The first edition of Understanding Actuarial Management was published in 2003. It took a fresh approach to explaining the work of actuaries, using the Actuarial Control Cycle to draw out the principles common to all areas of actuarial practice and illustrating them with a wealth of examples drawn from around the globe. Since then, the book has been widely adopted in the academic and commercial world and has also been translated into Chinese.

The Actuarial Control Cycle is a framework that actuaries use to assess, evaluate and manage risk, where there is uncertainty of future events.

In a world where increasing complexity and global interconnections add to the difficulty and importance of sound risk management, the fundamental principles of the Actuarial Control Cycle continue to provide a systematic approach to the application of actuarial theory to real world problems.

In this completely revised and updated second edition:

- every chapter has been updated or rewritten, aligning the content with the Actuarial Risk Management syllabuses of the International Actuarial Association, the Society of Actuaries (US), the Institute of Actuaries of Australia and the Institute and Faculty of Actuaries (UK);
- each chapter includes a summary of key learning points;
- a glossary and an index have been added; and
- there are many new and revised exercises, with solutions provided on the accompanying CD.

Once again, prominent actuaries from around the world have contributed to this book and CD.

Understanding Actuarial Management: the actuarial control cycle is essential reading for actuarial students and other professionals. It provides insights into how actuaries manage financial risk within dynamic economic and social systems.
Foreword

*Understanding Actuarial Management: the actuarial control cycle* was first published in 2003 by the Institute of Actuaries of Australia, in response to demands from Australian universities for a resource to support Part II of its education syllabus. Since that time, the Actuarial Control Cycle concept has been adopted as part of the education syllabus of many actuarial associations around the world, including the Society of Actuaries.

In planning this second edition, the Institute of Actuaries of Australia and the Society of Actuaries have partnered to produce a completely revised text, ensuring that the requirements of both professional bodies and those of the International Actuarial Association and the UK Actuarial Profession have been met. This collaboration has resulted in what we believe to be a global textbook, for a global profession.

The teams of editors, authors and reviewers who participated in this project were sourced from around the world, reinforcing the project’s aims of global application. In particular, the commitment and dedication of the three editors of this edition, Clare Bellis, Richard Lyon and Stuart Klugman, have produced an extremely valuable resource for actuarial students in Australia, the US, Canada and around the world.

On behalf of the Institute of Actuaries of Australia, the Society of Actuaries and the rest of the profession, we offer our congratulations and sincere gratitude to the editors and authors of this second edition of *Understanding Actuarial Management: the actuarial control cycle*, for the exceptional contribution they have made to our future.

Bozenna Hinton S. Michael McLaughlin
President President
Institute of Actuaries of Australia Society of Actuaries

March 2010
Contents

Foreword vii
Preface xxv

Chapter 1: Introduction 1
by the Editors

1.1 What this book is about 1
1.2 What is an actuary? 1
1.3 The control cycle framework 3
1.4 The structure of the book 4
1.5 An illustration of the Actuarial Control Cycle 5
1.6 Fred’s coffee shop 6
1.7 Applying the control cycle framework 6
1.8 Communicating the results of actuarial work 6
1.9 Conclusion 7

CD Items 7
References (other than CD Items) 7

Fred’s Coffee Shop – Risk Management Frameworks 9

Chapter 2: Risk Management Frameworks 11
by Ian Laughlin

2.1 Introduction 11
2.2 Risk management framework (RMF) 11
2.3 Large financial services providers 12
2.4 What is risk? 14
2.4.1 Systemic and diversifiable risks 14
2.4.2 Risk and reward 15
2.5 Types of risk 15
2.5.1 Financial risks 16
2.5.2 Non-financial risks 17
2.5.3 Hazard risks and underwriting risks 17
2.5.4 Formal definitions of risk types 18
2.6 What is risk management? 18
2.7 What is ERM? 18
2.7.1 Defining ERM 19
2.7.2 Forces supporting ERM 20
2.7.3 Integration of ERM into planning 21
2.8 Risk management process 21
2.8.1 Establish the context 22
2.8.2 Identify risks 24
2.8.3 Analyze risks 25
2.8.4 Evaluate risks 29
2.8.5 Treat risks 29
2.8.6 Monitor and review 32
2.9 Communicate and consult
2.9.1 Documentation and reporting
2.9.2 Risk management policy and/or strategy

2.10 Execution

2.11 Risk management interests, responsibilities and governance
2.11.1 Shareholders
2.11.2 Board of directors
2.11.3 Board risk management committee and audit committee
2.11.4 Senior management
2.11.5 Chief Actuary
2.11.6 Middle management and staff
2.11.7 Customers (policyholders, bank depositors and borrowers, pension fund members etc)
2.11.8 Regulators
2.11.9 Service providers and intermediaries
2.11.10 Employers as pension/superannuation fund sponsors

2.12 Capital and risk management

2.13 Critical success factors and causes of ERM failure

2.14 Measurement of success

2.15 Practical implications for actuaries

2.16 Key learning points

CD Items

References (other than CD Items)

Recommended further reading

Fred’s Coffee Shop – Being Professional

Chapter 3: Being Professional

by Clare Bellis

3.1 Introduction

3.2 What is a profession?
3.2.1 The characteristics of a profession
3.2.2 The theory about why professions exist
3.2.3 How the concept of a profession is changing over time
3.2.4 How the concept of a profession varies from country to country

3.3 The role of the professional body
3.3.1 General comments
3.3.2 The actuarial profession: the international level
3.3.3 The national level
3.3.4 Professional guidance
3.3.5 Monitoring standards within the actuarial profession
3.3.6 How do the codes apply to you?

