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## *of*
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# ANNUAL MEETING
## October 7–9, 1982
## Cambridge, Massachusetts

MR. WILLIAM A. HALVORSON (President): It is time to call the 1982 Annual Meeting of the American Academy of Actuaries to order. Before starting our formalities, I would like to thank the Conference of Actuaries in Public Practice and especially its President, George Swick, for the tremendous hospitality we have experienced. We've already experienced a day and a half of terrific meetings and we are very pleased to have a chance to participate with you.

On behalf of the American Academy of Actuaries program committee, which is primarily Adger Williams and the Vice Presidents, we particularly want to thank the Conference's program committee, Ray Cole and others, for the beautiful cooperation that we've had in designing and working out the details of this program. To the Academy members and others who were asked to participate in our programs, we appreciate your doing so.

Getting right on to the subject at hand, the first item of business is to hear a report from the Nominating Committee. In the absence of Chairman Ron Bornhuetter, Adger Williams will present his report.

# BUSINESS SESSION
# NOMINATION AND ELECTION OF DIRECTORS

MR. P. ADGER WILLIAMS: The Nominating Committee nominated the following members as Officers of the Academy for 1982-83:

| | | |
|---|---|---|
| President-Elect | - | A. Norman Crowder, III |
| Vice Presidents | - | John A. Fibiger |
| | - | Walter S. Rugland |

<u>and for Re-election</u>

| | | |
|---|---|---|
| Secretary | - | Carl R. Ohman |
| Treasurer | - | W. James MacGinnitie |

The By-Laws provide that the Board elect the Officers and I'm pleased to report the above Officers were elected at the September 28, 1982 Board Meeting.

Many of these newly elected officers are here. Would they please stand and be recognized at this time.

At this meeting, we would like to place in nomination the following members for three-year terms on the Board of Directors:

Phillip N. Ben-Zvi
Douglas C. Borton
C. K. Khury
Richard S. Miller
John O. Montgomery
Joseph J. Stahl, II

I move the nomination of the above candidates. Do I hear a second? It has been moved and seconded. Are there any other nominations? Hearing none, I ask for a motion that the nominations be closed and that the Secretary cast a unanimous ballot for the slate. (It was so moved, seconded and carried.)

# BUSINESS SESSION
# REPORT OF THE SECRETARY
# CARL R. OHMAN

In the past year, the Board of Directors of the American Academy of Actuaries has met on three occasions: December 9, 1981; March 17, 1982; and September 28, 1982.

The meeting held in March of this year was a special Board meeting, in that it focused upon a review of the activities of the various Academy committees and their proposals for future activities. The other meetings were more routine in format, directed to business more immediately at hand.

Non-routine actions taken at the first two meetings have previously been reported to you in the Academy Newsletter. Non-routine actions at the September 28 Board meeting will be covered in a report to be published in the November, 1982, Newsletter (now Actuarial Update).

In addition to the three meetings of the Board of Directors, the Executive Committee of the Academy has held five meetings during the past year: November 18, 1981; February 18, 1982; May 4, 1982; July 13, 1982; and September 1, 1982.

Since October 1, 1981, 434 new applications for membership in the Academy have been received. In the same period, 298 applications have been approved and 136 are still in process.

Effective July 1, 1981, the Academy reorganized its system for admitting new members to the Academy. A progress report on the new admissions processing system, prepared by Admissions Committee Chairperson Dale Ethington appeared in the August, 1982, Newsletter. Under the new system, the average time to process applications for membership has greatly improved while the quality of professional review of individual applications has been maintained. The success of the new system reflects the very fine work of the Admissions Committee and of the Academy's Administrative Staff.

# BUSINESS SESSION
# REPORT OF THE TREASURER
# W. JAMES MACGINNITIE

I would like to report to you briefly on the Treasurer's 1982 functions.

Membership in the Academy has increased from 6,544 members on October 31, 1981 to 7,064 members as of September 30, 1982. It is anticipated that membership will continue to increase gradually. Continued growth is indicative of the integral role the Academy plays in the actuarial profession.

Our 1982 income is currently projected to approach $950,000, while 1982 expenses will be about $825,000. The year-end cash assets should be slightly less than $450,000, or nearly 50% of projected 1983 expenses.

For 1983, the Board has approved continuation of the present dues structure, without increase. It is projected that there will be a small excess of income over expenses.

Academy finances have benefited from recent high interest rates. Maturities of investments were recently lengthened somewhat, to take advantage of higher yields. This action was taken by the newly formed Budget and Finance Committee.

Detailed financial reports of the Academy are reviewed regularly by the Budget and Finance Committee and by the Board. A certified audit is conducted annually at the close of the fiscal year.

# BUSINESS SESSION
# REPORT OF THE GENERAL COUNSEL
# WILLIAM D. HAGER

Two areas that I would like to talk briefly about with respect to Academy on-going activities include (1) legal considerations for the profession and (2) government relations.

Legal Considerations

In the area of the law, it strikes me that a professional association has three key concerns in terms of its ongoing (and for that matter past) activities. The first concern is that those individuals who carry out the profession's work and business are made aware of the legal dimensions of their activity. And with respect to professional associations, there is an increasingly enlarging body of law that comes to bear on the work of professional associations, and thus it is critical that people that carry out the professional association's work become cognizant of this.

The second concern (and really a subsection of the first) is to develop organizational awareness of the antitrust exposure which comes to bear a professional association's activities. The third area of legal activity is that of expressing the profession's positions in courts of law.

As to the first, one of the things I have tried to do at the Academy is to suggest the importance of recent U.S. Supreme Court decisions directly impacting on professional associations. One current example is the American Society of Mechanical Engineers' case (a case in which the federal district court awarded damages to the tune of $7.5 million against the association). In that case the committee chairman of a professional association used his professional association position to impede competition as to one of his competitors in his private employment.

The second area (see above) is the ever growing impact and application of antitrust law to professional associations. Recent Supreme Court decisions likewise, have left the matter in my judgment pretty much unequivocal. There is a very far reaching body of law in the antitrust area that impacts on professional associations. We have made appropriate note of that as we have promulgated our professional standards which is the area traditionally where these problems arise.

An example of the third area of legal activity includes the Academy's Committee on Risk Classification which recently finished work on an amicus brief in the Norris case out of Arizona. That decision concerns Title VII of the 1964 Civil Rights Act and the question of equal benefits. The Academy's brief was very simple, relatively uncontroversial; it simply stated that as people possessing key information about the potential impact of decisions such as that set out in Norris, we believe the court case is important and secondly we believe the court ought to review the decision.

## Government Relations

The second area of activities relates to government relations. The profession over the years, at least as I have come to see it, has been pretty schizophrenic as to the area of government relations. What we have tried to do over the last few years is to heighten the profession's profile in Washington among regulators and Congressional people, and to emphasize the need for timely and accurate actuarial input into various legislative and regulatory proposals. In my own judgment, I think it is one of the obligations of every profession that posesses key information to get that information before the decision makers so that they will come forward with the best possible decisions.

Areas of Academy activity in terms of issues vis-a-vis government relations: (1) Social Security; (2) pro-competition in health insurance; (3) various ERISA bills; (4) the PEPRA bills which are federal proposals to put standards on the state and municipal sponsored retirement plans; (5) risk classification (specifically S. 2204 and H.R. 100, both of which go to cost-base pricing in the insurance and pension area); (6) the Baucus amendment for health care providers with respect to medical supplemental policies; and (7) a bill that is in the property-casualty area, H.R. 6114, which proposes to provide as a business expense deduction, reserves that are set up against property-casualty risks.

Finally, in terms of specific activities, I'll just mention these briefly: (1) a luncheon held last year (which will be made annual); (2) the Issues Digest, summarizing positions on issues before legislative and regulatory forums; (3) the ongoing monitoring supplement to the Actuarial Update which sets out actuarial issues being considered by Congress, regulatory agencies, the NAIC, and the accounting profession; and (4) finally, of course, obtaining invitations for testimony and the like.

That summarizes our activities. I would urge ongoing membership support for the very simple, straightforward, and it seems to me obligatory responsibility of any profession to provide fundamental, operative, and key information in their possession to various congressional and regulatory decision makers.

Thank you.

# BUSINESS SESSION
# REPORT OF THE EXECUTIVE DIRECTOR
# STEPHEN G. KELLISON

I am pleased to be able to present this annual report of the Executive Director. The scope and volume of Academy activities has grown substantially during the past year, both internally within the actuarial profession and externally with the Academy's public interface activities. The growth of Academy activities is largely the result of the rapid transformation of the actuarial profession over the 17 years of the Academy's existence from a private inward-looking scientific society to a true outward-looking public profession, with public responsibilities and accountability.

The past year has been one of continued growth in the Washington office of the Academy. We currently have a staff of 12 employees in the Washington office. In addition, the Chicago office of the Society of Actuaries provides certain administrative functions related to the computer-based membership roster of the Academy, as it also does for the Conference of Actuaries in Public Practice. I hope that you will take the time to introduce yourselves to those staff members in attendance at this meeting and express your appreciation to them.

Normally, in my report at the annual meeting I discuss some highlights of the Academy's public interface activities. However, since we have just heard a report discussing the government relations program of the Academy and since Bill Halvorson plans to follow with a special presentation on public relations, I thought I would shift gears somewhat and talk about membership involvement and participation in Academy affairs.

The Academy has long felt the need for strengthening the ties with our membership. We feel that this is a two-way street in which everyone would benefit from an increased level of awareness by the membership in Academy activities and increased membership involvement in those activities. Underlying these goals is our concern to rectify a misconception about the Academy that we sometimes hear to the effect that the Academy is somehow a closed group of insiders which really does not welcome active involvement of a broad cross-section of membership.

Nothing could be further from the truth! I am not certain that such criticisms were ever valid; but, to the extent they ever had any validity, they were a commentary on the Academy of several years ago and not the Academy of today. Let's examine some of the ways in which the Academy has opened up the process to the membership. There are four areas I would like to mention briefly.

First is our new Statement of Purpose. This was adopted by the Board of Directors last December following a full exposure process with membership. It was sent to you shortly after the beginning of the year and will be incorporated into the 1983 Yearbook. Several improvements in the Statement of Purpose were adopted as the result of membership comment and we were pleased that no one spoke in opposition to the new Statement of Purpose. The new

Statement has the dual advantages of not only clarifying what the Academy is all about to our members, but also of improving our working relationships with our sister actuarial organizations, such as the Conference.

The second area is the development of standards of professional conduct and practice, i.e., the Guides, Opinions, Recommendations, and Interpretations and the new Qualification Standards, all of which appear in your Yearbook. We have developed a system which directly provides for membership involvement in the development of these standards through an Exposure Draft process. Moreover, this is not a hollow procedure, since the committees developing these pronouncements are required to either accept suggestions offered by members or to provide a rationale why such suggestions were not appropriate. All Exposure Drafts are sent to you with blue covers for easy identification and we urge that you comment on them when they come along.

The third opportunity for membership involvement is in our government relations program. All of you should have received a booklet entitled "Guidelines for Making Public Statements" which was distributed in May of this year and was the subject of one of the concurrent panels yesterday. These guidelines were developed specifically to provide for increased membership participation in this process and will be permanently incorporated into the Yearbook.

There are a number of vehicles which allow members to be more a part of this process. By now you should have received the first issue of a new supplement to our monthly newsletter entitled "Government Relations Watch" which appeared in September. This publication is designed to convey the current status of a number of pending issues involving actuarial considerations and the Academy committee involved. Once a statement is issued it is noted in a regular column in the newsletter entitled Checklist of Academy Statements and copies are available on request. Each year the statements for that year are incorporated into the permanent literature by being incorporated into the Journal.

You also may recall that last spring you received a publication entitled the Issues Digest which provided more extensive background on a number of issues with which we are dealing and it is currently planned to produce a second edition of the Digest next Spring. Finally, we now have added a Letters to the Editor feature to the Newsletter which members are encouraged to use to express their views on public issues as well as any other Academy-related matter.

We recently examined the practices of a number of professions concerning how they handled their government relations program in relation to their membership. I am pleased to report that we could find none that approached the Academy in directly communicating with the membership on this activity or in providing opportunity for membership input.

The fourth and final area of membership participation I would like to mention is at the local actuarial club level. We feel that significant improvements in both government relations and public relations for the profession are possible at the state and local level with more active participation of the local clubs. The Academy is developing some proposals along these lines which it will be sharing with the local clubs. We hope you will get involved with this activity and encourage your colleagues to do so as well.

In closing, I would like to express the gratitude of the staff and myself to the officers and directors of the Academy, to the committees and task forces, and to the general membership for the outstanding support which we have been afforded during the past year. The staff always welcomes your comments and thoughts as to how we can better serve the needs of the membership in the years ahead.

Thank you.

# BUSINESS SESSION
# REMARKS OF THE PRESIDENT-ELECT
# A. NORMAN CROWDER, III

My Mother always asked: "When are you going to write an actuarial paper?" After 20 years of looking over topics in my vast store of knowledge, I have yet to find anything that I believed anybody else would want to hear about. So I decided to turn my hand to something else and to try to assume a leadership role. In that new role, as President-Elect, I want to ask each of you to help me make the Academy more effective. As Adger and I work together over the next year, our objective, mine clearly, is to make the Academy increasingly more meaningful, not only to its members - you, and me, and everyone else - but also to its publics. And so, believe me, I will be calling on many of you to help us, as we meet the various tasks that the Academy faces in the coming years.

Thanks.

# BUSINESS SESSION
# PRESIDENTIAL ADDRESS—THE PAST IS PROLOGUE
## WILLIAM A. HALVORSON

The curtain is closing on my presidency, but that far from expresses my feelings at this moment. On the contrary, I feel a tremendous excitement, as if the curtain were rising and the stage were being set for a very long running show. My role in this production has been like that of the presidents who have preceded me, that is, to prepare us for the rest that will follow.

As many of you know, I contend that we are entering a new era, an era of greater public recognition for the profession. This future growth depends upon the public's awareness of both our role, and our commitment to living up to these public responsibilities.

We are, of course, a unique and necessary profession. As I've often said, "If we didn't exist, we'd have to be invented." As public guardians of future benefit expectations, we have some pretty awesome responsibilities. But no one is better equipped to shoulder those responsibilities than the actuary.

Who else has the thorough knowledge of the mathematics of risk and finance that is required to make judgments about the value of long term promises? Who else can be relied upon to always give objective information to every party? Who else is able to communicate the results of our studies, in language that everyone can clearly understand? Well, we should be able to, anyway. Of course, it's the actuary, who is a part of an increasingly public profession.

Four years ago, in my presidential address to the Society of Actuaries, I set forth three challenges I saw for the profession. With your indulgence, I'd like to repeat them today.

First, to define the actuary's function in society, and our responsibilities to each of our publics;

Second, to develop the programs necessary to establish the visibility and credibility of the actuarial profession; and

Third, (and this depends upon the success of the first two) to achieve a general licensing law for actuaries in the United States.

I firmly believe that we have made significant progress on the first two objectives.

The Joint Committee on Public Relations, about which we reported at last year's meeting, has articulated goals for the profession which have helped to define our public responsibilities. In addition, the market research carried

out by the Joint Committee has helped us better understand our relationships with our many publics.

With these goals and public responsibilities defined, we've begun to frame programs to enhance the visibility and credibility of the actuarial profession. To do that, we have needed the guidance of a public relations professional. Acting on the Joint Committee's recommendation that a full-time public relations practitioner join the Academy staff, we hired Erich Parker just about one year ago today. I have asked him to take a few moments to outline for you some of the flags he's flying to call media and public attention to the profession.*

REPORT OF ERICH PARKER
DIRECTOR OF PUBLIC INFORMATION

MR. ERICH PARKER: I am delighted to have this chance to speak to you this afternoon to describe some of my work products of the past year.

I have these past months issued news releases to publicize Academy-related meetings, congressional testimony, and new members. That is rather standard fare for association publicists. What I have found most challenging, though, has been implementing a long-range public relations program for the Academy and, indeed, the profession as a whole.

Our first order of business this year was the issuance of a media kit to finance and business editors in more than 2,500 media outlets. By news outlets I mean television stations, radio stations, and newspapers. The kit contains general information about the actuarial profession and actuarial science - such things as: Questions and Answers About Actuaries, Glossary of Frequently Used Terms, History of the Profession, and, working with Linda Delgadillo of the Society, Build and Blood Pressure Findings. This mass mailing was intended to give the mass media a point of contact, the Academy office, when stories or questions arise with actuarial implications. My last thought was that the mailing would not generate any stories. Well, to my surprise and pleasure, it did. Since the mailing, we have conducted a number of interviews with newspapers, a magazine, and Steve Kellison's first-ever live, radio call-in show next week.

This year we've concentrated a good bit of effort on Social Security's funding problems. Not solving them, I hasten to add, just publicizing them. In the September issue of Changing Times, one of its cover stories was "Cures for What Ails Social Security." That story with its editorial roundtable format was the result of a number of discussions with Changing Times editors. One of your colleagues, Haeworth Robertson, is featured in the article. In addition, we have issued three syndicated columns on Social Security, outlining many of the problems now facing the system and some solutions.

We receive newspaper clippings when our stories appear, but only a number representing about 25% of pick-up. So, if conventional PR wisdom holds, our 150 clips per story indicate that each column has appeared some 600 times. We've also gone out with a radio spot on Social Security to medium-size and small stations across the nation. I'm expecting exceptional pick-up. We should know something in a month or so when the user cards are returned to us. Lastly, my staff and I have written and prepared a slide/speech presentation on Social Security which just last week was mailed to local Actuarial Clubs. We have urged the clubs to give this program at their area community

service and fraternal clubs, like the Kiwanis or Lyons Clubs, for example. Next year, I anticipate that we'll continue the syndicated columns on topics as yet to be determined. I am planning both a radio spot and a television spot. We'll be producing a fact book on the Academy, and continue to improve our Newsletters. And, there are other projects in the wings I hope to tell you about, maybe at next year's Annual Meeting.

* * * *

MR. HALVORSON: So, for the first time, the profession has a long-range public relations program underway. We are proceeding with some success on the regulatory and legislative fronts as well. This is probably best typified by our frequent testimony before Congress. Reports I have received say that we seem to have gained acceptance by Congress as a source of objective information. It is important that we not be perceived by that body as defenders of the status quo for either the insurance or the employee benefit industries. It's a tight rope to walk sometimes, but it's the correct posture, one I believe our committees are maintaining with distinction.

Our continuing dialogue with the NAIC, the FASB, and the AICPA are aimed at strengthening our mutual understanding and reliance in serving the public's needs. We have reason to hope that our current efforts will help the profession achieve a greater degree of visibility and credibility to the ultimate users of our services, that is, to policyholders and plan participants.

So, once again, we have made good progress towards our first two objectives. What about that final challenge?

Can we achieve a general licensing law for actuaries in the United States? Some ask, still, should we? I believe it to be a worthy objective. There are strong self-regulatory winds blowing in Washington, D.C., and throughout the country right now. If we seize the moment in this very favorable climate, we can make a lot of progress toward that objective.

There will be some necessary public oversight accompanying a move in this direction, but that's all for the good of the profession. The way I see it, in return for receiving the franchise for defining our profession's qualifications and standards of practice, we must accept a degree of public oversight. That's necessary to assure our publics that we are serving their interests.

It's a challenge, but to set a lesser goal would be a denial of our public responsibilities.

I'm very optimistic that we are overcoming most external opposition to this objective through our public-oriented service. Our biggest job, now, may be to get the entire profession to dedicate itself to this goal. When I say the entire profession, I'm not speaking in the abstract. I mean each one of us. For one thing is certain, if we are not united in this, we cannot expect public regulators and legislators to accommodate our initiatives.

I believe we have a good understanding within the profession, and I want to acknowledge the excellent working relationships we've enjoyed this year in the Council of Presidents. I'm certain that Adger Williams, and other incoming leaders of the profession, will continue to work together as one profession.

Thank you for the opportunity you have given me to serve. The past is prologue, and the play is just getting underway, so, let's get on with the show.

Now let's hear from Adger Williams, your new president.

# BUSINESS SESSION
# REMARKS OF THE INCOMING PRESIDENT
# P. ADGER WILLIAMS

Thanks, Bill, for the introduction, and a larger thanks from the Academy for your leadership this past year.

At the September 28th meeting of the Academy Board of Directors, we presented Bill Halvorson with the Mandarin statuettes of the Mathematician and the Secretary, the traditional gift to the outgoing president. With that token of our appreciation also goes our gratitude to Bill for his dedication and service to the American Academy and to the entire profession.

Bill has expressed regret that he is departing just as the curtain goes up. But much of the script that we will be following for many years was written by Bill Halvorson and is the result of the work he has done for the profession. He has set the stage.

The drama unfolding for the profession has many settings and many roles, each contributing to the profession's common goal of serving the public well.

It was just a short while ago that the leaders of the various actuarial organizations spent most of their time talking about reorganization. There was not a conference or a meeting that did not have a panel or speaker discussing the latest scheme for the amalgamation of the profession. The feeling was pervasive that we could not be one profession unless we were one organization.

That was a necessary inspection of the possibility of unification, but it had its price. Separate attempts at long range planning ceased, giving way to reorganization committees, and the incentive for separate organizational assertiveness waned.

That era has mercifully passed. We have emerged with the understanding that we are one profession, and that as such we can operate without giving up the separate identities that have been so important to the development of the specialized skills that characterize our profession. Reorganization has given way to coordination.

At the same time, a proud parochialism has reappeared:

- The Society of Actuaries is reinspecting and reaffirming the importance of the FSA designation.

- The Casualty Actuarial Society is reviewing its organizational structure.

- Here at this meeting, the Conference of Actuaries in Public Practice is exploring the similar concepts of the different disciplines.

- Planning is already underway to address the special problems of the pension actuary at the 1983 Enrolled Actuaries' Meeting.

- Thirty-nine actuarial clubs around the country affirm the need for grass roots attention to the local and specialized problems of the profession.

There is strength and vitality in this actuarial diversity, with each segment of the profession addressing the problems that are uniquely theirs.

We are all part of a larger group that makes up the actuarial profession in the United States. It is as part of this group that the public will or will not know us. It is to the members of this group that the appellation "actuary" is attached. So we have, with each other, the common problem of establishing a common professional identity which is widely recognized by, and can be clearly communicated to, the public.

The American Academy has equipped itself to fulfil this coordinating role for the profession, to give us one voice when we find it necessary to act in concert. We have improved our contacts and are working more closely with agencies of the Federal government than ever before. We have strengthened our ties with the state regulatory mechanism through contacts with the N.A.I.C. Liaison has been established, and a continuing dialogue is taking place with the accounting profession. The voice of the actuarial profession is being heard; our influence is being felt.

During the coming year, I hope we can establish a new spirit of cooperation among the actuarial organizations, with a new sense of mutual respect for our separate capabilities.

Our goal in the American Academy is to serve the profession. When problems arise that are interdisciplinary in nature, when we find the need to coordinate our efforts and present a united front to the public, I offer the services of the American Academy both to the individual members and the organizations that make up the profession.

# CONCURRENT SESSION
# THE CONTINUING DILEMMA—PUBLIC STATEMENTS BY THE ACTUARIAL PROFESSION

- New Academy Guidelines for Public Statements
- Need for Public Statements in Today's Environment
- Practical Problems in Developing a Statement - Need for Membership Input and Reflecting Minority Opinion
- Drawbacks and Risks in Public Statements
- Alternatives in the Future

MR. A. NORMAN CROWDER, III: Good morning, ladies and gentlemen. This is Panel E, the Academy session on the "Continuing Dilemma of Public Statements by the Actuarial Profession."

Before we get into this discussion of the guidelines for making public statements, I'd like to introduce my two colleagues: Steve Kellison who is the Executive Director of the American Academy of Actuaries; and Don Grubbs who is with the George B. Buck organization. Both of these gentlemen participated with me on the task force which developed the guidelines that are the topic of our discussion this morning.

Our intent is to do three short presentations of about 10-15 minutes each dealing with three different aspects of this dilemma involving public statements. The balance of the time - about 45 minutes - will be devoted to questions and discussion. We would like your reaction as Members of the American Academy to the whole proposition of public statements by the profession and to the specific guidelines as newly defined.

## Introduction

Our purpose this morning is to discuss the new guidelines for making public statements which were adopted by the Board of Directors of the Academy on December 9, 1981. The guidelines were published in booklet form in May 1981.

I'd like to begin by describing some of the background behind these guidelines and the thinking that went into developing them. I would also like briefly to review some of the key highlights of the guidelines themselves. But, let me first pose the dilemma: How can the Academy speak out (for its Members) on current issues in a timely and effective manner without compromising its professional bearing?

## Background

When our task force was charged with the responsibility for reviewing the process by which the Academy makes public statements, there was basic

agreement that we did not want to impair the effectiveness of the Academy as a spokesman for the actuarial profession to its various publics. Yet, we wanted to insure that the process would gather an orderly and thoughtful concensus of Members' views about the particular issue at hand. The revised Academy purpose states clearly that a basic role of the Academy is to "represent the actuarial profession in areas of public issues and discussions involving actuarial concepts." In fact, the Academy has tended to speak out on issues with a concerted voice. However, this does not mean that all actuaries agree there is only one view of an issue, merely that a significant segment supports a particular position.

At the same time, the Academy wants to encourage input from its Members as broadly as possible and it wants to encourage its Members to speak up as individuals on issues. If the Academy is to carry out its mission, it must continue to make statements about public matters that concern the actuarial profession. Whatever effectiveness has been achieved to date has been partially attributable to the lack of elaborate constraints or procedures in the preparation of public statements. The Task Force felt that procedures should not become so formal or elaborate as to constrain the effectiveness of the Academy to speak on relevant public issues. Nonetheless, it was realized that we must recognize the diversity of views on some subjects in order to evaluate whether or not it is appropriate to present a minority view in a final public statement.

Now let me briefly outline our practices prior to the issuance of the new guidelines. Up until 1982, there had been no formal procedures for the preparation and issuance of public statements. A committee, officer, staff or individual Member could identify the need for an Academy statement. Normally, the appropriate committee would prepare a statement and seek a concensus within its group. There was no formal review or approval required from an officer or the Board of Directors before a statement was issued. Frequently, no review or approval was given. Then, the committee, the committee chairperson, the Vice President or the President would select a person(s) to present the statement and the form for making its public statement. Nonetheless, the committee and the drafters of the statement did attempt to keep all parties informed and did informally seek input. A sensitive issue would often be pushed upward and the Board would occasionally exercise its right to review and amend a proposed statement.

Another problem that a committee often faced, in preparing a response or public statement on a given issue, was the need to develop a statement that was consistent with previously expressed positions of the Academy and something which would meet with the approval of the Academy Board. Hopefully, it would also be representative of the Academy membership in general. Many issues presented were new, while others had been addressed before in one way or another. The Academy had no mechanism to achieve consistency of position on similar issues. Moreover, the timing required of most responses made it impractical to get Board reaction to a proposed statement. While the Academy had managed to live with these handicaps, improvements in the procedures were desirable to achieve greater consistency and concensus. However it should be acknowledged that there is probably no set of procedures which will satisfy all these conflicting objectives. The best that can be expected is some improvement in the present informal system.

Therefore, the new guidelines are intended to codify and extend somewhat the informal procedures that were in place. Our new approach does several things.

First, there is an explicit recognition of the need to solicit the views of Members about issues that will be the subject of a public statement. The selection of committee members is a key means of seeking minority views, i.e., a diversity of Members who will give a broader range of opinions. However, the guidelines try to be realistic about these requirements so that our timeliness and effectiveness are not compromised. Second, most of the initiative for the development and issuance of statements rests with the committee chairpersons. The Task Force felt that it was appropriate to build the guidelines around these individuals, although we still believe that there should be a certain degree of control by appropriate Academy officers. Accordingly, there are procedures for review and approval defined in the guidelines.

The Guidelines Themselves

Now let's look at some of the specific features of the new guidelines for making public statements. First, we define what constitutes a public statement. This may seem a little trite, but in fact, a clean list of categories is not easy. A public statement has been defined to be "a formal, written statement on behalf of some Academy entity to an external group." This does not include a statement representing the views of an individual Member. Three specific categories of public statements are enumerated: a) statements to governmental entities, b) statements to professional and other groups and c) letters to publications. There is some guidance as to the nature of each of these categories. However, as you will hear from Don Grubbs, we have already encountered another area which could be called a "public statement," i.e., public relations activities, which has not been treated within these guidelines.

Second, I'd like to briefly touch on the scope of public statements. The Task Force felt that the actuary's technical expertise encompasses a broader spectrum than is reflected purely by the concerns of the actuarial science. There are numerous instances when the actuary's knowledge, while not the exclusive concern, will be an invaluable addition to the information mix surrounding a given issue. The Task Force believed that it would be a disservice to all parties for the profession to make public statements only in the narrow areas where the actuary's knowledge is unique. Guidance is given that a statement must reflect the dignity and standards of the profession and that it must be a balanced statement of significant facts. However, the guidelines indicate that a statement need not confine itself wholly to statements of fact. They state that it is quite proper for a statement to draw logical inferences from the facts which are presented in a public statement. It would be unfair to limit a public statement purely to factual matters and thereby deny the public the benefit of the full range of the actuarial profession's capabilities. However, the guidelines make it clear that the Academy should not take positions on social and political implications of issues. Moreover, it is pointed out that there are some issues which, although they have actuarial implications, are better dealt with by trade associations, insurance companies or individuals, e.g., plan design matters or other issues where the actuary's knowledge and expertise is not unique. Lastly, there is an admonition that public statements should not be self-serving, but that the Academy should not hesitate to speak out on matters that involve legitimate, professional self-interests.

I will not go into a detailed recitation of the guidelines. They define a procedure which describes the identification of an issue through the development, exposure and presentation of a public statement. The key player in the process is the chairperson of the appropriate committee which has been charged with developing a public position. There is a new procedure for notifying Members through the Academy newsletter (called "Government Relations Watch") that a matter is under consideration for the preparation of a public statement. This is intended to allow Members to have input in the development of a public statement. There is also outlined a procedure where a lack of concensus or strong minority view emerges in preparing a public statement. There are provisions by which the Academy officers or Board of Directors will review, and may in fact override, aspects of a public statement in preparation. Lastly, the committee or group issuing a statement must clearly state who has developed the statement. No blanket sponsorship by the Academy is to be implied.

Although the guidelines are quite deliberate and elaborate, the Task Force (and anyone who has worked on a public statement) is well aware that time pressures can be severe. The intent of the guidelines is to provide maximum Member input and the development of minority views (if appropriate). But, the hard facts are often that these procedures must be collapsed somewhat in order to meet the time demands of an emerging issue. Nonetheless, the Academy Board, in passing these guidelines, believed that provision should be made for additional Member inputs wherever possible.

Closing

That's enough background and overview about the guidelines for making public statements. Now, let's have Steve Kellison describe some of the real world aspects of public statements and the need for them in today's environment. Thereafter, Don Grubbs will tell us about some of the problems and inherent risks in public statements. If we have time, I would then like to outline a long-term (second stage) solution that the Task Force felt might impose a greater rationale and structure on the development of public statements. This long-term procedure was not outlined in the Task Force final report, but was part of our thinking about this need for guidelines for public statements.

MR. STEPHEN G. KELLISON: My name is Stephen G. Kellison and I am the Executive Director of the American Academy of Actuaries. I am pleased to be here today to discuss public statements by the actuarial profession.

I would preface my remarks with the observation that what we are addressing today is the government relations program for the profession rather than our public relations program. The two are distinct.

One important element that I would include, although it is not strictly government relations in the literal sense of the word, our relationship with the accounting profession. We have extensive relationships with the Financial Accounting Standards Board for accounting standards and with the American Institute of Certified Public Accountants for auditing standards, which are quite similar to our government relations program.

Another distinction I would make, by way of background, is the distinction between a professional association and a trade association. As a professional association, we do not engage in many of the activities that trade

associations conduct, such as direct lobbying on political issues, contributions to political campaigns, etc. Rather, we address issues with professional actuarial implications.

Associations in general are becoming much more active with the political process. I have some numbers here which I think will startle you a little.

The American Society of Association Executives, which is the trade association of associations, conducted a survey in 1982 which showed that there are 2,666 associations with Washington, D.C. offices.

The Academy opened its Washington office in 1976. During the period of time during which the Academy has been in Washingtoin, the number of associations with Washington offices has increased over 30 percent.

Now you might ask why are so many groups coming to Washington? Is it because Washington is the geographic center of the country; or the financial center of the country; or the population center of the country; or the media center of the country? Or maybe it's because we have a great climate, sandy beaches, tall mountains. There is probably another reason why so many associations come to Washington. That is because the government is there, and they perceive a need to get involved with government because it is affecting the members of that association. And I guess we're no different. We have a lot of company.

Now, of these 2,666 associations, there are many that are very well known which have members and resources that far surpass ours. There is also a very large number that are considerably smaller than the Academy. We may think we are tiny, but we really are not. There are obviously groups that are much more substantial, but there are many that we would look big along side of, too. There is quite a range in size.

Now the question is: Are all of these various smaller associations, who cannot play the traditional political hardball, just kidding themselves and wasting their time and money? Well, I really do not think so. I think resources in the kind of economy that we have today are far too precious for these organizations to be just frittering money away without any results.

If you look at all of the other professions, you will discover that they engage in exactly the same kind of activity that the Academy is doing for the actuarial profession. I say that virtually without exception. Thus, I would submit that the burden of proof is on those who would say we should not be active in public forums to indicate why we are different from any other profession, rather than the other way around.

Of course, I recognize in saying this that just being a copy-cat is not a sufficient rationale to engage in public-interface activities; maybe all of us are just kidding ourselves. But I will try to give you a more positive rationale than just saying we should do it because everybody else does it.

First of all, I would submit that we do have a unique professional body of knowledge that others do not possess. Moreover, I would suggest that this knowledge is relevant to a number of issues that are being debated in political forums, and that the insight and expertise of actuaries can make a positive contribution to solving real world problems that are being considered in the political arena.

Therefore, I think our participation in this process is in the public interest. In order to contribute to this dialogue, we bring our expertise to bear and hope that the end result is a more positive one on balance for society as a whole.

In fact, I would go even further than that and say that if we do not do this, we are shirking a responsibility that we should be fulfilling.

Secondly, I would suggest that the political arena is a little different from the corporate arena that most of you deal in. It is very much an open marketplace of competing ideas in which ideas are advanced for many reasons, good, bad and otherwise. Decision-makers are continually bombarded with never-ending streams of information from every interest group in the country. They have to sort through this mass of material and try to arrive at what they feel is the best balance of all the conflicting and competing views that they have.

This is not an arena where somehow pure truth just miraculously emerges out of the process. If you have an insight to bring to bear on an issue, you may have to sell that truth. This is an arena where truth may have to be sold rather than being sought out. And if we do not speak up, there will be others who will be happy to fill this vacuum.

Thirdly, I think Norm has mentioned that we do have a legitimate self-interest as a profession. I hate to use self-serving arguments, but I think it is important to recognize that actuarial science is a very small profession. We have no guarantee of being a vital, vibrant profession into the twenty-first century. We have no guaranteed role, no licensing that protects us in quite the same way other professions do. We could be essentially drummed out of business by the course of events. We continue to have battles with the accounting profession over who is on whose turf. We have many economists and other types of operations researchers who are doing work that many of us would consider to be actuarial in nature. I could go on.

But the point is that we have no guarantee as a profession of a future existence with which we will feel comfortable. And I think we do have many illustrations of how, when actuarial principles are not properly followed, insurance and benefit programs get into trouble. The multiple employer trusts, which are so much in the news these days, are a good example of where the actuarial role is not properly recognized and such lack of recog-

nition is causing major problems. Had the actuarial role been more properly recognized in a regulatory sense earlier, many of these multiple employer trusts might not now be failing.

So that is the rationale that I have for why it is inevitable that the profession must have a strong government relations program. Now the question obviously comes up, is it effective or can it be made effective?

That is a very difficult question to answer because the only way would be to relive the past under a different scenario and see how it would have worked out if you had not done what you actually did. And, since you cannot do that, and since most issues that are resolved in the political arena have many other factors impinging on them (other than just actuarial matters), many times issues get decided for reasons which are somewhat extraneous to our concerns. So, it is tough to answer that question. Obviously, we could always wish for more effectiveness. But I would be happy to submit an unqualified "yes," that it is effective; it could be more effective. We continue to try to work to make it more effective. But I think our government relations program is successful today and I think it will become more successful in the future.

Along these same lines, I think it is important to point out that, although actuaries as individuals can get involved in the political process on some of these problems, there are many situations in which an organization can be much more effective than any one individual could possibly be, regardless of how meritorious the input of that individual.

I think human nature being what it is, it is inevitable that many decisionmakers will give more weight to the input received from a collective group, from an organization, than they would from the input of any one individual. Let me cite some examples from the actuarial profession which I think help illustrate this statement. I will run through these very briefly.

The Universal Coverage study, which a group did under the auspices of the Academy and the Actuarial Education and Research Fund, provided a major actuarial study on a pressing problem which just would not have been done by one sole independent researcher or firm. It would not have had the same effect that a collective approach has.

Pension terminology is another area in which we have been very active in trying to bring a rational set of terms out of the morass that exists today. It has to be a collective effort. I think any individual effort is doomed to failure, because we have several instances in the past in which individual authors tried to rewrite the dictionary. Inevitably they fail. I am not certain that what we have done now will succeed, but at least it has a chance because it has the profession behind it as compared to just an individual.

Consider FASB 35. Here we have a document that many actuaries may not like. But, look at what the alternative would have been. It became apparent early on that FASB was going to promulgate rules in which actuarial liabilities appeared on the balance sheet of plan's financial statements. That became a given. We tried to talk them out of it but they indicated clearly that they intended to proceed. Now, you have an option to either try to stonewall it and just let the chips fall out where they will, or you have the option of trying to work with them to produce the best possible document under the circumstances. And, as a result of significant deliberations, there was

an agreeable consensus arrived at between the U.S. Department of Labor, the FASB and the Academy. Not everybody was totally happy with it, but at least collectively all three felt it was something that they could live with.

