79 - Professionalism Debate

Val Act 2019
SESSION 79
Professionalism Debate

Craig Reynolds, FSA, MAAA
Doug Robbins, FSA, MAAA
Dorothy Andrews, ASA, MAAA
Patrick Davidson, ASA, CERA
Tim Cardinal, FSA, MAAA, CERA
Kelly Rabin, FSA, MAAA

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Organization of Debate

- Introduction and Recitation of the Facts of the Case
  - Craig Reynolds – 10 minutes
- Opening Statements
  - Prosecution: Dorothy Andrews & Patrick Davidson – 12 minutes
  - Defense: Tim Cardinal & Kelly Rabin – 12 minutes
- Cross Examination of the Accused (Doug Robbins)
  - Prosecution, then Defense –5 minutes each
  - Rebuttals – Prosecution, then Defense – 3 minutes each
- Closing Statements
  - Prosecution, then Defense – 10 minutes each
- Moderator Audience Polling and Discussion – 20 minutes

THE CASE OF THE SOFT GAAP PROJECTION
Statement of Situation

Mike Spencer, an ASA and recent MAAA, works for a medium-sized stock life insurance company, which has concentrated on its life and health insurance business for many years, while maintaining a small fixed deferred annuity line. Senior management, including the Chief Financial Officer and the Chief Actuary, focuses virtually all of its attention on the life & health side.

John Simon, the Annuity Product Manager, is a dynamic young MBA with a strong marketing and product development orientation. Three years ago, he convinced senior management to allocate a substantial amount of money to his department in order to implement an ambitious new strategy for growing the deferred annuity line. Mike was assigned to be the actuary for this line, reporting to John. He was assigned to prepare the GAAP financials for this new line of business, including an initial business plan.

In the past, because the deferred annuity line was relatively small and static, the modelling required to produce GAAP financials was fairly rudimentary. The new strategy for the annuity line called for significant increases in sales, new product designs that included up-front bonuses and aggressive interest rate guarantees, and an increase in overall company support for the line, combined with good management of expenses. Mike did not have any sophisticated annuity models in place, nor did he have time to develop a modeling capability. As the new strategy unfolded, Mike developed the best projection of GAAP earnings he was able to, using the simple models already in place.

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The initial projection produced a Deferred Acquisition Cost (“DAC”) k-factor of 70%, with good year-after-year GAAP profits, and strong annual ROEs. The models included deferral of the bonus component, but they assumed level credited spreads (ignoring the interest-rate guarantee, since it seemed unlikely to ever cause the company any actual revenue reduction). The projections were clearly soft, and after discussing the matter with John Simon, they decided not to disclose how soft to senior management, because they both wanted the projections to provide strong support for the new strategy.

As year one under the new individual life strategy came to a close, it was obvious that experience was not going to be in line with initial projections. There were significant expense overruns, and attainable yields proved problematic, resulting in a preliminary updated k-factor estimate of 90%, and poor first-year ROEs. However, it was important to have a successful perceived launch of the new line, and Mike committed to John Simon that he would find ways to restore the k-factor to 75% or lower. After a quick analysis, Mike determined that assumed post-surrender-charge lapse rates were very conservative, and with some updates to certain factors, he could accomplish the desired effect. The assumption changes were made, and earnings came in more or less as planned.

By the end of year two, earnings for the year trailed the forecast again, as expense overruns continued, and market interest rates had also risen, triggering unexpected dynamic lapses of 25%, further reducing the forecasted EGPs.

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Again, John Simon wanted to see ideas on how earnings could be brought in closer to initial projections. Mike decided to review the assumptions for capitalizing and amortizing expenses for new issues. He was able to convince the Accounting Department that because of the increased activity in the Annuity area, a higher percentage of expenses should be capitalized, and that the new business being sold would persist even longer than that which was assumed in the current assumption set. He was able to get the external auditors to sign off on the changes, after committing to do a complete analysis of the capitalization and amortization basis for the line, as well as loss recognition testing, during the next year. Again, he was able to bring earnings and ROEs back in line with those initially projected.

This year, year three, has started out worse than the first two with regard to actual earnings vs. plan. John Simon has told the Chief Actuary that the Annuity line is going to have to prepare for the possibility of loss recognition at year-end. Senior management has suddenly become interested in the Annuity line. Now, both the Chief Financial Officer and the Chief Actuary have asked Mike Spencer for a full report on the development of the original GAAP earnings projection for the new strategy, an analysis of actual earnings for the first two years, and a detailed presentation of expected earnings for this year and the next two years.