3.4 The regulatory role of the actuary
3.4.1 General comments
3.4.2 Prudential supervision
3.4.3 Other customer protection
3.4.4 Disclosure to third parties
3.4.5 Examples of legislated roles for actuaries
3.5 Professional issues to consider while you work on any task
  3.5.1 Ethical behavior
  3.5.2 Conflicts of interest
  3.5.3 Consideration of other stakeholders
  3.5.4 Materiality
  3.5.5 Reliance on other experts
3.6 How to do a professional job
  3.6.1 Before you start
  3.6.2 Define the task
  3.6.3 Collect the information you need
  3.6.4 Check for reasonableness
  3.6.5 Communicating the results
3.7 Practical implications for actuaries
3.8 Key learning points
CD Items
References (other than CD Items)

Fred’s Coffee Shop – The Need for Financial Products
Chapter 4: The Need for Financial Products
by Anthony Asher
4.1 Meeting needs
4.2 The financial life cycle
  4.2.1 Introduction to the financial life cycle
  4.2.2 Income
  4.2.3 Expenses
  4.2.4 Savings
  4.2.5 Different socio-economic classes
4.3 Risks and volatility in the life cycle
  4.3.1 Studies of household income, expenses and savings
  4.3.2 Income risks
  4.3.3 Expense risks
  4.3.4 Risks in savings
4.4 Business needs
  4.4.1 Equity or capital
  4.4.2 Managing risks
  4.4.3 Tax and regulatory arbitrage
4.5 Products designed to meet financial needs
  4.5.1 Monetary products
  4.5.2 Insurance
  4.5.3 Long-term savings products
  4.5.4 Retirement income products
4.6 Other sources of financial security
  4.6.1 Families
  4.6.2 Governments
  4.6.3 Employers
4.7 Practical implications for actuaries
4.8 Key learning points
CD Items
References (other than CD Items)
Chapter 5: The Context of Actuarial Work
by John Shepherd

5.1 Why consider the context?
  5.1.1 Introduction
  5.1.2 Context: external forces
  5.1.3 Context is not static

5.2 Components of the context

5.3 Two special components

5.4 Government and judicial context
  5.4.1 Government
  5.4.2 Taxation
  5.4.3 Social assistance and social insurance
  5.4.4 Judicial decisions

5.5 Physical environment
  5.5.1 Climate and natural perils
  5.5.2 Pandemics
  5.5.3 Man-made disasters
  5.5.4 Technological developments

5.6 Economic and social environment
  5.6.1 Economic conditions and trends
  5.6.2 Demographic structure and trends
  5.6.3 Work and employment patterns
  5.6.4 Social factors and trends
  5.6.5 Industrial issues

5.7 Industry and business environment
  5.7.1 Range of products and services offered
  5.7.2 Convergence of financial institutions
  5.7.3 Product distribution and intermediaries
  5.7.4 Accounting standards and practices
  5.7.5 Competition
  5.7.6 Industry associations
  5.7.7 Stakeholders
  5.7.8 Corporate culture
  5.7.9 Globalization

5.8 Practical implications for actuaries

5.9 Key learning points

CD Items
References (other than CD Items)
6.3 Risk assessment 152
6.3.1 Quantitative versus qualitative assessment 153
6.3.2 Experience data 153
6.4 Risk treatment 157
6.4.1 Avoid 159
6.4.2 Retain 160
6.4.3 Reduce 162
6.4.4 Transfer 162
6.4.5 Exploit 165
6.4.6 Reinsurance 165
6.5 Recent lessons learned 167
6.5.1 Systemic connections more extensive than expected 168
6.5.2 Misaligned incentives worsened the turmoil 168
6.5.3 Insufficient consideration of extreme events 169
6.5.4 Insufficient investor due diligence 169
6.6 Practical implications for actuaries 170
6.6.1 Risk management is more than just risk models 171
6.6.2 Each period of turmoil is different 172
6.7 Key learning points 172
CD Items 173
References (other than CD Items) 173

Fred’s Coffee Shop – Regulation 175
Chapter 7: Regulation 177
by Craig Thorburn
7.1 Introduction 177
7.1.1 The sources of law 177
7.1.2 Levels of regulation 178
7.1.3 Types of law 179
7.2 The scope of laws that influence the financial sector and the work of actuaries 180
7.3 Types of regulation and the objectives of governments 181
7.3.1 Taxation legislation 181
7.3.2 The regulation of markets and companies 181
7.3.3 Other objectives for regulation 184
7.3.4 The regulation of specific types of business 185
7.3.5 Prudential regulation 186
7.3.6 Arguments for keeping regulation to a minimum 188
7.3.7 Arguments in favor of regulation 189
7.4 International organizations that influence regulation 190
7.4.1 International regulatory standards 190
7.5 Summary of core principles 192
7.6 Official roles for actuaries 192
7.7 The structure of regulation and supervisory institutions 193
7.8 Practical implications for actuaries 194
7.9 Key learning points 194
CD Items 196
References (other than CD Items) 196
Fred’s Coffee Shop – Product Design 197
Chapter 8: Product Design 199
by Jeffrey Beckley

8.1 Introduction 199
8.2 Stage 1 of the product design control cycle 199
8.2.1 Identify the need for a new product 199
8.2.2 Develop a product strategy 202
8.3 Stage 2 of the product design control cycle 207
8.3.1 Project management 207
8.3.2 Design features to control risks 209
8.3.3 Competition, the marketplace, and the pricing process 210
8.3.4 Stakeholder expectations 212
8.3.5 Deciding whether to launch the product 214
8.4 Stage 3 of the product design control cycle 214
8.4.1 Distributing the product to our clients 215
8.4.2 Risk selection 218
8.4.3 Administration of the product 220
8.4.4 Asset-liability management 221
8.5 Stage 4 of the product design control cycle 221
8.6 Practical implications for actuaries 221
8.7 Key learning points 222
CD Items 223
References (other than CD Items) 223