But, this effort had to be done via a professional association like the Academy. I think you would find it rather silly to conjure up a situation where it was the joint product of FASB, the U.S. Department of Labor and three actuaries, John Jones, Steve Smith and Ron Williams. I think that would be sort of laughable when you think about it.

Another example is a bill that ultimately was incorporated into the TEFRA legislation which just passed the Congress. It was called the Rangel bill, a very controversial bill that had a public hearing in May and June. There was so much interest in that bill that there were 75 groups which requested an opportunity to testify on the bill. The Academy was given one of the slots to testify. Numerous consulting actuarial firms were very interested in testifying on that bill. None of them were given slots. Why? Well, because the Congressional staff gave priority to organizations as opposed to individuals.

My final example is risk classification. Many of you have read in the Academy newsletter of the cost study on the proposed unisex legislation which we delivered to Congress. This involved pulling together project teams from all of the various areas affected: life insurance, health insurance, pensions, automobile insurance. These are the various areas where sex is currently recognized in the pricing.

Pulling together the collective effort of these project teams would have been extremely difficult to achieve under a situation where there was not an organization in place.

When I first came to Washington in 1976, we spent a lot of time going around town introducing ourselves to people so that they would become aware of the Academy. I think one measure of how effective the Academy has become is the fact that sometimes now we actually get the calls instead of the other way around; we actually hear from others before we call them. It does not happen all the time, but it is a refreshing change when it does.

Let me give you one recent example that illustrates this point. Congressman Frenzel from Minnesota has developed a bill to allow tax deductibility for self-insurance reserves in the property-liability area. He recognized that, as part of this proposal, some type of actuarial certification of those reserves would be required, and that he would have to address the issue of the qualifications of the actuary. It is H.R. 6114, by the way, for any of those of you who want to delve into this issue.

The drafters of the bill had a provision in the bill about the actuarial certification and the qualifications of the actuary, but they were not happy with it. So they sought us out and asked for comments on it because they felt that they needed the input of the actuarial profession.

I found that kind of refreshing, that for once they called us instead of the other way around.

Now I would like to talk about the openness of the Academy. One of the criticisms that we hear a lot is that somehow we are a closed group that does not really welcome input or give the membership an opportunity to participate and get involved in the process. If that criticism were ever valid, I would submit to you that it is a commentary on the Academy of several years ago and not the Academy of today.

Norm has already mentioned the guidelines which are the main topic on this particular panel, so I will not go back into that again. But I would like to cite some other examples.

He mentioned the Government Relations Watch, which made its inaugural appearance in the September issue of the newsletter. This is our attempt to follow through on one of the points that was in this panel earlier, i.e., to keep the membership apprised of current activity on pending issues.

Another document that we put out is the Issues Digest which was sent to the membership. This originally was designed for a VIP government relations luncheon which we held in Washington in March. The Executive Committee decided that this Digest had useful information in it that would be of interest and benefit to the membership as a whole. So, we decided to print additional copies and send them to all members.

Letters to the Editor --- within the last two months the Academy has opened up its newsletter to direct letters from members.

All of our public statements are available on request from the Washington office, and notices are run in every issue of the newsletter so that you can see exactly what statements are in progress, what we have done and get a copy of any statements. At the end of the year all of the statements are put into the permanent records of the Academy via the Journal.

Finally, another area that I think cannot be overlooked is the staffing of committees. In the final analysis much of what the Academy can do in the public interface activity depends upon the activity of your committees. So it is very important in staffing committees to get a broad cross section of people on the committees that represent a variety of interests and views. We work very hard to do just that. We obviously may not succeed to everyone's satisfaction, but this is very carefully considered whenever committees are staffed.

Just to give you some examples. Don Grubbs, who is on this program and is quite critical of many of the things I am saying today, has been chairman of the ERISA subcommittee of the Pension Committee for several years. It is probably the most significant subcommittee in the pension area.

We worked very hard on our Risk Classification Committee to be sure that people are put on that committee who do not necessarily represent the economic interests of the insurance industry.

Another example is our Dividend Principles and Practices Committee, which recently released its Recommendations and Interpretations. One individual was critical of the material the committee was developing. He was added to the committee. Ultimately, his views and those of other members of the committee were resolved, satisfying both parties and leading to a better final document.

So, we do not attempt to squelch diversity and differences of opinion. We encourage it on our committees. We also encourage actuaries to speak as individuals. Our efforts in presenting the Academy's views on issues is in no way an attempt to inhibit or discourage actuaries from also speaking out as individuals.

In looking at all these various actions, we have tried to open up the process. Compared with other professions, I can assure you that we stand head and shoulders above all others in the level of communication that we have with our members on these public issues. The extent to which we communicate with the membership surpasses anything that you see in the accounting profession, the legal profession, or any of the others, in a direct attempt to get membership involvement in the process.

In closing, if you have concerns about what the Academy is doing in the public interface area, I'd like to ask you to run an experiment. Go take one of the Academy's Journals -- take the most recent one or take them all if you really have a lot of time for this -- and read it. Read one year's worth of public statements from top to bottom, read the whole thing. And when you get done reading it, I would like to have you ask yourself two questions: First, although I might quibble with bits and pieces here and there, what is my comfort level with the whole effort, with the document taken as a whole? And the second question is: Do I think that the entire effort advanced our collective interests as a profession, recognizing that the alternative would have been a vacuum often either unfilled or filled by those less qualified?

If you are willing to run this experiment, I think you will discover, first, a very high level of comfort overall, although we cannot obviously satisfy 100 percent of the membership on every issue; and, secondly, that our legitimate professional actuarial interests have been advanced in the process.

I think you will also discover that the overwhelming majority of that material addresses issues like actuarial accreditation, items directly affecting the actuaries' work product, actuarial components of major issues, and that precious little of it could be characterized as controversial political opinions on social issues.

MR. DONALD S. GRUBBS: The new guidelines for making public statements for the Academy attempts to enable the Academy to develop public statements that clearly represent the views of members. It was a good faith effort. And it is better than no guidelines at all. But the problems are so formidable that only very limited success is possible.

The first problem is the virtual impossibility of finding out what Academy members themselves believe about the issues. Ideally the Academy should inform all members of what issues it is going to address, inform them of all the positions taken on the issue by various individuals and groups, the facts and arguments supporting and opposing the various positions; and then it would give them a ballot with self-addressed envelopes to get responses and weigh them.

It is no criticism of the Academy to recognize that ordinarily there is just not sufficient time and often not sufficient resources to carry on that kind

of a process. Therefore, if the Academy is going to express any opinion at all, it must be done in ignorance of what its members think. Thus there are apt to be misrepresentations of the views of members. The Academy endeavors to solve this by the use of committees of individuals from varied backgrounds, but actual experience shows this has only limited success.

The second problem is that of minority opinions. One of the great things about our profession is that it develops independent thinking. As a result there are few issues about which actuaries agree. What does the Academy do about this? The honest thing to do in public statements that purport to represent the Academy's view is to acknowledge that part of the members support a view and part oppose it, with an indication of the proportion supporting each side in those rare instances where the members have been polled. While the Guidelines allow the committee involved to consider opinions of members who are not part of the committee, there is no requirement that it reflect their views in any way in its statement. If no consensus is reached among committee members themselves, the Guidelines state, "The chairman should consider either preparing a statement which includes the views of any substantial minority or electing not to issue a public statement." But these alternatives of reflecting minority views are only elective, and in fact are seldom if ever used. Time after time we see Academy positions published without even a hint that a minority opinion exists.

Another problem of public statements is that they almost always reflect the business interests of employers and clients of the actuaries, rather than independent scientific judgements. A recent example is Academy comments on "Individual Health Insurance Rate Filing Guidelines." At issue was the question of what expected loss ratios should be required under individual accident and health policies. The Academy stated that for disability income policies, acceptable loss ratios should be 45% for non-cancellable policies and 50% for guaranteed renewable policies, i.e., policies under which the company reserves the right to increase premiums. It further stated that these 50% and 45% loss ratios should be even lower for small policies. As an actuary who has prepared many such filings for small insurers, I can understand my insurance company clients supporting the Academy positions. But I cannot understand an alleged professional organization with an obligation to the public endorsing policies under which less than half of the premium is used to provide benefits.

Another problem is the tendency of actuaries to measure costs but ignore the measurement of benefits. The Guidelines try to prevent this with these words: "Statements should contain a balanced presentation of the significant facts, including benefits and costs, in a clear, concise manner." But the Academy's statement to the Senate Committee on Commerce, Science and Transportation on July 15, 1982 clearly failed to do so. The Fair Insurance Practices Act (S.2204) would have required certain health insurance policies to include maternity benefits. The Academy's presentation presented estimates of the increases in premiums both as a percentage and as a total dollar amount for all policies. It states that the legislation would have "four areas of major potential impact" and then listed four cost factors. There was no indication that the additional benefits provided would have any effect whatsoever. There was no attempt to measure, or even refer to, the increase in benefits. Wouldn't any balanced presentation have given equal attention to the increases in benefits and the increases in costs?

There is a remarkable correlation between positions of the Academy and positions of the ACLI. Let's face it. The American Academy of Actuaries is a mouthpiece for the insurance industry and for other employers of actuaries.

This brings us to the next problem with the Academy's public statements. While we would like to be portrayed as a profession that searches for the truth objectively, the Academy tarnishes our image. On Capitol Hill the Academy is regarded as just one more business lobby whose primary concern is the profits of the employers and clients of actuaries, with a public-be-damned attitude. The effect upon the receivers of our statements is to lower, not raise, their esteem for actuaries.

Another problem of public statements is their effect upon some of the members. Those members who actually bother to read the statements are often upset by them. I am not bothered when hundreds of organizations of which I am not a part make statements I disagree with. But I am bothered when an alleged professional organization of which we are a part misrepresents us, fails to represent us, and makes misleading public statements.

Another problem is the combination of political action and accreditation in the same organization. The Academy is a lobbying organization. It presents testimony to Congressional committees to present its opinions on pending legislation. But the Academy was formed for the purpose of dealing with accreditation. Membership in the Academy has achieved a presumption of competence in certain required filings with state insurance departments and some federal agencies. For example, an Academy member is presumed to be competent to sign an annual statement with a state insurance department, but any other actuary must convince the insurance department of each state that he is competent, even if he is a Fellow of the Society of Actuaries with long years of life insurance experience. To be sure, the FSA I referred to will be able to persuade the insurance commissioners that he is really competent, but if he works for a company or consults for companies that are expanding into more states, he may be forced to go through this time-consuming process 50 times. Therefore he is coerced to be a member of the Academy, even if he is philosophically and morally opposed to the political positions it is using his dues to support.

One way to solve this problem is for the Academy to stop expressing opinions that don't represent its members. Because there is little chance that this solution will be adopted, some of us are trying to broaden the basis of accreditation. We believe that a Fellow of the Society of Actuaries should be given the same presumption of competence as a member of the Academy. The Society's Board of Governors will consider this question this month. This would end the coercion of actuaries to be members of a political lobbying organization whose objectives they oppose. On the face of it, it is absurd that a member of the Academy is presumed competent to sign annual statements while a Fellow of the Society is not.

There is no need for the Academy to make public statements. Individual actuaries frequently make public statements. Such individual statements have often been made before Congressional committees and regulatory bodies. They have often appeared in daily newspapers, Sunday supplements and trade journals, as well as on television. Statements by individual actuaries are adequate to fill the public's need for actuarial input.

An actuarial statement carries weight only to the extent it contains good ideas that are well expressed. Unlike major business and labor organizations, the actuaries have no political clout. No politician trembles at the thought of losing the actuarial vote. For this reason, a statement from the Academy carries no more weight than a statement by an individual actuary.

Even worse than the formal public statements of the Academy have been statements of a more informal nature. The Academy recently distributed a series of articles on Social Security and pension issues to over 3,000 American newspapers. This is probably the widest distribution of public statements ever made by the Academy.

What did these articles advocate?

1. Cut back full CPI-indexing under Social Security.

2. Provide inter-fund borrowing for Social Security.

3. Raise the retirement age under Social Security from 65 to 68 between 1990 and 2000.

4. Increase IRA limits.

5. Permit tax deferral of mandatory employee contributions in pension plans.

Every one of these five positions is a position with advantages and disadvantages. Each one is an issue about which Academy members have sharp differences of opinion, but the articles do not even hint that alternative views exist.

The proposal to cut back cost-of-living adjustments is particularly troublesome. It is improper to refer to CPI adjustments as "increases;" in real dollars these are the adjustments needed to stay level. Adjustments of less than the full CPI means a reduction in the standard of living of retirees. Retirees are the ones least able to afford any reduction in their standard of living. The average Social Security recipient over 65 has only about half as much income as the average worker under 65. For decades active workers received wage increases greater than the CPI resulting from growth in productivity, while the retirees had no share in the productivity gains and the rising standard of living. After a couple of years when wages increased less than the CPI, some want to switch retirees to the currently lower wage-indexed basis, but they give no thought to retroactive wage-indexed adjustments for the many years that retirees lagged behind active workers. They want the retiree to have the worst of both worlds. And for the retiree who receives part of his income from a private pension that does not rise with the CPI, even full CPI indexing under Social Security will not enable the retiree to maintain his standard of living.

My religion is one that calls me to be concerned about those in poverty. To me the proposal to cut back Social Security benefits is essentially immoral. I respect the right of others to hold and express views that are different from mine. But I strongly oppose the Academy expressing views on my behalf that are categorically opposed to my most fundamental beliefs.

This session is entitled "The Continuing Dilemma-Public Statements by the Actuarial Profession." For some of us the dilemma is whether to continue our membership in a political lobbying organization that opposes our fundamental beliefs, or to drop out in frustration.

MR. CROWDER: I think maybe it's appropriate for me to get between these two people. It's at my own hazard.

At this point, rather than our having a gentlemanly discussion about some very good points that have been made on both sides of a lot of issues, I think it's more appropriate to get your comments about what has been said or to say whatever you want about the whole issue of public statements.

The usual format when you want to speak is: go to the microphone, identify yourself and your business affiliation so that when we transcribe your comments into written form we can call you if we don't understand the transcript.

By the way, it doesn't have to be a question for one of us; it may be a statement that you would like to make. But please identify your intent so that we know whether one of us will need to respond.

MR. CONRAD SIEGEL: Connie Siegel, Conrad Siegel Incorporated, Harrisburg.

I guess this is probably a statement, but I would welcome any comments.

The guidelines refer to statements being made by the Board, by an officer, by committee, not individual views, refers to balance in presentation, presentations that are not outside the mainstream of knowledge and not have social and political implications. They provide for notice of preparation in advance to the membership, and that the presentation give a clear indication of the sponsorship.

Recently the Academy filed an amicus curiae brief called Arizona versus Norris, or perhaps Son of Manhart. The brief itself states that it is a brief by the Academy, not by the Board or by a committee. Only the internal cover memorandum indicates that the preparation was by our own inside counsel, our outside law firm and the Committee on Risk Classification.

The brief itself identifies the interests and skills of the actuary in pension matters. This is essentially an employee benefit matter which impacts on the pricing of insurance products.

I find it significant because I regard this case as an employee benefit matter under the Equal Pay rules, but the Risk Classification Committee, and not the Pension Committee, is involved with the statement. My concern is over well-intentioned influence of the insurance company actuaries and insurance consulting actuaries on the Risk Classification Committee.

The brief itself tells the Court that it should consider the case because the lower court decision is a bad one, and if the lower court decision is allowed to stand, all kinds of bad things will occur to the insurance industry. It is a one-sided brief. I cannot recall the general membership being given any opportunity to comment on the preparation of this brief.

I am sure most of the people here are not even aware or have not read the brief, although I think it is only the second or third amicus brief that has been filed by the Academy.

The Issues Digest also finds that the EEOC and Manhart issues are Risk Classification Committee matters rather than Pension Committee matters.

One of the interesting things in the Issues Digest is a title "Academy Recommendations," a study conducted by the Academy Risk Classification Committee at the request of a Congressional subcommittee has analyzed the cost differential of providing a group of 100,000 males and a group of 100,000 females a $10,000 annuity for life starting at age 65. The study found that the cost to fund the female group exceeded the cost of the male group by $41 million.

Now, I do not see how that is a recommendation. It might be a finding, it might be a single finding in a very, very complex issue of sex discrimination in employment. But I do not think it is a recommendation. Yet it is labeled as a recommendation.

Now the question that Norm brought up about benefit design, i.e., the Social Security recommendation to raise the retirement age from 65 to 68, to me, that is a benefit design matter. That is shown as an Academy recommendation. I find that not to be a purely actuarial matter.

Our 1981 statements, when read together -- and, Steve, I did do what you said.

MR. KELLISON: Good.

MR. SIEGEL: I read the entire 1981 statements.

MR. KELLISON: Excellent.

MR. SIEGEL: They're bizarre.

The chairman of the Committee on Social Insurance gives his personal feelings. He identifies them as his personal feelings. "These are my personal feelings on financing, these are my personal feelings on actuarial assumptions." But he does so as chairman of the Academy Committee on Social Insurance.

Then one of our committees commenting on self-insured medical malpractice takes a shot at Social Security because it is not fully funded for accrued benefits. I find that quite interesting.

Now let's see what has happened after the issuance of these guidelines. And I am just talking of the last three or four months.

In Statement 1982-12, the statement appears to be made by Steve Kellison on behalf of the Academy. There is no mention of a committee being involved. This is on a subject of relations of actuaries and accountants. The same thing is true of 1982-13 on crop insurance.

In 1982-14 is a statement by Pres Bassett on pension funding problems; no indication of a committee, simply on behalf of the Academy.

1982-19 is a statement by Steve on Joint Board examinations; no indication of a committee involvement.

Now, many of the statements that have come out since May are identified properly by committees and are identified as being prepared by the committees. I have not seen a minority opinion as yet. I would think that, in view of the fact that some of the original seven people who were opposed to the Manhart filing are still around and have not dropped out of the Academy, minority views on the subject of sex discrimination exist and have existed since 1976. Yet, these minority views have apparently not been sought out for input into these risk classification and sex discrimination filings.

And as a member, I am personally embarrassed with the quality of the Academy statements. The work is done very quickly. I realize it is in a rush, but I would sometimes wish that we could attain better quality.

We have a certain degree of credibility as technicians. If we take partisan positions favored by our employers, our clients, our insurance industry, then we lose that credibility and we serve no purpose.

MR. KELLISON: I would like to address a couple of things there, if I could. As Connie covered a lot of ground, it is hard to know where to start.

Let's take the Norris case, though, for just a second. You did spend quite a bit of time on that, so I think that is worth discussing in a couple of respects.

First of all, in terms of the sponsorship of the brief, the question as to whether it was done on behalf of the Academy as a whole or some subset of the Academy was not ignored. That question was raised by the attorneys who were involved in the development of it, and they posed that as a very significant aspect of that brief. It was sent to the Academy's Executive Committee where a decision was made to file the brief in the name of the Academy.

Now we can quarrel about whether the Executive Committee should have done that or not. But I do want to point out that the issue was faced, addressed and decided on its merits.

It is also important, I think, to note in this case that this was a brief designed to encourage the court to grant a writ of certiorari, which means that they would hear the full case.

The Norris case involves issues not addressed by the Court in Manhart. The Court may well force unisex annuity options. I'm not disputing that. The Supreme Court has every power to do that. But they did not, in fact, decide that with Manhart. They specifically wrote a very narrow opinion that leaves many unresolved issues.

The lower courts were writing sweeping opinions that sounded like all the issues had been resolved; these cases almost ought to be summary judgments, practically, when in fact, the Supreme Court bent over backwards to write a narrow opinion in the first place and leave a lot of territory untouched.

So I think that the lower court decisions may or may not stand up ultimately. But the issue is that some of the reasoning in the lower court decisions was pretty shabby. And I think it was that point, not that the decision itself was right or wrong, that we were concerned about.

MR. SIEGEL: Excuse me. Can I just interrupt? I agree what you have said is absolutely true. The reasoning given cites the quality of the reasoning in the lower court decision. But you do make these statements. "The decision below, however, if allowed to stand will almost surely apply to an even more important class of retirement plans, namely, defined contribution, pension and profit sharing plans. It is also very likely to affect that structure of a still broader type of retirement plan, namely defined benefit pension plans." Reading further, "if the decision is allowed to stand, those employers are likely to refrain from providing benefits in the form of annuity payments that would last for the lifetime of their employees." Reading further, "if the decision below stands, many hundreds of thousands, perhaps millions, of employees may well enjoy less attractive benefits."

So this is far more than simply saying it is bad reasoning; it is saying these are the consequences of what happens. Now this is what is not balanced.

MR. GRUBBS: Let me say a word about that. I agree with Connie -- it certainly did address issues. It was not merely addressing the question of whether they should hear the case.

I chaired the task force that was involved with developing the Manhart brief, which were treacherous shoals to navigate. I was not happy with the task force results at the time. I thought that one of the most serious problems was that the counsel who had been selected were not counsel with broad experience in pensions. They were counsel who have extensive experience in serving the life insurance industry.

And their background had affected how the brief came out. They were not merely taking the viewpoints developed by the task force members and trying to put them into proper legal framework to make sure that we were legally correct, but they were inserting viewpoints from a particular bias. And that has certainly happened in the Norris brief.

MR. CROWDER: In the interest of time, we would like to gain comments from others.

MR. BARNET N. BERIN: Bob Berin, William M. Mercer Inc., New York. I would like to make a general statement about these public utterances.

I think that Academy positions taken, which are not actually followed by the profession, demean all of us within the profession. I am not going to point to any particular statement, but I think we are all harmed by having statements that most actuaries do not agree with.

And so I have a positive suggestion that would apply to the Academy, the Conference, the Society, and actuaries' clubs. Rarely, if ever, is there a current, immediate need to get a statement out in a week or a day. Usually, there is ample time to distribute it to the total membership. There

is ample time to ask for a 30-day response: do you approve, do you disapprove, no comment. When the statement then goes out, I suggest adding a footnote that says, "There are (blank) members of this organization, (blank) members responded to the request for an opinion. Of those who had an opinion, (x) percent support this statement."

I think that would go a long way to solve many problems. For example, if very few members respond to a statement, there has to be a reason for this kind of disinterest and it acts to water down the statement sufficiently. If a lot of members respond and it is a borderline case, I think that public is entitled to know that.

It is a simple proposal and most people I guess tend to distrust simple proposals. It might look like it is complex, but I think democracy belongs in all of these organizations. And, we suffer because we don't have much of it.

MR. CROWDER: I have a question for you. Suppose as we sometimes have on exposure drafts, nine responses, three of which are in favor. It may be not worth making a statement if we take that sample as substantiation of our members' interest in the position.

MR. BERIN: But, I think that is exactly the right conclusion. I think there is an education job here, too. Once you get onto this kind of procedure, membership interest is bound to pick up. But, I would not be embarrassed by a very low turnout. I would think about withdrawing the statement.

MR. CROWDER: Thank you.

MR. HERBERT S. WOLF: Herb Wolf, Wolfman & Moscovitch, Chicago. In looking at this entire topic, I think that we have to also address ourselves to the actuarial profession as a whole. It is a small profession. It is a multi-discipline profession. And we also have to look at the educational system.

The educational process is a long, drawn-out, multi-examination system. And, further, it is a profession that, except in the area of pensions with the enrolled actuary, does not have a state or federal licensing system.

As a result, we have the Academy which is set up as the accreditation organization for actuaries. If I were given a choice between having an organization that is an umbrella for accreditation, given all these circumstances, or an organization which will make statements for the profession, I would certainly take the first choice rather than the second.

We have gone through the exercise with enrolled actuaries of having essentially two organizations today, ASPA and the Academy, recognized as accrediting organizations. I think that it is more important for the profession to speak in a unified manner on accreditation than on other topics.

I think that this is the direction that we should go. However, I am not too sure that the two necessarily have to be mutually exclusive.

I am on the Academy Life Insurance Committee. That committee so far has not made a public statement because, among other things, the committee is very concerned with this very topic. It has yet to come up with something that it feels is a purely professional issue and not an issue that also has political overtones.

I disagree with that sense once in awhile. I think there are issues. You are never going to get completely away from the political overtones. However, that notwithstanding, I think that we have to weigh the substantial professional issue versus the more insubstantial political overtone. I think we have to find the happy medium, but we have to give accreditation today, because of the profession, the major emphasis.

MR. CROWDER: Right. You are underlining the conflict that Don Grubbs sees also.

MS. LOTTIE LISLE: Lottie Lisle, U.S. General Accounting Office, Washington, D.C. I'm not speaking for my organization; I'm speaking for myself.

In all the years I have belonged to the Academy, I did not think the day would ever come when I would stand up and defend the Academy. But, in this particular case, I feel compelled to do so.

My main criticism of the Academy in the past has been that they have been too slow and too little in addressing important issues. I am very pleased at the trend that the Academy has taken in recent years, i.e., that they have come out with statements.

And even though Don Grubbs and Connie Siegel are very eloquent, I personally believe that the statements of the Academy on issues such as Social Security or the Manhart case do represent the majority view of the actuarial profession. And I hope the Academy will continue to take prompt action and to show the views of the actuarial profession.

MR. DOUGLAS C. BORTON: Douglas Borton, G.B. Buck Consulting Actuaries, New York. Having been involved in the preparation of a number of statements in the pension area, I must admit that my point of view is much closer to Steve Kellison's than my colleague, Don Grubbs. However, I always have a high degree of confidence in the things that Don says.

I think that the points that Steve Kellison made are very important. If we look back and recognize the very limited exposure and acceptance which the general public had of actuaries in the past, I believe that the Academy has come a very long way in a relatively short time. It is making the general public and the people in the political arena aware of the actuarial profession.

No group is perfect. I would not say that the Academy is perfect. Nobody would suggest that. But, I do feel that we have accomplished a great deal, both in the area of recognition and professional standards, and also in making the views of the profession known.

Obviously no organization speaks entirely for its membership. We all have different shades of view on different issues, sort of a bell-shaped curve. And I personally feel very comfortable with the statements which the Academy

has made. I think that we have expressed the view of the majority of the members of the profession in making these statements.

This does not mean that there are some people who don't disagree. There are also people who would say things differently. But, I think that this is true in many other situations. When the American Medical Association comes out on an issue, I don't think that anybody is naive enough to believe that all doctors in the United States agree completely with what is said. I think that there is an acceptance that this is the thoughts and preferences of the majority of the people that they are speaking for.

A question was raised by a previous speaker about the possibility of sounding out the members of the profession on different issues before a comment is made. Unfortunately, the time bind is usually very tight. Two months may sound like a lot of time, but by the time you get the group together that is preparing the statement and put something down on paper, several weeks go by. And at that point, in order to canvass the members of the Academy for their views, would certainly (in most cases) delay the preparation or the presentation of the material beyond the point where it would be of any value.

I also think a point raised by Norm Crowder is very valid. You will find various degrees of support and opposition to any statement which was going out. Last year the Pension Committee tried to get together a laundry list of issues that might come up during the year. Unfortunately, people -- and we're dealing with volunteers when we're dealing with committee members -- find it difficult to approach these problems on their own time until there actually is a need to meet a specific issue.

So, while it would be very desirable and nice to have a laundry list of the different issues which might come before the Academy (and members' reactions thereto), I think it is impractical.

I personally do not find anything offensive in the material which Connie Siegel read on the Norris brief.

So in summary, I think that I am very supportive of the efforts that have been done by the Academy in the pension area where I am most deeply involved. I cannot speak as well for the other areas. And I feel that some improvements could be made, but the new guidelines are better than to do nothing.

MR. CROWDER: Would anyone else like to add comments?

One thought that I will carry away with me is that the need to react rapidly, if it is a valid one, and to make our point of view known in the regulatory or legislative arena, should be no excuse for a compromise of the quality of what we have to say. And we should, as much as possible, take into account all the professional issues involved, both pro and con.

Expediency can be an excuse. But I believe we must guard against that. And the comments which Don Grubbs raised, which are all extremely thoughtful, are definitely cautions that we should have.

My other observation:

I am relatively new to the Academy and some of these kinds of activities. I think the Academy itself is new to this arena of public statements, and

we have got a lot to learn. We have come a long way, thanks to Steve Kellison and his staff, others who have also volunteered their time. We may never be politically effective, in the sense of many other lobbying organizations or associations in Washington. But, most of us would not want to be that politically effective. We have to find a degree of compromise. And compromise always leaves room for dissatisfaction on both ends of the bell curve, if not in the middle also.

Would either of you like to make any further comments?

MR. KELLISON: One point Don Grubbs made which deserves some thoughtful commentary. He sees a conflict, if you like, between the accreditation function of the Academy and the public interface function of the Academy. I think that is a point of view that has some merit.

I would harken back to Winston Churchill's assessment of democracy: it's probably a pretty lousy system, it's just better than anything else that anybody has come up with yet. The resources of the actuarial profession are such that to try to separate the accreditation function and the public interface function, both of which I believe are quite necessary and desirable, would spread us too thin. I think that it may not be practical to do both with two separate, independent structures.

And I think the Academy is the only organization in a position to represent the actuarial profession because it is the only organization that includes actuaries in all the various areas of specialization. So, there may be no better alternative.

I would also point out that this particular situation is not unique to the American Academy of Actuaries in the United States. The Canadian Institute of Actuaries operates very much the same way as does the British Institute of Actuaries. So, although I see the logic in what Don Grubbs says, I just don't come back with an alternative that is any better than the one that we have.

MR. GRUBBS: Well, let me just comment on that point. The alternative I suggest is that we broaden accreditation so that the actuary would not be coerced to be a member of this political organization, the Academy, but his Fellowship in the Society and perhaps other criteria could be developed with the same presumption of competence.

And I would hope that the Society, which is also a democratic organization that needs to reflect the viewpoints of its members, will involve the membership in responding to that question which is now before the Board of Governors.

MR. KELLISON: Well, I think in the long run the only real solution to this problem is some kind of licensing law. In other words, the reason that this problem comes up for actuaries and does not come up for other groups is because the other professions have licensing. The reason it does not come up for the American Bar Association is because you get your right to practice as a lawyer some other way. The reason it does not come up for the American Medical Association is because you get your license to practice some other way. This problem would vanish overnight if there were some licensing mechanism for actuaries, but that is just not on the short-term horizon. I think that is the real problem.

The other thing I wanted to mention is that written statements and oral statements are not really quite the same thing in many respects. Some comments here today were critical of those who have expressed a personal view. In general, if you will examine these situations, you will discover that invariably they were oral statements and not written statements. And when you get into an actual testimony, it is very inhibiting for the person and for the organization if you refuse to discuss a matter merely because it is a bit beyond the scope of the written statement.

So, all Academy witnesses are presumed to have the judgment necessary to operate in that dynamic, verbal environment. So, if the need should arise for them to express a personal view in order to be responsive to a question, they are empowered to do so.

Don Grubbs knows this from personal experience. He testified on the vesting regulations of the Internal Revenue Service, one of the best pieces of testimony ever done for the Academy. In the question-and-answer session, he was asked to express his views on many issues, which he did.

If you look at the case of Jim Swenson last year on Social Security statement, that is the same situation. These instances come up because of the give-and-take that occurs when the witness is in a hearing situation.

Maybe we ought to edit the formal Academy statements and shorten them and delete personal opinion. I do not know what the practicalities of doing that are because sometimes it is integrated into the whole statement. There may be another way of solving this problem so that it did not show up in the written copies that appeared. But that would be a significant editorial job.

Another point, the position statements where Connie Siegel said I personally represented the Academy in the case of the relationship between actuaries and accountants and the crop insurance, were intended to be positions that had previously been espoused by an Academy committee in prior years. If you search back through prior statements, you will discover that I was reiterating material that had been put forward before.

MR. WILLIAM A. HALVORSON: Bill Halvorson, current president of the American Academy of Actuaries. I just wanted to make one comment about the future. I think we are more concerned about how we can prepare and present public statements in the most responsive way. I recall that the task force which developed these guidelines for public statements was quite concerned about ways to get the members involved in these public issues. For this reason, the Board wants each public interface committee to identify issues in advance. We have asked the Health Insurance Committee, the Property and Liability Committee, and the Life Insurance Committee to do this in order to let our members know what issues they see coming up over the next year, and to identify areas where the Academy may need to make public statements.

In the case of the Pension Committee, they actually did write an article for the Academy newsletter which identified the issues that they thought they would be dealing with over the coming year. They asked members who had any ideas on these issues to write to the Pension Committee in order to give their views.

Academy members must do that if they are going to be critical later. They should comment in advance. When the time for a statement comes, we do not

always have time to go back and deliver it to all members. That has been the time realities of most of our statements.

A hearing comes up on the tax bill this year. From the time that bill was developed or we heard about it, until it was practically signed, sealed and delivered, was probably 60 days at the most. And the testimony occurred within two or three weeks. There was hardly time to prepare our own statement.

I also believe that the new Issues Digest is going to be very important for the future as a means to let our members and the public know where we stand and what we are presenting. This is an opportunity. It has already generated a great deal of interest on the part of our public, and also of our members who did not realize that we were taking certain positions. The Issues Digest is a chance for all to see what those positions are. If they do not agree, then certainly they should let us know. We will put them in touch with the appropriate chairman. But that is the only way we can operate, and we try to operate as democratically as possible. Thank you.

MR. CROWDER: We are a little over our time. Let me follow up one point. The task force had one idea which did not emerge in its final report, but it is worth mentioning. We felt that a long-term solution would be to have the various committees involved develop positions on various issues, identify them in advance, even if they are not in the public arena, and develop a policy statement on each of these major issues. These positions would be submitted to the members and to the Board for approval. These position papers would be a framework of policy statements that could then be used as a frame of reference as specific matters arose. For example, we might say we are in favor of Social Security. Then when a specific issue comes up, that committee would then have a framework of guidance in preparing its statements.

That is ideal and obviously things will come up which have not been anticipated. Also, we were aware of the tremendous amount of work that this approach would involve. However, the Academy and its founding organizations have taken positions on various matters which can be a start to building this framework.

I thank you very much for coming to this session. There has been a lot of thoughtful input. Public statements, and the process of developing them, is an area where we continually need to improve. And as the new President-Elect, you have given me food for thought about the Academy and its public interface activities. Thank you.

# CONCURRENT SESSION
# ACTUARIES, ACCOUNTANTS AND AUDITORS—WHAT ARE THE RELATIONSHIPS?

* Preparing Financial Reports that are More Meaningful and Helpful to the Public
* Desire for More Reliability
* Identification of Responsibility
* More Effectively Working Together with Accountants

MR. W. H. ODELL: During the last year, the Academy's leadership has brought into focus the question of how our profession can best serve the public in the area of financial reporting for all types of organizations -- pension plans, life companies, plan sponsors, health care organizations, health care plans, property/liability companies, and so on. This subject is intertwined with many complex issues and also with the subject of actuary/auditor relationships. Late last year, officers of the Academy met with responsible members of the AICPA and other interested parties and presented some of the Academy's thinking on this subject. As a result of those discussions, three issues were identified:

1. Expression of reliance, which identifies the actuary.

2. The working relationship between actuaries and auditors (i.e., SAS 11).

3. Independence/self-review.

The representatives of the professions agreed continued discussions on the first two subjects would be fruitful. They also agreed that it would not be fruitful to pursue the third item, independence/self-review, at this time.

The subject was discussed again at a meeting of the Academy's Committee on Relations with Accountants and the AICPA Committee on Relationships with Actuaries in January 1982. These discussions are informal and completely unofficial; they serve simply as a vehicle for communication. And, they are not in any way a decision-making process.

The Academy Committee wanted to pursue these subjects for three reasons:

1. It is in the public interest for users of financial statements to have the benefit of the identification of the actuary who has taken responsibility for certain items of the statement.

2. It would relieve the auditor of the responsibility for forming a valid judgment upon determinations requiring specialized actuarial training; and with the responsibility, of course, goes the liability.

3. Working relationships between the professions would be improved and together the professions could do a better job in serving the public.

Accordingly, a Task Force of the Academy was appointed. The Task Force consists of the panel members who are before you today and also Jim MacGinnitie. The Academy is particularly grateful to Steve Kellison, who has been of inestimable value to the deliberations of the Task Force, and to other actuaries who have contributed their time and talent.

The charge of the Task Force was to develop a framework within which the above items 1 and 2 could be worked out.

Your panel will, today, be reporting on the progress of this Task Force. Please keep in mind that these discussions are informal; they are not definitive; they do not carry the weight of professional opinion and, in fact, they represent preliminary thinking only. Also the ball on this subject is in the court of the actuarial profession. What happens next is our responsibility.

We will be presenting to you the results of our deliberations and indicating some options available to our profession. If progress is made in returning the actuary to the profession's traditional role in financial reporting, then that process must be defined in some detail. Also, many actuaries will need to take part in defining what is to be done and we invite you to contribute your thinking to this very important subject during our brief time together today.

How these matters are resolved will determine, in no small part, the type of services our profession will be providing in the next few years and will significantly impact what service we can provide to the public for the indefinite future. The approach finally adopted will have a significant impact on what it means in future years to be an actuary.

MR. BURTON D. JAY: What are the distinct features of the actuarial profession which justify a different relationship with accountants in an audit function from the relationship specified by SAS 11 for specialists in general?

Many actuaries feel that they are indeed different from other specialists mentioned in SAS 11. SAS 11 provides guidance to auditors in using the work of appraisers, engineers, geologists, and other specialists in performing an audit when elements of the financial statement that they are auditing are provided by these specialists. In general, SAS 11 requires that an auditor obtain an understanding of the methods and assumptions of the specialist and strongly discourages making any reference to the specialist in the auditor's opinion statement. An exception is when the specialist is an attorney - attorneys have their own SAS. SAS 12 deals with the auditor/attorney relationship. Presumably, it has something to do with the status of the lawyer/client relationship.

