

THE PERSONAL

UNTIL RECENTLY, ACTUARIES HAVE APPLIED THEIR KNOWLEDGE AND SKILLS almost exclusively to addressing the problems associated with groups of individuals. Pension, life, and health actuaries have developed and applied rigorous mathematical models to estimate liabilities associated with large numbers of employees or insured individuals, determine the nominal value of assets needed to counterbalance the liability, and measure the risk associated with various strategies to secure assets compatible with the volatility of the determined liabilities. They've developed these models in the context of a comprehensive understanding of the patterns and rhythms of the free-market economy, the financial realities of regulations and controls, and the methods used to provide a social welfare safety net throughout the free world.

Over the past decade or so, a number of actuaries have begun to use these skills to help individuals identify and measure their own unique risks and to develop strategies that enable the individual to use his or her resources most effectively relative to those risks. Although there are no typical cases—each situation presents a unique set of issues and challenges—we offer the following example:

Mr. Smith's 80-year-old mother, who has \$400,000 of assets, is in an assisted-living facility. She is relatively healthy but is on the brink of needing to move to skilled-nursing care. She has fallen several times recently and has just begun to show some signs of dementia. Mr. Smith has no siblings and is his mother's sole heir. Half of his mother's assets are invested in CDs and half in a fixed annuity, paying 3.0 percent interest. His mother receives \$15,000 a year from Social Security, and her annual living expenses are \$50,000. He has the following questions for his personal actuary:

1. How long will his mother's assets last?
2. Should he invest her assets more aggressively?
3. And if he does so, how much longer will her assets last?

Because of his knowledge of the welfare safety net, the personal actuary incorporates the following information into his analysis. This information isn't commonly known by the public at large or even by most financial planners.

1. Because her husband served in the military during a time of war, Mrs. Smith will be entitled to a monthly benefit from Veterans Affairs once her assets fall below \$80,000.
2. If she's medically qualified for skilled-nursing care and she runs out of money, the state Medicaid system will provide for Mrs. Smith's care.

The personal actuary develops a model to test various asset-allocation strategies associated with the facts presented above. These models show the following:

1. If the investment strategy isn't changed, Mrs. Smith's assets should last until she is 92 years old. VA benefits begin at age 90.
2. A more aggressive investment strategy, however, increases the duration of her funds by only one year, or until age 93. VA benefits don't begin until age 92.
3. The probability of an 80-year-old living to age 92 is only 33 percent, and to age 93, only 27 percent. Because her health is already compromised, the likelihood of Mrs. Smith's living to 92 or 93 is even less.

As a result of his analysis, the personal actuary concludes:

1. There is little downside risk associated with investing more aggressively. If the resulting asset volatility results in a more rapid consumption of assets, the social safety net will provide for Mrs. Smith's care at the same level she would receive had her assets not been depleted.
2. There is substantial upside potential. It's unlikely that Mrs. Smith will live more than a couple of years. The investment strategy shouldn't be based on the time horizon for Mrs. Smith's needs but rather on the retirement accumulation needs of her son.

ACTUARY

Risk Management With an Individual Touch

BY PAUL RICHMOND

Some view actuaries as merely highly skilled mathematicians. But if actuaries are recognized as comprehensive problem solvers who apply a broad base of knowledge of economic systems, using mathematical models and techniques to identify, assess, and manage risk, a world of opportunity opens up.



The knowledge, skills, and modeling processes the personal actuary used in this example are much more comprehensive than what would be deployed by the typical financial planner. The financial planner may have arrived at the same answer but wouldn't have been able to explain the underlying dynamics. The personal actuary equips his client with a greater understanding of the levers that are working both for and against him, and the client is therefore able to make a more reasoned decision.

The problem for the personal actuary is that his work crosses over into an area that's subject to a high degree of regulatory supervision. Defining the personal actuary as a professional discipline, separate and apart from the financial industry, will be very challenging, if not impossible. The established regulatory environment severely limits a personal actuary from providing services directly to the public, unless he or she complies with the examination and regulatory requirements set forth by the government and other entities with regulatory authority. Personal actuaries who comply will certainly be able to practice; however, unless significant intervention occurs from the Society of Actuaries (SOA) and the American Academy of Actuaries, they may lose public identity as members of the actuarial profession.

Perhaps there is a role for the personal actuary in the back office of financial planning organizations, but it's unlikely that such institutions will allow personal actuaries to employ their actuarial skills or to advertise their actuarial credentials directly to the public. The more deeply embedded personal actuaries are within an organization, the more likely it will be that they can practice. But the more visible they become to individual clients, the more likely it will be that their employers will demand reliance on credentials associated with the financial world and discourage and even prohibit the use of actuarial designations.