Fred’s Coffee Shop – Modeling 225
Chapter 9: Modeling 227
by Andrew D. Smith

9.1 Introduction 227
9.2 Examples of models 227
9.2.1 Automobile insurance 227
9.2.2 Savings product with an investment guarantee 227
9.2.3 Fairness of insurance prices 227
9.2.4 Valuing pension benefits 228
9.2.5 Investment risks and returns 228
9.2.6 Setting dividend policy 228
9.2.7 Mortality improvement 228
9.2.8 Social behavior 229
9.3 What is a model? 229
9.3.1 Case study – building a model of inflation and interest rates 229
9.3.2 Using a fitted model 236
9.3.3 Challenging a fitted model 237
9.4 Normative approaches to modeling 238
9.4.1 Modeling in the physical and social sciences 238
9.4.2 Exploratory data analysis 239
9.4.3 Model calibration 240
9.4.4 Fit to evidence 241
9.4.5 Hypothesis testing 242
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.4.6</td>
<td>Parsimony</td>
<td>244</td>
</tr>
<tr>
<td>9.4.7</td>
<td>Fit to theory</td>
<td>245</td>
</tr>
<tr>
<td>9.4.8</td>
<td>Computer technology development</td>
<td>247</td>
</tr>
<tr>
<td>9.4.9</td>
<td>Using models for projection</td>
<td>248</td>
</tr>
<tr>
<td>9.4.10</td>
<td>Bootstrapping</td>
<td>250</td>
</tr>
<tr>
<td>9.4.11</td>
<td>Computational model classification</td>
<td>250</td>
</tr>
<tr>
<td>9.5</td>
<td>Limitations of the normative approach</td>
<td>253</td>
</tr>
<tr>
<td>9.5.1</td>
<td>Practical difficulties</td>
<td>253</td>
</tr>
<tr>
<td>9.5.2</td>
<td>Theoretical ambiguities</td>
<td>254</td>
</tr>
<tr>
<td>9.5.3</td>
<td>Expecting the unexpected</td>
<td>255</td>
</tr>
<tr>
<td>9.6</td>
<td>Commercial modeling</td>
<td>255</td>
</tr>
<tr>
<td>9.6.1</td>
<td>The role of modeling within the Actuarial Control</td>
<td>255</td>
</tr>
<tr>
<td></td>
<td>Cycle</td>
<td></td>
</tr>
<tr>
<td>9.6.2</td>
<td>Costs of models and data</td>
<td>256</td>
</tr>
<tr>
<td>9.6.3</td>
<td>Robustness</td>
<td>257</td>
</tr>
<tr>
<td>9.6.4</td>
<td>Governance and control</td>
<td>258</td>
</tr>
<tr>
<td>9.6.5</td>
<td>Models for advocacy</td>
<td>259</td>
</tr>
<tr>
<td>9.6.6</td>
<td>Models and markets</td>
<td>260</td>
</tr>
<tr>
<td>9.6.7</td>
<td>Disclosure</td>
<td>261</td>
</tr>
<tr>
<td>9.7</td>
<td>Practical implications for actuaries</td>
<td>263</td>
</tr>
<tr>
<td>9.8</td>
<td>Key learning points</td>
<td>263</td>
</tr>
<tr>
<td>CD Items</td>
<td></td>
<td>263</td>
</tr>
<tr>
<td>References (other than CD Items)</td>
<td>264</td>
<td></td>
</tr>
</tbody>
</table>

Fred’s Coffee Shop – Data and Assumptions 265
Chapter 10: Data and Assumptions 267
by Stuart Klugman

10.1 Introduction 267
10.2 Data
10.2.1 Why is data critical to actuarial practice? 268
10.2.2 Specifying data requirements 270
10.2.3 Sources of data 272
10.2.4 Obtaining high-quality data 273
10.2.5 Data checks 274
10.2.6 Data repair 277
10.2.7 Missing or inadequate data 277
10.2.8 Standards of practice and professional implications 277
10.2.9 Challenges presented by limited data 278

10.3 Assumptions
10.3.1 Why are assumptions critical to actuarial practice? 280
10.3.2 The assumption-setting control cycle 281
10.3.3 Identification of assumptions 281
10.3.4 Quantifying assumptions 282
10.3.5 Interdependency of assumptions 284

10.4 Practical implications for actuaries 284
10.5 Key learning points 285

CD Items 285

References (other than CD Items) 286
Fred’s Coffee Shop – The Need for Capital
Chapter 11: The Need for Capital
by David Knox

11.1 Introduction: what is capital?
11.1.1 Types of capital

11.2 The reasons for capital
11.2.1 Providing operational capital
11.2.2 Withstanding fluctuations within ongoing operations
11.2.3 Consumer confidence
11.2.4 Withstanding unexpected shocks
11.2.5 Ability to respond to future opportunities or capital needs
11.2.6 Credit rating
11.2.7 Stability and confidence in the financial system

11.3 The need for capital: perspectives of different stakeholders
11.3.1 Introduction
11.3.2 The shareholders (ie the investors)
11.3.3 The board and senior management
11.3.4 Regulators
11.3.5 Customers
11.3.6 Rating agencies and market expectations

11.4 Financial institutions without shareholders
11.4.1 Mutual organizations
11.4.2 Superannuation funds

11.5 Risks and capital needs in financial institutions
11.5.1 Asset risks
11.5.2 Liability risks
11.5.3 Asset/liability risks
11.5.4 Operational risk

11.6 An overall company perspective
11.6.1 Diversification benefits
11.6.2 Economic versus regulatory capital
11.6.3 Target surplus
11.6.4 Capital allocation

11.7 Practical implications for actuaries
11.8 Key learning points

CD Items
References (other than CD Items)

Fred’s Coffee Shop – Valuing Liabilities
Chapter 12: Valuing Liabilities
by Richard Lyon

12.1 Introduction
12.1.1 A brief history
12.1.2 What are liabilities?
12.1.3 Liabilities in the accounts
12.1.4 Measuring liabilities

12.2 The nature of liabilities
12.2.1 Short-term or long-term liabilities
12.2.2 Types of liability
12.3 Measuring liabilities 323
  12.3.1 Best estimate liabilities 323
  12.3.2 Liabilities with margins 324
  12.3.3 Profit margins 325
  12.3.4 Market value of liabilities 326
  12.3.5 Calculation methodology 327
  12.3.6 Valuing guarantees and options 329
  12.3.7 Allowing for risk 331
  12.3.8 Other considerations 332

12.4 Profit and the liability valuation 334
  12.4.1 The valuation objective 335
  12.4.2 Liability valuation basis and total profit 340
  12.4.3 The accuracy of the valuation 341
  12.4.4 Intrinsic capital funding 342
  12.4.5 Liabilities and pricing 343

12.5 Practical valuation issues 343
  12.5.1 Materiality 343
  12.5.2 Sensitivity 343
  12.5.3 Data 344
  12.5.4 Projection assumptions 345
  12.5.5 Discount rates 347