The following reasons are given as to why we feel that the actuary should also be dealt with different from other professionals by accountants in performing audit functions. I have seven points and I have some slides that summarize what the points are.

1. Professional objectivity is a traditional cornerstone expected of all actuaries regardless of the status of their employment. This expectation exists with equal force whether or not the actuary is financially or organizationally independent of the client being audited. To quote from the Opinions to Professional Conduct of the Academy, "a requirement

common to all actuarial procedures is that assumptions and methods be selected and applied with integrity, informed judgment, and perspective in relation to the purpose for which the results are intended."

2. The work of the actuary is oriented towards the future in a quantitative sense more than is the case for other professions. The actuary is concerned with quantifying the present financial impact of future contingent events often over long periods of time. Other specialists are primarily concerned with the measurement of present physical quantities and past events.

3. The future events which the actuary must quantify are uncertain ones subject to considerable statistical variability. While many of the elements of financial statements furnished by others also involve uncertainty, the elements furnished by the actuary involve a much greater degree of uncertainty, the measurement and quantification of which is the essence of the work of the actuary.

4. The magnitude of the actuarial numbers in financial statements of insurance companies and employment benefits is very material. Actuarial liabilities of an insurance company are a high percentage of the total assets of the company and, for a pension plan, may be many times the total assets.

5. Within the past eight years legal requirements have been imposed on actuaries who take responsibility for actuarial values which appear in certain financial statements. Since 1974, ERISA has required a certification statement by a qualified actuary on private pension plans. An actuarial statement of opinion has been required on annual statements of life, accident and health insurance companies filed with state regulatory authorities since 1975. In 1980, the NAIC adopted a similar actuarial statement of opinion for fire and casualty insurance companies' statutory statements, although to date, this requirement has only been adopted by a few states. It should be noted that, consistent with the traditional expectation of objectivity for all actuaries, neither the U.S. Congress nor the NAIC has seen the need to impose any independence requirements on actuaries responsible for the values in financial statements.

6. Actuaries are subject to written professional standards. Academy members taking responsibility for the values which appear in financial statements are governed by the Guides and Opinions, which are standards of conduct, and the Recommendations and Interpretations, which are standards of practice.

7. Finally, the actuarial education and examination program includes significant formal training in accounting matters. This is not the case for most other professions.

MR. JAMES H. CROWLEY: Now that Bill and Burt have set the stage, it is in order to introduce some of the operational aspects of actuary/auditor relationships. More specifically, I would like to comment briefly on insurance reporting and related actuarial opinions. In addition, I will touch on the subject of on-the-job working relationships between the actuary and the auditor.

Conceptually, the "division of responsibility" approach appears to be equally appropriate for both statutory and GAAP financial reporting. For practical reasons, however, the Task Force has tentatively concluded that statutory should be addressed first, with only modest short-term goals in connection with GAAP reporting.

Implementing a "division of responsibility" approach for statutory reporting appears to pose fewer problems because the legal framework already exists in the NAIC requirements for statements of actuarial opinion covering major items in annual statements. Furthermore, the NAIC process for periodic examinations of insurance company financial condition provides a built-in review feature. Finally, our guides to professional conduct are currently somewhat more oriented to statutory reporting, especially in the property/liability area.

For those reasons, and because it is judged that securing NAIC blessing for a "division of responsibility" approach (in those instances at least where audited financial statements are required) will be less difficult than obtaining SEC sanction for a similar approach to GAAP statements, the short-term goal for GAAP will be to obtain increased recognition for the actuary. This could be done by identification of the actuary in the footnotes to GAAP financial statements along with appropriate mention of the actuary's work, and by publication of the actuary's opinion in annual reports. Long-term, however, the goal remains "division of "responsibility."

I would like to return now to statutory financial reporting and develop some particulars with regard to actuarial opinions. Actuarial opinions can be looked at from two perspectives. We can look at items to be included and we can look at the form of actuarial opinions.

In general, actuarial items are those which actuaries are uniquely qualified to determine. In a less tautological and more practical sense, these are items which generally involve the measurement or estimation of the financial effects of future contingent events or current experience, or some combination of the two. Even this is not a wholly satisfactory definition because there are a number of items which may not fall clearly within or outside this definition. I will return to this in a moment.

For statutory financial reporting purposes, the NAIC has specified the minimum requirements with regard to items included in the actuary's opinion. For life companies, the opinion includes life reserves, accident and health reserves, claim reserves, and deferred and uncollected premiums. For fire and casualty companies, the NAIC opinion covers unpaid losses and loss adjustment expenses. In both instances, the required items appear to fall reasonably within our general definition involving future contingencies and experience measurement. Other items which might also fall within the actuary's purview in statutory financial statements include experience rating assets and liabilities, contingent commission reserves, retro premium reserves, and policyholder dividends.

With respect to insurance company annual statements, the present model form of opinion contained in the NAIC instructions and Academy professional standards appears to be appropriate for statutory purposes. The form of GAAP opinion appearing in the professional standards literature also seems to be suitable for our currently limited objectives, although some work in the property/liability area may be necessary. Longer term, a considerable amount

of development work on professional standards and related matters may be expected to ensue.

A final word is in order about working relationships. Good communications and clear advance understandings about individual responsibilities are important in any joint undertaking by professionals. The "division of responsibility" approach being discussed today would lend even more importance to these aspects of actuary/auditor relationships, and I am sure you will be hearing more about this from our next panelist. Finally, I join with all the Task Force members in urging you to communicate your ideas and suggestions as we proceed to explore more fully this important undertaking.

MR. JAMES F. A. BIGGS: I am going to be talking today about the specific reporting problems of plans which are subject to ERISA. Plans covering public employees have their own problems and the reporting problems as far as a plan sponsor's financial statements and the pension information therein are another whole set of problems, and I am not going to be touching on those today.

The requirements for ERISA plan financial statements really come from two sources. The first, of course, is ERISA itself. Section 103(b) of the Act says that the administrator must file a set of financial statements. It also says that those statements must contain a statement of the assets and liabilities of the plan, and the changes therein during the year, and that the notes to the statement must include information such as a description of the plan and the changes therein during the year and the financial impact of those changes, the funding policy being followed and any changes in that funding policy, termination priorities or the allocation of assets upon plan termination, an indication whether or not the plan has an IRS determination letter and the usual catch-all type of language, namely, other matters necessary to fully and fairly present the financial condition of the plan.

Section 103(a) then states that the administrator shall engage an independent, qualified public accountant to conduct an examination of any financial statements of the plan, and form an opinion as to whether the financial statements and schedules required by Section 103(b) are presented fairly in accordance with generally accepted accounting principles. That inevitably raises the questions, "Okay, what are Generally Accepted Accounting Principles with respect to a pension plan?" That was defined for us by Statement of Financial Accounting Standards No. 35 which was issued by the FASB a couple of years ago. That Statement defines GAAP for a defined benefit pension plan. FASB 35 requires that the financial statement contain two statements plus two sets of information. The statements must be a statement of the net assets of the plan available for benefits and a statement of the changes in the net assets available for benefits. The two sets of information required are information as to the present value of accumulated benefits and information as to the changes in present value of accumulated benefits. Note that the Board did not require that there be four statements specifically. I will be touching on that in just a minute.

ERISA, as you know, also requires that there be an actuarial statement which has taken the form of our beloved Schedule B. So the total filing for an ERISA-subject pension plan includes, first of all, form 5500 prepared and signed by the plan administrator, a Schedule B which is normally prepared and which must be signed by the enrolled actuary, and a set of financial statements signed by no one (but the plan administrator has the responsibility for

the preparation of those financial statements). Those financial statements must be accompanied by or include an opinion signed by the auditor. That opinion now normally covers the actuarial information as well as the purely financial information. These ERISA plan financial statements represent an ideal case for limitation of the auditor's role through the "division of responsibility" concept that this Task Force has been talking about.

Note that this "division of responsibility" in effect will assign different kinds of responsibilities to the actuary and the auditor. In the case of the actuary, it will be a responsibility for certifying with respect to the preparation of certain information or the performance of certain actuarial tasks. On the other hand, the auditor in all cases is expressing an opinion with respect to financial statements which were done by someone else.

Why do I say that these financial statements are an ideal case for this "division of responsibility" concept? First of all, the actuary is already certifying to the present value of accumulated benefits on Schedule B. It is the same present value of accumulated benefits that appears in the financial statements. So the incremental risk that the actuary is assuming by taking on responsibilities for the numbers that appear in the financial statements and signing his name to them is a minimal one. Second, it has been my perception that in many cases the ERISA audit is not viewed seriously by the plan sponsor. As a consequence, he is not willing to devote the financial resources to a truly major audit, and as a result the auditor, in effect, is forced to decide to rely on the actuary, in fact whether he states so or not, with very little, or perhaps no in-depth review of the actuary's work. Hence, the auditor would and should welcome the opportunity to reduce his responsibility and his liability with respect to these plan financial statements. Third, ERISA itself specifically provides that the auditor may rely on the correctness of any actuarial matter on which the actuary has expressed an opinion. Fourth, Statement 35, as I indicated before, deliberately permitted flexibility in the format of presentation for these accumulated benefit numbers. You do not have to present it in statement form. You can present the liability information or the accumulated benefit information directly along with the asset information. You can present it in separate statements, or, you can present it in the notes to the financial statement. Furthermore, the FASB noted that inclusion of the benefit information within financial statements does not necessarily require it to be audited by an independent accountant. Now, it is not the FASB who decides whether an audit is necssary, but I think one of the reasons why they permitted this flexibility is to leave to the accounting and actuarial professions the issue of where the information should appear and whether or not it should be audited.

To accomplish the purpose of "division of responsibility," the structure of the financial statements must make it clear that the auditor is not assuming responsibility for the actuarial information. There are two ways in which this possibility could be approached. One is through the auditor stating what we have referred to as reliance; that is, the auditor in his opinion says the actuarial information has been developed by a member of the American Academy of Actuaries, he has examined the financial statements and he is expressing an opinion partly in reliance on the report of the actuary as presented. That, I suspect, is not going to accomplish the purpose that we seek. As long as the auditor is expressing an opinion on the financial statements taken as a whole, even if he is stating reliance on the actuary, I find it difficult to believe that the auditor is not going to insist on

making some determination as to the actuary's qualifications and as to the reasonableness of what the actuary has done. On the other hand, a statement of reliance very possibly would permit the auditor to make less of an investigation than he feels necessary at this point in time.

The other alternative is to have a presentation format in which you do have four statements. The statement of net assets available for benefits and a statement of changes therein would have an opinion of the auditor. The other statements would be the statement of present value of accumulated benefits and the statement of changes in the present value of accumulated benefits. These would have a statement of opinion by the enrolled actuary. The auditor's opinion would specifically state that the auditor has not examined the latter statements and he is expressing no opinion with respect to those statements. The basic issue here would be the question of whether this does indeed constitute generally accepted accounting principles and it probably does not. Assuming that it does not, would the Department of Labor nonetheless accept such a "division of responsibility" and accept such a qualified opinion by the auditor as meeting the stated Congressional intent. To the extent that Congress has already said that the auditor can rely on the actuary, the DOL might be prepared to interpret Congressional willingness for reliance as encompassing the concept of a full disclaimer of responsibility.

The actuary's opinion in this case would be included with the financial statements because the actuary is expressing an opinion on two statements or schedules which are a part of the financial statement. The actuary's opinion would in structure be very similar to the type of opinion that an auditor now is issuing, but containing certain actuarial aspects. He would state that he has performed an actuarial valuation of the plan. He would state that the information contained in those two schedules is based on his actuarial valuation. He would state the date as of which he has performed the valuation. He would state the source of the data he has used in performing this valuation and whether he has recognized certain amendments. For example, he might well state whether he has relied upon certain opinions of Academy Committees and perhaps state specifically what those opinions are, and presumably, he would also have to state that he has prepared this information in accordance with his understanding of FASB 35. Again, much of this certification would be very similar to the information that is included now by the actuary in his normal certifications which accompany an actuarial report.

This all assumes that the financial statements themselves would include only the information required by Statement 35. If the plan administrator wants to include additional information of an actuarial nature, such as the present value of accumulated benefits with a salary scale, or the unfunded actuarial accrued liability, or other information of an actuarial nature, that information under these circumstances either would have to be included in an additional statement upon which the actuary would be expressing an opinion, or perhaps, in a separate set of notes. In any event, assuming that you want the auditor to be making no investigation and taking no responsibility, that additional actuarial information should not appear in the notes which constitute a part of the basic financial statement. Fundamentally, if you do not want the auditor to investigate the qualifications and the work of the actuary, then there must be some effective mechanism for the auditor to lay off that liability - whether it be through reliance, which may or may not be sufficient, or through a full disclaimer of responsibility.

MR. EDWIN F. BOYNTON: Most people in this room are familiar with, or have

heard of at least, SAS 11, a Statement on Auditing Standards entitled "Using the Work of a Specialist." SAS 11 was issued in December of 1975 by the Auditing Standards Executive Committee, then of the AICPA; it is now the Auditing Standards Board. It contains a lot of very significant items to the actuarial profession, and it covers a whole range of specialists, not just actuaries. Basically, the Accounting Standards Board acknowledges that auditors and accountants are not experts in all fields and that help is needed from these experts. SAS 11 tells them how to use it.

Immediately following SAS 11, the AICPA issued SAS 12 which deals specifically with using an attorney in terms of evaluating contingent claims that might appear in a company's books. The American Bar Association didn't like what the accounting profession did in SAS 12 so they wrote their own comments on it, which are included with it, and which say, in effect, that no matter what the accountants ask for, do not reveal anything that you do not want to. So, it is sort of a standoff.

The statements give the auditor some guidance in terms of selection of an expert. Examine the expert's professional credentials - certification or licensing, or whatever professional credentials he has, his reputation - including his standing in the business, financial, and actuarial communities, and additionally, the question of independence in terms of the client - is he independent of the client. Now obviously, this raises a question for the auditor where the in-house actuary is calculating reserves. It also raises a question in connection with the self-review issue which has been set aside for the moment -- an issue which actuaries have often raised and which has been the subject of countless discussions over the past few years. Maybe we should also talk about the relationship of the auditor to the actuary. It does not appear in SAS 11, and is not likely to appear in SAS 11 or anything coming out thereafter. It was an issue that was raised and most of you are familiar with the problem.

Just to continue, the key phrase in SAS 11 which probably led to most of the problems and misunderstandings that the actuarial profession has had with the accounting profession - a great deal of it in the pension area - is a phrase which states that the auditor must have an understanding of the methods or assumptions used by the specialist to determine whether the findings are suitable for the financial statement. Different auditors and audit firms make different interpretations of what that means. They have many different interpretations ranging from a very casual review of certain information to 20 page questionnaires exploring every aspect of the actuarial work done. SAS 11 also says that if the specialist is related to a client, for example an insurance company actuary calculating reserves, then consider performing additional procedures. It does not really say what additional procedures. One possibility is to hire another specialist to review the work, and that is done in a lot of cases. Another possibility is where the auditor runs into something that does not appear reasonable, or that he has doubts about. He is not supposed to resolve a question in the area of the expertise of the expert himself; he should look to get a second opinion.

Incidentally, SAS 11 does not relate to the question of the actuary who works for the audit firm.

One of the other key parts of SAS 11 states that there should be no reference to the specialist in an unqualified opinion. The reasons they give are that it might make people tend to think the opinion is qualified, or it might

imply a "division of responsibility". It might imply, on the other hand, a more thorough audit of the work than if there is no reference. Hence at the present time, any reference to a specialist in an opinion paragraph would be deemed to be a qualified opinion, which is to be avoided like the plague in most financial statements.

We often get involved in discussions about who does what to whom and about how we lose sight of the fact that the auditor's role sometimes is different from that of the actuary. The auditor is reviewing and giving an opinion on original work. He does not do the work - he gives an opinion on someone elses work. One of our key issues to be resolved stems from the fact that the actuary involved is doing the work. If there is to be an audited opinion on a financial statement that includes actuarial values, who is to review the work of the actuary? Should we push for a requirement that all actuarial valuations be subject to an actuarial audit? If we take the position that the auditor should not review the work, then we are in effect saying that the actuary is so good no one can challenge or review what was done, that the actuary does not make mistakes.

It is also of interest to review exactly what the auditor's opinion constitutes. I have been on the fringes of this issue for quite a few years. It seems every time I go to a meeting I learn something new about what auditors do and do not do. I am beginning to get a clear understanding of what an auditor's opinion does mean. The key words are found in any audit opinion. They indicate that the financial statements present fairly the financial position of the organization, that the financial statement is prepared in accordance with generally accepted accounting principles. What are generally accepted accounting principles, of course, is a function of the Financial Accounting Standards Board which is having another meeting right now. Further, and most importantly, the opinion indicates that the examinations have been conducted in accordance with generally accepted auditing standards. The auditor's opinion is not a certificate or even an opinion that the statement is correct or that it is accurate. It does not say the numbers are right - it simply states an opinion, based on generally accepted auditing standards, that the numbers are presented in accordance with generally accepted accounting principles. That is a very important distinction. This distinction has held up in court in certain liability cases. It _is_ a line of defense for an audit firm to demonstrate that in fact they conducted the audit in conformity with GAAS. In some cases this relieved them of some liabilities when statements have been wrong.

By contrast, actuaries' opinions vary considerably. In fact, in many cases they are much stronger than an audit opinion. Again, we are often dealing with original work. There is a statement in the insurance company opinion that essentially says the reserves make good and sufficient provisions for the policy obligations of the company. That is a very strong statement to make. In the pension area, the actuary makes a statement about the best estimate of future experience under the plan - this probably is stronger than an auditor's opinion. Thus, one of the questions is whether we should take a long look at exactly what actuaries should be certifying to. What should their opinion cover? I do not think we ever explored this.

There is a whole array of wording in use either opinionating or certificating that the results are correct, or that the results are reasonable, or that the results are not unreasonable, or that the results are calculated in accordance with generally accepted actuarial principles, and so forth. Maybe

before we get through with this project we can come up with some ideas about what it is that actuaries should be attesting to. One of the purposes of this panel obviously is to seek guidance, help and ideas from the group here today.

A major problem under a division of responsibility concept occurs when you go upstream from the pension plan financial statement to the financial statement of the plan sponsor. The pension items now become an important, but not overwhelming, portion of that balance sheet - or, in some cases they are "bigger" then the balance sheet. FASB will likely require that unfunded liabilities go on the balance sheet. The item which has been described as one that would lend itself to a "division of responsibility", for which the auditor claims no responsibility, now winds up on the company's balance sheet and the pension expense is a material part of company earnings. When you get to the client/sponsor financial statement either you decide that pension items on the financial statement are not material, which is not true, or you must have a disclaimer on the financial statement of the plan sponsor. The financial community would need to accept such a statement on the financial statement and the auditors would not have to be deemed to have given a qualified opinion. The solution to the problem of the pension plan financial statement does not lend itself very well to solving the problem of the plan sponsor financial statement, but we intend to pursue it.

Another alternative is to look at a revision of SAS 11 or a separate SAS specifically aimed at actuarial work. This could define the auditor's role in such a way as to meet their rules and still address the issues we are talking about. First, the auditor would have to satisfy himself as to the qualifications of the actuary. Second, the auditor should assure himself by contacting the actuary that the actuary has considered a number of significant factors. Such factors would make up a sort of a checklist which could be worked out between the actuarial profession and the accounting profession. For example: Did you review the investment experience of the fund? Did you get an auditor's financial statement? Does the data appear reasonable from one year to the next? The actuary could then respond to give the auditor assurance that all of these have been taken into account. There is no escaping the fact that a number of some type is going to appear in the financial statement and, therefore, the auditor must have a feeling that the number is reasonable. He would want to be sure that the actuarial values that appear in the financial statement are reasonable overall, and obviously that is difficult to define. I do not see how we can avoid some kind of an overview test like that if the auditor is to include actuarial values in his opinion. The fact that the auditing profession has already issued a separate auditing standard, SAS 12, for one group indicates they could also do so for actuaries.

Going back to the first point - what basic actuarial qualifications should the auditor expect for any kind of actuarial determination? There are probably a series of special qualifications that an auditor would consider depending on the nature and complexity of the assignment. Additionally, another issue quite likely to be raised is independence - the relationship of the actuary making the determination to the plan sponsor or organization involved. In pensions, I suppose the status of enrolled actuary is the basic qualifications test since the government has licensed people to do that. On the other hand, I would think the auditor would want to go beyond that and assure himself of other qualificatins of the actuary, such as other professional designations, years of experience, and the kind of experience he has

had. Similarly with insurance, the basic qualification would seem to be either F.S.A. or F.C.A. or the Academy's standard of qualification. All this might result in the development of a brief questionnaire on experience to assure the auditor of the qualifications of the actuary.

MR. ODELL: Let me attempt briefly to summarize what we have talked about. Any summary is bound to be unfair to the question because "summary" implies conclusion and obviously there has been no conclusion reached on a number of the items presented. Let me nevertheless give a summary that will give a framework for our discussion. Also, it might help if we were sure we come at this from a certain perspective. We are talking about an arrangement whereby there would be some kind of "division of responsibility" for financial statements between the professions, with the actuarial profession taking responsibility for certain statement items and the auditor vis-a-vis these items satisfying himself as to the qualifications of the actuary, the correctness of the numbers going to the actuary, and making sure the actuary has looked at the things that the actuary clearly should look at. This type of thinking has, so far, and keep in mind this is very informal, received encouragement from the accounting profession to develop our thinking more fully.

The perspective we might bring to our discussions is that the ball is now in the court of our profession; we are not in a position to say we cannot do thus, thus and thus because of the accounting profession, SEC, FASB, or what have you. Rather we are in the position of having been asked to present what the actuarial profession thinks the ground rules ought to be. I mention this so that we do not feel our discussion has to be shackled by the way the world is right at this minute - we are free to consider the way the world ought to be, realizing that after we have reached our conclusions we may have to temporize in implementing them.

MR. JOSEPH E. DEAN: One of the things that the panelists spent a lot of time on is the fact that the auditor expresses an opinion while the actuary does original work. I am not fully prepared to dismiss the idea of an actuarial audit meaning double fees. It may lead to that, but I just wonder whether there could not be some kind of an organization in the actuarial profession, similar to FASB, that determines what actuarial standards are. I just wonder Jim, in particular, if you feel that if such a mechanism existed, an actuarial audit would be satisfactory to the accounting profession?

MR. BIGGS: You are supposing that there is a body within the actuarial profession which defined the standards not only for performance of actuarial work but for review of actuarial work?

MR. DEAN: To clarify, suppose such a body were to determine standards and a second actuary were to not redo another actuary's work but express an opinion as to whether the procedures he followed conformed with the standards dictated by that body. The body might be a board of a half dozen people.

MR. BIGGS: In a sense, Joe, I think that is happening in the audit process now. In other words, obviously some auditing firms have actuarial staff. Other auditing firms use actuarial expertise from actuarial consulting firms to assist them when they feel it necessary in the review of both pension plan financial statements and the review of insurance company financial statements. In all of these cases, the actuary is not being asked to, as you said, "redo" the work of the first actuary or to check what first actuary has

done. What he is doing is trying to help the auditor form an opinion of the type Ed described before as to whether the work process of the actuary who did the work in the first place appears to conform with the standards of the actuarial profession for performing actuarial work and finally whether the results were reasonable (or whether the results were not unreasonable). That is ultimately the judgment that the auditor now has to make. He may or may not use actuarial expertise to help him make that judgment. You are talking about another actuary making this review in order that the auditor can exercise forebearance and sign off on the financial statements taken as a whole without making a review of his own.

MR. DEAN: Essentially, the way it works right now, the auditor makes the review and expresses an opinion. Work is reviewed more and more. Why doesn't the actuarial profession do this themselves rather than having it done by the accounting profession?

MR. ODELL: You have touched on about four meaningful subjects. The Task Force has on its agenda, as soon as we can get some other things wrapped up, discussion of what you might call oversight function, which is already being done to some extent by the Academy. That is oversight by actuaries and/or others of what it is actuaries are doing both in original reporting and review. The context of the proposal we are talking about is one of original work where there would not be an actuarial review in the auditor's function. What we are talking about is the situation where the auditor's review is to check the qualifications of the actuary, the data the actuary is intending to use, being sure the bases have all been touched and so on. Another perception I want to bring to this is that one of the things your Task Force has been exposed to is probably more knowledge of the accounting profession. It is the perception of some of us that in other professions, including accounting, when an audit opinion is signed it can be signed by someone who, the way we use the word, is not "independent"; that is, by someone who has done the complete work and then turns around and signs the audit statement. We do not do that in our profession. That's another insight.

MR. JARVIS FARLEY: I think it is very pertinent at this stage to note that the mechanisms exists for what has just been suggested. The Board of the Academy has just approved Opinion A-7 which specifically defines generally accepted actuarial principles and practices and the Board has approved previously publications which define the responsibilities of an actuarial audit or the expression of an actuarial opinion or matters relating to independence in case there is an opinion expressed for public review and reliance, that sort of thing. So, I think that the mechanisms do exist. There is nothing now which says you have got to use those mechanisms. That is a part of what is open to you. I think it is important to note the existance of the mechanisms and particularly the most recent brick put into place, Opinion A-7.

MR. BIGGS: The fundamental problem is that at the end of all of this process is a statement of opinion being signed by an auditor. If that statement of opinion is a statement of opinion with respect to a set of financial statements taken as a whole and that set of financial statements contain actuarial information which is material to the validity of those financial statements, the auditor has to have some way of assuring himself as to the validity, the credibility, the reasonableness of that actuarial information, and so the whole question becomes one of process as to how does the auditor get that assurance. Can he get that assurance merely by knowing that Joe Dean,

qualified actuary, has performed a review in accordance with the standards of the actuarial profession? Maybe, but you are not working for that auditor and it is not your name that is at the bottom of that opinion. This is the difficult problem with which the Task Force is wrestling and will be with the accountants.

MR. STEVE KELLISON: The review question is one that you have been wrestling with a lot today and we have wrestled with in the deliberations of the Task Force for quite awhile. I think at the heart of Joe Dean's question, and Ed Boynton brought it up, is the extent to which actuarial work should be reviewed, and, if it should be reviewed, by whom? That is a very difficult question to answer really with intellectual honesty, but it also gets into a swamp of problems involving business considerations too. The specter of double fees, or outside actuaries reviewing the work of in-house actuaries, are obviously inflammatory areas to get into.

We could use more insight from the members on the extent to which they feel actuarial work does need to be reviewed and ways in which a meaningful review could be done, so that we have a stronger consensus of views within the actuarial profession to take to the accounting profession.

One position is that the actuary's work is so good it does not need to be reviewed by anybody. Well, maybe we think that, but it sounds a little egotistical to outside audiences - maybe not something we could totally defend. We could say let's let the CPAs review it. Well that is what they do now and we do not seem to like that system or we would not be putting all this time and energy into these proposals. We could let a second actuary review it. We just explored that and saw that that is going to create a lot of problems too.

These kinds of considerations led the Task Force to one of its conclusions, which was to concentrate on the statutory insurance area and on the plan statement in the pension area, because at least there is some governmental oversight in these areas. That is a linkage that might be worth making in answer to those who criticize the Task Force today for drawing such a sharp distinction between statutory and GAAP. Maybe we should not have drawn it; I don't know. Maybe we will change our minds as we go further downstream. But, the reason that it was drawn originally is because here there is some review of the actuary's work. The problem in GAAP is that something similar does not exist.

Ed Boynton mentioned SAS 12 for attorneys. We have a special case for actuaries. We have given a very good defense up here as to why actuaries are unique. Unfortunately, the reason for the SAS 12 seems to have to do with the special nature of the confidentiality of the client/attorney relationship. Information that is confidential between the client and the attorney cannot be protected when the auditor finds out about it. So there are some legal reasons why SAS 12 came out like it did. It is, however, clearly a precedent for them doing something special for a certain profession.

Yesterday I was in Stamford, Connecticut, at the FASB along with the President of the Academy and the President-Elect of the Academy. There are two things to report - one is sort of a positive and one is more of a negative in terms of the work of this Task Force.

The item on the positive side goes to the question of why the AICPA would be

interested in doing this. One of the new Board members of FASB is a prior Chairman of the Auditing Standards Board who was chairman during the period of time when they put out Statements numbered from the twenties to the forties. He specifically mentioned that he was not there when SAS 11 was done. It was indicated the AICPA was willing to take a serious look at this subject, which kind of surprised me. It was brought out - I didn't raise the question. There is an increasing recognition in the accounting profession that the world we live in is perhaps more complex than it seemed to be in 1975 and that maybe auditors do not necessarily have the capabilities of auditing every single financial entry in every single financial statement in the country without some help.

On the minus side, I think one of the things that disturbs me is that apparently in one of their tentative decisions the FASB reached the conclusion that the identification of the actuary should not be required as part of a disclosure. That is a step in the wrong direction, one that the Academy should try to get changed in FASB's further deliberations on this. Coupled with our concept of "division of responsibility" in the statutory and the plan area was the idea that in the GAAP and plan sponsor area, where we are not asking for "division of responsibility", there should be increased recognition of the actuary. There is insufficient recognition of the actuary today with GAAP for insurance companies and with pension plan sponsor statements. This does not happen in the plan's financial statements because the actuary is directly tied into those numbers via Schedule B. That won't happen in the plan sponsor's statements. I would much prefer to see FASB moving in the direction of saying the actuary who provides the numbers would get explicit recognition by the disclosures indicating who the actuary is that did this work. Expressing reliance on his opinion is going to be a tougher concept to sell. Something short of that would be identification and recognition of the actuary as part of the disclosure.

MR. ODELL: I can suggest one reason why some of the accountants were interested in opening up this subject. My perception is that there are accountants, especially some of the better ones, who really feel that the actuaries are doing a better job of presenting actuarial items to the public than the typical accountant. This whole subject is being discussed probably for the last time. We have been told by a number of people the accounting profession does want to have a representation from the actuarial profession as to what the actuarial profession wants and then perhaps not hear from us for awhile. As Steve pointed out, there is a real question as to what we actuaries want. Let's get it out on the table.

MR. GEORGE B. SWICK: One area that we have not addressed, and I wonder if the Task Force has done any work on this, is whether the financial community, plan sponsors and insurance company executives, want their financial statements prepared by an actuary - or significant parts of their financial statements prepared by an actuary? Are they willing to give up their responsibility as senior executives of those firms to allow the actuary sole discretion as to how these numbers are calculated and what they are and how they are reported? I have heard some indications that perhaps even some actuaries who are now senior officers of large institutions do not look favorably upon that and I just wondered if we don't have to talk to another constituency before we get too far down the line with the accountants?

MR. CROWLEY: George, I agree that there is another constituency that needs to be heard from, especially if we do get into a situation where some audit

fees would be required if the actuary doing the review were required to be independent. I do not understand the implication that suggests that the actuary has to somehow be independent of management in order to do an honest financial statement. I realize I am paraphrasing your words and maybe distorting the meaning in the process. I think lots of insurance companies operate where the actuary has a great deal of influence in the outcome of things without impairing his professional standards.

MR. SWICK: There is a lot of judgment involved in actuarial work. There are calculations on the one hand and there are judgments on the other. Many actuaries present ranges and options to their sponsor or to their company and someone has to ultimately make a decision as to where in that spectrum the numbers are going to come out and how they are going into the financial statements. I just ask if that is a problem or is not a problem. Are the people who put together financial statements going to give up that last judgmental decision element in the selection of the adequacy of the assumptions? I don't know.

MR. CROWLEY: I doubt it because in most cases there is not a unique correct answer. Therefore, there is no need for anybody to give up flexibility as long as the actuarial portions of financial statements are within boundaries that are comfortable to the actuary. I don't see what difference it makes whether it falls at this end of the alternatives or that end, as long as it is within a range the actuary is comfortable with.

MR. ODELL: George, there is one thing that was discussed by the Task Force awhile back that may relate to this. One of the very philosophical issues which was raised by people not even on the Task Force was whether actuarial numbers in a sponsor statement or an insurance company statement are numbers of the actuaries or are numbers of management. We went round and round on this and figured it was not up to us to make the decision. But then, the following insight was presented. Take statutory accounting for insurance company where the actuary signs a statement. Once the actuary signs that statement it may really not make that much difference to the outside world whether that was the actuary's number or management's number because once the actuary signed it by golly it was his number and he is liable for it. If the actuary were to sign that statement and it was not his number, he owns the problem. That may or may not answer your question, but it is an interesting insight.

MR. EDWARD J. PETERS: I personally have no objection to a review of my assumptions. If I have to actually take a person through a course of actuarial instruction, I do resent that. I really have no problem with a review by another actuary including an actuary from an accounting firm.

MS. BARBARA B. CRIDER: I know in our firm we have statements reviewed by another member of the firm and the person who does the original work signs it as the preparer and the second person signs it as the reviewer. I spend many, many, many hours every January and February trying to educate the new staff accountants that come in, from the Big-8 firms or from any other accounting firm, and educate them as to what insurance is and what reserves are and how it all relates. It would from my standpoint mean a great deal of savings if there were an actuary in connection with that firm who was handling that part of the audit. I have worked with an accounting firm which hired members of our firm as independent actuaries to assist them in auditing the actuarial parts of the statement.

MR. ROBERT H. TAYLOR: One thing I think the Task Force had better be sure to think about is what is happening in Wisconsin - the case against Bruce & Company and Touche Ross. Here you have got all of the mixes. There is statutory certification as to adequacy, there is the GAAP statement on behalf of the accounting firm where really this is a reliance on experience. You are going to have to look at both sides of these in whatever you come up with. I doubt if you can synthesize both of these things into one position even if you were to have a review. Bruce & Company was probably in a review position of somebody else. So you see a review may not do any good at all.

MR. ODELL: You have a good point, Bob. As one actuary pointed out in reference to that particular case, if some of the things being discussed here were to go forward, only one firm might have been mentioned in the suit - which is a rather sobering thought. Your Task Force does want your thoughts. This is going to be of tremendous significance to our profession and it is probably the last time this whole question of restoring the actuarial profession to its traditional role will be discussed. We stand adjourned. Thank you for coming.

# CONCURRENT SESSION
# BENEFIT PLANS FOR PUBLIC EMPLOYEES

*Moderator: THOMAS P. BLEAKNEY. Panelists: HARRY E. ALLAN, KENNETH A. STEINER*

1. Requirements for Funding Standards

2. Role of the Actuarial Profession in Setting Standards

3. Actuarial Qualificiations Relating to Public Pensions

4. Current Legislation

5. Accounting Issues - FASB or Government Accounting Board?

MR. THOMAS P. BLEAKNEY: A major focus of our discussion today will be answering the question - what should be the posture of the American Academy of Actuaries with respect to financing public employee retirement programs? Actually I think that there are many who would say, "None", and walk out right now, and there are others who would have some very substantial detailed types of things, and then there are those who fall in between.

I think that you'll find that our first speaker is probably in the second category with a great deal of detail. Ken Steiner will be talking about some of the developments with respect to work that he did on a paper which was presented last year to the Conference of Actuaries in Public Practice, and some of the further thoughts that have been had on that paper, both of his own and those that have come to him from others.

MR. KENNETH A. STEINER: The purpose of my presentation today is to discuss general issues and current Academy standards of practice relating to public pension plans, to propose changes in the current standards designed to encourage public plan actuaries to maintain funding standard accounts, to briefly review the public funding standard account presented last year at the CAPP meeting and to propose it again as a possible standard to be considered by the Academy as I will discuss later.

Before addressing some of the specific issues concerning whether the Academy should encourage public plan actuaries to maintain funding standard accounts, I'd like to address some of the general issues relating to what the Academy's role is (or should be) with respect to public pension plans.

Guide 1-A entitled, "Professional Duty" states that, "the actuary will act in a manner to uphold the dignity of the actuarial profession and to fulfill its responsibilities to the public". Is the Academy currently fulfilling its responsibilities to the public with respect to public pension plans?

Is the Academy currently able to effectively respond to the public when disputes arise over different levels of cost or different funding approaches? One of the stated purposes of the Academy is to represent the actuarial profession in areas of public issues and discussions involving actuarial concepts. Most groups of interested taxpayers and legislators want to know whether their plans are being soundly funded. Is the Academy able to adequately respond to the needs of these groups?

What is the public's perception of what we do? Are we perceived as premium setters? Does the public really understand the consequences of using alternative actuarial funding approaches or assumptions? Because actuaries may be involved in the funding of a system, is the funding status therefore considered "sound" regardless of the contribution that may be made?

What are the responsibilities of a public plan actuary? Are they different from the responsibilities of a private plan actuary? Do responsibilities extend to benefit levels and funding or just costing? Do we have unambiguous, high standards of practice with respect to services performed for public plans?

Recommendations published by the Academy's Committee on Pension Actuarial Principles and Practices together with Opinion A-4 constitute generally accepted actuarial principles and practices relating to pension plans. In the Introduction to Opinion A-4, the Committee claims that, "a statement of the basic responsibilities of the actuary will tend to minimize the possibilities of misunderstanding or misinterpretation by those relying on his work". Item 3 of the opinion states, "the actuary has a responsibility to avoid misunderstanding by means of adequate disclosures". Specifically, an actuary's report should include a number of items including: "a summary of the basic valuation results with a suitable statement relative to an appropriate level of pension cost and an appropriate range in contributions". No attempt, however, is made by the Academy to define what "an appropriate level of pension cost" or what "an appropriate range in contributions" might be for common usage within the profession.

Opinion A-4 also states that if no recommendations have been promulgated, actuaries should be "guided by sound principles established by a precedent or common usage within the profession". One might wonder whether maintenance of funding standard accounts for the many private plans we serve and disclosure of those accounts in our reports constitutes a precedent for public plans or a principle established by common usage.

