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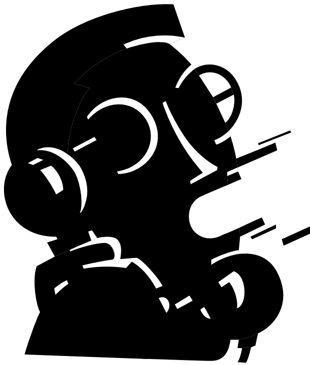
Let's talk

Discussion is needed on actuarial assumptions, consistency

by Rachel M. Hancock

The role of the actuary is changing, and with this change comes an increased need for communication with other actuaries and financial officers of the company. Gone are the days when the actuary's role could be performed in an isolated back room far removed from the rest of company management.



Witness the change in the actuary's role as unbundled, investment-oriented products evolved. Risk management for these products required the continued interaction of the pricing actuary, investment officer, valuation actuary, and interest crediting committee. Recently, a dual focus on shareholder value and policyholder value has emerged, and with it, the need for actuarial communication has become even more important.

Here's a review of some of the key roles and responsibilities company actuaries face today.

- ***Illustration actuary:*** Responsible for the soundness of illustrated values provided to policyholders
- ***Pricing actuary:*** Responsible for the development and pricing of competitive and profitable products
- ***Financial reporting actuary:*** Responsible for the financial picture painted to regulators and rating agencies (statutory statements) and public and private shareholders (GAAP statements)
- ***Valuation/appointed actuary:*** Responsible for the adequacy of reserves and solvency of the company

As we consider each of these roles, some interesting points come to mind.

First, all roles require the actuary to develop future assumptions for mortality, lapse, interest, and expenses, and to apply them in the development of actuarial forecasts and projections.

Second, some roles are focused primarily on policyholders (illustration actuary), some primarily on shareholders (GAAP financial reporting), and some on both (pricing, valuation, statutory financial reporting).

And third, despite the common thread of requiring the development of assumptions and actuarial projections, often these roles are performed independently and by different actuaries. Too often, different assumptions and methodologies are used — depending on the purpose at hand.

Whether the reason is lack of communication or not, if actuaries are ever asked why the differences exist, could we justify materially different approaches for policyholder reporting (on illustrations, for example) than for shareholder reporting?

Of course, assumptions can, and should, differ between those used for cash-flow testing, GAAP reporting, and illustrations. Cash-flow testing by definition should contain some conservatism. GAAP assumptions for deferred acquisition cost (DAC) amortization should be realistic for FAS 97 business (investment-oriented insurance products), and contain a provision for adverse deviation for FAS 60 products (traditional insurance products). Illustrations are based on best estimate assumptions taking into account historical performance. But the basis, or fundamentals, behind the development of such assumptions should be the same.

Let's consider a simple example. Suppose pricing mortality was assumed to be 50% of the 7580 table while experience over the last four years had consistently been running at 60% of 7580. Should this experience be ignored for DAC amortization but not for illustrations? Is it reasonable to assume mortality improvement for DAC and cash-flow testing but not for illustrations?

Let's get closer to home. What about interest spreads? Clearly, most illustrations today assume a level interest spread for all years into the future. What about for DAC amortization and recoverability testing? Cash-flow testing? Widening interest spreads seems to be fairly commonplace. If asked the question, could we, the actuaries of the company, justify widening spreads to one audience but not another?

Today, company practices are being subjected to external scrutiny more than ever before. From policyholder lawsuits, to accounting crackdowns, today's actuaries need to be prepared to justify the consistency of their assumptions and methodologies. How will your company fare?

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