12.6 Financial economics and discount rates 350
  12.6.1 Arbitrage-free pricing and state price deflators 350
  12.6.2 The risk-return trade-off: CAPM 351
  12.6.3 Actuaries and financial economics 353

12.7 Practical implications for actuaries 354

12.8 Key learning points 355

CD Items 355

References (other than CD Items) 356

Fred’s Coffee Shop – Pricing 357

Chapter 13: Pricing 359

by Mark Rowley 359

13.1 Introduction 359
  13.1.1 What is pricing? 359
  13.1.2 Pricing process: application of the Actuarial Control Cycle 359
  13.1.3 What is covered in this chapter? 360

13.2 The environment in which actuaries operate 360
  13.2.1 Pricing objectives – competitiveness and profitability 360
  13.2.2 Stakeholders 361

13.3 Product design 361
  13.3.1 What is product design? 361
  13.3.2 Interaction of product design and pricing: an iterative process 361

13.4 Prices postulated 362
  13.4.1 Setting and testing prices 362
  13.4.2 Impact of prices and commission on sales 363

13.5 Modeling 363
  13.5.1 What is modeling? 364
  13.5.2 One pricing model 364
13.6 Assumptions 365
13.6.1 What are assumptions? 365
13.6.2 What process is used to set assumptions? 365
13.6.3 What is a margin? 366
13.7 Expenses 369
13.7.1 Analyzing expenses 369
13.7.2 Pricing for expenses 370
13.8 Profit objectives 372
13.8.1 What are profit objectives? 372
13.8.2 New business strain 372
13.8.3 Alternative profit measures 373
13.9 Profit testing 374
13.9.1 What is profit testing? 374
13.10 Sensitivity tests 379
13.10.1 What are sensitivity tests? 379
13.11 Pricing report 381
13.12 Product monitoring 382
13.13 Pricing for long-term commitments 383
13.13.1 What does it mean to price for long-term commitments? 383
13.13.2 Applying the Actuarial Control Cycle 383
13.13.3 Funding methods in general 384
13.13.4 Funding methods – accrued benefits 384
13.13.5 Funding methods – projected benefits 385
13.13.6 Funding methods – projected unit credit versus aggregate 385
13.13.7 Responsibility and authority for making choices 385
13.13.8 Wider applications 386
13.14 Practical implications for actuaries 386
13.14.1 What professional implications are most common in pricing? 386
13.14.2 Consideration of overheads in pricing 386
13.14.3 Actuarial assumptions and the future 387
13.15 Key learning points 388
CD Items 389
References (other than CD Items) 389

Fred’s Coffee Shop – Assets 391
Chapter 14: Assets 393

by Richard Lyon 393

14.1 Introduction 393
14.1.1 What are assets? 393
14.1.2 Assets in the accounts 393
14.1.3 Asset valuation terms 394
14.2 Types of asset 396
14.2.1 Short-term or long-term assets 396
14.2.2 Non-investment assets 396
14.2.3 Investment assets 398
14.3 Valuing assets 402
14.4 Asset risks 405
<table>
<thead>
<tr>
<th>14.5</th>
<th>Asset-liability management</th>
<th>409</th>
</tr>
</thead>
<tbody>
<tr>
<td>14.5.1</td>
<td>How assets relate to liabilities</td>
<td>409</td>
</tr>
<tr>
<td>14.5.2</td>
<td>Basic asset-liability risks</td>
<td>410</td>
</tr>
<tr>
<td>14.5.3</td>
<td>Cash flow matching</td>
<td>413</td>
</tr>
<tr>
<td>14.5.4</td>
<td>Immunization</td>
<td>414</td>
</tr>
<tr>
<td>14.5.5</td>
<td>“Appropriate” investment strategies</td>
<td>414</td>
</tr>
<tr>
<td>14.5.6</td>
<td>Liability-driven investment</td>
<td>416</td>
</tr>
<tr>
<td>14.5.7</td>
<td>Asset/liability modeling</td>
<td>417</td>
</tr>
<tr>
<td>14.6</td>
<td>Asset-liability management constraints</td>
<td>418</td>
</tr>
<tr>
<td>14.6.1</td>
<td>Investment mandates</td>
<td>418</td>
</tr>
<tr>
<td>14.6.2</td>
<td>Investment product offerings</td>
<td>418</td>
</tr>
<tr>
<td>14.6.3</td>
<td>Legislative constraints</td>
<td>418</td>
</tr>
<tr>
<td>14.6.4</td>
<td>Capital requirements</td>
<td>419</td>
</tr>
<tr>
<td>14.6.5</td>
<td>Access to capital</td>
<td>419</td>
</tr>
<tr>
<td>14.6.6</td>
<td>The impact of tax and fees</td>
<td>419</td>
</tr>
<tr>
<td>14.6.7</td>
<td>The impact of negative returns</td>
<td>420</td>
</tr>
<tr>
<td>14.7</td>
<td>Practical implications for actuaries</td>
<td>420</td>
</tr>
<tr>
<td>14.8</td>
<td>Key learning points</td>
<td>420</td>
</tr>
<tr>
<td>CD Items</td>
<td></td>
<td>421</td>
</tr>
<tr>
<td>References (other than CD Items)</td>
<td></td>
<td>421</td>
</tr>
</tbody>
</table>