Finally, Recommendation A-4 states, "the extent to which benefits of a plan should be funded in advance of the date when they must be paid is a decision to be made by the plan sponsor with the assistance of the actuary in light of many factors including regulatory requirements, collective bargaining considerations, [etc]. If the funding pattern differs from the long term pattern consistent with recommendations set forth herein, the actuary should disclose the trend of the funding pattern and should indicate, at least approximately, the expected impact of such funding pattern on future pension costs". Other Academy recommendations merely hint at what is meant by "the long term pattern consistent with the recommendations". The hints are found in Recommendation A(2) which

prohibits the use of the non-projected accrued benefit cost method for final salary plans, and in the next paragraph which permits the one-year term cost method for ancillary benefits provided stable costs are expected to result. While the Academy specifies acceptable cost methods, it effectively provides no restrictions on how the unfunded accrued liability is to be funded. Instead, the recommendations appear to rely on the funding periods specified in ERISA.

In the context of the terminology used by the Academy, the question to be answered by members of the profession is, can or should the Academy take a position on what is the minimum level associated with "the appropriate range in contributions" or "the long term pattern consistent with the recommendations". If the Academy does not clearly define these terms, will someone else define them for us? In this regard, I think the preface to Opinion A-3 makes a good argument for self-regulation. It states, "Guidelines also have a great importance in informing the public about the standards of performance which members of the profession should be expected to observe. If such informaton is lacking, or is inadequate, the resulting public misunderstanding will lead to the adoption of politically determined regulations which conflict with sound professional practice". The same argument is made in the November, 1981 Academy release, "Procedures For the Development of Standards of Professional Conduct and Practice". It states, "Standards of conduct and practice are the cornerstones for the self-regulation of a profession. Proper procedures are required if we are to prove that we can effectively regulate ourselves".

If the Academy decides to take a position, what should the minimum cost level be? Should it be a function of how well a plan is funded? Would we have made the same suggestion for private plans? If it is to be a function of how well the plan is funded, how would it work? Would less well-funded plans be required to fund faster or slower than more well-funded plans?

I'd like to propose two changes to the current standards of practice. The first change would be to amend item 3 of Opinion A-4 to add a funding standard account to the items to be included in an actuary's report. Secondly, I'd like to see the Academy adopt an Interpretation providing consistent practice in the determination of charges and credits for defined benefit plans not subject to ERISA funding standards. What I am proposing is that public plan actuaries be encouraged by the Academy to maintain a funding standard account as a disclosure item. This standard would not require funding at any specified level, and the actuary would still be responsible for determining a plan's "appropriate level of pension cost". For example, if a plan's assets do not exceed the actuarial present value of the accrued or vested benefits, an actuary may determine that the appropriate level of pension costs will be in excess of the minimum.

If the Academy is to adopt an Interpretation, what should it use as a standard? Well, I'm glad you asked. Last year I presented a paper entitled, "Funding Public Pension Plans - A Minimum Standard". The paper contained, among other things, my definition of what constitutes inadequate funding and a description of a funding standard designed to prevent inadequate funding. The standard is quite similar to the minimum standard in ERISA in that an account is maintained and charges are measured

annually against credits to determine an account balance. The funding standard is different from ERISA in that the Entry Age Actuarial Cost Method is prescribed for determining charges and credits (other than the credit for the sponsor's contribution), the initial unfunded accrued liability is "amortized" in perpetuity with level percentage of payroll payments, increases or decreases in the accrued liability resulting from assumption changes or active benefit increases are amortized over 20 years with level percentage of payroll payments and increases in the accrued liability resulting from benefit increases for non-active members are amortized over 10 years with level dollar payments. Another difference is that there would be an assumption with respect to covered payroll growth, and deviations from this assumption would result in actuarial gains and losses. A negative credit balance would be permitted, as the proposed standard would be merely for disclosure purposes.

To add an element of conservatism and discourage manipulation of the initial charges, a maximum of 4% would be placed on the future payroll growth assumption. However, if a system is assuming post-retirement cost-of-living increases in excess of 4%, a higher payroll growth assumption may be used. If this assumption proves to be incorrect, gains and losses will emerge and will be amortized in the same manner as other gains and losses (over 15-years with level dollar payments).

Since one can expect an individual member's pay to increase faster than the growth of a system's payroll (in the absence of population growth), the standard requires the actuary to use a salary scale for individual members at least equal to the assumption used for future payroll growth. Another requirement would be that a higher minimum may be required if assets are less than accumulated member contributions. This is a "reverse alternative minimum" requirement which would provide that if the minimum charge is less than the amount necessary to bring the assets up to the level of accumulated member contributions, a higher minimum would result.

Further requirements would include: performance of an actuarial valuation at least once every three years, use of best-estimate actuarial assumptions (however, the assumptions used in determining the minimum charges would not necessarily have to be the same as those assumptions used in determining the actual contribution, and certainly the actuarial cost method would not have to be the same) and reflection of market value in the valuation assets.

If you are interested in a more detailed description of how the standard might operate over a number of years, or perhaps how the calculation of gains and losses differs from the calculation in ERISA, you should read the text of last year's Conference presentation. I encourage the Academy to consider this funding standard as one of possibly many it might find acceptable for adoption as an Interpretation.

If adopted by the Academy as an Interpretation, this particular standard would either be used to determine the actual contribution or it would not, but the account would be maintained in either case. If it is used to determine the actual contribution, let's examine some of the standard's characteristics. The standard would prevent inadequate funding,

at least as I have defined it my paper. It is my opinion that inadequate funding for public pension plans may be defined as that situation where existing plan assets plus future contributions, at the current percentage of payroll level, plus future investment income can be expected to fall short of providing for all future plan benefits. This definition of inadequate funding is founded on the premise that future generations of taxpayers can realistically be expected to afford contributions that are equal to but are no higher than those that present taxpayers can afford when contributions are measured as a percentage of a system's payroll.

Under this approach, each present and future generation of taxpayer would pay an equitable share of the unfunded accrued liability in existence at the time of adoption. This concept is easily understood by those involved in funding a retirement system in that no one generation, including the present generation, is expected to bear more of the funding burden than any of the others.

If the standard is used to determine the actual contributions, actuarial gains will reduce the contribution rate and losses will increase the rate. This is unlike the situation in ERISA where you can have a significant actuarial loss and a decline in the contribution rate. Under this funding approach, the unfunded accrued liability is expected to increase at the same rate as the covered payroll growth rate, and would result in an intergenerational transfer of liabilities similar to the transfer under interest-only funding in a non-inflationary environment. If we measure the magnitude of funding by the ratio of assets to the accrued liability (the funding ratio), unfunding will occur if the covered payroll increases faster than the plan's accrued liability. This situation is not likely to occur in either an immature or mature group, but may occur in an over-mature group. Finally, as some of you have probably guessed, if this standard is used to determine the actual contribution, the initial contribution may be less than the contribution determined under traditional private or public funding approaches.

Figure 1 shows some work that we did for a town in Massachusetts, and illustrates the contribution patterns produced by various alternative funding approaches. A few assumptions were made in developing this graph. One of the assumptions is that there would be no future gains or losses. Another is that the normal cost percentage would remain level over time as a percentage of covered payroll. Finally, we assumed that the pay-as-you-go line would level off at a contribution rate consistent with the actuarial valuation results. Like most of the towns in Massachusetts, this town was funding on a pay-as-you-go basis. The primary concern here was that future taxpayers would not be able to meet the rapidly increasing contribution requirements. As a result of a valuation performed for this town, they were told that they could contribute 40.7% of pay using the traditional level-dollar approach, or they could contribute 28.5% of pay using a 40-year level-percentage-of-pay approach, or they could continue to finance the benefits using a pay-as-you-go approach. It's not surprising that they chose the infinite funding approach (with its 23.5% of pay contribution) as a way to stabilize their contributions. This was the approach they felt best met their needs in that they had no real desire to contribute at higher levels in order to create a legacy for future taxpayers.

If the account is maintained but is not used to determine the actual contribution, the standard would provide funding flexibility in that if a credit balance exists, temporary funding emergencies could be handled by using up some or all of the balance. The standard also provides a measure of funding adequacy in that the magnitude of a negative credit balance measures the affordability, or lack thereof, of a system's current benefits, while the magnitude of the positive credit balance provides a measure of funding adequacy for comparison over time or for comparison between different systems. A non-negative credit balance will provide comprehensible assurance to today's taxpayers that greater funding burdens are not being passed to tomorrow's taxpayers. In the long run, these measures will be independent of the actuarial assumptions, and this approach should have a neutral impact on plan investment strategy.

In contrast, there are those who argue that the proper disclosure tool for public plans is the ratio of the market value of assets to the present value of benefits (determined either with or without a salary scale). I believe that maintaining a funding standard account, rather than either ratio, will provide a better measure of funding status, will allow more funding flexibility, will have less impact on plan investment strategy, and, in the long run, will be more independent of the actuarial assumptions used.

What are the benefits? Why should the Academy promulgate more standards of practice? Such standards will help the profession better meet the needs of the public it serves. We will better meet the needs of taxpayers who need to know if they can afford the retirement benefits being promised. We will better meet the needs of participants who need adequate benefits, and who also need to know that these benefits are being funded on an adequate basis. We will better meet the needs of policy makers who need to know the cost so that they can balance the needs of the above two groups, and who also need strong guidance so that they may be better able to defend the decisions that they make. The profession will also better meet the needs of the accountants, rating agencies and financial statement users who need comparable information that is useful in predicting future drains on anticipated revenues.

Adoption of a funding standard will increase the recognition of the profession and therefore, increase our credibility. Maintenance of the minimum funding standard will also result in increased understanding of actuarial science. While some of the limitations of actuarial science may become more apparent, there will be less chance for misinterpretation. Adoption of these standards of practice is clearly consistent with the Academy's professed purpose of representing the actuarial profession in areas of public issues involving actuarial concepts. Finally, adoption will result in increased professional integrity through unambiguous standards of practice.

I'd like to thank the Academy for the opportunity it has given me to express my views. To recapitulate, I believe: (1) Opinion A-4 should be amended to add a funding standard account to the items disclosed in an actuary's report, (2) An Interpretation should be promulgated by the Academy to provide consistent practice in the determination of the charges and credits for defined benefit plans not subject to ERISA, and (3) the Academy should consider the standard I've presented as one of many possible approaches that could be used for such an Interpretation.

MR. BLEAKNEY: Our next speaker is Mr. Harry Allan, who heads the Academy Committee on Principles and Practices for Pension Plans, and who will be telling us of some of the very substantial, basic work that has been done by the Committee recently. Although it deals with all pension plans, it certainly has a bearing on the topic at hand.

MR. HARRY E. ALLAN: When I was invited to participate on this panel, I was told I had two qualifications:

- I am a member of the Academy's Committee on Pension Actuarial Principles and Practices.
- I know absolutely nothing about public employees pension plans.

Accordingly, I will be talking about what our committee is doing on the question of acceptable actuarial cost methods in general. Beyond that, I'm here to learn, not to teach.

About two years ago, our committee became self-conscious about the fact that we were taking positions -- sometimes controversial positions -- on the acceptability of specific actuarial cost methods without having articulated any general definitions of acceptability. We have been working to correct this and are about to distribute to the membership of the Academy a paper that describes our tentative conclusions. It is rather grandly titled "General Characteristics of Acceptable Actuarial Cost Methods". This is the first public exposure of the ideas in our paper.

Because this morning's panel is about public employees' plans, let me emphasize two things:

- In our work, we were not specifically addressing public plans.
- Neither are we excluding public plans.

Our present attitute is that there is no reason to have separate standards of cost method acceptability according to whether the participants are public sector or private sector employees. We are very interested in hearing from those who disagree with us on this point.

Now I'll summarize briefly our conclusions.

First, we decided to look to existing practices to discover the general characteristics of acceptable methods. There is a range of practice that is widely considered to be generally acceptable, and we have tried to infer from that range of practice the underlying principles of acceptability.

Second, we have tried to identify those parties that have an interest in the selection of an actuarial cost method for a specific plan.

These are:

- The actuarial profession as a collective entity

o The individual actuary appointed to serve that specific plan

o The plan sponsor

o All the other users of the actuary's work.

Our main concern is to distinguish the responsibility of the profession from that of the individual actuary, without forgetting that the plan sponsor and other users have rights and responsibilities as well.

To make this distinction, it is necessary to also distinguish between the actuarial cost method (e.g., unit credit, entry age normal, aggregate) and the funding policy and expensing policy (e.g., normal cost plus thirty year amortization of the unfunded actuarial liability). Our current concern is the actuarial cost method. We have not addressed limitations on the funding policy or the expensing policy. Many of the questions that will be addressed today are questions of funding policy. Our paper does not offer answers to these questions.

To distinguish responsibilities we created a hierarchy of labels:

acceptable, reasonable, and appropriate. This is what these labels mean:

- The profession decides that a cost method is acceptable; that is, it should be available to qualified actuaries for use at their discretion.

- The individual actuary selects from the acceptable cost methods those that he considers reasonable for the specific application at hand.

- The plan sponsor or other users select from the acceptable and reasonable methods the one that is most appropriate to his goals.

We then go on to establish what we perceive to be the general characteristics of acceptability. This isn't the place for a detailed explanation of our criteria of acceptability. For that, you'll have to read our paper and you will have it soon. I will tell you that it is not a revolutionary document, and that we have not intentionally proscribed any widely used method.

Those of you who believe that the profession should do something to assure sound funding of public employees pension plans will think that we have ducked the issue. To understand our point of view, consider that actuaries communicate with one another, their clients and the public in two distinctly different ways:

- As experts, basing our statements on facts and therefore justified in insisting that our views prevail.

- As non-experts, basing our statements on preferences and subjective judgment and relying on persuasion.

I have concluding that we are non-experts in this sense when we address funding policy. We are entitled to be heard, but not to insist on obedience.

Because our Committee is charged with establishing Generally Accepted Actuarial Principles in the pension area, we are hesitant to set positions that are arbitrary or based primarily on subjective judgment. If we go to the Academy board with a recommendation that it establish positions with the force of disciplinary sanctions behind it, we want to be sure that we have a solid factual foundation for that position.

MR. BLEAKNEY: I would like to start with some commentary on Ken's remarks. I don't know how many of you know it, but a few years ago Ken was a colleague of mine. We were in different offices of the same firm. He suffered about the only disadvantage I can think of, being born many years after I was; he had to feign acceptance of my actuarial approaches to things. And one thing he picked up, one of my worst characteristics, was the ability to obtain a whole bunch of nits and attach them to the actuarial process. Now of course we nit-pick all the time, so we have a lot of these nits left over. I think Ken has found a whole bunch of surplus nits and has attached them to the actuarial process here. In short, my biggest objection to Ken's approach is that is it too detailed.

But I also think that is is an enormously spectacular start. In particular, I would like to subscribe 100% to the following statement that Ken has as his definition of whether inadequate funding is occurring:

> " . . .[F]uture generations of taxpayers should be realistically expected to afford contributions that are equal to but are no higher than those that present taxpayers can afford when contributions are expressed as a percentage of a system's payroll. Since pension costs can be considered as additional payroll expense, this premise is equivalent to assuming that future generations can meet future payrolls. While it is reasonable to assume that future generations will be able to meet payroll expenses, one must question whether it is reasonable to assume that they can afford more. Therefore, a system is inadequately funded if future generations are expected or required to make contributions which represent a larger percentage of the system's payroll than the percentage required of the current generation."

I like to refer to that concept as the "watershed". If the percentage of pay that is scheduled for the future has to go up, then that's beyond the pale, if you will.

Again continuing with the quote from Ken's paper:

> "We cannot realistically expect future generations to shoulder a greater financial burden than we place on ourselves, nor can we anticipate that future taxpayers will somehow find it easier to pay a higher percentage of payroll contributions that we now struggle to make. Mr. Juan Kelly, a pension actuary, while speaking at a meeting at the Conference of Actuaries in Public Practice, said, 'The governor [of Massachusetts] . . . has gone on record as saying that when the state has the money, they will fund public pensions. They simply do not have the money.' One wonders when it might be that Massachusetts, with its already high property taxes and state income taxes, will ever 'have the money'."

I think that's getting to the heart of the problem. Unfortunately it doesn't solve the problem. It says that we should have a basis for setting a level of contributions more than which we cannot expect future taxpayers or other plan sponsors to be reasonably able to afford. But how do we go about defining what that level is in more specific terms and regulating that that particular approach is the way to go.

And this brings me to a few of the issues that I feel are vital for us as members of the Academy, or for the Academy structure as a whole, to address. First of all, who should set the standards? Should it be within the Academy, or any other actuarial body, to develop for its own members such as the idea that Ken espouses? Should it be imposed by another professional body say, accountants, because the accountants have more people, more clout? Or should it be a government-imposed standard? If it is the goverment, should it be the Federal government, as conceivably could occur in the extension of the current legislative process, or should it be the individual state governments, or should it be at lower levels? Where should that power reside?

Another question that is all entangled in this is, what level of detail should there be in the standards? Ken has presented a detailed approach such as the funding standard account under ERISA, by setting a number of specifications relative to the amortization of certain gains and losses, etc. How detailed should it be? Should it be simply a very broad statement? Or should it be a very specific set of standards that would be clear and unambiguous but, as Ken so aptly said, would take a lot of the fun out of being an actuary. Maybe the whole responsibility is not meant for our fun, but I must admit that just filling in blanks which a very detailed standard might set up would not be as much fun as we now have with essentially no regulations in the public sector.

If the Academy should be setting the standards, at what level should those standards be set? Should they be broad guidelines that specify the type of acceptable funding mechanism which we might consider? Or should they be more specific in directing the actions of the actuary? For example, if you are writing a report for a system governed by a law stating that it is pay-as-you-go, should the standards require that you cannot give a report without also reporting that this isn't right, and the plan sponsor should be thinking about this other number? Or should you resign an account where they are not taking your word, in effect, saying, "Well, I'm sorry, we just can't continue under those circumstances."

I'm sure that the last situation is an extreme that we're likely not to get to, but it is within the spectrum of possibilities at which I think we should be looking to see what is the responsibility of the Academy. At the moment, we are dealing with the subject from the standpoint of the Academy, but perhaps the Academy should say, "This really is not in our province, but we would urge -- whoever -- to work on it, since this is where we feel the regulation should take place."

Along this line, the National Council on Government Accounting is about to release an extensive draft as a discussion memorandum for exposure. It will be dealing with the question of pension accounting and financial reporting for public employee retirement systems and other state and local government employer entities. I have been assured that they are very receptive to actuarial input.

As chairman of the Subcommittee on Public Employee Retirement Systems of the Academy, I would also offer to serve as a clearing house for any further thoughts that might come up with respect to today's general topic of what the Academy's role might be in this whole area. If after two weeks, you should wake up in the middle of the night and think "This is what we should be doing," I would be very glad to receive a note from you, because our Committee will undoubtedly be addressing this question, and every little bit of help we can get we will certainly appeciate.

MR. STEINER: The reason I wrote a paper on minimum funding standards for public plans was that we had done some work for a particular state, and the actuary for that state was using an acceptable cost method (the Entry Age Actuarial Cost Method) and was funding the system's unfunded accrued liability over a period of 30 years. But the actuary was not using level-dollar amortization of the unfunded accrued liability; he was not using level-percentage-of-pay-amortization of the unfunded accrued liability. He was using an approach that produced amortization payments that were expected to represent an increasing percentage of each successive year's system payroll, and his assumptions were generating significant actuarial losses. He was using fairly optimistic assumptions like forty percent turnover between age 55 and 65 without valuing the associated cost, even though the normal retirement age was 60 and people could retire with heavily subsidized benefits as early as age 55.

Recognition of these losses was being deferred to later years because of the increasing-percentage-of-pay amortization approach, and so what looked like an acceptable actuarial funding approach was really producing recommended contributions that were less than pay-as-you-go, and the system was dipping into member contributions to pay benefits.

We did a projection of future contribution rates using what we (and the state's economists) felt were realistic assumptions, and the projected contribution rate went from 14 percent to 59 percent of pay over a period of twenty-five years. As a result of our study, we said that we didn't think that this was a realistic way to fund a plan.

We said we didn't think that that the current contribution level was a realistic estimate of the cost of the system's benefits. The actuary for the state responded that there was no actuarial definition of "realistic funding". We looked to the Academy guidelines, and there was not a thing there on which we could hang our hats.

So my response to Harry is that I just don't think that we can rely on calculation of the normal cost without taking a look at how the other component of the cost, the amortization of the unfunded accrued liability, is being determined.

Since we're quoting here, I'd like to quote the preamble to the guides. It concerns professional relationships, but I also think it applies to professional conduct.

> "In all these relationships, every member of the profession is concerned with his own behavior and, as the good name of the profession is the concern of all members, with the behavior of his colleagues."

To respond to Tom, I thought he was going to quote the passage in my paper where I quoted him as the only thing about the paper with which he could really agree.

As far as the question of who should set the standards, I don't know. Perhaps I feel guilty about our profession's lack of response on some of these issues. It seems to me that many of the regulations being forced on us and our clients have resulted because we're not establishing our own standards.

I would like you to think back to before 1974. Why were funding standards imposed on our private plan clients and us in ERISA? If we had established the funding standards, would we have come up with the same funding standard account? Would we have permitted 30-year amortization of benefit increases that occur every two or three years in flat-dollar plans? Would we have said 30-year funding is okay for retiree increases where the expected lifetime of the average retiree is 10 to 15 years? I just wonder if it is better that we address these issues rather than having them foisted on us.

MR. ALLAN: We are very much aware that the rules we write are not stringent enought to prevent every bad thing that someone might do. We deliberately decided that this is not the approach that we would take. We recognized, for instance, that someone could choose an outrageously high valuation interest rate and that we could not point to a specific rule that says it is too high.

There are probably places where we can narrow practice further, eliminate things that we could consider abuses, but not take out of the hands of the competent, conscientious practitioner the freedom he needs to serve his client properly. We are working on that. But it is extraordinarily difficult to do this; we have not yet found solutions with which we are intellectually satisfied to publish and impose on the profession.

MR. EDWARD H. FRIEND: I wanted to congratulate Ken for his endeavors on the subject of funding for public pension plans. It is an important area and worthy of our deliberative attention here today. Harry, all of us are indebted to you and to your committee for its work in the broader area of developing principles for acceptable actuarial methods.

I am afraid, however, that actuaries are in a very difficult position on this issue and am inclined to agree with Tom Bleakney. Unlike the auditors who have established the importance of a GAAP statement in response to the SEC's demand for a standard by which it would govern, and unlike the response of the actuary to the IRS requirements pursuant to an ERISA law promulgated by Congress, the actuary has no status to require such disclosures.

If our client tells us not to publish a set of results which we would argue are appropriate to publish and to disclose, we cannot tell our public client that we must publish. There is no basis for our insisting.

Now Tom has pointed out that there may be three different ways to accomplish this if we cannot. He indicates the accountants might require it of us. But even the Financial Accounting Standards Board has had

trouble imposing FASB 35 on public sector plans. Resistance in the public sector has been strong, particularly as to the manner in which plan assets are valued.

We have a Government Accounting Standards Board (GASB) concept prepared. We have the National Council on Government Accountants to which Tom has just made reference. The fight is just beginning.

Consider the government. The government has no status. That is, federal and state separation creates real problems. The case of Usery versus the League of Cities makes this particular possibility, at this point, most questionable. It is not likely that the federal government can impose funding requirements on states. Although states, themselves, can impose funding standards on subordinated public jurisdictions (as has been done in Florida, and I think that's a great start, but it hasn't happened anywhere else), the states are not going to impose standards on themselves.

In the Far West, in the State of California, the Teachers Retirement System is attempting to fund in accordance with the standard which Ken has suggested, "infinite funding", and has failed, fallen short despite that low standard; whereas in the State of New York, where funding is very, very strong, administrators would be frightened of a standard such as Ken suggests, because it would give the legislators license to "unfund". Thus, a very difficult set of conflicting goals is confronted.

As I look at this entire picture it seems to me the only answer, the only practical answer, is somehow to get to the SEC, or a similar rule making body, to require certain statements in connection with the promulgation of general obligation and other special issues of the public jurisdiction. Until and unless those statements are published in accordance with some certification which the actuary should be actively prepared to recommend, unless we get that kind of requirement coming to us from a governmental agency, we are absolutely powerless, and I submit to you in very dangerous territory because I just don't think we have any domain.

Changing the subject for a moment, one of the most serious difficulties in Ken's proposal is in his recommendation regarding an acceptable growth percentage of payroll assumption to be used in developing the cost of amortizing the unfunded accrued actuarial liability. I think that the impact of small differences between actual and assumed growth for purposes of the percentage of payroll requirement for amortization can lead to massive actuarial losses.

A 15-year amortization of losses arising from such differences could be so massive that in a period when the client is in the worst possible shape, heavy, heavy additional funding requirements would be imposed.

And the choice of these assumptions is so delicate, I don't concur with the concept of simply keeping it below the COLA level. It could be appropriate to set it well below the COLA level because of attrition. This is probably the most controversial component of Ken's proposal. Moreover, local jurisdictions cannot accommodate significant swings in budgeted cost.

By the way, Harry, that's one area where I do think the corporation and the public sector come apart. The corporation must amortize its unfunded accrued actuarial liability, not only because of IRS requirements, but also because corporations do go out of business. Public sector jurisdictions "presumably" (I use that word advisedly) have infinite life and therefore, do go on and on or may be swallowed or annexed by larger jurisdictions, and hence need not amortize the dollar level (but probably should amortize the relative debt to payroll level) of the unfunded amounts, but corporations must amortize.

Ken's approach would have the unfunded accrued actuarial liability grow in proportion to a presumed growth in that payroll. So we have to be very careful to distinguish between the private sector and the public jurisdiction.

MR. BLEAKNEY: Ed brings up a key question that needs to be addressed. He referred to New York in one instance and California on the other instance. The New York funds are very comfortably funded, and the California Teachers' fund is very uncomfortably unfunded. How does one deal, within one set of guidelines, with those two concepts without creating either an unworkable monster in California or an unthinkable public relations problem in New York? I believe this difficulty is an argument for keeping the problem within the profession. We can present a more sophisticated set of guidelines to the general public. In New York we would be able to say, "Yes, you just continue on with what you're doing," and in California we'd say, "You've got to move up." But realistically, we cannot expect California to jump immediately onto the New York level of funding. It just isn't practical. Some form of a ratchet is necessary. You do not slip below where you are. You keep moving up. But you can not expect to get immediately to the top rung.

MR. ROBERT M. MAY: What if as a standard we called on actuaries to follow a position of a level percentage of payroll over time as a guideline, or to justify the rationale for using a method that produced an increasing percent of payroll?

MR STEINER: I think that is exactly what I am proposing. I am proposing that to avoid a negative credit balance, the contributions be designed to be a level percentage of pay. Also, keep in mind, the standard would not require contributions at the minimum level. If the people in New York feel that they want to continue their funding program, fine. They build up a credit balance.

I am not suggesting that anyone fund on a basis different from the basis on which they are currently funding. I am suggesting that we encourage actuaries to maintain funding standard accounts to disclose how contributions measure up against minimum charges and credits.

MR. MAY: Well, it seems to me that you are saying that we need a specific approach to deal with the problem, and I am wondering if a more general disclosure would suffice.

MR. STEINER: As with all other generally accepted actuarial principles and practices, you can deviate from them as long as you disclose that you have done so, and the reason why you did it. You must, however, be prepared to support why you have done so.

To respond to Ed, I am not suggesting that you have to put a funding standard account in your report, but I think that if you want to say that your report meets generally accepted actuarial principles and practices, you must either include such an account in your report (determined either consistently or inconsistently with the interpretation that the Academy might promulgate) or you specifically exclude it and disclose in your report your reasons (such as your client did not want it disclosed).

MR. FRIEND: Ken, I would like to agree with you. I would like to have that kind of requirement imposed upon me by the Academy, but I don't think the Academy can. I don't think the Academy can discipline me for following my client's proscription against my putting any such statement in my report.

There is nothing anywhere in the principles and practices, and I don't think Harry Allan will be successful in requiring us to do so, to put something in that our client doesn't want in there unless we have the force of law.

We have standards by which we must practice, and -- I wish this weren't true -- if we were to put in our report that "here is the cost of funding this program in accordance with pay as you go" or "here is the cost of funding this program with pay as you go less some amount, with a certain deficiency building up".... if we were required simply to disclose these facts, we would be moving a long way to accomplishing the objectives being sought here. Unfortunately, there is no such requirement.

I would hope that we could have this imposed upon us, but I don't see how unless by some government agency -- and this is why I suggest the SEC or a similar entity -- because the public jurisdiction must go out and acquire funds from the public, and this means proper disclosure to an investor.

It seems to me reasonable that if the leadership of the profession would go to the SEC or other rule making body and say, "We think the investor needs this disclosure in the prospectuses of the public jurisdictions," we might be successful. Of course, we might then be brought back to Usery versus the League of Cities, and the question of whether the governmental rule making body would have the appropriate power.

The government may well have it in that narrow area. This I think is where it has to come from.

MR. BLEAKNEY: I have some difficulty with the idea that the only way that we can practice our profession properly is by pressure from outside. I would like to believe that it is possible to establish standards to live by within the profession.

I like Bob May's idea. It happens to be one to which I could easily subscribe. Suppose our guidelines somewhere were to address the situation where the actuary expects his recommended contribution rate to increase as a percentage of payroll. The guidelines might spell out that the actuary's responsibility is to point this out to the plan sponsor and to make some estimate of the implications and weight of this expectation.

If that were the case, such a statement would be required in California in the reports given to the systems where the contribution rates are below what will ultimately be required. In my own home state of Washington, we have a situation which is devastating. In our systems, which have been well funded over many years, the actuary has been presenting reports to the legislature stating the amounts of money that should be contributed. In the last three or four years, for economic reasons, the legislature has been ignoring the actuary's reports. This has contravened a 25-year pattern of the legislature accepting the rates presented by the actuary, whether they hurt or not.

I do not know how this problem should be addressed. Should the actuary follow up after presenting the required contribution rate? If his recommendation is not adopted, what should he do? I don't have an answer. I do know that we are the ones who should know what is going to happen if our recommendations are not taken into account. If you will recall the chart that Ken showed of the rates going up and down, I think we are the ones who should have some feel as to what our recommendations are going to do along this line. I find it very hard to believe that the actuary presenting the rate which was at the low level could not have foreseen that the rate would continue to increase. It strikes me that all these things have to be taken into account, and we're the ones who would likely know.

MR. WILLIAM A. HALVORSON: I was interested in this discussion of public retirement plans because I am interested in what the Academy should be trying to do.

I am fascinated by the discussion because apparently we really believe that we, as actuaries, have no domain, no authority. You suggest that one of the ways we can have such domain is through the SEC with respect to ratings of municipal and state bonds. I assume maybe some of the bond rating organizations would also be other vehicles for us to have some influence and some domain.

But my interest in this, and the reason I think the public employer retirement plan management is different from that for private corporations, is that I've always had the feeling -- and I don't work in this field extensively -- that future taxpayers are just not being represented in setting the course of funding of pension plans or deciding on the level of benefits. And I don't think you can separate those two. I think you have to look at both the level of benefits being provided and the funding rates.

So when you say we have no domain, then I have a feeling that taxpayers really have no domain, and that bothers me even more. Now we can't self-appoint ourselves as representing future taxpayers, but I'd like to find a way that we can approach this problem. We can start with the position that nobody is representing, in the typical situation, the future taxpayers. So that the actuarial profession, which is in the business of making long-range forecasts and predicting where things may come out, and developing sound funding systems that future managements can handle, et cetera, will take on that role. And self-appointed as it may be, we could say that we have an obligation to give such a report to the public.

And I don't mean just the sponsors or the person who is managing the system for the city or the county, but to the taxpayers that eventually pay for it all. We must disclose to them, on the basis of our work with the plan, what their obligations are likely to be in the long run.

How we get to that point and whether that protects us adequately are important questions. But I start with a thesis, and I guess that's what I would recommend to our various committees, that they look for ways for actuaries to make some kind of public statement to the taxpayers concerning the level of funding that they're now taking on, or that is implied in the funding system.

I want to remind you that we do not even have this with respect to Social Security or Civil Service employees either. But the actuary for the Social Security Administration is now putting out a separate letter. We are encouraging that because we think it is important for the public to understand not only what the funding rates are, but also what he or she had recommended and the implications of the funding rates chosen.

MR. FRIEND: Bill, I think the ideas that you are advancing are excellent, and I really agree that the public has no representation. The actuary, I am afraid, has no status, and I agree that the problem is very serious.

Going back to Tom's comments and joining in the observation that you've made, Tom has said that "gee, we ought to be willing to disclose, and if they ignore us, well, at least we've done our job". The problem is sometimes if we insist on disclosing and the client is prepared to agree and says, "Okay, disclose this information to me. I'll take it from there, but I don't want you to talk to A or B or C. You shall not present this in the legislature. We will not give you a forum". Under such circumstances, the actuary is constrained from presenting what information he believes needs to be disclosed. He has no position. If he contravenes the request of his client, he runs not only the risk of being dismissed by the individuals who have authority over him, but he actually runs into some legal risk. I think if the profession, for example, were to impose some requirement on the actuary, it, the profession itself, would be involved in some legal risk. The thing is not that simple.

We would _like_ to appoint ourselves as overviewers or as protectors for the public, but we really need to be very careful in that self-appointment. I think we need to be joined, we need to encourage, some governmental agency to require it of us. I think this is something we _can_ do. I think it is the _only_ route to follow.

I would like to be more optimistic, but I've been exposed and seen a lot of pressure applied by authorities from these public jurisdictions, and I've looked, as Ken has, as Tom has, for some acceptable solution or means of "forcing" disclosure, but I don't find any.

MR. BLEAKNEY: I feel that we are embarking on a rather treacherous voyage. Those of you who followed the federal legislation pattern over the years will recall that ERISA has a provision that it would not apply to public employers, but instead called for a study. The study came out in a very scathing report on what a terrible condition public funds were in. This caught some interest and it was one of the bases for PERISA. But PERISA has no funding standards. It had some of the other provisions almost copied verbatim from ERISA but nothing in the way of funding standards. Now PERISA has become PEPPRA, with something in it regarding disclosure, but again, not a lot of teeth.

My point is that it is not easy to move in this area because of the various pressures that occur from the California/New York type of distinctions. My personal judgment is that it would be well to walk before we run. Although I would not object to an SEC approach or something of the sort, I feel that an Academy initiative even if we disclose and nothing happens, if it is completely ignored, this would be a step in the right direction. Then if the SEC or the bond-rating firms, the state or federal governments decide they want to do something, if we are very lucky, they might just adopt lock, stock, and barrel, what we have recommended, or if we are not lucky, at least we would have given them an initial bases for further discussion.

MR. STEINER: Although I disagree with much of what Ed has to say, I feel we all owe him a debt of gratitude for being concerned about these problems for a long time, and for voicing his concerns.

I would like to address some of the issues that Ed has raised. On the unfunding issue, again, all that I am recommending is that an account be maintained as a disclosure item (with a negative balance permitted). If the minimum standard is used to determine the contribution, however, there would be no unfunding. That is, if you define funding status as the ratio of assets to accrued liability, this ratio would not be expected to decrease even if the minimum level is contributed, so there would be no unfunding in this sense.

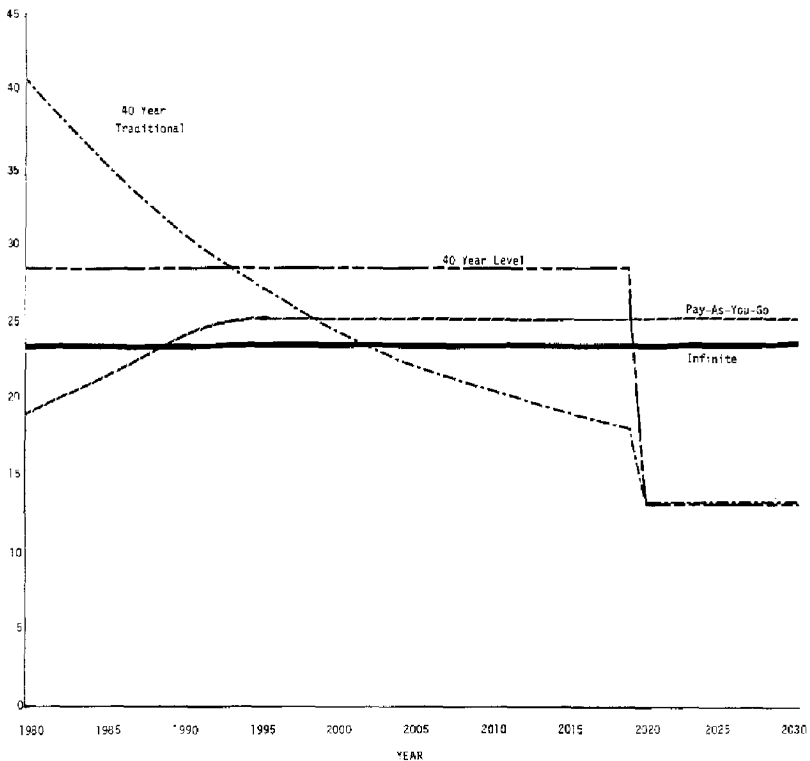
Regarding the issue of whether 15 year amortization of actuarial losses would create "heavy additional funding requirements", a system would always have the option of disclosing a negative credit balance for a few years or using up some of its positive credit balance rather than paying the contribution.

Regarding the issue about New York versus California, again, we are talking disclosure. If New York wants to keep funding at the present level, more power to them. The reasons for funding at higher levels than as a level percentage of pay still exist. They exist now as they did before. The problem I see is that if this standard is adopted, perhaps some actuaries will have a little more trouble convincing their clients that they should continue their current conservative funding approach, and I don't see that as necessarily a bad thing.