The Prosecution

Overview of actuarial standards

From the ABCD's website:

The Code's purpose, stated in its introduction, is "to require actuaries to adhere to the high standards of conduct, practice, and qualifications of the actuarial profession, thereby supporting the actuarial profession in fulfilling its responsibility to the public."

Upholding the Code of Professional Conduct

Precept 1, Annotation 4:
"An Actuary shall not engage in any professional conduct involving dishonesty, fraud, deceit, or misrepresentation or commit any act that reflects adversely on the actuarial profession."

Precept 8:
"An Actuary who performs Actuarial Services shall take reasonable steps to ensure that such services are not used to mislead other parties."

Methodology
- "Soft" GAAP projections
- Manipulation of assumptions

Historical experience
- Expense overruns
- Spread compression

Peer review
- Influence of John
- No third party involvement

Relevant ASOPs

ASOP 10: U.S. GAAP methods and assumptions

- Expense assumptions not based on company’s actual recent experience data
- Excessive use of actuarial judgement

ASOP 41: Actuarial communications

- Uncertainty or risk should be clearly communicated
- Significant limitations should be clearly communicated

ASOP 54: Pricing a life insurance product

- Selected model should accommodate the product design
- Assumptions reflect relevant and credible data

Adherence to the Qualification Standards

Qualification Standards, 1.2:
"— A Statement of Actuarial Opinion may be used by parties who are not familiar with the qualifications of an actuary who issues such statements.
An actuary who issues Statements of Actuarial Opinion must have achieved fundamental education and experience in relevant areas of actuarial practice and must maintain necessary expertise through continuing education."

Qualified actuary	Mike Spencer
• 3 years experience under review of qualified actuary • Upholds Code of Professional Conduct • Observes ASOPs	• Recent MAAA indicates lack of relevant experience • Does not uphold the Code or observe ASOPs

Prosecution Conclusion

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The Defense

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Code of Professional Conduct

Professional Integrity

PRECEPT 1. An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession's responsibility to the public and to uphold the reputation of the actuarial profession.

ANNOTATION 1-1. An Actuary shall perform Actuarial Services with skill and care.

ANNOTATION 1-2. An Actuary shall not provide Actuarial Services for any Principal if the Actuary has reason to believe that such services may be used to violate or evade the Law or in a manner that would be detrimental to the reputation of the actuarial profession.

ANNOTATION 1-3. An Actuary shall not use a relationship with a third party or with a present or prospective Principal to attempt to obtain illegal or materially improper treatment from one such party on behalf of the other party.

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Qualification Standards

PRECEPT 2. An Actuary shall perform Actuarial Services only when the Actuary is qualified to do so on the basis of basic and continuing education and experience, and only when the Actuary satisfies applicable qualification standards.

ANNOTATION 2-1. It is the professional responsibility of an Actuary to observe applicable qualification standards that have been promulgated by a Recognized Actuarial Organization for the jurisdictions in which the Actuary renders Actuarial Services and to keep current regarding changes in these standards.

ANNOTATION 2-2. The absence of applicable qualification standards for a particular type of assignment or for the jurisdictions in which an Actuary renders Actuarial Services does not relieve the Actuary of the responsibility to perform such Actuarial Services only when qualified to do so in accordance with this Precept.

Code of Professional Conduct

Standards of Practice

PRECEPT 3. An Actuary shall ensure that Actuarial Services performed by or under the direction of the Actuary satisfy applicable standards of practice.

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ANNOTATION 3-2. Where a question arises with regard to the applicability of a standard of practice, or where no applicable standard exists, an Actuary shall utilize professional judgment, taking into account generally accepted actuarial principles and practices.

ANNOTATION 3-3. When an Actuary uses procedures that depart materially from those set forth in an applicable standard of practice, the Actuary must be prepared to justify the use of such procedures.

Communications and Disclosure

PRECEPT 4. An Actuary who issues an Actuarial Communication shall take appropriate steps to ensure that the Actuarial Communication is clear and appropriate to the circumstances and its intended audience, and satisfies applicable standards of practice.

ANNOTATION 4-1. An Actuary who issues an Actuarial Communication shall ensure that the Actuarial Communication clearly identifies the Actuary as being responsible for it.

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PRECEPT 5. An Actuary who issues an Actuarial Communication shall, as appropriate, identify the Principal(s) for whom the Actuarial Communication is issued and describe the capacity in which the Actuary serves.

ASOP 10: 1.1-1.2

1.1 Purpose—This actuarial standard of practice (ASOP) provides guidance to actuaries when performing professional services related to the preparation of life insurance companies' financial statements in accordance with U.S. generally accepted accounting principles (GAAP).

