed actuary and a reviewing actuary. The appointed actuary is loyal to the company whether he's an employee or a consultant. He does a job within the range of responsibility discussed by Bob in his presentation. The actuary does a professional job and meets the standards of practice, but the actuary is going to do the job for the company—that's who hired the actuary to do it.

Then we strengthen the system with the reviewing actuary so that the reviewing actuary has the ability to discover that it was not a 1990s version of an equity funding situation. You have your

independence in the reviewing actuary, and you don't have the reviewing actuary do all the work of an appointed actuary. That's the job of the appointed actuary. It's the reviewing actuary's job to come in, spend much less time, and just verify that the work was done professionally.

MR. GUTTERMAN: Just one comment regarding the first type of actuary—the actuary who is our advocate. I think there are limits to bring an advocate; we always need to remark and be objective. If the appointed actuary is looked at as merely being an employee or a true advocate of the company, I think that will be some inherent problems with such a system.

MR. MCCROSSAN: The in-house actuaries or staff have far more knowledge of company situations than an outsider is going to get without a lot of probing. If the insider's view is presenting the company's case without an objectivity standard, I would suggest that the reviewing actuary, is going to be very expensive and very in depth in order to try to uncover what isn't being disclosed.

As a professional, I'd rather see the profession impose the objectivity standards to serve the public on its members inside and outside and have the professional accountability solve the issue.

MR. STUART L. SORENSEN: I'm with Security Life of America. I have a quick question for Paul. You indicated that the appointed actuary has to give his opinion, "without personal consideration to the employer's interest." I guess I was wondering about the importance of that word *personal*, or how you would define the personal consideration in that context.

MR. MCCROSSAN: That's the essence of how the actuary received professional freedom in Canada. You cannot allow your employer's circumstances to influence your judgment in preparing what you think are the best estimates. You're required to determine what is the most likely scenario. The fact that it may embarrass your employer, or cause your employer to retrench business, or cause your employer to cut dividends cannot influence your judgment. This applies to pension actuaries as well.

Interestingly enough, I think there have only been two life-appointed actuaries brought up on discipline charges or discipline complaints. There have been many more cases involving pension actuaries. Particularly in negotiating situations, it's been argued they have violated the objectivity requirements because they have become too much of advocates and not objective enough. The standard applies if a report is required by law, or if you're providing a report for an auditor. The standard is not applicable if you're doing in-house reports for in-house purposes. If you're making a legally required report, that's the test. Probably one-third of all professional discipline charges in Canada are made under that rule.

FROM THE FLOOR: I wondered if something is happening to other companies. Our audit firm has been looking more and more at cash-flow testing over the last few years in order to perform a little more peer review. Is that happening at other companies?

MR. GUTTERMAN: In my experience, I want to look at asset adequacy reports and opinions that are performed. I think it's one thing for an audit firm to sign off on compliance with statutory accounting rules and formulas, but I think it's more important for the company, in terms of its insolvency risks, that the reserves be adequate. Therefore, I think that it is appropriate, particularly for an actuary employed by an auditing firm, to evaluate any cash-flow testing that is done. I know I do it for every company that I look at.

FROM THE FLOOR: I would like Paul to expand on his previous opinion that the actuary must not let his personal evaluation of the interest of the company change his opinion. For example, a lot of our work does directly affect the outcome of a block of business performance. If I file for a rate increase and get it approved on a closed block of A&H business, there's a number of different possible outcomes. One might be that I get a large shock lapse and renewal anti-selection, and the loss ratio that originally inspired me to file for a rate increase suddenly is even higher as a result of the rate increase.

There may be some gray areas when evaluating the impact of different financial facts on a company's situation. What I would write in an actuarial opinion, or a qualification of an actuarial opinion could similarly spiral in the negative direction. Have you seen situations of that sort?

MR. MCCROSSAN: First of all, the actuary is there to help, not to hinder or torpedo. Early detection and prevention is the first thing. The actuary is directed to look at certain things if they're material, but is directed to detect all material circumstances so that there's no safe harbor. My experience is that the best practice in 1992, when this was required, is so far below the minimum acceptable practice today that it really is a night-and-day situation.

I also found that the boards look at these reports and view them as a key business management tool. They have asked that the reports be expanded because they are very useful. If you're doing scenario testing, whether it be deterministic or stochastic, you're able to communicate well with your board. In Canada, you have the obligation to appear personally. They have to give you a hearing. If you're able to communicate well, you can do the job for the good of the company. Now come the regulatory filings. You can't conceal what is your best estimate for the regulator or from the auditor in a legal filing. That's what it says.

MR. WOLF: Isn't there a difference between the U.S. and Canada in terms of the fiduciary responsibility of all the officers, and don't the other officers and directors of the company view the actuary differently because of their liabilities in the fiduciary area?

MR. MCCROSSAN: I think that's a valid point. All financial services companies are viewed as fiduciaries—that is they have a trust capacity. The rough rule is any owner of a company can blow his own capital. You're entirely at liberty as an owner or as a member of management to blow through your own capital. Where the line is, is where you start blowing through your customer's capital, whether they're banks or policyholders.

There is the undue preference section. If a Canadian financial institution goes under, whether it's a bank or a trust company, or an insurance company, there's a judicial determination of whether it

was closed down soon enough to protect the interest of the creditors, which include policyholders and debt holders. If it wasn't, there's legal liability to all directors, all officers (including the appointed actuary), and all agents, which includes external consultants.