Tom mentioned the situation where a contribution has been recommended and just ignored. Often, there is no funding flexibility. You have a statute or an actuary that says, "30-year funding", and you either contribute at that level or the client ignores the recommendation and contributes at some other level. I think that our public clients need funding flexibility because it is not always easy to choose whether dollars should be put into the defined benefit plan or used to fund an extra policeman or fireman. These are difficult choices, and I don't think the pension plan necessarily is the right choice all the time.

As far as being dismissed, I agree with Ed. I think that without an Academy Recommendation, if you walked in and told your client that he had to maintain a funding standard account, you might be thrown out on the street. But I think if the Academy guidelines said the generally accepted actuarial practice is to include a funding standard account in a report, then there would be strength in numbers. If the client wanted the generally accepted actuarial practice label on his report, he would have to hire an actuary willing to either include the standard in his report, or to say in his report why he does not think it should be there.

Table 1




Based on interest return assumption of 7½%, covered payroll growth assumption of 4½%

# CONCURRENT SESSION
# ACTUARIAL MALPRACTICE—THE EMERGING LAW AND GROWING EXPOSURE

*Moderator: DAVID M. READE. Panelists: WILLIAM A. FERGUSON, WILLIAM D. HAGER, LESLIE S. SHAPIRO*

MR. DAVID READE: Malpractice has, up until somewhat recently, been the exclusive province of the medical profession, but lately accountants and lawyers have been getting into the act and now we, too, are being sued at times. So I think this is a topical subject.

We're presenting it in the form of a paper written by Bill Hager, with discussion by two others. We expect to have time for questions and comments from the audience.

Bill Hager has been admitted to the Iowa bar, the Illinois bar and to practice before the Supreme Court. He started out as general counsel to the Republicans from the House of Representatives in Iowa, later went to Washington as an aide to a congressman from Iowa, and for the last years has been with the American Academy of Actuaries. I must point out too that he began his career, not as a lawyer, but as a teacher of mathematics. So you see we have a little bit more in common with him than you might have thought. Bill's current position is General Counsel and Director of Government Relations with the Academy.

MR. WILLIAM HAGER: Today I will talk about an area of the law that I've recently done some work in. Specifically, the area of actuarial malpractice or - if you will - professional liability and the actuary. My presentation is based on a law review article which I co-authored entitled "The Emerging Law of Actuarial Malpractice." You can find this article in the September 1982 edition of the Drake University Law Review.

Before we get into the substantive issues of the article, I'd like to explain how easy it was to acquire the legal citations to virtually all the cases included in the article.

Surprisingly, it took me a total of 30 minutes of legal research. I sat down in front of a Lexis Computerized Legal Research terminal and punched in the words "actuary, generic", and then I punched in the words "liability, generic,". I then asked the computer to draw out all recorded U.S. cases in which the words "actuary" and "liability" (used in a generic sense) appeared within a band of ten words of each other.

After a seven minute wait I received a printout of the titles to 45 cases. Then, still at the terminal, I examined the text of the paragraphs in each case where that combination of words appeared, and eliminated the cases where the combination was simply a coincidence, and therefore, irrelevant for my purposes. After identifying the relevant cases, I got a full printout of those cases.

From the time I sat down in front of the Lexis terminal until the time I left, a total of 30 minutes, I had extracted most of the relevant cases in the area of professional liability.

The point I'm trying to make is that any lawyer, anywhere in the U.S., in the span of seven minutes can extract the critical body of law that comes to bear on an actuary's work product. If attorneys who represent plaintiffs potentially harmed by the actuary can retrieve applicable law in seven minutes, I suggest it's worth the actuary's time to become aware of what that law is.

As a result, in today's discussion, I hope to dispel a few myths that I hear repeated within the profession by pointing out the current status of the law. The most common myths include:

1. There's no such thing as actuarial malpractice.

2. No court of law can pass judgment on an actuary's work product because it's too complex and only those who understand it, after all, can judge it.

3. There's no such thing as generally accepted actuarial principles.

4. By promulgating professional standards, the American Academy of Actuaries actually increases the liability exposure for practicing actuaries.

Now let's compare those myths against reality and against the law, to see how they stack up. In doing so, I'd like to discuss six key areas as they come to bear on actuarial liability: (1) general principles of professional liability, those generic principles that come to bear on all professionals when they produce their work product, (2) the law's recognition of actuaries as professionals, (3) the law's embodiment of generally accepted actuarial principles, (4) the nature of an actuary's liability exposure, (5) recent court cases that relate to actuaries and their professional liability, and (6) the steps an actuary can take to structure his behavior, work product, and office, so as to minimize the potential of professional liability.

## I. General Principles of Professional Liability

Our first area of discussion is the generic principles of professional liability. When a professional, any professional, dentist, architect, engineer, physician, lawyer, actuary advises his employer, client or others, a duty arises to exercise due professional care. It's a very simple, straightforward, and basic, but compelling requirement. Another way to describe this duty is the requirement to exercise reasonable care and competence. Any failure to so perform, imputes liability to the professional for negligence.

However, a professional does not guarantee accurate or correct judgment. He does, however, guarantee that in formulating his work product, he will

exercise reasonable care and competence, act in good faith, and obviously, act without fraudulent intent. Let's reflect on this for a second. Almost all professionals typically produce a work product which will function in a future environment, a future environment which they cannot totally predict. I sometimes hear actuaries say that they are unique because their work product is applied in the future. However, the fact is the work product of all professionals is applied in the future. Take, for example, the work of a trial lawyer. When a criminal lawyer makes a decision not to put a defendant on the witness stand, he doesn't know at that moment whether he made the correct judgment; he cannot guarantee favorable results. Nonetheless, based on his experience, and his best professional judgment, he has determined what he believes is in the best interest of his client. Even though his client is subsequently convicted of murder and the jury later comments that had they only heard from the defendant, the verdict may well have gone the other way, nonetheless the lawyer has not acted negligently. Because the question is not what the jury says after-the-fact, the question is under the totality of circumstances, at the time the decision was made, whether it was a valid professional judgment. In this instance (even though it proved not to be the best choice), because the lawyer has met the due professional care standard, he would not be liable for professional negligence.

## II. Recognized Professions

Having considered the general principles of professional liability, let's now take a look at the recognized professions in law.

Law, itself a recognized profession, has recognized such additional occupations as medicine, dentistry, and the clergy. More recently, the professions that have been added to the list include accounting, architecture, engineering, and -- you guessed it -- actuarial science.

In support of this statement, we can look to case law. For example, one case held that "actuaries are individuals whose profession is the calculation of insurance risks and premiums." ERISA by statute gives the enrolled actuary professional status.

Not only has the case law held that actuaries are deemed to be professionals, but actuarial science satisfies the traditional criteria of a profession. This definition being "a branch of science which requires a special knowledge or learning."

Now, given that overview, how does a situation of professional liability arise with respect to the actuary? A typical fact pattern is as follows: An actuary performs a professional task. His client or some third party suffers monetary damage, and as a result, sues the actuary in state or federal court, alleging lack of due competence, due diligence, and due care in the work product, which caused his injury. Fine. We've got an actuary in civil court who has been sued; the allegation being unprofessional work product. But what standards come to bear on that work product? Are there a series of standards that a court of law will apply to that work product in order to judge it?

III. Generally Accepted Actuarial Principles

Yes, they are called generally accepted actuarial principles. By definition, GAAP are standards and practices that have been recognized either by the courts or the profession as appropriate for application in specific actuarial contexts.

Indeed the concept of generally accepted actuarial principles has been recognized in two U.S. Supreme Court cases. In the case U.S. v. Consumer Life, the United States Supreme Court determined that with respect to insurance company reserves for federal tax purposes, the determination of reserves was to be carried out under "...accepted actuarial standards..."

Moreover, in U.S. v. Zazove, another case involving reserves for federal tax purposes, the U.S. Supreme Court determined that with respect to setting reserves, the criteria for determining their appropriate level is under accepted actuarial principles.

Well, that's fine. We found a term. What is it? What does it consist of? What's it composed of? What are these standards that come to bear in a civil action for professional liability when an actuary is the defendant?

Basically, there are three main sources of generally accepted actuarial principles.

1. Standards Promulgated by the Profession

First of all, there's the codified portion within the profession. These are the guides, opinions, recommendations, and interpretations set out in the American Academy of Actuaries' Year Book. They are your safe harbors. If you are a professional actuary, read them. If you've produced a work product that is alleged to be deficient, and the plaintiff's attorney can show that that product violates your own professional standards, you are in deep trouble. On the other hand, if you can show you acted in accordance with the profession's standards, your legal posture is much improved.

2. Statutes

The second source of generally accepted actuarial principles are requirements of law. ERISA is a good example of a law which imposes specific requirements upon the professional actuary. Other examples of statutory obligations imposed on the practicing actuary are various insurance laws and the codification of many loss ratio calculations (Baucus HCFA). The question is not whether the practicing actuary likes what he sees in the codified statutory provisions, the question is what are the statutory requirements imposed on him.

3. Uncodified

The third source of generally accepted actuarial principles is uncodified portion. Let's say there is neither a professional standard nor a statutory requirement that applies to the actuarial work product in question. What does the actuary do as he tries to determine how to approach the

problem in a professional way and therefore preclude subsequent liability. One place to start is to read the Academy's Opinion A-7. It's good reading in the sense that it shows you how to construct your own principles in a situation where there's nothing specifically codified. In doing so, it directs you to inspect a variety of resources. Examples include (1) actuarial textbooks, (2) actuarial literature, (3) Professional journals, and (4) study notes for CAS and SOA.

## IV. Scope of the Actuary's Professional Liability

Let's next talk briefly about the scope of liability. It seems to me that *in practice the consulting actuary has the greatest liability exposure.* The consulting actuary's exposure is in contrast to the actuary employed by an insurer as an in-house corporate actuary, because pragmatics suggest that lawyers aren't going to fool around suing an actuary in an insurance company when they can zero in on the corporation itself. That's where the cash is and where the lawyer is going to concentrate.

Consulting actuaries do not normally have this shield of protection. The types of errors that can result in liability for the actuary can be set out into three areas. The first area is negligent acts, such as miscalculations. The second is negligent omissions. That is where the actuary fails to inform his client as to the scope of risks that are involved in performing his professional services.

### Negligent Omission

Failure to question a client's information if it appears or should appear to be erroneous is another classical omission. The fact that a client gives you the data does not in and of itself provide a shield of protection. A valid *defense cannot be, "the client gave me the data"* because when you get data that looks bad or doesn't track with last year's data, you, as a professional actuary, have a responsibility to challenge that data. The consequences of proceeding without challenging the data in a situation where a comparably situated professional would have challenged it, subjects the actuary to liability exposure.

### Unwarranted Delays

The third kind of problem that can arise for all professionals is unwarranted delays which result in penalties, lost opportunities, wrong decisions. A classical professional liability action against an attorney arises when he lets the statute of limitations run on his client's case. The same kind of thing applies to actuaries.

### Specific Cases

I would like to review very briefly the essence of the cases cited in my law review article. The first one is Equity Funding. I think everybody *here is familiar with the fact pattern. The specific allegation is a claim* by investors against the actuarial firm that serviced the plans. The allegation was that the actuaries knew or should have known about the underlying fraud. Although the case was never litigated to final judgment,

the U.S. District Court determined that the allegations made did constitute a cause of action which formed a legitimate foundation for the initiation of a liability action against the professional actuaries. The point here is that all professionals, including actuaries, have a higher level of professional responsibility in situations where they know the client or other third parties are ultimately going to rely on their statements. It's a very basic, very generic statement of professional liability law.

I next cite the British Columbia Automobile Association case, a Canadian case. The factual pattern is that an actuary made an erroneous calculation in determining the financial impact of a pension amendment. The court concluded that the actuary, and in this instance the actuary's employer, an insurance company, were liable for damages in the amount equal to the differential between the costs the client paid under the amendment and what the client would have paid had he received accurate advice.

Safeco v. Occidental Life Insurance Company is an important case in the sense that the U.S. Court of Appeals confirmed a District Court's finding of "actuarial malpractice."

Another case, Dill v. Wood Shovel and Tool Company, merely demonstrates a third party action against an actuary.

Minimizing Liability

What can a professional actuary do to minimize his liability? Well, it seems to me your approach ought to be two-fold. First of all, be cognizant that liability exists. Once again, that liability is there, not on vote of the profession, but upon enactment and implementation of law. Thus, spend less energy resisting the phenomenon, and accept it. Then, structure your affairs so as to minimize your liability.

Let me summarize some steps you can take, (1) to begin with you ought to carry professional liability coverage, (2) when you issue statements of opinions, especially statutory opinions in which the statute recognizes that you can qualify those opinions, qualify the hell out of them. At the same time recognize that you can't qualify away your professional responsibilities; you can't say, "I didn't know anything about this", (3) carefully document your reliance on the client's underlying records and summaries. A classical area of liability arises in instances where the actuary receives erroneous data form the client and didn't challenge that data. Protect yourself in two ways: one, document the initial data requests to the client, articulating clearly the parameters of your requests, and two, if you're relying on summaries and records provided by the client, challenge those clients who provide insufficient or questionable data. Do not sign an opinion based on such data. Selectively check the reliability of your data, and confirm oral opinions in writing.

An actuary can also look to the applicable law. Thus, if you are an enrolled actuary, and you want to minimize the likelihood that you will be characterized as a fiduciary, take a look at the law, if you're doing reserve work, take a look at state insurance law on reserving.

Finally, examine your own methodologies and assumptions used for determining the reserves and satisfy yourself that they meet the tests and various standards.

Now let's say that you just slept through everything I said -- and I know no one here has done that -- and have concluded that old Hager up there has talked about a few esoteric questions that are floating around in his head. After all, he's probably one of those Washington lawyers with nothing to do and so he invents things to write and talk about. If so, then I've got something you might be interested in. I'm looking at some pleadings in a cause of action. One of the parties named in this action is an actuary. The prayer for relief, that is, the damages being sought against the actuary, $50 million.

Let's look at some of the language within the pleading: "At all times relevant herein the actuaries held themselves out to the general public as possessing the skills and experience of consulting actuaries in actuarial matters, and being particularly qualified in all actuarial areas required by a life, accident and health insurance company." This is not a finding of the court, it is language from the pleadings. Continuing to read from those pleadings: "The reserves in this case have been computed in accordance with commonly accepted actuarial standards consistently applied and fairly stated in accord with sound actuarial principles, and are based on actuarial assumptions which are in accord with or stronger than those called for in the policy provisions."

Throughout these pleadings you'll find the statement "accepted actuarial standards" repeated. It does exist. It will be litigated in a court of law. It doesn't take much creativity to figure out what the plantiffs are going to argue, that they're going to set forth standards they believe should have been adhered to.

My point is simple. It's twofold: one, liability exists, and two, there are very direct methods you can use to structure your affairs to minimize that liability.

I think it's a pretty straightforward concept that is totally consistent with every other profession.

MR. READE: Our next speaker is known to most of us as the Executive Director of the Joint Board for Enrollment of Actuaries. Some of us may think that Les came into being only when ERISA was proclaimed, but, in fact, he has been for several years the Director of Practice for the Treasury Department and, as such, is responsible for all professional practice before the Internal Revenue Service and before the Bureau of Alcohol, Tobacco & Firearms. So he's responsible not only for the enrollment of actuaries but for disciplining people like lawyers, accountants and enrolled agents. Les has been admitted to the bar in Minnesota and in D.C., and to practice before the Supreme Court.

MR. LESLIE S. SHAPIRO: I read with interest Bill Halvorson's message in last month's edition of the Academy Newsletter. I would like to share part of that message with you. He states:

> "The curtain is rising. The work of the actuary may now be seen by those who care. And the profession is making sure that people who should care are learning about the actuary's role in society."

I think the quotation is significant in that it relates very much to what Bill Hager has just spoken to you about and to what I am going to say. Bill Halvorson addressed an objective of the Academy to expand its public outreach activities in part by conveying the message to millions of insurance company policyholders and employee benefit plan participants that the actuarial profession plays an important role in assuring their financial security.

A direct effect of the emergence of the actuarial profession into the public eye is the vulnerability of its members to public scrutiny. As Bill just described, a residual of that is the potential of a malpractice action. The litigation-conscious nature of our society today makes this a real possibility.

There are in fact three forms of liability to which a professional is subject. Bill addresed the area of civil liability. Another form of liability - which is the most extreme - is criminal. It would attach if a violation of a specific crime is proven. With respect to the actuarial profession, examples of such crimes are aiding and abetting in a securities fraud, e.g., the issue raised in the Equity Funding scandal, or evading or participating in the evasion of taxes. The burden of proof in a criminal action is on the government and, as I believe you know, the element of proof is that beyond a reasonable doubt.

The third form of liability is that of a breach of professional responsibility. This, of course, is the form of liability in which I am the most interested and concerned. However, the subject of this session deals with malpractice. You may wonder what ethics and professional responsibility in and of itself has to do with malpractice. Well, I'm going to tell you.

As I think we all know, historically, malpractice applied to physicians and surgeons. Specifically, it was the result of a finding by a court of a bad, wrong or injudicious treatment of a patient by a physician or surgeon acting in his professional capacity and in respect to the particular disease or injury. Such treatment must have resulted in added injury, unnecessary suffering, or death to the patient. The measures of the inpropitious treatment must have proceeded from ignorance, carelessness, want of professional skill, disregard of established rules or principles, neglect, or a malicious or criminal intent. The concept of malpractice has evolved considerably and is more currently considered in legal parlance as any professional misconduct, unreasonable lack of skill or fidelity in professional or fiduciary duties, evil practice, or illegal or immoral conduct. Hence, it now addresses professionals from all walks of life and its application in today's society has a great deal more flexibility than it once had. Yet the benchmarks of proof have not varied significantly.

As you undoubtedly recognize, the nexus between professional responsibility and malpractice is significant. It is a threshold of proof in malpractice

litigation - at least one where negligence or the like is alleged. The bodies or rules on the subject therefore are critical in this respect. In my judgment, another form of malpractice is a breach of those rules and *resulting disciplinary action.* Such *discipline is unlike a criminal* conviction which carries with it possible imprisonment, probation and money fines and is unlike the money damages flowing from civil liability. Instead, a finding of an abuse of professional responsibility besmirches one's professional reputation and, insofar as the enrolled actuary is concerned, has the potential of taking away enrollment privileges, thereby depriving the actuary of at least a portion of ability to earn his or her livelihood. It is the responsibility of the enrolled actuary with which I am most familiar and is the subject on which I will dwell.

As you know, the Joint Board was issued a mandate by Congress to suspend or terminate the enrollment of an actuary if it is found that the individual has failed to discharge his duties under ERISA or has not satisfied the requirements for enrollment as in effect at the time of enrollment. Consistent with that mandate, regulations have been adopted by the Joint Board, violation of which by an enrolled actuary has the potential of having the results I just described. But perhaps even more than that, the Board's rules, just as those of the Academy and the Conference, should point the way to the aspiring actuary and should provide standards by which to judge the transgressor. Each actuary must find within his or her own conscience the touchstone against which to test the extent to which his or her actions should rise above the minimum standards. In the last analysis, it is the desire for the respect and confidence of the members of his profession and of the society which he serves that should provide the actuary the incentive for the highest degree of ethical conduct. The possible loss of that respect and confidence is, perhaps, the ultimate sanction.

What I have just said may be characterized as idealistic and may give you the impression that the regulations of the Joint Board are inspirational in nature. This is not the case. Unlike canons of ethics, which are axiomatic norms and express in general terms what is expected of a professional, and unlike rules which are aspirational, our rules, in my judgment, are mandatory in character. They are intended to state the minimum level of conduct below which no actuary may fall without being subject to disciplinary action. The severity of judgment against one found to be in violation of a regulation ordinarily is determined by the nature of the offense and the attendant circumstances.

When speaking or writing on the subject of professional responsibility, I always mention, as do most who speak or write on the subject, that the only sure thing about guides to professional conduct is that there are none. It is an area that is necessarily imprecise because decisions on matters of ethics are by their nature subjective. Judgment in each case must take into account the proper blend of the practitioner's competence and obligations to his clients, to the government and to his ethical conscience.

I think that with respect to substantive actuarial services under ERISA and perhaps generally, there are three areas which have an impact on review of purported abuse of professional responsibility. They are articulated in the

Joint Board's regulations and I will merely summarize them at this point. I wish to emphasize that these same areas come into play in a civil action for malpractice. In my opinion, resolution of the application of these areas to a given case, be it civil action for malpractice or a disciplinary action, are so inextricably intertwined as to be inseparable.

1. The first is an admonition to undertake an actuarial assignment only when qualified to do so. This, in essence, states that an actuary must have the requisite competence to handle an assignment. If there is a finding he does not, it may be determined he has violated the regulations.

2. Secondly, misconduct may be found if an actuary has erred in the discharge of his professional services and such error is found to be the result of a willful act. Willfulness, as judicially defined, carries with it a connotation of a voluntary, intentional violation of a known duty, accompanied with bad faith and a want of justification in view of all the circumstances surrounding the matter. A clear example of this would be an enrolled actuary's failure to prepare a required actuarial information document, i.e., Schedule B of the Form 5500.

3. Thirdly, misconduct may have occurred if an actuary is found to have acted negligently. Under the Joint Board's regulations, the issue of negligence has been addressed by making it the failure to discharge an affirmative duty. By this I mean the enrolled actuary is required to exercise due care, skill, prudence and diligence in the discharge of his duties. "Due diligence" has been defined by our courts to mean such a measure of prudence or activity as is proper to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstances. An example of the failure to exercise due diligence by an enrolled actuary would be preparing a Schedule B but omitting by oversight some of the information required on it.

While the sense of the areas I have just summarized may be understood, the application of the rules to a given set of circumstances is, at best, difficult. Further, there is a dearth of established precedent or writings in the area to offer meaningful assistance. Bill, in his article, refers to a number of reported cases involving the accounting profession and to a couple involving actuaries. Certainly the cases involving accountants are meaningful in many ways, particularly with respect to social policy and to the duty of care, in the legal sense, owed by an accountant to a reliant client or third party. The couple of actuary cases are meaningful in that they seem to be following the line of accountant cases. These cases address common law cases by parties alleged to have been damaged by the acts of the professional. One distinction between a pure malpractice action and a disciplinary action is that a matter arising from a breach of ethics and involving a disciplinary action does not necessarily involve an injured party.

Also, let me state again that guidance in the area is necessarily imprecise because such matters require predominately factual determinations. Decisions in this area are affected not only by the matter itself, but by such factors as the customs of the profession, the harm or potential harm suffered by either the client (including for the enrolled actuary, the plan participants) or the government, and the actuary's explanations. All must be reviewed and evaluated in the light of the regulations. As one can imagine, allegations of misconduct embrace many gradations, and it is not always an easy task to make determinations which will be fair to all those affected.

For example, ERISA and the regulations promulgated thereunder require an enrolled actuary to seek and obtain approval of the Secretary of the Treasury or his delegate before changing a number of funding methods of pension plans. If my office were to receive a referral indicating that a funding method was changed without obtaining the requisite approval, how are we to view the situation? We could conclude that the actuary, in preparing the Schedule B, failed to exercise due diligence because he or she utilized a funding method not authorized, thereby reflecting incorrect entries on the schedule. Certainly this conclusion would be irrefutable. However, we also could conclude that the actions of the actuary in preparing the Schedule B in this fashion was the result of his or her willful act. After all, it is presumed the actuary is familiar with the requirements of the law. Consequently, failure to comply with one of those requirements may be considered a voluntary, intentional violation of a known duty. Finally, we could conclude that the actuary undertook an assignment for which he was unqualified, i.e., the actuary was incompetent. Certainly the law applicable to something as fundamental as the requirements relative to the funding of a plan should be within the scope of the actuary's knowledge if he is enrolled to perform actuarial services under ERISA. If he has overlooked the law (or has failed to research it), the requisite competence is not there. Under this elementary fact situation, all three areas of violation could be found. The resolution of the matter would be to a great extent dependent on the explanations of the actuary and any mitigating circumstances presented. We also would be inclined to look to the harm suffered by the participants and the government and any corrective action taken. In my judgment, there appears to be no way in which the actuary could justify or excuse his actions to the point of exoneration. But the mix of the facts and the explanations could, for example, turn the tide from a willful act to one evidencing failure to exercise due diligence. It also may dictate the nature of the discipline warranted.

Whether or not the example I have used is relevant for a malpractice court action is dependent to a significant extent on the damage suffered by the plaintiff. In this connection, the implications of the change of funding method takes on a different dimension. And certainly the professional is accorded ample opportunity to defend himself in a malpractice suit. With respect to the implementation of the Joint Board's rules of conduct, I have tried to indicate over the years that they will be applied as evenly and as fairly as possible, and that nothing of an impetuous nature will be done. Like the Academy and the Conference, full due process safeguards are accorded an actuary. In fact, ours are mandated by Congress.

I think the die is cast with regard to the actuarial profession. The bubble of mystique in which the actuary has shrouded himself is bursting, and the potential for malpractice - be it in a civil action or a disciplinary proceeding is closer than around the corner; it is here. I am interested in hearing an actuary's response to the concept and prospect.

Note: While Mr. Ferguson was unable to attend the session, the remarks he had prepared follow.

MR. WILLIAM A. FERGUSON: My part of this panel is to describe for you the quality control procedures followed by Tillinghast and the manner in which these procedures relate to the standards and guidelines of the Academy.

First, let me say up front that a lawsuit or a charge of malpractice can be a devastating experience. Setting aside the potential financial impact of an adverse judgment or settlement, the time and expense that it takes to defend against such suits or allegations can be substantial, regardless of the merits of the case. Also, there is always the concern as to the possible negative effect on the reputation of the firm and its professionals from simple involvement, again regardless of merits.

The issue of individual professionalism and firm responsibilities has been debated over the years. The conclusion at Tillinghast has been to subscribe to a policy of peer review of professional work products of all professionals and we believe this policy to be in the mutual best interest of our clients, our firm and ourselves. This policy is made up of:

- A Statement of Work Policy
- Procedures for the implementation and administration of the policy.
- Audit reviews

The Statement of Policy

The Standards of Work Policy is applicable to all four divisions of the firm. The policy charges each division to adopt and implement such procedures as it believes to be appropriate and necessary to assure:

- A high quality of work performance and work product communication, and
- Conformity and compliance with applicable standards and guidelines of nationally recognized professional bodies.

Thus, we ask our professionals to adhere to the professional standards of the organizations to which they belong but we do not rely on these standards as sufficient to guide our professionals in all areas of our business.

I will not read to you our Standards of Work Policy - it runs 2-1/2 pages - but I will identify the points addressed.

- The lead statement emphasizes the importance of, and endorses, high professional standards.

- The concept of internal standards and procedures related to work performance and communication of work products is established.

- The objectives of the standards and procedures are stated, i.e., to assure:

  - appropriate and acceptable assumptions

  - reasonable and supportable judgements

  - correct, complete and understandable communications

  - supportable statements and conclusions

- A system of peer review is endorsed

- The stratified review system based on the degree of risk associated with an assignment is established

- "High risk" work is defined and procedures for handling are indicated.

- Each operating area of the firm is directed to establish procedures related to both "high risk" and normal projects

- Finally, each professional of the firm is expected to interpret and apply the standards and procedures of his professional organization with diligence and to apply more stringent standards and procedures when circumstances warrant.

<u>The Implementation and Administration</u>

This has been achieved in different ways by our different operating divisions:

- Life - The Life Division has designated a single individual to coordinate the peer review procedures. The individual personally does the review on most jobs which are classified as high risk and arranges for the review on others.

- Benefits - The procedures of the Benefit operation provide for the classification of every work product into one of four categories, each of which has a designated review procedure and designated qualified reviewers. The most stringent of these requirements relate to "high risk" projects and require that two Principals from our Benefit operation co-sign the final work product.

- Casualty and Risk Management - These divisions follow the practice of naming, at the time a project is undertaken, the individuals who will do the job and who will provide the

review. The selections reflect the expertise of the individuals relative to the project and their availability.

The Audit

An audit function relative to the implementation and administration of the policy is necessary to assure that standards are being maintained. It is difficult to determine how much audit is enough, especially when the cost of audits, directly or indirectly, is borne by the clients. At the present time, our audit function is minimal and is limited to little more than the situations where inquiries or questions (or lawsuits or allegations) suggest that an audit is appropriate.

The Role of GORI

There is little doubt that standards for actuarial practice do now exist and that these standards will be further developed as times goes by. The real question is how and by whom. Our strong preference is for the actuarial profession to take a strong leadership role - as opposed to leaving the job to the courts or the accounting profession. It follows, then, that we support the activities of the professional organizations in establishing reasonable guides, opinions, recommendations and interpretations.

A Final Observation

The driving motivation for establishing peer review procedures is to protect the firm and its professionals against financial disaster. There is a much more positive aspect to quality control and peer review procedures, however. A well conceived policy of review, reasonably administered, is likely to result in a consistent flow of high quality work products into the market place which, over the years, can do a great deal to enhance the image of a firm and the people who make it up.

MR. JOHN HANSON:* All pension actuaries have presumably become aware that we do not work in a vacuum. The paper by Mr. Hager provides a welcome outline of the possible sources of liability.

I have consistently objected over the years to the Recommendations and Interpretations of the Academy because I have felt they were more likely to hinder rather than help an actuary under cross-examination by an opposition attorney in a judicial proceeding.

I have taken exception to the frequent assertions that the Recommendations are "only suggestions" from which one is free to deviate.

I welcome the paper because it affirms authoritatively that statements by a profesional body will carry a considerable weight in a courtroom. Clearly one who deviates will be on the defensive.

*Mr. Hanson, not a member of the Academy, is a Fellow of the Society of Actuaries and a Fellow of the Conference of Actuaries in Public Practice.

The reasons I have felt and continue to feel that the Recommendations and Interpretations will hinder rather than help are these:

1. I see differences between the Recommendations and Interpretations on the one hand and the requirements of the IRS and the Joint Board on the other; and

2. the Recommendations and Interpretations are in many respects unclear.

I propose in this discussion to give one example of each kind of problem. I can assure you that there are many more problems of this character in the Recommendations and in Interpretations 1 and 2. (A more reasonable approach was taken in developing Interpretation 3 with the result that it is less undesirable, in my opinion, than the recommendations in the prior Interpretations.)

It is not clear to me how frequently actuaries will be involved in judicial proceedings. I expect the involvement will be less frequent than is the case with auditors or some other professionals.

If the kinds of problems I raise in these examples are unlikely to be a source of contention in a courtroom, then my views are of no practical consequence. I have always been ready to acknowledge this may be the case.

It will be of interest to me to see how these questions evolve in judicial proceedings over the years and whether the Recommendations and Interpretations are helpful, harmful or of no consequence to the practicing pension actuary.

Should these kinds of problems become issues in a judicial proceeding, I have been told by attorneys with some knowledge of these matters that the kinds of examples I cite below would, without question, be detrimental to the position of the actuary in the proceeding.

In a letter circulated within the profession, Mr. Hager has advised the Academy that their adoption of Recommendations and Interpretations reduces the potential liability of pension actuaries because these Recommendations and Interpretations provide a "safe harbor".

It is my belief that this view was not based on an analysis of the content and quality of the existing Recommendations and Interpretations. I believe this view was based on general concepts and that he assumes too much about the quality of the Recommendations and Interpretations already adopted.

My view is that the existing Recommendations and Interpretations do not provide a "safe harbor" with respect to many areas of practice to the extent that they conflict with IRS and Joint Board rules, and to the extent that they are unclear.

Conflict with IRS and Joint Board Rules

The Joint Board standards include the following with respect to an actuary's obligation regarding the review of employee data:

"(f) Report or Certificate

An enrolled actuary shall include in any report or certificate stating actuarial costs or liabilities, a statement or reference describing or clearly identifying the data, any material inadequacies therein and the implications thereof, and the actuarial methods and assumptions employed."

Proposed joint board rules are exposed to the profession. The above requirement was modified in a number of respects after comments by enrolled actuaries. For example, the original draft did not include the statement that inadequacies were to be "material".

The Academy present value Recommendations include in part the following:

"7.1 The actuary preparing a present value calculation in accordance with these Recommendations should make a clear statement as to the source and adequacy of the employee data used as a basis for the calculation.

7.2 He should indicate the extent to which the calculation is based on unreported data, the probable effect on the accuracy of the calculation, and the adjustment made in the actuarial present value to correct for such unreported data."

Regarding 7.1, it would probably be easy to prove that most actuaries do not "make a clear statement as to the .... adequacy of the data." I doubt that many actuaries could make such statement and it appears to be superfluous requirement. The Joint Board requirement that indicates the actuary must clearly identify "material inadequacies" is more to the point.

As to 7.2 of the Academy Recommendations, how can an actuary identify "the extent to which a calculation is based on unreported data?" Where is the reference to materiality? Again, it will appear to me that most actuaries automatically have not met this requirement.

It is also my opinion that an attorney could embarrass most actuaries on the basis of these requirements.

Lack of Clarity

I will turn to the kinds of questions that would be likely to be put to a pension actuary in a judicial proceeding in connection with the use of assumptions specifically adopted under a final average compensation plan.

Section 4.3 of the Academy Recommendation B indicates that the "effects of inflation may be recognized in actuarial assumptions either implicitly or explicitly," and these two approaches are then defined.

This categorization was to the best of my knowledge originated by members of the Academy Committee on Principles and Practices. It is, I believe, nonsense, that actuaries use one of these two approaches. Since the profession had no significant opportunities to discuss the proposed content of the Recommendation, there was and is no basis for believing that these

definitions reflect the thinking of anyone other than the members of the Academy Committee at that time. Lack of revision in the Recommendations might suggest agreement by the present members of the Committee. But they have revised nothing, and to the best of my knowledge, there is no program of review underway in the Academy of previously issued Recommendations and Interpretations. In effect, Recommendations are chiseled in stone and are dead rather than living documents.

A paper was recently presented to the Society entitled "Pension Plans in an Inflationary Environment." The author, Mr. Furnish, describes the explicit approach as requiring "each assumption standing alone to be reasonable." Paragraph 4.3 of the Academy Recommendation defines the explicit approach as follows:

> "Explicit recognition means that each assumption is chosen as the actuary's estimate, with suitable allowance for adverse fluctuations, of the plan's average long-term future experience with respect to that assumption, recognizing the expected rate of inflation if any."

Except for a handful of actuaries who delve into complex theories of economists and believe them, most actuaries would probably agree that the financial uncertainties of inflation make it impossible to select one set of assumptions they truly believe is more appropriate than any other.

Economists differ widely on future inflation. How then could an actuary predict future inflation with confidence? The answer is that actuaries generally don't think that they can. Only those who adopt one of the conflicting economic views of economists, or innovate their own views, can actually believe in the validity of the explicit approach.

If actuaries don't generally utilize the explicit approach, is not the implicit approach the alternative? Mr. Furnish defines the implicit approach as one "which requires only that the assumptions in the aggregate produce a reasonable result."

The definition of the Academy is as follows:

> "Implicit recognition of inflation in actuarial assumptions means that two or more material actuarial assumptions do not individually represent the actuary's expectation of average future experience, but that the aggregate effect of their combined use results in costs which currently are approximately the same as if explicit recognition had been given to inflation in each assumption. For example, the actuary might assume rates of investment return and salary increase which are each lower than he expects will be experienced."

Actuaries in my opinion do not generally follow the thought process suggested here by the Academy. They do often take the approach suggested by Mr. Furnish in his paper -- they project results under various alternative assumptions before determining their best estimate. They might even make the observation that the results under two alternative sets of assumptions are relatively close. But they do not cite a particular set of assumptions

as their best estimate when other assumptions provide a real expectation of future experience.

Let us now speculate on the kinds of questions a skillful and aggressive attorney would be likely to ask a pension actuary during a judicial proceeding.

(1) Presumably there would first be a number of questions to elicit from the actuary the nature of the assumptions used to develop the cost under a final pay pension plan. Seems likely the following might be established:

- that a present value is too low if the assumed rate of interest is too high, and vice versa;

- the present value is too low if the assumed salary increase is too low, and vice versa;

- that we are dealing with the uncertainties of inflation;

- that inflation impacts on both the assumed rate of investment return and the assumed rate of salary increase;

- that in setting assumptions an important consideration is the "spread" between the rate of interest and the salary increase;

- that the actuary is enrolled, a member of the Academy and of other professional groups.

(2) Then for this discussion, let us assume that the actuary utilized a 6.6 percent assumed rate of investment return and a 5.0 percent assumed salary increase. These are the average assumptions reported by the Greenwich Research Associates in a 1982 survey. They reflect what actuaries are doing. Testimony would also establish that current bond interest rates in early 1982 were well over 13 percent. It would also be established in a typical situation that salary increases had averaged far more than five percent over recent years.

Cross-examination would then depend on whether the actuary responds that he is using the explicit or implicit approach, or neither.

## Explicit Response

I doubt that many actuaries would, in the final analysis, maintain under cross-examination that they used the explicit approach as defined by the Academy. It is very difficult to adhere to that definition in view of the differences in recent experience and assumptions. Indeed, Mr. Furnish in his paper referred to above indicates: "the financial uncertainty of

inflation creates doubt as to one set of assumptions can truly be called explicit."

## Implicit Response

I think most actuaries would indicate, under cross-examination, that they essentially use the implicit approach. I should imagine the Academy definition would be read into the record and the attorney might ask questions such as these:

- Why do you use assumptions that do not reflect your "expectation of future experience?"
- Since you don't use assumptions reflecting your expectation of future experience, does that mean your assumptions are wrong?
- How do you know that two wrong assumptions result in "costs that are approximately the same" as if the assumptions are right?
- If you computed the costs under these other assumptions that you think are right, why did you not use these results in your certification?

## Alternative Response

My response, of course, would be that I don't use either approach. The attorney would then probably ask why the Academy would reduce these two alternatives to writing if there are other acceptable approaches. (I would be uniquely qualified to respond to that question because of my familiarity with the reasons for the Academy's adoption of the recommendations and because I do not belong to the Academy.)