1.2 Scope—This standard applies to actuaries when performing professional services related to selecting or reviewing methods or assumptions used in the preparation of life insurance company GAAP financial statements.

ASOP 10: 3.1

3.1 The Role of the Actuary—The GAAP financial statements of life insurance companies are the responsibility of management. The methodologies used in determining financial statement amounts are, for any specific element, generally prescribed by authoritative GAAP guidance. Actuaries frequently participate in the processes of developing specific techniques for application of GAAP methods and selecting or considering assumptions used in the preparation of life insurance company financial statements. To the extent the actuary participates in these activities, the actuary should be guided by this standard. In addition, the actuary should be familiar with accounting and actuarial literature that is relevant to the activities in which the actuary is participating.

ASOP 10: 3.3

3.3 Best-Estimate Assumptions—In instances where GAAP requires best-estimate assumptions, the actuary should use assumptions that reflect management's assessment of emerging experience without provisions for risk or uncertainty. Where there is no emerging experience, the actuary should use assumptions that reflect management's expectations of how experience will emerge. Best-estimate assumptions may be established as the "most likely," "average," or "central" outcome, corresponding, respectively, to the mode, mean, or median of a probability distribution. Other interpretations of best estimate are possible. The actuary should use actuarial judgment to determine which interpretation of best-estimate is appropriate for the situation at hand with reference to the applicable authoritative GAAP guidance.

ASOP 10: 3.3 continued

In advising management as to the selection of best-estimate assumptions, the actuary should consider, among other things, the characteristics and magnitude of the company's business; the maturity of the company and its rate of growth; the prior experience of the company and the trends in that experience; as well as medical, economic, social, and technological developments that might affect future experience. The actuary's advice should consider the company's actual recent experience data, if, in the actuary's judgment, it is relevant and credible.

The actuary should also consider relevant industry data or data from other similarly situated companies to supplement available company specific data. ASOP No. 23, *Data Quality*, gives further guidance to the actuary on issues related to the selection of data, use of imperfect data, and reliance on data supplied by others.

ASOP 10: 3.7.d.

3.7 Methods and Techniques—Methods used to determine GAAP financial statement amounts are generally prescribed by authoritative GAAP guidance and will vary according to the specific literature that applies.

When developing detailed techniques for determining financial statement amounts in accordance with the prescribed GAAP methodology, the actuary should consider the following:

d. the materiality of resulting financial statement amounts;

ASOP 10: 3.10

3.10 Simplifications and Approximations—The actuary may, when appropriate, use assumptions and techniques (for example, models) that simplify calculations. Simplification and approximations are acceptable only if the results are reasonably expected not to differ materially from more detailed calculations. The actuary should seek guidance from accounting professionals on questions related to financial statement materiality.

Defense Conclusion

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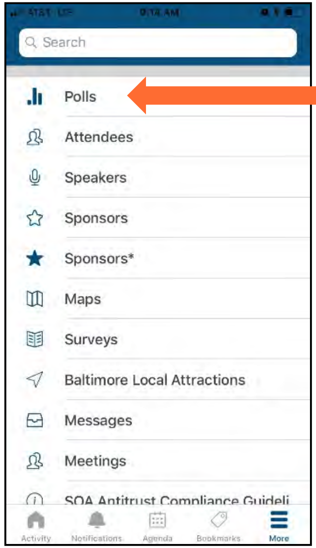

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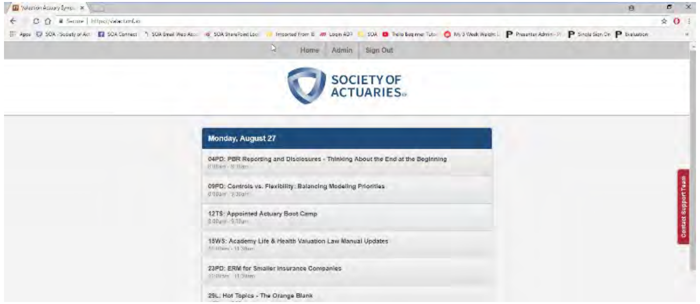

