

Self-Regulation Requires Hard Choices

In the Eye of the Beholder,” Lauren Bloom and Michael Lamonica’s article in the March/April issue of *Contingencies*, defends the approach that the Actuarial Standards Board (ASB) has always used to develop Actuarial Standards of Practice (ASOPs). In December 2004, the ASB formalized this approach—which amounts to following the consensus of practitioners in the field—by adopting the *Introduction to the Standards of Practice* (the *Introduction*). Bloom and Lamonica accurately note that the ASB’s bottom-up approach to setting standards is controversial. The strong standards our profession needs today can’t be developed by mere consensus. Rather, they must be the result of informed judgment and forward-looking leadership.

We understand that most ASOPs are written to reflect generally accepted practice. But this approach, which amounts merely to cataloging existing practice, assumes that qualified actuaries will evolve the practice. How might such evolution occur? Do we wait for developments in actuarial science to inform the practitioners, who will then modify their practice accordingly?

This practice-filtering process won’t suffice. The rule-making ASB must connect directly with advances in actuarial science. We’re concerned that many such advances won’t even enter into the practice, because:

- Advances in actuarial science may be unattractive to those who consume our services. For example, better appreciation of underlying risks may require recognizing higher liability values. Under these circumstances, competition from less well informed or more permissive actuaries will prevent such recognition. This may be seen as a form of Gresham’s Law; inferior but popular practice may



bar better practice from entry into the marketplace.

- Advances in actuarial science may occasionally call for better practices that lie outside the range of today’s generally accepted practice. We recognize that the existing ASOPs incorporate a procedure for using and defending such an outlier. But when the outlier is more rigorous and less favorable to clients, it’s highly unlikely that practice will embrace the outlier without leadership from the ASB.

A broad review of the *Introduction* confirms its consistency with some of the finest actuarial traditions—individual

responsibility and judgment applied within a flexible environment. Unfortunately, recent difficulties experienced by actuaries and some sister professions suggest that even our most honored traditions may conflict with our role in the modern world.

As currently written, the *Introduction* rejects narrow prescriptions in favor of actuarial science informed by education, experience, and judgment. This misstates the choices the profession faces today. We operate in an intensely prescriptive environment. We, however, have not been doing the prescribing. Others have prescribed for us, filling public needs that our standards have not met. The ASB need not choose between principles of actuarial science and prescriptive rules. Rather, it must choose between traditional principles and new principles that challenge today’s practice.

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We created the ASB, in part, to make our self-regulation more credible. The public may question the profession's commitment to self-regulation if it perceives that the ASB is reluctant to grapple with modern challenges to historic principles. Although we value broad principles highly and find detailed rules (particularly those imposed on us by others) irksome, the profession's case for self-regulation will be enhanced by an ASB that makes judgments, sorting out good from bad actuarial principles regardless of popular practice.

Swords or Shields

Practicing actuaries who diligently follow the ASOPs may be shielded from increas-

ing malpractice exposure while those who are less diligent may meet the sword. Some suggest that stronger standards (which bolster our self-regulation case) might increase the practicing actuary's exposure to the ASOPs as swords. Others suggest that if the ASOPs get too far ahead of existing practice, many actuaries won't follow.

The second of these observations is answered by the first; fear of exposure means that actuaries will follow stronger ASOPs.

As the plaintiff's bar sharpens its swords, we need to strengthen our shields. Section 3.1.6 of the *Introduction* ("The ASOPs intentionally leave significant room for the actuary ...") may appear to

shield many actuaries in the short term—because it's loose enough to cover a wide range of practice—but it won't protect us against our collective failure to advance our science and our practice. We must choose between calling actuaries to stricter standards—a smaller but stronger shield for those who comply—and the danger of being discredited *en masse*, as suggested by the recent experience of actuaries in the United Kingdom.

Some are concerned that strengthened actuarial standards may be cited in litigation challenging earlier practice. Every profession faces this issue and must treat it with care. The ASB will want to emphasize that such changes reflect all actuarial

Three Illustrative ASOP Problems

ASSET VALUATION (PENSION)

The proposed ASOP dealing with the selection and use of asset valuation methods for pension valuations states no preference between market value and various techniques designed to smooth out market value. Plan sponsors prefer asset smoothing, which cushions the effect of changing market values on their cash flow and financial reports.

Many accountants and actuaries now question whether smoothing is ever appropriate for plan financial reporting. Given the plan sponsor preferences, though, only an ASB designation of market value as a preferred practice can prompt a practitioner migration and help practicing actuaries wean clients away from smoothing. In the next several years, the FASB will most likely require market value without smoothing. Under the philosophy espoused in

the proposed *Introduction*, our profession must abandon any hopes of leadership in this area and await FASB action. Will we bemoan yet another intrusion from outside?