The main problem in our profession is credibility. We have to learn to explain the nature of our work to laymen. Simplifications are frequently needed depending on the audience. The Academy Recommendations were produced in large measure for a non-actuarial audience. The Committee may have thought they were merely providing a simplification of actuarial thought for the benefit of the laymen. In fact, this particular Recommendation provides an incorrect description of the thought process of most actuaries and will be an embarassment in future judicial proceedings.

We do our best to make reasonable assumptions. It is not always easy to support assumptions, particularly those impacted by inflation. Sometimes we have trouble being convincing. Our assumptions may be characterized by others as implicit or explicit, depending on their view. Why should the Academy make our day in court difficult by suggesting to the world at large that we use assumptions that we know are not as good as other assumptions that we choose not to use.

MR. READE: I think Mr. Hager would like to respond to you.

MR. HAGER: As professionals, actuaries are subject to liability considerations. Keeping this in mind, I would like to comment on the conflict

between professional standards and statutory provisions by setting out an example: As a member of a state bar association, I must follow its professional standards. One such standard of my bar association is the prohibition of lawyer advertising. Surprisingly, this standard is in violation of recent U.S. Supreme Court decisions. Given such a conflict, I must comply with the U.S. Supreme Court. What I am getting at is that whenever a professional standard violates a statutory provision, regulatory provision, or judicial decision, in the hierarchy of law, a professional's obligation is to comply with the statutory or regulatory provision or the judicial decision.

Additionally, out of approximately one hundred and fifty pages of professional actuarial standards, John Hanson has pointed out only four paragraphs in which he thought there may be some problems.

Assume as an attorney, I have two clients, both actuaries, who have been alleged to have produced a professionally deficient work product. One of those clients has complied with the underlying professional standards that come to bear on his work product. The other client has ignored the professional standards. I'm not going to suggest a result of the two separate law suits, but I'd like you to reflect on which of these two cases would be easier to defend.

Furthermore, I think a main problem for actuaries is that they are accustomed to working in an area that has a lot of precision. As a result, when dealing with their professional association, they're frequently troubled because when so many minds are brought together, you're bound to have inconsistencies and a wide array of views. I doubt that any professional association has ever had a unanimous view on anything. No one should be surprised that the same is true in the actuarial profession.

In summary, always follow statutory provisions when they are in conflict with professional standards.

I have encouraged the Academy to make its professional standards a living document. As legal counsel, I would have advised that the standards be reviewed and adjusted as they become obsolete or inconsistent with the prevailing law and practice.

There is a general principle of law that comes to bear in civil actions. Typically, a professional is held responsible for the state of the art (or standards in force) at the time he produces the work product. That is, the general principle is that professionals are judged according to prevailing standards in effect at the time one produces the work product.

MR. SHAPIRO: Well, I'm not really sure how the Joint Board comes out as a result of John's statement, so I'm not going to broach that. I think that there is an element of professional responsibility, vis-a-vis exposure draft of Opinion A-7. I think that the idea of this Opinion is excellent and I think that every profession needs it. The American Bar Association promulgates formal opinions which in fact interpret its canons of ethics and give direct applicability to a specific area of legal practice. For instance, the ABA recently came out with Formal Opinion 346 which addresses

an attorney's responsibilities in issuing opinions relating to tax shelters. I think that exposure draft Opinion A-7 is excellent in that it addresses specific areas of practice by the actuarial profession and pronounces sound actuarial principles in the judgment of its authors. I encourage you all to respond to this exposure draft.

MR. READE: Opinion A-7 was exposed, it has been adopted by the Academy's Board of Directors. It is now being printed and it will be distributed very shortly in final form. Just to give a rough synopsis of it though, it merely says that if you do not follow the Recommendations and Interpretations of the Academy, then be prepared to justify what you do. Use principles and practices that are not recommended, just be prepared to justify them. Surely no one uses principles and practices they are not prepared to justify in the first place so I think it should be clear what Opinion A-7 is all about.

MR. SHAPIRO: Now the point I was going to make about that. I think that an opinion such as this should be flexible in nature because of the varied nature of issues of professional responsibility. You should have bench marks, but in the interpretation of those bench marks, you have to provide enough flexibility to adapt your practice to whatever confronts a particular situation. Hopefully the application of Opinion A-7 will embrace that concept and that is the bottom line of what I wanted to say.

MR. GEORGE SWICK: John Hanson brought up a point that's troubled me for some time and I wonder if Bill might give some reaction to it. As one of the original members of the Committee in the pension area, it was our expectation, that these would be living documents and would be revised periodically. Now it's been a little troubling to me that there has not been a conscious effort to revise these documents. I don't know about the financial reporting parts of principles and practices but, Bill, is it desirable for the profession to keep these things under constant review or periodic review. What is the best way to go about it?

MR. WILLIAM HALVORSON: I'm still current president of the Academy of Actuaries. I want to remind everyone that there is a task force that's been appointed. It's a high level task force of the Academy, chaired by Norm Crowder, with the specific task to review the whole area of the Academy's professional standards of practice. The purpose of the task force is to establish a framework in which the creation of standards of practice can go forward. Reading from the minutes of the Board meeting: "Mr. Crowder reported that the task force had held its first meeting on the day before the Board meeting, September 27, and expected to meet again in December, citing the need for us to educate ourselves and other Academy members of the need to develop standards rather than to have standards imposed on us by the courts and others." Certainly the aim of this is to develop a procedure, or process, so that all of our standards of practice can be properly exposed, can be reviewed, brought up to date in view of the changes that have occurred since they may have been written. It is a very complex process. My own feeling and opinion is that we may end up having to elect or have boards of standards of practice which have full-time staff working with that board so that we can have consistency in our standards throughout all the areas of practice. What the particular task force will

recommend to the Executive Committee or to the Board I have no idea; but the process is moving forward.

MR. HAGER: I have encouraged the Academy to make its professional standards a living document. As legal counsel I would have advised that the standards be reviewed and adjusted as they become obsolete or inconsistent with the prevailing law and practice.

MR READE: Let me just clarify some of the background of the Academy's Committee. The Committee on Guides to Professional Conduct deals with Guides and Opinions as to Professional Conduct. You may have heard reference to GORI. The G and O have to do with ethics, with professional practice. The R&I stand for Recommendations and Interpretations which have to do with standards of practice. They zero in on your standards of practice, if you happen to be a pension actuary or a casualty actuary or what have you. So, of course, the fact that John was only commenting on a few pages of the whole is because John's expertise is in the pension field and naturally he was only looking at that particular area. The Committee on Guides has nothing to do with Recommendations and Interpretations, except to say in Opinion A-7, if you don't stick to them then you've got to explain yourself. As a matter of fact, we are currently restructuring the Guides and Opinions, to permit the transfer of material that we consider to be standards of practice to the Recommendations and Interpretations. You've seen some of this already; you'll be seeing more. I would encourage you to respond to exposure drafts. You probably think that your comments won't be taken into account, that people have already considered it and will dismiss it. It's not true. I would say that more than half of the letters do result in a change. So comment on exposure drafts. And you're even allowed to comment favorably, if that's possible. The gentleman over here."

A VOICE: At an enrolled actuary's meeting several years ago on this same subject, an attorney, I don't remember the name, made the comment that we, as actuaries would be judged, our work would be judged by the standards in effect at the time of the trial rather than the standards in effect at the time the work was performed. First of all, it seemed terribly unfair to me that that would be true; but he did say it. I would like to get your comments on this because, if standards are going to change, invariably some of us will be behind the times, and I'm just wondering what exposure we have from this point of view.

MR. SHAPIRO: I can speak from the Treasury Department's point of view on evolving regulations addressing professional conduct. A very simple answer to your question is that the attorney who spoke at that EA meeting may have been incorrect, although I did not hear the context in which he made the reference. Normally, when we promulgate regulations which change the nature of what we're trying to do, we will have a savings clause, and an effective date clause. Consequently, the practitioner community knows that this will be the benchmark of behavior from whatever date we place on the regulations. In my experience, the applicability of rules have never been retroactive in nature. An exception to this, I think, would probably be Bill's example of advertising and solicitation where the current court decisions could dictate the state of the art with respect to that area. If

my office were to bring a disciplinary proceeding against an attorney for what we consider to be unprofessional advertising or solicitation based on our regulations and the Supreme Court cases on the subject is at variance with our regulations, the Supreme Court cases would, of course, dictate what we would do in that area.

MR. HAGER: There is a general principle of law that comes to bear in civil actions. Typically, a professional is held responsible for the state of the art (or standards in force) at the time that he produces the work product. That is, the general principle is that professionals are judged according to prevailing standards in effect at the time one produces the work product.

MR. THOMAS McCALL: Les, you suggested as an example of misconduct the willful failure to file a Schedule B. How would the Joint Board view a practitioner's decision not to expend any more time or effort on behalf of a client who fails to pay his bill?

MR. SHAPIRO: I think that, if you have a client and are having a problem in the payment of the fee, you have two choices. One is to excuse yourself from the assignment. However, as long as you have him as a viable client, you must perform the requisite professional services. If he owes you some money, then you take it up with him in whatever manner is appropriate under the circumstances. But as long as he is your client, in my judgment you would have to proceed with whatever professional responsibilities you have been retained to perform.

MR. McCALL: But it would be no problem as far as the timing of when the client relationship ceases. After the valuation is done but before the schedule has been prepared.

MR. SHAPIRO: If you owe him a Schedule B for a particular plan year, I believe that you should give him the work product.

MR. McCALL: I guess the question is whether you owe it to him or not if he hasn't paid you.

MR. SHAPIRO: I contend that you do owe it to him. Take it up in a court of law if there is money owed you.

MR. GEORGE BERISH: Does the duty extend beyond providing the Schedule B to actually following through on the filing if it is provided to the sponsor to be appended to the 5500.

MR. SHAPIRO: It is my understanding of the law that the enrolled actuary does not have *an affirmative* duty to file the Schedule B. He is required to provide it to the person he considers his client, such as the plan administrator.

# STATEMENTS OF THE ACADEMY
# RELEASED IN 1982

Each year's Journal includes the full text of the Statements released by the Academy in that year. Although most of the Statements are self-explanatory, knowledge of the circumstances giving rise to the Statement helps provide perspective. The following Summary of Statements section provides background information, including any cross-references to previous Statements. For purposes of cross-referencing and indexing, Statements have been assigned numbers by calendar year and by order of release in that year, e.g., 1982-1 was the first Statement released during 1982. The summary also gives the page number on which the full text begins.

Statements made before 1977 were not compiled, but copies of such Statements may be requested from the Executive Office of the Academy, Suite 515, 1835 K Street, N.W., Washington, D.C. 20006.

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Statements of the Academy are not expressions of official positions embraced by the membership as a whole. Rather, they are intended as relevant responses to situations which appear to require a professional statement on actuarial matters.

SUMMARY OF 1982 STATEMENTS

Index Code: 1982-1

To: Bureau of Labor Statistics

Date: February 5, 1982

Length: 2 pages beginning on page 113

Concerning: Producer price index for life insurance

Background: This letter was sent to the Bureau of Labor Statistics in connection with a BLS project to develop a producer price index for life insurance. Some background papers on this project had been provided to the Academy for review.

Drafters: The letter was sent by Executive Director Stephen G. Kellison with the assistance of the Committee on Life Insurance, chaired by Richard S. Robertson.

Index Code: 1982-2

To: House Committee on Education and Labor

Date: February 8, 1982

Length: 11 pages beginning on page 115

Concerning: Pension legislation

Background: This testimony was presented to the Subcommittee on Labor-Management Relations of the House Committee on Education and Labor at a public hearing on H.R. 4928 and H.R. 4929, the Public Employee Retirement Income Security Act of 1981 (PERISA). Attached to the statement was a copy of the final report of the Joint Committee on Pension Terminology. The Academy had previously testified on similar legislation in 1980 (see statement 1980-27).

Drafters: The Subcommittee on Public Employee Retirement Systems of the Pension Committee. The respective chairmen are Thomas P. Bleakney and Douglas C. Borton. Executive Director Stephen G. Kellison presented the testimony at the public hearing.

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Index Code: 1982-3

To: Financial Accounting Standards Board

Date: February 11, 1982

Length: 7 pages beginning on page 126

Concerning: Insurance accounting

Background: This statement was submitted in response to an FASB Exposure Draft on "Accounting by the Insurance Industry" dated November 18, 1981.

Drafters: The General Committee on Financial Reporting Principles, chaired by Stephen D. Bickel.

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Index Code: 1982-4

To: American Institute of Certified Public Accountants

Date: March 4, 1982

Length: 7 pages beginning on page 133

Concerning: Audit guide on employee benefit plans

Background: This statement was submitted to the AICPA in response to an

1982-4 (Cont.)

Exposure Draft of the chapter of the Audit Guide on Employee Benefit Plans dealing with health and welfare plans. The Academy had previously commented on an earlier draft of this chapter on December 21, 1981 (see statement 1981-37).

Drafters: The statement was prepared by the Subcommittee on ERISA Health and Welfare Plans of the Committee on Health Insurance. The respective chairmen are Anthony J. Houghton and W.H. Odell.

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Index Code: 1982-5

To: House Committee on Education and Labor

Date: March 5, 1982

Length: 8 pages beginning on page 140

Concerning: Multiple employer trusts

Background: This testimony was presented to the Subcommittee on Labor-Management Relations of the House Committee on Education and Labor at a public hearing on the financial difficulties of a number of multiple employer trusts. The Academy had previously testified on this subject at a Department of Labor hearing in 1977 (see statement 1977-8).

Drafters: The Committee on Health Insurance, chaired by W. H. Odell. The testimony was presented by Stephen D. Brink, a member of the Committee.

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Index Code: 1982-6

To: House Committee on Post Office and Civil Service

Date: March 16, 1982

Length: 4 pages beginning on page 148

Concerning: Federal statistics

Background: This statement was submitted for the written record of a public hearing on federal statistics held by the Subcommittee on Census and Population of the House Committee on Post Office and Civil Service. The purpose of the hearing was to assess the degree of utilization of various statistics compiled by the federal government in the face of budgetary cutbacks.

Drafters: The Committee on Health Insurance, chaired by W. H. Odell. The testimony was presented by E. Paul Barnhart on behalf of the Committee.

Index Code: 1982-7

To: NAIC Life, Accident and Health Technical Staff Actuarial Group

Date: March 22, 1982

Length: 12 pages beginning on page 152

Concerning: Health insurance rate filings

Background: This statement presented proposed changes in the NAIC Model Guidelines for Filing of Rates for Individual Health Insurance Forms.

Drafters: The Subcommittee on Liaison with NAIC of the Committee on Health Insurance. The respective chairmen are E. Paul Barnhart and W. H. Odell.

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Index Code: 1982-8

To: Senate Committee on Finance

Date: April 8, 1982

Length: 11 pages beginning on page 164

Concerning: Pension legislation

Background: This testimony was presented to the Subcommittee on Savings, Pensions, and Investment Policy of the Senate Committee on Finance for the record of hearings on S. 2105 and S. 2106, the Public Employee Retirement Income Security Act of 1981 (PERISA). Attached to the statement was a copy of the final report of the Joint Committee on Pension Terminology. The Academy had previously testified on the same legislation in the House on February 8, 1982 (see statement 1982-2).

Drafters: The Subcommittee on Public Employee Retirement Systems of the Pension Committee. The respective chairmen are Thomas P. Bleakney and Douglas C. Borton.

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Index Code: 1982-9

To: American Institute of Certified Public Accountants

Date: April 16, 1982

Length: 13 pages beginning on page 175

Concerning: GAAP accounting for annuities

Background: This Discussion Memorandum on accounting for single premium

1982-9 (Cont.)

deferred annuities was presented to the Non-Guaranteed Premium Task Force of the AICPA. Neither the accounting nor actuarial literature has addressed GAAP accounting for such products and a variety of practices have developed.

Drafters: . The Committee on Life Insurance Financial Reporting Principles, chaired by Burton D. Jay.

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Index Code: 1982-10

To: NAIC Insurance Statutory Accounting Principles Board

Date: April 22, 1982

Length: 6 pages beginning on page 188

Concerning: Statutory accounting for insurance

Background: This statement was submitted to the NAIC Insurance Statutory Accounting Principles Board in response to their request for input on statutory accounting for deferred taxes.

Drafters: The Committee on Life Insurance Financial Reporting Principles, chaired by Burton D. Jay.

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Index Code: 1982-11

To: Senate Committee on Labor and Human Resources
House Committee on Education and Labor

Date: April 27, 1982

Length: 19 pages beginning on page 194

Concerning: Pension legislation

Background: This statement was submitted to the Subcommittee on Labor of the Senate Committee on Labor and Human Resources and to the Subcommittee on Labor-Management Relations of the House Committee on Education and Labor. It contained an analysis of ERISA and the Internal Revenue Code with the changes in terminology that would be needed in order to bring terminology into compliance with the report of the Joint Committee on Pension Terminology. The Academy proposed incorporating these changes into S.1541 and H.R. 4330, the Retirement Income Incentives and Administrative Simplification Act. The Academy had previously testified on this bill on matters other than pension terminology (see statements 1981-31 and 1981-35).

Drafters: The Committee on Pension Terminology, chaired by Michael J. Tierney.

Index Code: 1982-12

To: Four Congressional Committees

Date: May 26, 1982

Length: 3 pages beginning on page 213

Concerning: Pension legislation

Background: This statement was submitted to members of the following congressional committees in connection with the relationship between actuaries and accountants in various proposed pension bills:

1. Senate Committee on Finance
2. Senate Committee on Labor and Human Resources
3. House Committee on Education and Labor
4. House Committee on Ways and Means

This statement reiterated the Academy position on the relationship between actuaries and accountants in pension legislation presented in several recent statements (see statements 1981-31, 1982-2, and 1982-8) and elaborated upon the previously stated position.

Drafters: Executive Director Stephen G. Kellison

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Index Code: 1982-13

To: Senate Committee on Agriculture, Nutrition, and Forestry

Date: June 3, 1982

Length: 5 pages beginning on page 216

Concerning: Crop insurance

Background: This statement was submitted for the record of a public hearing held by the Subcommittee on Agricultural Production, Marketing, and Stabilization of Prices of the Senate Committee on Agriculture, Nutrition, and Forestry. The hearing was devoted to an oversight of the Federal Crop Insurance Act. This statement derives from previous statements on crop insurance in 1977 and 1979 (see statements 1977-4, 1977-17, 1977-20, 1979-5).

Drafters: Executive Director Stephen G. Kellison in consultation with certain members of the Committee on Property and Liability Insurance.

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Index Code: 1982-14

To: House Select Committee on Aging

1982-14 (Cont.)

Date: June 7, 1982

Length: 11 Pages beginning on page 221

Concerning: Pension funding

Background: This statement was submitted for the record of a public hearing held by the House Select Committee on Aging to investigate the funding status of private pension plans. There was no proposed legislation being discussed at the hearing.

Drafters: Preston C. Bassett on behalf of the Pension Committee.

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Index Code: 1982-15

To: NAIC Manipulation, Lapsation, Dividend Practices and Annuity Disclosure (A) Task Force

Date: June 8, 1982

Length: 3 pages beginning on page 232

Concerning: Dividend principles and practices

Background: This statement was presented to the NAIC Manipulation. Lapsation, Dividend Practices and Annuity Disclosure (A) Task Force as a status report of the activities of the Committee on Dividend Principles and Practices. This statement follows numerous previous submissions on this subject to the NAIC (most recent statement 1981-36 on December 10, 1981).

Drafters: The Committee on Dividend Principles and Practices, chaired by John H. Harding.

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Index Code: 1982-16

To: House Committee on Ways and Means

Date: June 10, 1982

Length: 9 pages beginning on page 235

Concerning: Pension legislation

Background: This statement was presented at a public hearing on H.R. 6410, the Pension Equity Act of 1982 introduced by Rep. Charles Rangel. This bill would make a number of sweeping changes in the Internal Revenue Code affecting private pension plans. The Academy statement commented on maximum benefit limitations and on integration with Social Security.

1982-16 (Cont.)

Drafters: The Pension Committee, chaired by Douglas C. Borton who presented the testimony at the public hearing.

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Index Code: 1982-17

To: American Institute of Certified Public Accountants

Date: June 10, 1982

Length: 1 page beginning on page 244

Concerning: Reinsurance accounting and auditing

Background: This statement was submitted to the AICPA Reinsurance Auditing and Accounting Task Force in response to an Exposure Draft on Auditing Property and Liability Reinsurance dated March 15, 1982. This statement follows four previous Academy submissions (see statements 1980-1, 1980-20, 1981-1, and 1981-19), which were attached as part of this submission.

Drafters: The Task Force on Reinsurance Accounting, chaired by Ronald E. Ferguson.

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Index Code: 1982-18

To: American Institute of Certified Public Accountants

Date: June 11, 1982

Length: 13 pages beginning on page 245

Concerning: Relationship between actuaries and accountants

Background: This set of slides was presented at a joint meeting of the Academy Committee on Relations with Accountants and the AICPA Relations with Actuaries Committee as background for a discussion of the future relationship between the two professions.

Drafters: The Task Force on Actuary/Auditor Relationships, chaired by W. H. Odell.

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Index Code: 1982-19

To: House Committee on Education and Labor

Date: June 23, 1982

Length: 4 pages beginning on page 258

1982-19 (Cont.)

Concerning: Pension legislation

Background: This statement was submitted to the Subcommittee on Labor-Management Relations of the House Committee on Education and Labor as a correcting supplement to the prior statement of April 27, 1982 (see statement 1982-11).

Drafters: The Committee on Pension Terminology, chaired by Michael J. Tierney.

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Index Code: 1982-20

To: Joint Board for the Enrollment of Actuaries

Date: June 23, 1982

Length: 8 pages beginning on page 262

Concerning: Enrollment standards

Background: This statement was presented at an open meeting of the Advisory Committee of the Joint Board for the Enrollment of Actuaries, attended by Joint Board members as well. The statement addressed the education and examination standards for enrolled actuaries and the subject of pension terminology.

Drafters: Executive Director Stephen G. Kellison.

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Index Code: 1982-21

To: Senate Committee on Finance

Date: July 9, 1982

Length: 6 pages beginning on page 270

Concerning: Pension legislation

Background: This statement was submitted to the Subcommittee on Savings, Pensions, and Investment Policy of the Senate Committee on Finance. The statement proposes a number of terminology changes to the Public Employee Retirement Income Security Act being considered by the Subcommittee that arise from the Final Report of the Joint Committee on Pension Terminology. The Academy had previously submitted proposals for comparable terminology changes in ERISA (see statements 1982-11 and 1982-19).

Drafters: The Committee on Pension Terminology, chaired by Michael J. Tierney.

Index Code: 1982-22

To: Senate Committee on Labor and Human Resources
House Committee on Education and Labor

Date: July 12, 1982

Length: 6 pages beginning on page 276

Concerning: Pension legislation

Background: This statement was submitted to the Senate Committee on Labor and Human Resources and the House Committee on Education and Labor in connection with problems in Section 6058 of the Internal Revenue Code.

Drafters: The Committee on Pension Actuarial Principles and Practices, chaired by Harry E. Allan.

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Index Code: 1982-23

To: Senate Committee on Commerce, Science and Transportation

Date: July 15, 1982

Length: 18 pages beginning on page 282

Concerning: Risk classification

Background: This statement was presented at a public hearing of the Senate Committee on Commerce, Science and Transportation on S. 2204, the Fair Insurance Practices Act. This bill is virtually identical to H.R. 100, the Nondiscrimination in Insurance Act. The Academy had previously testified on this latter bill in 1981 (see statements 1981-9 and 1981-23).

Drafters: The Committee on Risk Classification, chaired by Jay C. Ripps.

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Index Code: 1982-24

To: Financial Accounting Standards Board

Date: August 18, 1982

Length: 7 pages beginning on page 300

Concerning: Accounting for pension plans

Background: This letter was submitted to the Financial Accounting Standards Board in reaction to a draft of "Tentative Conclusions" released by the FASB in connection with its project on accounting for pensions on the plan sponsor's financial statements. The Academy

1982-24 (Cont.)

had previously commented in 1981 on a Discussion Memorandum which preceded the "Tentative Conclusions" (see statements 1981-15 and 1981-21).

Drafters: Edwin F. Boynton, Chairman of the Committee on Pension Accounting Matters, although the letter does not represent a formal statement of the Committee as a whole.

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Index Code: 1982-25

To: U. S. Supreme Court

Date: August 18, 1982

Length: 8 pages beginning on page 307

Concerning: Norris case

Background: This amicus curiae brief was submitted to the U.S. Supreme Court in connection with Arizona Governing Committee v. Nathalie Norris. This brief addresses the petition for a writ of certiorari but does not address the issues involved in the case itself which will be addressed later if the court decides to hear the case.

Drafters: The brief was developed by the joint efforts of General Counsel William D. Hager and the law firm of Shea and Gardner in conjunction with the Committee on Risk Classification, chaired by Jay C. Ripps.

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Index Code: 1982-26

To: National Association of Insurance Commissioners

Date: August 19, 1982

Length: 3 pages beginning on page 315

Concerning: Actuarial liaison with NAIC

Background: This letter was sent to Commissioner Roger Day, Vice President and Chairman of the Executive Committee of the NAIC, proposing the establishment of an Actuarial Liaison Group to NAIC Executive Committee.

Drafters: President William A. Halvorson.

Index Code: 1982-27

To: Health Care Financing Administration

Date: August 24, 1982

Length: 12 pages beginning on page 318

Concerning: Minimum loss ratios for Medicare supplement policies

Background: This statement was submitted to the Health Care Financing Administration in connection with interim final regulations for Medicare supplement policies. The regulations appeared in the Federal Register on July 26, 1982 (47 FR 32390-32404). This statement follows a previous statement dated March 17, 1981 on previously promulgated proposed regulations (see statement 1981-7).

Drafters: General Counsel William D. Hager in consultation with certain members of the Committee on Health Insurance, chaired by W.H. Odell.

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Index Code: 1982-28

To: Congressman Bill Frenzel

Date: August 25, 1982

Length: 4 pages beginning on page 330

Concerning: Self-insurance reserves

Background: This statement was submitted to Congressman Bill Frenzel (R-MN) who is the sponsor of H.R. 6114. This bill provides for tax deductibility for self-insurance reserves for various property and liability programs.

Drafters: General Counsel William D. Hager in consultation with certain members of the Committee on Property and Liability Insurance, chaired by Jerome A. Scheibl.

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Index Code: 1982-29

To: NAIC (D2) Risk Retention Task Force

Date: October 20, 1982

Length: 3 pages beginning on page 334

Concerning: Risk retention groups

Background: This testimony was presented at a public hearing of the NAIC (D2)

1982-29 (Cont.)

Risk Retention Task Force considering the Model Product Liability Risk Retention Act being developed by the NAIC. This Model Act is being developed to implement the Product Liability Risk Retention Act of 1981 passed by the U.S. Congress.

Drafters: Executive Director Stephen G. Kellison in consultation with Jerome A. Scheibl, Chairman of the Committee on Property and Liability Insurance.

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Index Code: 1982-30

To: NAIC (D2) Risk Retention Task Force

Date: November 8, 1982

Length: 1 page beginning on page 337

Concerning: Risk retention groups

Background: This statement was submitted as a supplement to the testimony of October 20, 1982 (see statement 1982-29) to the NAIC (D2) Risk Retention Task Force considering the Model Product Liability Risk Retention Act. The statement proposes specific language to accomplish the recommendations of the prior testimony.

Drafters: General Counsel William D. Hager in consultation with Jerome A. Scheibl, Chairman of the Committee on Property and Liability Insurance.

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Index Code: 1982-31

To: Joint Board for the Enrollment of Actuaries

Date: November 17, 1982

Length: 2 pages beginning on page 338

Concerning: Enrollment standards

Background: This statement was presented at an open meeting of the Advisory Committee of the Joint Board for the Enrollment of Actuaries, attended by Joint Board members as well. The statement addressed the education and examination standards for enrolled actuaries and supplements an earlier statement of June 23, 1982 (see statement 1982-20).

Drafters: Executive Director Stephen G. Kellison.

Index Code: 1982-32

To: U. S. Supreme Court

Date: November 24, 1982

Length: 33 pages beginning on page 340

Concerning: Norris case

Background: This amicus curiae brief was submitted to the U.S. Supreme Court in connection with Arizona Governing Committee v. Nathalie Norris. This brief addresses the issues in the case and follows a previous brief of August 18, 1982 addressing the petition for a writ of certiorari which was granted by the Court (see statement 1982-25).

Drafters: The brief was developed by the joint efforts of General Counsel William D. Hager and the law firm of Shea and Gardner in conjunction with the Committee on Risk Classification, chaired by Robert L. Knowles.

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Index Code: 1982-33

To: American Institute of Certified Public Accountants

Date: December 17, 1982

Length: 1 page beginning on page 373

Concerning: Reinsurance accounting and auditing

Background: This statement was submitted to the AICPA Reinsurance Auditing and Accounting Task Force in response to the AICPA discussion draft on "Accounting for Foreign Property and Liability Reinsurance." This statement is the sixth in a continuing dialogue with the AICPA on reinsurance accounting and auditing (see statements 1980-1, 1980-20, 1981-1, 1981-19, 1982-17).

Drafters: The Task Force on Reinsurance Accounting, chaired by Ronald E. Ferguson.

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Index Code: 1982-34

To: American Institute of Certified Public Accountants

Date: December 20, 1982

Length: 1 page beginning on page 374

Concerning: Accounting for HMOs

1982-34 (Cont.)

Background: This statement was submitted to a task force of the AICPA in response to a draft Issues Paper on Accounting for Health Maintenance Organizations and Associated Entities.

Drafters: The Committee on Health Insurance, chaired by Robert H. Dobson.

STATEMENT 1982-1

AMERICAN ACADEMY OF ACTUARIES
1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

STEPHEN G. KELLISON, M.A.A.A.
EXECUTIVE DIRECTOR

February 5, 1982

Mr. Gregory Gilbert
Economist
Bureau of Labor Statistics
600 E Street, N.W.
Room 5613
Washington, D.C. 20212

Re: Producer Price Index for Life Insurance

Dear Mr. Gilbert:

Thank you for sharing the material developed by the Bureau of Labor Statistics in connection with a Producer Price Index for Life Insurance. This material has been referred to the Academy's Committee on Life Insurance.

The Committee is not prepared to provide technical commentary on the proposal at the present time. For example, the particular formula that is used to calculate a company's retention was not provided.

The Committee did observe that the stated objective of not having changes in mortality and interest rates affect the index has not been achieved. The valuation assumptions would be frozen at a particular point and any increase in interest or reduction in mortality would serve to reduce the cost basis.

It is important to consider basic design features of any proposed index prior to considering the technical details of the methodology. For example, the cost of insurance is measured by an index weighted by the costs of policies purchased in a given year. Depending on what is intended to be measured, a more logical index might be based on policies in force in a given year. This is analogous to the issue of whether the housing component of a cost of living index should be based on the cost of new mortgages or a weighted portfolio of existing mortgages.

Another example of a basic design issue that should be addressed is the effect of changes in the mix of policies issued --- i.e., the trend toward term insurance, the trend toward universal life and other new products, the trend toward larger shares of the market held by specialty companies such as term brokerage companies, and other similar factors.

The Academy is interested in continuing to monitor this project as it proceeds. I would be happy to share any further drafts which you may

develop with our Committee on Life Insurance. If the Academy can be of further assistance to you, please let me know.

Yours truly,

Stephen G. Kellison

SGK:bjn
cc: Committee on Life Insurance

# STATEMENT 1982-2

STATEMENT OF THE

AMERICAN ACADEMY OF ACTUARIES

ON HR 4928 AND HR 4929 ("PERISA")

TO THE HOUSE SUBCOMMITTEE ON LABOR-MANAGEMENT RELATIONS

February 8, 1982

Stephen G. Kellison, Executive Director

## I. Introduction

The American Academy of Actuaries ("Academy") is pleased to submit these comments on HR 4928 and 4929, each entitled the Public Employee Retirement Income Security Act of 1981 ("PERISA"). The Academy is vitally interested in these bills, since the large majority of actuaries performing actuarial services for state and local public employee retirement systems are members of the Academy. Appendix A contains some background information about the Academy.

These bills are very comprehensive, having a number of provisions that would affect the work of actuaries in connection with state and local public employee retirement systems. However, we would prefer to make specific comments today on only three aspects of the bills: the relationship between actuaries and accountants, the enrollment of actuaries, and the question of pension terminology.

Before making those comments, we would like to put on the record our appreciation to the Subcommittee and its staff for the opportunity to review some of the technical material in these bills and their predecessors as they were being prepared. A committee of the Academy spent many hours reviewing the reporting

and disclosure provisions of these bills (with particular emphasis on those sections which deal with actuarial disclosure), and although the Academy takes no stand on these sections with respect to their desirability, we are satisfied with their content from a technical standpoint.

## II. Relationship Between Actuaries and Accountants

The relationship between actuaries and accountants under the Employee Retirement Income Security Act of 1974 ("ERISA") is important background to consider, since the general framework of PERISA is similar to that contained in ERISA in this area. However, despite their similarity, PERISA contains some fundamental differences from ERISA which will be discussed in Section III of this statement.

ERISA has given rise to an unresolved problem in the auditing area. Section 103 of ERISA provides that the accountant may rely on the correctness of any actuarial matter certified to by an enrolled actuary, if he so states his reliance (and conversely, that actuaries may rely on the work product of qualified accountants in an analogous manner). However, this provision has never become operational in the manner which Congress intended. This results from audit guidelines (which predate ERISA) issued by the American Institute of Certified Public Accountants (AICPA) which state that any opinion of an auditor which expresses reliance on the work of others becomes a "qualified opinion," with all the resulting negative connotations attached to that term. The AICPA has not changed this position, despite the statutory authority for such an expression of reliance contained in ERISA.

III. Analysis of HR 4928 and HR 4929

Sections 1104-1109 of HR 4928 and Sections 104-109 of HR 4929 are quite similar to Section 103 of ERISA in dealing with the relationship between actuaries and accountants, with two notable exceptions:

1. Section 1106(a)(2) of HR 4928 and Section 106(a)(2) of HR 4929 provide that the accountant shall rely on the correctness of any actuarial matter certified to by an enrolled actuary. Likewise, Section 1107(b) of HR 4928 and Section 107(b) of HR 4929 provide for similar reliance by actuaries on accountants. Thus, PERISA changes the voluntary reliance of ERISA to compulsory reliance.
2. Section 103(a)(3)(A) of ERISA indicates that audits shall be conducted in accordance with "generally accepted auditing standards." Section 1106(a)(1) of HR 4928 and Section 106(a)(1) of HR 4929 contain the same wording, with the important addition that the reliance provisions described above are specifically authorized, even though departing from generally accepted auditing standards as presently defined by the AICPA.

The Academy strongly endorses these two provisions contained in PERISA. We believe that they would be quite beneficial in resolving the difficulties which have arisen under ERISA, as described in Section II of this statement. Furthermore, we believe that they are quite compatible with the division of responsibilities between actuaries and accountants intended by the Congress in the implementation of Section 103 of ERISA.

In addition, the Academy would like to prepare several additional amendments to further clarify the relative roles of the two

professions. These amendments are consistent with the intent of HR 4928 and HR 4929 and are submitted for the consideration of the Subcommittee in Appendix B.

## IV. Other Legislation

We would also like to call attention to the fact that major ERISA revision bills currently before the Congress contain provisions similar to those contained in PERISA described above. In particular, HR 4330 and S 1541 (the Retirement Income Incentives and Administrative Simplification Act of 1981) contain such provisions.

We believe that these bills, along with HR 4928 and HR 4929, are indicative of strong Congressional interest in resolving the relative roles of actuaries and accountants on a consistent basis in all areas of pension legislation. We strongly support these efforts.

## V. Enrollment of Actuaries

When ERISA was passed in 1974, it contained a provision for enrollment which allowed for a "grandfathering" of actuaries in practice at that time who met the qualifications and applied for enrollment prior to January 1, 1976. Those who did not so qualify or who did not apply by that date were subject to more extensive education or examination requirements and experience requirements after that date.

Actuaries practicing in the private field were, of course, quick to apply so as to be qualified for continued practice in their profession. On the other hand, actuaries dealing with public

employee retirement systems did not have the same need for enrollment and, in some instances, did not therefore apply for enrollment.

If PERISA should become law, those actuaries who practice exclusively in the public sector but who have not become enrolled actuaries would not have had the same advantages afforded to them as was the case for the private pension actuaries in the initial enactment of ERISA. To correct this inequity, Section 1002(18) of HR 4928 and Section 3(17) of HR 4929 would allow to actuaries exclusively in the public sector the same privileges for initial qualification as were allowed under ERISA to actuaries for private plans. The Academy supports these provisions.

VI. Pension Terminology

Over the years a variety of pension terminology has evolved in laws and regulations and in the pension literature. We note that PERISA contains a number of terms for certain actuarial values which differ from those contained in ERISA.

The actuarial profession recently received a report from the Joint Committee on Pension Terminology composed of representatives from various actuarial organizations. This committee's charge was to arrive at a more uniform, consistent and unambiguous set of terminology. This report has now been formally endorsed by the governing boards of all U.S. actuarial organizations dealing with pension matters. The report is submitted for the consideration of the Subcommittee as Appendix C.

At the present time, the language of HR 4928 and HR 4929 is being reviewed for consistency with the terminology committee's report. In the near future, representatives of the actuarial profession will be discussing the results of that review with the Subcommittee's staff.

VII. Summary

In summary, the Academy strongly supports the provisions of HR 4928 and HR 4929 concerning the relationship between actuaries and accountants. We would also like to recommend additional amendments which are consistent with the intent of the bills to further clarify this relationship. We also support provisions of the bill authorizing special initial enrollment procedures for actuaries operating exclusively in the area of public pension plans. Finally, we would recommend that certain terminology be reexamined in light of an effort within the actuarial profession to foster the adoption of uniform terminology.

