

March 31, 2004

ASOP Introduction
Actuarial Standards Board
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By e-mail: comments@actuary.org

ASB Board and the Special Task Force on Introduction:

We are writing to comment on the Proposed Introduction to the Actuarial Standards of Practice. Our comments address Section 3.1, particularly Section 3.1.2.

Section 3.1.2

Section 3.1.2 states, in part, that “ASOPs are written to reflect generally accepted practice, i.e., practices that, over time and through common use, have come to be broadly accepted by qualified actuaries as appropriate ... In most cases, the ASB promulgates a standard only when practice ... has evolved to the point where it can be codified as an ASOP.”

We understand that this accurately describes the ASB’s approach throughout its fifteen-year existence. This approach, which amounts to “cataloguing” existing practice, invites stagnation. Section 3.1.2 assumes that qualified actuaries will evolve the practice. How might such evolution occur? Section 3.1.2 suggests that developments in actuarial science will inform the practitioners who will modify their practice accordingly. This “practice-filtering” process will not suffice. The rule-making ASB must connect directly with advances in actuarial science. We are concerned that many such advances will not 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 is highly unlikely that practice will embrace the outlier without leadership from the ASB.

The appendix illustrates these problems under existing ASOPs.

Section 3.1

A broader review of Section 3.1 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.

Section 3.1.5 rejects narrow prescriptions in favor of actuarial science informed by education, experience and judgment. This misstates the choices faced by the profession 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.

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.

Session 39 at the 2002 annual meeting of the Conference of Consulting Actuaries was titled: "ASOPs – Swords or Shields". An ASB member and co-panelists addressed the increasing malpractice exposure of actuaries. Practicing actuaries who diligently follow the ASOPs may enjoy the shield effects 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 will not 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 ("The ASOPs intentionally leave significant room for the actuary ...") may appear to shield many actuaries in the short term – because it is loose enough to cover a wide range of practice – but it will not 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 U.K. actuaries.

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 incorporate *recent* actuarial advances and apply only on and after an effective date.

It has been argued that Section 3.1.3 is the mechanism that allows the ASB to recognize and adopt new principles that flow from advances in actuarial science. More accurately, Section 3.1.3 may be used occasionally to prune particularly unacceptable practices (or to fill a new-area vacuum). Nothing in 3.1.3 suggests that the ASB will choose between popular existing practice and more rigorous innovations in the underlying science.

Section 3.1.7 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 our laissez-faire approach is insufficient?

Section 3.1.8 identifies various sources for innovation in actuarial science. It is at just this point, however, that 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 upwards. Like it or not, judgment must be exercised by our leaders who must rise to the occasion with knowledge, commitment and attentiveness.

Our 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 Proposed Introduction to Actuarial Standards of Practice formalizes the ASB’s approach to standard setting. Section 3.1 codifies a 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.

Section 3.1 (especially Section 3.1.2) 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 is 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.”

The signers 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 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 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 welcome the review of the role of the ASB and the ASOPs that is implicit in the promulgation of the Proposed Introduction at this time. In light of recent challenges to our profession around the world, the time has come to wrestle with the historic implications of Section 3.1 and to establish a more rigorous and vigorous approach to rule-making by actuaries.

SIGNED

24 Signatures

Appendix – Illustrative Problems under Existing ASOPs

1. *Pension – asset valuation.* The Exposure Draft: 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 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?

2. *Pension – discount rate selection.* To select a discount rate, ASOP 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 27. Because the lower rates are not favored by clients and would constitute a deviation from ASOP 27, practicing actuaries cannot move in the financial economics direction on their own. The practice cannot evolve.

The implications of financial economics are now being debated by pension actuaries. The signers of this letter are not, therefore, suggesting that these implications should be accepted by the ASB today. It is 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 27 has been challenged. On what basis shall this challenge be adjudicated and resolved? The Proposed Introduction implies that the ASB will not address the question until and unless a critical mass of practice has migrated on its own initiative.

3. *Casualty – loss reserving methods.* ASOP 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 that the AAA and/or ASB gives the actuary with regard to evaluating the adequacy of P&C Loss Reserves. It has been known for decades that standard link-ratio methods are extremely poor tools for projecting ultimate liabilities for a given block of business. Nonetheless, many opining actuaries rely exclusively on them. A rigorous, detailed, sufficient analysis (e.g. stochastic reserving methods) will frequently cost a client much more than they are willing to spend and, furthermore, the opinion is often viewed as a regulatory hurdle to be cleared, not a valuable source of management information. This lack of clearer guidance and more explicit standards makes it very hard for practitioners to migrate towards state-of-the-art practice.