I can't say too much, because right now I'm subject to a judicial gag order. There was recently a fairly large insurance failure in Canada. It became apparent some time before it failed that it was going to fail. If my partners and I had stayed silent, we would have been criminally liable. In my opinion, we exercised our duties.

MR. GUTTERMAN: I agree that there's a legal distinction between the countries. If anyone has ever looked at *directors and officers claim*, I think that the liability for directors exists in the U.S., whether it be by law or by judicial action. I think that every board member should feel a significant fiduciary responsibility.

MR. WOLF: Bob, you had an interesting comment that I had not heard before in relation to the appointed actuary. You suggested, where feasible, to rotate the appointed actuary.

MR. MEILANDER: The comment I made was not as much related to rotating the appointed actuary, as it was related to rotating the people who work with the statements of opinion. At Northwestern, we have more than one or two people who are involved in producing that work and in producing the report itself. By moving things around now and then, you get a new look. You can do that at any level of the operation. It doesn't have to be simply with the appointed actuary.

FROM THE FLOOR: I was wondering where, in the Canadian world, the standards do seem to be a little bit higher whether the valuation actuary-type role in Canada is a full-time job, or whether the valuation actuary is still wearing many hats.

MR. MCCROSSAN: It varies by size of company. In the large company, we had a consolidation of the industry, which is similar to yours, but very dissimilar to what has happened in the states so

far. To illustrate, we now have 85% of the assets in the Canadian life companies held by six companies out of 140. That's up from about 30% when the new regulations came in.

Part of what's driving the consolidation has been, in effect, the work of the actuary looking forward, advising managements well in advance when they could get out, that they weren't viable. They have argued that work pays off now.

In the large companies, they're generally full-time appointed actuaries. By law, they cannot be the CEO, the CFO or serve on the Board. In the smaller companies, often they're outside but, if they're inside, they typically will ask for a peer review by an outside firm at three-to-five year intervals.

My experience, in terms of cost, is that the cost of doing good work is not that much in excess of the cost of doing average work. However, the payoff for doing good work is phenomenally higher than the payoff for doing average work.

MR. GUTTERMAN: I second that. I think that real value-added insights are worth all the money that companies pay for them. But some other work is clearly not worth the money even if it's less in dollars.

MR. WOLF: Paul, you alluded to another large difference between the U.S. and Canada. First of all, your report is a forward-looking report.

MR. MCCROSSAN: Yes.

MR. WOLF: In Canada, it deals with solvency and it has a horizon of five years. The U.S. report is run on reserve adequacy on a closed-block basis, and it has a horizon which I believe the standards say, runs until all the material risks are satisfied. There's a large difference that we should consider.

I am not necessarily advocating solvency testing. However, I do feel that in the U.S., a reserve adequacy opinion with the horizon of 20 to 30 years on the basic deterministic scenarios, where the

variation extends ten years and is held fixed thereafter, may also be ultimately questioned by the public as having no valid meaning while within the context of the current actuarial standards.

MR. MCCROSSAN: There's a fundamental difference in starting points. You have two sets of statements. GAAP financials and statutory. The statutory regulations of the states are designed to be adequate come hell or high water.

In Canada, they're not. A GAAP reserve is too adequate if it exceeds the expected liability by more than, say, 1.5 standard deviations. If you turn it around an actuarial liability is expected to be inadequate about 15% of the time. So then there's much more emphasis on risk-based capital. If you are running on a single set of financials where liabilities can be inadequate, then the thrust must be on the combined adequacy of the liabilities and the risk-based capital.

I'd observe that our liability statutory standards are weaker than yours, and our risk-based capital is stronger. The opinion is on the solvency. It's on the combination of the two that they will be adequate.

FROM THE FLOOR: Paul, when you were talking about Rule 17, you mentioned that there are committees within the practice areas in the CIA that give confidential advice to members. I wonder if you could tell us a little more about those committees and the type of advice they give, and the form of the advice that they give. Does it have any kind of legal standing because it's coming from the profession?

MR. MCCROSSAN: The law gives you a lot of protection, specifically both qualified privilege and privilege from civil suits if you're acting within accepted actuarial practice. To the extent that something has been ruled actuarial practice, you have a lot of legal protection.

Regarding the way the committees function, there are: life practice, property/casualty, actuarial evidence, and workers' compensation. There's any number of practice areas. An individual can take a question to the Practice Committee anonymously or not anonymously. However, as you can take

a question to the chairman of the committee, the chairman of the committee is required to preserve your anonymity and take the question to the committee for discussion. You then can receive a ruling from the committee, or have a question and answer dialogue back and forth with the committee as to whether what you're proposing is accepted actuarial practice. Once that ruling is received, it's effectively binding.

Also, the practice committees tend to publicize somewhat after the fact. There's an annual report in the yearbook that indicates major rulings and so on. Where they're deemed of significant importance, it's insured that they're put on the programs of the CIA. So these practice committees—there's one on life insurance financial reporting, and there's one on solvency—split the life job in two. If an appointed actuary has questions on the right way to report in accordance with generally accepted accounting principles, then by combining that with actuarial can get a rule. If he or she has a question about what his or her jobs are in terms of solvency reporting, that person can get that answer as well.