Douglas C. Borton, Chairman
Pension Committee

Subcommittee on Public Employee Retirement Systems
Thomas P. Bleakney, Chairman
James A. Beirne
Barry M. Black
Edward H. Friend
James B. Gardiner
Norman S. Losk
Robert H. Smith

## APPENDIX A

## BACKGROUND INFORMATION ON THE AMERICAN ACADEMY OF ACTUARIES

The American Academy of Actuaries is a professional association of actuaries which was formed in 1965 to bring together into one organization all qualified actuaries in the United States and to seek accreditation and greater public recognition for the profession. The Academy includes members of three founding organizations - the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, and the Society of Actuaries.

The Academy serves the entire profession. Its main focus is the social, economic, and public policy environment in which the actuarial profession functions. Its primary activities include liaison with federal and state governments, relations with other professions, public information about the actuarial profession and issues that affect it, and the development of standards of professional conduct and practice.

Over 6,500 actuaries in all areas of specialization belong to the Academy. These members are employed by insurance companies, consulting actuarial firms, government, academic institutions, and a growing number of industries. Actuarial science involves the evaluation of the probabilities and financial impact that uncertain future events - birth, marriage, sickness, accident, retirement, and death - have on insurance and other benefit plans.

Membership requirements can be summarized under two broad headings: education and experience. At present, the educational requirements can be satisfied either by passing certain professional examinations sponsored by the Casualty Actuarial Society or the Society of Actuaries, or by

becoming an enrolled actuary under the Employee Retirement Income Security Act of 1974 (ERISA). The experience requirement consists of three years of responsible actuarial work.

## APPENDIX B

## PROPOSED AMENDMENTS TO HR 4928 AND HR 4929 BY THE AMERICAN ACADEMY OF ACTUARIES

Note: All page numbers refer to the respective bill.

### HR 4928

1. page 33, line 10 — add two new sentences after "actuary" as follows:

   "The opinion of the accountant under this section shall not extend to actuarial matters certified to by the enrolled actuary. 'Actuarial matters' may be further defined by regulation by the Board and shall include the items required to be included in the actuarial statement under Section 1107."

2. page 34, line 21 — delete "liabilities" and substitute in its place "non-actuarial liabilities of the plan."

3. page 36, line 10 — insert before "liabilities" the word "non-actuarial."

### HR 4929

1. page 31, line 22 — add two new sentences after "actuary" as follows:

   "The opinion of the accountant under this section shall not extend to actuarial matters certified to by the enrolled actuary. 'Actuarial matters' may be further defined by regulation by the Secretary and shall

| | |
|---|---|
| | include the items required to be included in the actuarial statement under Section 107." |
| 2. page 33, line 8 | delete "liabilities" and substitute in its place "non-actuarial liabilities of the plan." |
| 3. page 34, line 22 | insert before "liabilities" the word "non-actuarial." |

## APPENDIX C

[Report of the Joint Committee on Pension Terminology]

STATEMENT 1982-3


# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196


February 11, 1982

Director of Research and Technical Activities
File Reference 1063-078
Financial Accounting Standards
High Ridge Park
Stamford, Connecticut 06905

Dear Sir:

The following comments on the Exposure Draft, "Accounting by the Insurance Industry" are submitted on behalf of the American Academy of Actuaries by its General Committee on Financial Reporting Principles.

The American Academy of Actuaries has three committees which are responsible for examining actuarial considerations applicable to financial reporting for insurance companies. One deals exclusively with life insurance financial reporting, another with property/liability insurance financial reporting, and the third is a coordinating body. These committees have worked closely with the AICPA in the development of the audit guides for life insurance and property/liability insurance companies. In addition, these committees have promulgated guidelines for actuaries for implementing these guides, in the form of Recommendations and Interpretations. A copy of these Recommendations and Interpretations, as published in the 1982 Yearbook of the American Academy of Actuaries, is enclosed for your reference.

Our comments focus on two basic areas: First, we request that the list of issues that are identified on the first two pages of the "Notice" section be included as an integral part of the final Statement, so that accounting and actuarial practitioners are formally made aware that there are still many important unresolved issues. The Academy Committees look forward to working with the FASB towards a timely resolution of these issues.

Second, there are numerous changes of a technical nature upon which we wish to comment. Although the proposed Statement primarily involves an extraction of existing principles and practices, we believe many changes from this draft are necessary, and we strongly urge that, once the FASB receives comments from the various interested parties, they redraft and reexpose the proposed Statement before it is issued. Our comments are as follows:

Director of Research and Technical Activities
February 11, 1982

1. Paragraph 3. The first sentence should be shortened to, "The primary purpose of insurance is to provide economic protection from identified risks." The balance of the sentence is too narrow in that it does not encompass such things as investment risks, and it does not address the transfer of risks, as opposed to pooling or spreading.

   The second sentence could be improved by eliminating the reference to "burglary", as it is quite minor compared to the other examples.

2. Paragraph 4. Appropriateness of criteria for identifying short duration and long duration contracts. The second and third sentences should be deleted, since they attempt to define long duration contracts in terms of functions or services, rather than the length of contractual provisions. A possible substitute is as follows:

   "Generally, the two methods reflect the nature of company obligations and policyholder rights under the specific provisions of a contract. Contract provisions to be considered include the insurance protection period, renewability option, duration of premium payments and premium level guarantees."

   The accuracy of the penultimate sentence of this paragraph is subject to question. It could be improved by rewording it as follows:

   "For example, property and liability insurance contracts that are not expected to remain in force for an extended period are considered short-duration contracts for purposes of this Statement."

3. Paragraph 6. Mortgage Guaranty Enterprises. This Statement should not apply to mortgage guarantee insurance enterprises, since an audit guide for such enterprises does not presently exist. The development of appropriate principles for such enterprises should be undertaken as a separate project with more comprehensive exposure.

4. Paragraph 8. In the last sentence, it would be preferable to delete the words "Individual and group", since most group contracts are not classified in these terms.

5. Paragraph 15. This paragraph is more restrictive than the life audit guide and does not provide for a common practice. Some companies recognize premium as revenues when due and paid -

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especially on coverages with high early lapses - and this should be expressly permitted in the Statement.

Recommendation 5 of the Academy's Committee on Life Insurance Financial Reporting Principles describes the following four methods of premium recognition: (1) due and paid, (2) due, (3) continuous, and (4) statutory. The recommendation describes appropriate methods of determining actuarial reserves and related items for each method. As explained in paragraph 7 of Interpretation 5-A, only the fourth method is presently considered to be unacceptable for GAAP financial statements.

6. Paragraph 21. Seven lines down, there is a sentence "The assumptions shall include provision that actual experience will be more adverse than the assumptions used....". This is poorly worded. Suggested rewording is: "The assumptions shall include provision for the risk of adverse deviation."

   We believe it would be helpful to auditors to include a footnote at this point explaining the relationship between accounting and actuarial standards, as was done in the Audit Guide for life insurance companies, pp 63-64, along the lines of the following:

   > The choice of actuarial assumptions and the disciplining of that choice are primary responsibilities of the actuarial profession. The American Academy of Actuaries has developed standards for the actuarial profession in the form of Recommendations and Interpretations from its Committees on Financial Reporting Principles. The auditor should expect the actuary to be able to demonstrate that assumptions used in determining actuarial items in a general purpose financial statement meet such standards.

7. Paragraph 23. We note that very little is said about selection of mortality assumptions - as compared to the discussions in paragraphs 24 and 25 dealing with morbidity and termination. We suggest that a reference be made to the Academy's Recommendation 1 - Interpretation 1 E dealing with the selection of mortality and morbidity assumptions.

8. Paragraph 28. Premium taxes and premium collection costs generally are considered as acquisition costs only on short duration coverages. This should be clarified.

9. Paragraph 31. The life audit guide requires that acquisition expenses be amortized using the same assumptions for interest, mortality, withdrawals, and expenses as for benefit reserves. This results from a statement on page 71 that all costs should be determined using those assumptions, and the listing of

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February 11, 1982

acquisition expenses as one of such costs. The consistency in the assumptions is also required by the statement on page 74 that the separate accounting of acquisition expenses and benefit reserves should produce the same net income and stockholder's equity as the use of a single valuation reserve for all benefits and expenses.

This requirement has been lost in the proposed statement. Assumptions for investment yields, mortality, morbidity, termination, and expenses are required in paragraph 21 in computing the liability for future policy benefits. However, there is no comparable requirement in paragraph 31 for acquisition costs.

We therefore suggest that the following sentences be inserted in paragraph 31 before the final sentence:

"Annual charges for acquisition costs should be determined using methods which include the same assumptions for interest, termination, and expenses as are used in computing the liability for future policy benefits. The separate accounting for policy benefits and unrecovered acquisition costs should produce the same net income and stockholder's equity as would result from using a single valuation reserve, which would provide for all benefits and expenses."

10. Paragraph 35. The second sentence is incorrect. The words "estimated future benefit costs and related expenses" should be changed to "the liability for future policy benefits".

11. Paragraph 39. The paragraph is ambiguous. In the first sentence, the words "shall be reduced by" should be changed to "shall reduce". Later on, the words "estimated future servicing costs" should be changed to "estimated excess future servicing costs".

12. Paragraph 40. It would be preferable to replace the term "insurance risk" with the broader term "economic risk". For example, on an annuity, investment risk may be a bonafide economic risk but generally is not considered to be an insurance risk.

13. Paragraphs 50 & 51. These paragraphs should be changed to permit increasing the value of an investment from a reduced cost basis prior to sale, maturity, or other disposition of the investment. The inability to make such recoveries discourages companies from reducing values from the original basis, and results in less conservative balance sheets.

14. Paragraph 54. The phrase "long-term" seems to be inappropriate in this paragraph, and accordingly should be deleted.

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15. Paragraph 60. (Proposed Disclosures)
    a. Item (e) of paragraph 60 should be shortened to simply read:

       "The nature and significance of reinsurance transactions to the insurance enterprise's operations."

       Unpaid claim and claim adjustment expenses are frequently estimated net of reinsurance, particularly in property and liability insurance companies. The inclusion of the second half of the proposed sentence would significantly change current practice by requiring additional estimates. Such a change is inappropriate at this time, since the AICPA is currently involved in a project of reviewing reinsurance auditing procedures.

    b. Item g. in paragraph 60 requires disclosure of several items relating to statutory capital and surplus requirements. However, the term "minimum statutory capital and surplus requirements" cannot be uniquely defined and, contrary to the statement in item g(2), it is not always equivalent to the amount of stockholder's equity that is restricted by statutory requirements. We believe that the standards contained in the SEC S-X revisions provide a much better disclosure. Rule 7-03.24(c) of the regulation requires disclosures of the amount of statutory stockholder equity and statutory net income or loss. Rule 4-08(e) deals with disclosure of significant restrictions on payment of dividends. It requires a description of the most significant restrictions on the payment of dividends and, where appropriate and determinable, the amount of retained earnings or net income so restricted. Adoption of the SEC standard would also have the advantage of consistency.

    c. Reconciliation Disclosure (Statutory to GAAP). We believe that reconciliation disclosure should continue to be encouraged since it draws attention to, and appropriately identifies, the major differences between GAAP accounting as applied to stock companies and statutory accounting practices. Statutory accounting remains a necessary and very important means of reporting insurance company results to many interested and knowledgeable users of financial statements.

    d. Disclosure of the average rate of assumed investment yield. The average rate should be defined as the assumed average rate in effect for the current year (as contrasted with some other longer range average rates). The Committee does not favor requiring its disclosure since it does not fully reflect the level of margin for adverse deviation and only highlights one of several elements which affect the relative conservatism of the Company's liabilities.

Director of Research and Technical Activities
February 11, 1982

16. Paragraph 66. The definitions of Acquisition Costs and Maintenance Costs seem to overlap. Acquisition costs have been defined to include "collection costs" and "premium taxes": and maintenance costs have been defined to include costs of "processing premium collections" and "premium taxes". These definitions are very important and should be clarified.

17. Paragraph 69. In recent years, lapse experience on many products has been significantly worse than anticipated when the business was initially written. Where this is the case, use of the worksheet method as described in paragraph 68 is likely to cause a material distortion in earnings unless an adjustment, such as the one referred to in paragraph 69, is made for actual inforce. Accordingly, this paragraph should be modified as follows:

    Extend the third sentence to read: "...will be disproportionate to premium revenue, and a material distortion of earnings is likely to result if persistency experience is significantly different than anticipated when the business was initially written."

    Change the last sentence to read: "Although this method may be impractical because of the volume of schedules that would be required for each year's new business, such an adjustment should nevertheless be made if a material distortion in earnings would result in the absence of any such adjustment.

18. Other Changes. The closing paragraph of the "Notice" requests that we identify other changes that are needed. As mentioned earlier, we request that the issues identified in the "Notice" section of the Exposure Draft be retained in the final Statement. Additionally, there are other issues that the Committees believe should be acknowledged. These issues include the following:

    a. With the trend toward higher interest rates, annuities (especially single premium deferred annuities) are increasing in popularity. Such contracts may have, as a major source of income, gain (or loss) from investment income. The technique for properly matching costs and revenues on such contracts is still not clearly stated.

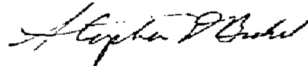
    b. A growing number of companies are making GAAP adjustments for contracts funded by separate account assets. Unamortized acquisition expenses are held in the general account and are amortized in relation to various charges transferred from the separate account. Some companies are also making benefit reserve adjustments, reducing liabilities by the value of future charges. The procedures for making such adjustments are not provided

Director of Research and Technical Activities
February 11, 1982

for in the Exposure Draft.

We hope these comments will be helpful to you.

Sincerely,



Stephen D. Bickel
Chairman
American Academy of Actuaries
General Committee on Financial
Reporting Principles

STATEMENT 1982-4

# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

March 4, 1982

Mr. Brian Zell
Manager, Auditing Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036

RE: Proposed Audit Guide
Audits of Employee Benefit Plans - Chapter 4
Exposure Draft Dated January 15, 1982

Dear Brian:

Here are our comments on this exposure draft. Brian, these comments are just about identical to those submitted earlier. The only changes are some amplifying comments as a result of another reading. These do not represent substantive changes.

For your convenience, the comments of December 21st were rewritten taking into account the thoughts mentioned above and changing the section numbers to conform to those in the exposure draft.

If you have any questions on this material, please call on us.

Thank you again for the opportunity to comment.

Sincerely,

W. H. Odell, FSA, ACAS, MAAA, EA
Chairman, Committee on Health Insurance

WHO/dw

Enclosure

cc: AAA Subcommittee on Health & Welfare Plans
AAA Committee on Health Insurance, Other Members
Committee on Relations with Accountants (sans Enclosure)
Stephen G. Kellison
AICPA Relations With Actuaries Committee (sans Enclosure)

FILE REF. NO. 3820

PROPOSED AUDIT GUIDE

AUDITS OF EMPLOYEE BENEFIT PLANS

CHAPTER 4

COMMENTS BY: AMERICAN ACADEMY OF ACTUARIES
COMMITTEE ON HEALTH INSURANCE

This Chapter, and indeed, the entire Audit Guide will we believe be of considerable help to practitioners in this complex field. We welcome the opportunity to comment on this early draft. The comments below are divided into two (2) groups - first general comments. Secondly, comments on specific paragraphs:

Our general comments are:

1. We believe that the benefits which may accrue for future service are not a liability of the plan. This matter was discussed in the "Statement to Financial Accounting Standards Board by the Sub-Committee on Pension Accounting Matters, American Academy of Actuaries, concerning the FASB discussion memorandum Re: Employer's accounting for pension and other post-retirement benefits" communicated to FASB on June 16th by Walter L. Grace, President of the Academy. A copy of this statement is attached for your convenience.

   Also, some portions of this draft chapter can be read to include post-retirement benefit liabilities. Some of the suggestions below put forth wording that would remove this interpretation. This subject was also discussed in the above statement, and is still being studied. That is why we suggest post-retirement benefits not be considered at this time.

2. We are pleased, of course, at your reference to obtaining actuarial assistance in connection with evaluating certain claim liabilities. Actuaries feel they can also be of assistance in areas such as rate credits (Paragraph 12), eligibility credits (Paragraph 20), etc. We would like to think that the practicing auditor will call on specialist's help as appropriate. One of the paragraphs we have suggested adding touches on this.

3. One of the reasons this field is so complex is that there is a tremendous variety of risk arrangements. We suggest that the practicing auditor consider each risk arrangement separately, study it carefully, obtain actuarial estimates of liabilities for that particular risk arrangement, and be sure the disclosures differentiate between different risk arrangements existing under the same plan. Related to this is a question, which in part is semantics, namely, distinguishing between the different types

of organization which the plan may be using for financing purposes. For example, on Page 1 "a fund" and "an insurance company" are referred to; however, there may be a Blue Cross - Blue Shield Plan involved, an HMO, etc.

Turning to Specific Comments:

1. Section 14 -
<u>Accrued Experience Rating Adjustments:</u>

   We believe that when a refund or dividend has been fully earned, the estimated value is a proper asset of the policyholder. However, when there is only a partial refund period and such period may be unrepresentative of the full insurance period because of either seasonal factors or fluctuations, it is doubtful whether such a potential gain or deficit should be established as part of the financial statement. To give an example, suppose a school system is on a calender financial basis but its insurance contract begins on September 1, the start of the school year, and ends August 31 of the following year. The financial experience covering the period September 1 through December 31 may appear to be very favorable and the policyholder has earned a refund equal to 15% of the premiums earned during this four month period. This conclusion may be misleading because the immediate winter months may have higher claims and traditionally school teachers postpone elective medical care until the end of school and at that time, incur very large expenses during the months of June or July. Also, many hospitals raise their rates on January 1st. Therefore, it is quite likely in the situation used for this example that no refund will materialize when the full policy year has ended after August of the following year.

   We, therefore, think you might want to consider wording such as the following to be added to Section 12 - - "however, when the period covered by the estimated refund is only a portion of the policy year, care must be taken not to over-state the asset, especially where the experience with the remainder of the policy year can be expected to be less favorable than the experience for the portion of the policy year which has expired.

2. Section 15 -
<u>Accrued Experience Rating Adjustment</u>
   This section suggests that a deficit which will be carried forward by a carrier should be established as a liability on the policyholder's financial statements. We believe this is doubtful unless there is a financial agreement that requires the policyholder to repay this deficit. The reasons for not establishing this liability include the following:

a) The policyholder may transfer the insurance coverage to another carrier, thereby, erasing the deficit.

b) If the carrier does not include a special margin for recovery, the policyholder is in almost exactly the same position had there been no deficit. The only difference is that before a refund is available the deficit must be recovered.

c) Some policyholders will rebid their insurance contract and if it is awarded to the existing carrier, it still may result in eliminating the prior deficit.

We therefore suggest dropping what are now the second and third sentences of this Section and adding something like the following -- frequently, because of transfer of the insurance program, re-rating of the contract with the existing carrier, or for some other reason, the deficit will never be paid by the plan. However, if the deficit may be assessed retrospectively against the plan, then it should be recorded as a liability of the plan". (We realize we probably do not have the appropriate accounting terminology to describe this situation when the premium deficit is "really" a liability).

3. Section ?

We suggest that at some point in the Chapter an indication be given to the practitioner of the variety of risk arrangements, etc. Perhaps the place to do this is after the present "financial statements" Section 8. In any event, we suggest something like the following:

"Health and Welfare Benefit Plans are arranged through a variety of risk arrangements. Under some risk arrangements the plan retains almost none of the risks, under other arrangements the plan retains almost all of the risks. Parties with whom the plan may contract include not only trustees, but also insurance companies, Blue Cross - Blue Shield organizations, health maintenance organizations, and other health care financing organizations. The exact nature of each risk arrangement needs to be determined. The actuarial estimates of liabilities discussed below need to be determined for each risk arrangement and the information for each arrangement disclosed as described below.

4. Sections 17, 18, and 19
Claims
We agree with the sentence in Section 15 that requires that the financial statements of a self-insured plan should include the amount of claims reported but not paid and claims incurred but not reported. We believe that it is not always desirable as indicated in Section 18 to determine separately and independently the claims reported but not paid and the claims incurred but not reported. Often the combined total of these amounts is determined then the amount reported but not paid is subtracted to determine the amount incurred but not reported. We also believe that the language should not indicate claim liabilities may be determined by a plan's insur-

ance consultant. While some insurance consultants are actuarially trained to determine claim liabilities, for others it is not within their scope of expertise. We believe the calculation of claim liabilities should be determined by an actuary when they extend over any period of time or in volume a claim volume which makes inventorying of actual amounts impractical.

It is unclear whether the claims referred to in Sections 17, 18 and 19 include only benefits which have accrued and are not contingent on future events or whether they include those types of benefits or ones for which contingencies still exist. For example, in the case of disability income, are these sections meant to include all benefits accrued throughout the end of the financial statement, or will they also include the present value of benefit payments which are contingent on the insured remaining disabled? In the case of death benefits, are these liabilities to represent only the amounts for those who have died prior to the financial statement or will they include in the case of a benefit that has a waiver of premium, the present value of the death benefits for those who have become totally disabled before the financial statement but who have not yet died?

We, therefore, suggest that in Paragraph 17 the following be added as a second sentence: "both the 'reported but not paid' category and the "incurred but not reported" category include amounts for which the company as of the statement date is liable even though they will not become due until a future date as well as amounts past due. For example, under a disability income coverage these amounts include the estimated present value as of the statement date of payments which will become due after the statement date during the continuance of disability if the plan is liable for such benefits".

In Section 18, we would suggest changing the second sentence by deleting the words "insurance consultant or" and make the same change in Section 19. We understand that the independent auditor makes the final decision as to who is called upon as a specialist. In Paragraph 18, we suggest adding a sentence such as the following: "Acturial techniques often involve estimating in the aggregate the total of claims reported not paid and claims incurred but not reported, rather than developing the two components of the liability separately".

We also suggest adding a Section 20 containing a sentence such as the following: "the development of the claim liabilities is performed separately for each risk arrangement and type of benefit.

5. Section 22
<u>Accumulated Eligibility Credits</u>
It may be unclear to the practitioner from this section whether

this is referring to labor negotiated contracts where individual workers have accumulated the right to certain future insurance benefits independent of their future working status or whether it refers to the recognition of post-retirement medical benefits or life insurance benefits. In the case of the latter, there may be provisions which must be met in order for these benefits to be payable such as future vesting and changes in the plan which may occur before some or all of these post-retirement benefits become payable. In any event, as pointed out above, we suggest post-retirement benefits not be considered at this time. We do not have specific wording to suggest as to clarifying the questions mentioned at the beginning of this paragraph.

6. Section 26
   Disclosures
   We suggest modifying the second line slightly along the following lines: " - - the following additional disclosures by risk arrangement, if applicable: - - "

7. Illustration of Financial Statements - Page 23
   On Page 23 under liabilities there are five separate items. The first two items, "Health Claims Payable" and "Estimated Health Claims Incurred But Not Reported", we understand to be the traditional liability for health claims which have been incurred but were unpaid. We believe both should include benefits which are unaccrued as of the statement date such as disability payments involving participants who are disabled on the valuation date with respect to the benefits payable for such disability which will continue into the future until the participants recover or die. Classification of amounts between these two line items has been very troublesome in insurance company financial statement reporting. We suggest something like the following:

   "Health Claims - estimated future payments on incurred claims (includes incurred but not reported claims)"

   If for tax reasons two lines are desired, then something like the following might do:

   "Health Claims - liability for past-due payments"*, and

   "Health Claims - estimated other future payments on incurred claims (includes incurred but not reported claims)"

   The third item which related to future benefits based on participants' accumulated eligibility has some uncertainty. Based on the notes on page 25, this may result from contractural eligibility credits which can guarantee a participant up to one year's extended benefit. Presumably, this would not include any liability relating to future service.

   The fourth item, estimated benefits to retired participants, may be similar to the previous item except pertaining to those participants who are now retired. This would be somewhat

*If the words "past due" are objectionable the line could be labeled "Health claims - liability for accrued payments on reported claims".

different than establishing the accrued value of post-retirement death benefits. As indicated previously, we think that question is still not resolved and we do not think anything in this chapter should imply that there must be a liability for post-retirement benefits or that they must be recognized in a particular way.

The fifth item estimated future death benefits, may involve: (1) Unpaid death benefits for those already dead; (2) Present value of death benefits for those who are disabled and have continuous coverage under a waiver premium provision, or (3) based on the notes on Page 25 the present value of contractually paid up death benefits which result from contractual credits which exceed the maximum of one year's coverage. Two line items might help such as:

"Death Claims - unpaid death benefits" and

"Death Claims - present value of life insurance coverage on disabled employees and employees with excess eligibility credits"

We believe this example should be studied carefully to be sure it will not mislead an auditor into thinking he should require a liability be established for such things as future unaccrued benefits that are recommended in the case of labor negotiated contracts or post-retirement benefits.

We appreciate very much the opportunity to comment. We hope the above comments are helpful. This Chapter we think will be of assistance to everyone interested in this complex subject.

Health Committee
W. H. Odell, Chairman

# STATEMENT 1982-5

# AMERICAN ACADEMY OF ACTUARIES

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STATEMENT TO THE SUBCOMMITTEE ON LABOR-MANAGEMENT RELATIONS
OF THE HOUSE COMMITTEE ON EDUCATION AND LABOR
BY STEPHEN D. BRINK, ON BEHALF OF THE
COMMITTEE ON HEALTH INSURANCE OF THE
AMERICAN ACADEMY OF ACTUARIES

March 5, 1982

Mr. Chairman and members of the Subcommittee, my name is Stephen D. Brink. I am a member and here on behalf of the Committee on Health Insurance of the American Academy of Actuaries. I am also a consulting actuary experienced in the health insurance field and have worked directly with many multiple employer health insurance trusts (METs). I am here today to discuss some of the issues involved with multiple employer health insurance trusts. We believe that actuarial involvement is essential to the financial soundness of METs, and some form of regulation which includes actuarial guidelines is necessary to protect the interests of persons covered under these plans.

The American Academy of Actuaries is a professional organization composed of actuaries practicing in a variety of fields, including the field of health insurance. Attached to this statement as Appendix A is additional background information about the Academy.

The actuarial profession serves a wide variety of organizations which provide financial security programs such as life insurance, health benefits, pensions

and casualty coverages. The organizations served by actuaries include insurance companies, employers and trusts.

The broad role of the actuarial profession is to help these organizations carry through on their promise to provide financial assistance in the event of death, retirement, high medical expenses or other contingencies.

The recent collapse of the National Health Care Trust, and the collapse of other similar trusts in recent years, indicate a clear need for the regulation of uninsured multiple employer trusts. The American Academy of Actuaries would like to offer its assistance in working with regulators at either the federal or state level in developing an effective regulatory environment for METs. Such activity on our part could involve the development of actuarial requirements involved in the regulatory system and the definition of qualified actuaries for this purpose.

Description of METs

A multiple employer trust can be broadly defined as a trust formed for the purpose of providing group insurance to employers having 2 to 25 employees. Once a trust is formed, employers can join the trust to participate in the group insurance plans which may include life, medical, disability and sometimes dental benefits. All sales and administrative services are provided by the sponsoring broker or administrator.

With an insured MET, a group insurance contract is issued to the trust by an insurance company. Because of the insurance risk, the insurance company usually is involved, along with the broker or administrator, in managing the program.

An uninsured MET is a trust which does not involve an insurance contract or an ultimate guarantor. Some METs will insure the life but not the health benefits. It is the uninsured METs with which we are concerned and we will be addressing today.

The Problem

A MET must be operated on an actuarially sound basis if it is to avoid collapse and be able to deliver on its promise to pay benefits when due. Unfortunately, often there is a lack of sincere interest on the part of a sales-oriented management to operate the MET according to sound actuarial principles. In fact, many uninsured trusts got started in 1974-1975 when the broker or administrator received what they considered to be unreasonably high rate increases from insurers. In addition, these brokers and administrators considered the MET to be an "employee welfare benefit plan" under ERISA, and therefore exempt from funding standards and state insurance regulation.

The success of any medical care insurer, or non-insurer, promising future benefits depends heavily on the experience and competence of the plan's management. Good management begins with a careful reading of the need for a product, and the market place in which the product will be sold, to determine if the product can be sold profitably and to the advantage of the consumer as well as the marketers. It further demands a careful monitoring of costs and emerging experience, and requires decisive action on rates and benefit designs. Good management knows the necessity of good underwriting and good data base construction. Good management knows that adequate provision must be made for things that can go wrong. For many multiple employer trusts, good management is lacking, since many of those active in this area have had no experience in managing a health insurance business.

The financial status of a multiple employer trust can look deceptively good until it is too late, and even after trouble is suspected, the conditions are not conducive to acceptance of the necessary actuarial medicine. The cash flow to a multiple employer trust is usually positive, because of the long lag between receipt of premium income and actual benefit payments. Thus, a new plan or a plan which is expanding enjoys a brief period of positive cash flow, even though the rates may be inadequate. In view of the undesirability of any increase in rates from the point of view of the salesmen for the plan, and the lack of hard data, there is often reluctance to increase premium rates until it is too late.

Poor selection of risks and adverse selection by employer groups is also a grave problem in multiple employer trusts, so that even well designed rating structure might prove to be inadequate. The broker-administrator may not understand the need for careful underwriting of the groups of employees, having been accustomed to relying on an insurer to do the underwriting. The fact is that small groups of employees must be underwritten, if the plan is to be financially sound.

The lack of a guarantor is a serious problem for many METs. When a large employer self-insures his employee benefit health program, he understands that he is the ultimate risk taker and guarantor, with the resources of the corporation to stand behind the promises. However, small employers joining the uninsured MET may be unaware that the plan is not insured and the risks they are taking. Further, they are rarely represented in any

discussions relating to the management of the Trust and so have no control over the risk. With no guarantor, a plan in serious financial difficulty has no ready source of funds, and so has no alternative but to collapse leaving participants with unpaid medical bills.

The lack of a benefit guarantor, therefore, imposes a need for premium margins to develop funds to meet contingencies as they arise. These margins are seldom added to MET rates because the rates would be higher than comparable insured trusts, which is viewed as non-competitive from a sales point of view.

## Actuarial Involvement

There are a number of areas in the operation of a MET in which the actuarial element is essential. An obvious example is the setting of initial rates and the continued monitoring and updating of rates. However, rate setting alone is not sufficient. The setting of appropriate reserve levels, both for active participants in the plan and for those participants and beneficiaries who are in claim status, is another important actuarial function. Also, the establishment of appropriate contingency reserves is vital to protect against adverse deviation of experience from the anticipated. Even the largest METs are subject to the considerable fluctuation in experience that is inherent in any risk enterprise. The actuary involved must determine an appropriate contingency reserve such that participants can feel confident that benefits will continue to be paid even if the experience deviates substantially from that expected. Actuaries also make other contributions to the sound operation of METs, but the above examples describe some of the major areas of actuarial activity.

The Role of the Actuary in Regulation

The role of the actuary in the regulation of such enterprises has been broadly recognized on both the state and federal levels. For example, at the state level the National Association of Insurance Commissioners (NAIC) for several years has required an actuarial statement on opinion in connection with the Annual Statement Blank filed by life and health insurance companies, and a similar program has recently been added to the Annual Statement Blank for property and casualty companies as well. This actuarial statement of opinion contains several items, including a statement that "the amounts carried in the balance sheet on account of the actuarial items....make a good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies." The NAIC has formally recognized members of the American Academy of Actuaries as qualified to render such statements of opinion.

At the federal level, ERISA places a number of requirements on the Enrolled Actuary under defined benefit pension plans. Under ERISA, actuaries must use "actuarial assumptions and methods which, in the aggregate, are reasonable and which, in combination, offer the actuary's best estimate of anticipated experience under the plan." The Enrolled Actuary is also required to provide extensive information on the funding status of the pension plan.

Unfortunately for MET plan participants, the Department of Labor, which has responsibility for "employee welfare benefit plans" under its jurisdiction, has not developed actuarial standards or guidelines for rate setting or reserving. In most cases, the DOL has rejected METs as not being subject

to their regulation. The individual states must then subject these METs to their regulation, either as an insured MET or as an unininsured MET, which has resulted in an uneven and somewhat uncertain regulatory environment. Some states have moved aggressively to protect MET participants while others have not. Because of history of financial collapse of METs, we believe that actuarial and management requirements of METs should be addressed at both federal and state levels so the current regulatory unevenness and uncertainty can be resolved.

I appreciate the opportunity to participate in this hearing and would like to repeat that the actuarial profession is ready to be of service in helping to assure the financial integrity of METs and to protect the interests of their participants and beneficiaries. In particular, the Committee on Health Insurance of the Academy would be available to work with the Subcommittee and its staff, and with other legislators and regulators at either the federal or state level, in developing language which would provide for an appropriate regulatory environment for METs.

## APPENDIX A

The American Academy of Actuaries is a professional organization of actuaries which was formed in 1965 to bring together into one organization all qualified actuaries in the United States and to seek accreditation and greater public recognition for the profession. It includes members of three founding organizations -- the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, and the Society of Actuaries.

Requirements to become a member of the Academy can be summarized under two broad headings: (1) education and (2) experience. At the present time, the education requirements for membership can be satisfied by passing certain professional examinations given either by the Casualty Actuarial Society or the Society of Actuaries or by becoming an "enrolled actuary" under the Employee Retirement Income Security Act of 1974 (ERISA). The experience requirement consists of three years of responsible actuarial work.

As of the end of 1981, the Academy membership exceeded 6,600. The Academy is unique as the national actuarial organization for actuaries in all areas of specialization. These actuaries have a variety of types of employment, including insurance organizations, consulting firms, academic institutions and government. A large majority of those individuals who have satisfied the education and experience requirements of the Academy have, in fact, joined the Academy.

The Academy is active in the development of guides to professional conduct and standards of practice required of members in their professional practice. The Academy is also active in government relations, liaison with other professions and public relations.

AMERICAN ACADEMY OF ACTUARIES
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# STATEMENT TO THE SUBCOMMITTEE ON CENSUS AND POPULATION OF THE HOUSE COMMITTEE ON POST OFFICE AND CIVIL SERVICE BY E. PAUL BARNHART, ON BEHALF OF THE COMMITTEE ON HEALTH INSURANCE OF THE AMERICAN ACADEMY OF ACTUARIES

March 16, 1982

Mr. Chairman and members of the Subcommittee, my name is E. Paul Barnhart. I am a member of the American Academy of Actuaries and am submitting testimony on behalf of the Academy's Committee on Health Insurance. I am also an independent professional consulting actuary, nationally known as a specialist in health insurance. I serve all forms of clients needing actuarial help in this field: insurance companies, non-profit service corporations, welfare plans, professional and trade associations, governmental agencies.

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In health insurance actuarial work, the principal areas in which federal statistics are utilized are as follows:

1. <u>Medicare and Medicaid Statistics</u>

   Medicare and Medicaid statistics concerning utilization and cost of all forms of provider services have become very important. This is due to the increasing volume of Medicare Supplement insurance plans sold privately,

as well as other health care programs having some relation to these two federal programs. Actuaries, private insurance companies and state insurance regulatory agencies all depend on the available federal data quite heavily in this area.

2. Social Security Disability Data

   An increasing number of private disability plans, both group and individual, involve some form of supplementary integration over Social Security disability benefits. Availability of federal data and actuarial analysis in this area is important to the pricing of these private insurance programs.

3. Other Data Published by the U.S. Labor Department, Health and Human Services Department, Census Bureau, etc.

   Several other types of data gathered and published by federal agencies in such areas as incidence and types of accidents, incidence of various diseases, utilization of health care services, trends in costs of such services, etc., are very useful to actuaries, particularly when working with new or experimental benefit plans for which limited data, or none at all, is available from private insurance sources. At times, there is little data from which to begin other than what can be obtained from federal statistical sources.

Finally, there are areas of practice other than health insurance actuarial work in which federal statistics are used. For example, actuaries frequently use the various life tables prepared subsequent to each decennial census of the United States. These tables provide the best information that exists on mortality rates of the U.S. population as a

whole and also provide useful breakdowns among various components of the U.S. population.

While this statement is a very brief summary, I hope that the Subcommittee will find it of some value. In the event further analysis is necessary, I would be most happy to provide my assistance to the Subcommittee in its investigation.

## APPENDIX A

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Requirements to become a member of the Academy can be summarized under two broad headings: (1) education and (2) experience. At the present time, the education requirements for membership can be satisfied by passing certain professional examinations given either by the Casualty Actuarial Society or the Society of Actuaries or by becoming an "enrolled actuary" under the Employee Retirement Income Security Act of 1974 (ERISA). The experience requirement consists of three years of responsible actuarial work.

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The Academy is active in the development of guides to professional conduct and standards of practice required of members in their professional practice. The Academy is also active in government relations, liaison with other professions and public relations.

# STATEMENT 1982-7

March 22, 1982

Mr. Ted Becker
Staff Actuary
State Board of Insurance
1110 San Jacinto
Austin, Texas 78786

Subject: Individual Health Insurance
Rate Filing Guidelines: Revisions
recommended by AAA NAIC Liaison
Subcommittee and Comments

Dear Ted:

Our AAA Subcommittee on Liaison with the NAIC has met and discussed the pending revision of the NAIC Model Guidelines for Filing of Rates for Individual Health Insurance Forms, and we recommend a number of changes.

These are all shown on the enclosed copy of the pending revision, together with left margin references to a page of numbered comments explaining the key reasons for the recommended changes.