Fred’s Coffee Shop – Solvency 423
Chapter 15: Solvency 425
by Shauna Ferris 425

<table>
<thead>
<tr>
<th>15.1</th>
<th>Introduction</th>
<th>425</th>
</tr>
</thead>
<tbody>
<tr>
<td>15.1.1</td>
<td>Deciding on the acceptable level of solvency</td>
<td>425</td>
</tr>
<tr>
<td>15.1.2</td>
<td>Solvency management and capital</td>
<td>426</td>
</tr>
<tr>
<td>15.1.3</td>
<td>Three views of solvency</td>
<td>427</td>
</tr>
<tr>
<td>15.2</td>
<td>Cash flow solvency (or liquidity)</td>
<td>427</td>
</tr>
<tr>
<td>15.2.1</td>
<td>Liquidity risk in normal conditions</td>
<td>427</td>
</tr>
<tr>
<td>15.2.2</td>
<td>Liquidity risk in a crisis</td>
<td>428</td>
</tr>
<tr>
<td>15.2.3</td>
<td>Managing liquidity risks</td>
<td>429</td>
</tr>
<tr>
<td>15.3</td>
<td>Discontinuance solvency and going-concern solvency: general approach</td>
<td>431</td>
</tr>
<tr>
<td>15.3.1</td>
<td>Introduction</td>
<td>431</td>
</tr>
<tr>
<td>15.3.2</td>
<td>Alternative forms of discontinuance</td>
<td>432</td>
</tr>
<tr>
<td>15.3.3</td>
<td>Measuring discontinuance solvency</td>
<td>432</td>
</tr>
<tr>
<td>15.3.4</td>
<td>Measuring going-concern solvency</td>
<td>433</td>
</tr>
<tr>
<td>15.4</td>
<td>Valuation of assets for solvency purposes</td>
<td>434</td>
</tr>
<tr>
<td>15.5</td>
<td>Valuation of liabilities for solvency purposes</td>
<td>435</td>
</tr>
<tr>
<td>15.5.1</td>
<td>Methods for the valuation of liabilities</td>
<td>435</td>
</tr>
<tr>
<td>15.5.2</td>
<td>Adjustments to reflect the impact of discontinuance on the liabilities</td>
<td>439</td>
</tr>
<tr>
<td>15.5.3</td>
<td>Dealing with discretionary benefits</td>
<td>439</td>
</tr>
<tr>
<td>15.5.4</td>
<td>How can we be sure that the value of liabilities is correct?</td>
<td>440</td>
</tr>
<tr>
<td>15.6</td>
<td>Capital requirements: the risk-based capital approach</td>
<td>440</td>
</tr>
<tr>
<td>15.6.1</td>
<td>Introduction to risk-based capital</td>
<td>440</td>
</tr>
<tr>
<td>15.6.2</td>
<td>Creating a risk-based capital standard</td>
<td>441</td>
</tr>
<tr>
<td>15.7</td>
<td>Risk-based capital: internal models</td>
<td>445</td>
</tr>
</tbody>
</table>
15.8 Integrating the capital management model into the control cycle 445
15.9 Assess the amount and quality of the capital 446
15.10 The role of risk management and market discipline in solvency regulation 449
15.10.1 Introduction 449
15.10.2 Internal risk management 450
15.10.3 Reporting requirements and early warning systems 450
15.10.4 Disclosure and ratings 451
15.10.5 The role of the professional 452
15.10.6 Financial condition reports 453
15.10.7 Dynamic Solvency Testing 454
15.11 Responding to solvency problems 455
15.11.1 Deciding when to intervene 456
15.11.2 Deciding how to intervene 457
15.12 Guarantee funds 458
15.12.1 Arguments for and against guarantee funds 458
15.12.2 Design of guarantee funds 460
15.13 Practical implications for actuaries 462
15.14 Key learning points 462
Answers to questions in Example 15.1 463
CD Items 464
References (other than CD Items) 465

Fred’s Coffee Shop – Profit 469
Chapter 16: Profit 471
by David Service and Richard Lyon
16.1 Overview of profit 471
16.2 Profit measurement 472
16.2.1 The traditional view of profit 473
16.2.2 The modern view of profit 473
16.2.3 Profit measurement versus solvency 474
16.3 The emergence of profit 474
16.3.1 Sources of profit 474
16.3.2 Timing of profit recognition 475
16.3.3 Measurement issues 483
16.4 Profit versus value 484
16.5 Appraisal values 485
16.5.1 Overview of appraisal values 485
16.5.2 Components of an appraisal value 486
16.5.3 Appraisal value as a profit measure 489
16.6 Practical implications for actuaries 489
16.7 Key learning points 490
CD Items 490
References (other than CD Items) 490
Fred’s Coffee Shop – Monitoring Experience
Chapter 17: Monitoring Experience
by David Service

17.1 Introduction

17.2 Why do we analyze experience?
17.2.1 Introduction
17.2.2 Reviewing assumptions
17.2.3 Providing understanding of the drivers of the emerging experience
17.2.4 Developing a history of experience over time
17.2.5 Aiding in an analysis of profit and its sources
17.2.6 Providing information to management
17.2.7 Providing information to shareholders and third parties
17.2.8 Satisfying regulatory requirements
17.2.9 Aiding public relations purposes
17.2.10 Satisfying disclosure requirements in a listing or acquisition

17.3 What do we analyze?
17.3.1 Introduction
17.3.2 General insurance
17.3.3 Life insurance
17.3.4 Funds management
17.3.5 Superannuation
17.3.6 Banking
17.3.7 Health insurance

17.4 How do we analyze experience?
17.4.1 Introduction
17.4.2 Product-specific
17.4.3 Economic
17.4.4 Investment performance
17.4.5 Expenses
17.4.6 Business volumes and business mix
17.4.7 Profit and return on capital

17.5 Data issues

17.6 Practical implications for actuaries

17.7 Key learning points

CD Items
References (other than CD Items)

Fred’s Coffee Shop – Responding to Experience
Chapter 18: Responding to Experience
by Bruce Edwards

18.1 Introduction

18.2 Role of the actuary

18.3 General considerations

18.4 Managing the business
18.4.1 Business plans
| 18.4.2 | Financial control systems | 531 |
| 18.4.3 | Audit controls | 532 |
| 18.4.4 | Expense controls | 533 |
| 18.4.5 | Claims controls | 536 |
| 18.4.6 | New business and termination controls | 537 |
| 18.4.7 | Capital management | 538 |

18.5 Allocating interest to accounts 539
18.6 Unit pricing 542
18.7 Review of insurance pricing 544
  18.7.1 Pricing review cycle 544
  18.7.2 Pricing changes 544
  18.7.3 Pricing response 544
  18.7.4 Experience refunds 546

18.8 Defined benefit superannuation 546
  18.8.1 The actuarial review 546
  18.8.2 The pace of funding 547
  18.8.3 Responses to the actuarial review 547
  18.8.4 Returning excess funds to the employer 548