DISCOUNT RATE SELECTION (PENSION)

To select a discount rate, ASOP No. 27 looks generally to the expected return on plan assets. Financial economics, on the other hand, calls for a discount rate that will often lie below the range defined by ASOP No. 27. Because the lower rates aren't favored by clients and would constitute a deviation from ASOP No. 27, practicing actuaries can't move in the financial economics direction on their own. The practice cannot evolve.

Pension actuaries are now debating the implications of financial economics. We're not, therefore, suggesting that these implications should be accepted by the ASB today. It's rather our view that the ASB

must review, analyze, and judge the merits of the arguments of financial economics regarding the discount rate.

The existing prescription of ASOP No. 27 has been challenged. On what basis shall this challenge be adjudicated and resolved? The proposed *Introduction* implies that the ASB won't address the question until and unless a critical mass of practice has migrated on its own initiative.

LOSS RESERVING METHODS (CASUALTY)

ASOP No. 9 states: "Detailed discussion of the technology and applicability of current loss reserving practices is beyond the scope of this statement. Selection of the most appropriate method of reserve estimation is the responsibility of the actuary. Ordinarily the actuary will examine the indications of more than one method when estimating the loss and loss adjustment expense liability for

a specific group of claims."

This is all the guidance the Academy and/or ASB gives the actuary about evaluating the adequacy of P&C loss reserves. Recent research in casualty loss reserve theory has focused heavily on stochastic reserving techniques. Stochastic methods generally require explicit, testable assumptions and allow for the quantification of statistical confidence intervals. In certain circumstances, it may be desirable to use stochastic methods either in place of or in conjunction with traditional, standard link-ratio methods.

Stochastic reserving methods, however, have been slow to take hold in the North American actuarial profession, due in part to the learning curve involved. Thus, an improved loss reserving standard would offer clearer and more explicit guidance regarding the application of stochastic methods.

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advances that are known at the time the ASOP is approved and that the new ASOP will become effective only on and after a specified date.

It has been argued that the *Introduction*, as currently written, allows the ASB to recognize and adopt new principles that flow from advances in actuarial science. More accurately, the ASB may occasionally choose to prune particularly unacceptable practices (or to fill a new-area vacuum). Nothing in the *Introduction* suggests that the ASB will choose between popular existing practice and more rigorous innovations in the underlying science.

Section 3.1.7 of the *Introduction* reminds us that much of the discipline that chafes us (“where an actuary is prevented from applying professional judgment”) has

been imposed by others. Might we conclude that others believe that the ASB’s laissez-faire approach is insufficient?

Even though there are various sources for innovation in actuarial science, the ASB needs to study, judge, and choose among alternative claims for actuarial advancement. The profession needs a focal point where innovation meets learned judgment. We cannot be assured that innovations will filter upward. Like it or not, judgment must be exercised by our leaders, who must rise to the occasion with knowledge, commitment, and attentiveness.

These comments should not be taken as proposals for specific restrictions on practice. Rather, we are asking the ASB to accept the responsibility that must inure to the leaders of our profession.

Conclusions

The *Introduction* codifies the ASB’s traditional flexibility-preserving approach that relies on the informed judgment of practicing actuaries. Standards are generally promulgated only after practice has evolved. There are exceptions for new areas, for rare pruning of unacceptable practices, and for individual actuaries to defend variant practices.

The *Introduction* articulates a hands-off philosophy that must be reconsidered in light of the challenges actuaries face today and will face in years to come. The core of our profession is actuarial science. It’s subject to analysis, argument, innovation, and evolution. Our practice derives from the science, and, although there is room for the practice to inform the science, judgments must be made by learned leaders embracing the best principles of actuarial science lest inferior principles lead a “race to the bottom.”

We believe that the ASB and its practice committees are the proper location for the exercise of professional analysis and judgment. Even if our profession lacks the resources to fund a full-time leadership institution à la the Financial Accounting Standards Board (FASB), our volunteers must be committed to independent decision-making informed by in-depth study of the actuarial science issues at hand. They must advance our tried and tested science *in front of* our practice. Following, rather than leading, the practice is a prescription for stagnation and an invitation for outsiders to impose their rules upon us. We must lead, or we will be led.

We encourage other actuaries to join this ongoing debate on the role of the ASB and the ASOPs and move us all toward *leading rather than being led*. In light of significant challenges to our profession around the world, it’s imperative that we establish a more rigorous and vigorous approach to rule-making by actuaries. ●



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