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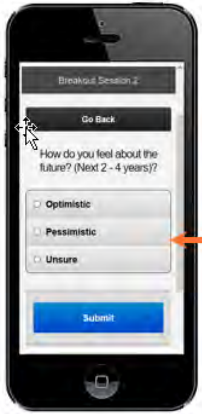
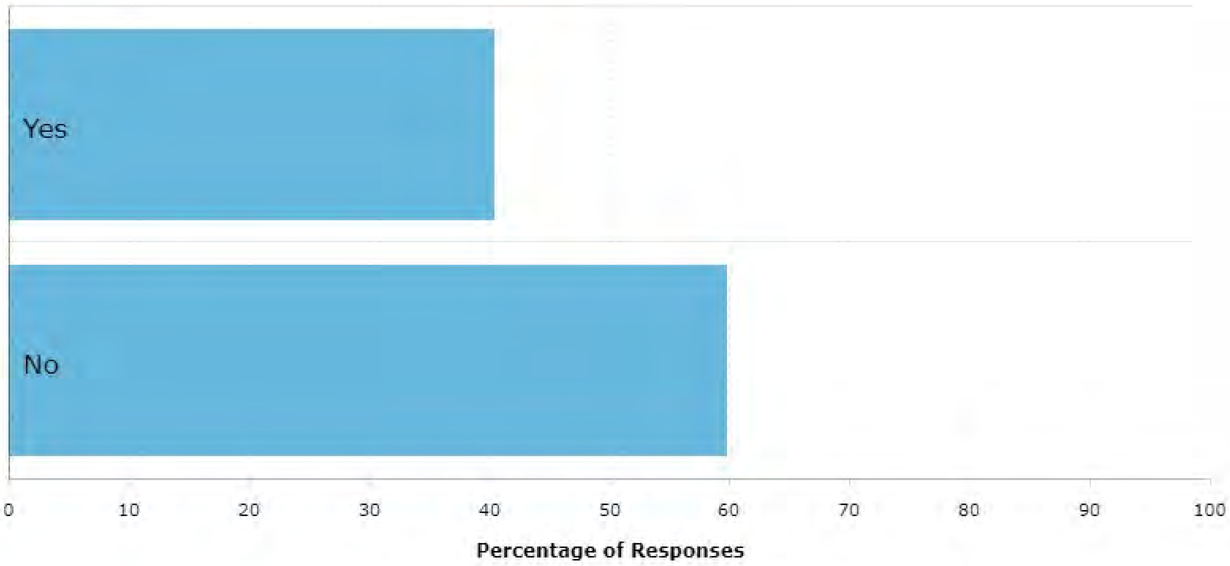


Respond to Polls when they appear

Poll: If you are an AAA member who somehow has become aware of the facts of this case, *SHOULD* you report Mike Spencer to the ABCD?



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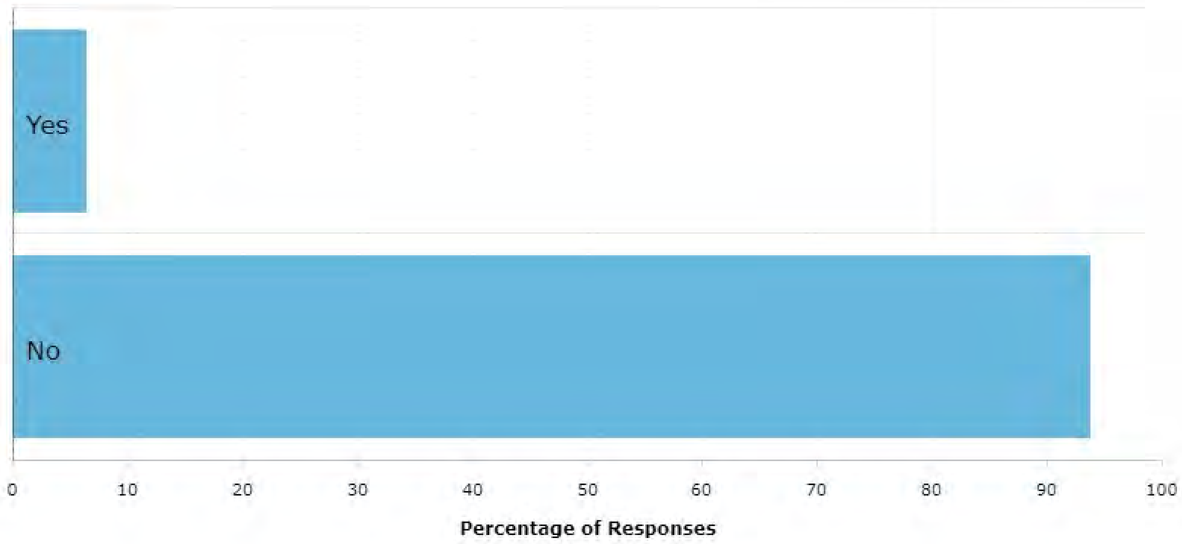

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