18.9 Participating life insurance 549
  18.9.1 The origins of the actuarial profession 549
  18.9.2 Participating policies 549
  18.9.3 Allocation and distribution of profit 550
  18.9.4 Allocation of profit 550
  18.9.5 Fair and equitable 550
  18.9.6 Distribution of profits 552
  18.9.7 Methods of distribution 553
  18.9.8 Asset share methods 554

18.10 Practical implications for actuaries 554
18.11 Key learning points 555
CD Items 555

Fred’s Coffee Shop – Applying the Actuarial Control Cycle 557
Chapter 19: Applying the Actuarial Control Cycle 559

by the Editors

19.1 Introduction 559

19.2 Advising on the viability and financing of a fiber optic cable project 559
  19.2.1 Background 559
  19.2.2 Developing a solution 560
  19.2.3 Comments on the fiber optic project 561

19.3 An application of the Actuarial Control Cycle to marketing problems 562
  19.3.1 Interview 563
  19.3.2 Comments on the marketing application 563

19.4 Risk management consulting 564
  19.4.1 Background 564
  19.4.2 Interview 564
  19.4.3 Comments on the risk management interview 566
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>19.5 A football tipping model</td>
<td>567</td>
</tr>
<tr>
<td>19.5.1 Background</td>
<td>567</td>
</tr>
<tr>
<td>19.5.2 Discussion</td>
<td>567</td>
</tr>
<tr>
<td>19.5.3 Comments on the tipping example</td>
<td>570</td>
</tr>
<tr>
<td>19.6 Conclusion</td>
<td>570</td>
</tr>
<tr>
<td>CD Items</td>
<td>571</td>
</tr>
</tbody>
</table>

Notes on Editors and Contributors  573

Glossary  581

Index  603
Preface to the Second Edition

The first edition of this book was published by the Institute of Actuaries of Australia (Institute) in 2003. It was written as a textbook for Part II of the Institute’s education program but it has since been used around the world – especially by the Society of Actuaries (SOA), as a textbook for its Fundamentals of Actuarial Practice e-learning course.

A lot has happened since 2003 and it is now time for a new edition. This edition sees the following changes to the editorial team:

- Clare Bellis has moved from Australia to the UK;
- Australia-based Richard Lyon, who was a late addition to the editorial team for the first edition, has been involved in the second edition from the outset;
- US-based Stuart Klugman has joined the team for the second edition; and
- John Shepherd has retired and, apart from revising Chapter 5 as author, has not been involved in editing this edition.

The three editors for this edition therefore span the globe; regular editorial telephone calls took place in the afternoon (US Central Time), late evening (UK) and early morning (Australia).

We have taken the opportunity to revise the topics covered in the book. The number of chapters hasn’t changed but we have added a chapter about Risk Management Frameworks (Chapter 2) and separated Data and Assumptions (Chapter 10) from Modeling (Chapter 9). At the same time, a single Assets chapter (14) replaces three investment chapters. One of the original investment chapters has been updated and is included as a supporting paper on the CD. In producing this new edition, we continued to take note of the IAAust’s Part II (Actuarial Control Cycle) syllabus; and we also covered the equivalents in the International Actuarial Association (IAA), the Institute & Faculty of Actuaries and the SOA.

We have also added an index and a glossary.

Many of our original authors have returned to update their chapters but the addition of several new authors has allowed us to make the panel truly international. This, together with a range of backgrounds, means a diverse selection of examples.

As the chapters were written, they were extensively reviewed by experts around the world, as well as by current and recent students. We gratefully acknowledge the assistance of these reviewers, whose names are listed at the end of the book, and also the guidance provided by the members of the editorial steering committee. Any errors or omissions remain, of course, the responsibility of the editors and the authors of the individual chapters.

Finally, our thanks go to Carol Dolan, Actuarial Education Consultant at the Institute of Actuaries of Australia. Carol has overseen the project from start to finish and her patience, efficiency, creative suggestions and meticulous attention to detail have greatly lightened our load.

Clare Bellis, Richard Lyon and Stuart Klugman

March 2010
Chapter 1: Introduction

by the Editors

1.1 What this book is about

In this book we explain the work of actuaries. We show how actuaries contribute to the design, construction and ongoing management of systems that provide a wide range of financial services. The typical reader of this book will be a student or actuarial trainee who has mastered the economic, financial, mathematical and statistical techniques of actuarial work. For these readers, we explain how actuaries use these techniques to provide advice to enterprises of many types, particularly in financial services. Readers from other backgrounds will also find the book useful for appreciating the work that actuaries perform.

Our emphasis is on the big picture of actuarial work, concentrating on the fundamental concepts that underpin actuarial work across both practice areas and countries. We do not cover the detail of laws, regulations, taxation rules, accounting standards and technical issues. Such detail is important for actuarial practice but not for our current purposes. You will build up your knowledge and understanding of the detail when you start to specialize in a particular practice area, either later in your studies or early in your working career.

Our overview of actuarial work will be structured around a framework called the Actuarial Control Cycle. The Actuarial Control Cycle represents the processes typically required in the ongoing management of a financial enterprise, product or scheme, and the relationships between those processes.

1.2 What is an actuary?

Chances are that you already have your own answer to this question. However, as it provides the foundation for this book, here is what three actuarial society websites say.

The Society of Actuaries (SOA, 2010) says:

An actuary is a business professional who analyzes the financial consequences of risk. Actuaries use mathematics, statistics and financial theory to study uncertain future events, especially those of concern to insurance and pension programs. They evaluate the likelihood of those events and design creative ways to reduce the likelihood and decrease the impact of adverse events that actually do occur.

Actuaries are an important part of the management team of the companies that employ them. Their work requires a combination of strong analytical skills, business knowledge and understanding of human behavior to design and manage programs that control risk.

The Actuarial Profession in the UK (AP, 2010) says:

Most people will know something about the professions of accountants, doctors and lawyers. But tell someone you’re an actuary and more than likely they will look at you blankly – never having heard of an actuary.

If, however, they are aware of the work that actuaries do, they are likely to be impressed; being an actuary carries quite a reputation. This is partly due to the
difficult exams, but mostly due to the fact that actuaries are experts in a field that is renowned for its complexity and mathematical prowess.