A Call for Intervention

It's very apparent that an actuary, with a minor amount of additional training, has the skills necessary to practice comfortably within the financial sector. The profession readily acknowledges that actuaries should be trained in the financial regulatory environment. Some additional training is necessary in the tax implications of individual financial products. Also, estate-planning skills must be acquired.

We believe that the examination process necessary to become an investment adviser and to sell insurance and securities products is probably appropriate. The syllabus for these exams contains material about the regulatory environment that's not covered by the actuarial exam syllabus. However, the financial exams aren't all that difficult, and, compared to the actuarial

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exams, are rather easy. Therefore, completing these exams shouldn't present a significant obstacle.

The profession is, however, quite concerned about the loss of identity as an actuary. The skills we've acquired set us apart from most financial planners. Our skills are broader, more comprehensive, more analytical, and more rigorously applied.

We should be able to maintain our credentials and use

them as personal actuaries working in

the financial arena.

Nevertheless, unless some major changes occur, the financial sector won't accept our entry into this field. The risk for financial service firms is just too high. Therefore, personal actuaries need the help and support of governing actuarial bodies to help them gain that acceptance.

The SOA has commissioned a study to determine whether the skills of an actuary are sufficient to distinguish a personal actuary from a professional financial planner, and to determine whether the marketplace will accept and recognize the additional skills we bring to the table. This was a great first step. But if the personal actuary is to be a viable discipline, additional support and intervention from our governing and credentialing bodies will be necessary. In addition to the support already provided, the SOA and the Academy need to help in the following ways:

1. Initiate discussions with the Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD), the National Association of Insurance Commissioners (NAIC), and the federal and state legislatures about giving actuaries the same status as lawyers, accountants, teachers, and engineers, who are acknowledged by law and regulation as having skills that are tangential and complementary to the financial sector.
2. Develop actuarial standards of practice that identify acceptable methods of practice for an actuary working closely with and/or within the financial sector. The purpose is to create a "supervisory" umbrella for financial actuaries similar to the supervisory requirements that exist in the financial world. The objective would be to reduce the anxiety that financial employers may have about supervising a profession for which they have limited or no expertise.
3. Develop a way for personal actuaries to acquire errors and omissions (E&O) insurance protection that complements the protection required by broker/dealer and registered investment adviser firms. Perhaps the SOA could initially serve as an "association" that will promote and/or sponsor E&O insurance protection for personal actuaries. In all likelihood, the SOA would command more attention to this issue within the insurance industry than individual actuaries acting alone.

Why the call for a greater level of intervention just when the actuarial profession seems to be on the threshold of accepting and promoting a new discipline, the personal actuary? The answer lies in a large dose of reality acquired by the accumulation of additional knowledge about the financial sector and its regulatory environment. If our credentialing bodies don't intervene and help obtain investment industry recognition of the profession, the personal actuary initiative could very well fail. Furthermore, as more and more actuaries are displaced as a result of the demise of defined benefit plans and the consolidation of life insurers, many will find a home within the financial sector and may very well relinquish their credentials as an actuary. The result will be a decline in membership and relevance for the actuarial profession.

The Regulatory Environment

The financial industry is heavily regulated by the SEC, the NASD, the NAIC, and the investment administrators and insurance commissioners for each of the 50 states. Laws established by Congress and the states, subject to the rule-making and authority of the identified regulators, cover essentially everything we've defined as a role for the personal actuary. After sitting for many of the examinations necessary to comply with the regulators, I've drawn the following conclusions about actuaries and their ability to work in the financial sector:

1. *We're not recognized as legitimate investment professionals.* An actuary isn't recognized as a legitimate professional adviser within the financial services industry.
2. *We must pass more exams to work in the financial sector.* In order to provide advice that is even remotely related to investments and securities, an actuary must pass a series of examinations established by the NASD, state administrators, and state insurance commissioners.
3. *We must subject ourselves to the supervisory authority of the financial services industry.* Once an actuary passes the necessary examinations, he or she must affiliate with a broker/dealer and a registered investment adviser firm. The broker/dealer and the adviser firm must provide comprehensive supervision of whatever work is then performed by the actuary.
4. *We probably will lose our identity as an actuary.* It's not uncommon for the supervisory firm to prohibit an actuary from advertising his or her actuarial credentials. Supervisory firms are fearful that the use of credentials other than those related to the financial sector might somehow mislead the public. Lawyers, accountants, teachers, and engineers are exceptions; by law, these professions are specifically permitted to retain their unique professional identities. The primary concern of supervisory firms is that they're not equipped to monitor and review the work and analyses performed by an actuary. Allowing the actuary to advertise his actuarial credentials may lead the public to believe that the professional is being supervised when, in fact, he's not.

To help our overall understanding, let's first identify and define the professionals who are recognized by the financial industry. I'll do this generically, referring to the examinations required by the regulating authorities. Next, I'll summarize some of the major rules that pertain to the identified financial professionals. I'll then give some observations about the regulatory environment for professionals. And finally, I'll review the supervisory activities required within the financial sector and how they can lead to the loss of identity as an actuary.