Actuaries apply financial and statistical theories to solve real business problems. These business problems typically involve analysing future financial events, especially when the amount of a future payment, or the timing of when it is paid, is uncertain. A lot of actuaries’ work might be thought of as ‘risk management’, assessing how likely an event may be and the costs associated with it.

Understanding how businesses operate, how legislation may impact and how financial economics can affect values are all vital skills for an actuary. But what differentiates actuaries is their core mathematical, economic and statistical understanding and their ability to apply this to real financial problems.

The Institute of Actuaries of Australia (IAAust, 2010) says:

Actuaries are among the brightest people in the business world. Actuaries apply their mathematical expertise, statistical knowledge, economic and financial analyses and problem solving skills to a wide range of practical business problems. Actuaries help organisations to understand the long-term financial implications of their decisions, many of which can affect individuals as well as the wider community.

Actuaries apply their skills in a variety of areas including:

- Measuring and managing risk and uncertainty
- Designing financial contracts
- Advising on investments
- Measuring demographic influences on financial arrangements
- Advising on a wide range of financial and statistical problems.

Leaving aside the sales pitch, it is clear that these three professional bodies all agree that actuaries solve business problems involving risk, particularly in a financial context.

Problem solving requires both a good understanding of the problem (and its context) and the tools to get the job done. Most readers of this book will already have the basic actuarial toolkit and will add to this toolkit throughout their actuarial education and beyond.

The actuarial profession has existed for over two centuries and originally concentrated on problems in long-term insurance and pensions (superannuation). For readers with an interest in the historical background, we have included on the CD some articles describing the development of actuarial science. Actuarial skills are, however, more widely applicable than just in the original areas of specialized practice. For example, solving problems involving the economics of distribution channels for any product is not really any different from solving problems connected with the economics of insurance sales.

Actuaries are also creative problem solvers. As the environment changes and new products are needed, actuaries are well-situated to adapt. The book includes examples of applications from a variety of practice areas and we encourage you to think, as you study each chapter, where else could these tools be applied? In the concluding chapter, we describe some applications from areas where actuarial skills would not have been applied even a few decades ago.
1.3 The control cycle framework

The Actuarial Control Cycle is a conceptual framework that is useful in describing the processes needed for the development and ongoing management of a financial enterprise, product or scheme. It is based on a simple problem-solving algorithm:

- define the problem;
- design the solution; and
- monitor the results.

The whole process, or control cycle, is conducted within an environment or context that shapes the decisions taken. The cycle is iterative: the three steps may be repeated or at any stage we may return to an earlier step.

This problem-solving process is universal. It applies to any field of activity. For example, a doctor will diagnose a patient’s condition and recommend treatment. If the condition does not improve, the doctor will reassess the diagnosis and the treatment. The doctor’s decisions will be shaped by the environment: the state of medical science, the availability of tests, drugs and procedures, the circumstances of the patient and so on. At each consultation, the doctor will make judgments about ongoing treatment, weighing up all the available evidence, including test results and the patient’s progress since the last visit.

What makes the Actuarial Control Cycle distinctly actuarial is the nature of the work carried out at each stage of the cycle. The problem will usually (though not always) involve uncertain future cash flows. The process of defining the problem includes understanding the background, fully identifying all the issues and specifying them clearly to ensure that the client and the actuary agree on the work to be done. The design of a solution will almost always involve modeling. The actuary may have ongoing responsibility for monitoring the experience as it develops and advising on the response, or may seek to build flexibility into the solution.

Figure 1.1 The Actuarial Control Cycle

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Figure 1.1 is a diagram of the Actuarial Control Cycle. In this diagram, we include the two components of the environment in which actuarial work is carried out. The actuary has to take account of external forces, such as economic conditions and the commercial setting. Then the whole process operates within the context of Professionalism, which is an inner guide to attitude and practice that governs the actuary in carrying out the work.

1.4 The structure of the book

The book contains seventeen chapters, each focusing on an aspect of the Actuarial Control Cycle, plus this Introduction and a final chapter on Applying the Actuarial Control Cycle. The order of the chapters roughly takes us round the cycle shown in Figure 1.1. However, the iterative nature of the cycle means that the topics are inter-related and we could easily have covered them in quite a different order. No topic can really be considered in isolation, so each author draws on concepts elsewhere in the book, both earlier and later. Generally, you should be able to understand each author’s message without referring to the other chapters but the messages are likely to be clearer on your second reading of the book.

 Chapters 2 to 7 cover the process of identifying and specifying the problem, including understanding the context. Our first topic, Risk Management Frameworks (Chapter 2), reflects the fact that actuarial problems typically deal with risk. A systematic framework helps us approach the problem, as well as helping the enterprises that actuaries advise to manage their risks. Next, Being Professional (Chapter 3) deals with the implications for an actuary of being a member of a profession. It is important that you understand these implications from the beginning, since they affect virtually everything an actuary does. The Need for Financial Products (Chapter 4) explains how products meet the needs of individuals and businesses. The Context of Actuarial Work (Chapter 5) describes how external forces must be allowed for by actuaries and the enterprises that they advise.

Next, we consider how businesses and regulators deal with risk. Applying Risk Management (Chapter 6) reviews how risk is managed in financial institutions, while Regulation (Chapter 7) discusses the impact of actions taken by governments, by courts and by other bodies that establish practices and accepted norms.

The next seven chapters cover the second stage: developing and implementing the solution. Product Design (Chapter 8) in some ways offers a solution: the development of a new product to meet some need. However, looked at from another perspective, the introduction of a new product is not an endpoint but the beginning of a whole new set of problems. How do we set a price for the product? How do we ensure that the product does not threaten the solvency of the provider? Modeling (Chapter 9), Data and Assumptions (Chapter 10), Valuing Liabilities (Chapter 12), Pricing (Chapter 13) and Assets (Chapter 14) provide the tools to help answer these questions. The Need for Capital (Chapter 11) comes in the middle of these chapters: you can think of this as representing the fact that capital is central to the Actuarial Control Cycle. Capital is needed to finance the cash outflows when expenses are incurred earlier than revenue is received and, most importantly for a financial institution, to absorb risks.