Financial Professionals

► *Investment adviser.* SEC Release IA-1092 issued in October 1987 defines an investment adviser as anyone who provides investment advice, reports, or analyses with respect to securities, is in the business of providing advice or analyses, and receives compensation, directly or indirectly, for these services. The SEC further states that the definition includes persons who offer investment advice for compensation, such as financial planners, pension consultants, and sports and entertainment representatives.

An individual who advises clients to select from among investing in real estate, intangibles, or other assets is an investment adviser. An individual who advises clients about budgeting their income is an investment adviser. An individual who advises a client regarding the selection from a variety of financial products, including securities, insurance products, and real estate is an investment adviser.

An individual doesn't even have to recommend any specific security to be considered an investment adviser. Simply advising on classes of investments makes an individual an investment adviser.

A person who receives any economic benefit as a result of providing investment advice as defined above is an investment adviser. This includes fees, commissions, or salary.

To become investment advisers, individuals must pass the Series 65 and Series 63 exams developed and administered by the NASD. Alternatively, they may pass the Series 66 exam.

► *Securities salesperson.* A securities salesperson must pass either the Series 6 and Series 63 exams or the Series 7 and Series 63 exams in order to sell investment securities. A person with a Series 6 license may sell mutual funds and variable insurance and annuity products. A Series 7 licensee may also sell stocks and bonds.

► *Insurance adviser and salesperson.* The sale of insurance products and the giving of advice on these products are regulated by the insurance commissioners of the individual states. The commissioners are administering insurance laws passed by individual state legislatures. These laws are based on model legislation developed by the NAIC.

Although rules vary some from state to state, individuals are generally prohibited from explaining or advising on an insurance product unless they're licensed insurance producers. Ironically, in many states, actuaries can design an insurance

product and can help establish underwriting standards for an insurance company, but they're prohibited from advising a client about the provisions of an insurance contract.

To become a licensed producer, an individual must pass an insurance examination developed by the commissioner of the state in which the prospective insurance adviser or salesperson resides. Other states will honor that exam if the adviser and/or salesperson requests and pays for an out-of-state registration.

The adviser and/or salesperson may become licensed to advise or sell just life and annuity products, just health insurance products (medical insurance, disability insurance, and long-term care insurance), or both.

Authorities and Restrictions

Financial professionals receive permission to do certain things and have limitations placed on them. Some of the rules pertaining to these authorities and limitations are summarized below:

1. An insurance salesperson must obtain sufficient information from the prospective consumer to determine that the insurance product being sold is financially suitable for the client.
2. A securities salesperson must obtain sufficient information from the prospective consumer to determine that the security being sold is financially suitable for the client.
3. An investment adviser must obtain sufficient information from the client to ensure that the advice provided is suitable to the financial needs and circumstances of the client.
4. An insurance salesperson must determine only if the insurance product is suitable for the client. He may receive commissions only on the sale of the product. He may not prepare a comprehensive financial plan for his client because if he does so, he is an investment adviser. He may not charge a fee. He has no obligation to disclose the commission he receives to his client.
5. A securities salesperson must determine only if the security is suitable for the client. She may receive commissions only on the sale of the product. She may not prepare a comprehensive financial plan for her client because if she does so, she is an investment adviser. She may not charge a fee. She has no obligation to disclose her commission to her client.
6. The basis for an investment adviser's work is a comprehensive financial plan. He may charge a fee for his work and for his advice. If he is properly licensed to do so, he may also sell insurance products and securities to implement the financial plan he's developed. However, if he sells insurance and securities products and services in addition to the development of the financial plan, he must disclose his commissions to his client.

Observations

From the perspective of someone new to the financial sector, the rules and regulations governing the industry seem to encourage the sale of financial products and services without ensuring a comprehensive understanding of the financial and personal goals

of the client. Although the regulatory authorities would probably dispute this conclusion, I believe that the suitability standard for salespeople is rather soft. Salespeople can perform a cursory suitability review, ask a dozen questions or so, and based on the answers provided, decide on the suitability of a product and make a sale. They're under no obligation to disclose the commissions they receive as a result of the sale.

On the other hand, the investment adviser performs a much more comprehensive analysis. It's quite likely that an adviser will discover that a specific financial product is totally unsuitable, whereas the salesperson, working with the same client, would have concluded that the product was entirely suitable. The adviser does a much more in-depth analysis and develops a much more rational basis for suitability. But the adviser must disclose all the income he receives for the project.

Isn't this a bit backwards? The person who does a better job of determining suitability (the adviser) has to disclose his income, while the salesperson doesn't. The regulators' position, however, is that that adviser, because she knows more, has a greater potential for a conflict of interest. The additional knowledge gives the adviser the ability to tailor her recommendations to products and services that will produce the greatest amount of income. The adviser has the ability to exert significantly more influence on clients and the decisions they make.