Four chapters cover the final stage of monitoring and responding to experience: Solvency (Chapter 15), Profit (Chapter 16), Monitoring Experience (Chapter 17) and Responding to Experience (Chapter 18). The Actuarial Control Cycle’s feedback mechanism is explained, whereby monitoring outcomes leads to better understanding of both the problem and the solution, so that the solution can be improved.
Finally, we examine a number of examples from various types of actuarial work in *Applying the Actuarial Control Cycle* (Chapter 19).

Each chapter, covering a single topic, is written by a different author. As far as possible, we have allowed the author to speak in his/her own voice and to address the topic from his/her own perspective. This means that the writing style varies quite significantly. This presents challenges for the reader but reflects the realities of actuarial practice, where information must be gleaned from a variety of sources.

Throughout the book there are exercises to reinforce the concepts being discussed. Outline solutions can be found on the accompanying CD. The CD also contains articles for further reading. At the end of each chapter there is a list of the relevant items on the CD.

### 1.5 An illustration of the Actuarial Control Cycle

Let’s review how the topics in this book fit together by considering a simple example. Suppose a life insurance company decides to sell lifetime annuities that increase in line with inflation. When the company sells an annuity, it immediately receives a large one-off payment (the single premium). Its commitment in return is to make regular, smaller, increasing payments for the lifetime of the customer. As this could be quite a long time, it is important that the company’s risks are properly managed (Chapter 2). In particular, the actuaries advising the company have professional responsibilities (Chapter 3), because people will be entrusting a large part of their retirement savings to the company in exchange for a lifetime income.

What needs will these annuities meet and why will people want to buy them (Chapter 4)? What is the environment in which the company will offer these products (Chapter 5)? How are they taxed? Are competing products available? What is the outlook for interest rates, inflation rates and mortality rates?

The company must understand the sources of risk for these products, such as volatile inflation and increasing longevity (Chapter 6). And the regulators (Chapter 7) will also be concerned about risk.

The product has to be clearly specified (Chapter 8). Decisions are needed on design issues, such as whether or not the annuity has a guaranteed minimum payment period, what that period is and how inflationary increases are to be defined.

Once the product is specified, an actuary can develop a model to forecast the likely future cash flows for the product (Chapter 9). The actuary must analyze available data, both to shape the model and to help in setting assumptions (Chapter 10).

The model will be useful in a number of ways. First, it will help to determine the extent of the risk the company will face. The company needs to know how much capital (Chapter 11) to hold for these annuities, in case inflation is higher, or lifetimes are longer, than anticipated. The company needs to know the value of the long-term liability it will be taking on (Chapter 12).

Secondly, the model, including allowances for liabilities and capital, will help the company decide what prices, or premiums, to charge (Chapter 13) for the product, allowing for the risks involved and the interests of all stakeholders.

After meeting initial expenses, the balance of the single premium is invested in assets (Chapter 14) to generate income from which to make the regular annuity payments. The
selection of assets must take into account the nature of the liabilities, so that the company meets its obligations and achieves its profit objectives without taking excessive risks.

At regular intervals, the company will compare its assets and liabilities to determine whether it has sufficient capital – in particular, whether it meets the capital requirements set by the regulators and is therefore solvent (Chapter 15).

Shareholders, and the taxation authority, will also be interested in how much profit (Chapter 16) is being earned from the lifetime annuities.

In designing, pricing and managing the product, the company will need assumptions about investment earnings, inflation rates, mortality rates and expenses in the future. Over time, the actual rates experienced will be compared with those assumed. Any differences must be analyzed and understood (Chapter 17). An actuary will advise the company how to respond in the light of trends and changes emerging from this monitoring of experience (Chapter 18).

In the control cycle framework, the feedback process closes the loop. In addition, at any point in the cycle, there can be a return to a previous step. For example, if the modeling process shows that the annuity product involves too much risk, the product design stage could be revisited, to seek an alternative product design that could meet the customers’ needs at less risk to the company.

1.6 Fred’s coffee shop

The example in Section 1.5 is a simplified description of a typical actuarial problem. To help guide you through this book, we have invented another, atypical, example: Fred’s coffee shop.

Fred is an actuary in a large financial institution. He enjoys his job but he also wants to try something new. He has recently decided to resign and set up a coffee shop.

We introduce each chapter with a discussion of how it relates to the coffee shop. We have chosen a coffee shop because the situation should be familiar to every reader – and, because it is not a financial services example, it should help you to appreciate how the Actuarial Control Cycle is applicable outside the financial services industry.

1.7 Applying the control cycle framework

The control cycle framework can be applied to the management of an entire financial institution. It can also be applied to subdivisions of the whole, such as subsidiary companies (eg a reinsurance subsidiary or an overseas company), business units (eg funds management), operational functions (eg claims handling), product groups (eg retail banking products) and, of course, individual products (eg disability income insurance). You will recognize cycles within cycles in many situations.

1.8 Communicating the results of actuarial work

It is not the role of this book to discuss the principles and practice of good communication. This does not mean, however, that they are not important for actuaries. An effective actuary needs more than just technical knowledge and skills and experience in applying them.
An actuary might produce technically superb models, projections, estimates and analyses, but whether or not they lead to good decisions, sound strategies, appropriate solutions and effective plans depends on two things. Did the actuary fully understand the client’s (or employer’s) real needs? Did the client fully understand the actuary’s advice? If both answers are “yes,” then sound technical work will make a difference.

Both good listening and strong oral and written communication skills are essential for an actuary. An actuary has to communicate effectively with clients and employers – and also with other professionals, such as accountants, lawyers, marketers and IT specialists. Many projects on which actuaries work generate questions that actuaries are not qualified to answer, so advice must be sought from someone who is qualified to give it.

1.9 Conclusion

The Actuarial Control Cycle is a useful framework but it should not be viewed as a template for every piece of work. Some roles that actuaries fulfill deal with only one stage of the cycle, or may not seem to have any direct connection with the cycle. Nonetheless, within this framework you will find principles that will be applicable to all actuarial work.

CD Items


References (other than CD Items)