The salesperson is merely a "clerk in the store," explaining the benefits and provisions of the product offerings. He has a duty not to sell a product that would be clearly unsuitable, but he's not placing himself in a position of trust. He's obligated to put the client's interest above his own, but he's not obligated to inquire too deeply to rule out reasons why the product may be unsuitable. Clients retain considerable responsibility for determining for themselves that the financial product satisfies a need that they themselves have identified.

It's the actuary's knowledge of the fundamental principles of insurance and the basic strategies underlying product designs that gives him the ability to help individuals understand policy language features and the relative merits of individual provisions and riders.

Supervision and the Loss of Actuarial Identity

The purpose of regulation is to protect the public from unscrupulous people and fraudulent behaviors. As a result, registered investment adviser firms are very cautious about what they'll permit their investment advisers to do. They're required to review all work performed by their representatives to ensure that the advice, recommendations, and subsequent sales of products and services are given with the best interests of the client in mind. Investment adviser firms have two major concerns:

1. They are themselves subject to active and aggressive supervision by federal and/or state regulators. They're subject to periodic audits and surprise audits. And they must be able to demonstrate that their representatives, or advisers, are in compliance with the rules.

It's the actuary's knowledge of the fundamental principles of insurance and the basic strategies underlying product designs that gives him the ability to help individuals understand policy features and the merits of individual provisions and riders.

2. They are very concerned about lawsuits. If they don't provide appropriate supervision, they're subject not only to censure from the regulators but also to significant monetary awards payable to clients who have been damaged.

Regulations require all investment advisers to report all outside business activities to their supervising firm. The purpose of this is to alert the firm to any potential conflict of interest the adviser may have. Investment adviser firms want their representatives to be substantially committed to giving investment advice. Although they won't be too concerned about a person with a business activity unrelated to the financial industry (for example, an adviser who runs a dog kennel), they do become concerned when that outside activity consumes a substantial portion of the adviser's time. And they get particularly concerned when the outside business activity is closely related to the financial sector.

An adviser who identifies actuarial services as an outside business activity will very likely draw considerable scrutiny from the investment adviser firm because it's so closely related. The firm is concerned that the public may not be able to distinguish the investment advice an actuary provides from an investment adviser's advice. While the firm can supervise the investment advice, it doesn't have the resources or expertise to supervise the actuarial services.

An investment adviser firm isn't apt to refuse to hire a fellow of the SOA merely because he's an actuary. Such a firm may even welcome the additional knowledge and skill an actuary brings to the table. However, the firm must exercise considerable caution about how the actuary is used with the public.

First, it must either exercise regulatory supervision of the actuary's work or disclaim supervision of the actuarial component of his work. Investment adviser firms generally can't supervise the actuarial work because they aren't qualified to do so. On the other hand, it's difficult if not impossible to disclaim

the actuarial component of a project because that component becomes so intertwined with the components that can be properly supervised.

A client may experience a poor outcome for a number of reasons, many of which have little to do with the advice given. However, if a client can show the advice was based on analyses prepared by an actuary and the work of the actuary wasn't properly disclaimed or supervised, the firm may be subject to censure by the regulatory bodies and civil liability for the poor outcome.

In light of this, some investment adviser firms have put the following restrictions on their advisers:

- Advisers must use financial planning software approved by the firm.
- Advisers may not develop their own spreadsheets, use software developed by the advisers themselves, or use software developed by other sources.
- Advisers may not use their actuarial credentials on any letterhead, business cards, or advertising that also identifies the firm.

These restrictions clearly dilute personal actuaries' ability to maintain their professional identities as actuaries.

Personally, I'm not averse to embracing the financial sector and relinquishing my actuarial identity if absolutely necessary. I would still apply the knowledge and discipline gained through becoming and practicing as an actuary; I just wouldn't call myself one.

But I'm proud of my accomplishments as an actuary and would like to retain my identity as one. I firmly believe that our skills are readily transferable to the financial sector. I also believe that a personal actuary delivers skill sets and products that are distinctly different from those offered by financial planners. I want to work in the financial world, but I also want to retain my identity as an actuary. And I believe that my colleagues who are personal actuaries want the same. Therefore, we are calling on the actuarial profession to help us.

Perhaps fundamental to the definition of a personal actuary is the definition of an actuary. Some view the actuary as a highly skilled mathematician. My view is that the actuary is a comprehensive problem solver, applying a broad base of knowledge of economic systems, using mathematical models and techniques to identify, assess, and manage risk.

If the actuary is defined by the narrower first definition, the opportunities for personal actuarial work are very limited. If the actuary is more broadly defined, however, the opportunities can be quite extensive. ●

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