In some cases, these merely serve, in our opinion, to clarify what we believe is already intended, or else to give more emphasis to certain important considerations. Several basic changes proposed, however, have to do with retroactive application of the Guidelines, once they have been adopted. We do not believe there should be any attempt to apply the Guidelines retroactively to business for which rates were filed prior to adoption of these Guidelines. In such cases, rate revisions should be subject to whatever guidelines were applicable to the prior rates. If no formal prior guideline was applicable, then we believe the insurer's own actuarial basis for its prior rates will often serve as an implied guideline (e.g., a filed statement as to the loss ratio anticipated under the prior rates, or else a filed description of the actuarial basis of the prior rates). In any case, we believe it appropriate that new guidelines only apply to original rate filings (and subsequent revisions of these) made after the new guideline effective date. Retroactive application will, in our opinion, lead to unfairness and inequity for either insurer or

Mr. Ted Becker March 22, 1982

policyholder or both, and would even be of questionable legality in many instances.

One subject that is not addressed in our recommended changes is the subject that has been raised by the State of Washington pertaining to premium and risk stabilization reserves. We have not tried to address this because we believe this subject would be more appropriately dealt with in the total context of reserve standards for adjustable premium individual health insurance, rather than handled as an aspect of rate filing requirements. The two subjects are, to be sure, closely related, but we think the subject of appropriate reserves needs to be examined in totality and in reference to the entire question of statutory reserve standards for policies with non-guaranteed premiums.

We believe that this examination will occur in the very near future, as part of the discussion and follow up that will evolve out of the recent Exposure Draft of the Report of the Society of Actuaries Committee on Principles of Health Insurance Valuation.

I expect to be at your meeting in Houston on April 3, to discuss the attached recommendations and to answer questions.

Respectfully submitted,

Paul Barnhart, Chairman,
AAA Liaison Subcommittee

EPB:cg
Enc.

cc: Mr. John O. Montgomery
Mr. W. H. Odell
Mr. David R. Carpenter
Mr. Stephen G. Kellison
Subcommittee Members

DRAFT Underlines indicate changed or inserted wording.
[Brackets] indicate wording appropriate only in those states where such wording would be applicable.

GUIDELINES FOR FILING OF RATES FOR INDIVIDUAL HEALTH INSURANCE FORMS

## I. GENERAL

Numbered Comments

A. Every policy, rider or endorsement form affecting benefits which is submitted for approval shall be accompanied by a rate filing unless such rider or endorsement form does not require a change in the rate. Any subsequent addition to or change in rates applicable to such policy, rider or endorsement shall also be filed.

### B. General Contents of All Rate Filings

The purpose of this regulation, including its Appendix, is to provide appropriate guidelines for the submission and the filing of individual health insurance rates and to establish standards for determining the reasonableness of the relationship of benefits to premiums. Each rate submission shall include an actuarial memorandum describing the basis on which rates were determined and shall indicate and describe the calculation of the ratio, hereinafter called "anticipated loss ratio," of the present value of the expected benefits to the present value of the expected premiums over the entire period for which rates are computed to provide coverage. Interest shall be used in the calculation of these present values only if it is a significant factor in the calculation of this loss ratio. Each rate submission must also include a certification by a qualified actuary that to the best of the actuary's knowledge and judgement the rate filing is in compliance with the applicable laws and regulations of the state to which it is submitted and that the benefits are reasonable in relation to premiums.

### C. Previously Approved Forms

Filings of rate revisions for a previously approved policy, rider, or endorsement form shall also include the following:

1. A statement of the scope and reason for the revision, and an estimate of the expected average effect on premiums, including the anticipated loss ratio for the form.

2. A statement as to whether the filing applies only to new business, only to in-force business, or both, and the reasons therefor.

3. A history of the experience under existing rates, including at least the the data indicated in section ID. The history may also include, if available and appropriate, the ratios of actual claims to the claims expected according to the assumptions underlying the existing rates. Additional data might include: substitution of actual claim run-offs for claim reserves and liabilities; determination of loss ratios with the increase in policy reserves subtracted from premiums rather than added to benefits; accumulations of experience fund balances; substitution of net level policy reserves for preliminary term policy reserves; reserve adjustments arising because of select period loss experience; adjustment of premiums to an annual mode basis; or other adjustments or schedules suited to the form and to the records of the company. All additional data must be reconciled, as appropriate, to the required data.

1.

4. The date and magnitude of each previous rate change, if any.

D. Experience Records

Insurers shall maintain records of earned premiums and incurred benefits for each calendar year for each policy form, including data for rider and endorsement forms which are used with the policy form, on the same basis, including all reserves, as required for the Accident and Health Policy Experience Exhibit. Separate data may be maintained for each rider or endorsement form to the extent appropriate. Experience under forms which provide substantially similar coverage and have substantially similar risk exposure may be combined, particularly where statistical credibility would be materially improved. The data shall be for all years of issue combined and for each calendar year of experience since the year the form was first issued, except that data for calendar years prior to the most recent five years may be combined.

2.

E. Evaluating Experience Data

In determining the credibility and appropriateness of experience data, due consideration must be given to all relevant factors, such as:

1. Statistical credibility of premiums and benefits, e.g., low exposure, low loss frequency.

2. Experienced and projected trends relative to the kind of coverage, e.g. inflation in medical expenses, economic cycles affecting disability income experience.

3. The concentration of experience at early policy durations where select morbidity and preliminary term reserves are applicable and where loss ratios are expected to be substantially lower than at later policy durations. Where this consideration is pertinent, ratios of actual to expected claims, on a select basis, will often be necessary to an adequate evaluation.

3.

4. The mix of business by risk classification.

II. REASONABLENESS OF BENEFITS IN RELATION TO PREMIUMS

A. New Forms

With respect to a new form under which the average annual premium (as defined below) is expected to be at least $250, benefits shall be deemed reasonable in relation to premiums provided the anticipated loss ratio is at least as great as shown in the following table:

| Type of Coverage | Renewal Clause OR | CR | GR | NC |
|---|---|---|---|---|
| Medical Expense | 60% | 55% | 55% | 50% |
| Loss of Income and Other | 60% | 55% | 50% | 45% |

4.

For a policy form, including riders and endorsements, under which the expected average annual premium per policy is less than $250, the appropriate ratio from the table above should be adjusted downward by the following formula, where R is the table ratio, X is the amount by which $250 exceeds the expected average annual premium and R' is the resulting adjusted guideline ratio:

$$R' = R \cdot \frac{750 - X}{750}$$

The average annual premium per policy shall be computed by the insurer based on an anticipated distribution of business by all applicable criteria having a price difference, such as age, sex, amount, dependent status, rider frequency, etc., except assuming an annual mode for all policies (i.e., the fractional premium loading shall not affect the average annual premium or anticipated loss ratio calculation.

For Medicare Supplement policies, benefits shall be deemed reasonable in relation to premiums provided the anticipated loss ratio is at least 60%.

The above anticipated loss ratio standards do not apply to a class of business where such standards are in conflict with specific statutes or regulations.

Definitions of Renewal Clause

OR - Optionally Renewable: renewal is at the option of the insurance company.

CR - Conditionally Renewable: renewal can be declined by class, by geographic area or for stated reasons other than deterioration of health.

7.

GR - Guaranteed Renewable: renewal cannot be declined by the insurance company for any reason, but the insurance company can revise rates on a class basis.

NC - Non-Cancellable: renewal cannot be declined nor can rates be revised by the insurance company.

II. B. Rate Revisions

5.

With respect to filings of rate revisions for a previously approved form, or a group of previously approved forms combined for experience, benefits shall be deemed reasonable in relation to premiums provided the revised rates meet the standards applicable to the prior rate filing for such form or forms.

Where [a predecessor regulation or guideline, or] the insurer's own rate filing declaration applies to a previously approved form, the guidelines (or implied guidelines) applicable to such prior rate filing will continue to govern the filing of new rate revisions. In general, the rule that applies is that any rate revision is subject to the guideline basis under which the previous rates were filed (with consideration of all relevant rating factors: morbidity, expenses, persistency, interest, etc.), and to those regulatory guidelines, if any, that were in effect at the time of such filing.

With respect to filings of rate revisions for a form approved subject to these guidelines, benefits will be deemed reasonable in relation to premiums provided both the following loss ratios meet the standards in IIA of these Guidelines:

1. The anticipated loss ratio over the entire future period for which the revised rates are computed to provide coverage;
2. The anticipated loss ratio derived by dividing (i) by (ii) where

   (i) is the sum of the accumulated benefits, from the original effective date of the form to the effective date of the revision, and the present value of future benefits, and

   (ii) is the sum of the accumulated premiums from the original effective date of the form to the effective date of the revision, and the present value of future premiums,

   such present values to be taken over the entire period for which the revised rates are computed to provide coverage, and such accumulated benefits and premiums to include an explicit estimate of the actual benefits and premiums from the last date as of which an accounting has been made to the effective date of the revision. Interest shall be used in the calculation of these accumulated benefits and premiums and present values only if it is a significant factor in the calculation of this loss ratio.

5. (deletion)

5. (deletion)

C. Anticipated loss ratios lower than those indicated in A and B will require justification based on the special circumstances that may be applicable.

   1. Examples of coverages requiring special consideration are as follows:

      a) accident only:
      b) short term non-renewable, e.g., airline trip; student accident;
      c) specified peril, e.g., cancer, common carrier;
      d) other special risks.

   2. Examples of other factors requiring special consideration are as follows:

      a) marketing methods, giving due consideration to acquisition and administration costs and to premium mode;
      b) extraordinary expenses;
      c) High risk of claim fluctuation because of the low loss frequency or the catastrophic, or experimental nature of the coverage;
      d) product features such as long elimination periods, high deductibles and high maximum limits;
      e) the industrial or debit method of distribution.

5. deletion of f)

Companies are urged to review their experience periodically and to file rate revisions, as appropriate, in a timely manner to avoid the necessity of later filing of exceptionally large rate increases.

March 1982

## Rate Filing Guidelines - APPENDIX

A basic actuarial requirement in the establishment of a premium rate scale is that the benefits provided be reasonable in relation to such premiums. This requirement has been incorporated in the statutes of many jurisdictions and in the regulations and operating rules, formal and informal, of the Insurance Departments of probably all jurisdictions.

One of the principal objectives of these Guidelines is to establish a basis for assisting both those filing rates and those responsible for regulatory review of such filings, in deciding whether a premium rate filing meets this requirement.

The individuals who drafted these Guidelines recognized that the Guidelines would be applicable to the wide range of products marketed by a diversity of methods under the general title 'Individual Health Insurance'. For this reason, they decided it would be inappropriate to establish rigid rules or inflexible standards. It should be recognized, therefore, that the Guidelines are intended to be only guidelines, and must be interpreted and applied flexibly.

Section IIA of the Guidelines includes a table of numerical values representing loss ratios that 'shall be deemed reasonable in relation to premiums'. This 'deemer' level of loss ratio is meant to be the initial Guideline test for establishing the reasonableness of the premiums in relation to benefits. Satisfying this test establishes that the premiums are reasonable in relation to benefits. However, premium rates not meeting this test may still have benefits that are reasonable in relation to premiums based on further considerations.

Other parts of Section II, and particularly Subsection C, give examples of situations where considerations beyond the initial test would be appropriate in determining the reasonableness of premiums in relation to benefits.

Although expenses are not specifically addressed in the Guidelines, the variation in loss ratio benchmarks by average annual premium per policy is clearly intended to provide for the fact that a substantial amount of general expense is not a function of premium but is flat per policy. Thus, the Guidelines intend to make realistic provision for actual expenses as incurred. As inflation causes unit expenses to rise, despite the gains from improved productivity through greater mechanization, etc., the possibility of lower loss ratios may have to be confronted for some forms.

One of the purposes of Section I of the Guidelines is to set forth the requirements for rate filings. The usefulness of this section is enhanced by showing herein the minimum requirements as to the documentation of these rate filings.

March 1982

In developing the checklist below, consideration was merely given to pointing out some of the factors which may be involved in calculating the rates, e.g., interest, mortality, morbidity, selection, lapse, expenses, inflation, etc., and spelling out how those factors might be used in such calculations. It was felt, however, that this approach would produce details not always necessary to justify or review the rate filing while leaving out possibly essential information.

The checklists are separate for filing of rates for a new product and filing of rate increases.

## Checklist of Items to be Included in Individual Health Insurance Rate Filing Submissions

### Rates for a New Product

I. Policy Form, application, and endorsements required by State Law.
II. Rate Sheet
III. Actuarial Memorandum
   A. Brief description of the type of policy, benefits, renewability, general marketing method, and issue age limits.
   B. Brief description of how rates were determined, including the the general description and source of each assumption used. For expenses, include percent of premium, dollars per policy and/or dollars per unit of benefit.
   C. Estimated average annual premium per policy.
   D. Anticipated loss ratio, including a brief description of how it was calculated.
   E. Anticipated loss ratio presumed reasonable according to the Guidelines.
   F. If (D) is less than (E), supporting documentation for the use of the proposed premium rates.
   G. Certification by a qualified actuary that, to the best of the actuary's knowledge and judgement, the rate submission is in compliance with the applicable laws and regulations of the state and the benefits are reasonable in relation to the premiums.
[IV. A statement as to the status of this rate filing in the company's home state.]

Rate Increases for an Existing Product for which rates are subject to this Guideline:

I. New Rate Sheet.

II. Actuarial Memorandum

A. Brief description of the type of policy, benefits, renewability, general marketing method and issue age limits.

B. Scope and reason for rate revision including a statement of whether the revision applies only to new business, only to in-force business, or to both, and outline of all past rate increases on this form.

C. Estimated average annual premium per policy, before and after rate increase. Comparison of proposed rate scale with current rate scale.

D. Past Experience, as specified in ID of the Guidelines, any other available data the insurer may wish to provide.

E. Brief description of how revised rates were determined, including the general description and source of each assumption used. For expenses, include percent of premium, dollars per policy, and/or dollars per unit of benefit.

F. The anticipated future loss ratio and description of how it was calculated.

G. The anticipated loss ratio which combines cumulative and future experience, and description of how it was calculated.

H. Anticipated loss ratio presumed reasonable according to the Guidelines.

I. If (F) or (G) is less than (H), supporting documentation for the use of such premium rates.

J. Certification by a qualified actuary that, to the best of the actuary's knowledge and judgment, the rate submission is in compliance with the applicable laws and regulations of the state and the benefits are reasonable in relation to the premiums.

The test in Section II B2 is an innovation of these Guidelines. It seems appropriate, therefore, that this appendix include an example of how it works.

4. The first test, II B1, is the same for a new form, new business on an existing form, or experience on existing business following a rate revision. Suppose that we are talking about an OR form with an average annual premium of over $250, and the new rates are originally set to provide the benchmark loss ratio of 60%.

When the new rates are applied to existing business in force and we calculate the present value of future premiums and benefits, we obtain the following results.

Table 1 - Future Projection

| | Present Value at Current Volume from next year anniversaries |
|---|---|
| Premiums | $30,000,000 |
| Benefits | 18,000,000 |
| Loss Ratio | .60 |

Then we look at the accumulated experience from the past. Suppose it can be summarized as follows: The poor recent experience has prompted the need for the current increase request.

Table 2 - Accumulated Experience

| | Prior to 3 years | Last 3 years | From last yr. end to next yr. anniv. | Total |
|---|---|---|---|---|
| Premiums | $50,000,000 | $10,000,000 | $10,000,000 | $70,000,000 |
| Benefits | 20,000,000 | 9,000,000 | 11,000,000 | 40,000,000 |
| Loss Ratio | .400 | .900 | 1.100 | .571 |

When the Accumulated and Present Value figures are combined, the following results appear.

Table 3 - Combined Experiences

| | Accumulated | Present Value | Total |
|---|---|---|---|
| Premiums | $70,000,000 | $30,000,000 | $100,000,000 |
| Benefits | 40,000,000 | 18,000,000 | 58,000,000 |
| Loss Ratio | .571 | .600 | .580 |

Test II B 2 is not met.

With respect to future premiums on the existing volume, the rates proposed must be reduced so that the .58 result is increased to .60. Since the Benefits are what they are and the present value is settled, we can work backwards to determine that the total Premiums must be $96,666,667 ($58,000,000 ÷ .60). Thus the Present Value of Future Premiums must be $26,666,667 and the proposed rates, applicable to new business, must be reduced by one-ninth, with respect to the existing volume. The new table which meets the II B 2 test is as follows.

Table 4 - Revised Combined Experience

| | Accumulated | Present Value | Total |
|---|---|---|---|
| Premiums | $70,000,000 | $26,666,667 | $96,666,667 |
| Benefits | 40,000,000 | 18,000,000 | 58,000,000 |
| Loss Ratio | .571 | .675 | .600 |

The next rate increase request will be what it will be depending on how experience develops. If the company wishes to charge the same rates for new business and renewal, it can do so by reducing the rates otherwise proposed for new business, but there is no requirement that it do so. The favorable experience in the early years of the form is recognized.

If the early experience under the form were poor, the losses would not be recoverable. Suppose, for instance, that only the last 3 years and the estimate from the last year end to next year's anniversaries in the above example existed and the proposed new business rates applied. Then, the following test IIB 2 appears.

Table 5 - Alternate Combined Experience

| | Accumulated | Present Value | Total |
|---|---|---|---|
| Premiums | $20,000,000 | $30,000,000 | $50,000,000 |
| Benefits | 20,000,000 | 18,000,000 | 38,000,000 |
| Loss Ratio | 1.000 | .600 | .760 |

The 60% benchmark applies.

It is believed that this test will be rather simple to apply, in practice, from readily available records. It will be an effective tool in reviewing the reasonableness of rate increases.

5. Section IIB, as amended, is not intended to substitute new standards retroactively in place of standards in effect before the date of these Guidelines. It is not intended that the rules be changed in the middle of the contract period. On the other hand, the principles of these Guidelines may have been implicit in a state's former rules and guidelines.

It should be emphasized again that the tests in II A and II B have to do with benchmarks, not legal minimums. Section II C mentions some situations in which lower loss ratios may be justifiable. If, however, a rate submission meets the benchmark standards and includes full documentation as described in the Guidelines and this appendix, the requirement that benefits be reasonable in relation to premiums should be considered met.

Numbered Comments on Recommended Revision
of Guidelines for Filing of Rates

1. Here we recommend insertion of an additional item citing the important consideration of appropriate adjustment for select period experience.

2. We believe this recommended change will clarify the circumstances under which combining of experience under similar forms is desirable.

3. We believe this important consideration deserves the additional emphasis supplied by the added sentence.

4. Continuing expense inflation, in our opinion, renders the $200 "breaking point" in the existing guidelines somewhat inadequate. We recommend $250. Further, the present guidelines rather arbitrarily set a second breaking point at $100. We believe it would be more equitable and logical to use a continuous adjustment basis below $250, and we recommend the formula shown, for this purpose.

5. These recommended changes are, in our opinion, very important. We believe they provide a far more appropriate basis for dealing with rate changes in cases where the previous rate filing was made before the current guidelines became effective. If this important circumstance is not properly recognized and handled in a manner consistent with the basis under which the previous rates were filed, seriously inconsistent and possibly inequitable and unfair retroactive rates could become applicable in relation to changes of previously filed rates. The result could be detrimental to policyholders or to insurers or to both.

   We strongly recommend that these guidelines, revised as recommended, should apply only to rates originally filed under these guidelines (or where the prior rates were filed subject to guidelines consistent with these guidelines).

6. We believe IV. should be bracketed to indicate that it should apply only in those states that actually require such a statement.

7. We have expanded this definition to include certain additional forms of renewal conditions which have become common.

# STATEMENT 1982-8

STATEMENT OF THE

AMERICAN ACADEMY OF ACTUARIES

ON S 2105 and S 2106 ("PERISA")

TO THE SENATE SUBCOMMITTEE ON

SAVINGS, PENSIONS, AND INVESTMENT POLICY

APRIL 8, 1982

1. Introduction

The American Academy of Actuaries ("Academy") is pleased to submit these comments on S 2105 and 2106, each entitled the Public Employee Retirement Income Security Act of 1981 ("PERISA"). The Academy is vitally interested in these bills, since the large majority of actuaries performing actuarial services for state and local public employee retirement systems are members of the Academy. Appendix A contains some background information about the Academy.

These bills are very comprehensive, having a number of provisions that would affect the work of actuaries in connection with state and local public employee retirement systems. However, we would prefer to make specific comments today on only three aspects of the bills: the relationship between actuaries and accountants, the enrollment of actuaries, and the question of pension terminology.

Before making those comments, we would like to address some of the technical material in these bills. A committee of the Academy spent many hours reviewing the reporting and disclosure provisions of these bills (with particular emphasis on those sections which deal with actuarial disclosure), and although the Academy takes no stand on these sections with respect to their desirability, we are satisfied with their content from a technical standpoint.

II. Relationship Between Actuaries and Accountants

The relationship between actuaries and accountants under the Employee Retirement Income Security Act of 1974 ("ERISA") is important background to consider, since the general framework of PERISA is similar to that contained in ERISA in this area. However, despite their similarity, PERISA contains some fundamental differences from ERISA which will be discussed in Section III of this statement.

ERISA has given rise to an unresolved problem in the auditing area. Section 103 of ERISA provides that the accountant may rely on the correctness of any actuarial matter certified to by an enrolled actuary, if he so states his reliance (and conversely, that actuaries may rely on the work product of qualified accountants in an analogous manner). However, this provision has never become operational in the manner which Congress intended. This results from audit guidelines (which predate ERISA) issued by the American Institute of Certified Public Accountants (AICPA) which state that any opinion of an auditor which expresses reliance on the work of others becomes a "qualified opinion," with all the resulting negative connotations attached to that term. The AICPA has not changed this position, despite the statutory authority for such an expression of reliance contained in ERISA.

III. Analysis of S 2105 and S 2106

Sections 1104-1109 of S 2105 and Sections 104-109 of S 2106 are quite similar to Section 103 of ERISA in dealing with the relationship between actuaries and accountants, with two notable exceptions:

1. Section 1106(a)(2) of S 2105 and Section 106(a)(2) of S 2106 provide that the accountant shall rely on the correctness

of any actuarial matter certified to by an enrolled actuary. Likewise, Section 1107(b) of S 2105 and Section 107(b) of S 2106 provide for similar reliance by actuaries on accountants. Thus, PERISA changes the voluntary reliance of ERISA to compulsory reliance.

2. Section 103(a)(3)(A) of ERISA indicates that audits shall be conducted in accordance with "generally accepted auditing standards." Section 1106(a)(1) of S 2105 and Section 106(a)(1) of S 2106 contain the same wording, with the important addition that the reliance provisions described above are specifically authorized, even though departing from generally accepted auditing standards as presently defined by the AICPA.

The Academy strongly endorses these two provisions contained in PERISA. We believe that they would be quite beneficial in resolving the difficulties which have arisen under ERISA, as described in Section II of this statement. Furthermore, we believe that they are quite compatible with the division of responsibilities between actuaries and accountants intended by the Congress in the implementation of Section 103 of ERISA.

In addition, the Academy would like to prepare several additional amendments to further clarify the relative roles of the two professions. These amendments are consistent with the intent of S 2105 and S 2106 and are submitted for the consideration of the Subcommittee in Appendix B.

IV. Other Legislation

We would also like to call attention to the fact that major ERISA revision bills currently before the Congress contain provisions similar to those

contained in PERISA described above. In particular, HR 4330 and S 1541 (the Retirement Income Incentives and Administrative Simplification Act of 1981) contain such provisions.

We believe that these bills, along with S 2105 and S 2106, are indicative of strong congressional interest in resolving the relative roles of actuaries and accountants on a consistent basis in all areas of pension legislation. We strongly support these efforts.

V. Enrollment of Actuaries

When ERISA was passed in 1974, it contained a provision for enrollment which allowed for a "grandfathering" of actuaries in practice at that time who met the qualifications and applied for enrollment prior to January 1, 1976. Those who did not so qualify or who did not apply by that date were subject to more extensive education or examination requirements and experience requirements after that date.

Actuaries practicing in the private field were, of course, quick to apply so as to be qualified for continued practice in their profession. On the other hand, actuaries dealing with public employee retirement systems did not have the same need for enrollment and, in some instances, did not therefore apply for enrollment.

If PERISA should become law, those actuaries who practice exclusively in the public sector but who have not become enrolled actuaries would not have had the same advantages afforded to them as was the case for the private pension actuaries in the initial enactment of ERISA. To correct this inequity, Section 1002(18) of S 2105 and Section 3(17) of S 2106

would allow to actuaries exclusively in the public sector the same privileges for initial qualification as were allowed under ERISA to actuaries for private plans. The Academy supports these provisions.

VI. Pension Terminology

Over the years a variety of pension terminology has evolved in laws and regulations and in the pension literature. We note that PERISA contains a number of terms for certain actuarial values which differ from those contained in ERISA.

The actuarial profession recently received a report from the Joint Committee on Pension Terminology composed of representatives of various actuarial organizations. This committee's charge was to arrive at a more uniform, consistent and unambiguous set of terminology. This report has now been formally endorsed by the governing boards of all U.S. actuarial organizations dealing with pension matters. The report is submitted for the consideration of the Subcommittee as Appendix C.

At the present time, the language of S 2105 and S 2106 is being reviewed for consistency with the terminology committee's report. In the near future, we will submit to the Subcommittee a list of those terms in the bills which would need to be changed in order to bring the bills into conformity with the terminology report. We will also be proposing that similar changes be made in ERISA as well.

VII. Summary

In summary, the Academy strongly supports the provisions of S 2105 and S 2106 concerning the relationship between actuaries and accountants. We

would also like to recommend additional amendments which are consistent with the intent of the bills to further clarify this relationship. We also support provisions of the bill authorizing special initial enrollment procedures for actuaries operating exclusively in the area of public pension plans. Finally, we would recommend that certain terminology be amended in light of the effort within the actuarial profession to foster the adoption of uniform terminology.

Douglas C. Borton, Chairman
Pension Committee

Subcommittee on Public Employee Retirement Systems
Thomas P. Bleakney, Chairman
James A. Beirne
Barry M. Black
Edward H. Friend
James B. Gardiner
Norman S. Losk
Robert H. Smith

## APPENDIX A

### BACKGROUND INFORMATION ON THE AMERICAN ACADEMY OF ACTUARIES

The American Academy of Actuaries is a professional association of actuaries which was formed in 1965 to bring together into one organization all qualified actuaries in the United States and to seek accreditation and greater public recognition for the profession. The Academy includes members of three founding organizations - the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, and the Society of Actuaries.

The Academy serves the entire profession. Its main focus is the social, economic, and public policy environment in which the actuarial profession functions. Its primary activities include liaison with federal and state governments, relations with other professions, public information about the actuarial profession and issues that affect it, and the development of standards of professional conduct and practice.

Over 6,600 actuaries in all areas of specialization belong to the Academy. These members are employed by insurance companies, consulting actuarial firms, government, academic institutions, and a growing number of industries. Actuarial science involves the evaluation of the probabilities and financial impact that uncertain future events - birth, marriage, sickness, accident, retirement, and death - have on insurance and other benefit plans.

Membership requirements can be summarized under two broad headings: education and experience. At present, the educational requirements can be satisfied either by passing certain professional examinations sponsored by

the Casualty Actuarial Society or the Society of Actuaries, or by becoming an enrolled actuary under the Employee Retirement Income Security Act of 1974 (ERISA). The experience requirement consists of three years of responsible actuarial work.

# APPENDIX B

## PROPOSED AMENDMENTS TO S 2105 AND S 2106

## BY THE

## AMERICAN ACADEMY OF ACTUARIES

Note: All page numbers refer to the respective bill.

### S 2105

1. page 33, line 10 — add two new sentences after "actuary" as follows:

   "The opinion of the accountant under this section shall not extend to actuarial matters certified to by the enrolled actuary. 'Actuarial matters' may be further defined by regulation by the Board and shall include the items required to be included in the actuarial statement under Section 1107."

2. page 34, line 21 — delete "liabilities" and substitute in its place "non-actuarial liabilities of the plan."

3. page 36, line 10 — insert before "liabilities" the word "non-actuarial."

S 2106

| | |
|---|---|
| 1. page 31, line 22 | add two new sentences after "actuary" as follows:<br><br>"The opinion of the accountant under this section shall not extend to actuarial matters certified to by the enrolled actuary. 'Actuarial matters' may be further defined by regulation by the Secretary and shall include the items required to be included in the actuarial statement under Section 107." |
| 2. page 33, line 8 | delete "liabilities" and substitute in its place "non-actuarial liabilities of the plan." |
| 3. page 34, line 22 | insert before "liabilities" the word "non-actuarial." |

## APPENDIX C

[Report of the Joint Committee on Pension Terminology]

AMERICAN ACADEMY OF ACTUARIES

LIFE INSURANCE FINANCIAL REPORTING PRINCIPLES COMMITTEE

DISCUSSION MEMORANDUM

# ACCOUNTING FOR SINGLE PREMIUM DEFERRED ANNUITIES

April 16, 1982

The purpose of this Discussion Memorandum is to develop a framework within which accounting methods and procedures for single premium deferred annuities (SPDA's) can be discussed and evaluated. Ultimately, this process should lead to the development of guidelines concerning the selection of accounting alternatives for such contracts. Prior to presenting the Committee's proposed recommendations, certain background information is provided. It is intended that this review of the nature of existing guidance and the range of current practices will focus attention on those areas which most significantly affect the determination of appropriate accounting methods and procedures for SPDA's. The final section of this Discussion Memorandum presents proposed recommendations in this area.

## Applicability of Proposed Accounting Recommendations

The scope of this Discussion Memorandum and proposed accounting recommendations is limited and is applicable only to those annuity products which are normally described as single premium deferred annuities and are included in the operations of the general account of life insurance companies. Such single premium deferred annuity contracts generally provide for the accumulation of premiums during the deferred phase at specified interest rates. The interest rates utilized are typically subject to certain guaranteed minimum rates, although those minimum rates may be supplemented by excess interest credits which are generally declared at the discretion of the company, may extend for various periods of time, and are subject to change from time to time.

The accumulation of premiums at declared rates is a fundamental characteristic of SPDA's. However, the specific contract provisions of any particular annuity contract may vary and may include features such as:

- Charges assessed against and deducted from the gross single premium (commonly referred to as "front end loads") prior to accumulation at declared interest rates.

- Charges assessed against and deducted from accumulated annuity values in the event of the full or partial withdrawal of contract values, the death of the annuitant, or the application of contract values to purchase available settlement options (commonly referred to as "back end loads").

- The determination of interest rates used in the accumulation of premiums may be based on a defined relationship to a publicly available, independently calculated indicator of the level of current market interest rates (commonly referred to as "indexing").

- The waiver of charges which would otherwise be assessed at contract termination in the event that declared interest rates used in the accumulation of premiums falls below a stated interest rate (commonly referred to as "bail out" provisions).

This list of contract provisions which are frequently encountered in single premium deferred annuity contracts is not intended to include all possible contract variations. The proposed accounting recommendations included in this Discussion Memorandum would be applicable to any and all single premium deferred annuity contracts which, regardless of the presence or absence of specific contract provisions, were, in all material respects, substantially

similar to the products described herein. The foregoing notwithstanding, it is not intended that the proposed accounting recommendations be applicable to flexible premium deferred annuities, immediate annuities, variable annuities, or life insurance contracts which are commonly referred to as "Universal Life" type policies.

Present Professional Guidance

Relatively little specific guidance concerning the application of generally accepted accounting principles to single premium deferred annuity contracts has been promulgated by either the accounting or the actuarial profession. That guidance which is provided generally has not been developed as a result of a thorough analysis of the characteristics of, and risks associated with, annuity contracts. Rather, annuity business often has been dealt with superficially and has been addressed in terms of its similarities to life insurance products. Until relatively recently this may have been sufficient as SPDA operations were seldom material to a company's operations. However, in the last five years circumstances have changed dramatically and the impact of single premium deferred annuity operations is commonly material and, in many instances, overwhelms other operating and financial decisions. As a result, the limited guidance provided by the AICPA Audits of Stock Life Insurance Companies (Audit Guide) and by the American Academy of Actuaries' Financial Reporting Recommendations and Interpretations needs to be thoroughly evaluated, updated, and clarified.

The Audit Guide does address the particular revenue and cost recognition principles which should be applied to annuity contracts. With respect to the recognition of premium revenues the Guide states that

> The reasoning underlying the accounting described for recognition of premium revenue for whole-life and limited payment life insurance contracts also applies to annuity contracts; therefore, annuity considerations should be recognized as revenue when due.

When literally applied to SPDA contracts this results in the recognition of the single premium and the related costs of acquiring new business in the period written. No deferral of acquisition expenses would be permitted under a literal interpretation as the Guide provides that

> The cost of acquiring new business should be deferred and other non-level costs should be provided for in order to charge operations in proportion to premium revenues.

Since premium revenues are limited to the receipt of the single premium, acquisition costs would not be deferred.

The Audit Guide also provides direction with respect to the recognition of deferred annuity benefit costs. The descriptions of deferred annuity contracts and the related risks of writing such business which are contained in the Audit Guide provide an interesting commentary on the context within which the benefit cost recognition principles were developed. For deferred annuities, the Guide recognizes the presence of two separate segments.

> The first segment is the accumulation or deferred period, during which there is relatively little risk to the company except failure to earn the guaranteed net interest rate...The second segment is the pay-out or liquidation period, during which annuity income payments are made to the annuitant and the mortality risks described above are introduced.

The understated references to the interest risks during the deferred period strongly suggest that the circumstances which companies now face differ sufficiently from those present at the time the Audit Guide was developed that consideration now should be given to the development of more appropriate benefit cost recognition principles. This is further highlighted by the Audit

Guide assertion that the deferred annuity contract is "much like a savings account (as) the cash surrender value may be withdrawn." Clearly, the SPDA investment and termination risks with which companies now must contend would have been more seriously considered in the adoption of accounting principles had these risks been of the magnitude that they now represent.

In establishing assumptions which address these risks, the Audit Guide states that

> in single premium deferred annuities, all of the net cash is invested immediately. However, some of the funds are usually reinvested and, therefore, some recognition of the possibility of adverse deviations in the investment income is appropriate.

Despite this sparse guidance, present literature has not been expanded or interpreted to provide for their application in the current circumstances.

Based on this understanding of investment risks and the manner in which interest assumptions should be determined, the Audit Guide describes the calculation of benefit reserves. The Audit Guide states that

> Reserves should be based on the accumulation of the maturity value equal to the estimated initial reserve required at the time the annuity becomes income paying.

In the context of the discussion concerning investment risks and the determination of investment income assumptions for reserve purposes, the Audit Guide appears to suggest that the realistic present value of projected maturity values constitutes the appropriate benefit reserve for SPDA contracts. In conjunction with the recognition of acquisition costs at the time of sale, this accounting would report the total income expected to be earned over the life of the contract (except for the release of provisions for adverse deviation contained in the interest rate) at the time the contract is sold.

The American Academy of Actuaries' Financial Reporting Recommendations and Interpretations does not specifically address single premium deferred annuity business. Generally, the recommendations and interpretations expand on principles enunciated in the Audit Guide. They do not pursue areas not included in the Audit Guide or only superficially addressed. This is consistent with the Audit Guide's handling of SPDA's and reflects the fact that the Academy was also developing guidelines in an environment which did not contain a significant volume of high risk, single premium deferred annuity business. As a result, little or no specific guidance concerning SPDA's is contained in the American Academy of Actuaries literature.

Current Practices

Current accounting practices and procedures with respect to single premium deferred annuity business vary substantially. This is no doubt due, in part, to the absence of specific guidance. However, it is also a result of the wide variety of contract designs, investment management philosophies, and risk evaluations. On one extreme, some companies apply the Audit Guide comments concerning premium revenue and benefit cost recognition fairly literally. Other companies, in an effort to justify and support the adoption of more conservative accounting policies, may stray from traditional practice and reinterpret the Audit Guide statements concerning revenue and cost recognition.

Those companies following the precise language of the Audit Guide do not generally carry any deferred acquisition costs as they have been charged against single premium revenues when the contract was issued. Benefit and maintenance expense reserves equal the conservative present value of future benefits and expenses to be incurred during the life of the contract. The determination

of such reserves requires the selection of assumptions related to some, or all, of the following transactions:

- Full or partial withdrawal of available contract values.
- Death of the annuitant.
- Application of contract values to settlement options.

In each instance, the projected cost associated with these contractholder actions is also estimated. The estimation of these expected costs depends on assumptions with respect to the interest rate to be credited to the contractholders' accumulating values, the imposition of surrender charges, if any, and the estimated value of settlement option rates.

In most instances, relevant prior experience is not available from which to develop any of the above assumptions. For this reason, and as the failure to recognize certain of these potential transaction may not materially affect reserves, many calculations do not involve projections of the incidence and expected costs of all of the possible transactions identified above. Resulting benefit reserves, therefore, range from amounts equalling the present value of a projected maturity value equalling the accumulation of premiums at assumed declared interest rates, to the present value of the projected costs of a great many potential contractholder actions. In all such calculations, the critical factor is the relationship between the interest rate used to discount projected costs and the interest rate used to determine projected contract values. It is this "interest spread" which can result in the determination of benefit reserves substantially below accumulated contract values and the reporting of a significant portion of the contract's expected total income in the period of issue.

In a simpler, less competitive, and stabler economic environment, such calculations may have been more reasonable. The unpredictability of policyholder actions, the unproven ability of maintaining desired investment spreads, and the severe disintermediation risks associated with these contracts suggest that these accounting practices may no longer be generally appropriate for all product designs, investment portfolio management practices, and declared interest rate procedures.

Other, more conservative practices also have been adopted by many companies and, as a class, are generally quite similar to one another. Normally, such practices are based on the maintenance of benefit reserves which are equal to accumulated contract values, prior to the recognition of contractual surrender charges. In some instances, conservative estimates of the present value of surrender charges to be earned will be determined and used to reduce gross contract values, although such adjustments normally are not material. In addition, and perhaps requiring a broad definition of the revenues arising from SPDA contracts, acquisition costs are generally deferred and amortized over a relatively short period of time. Amortization patterns may be arbitrary (straight line over five to seven years) or may be based on the projected realization of interest margins. Also, some companies may include the projected recovery of surrender charges in the stream of revenue utilized to determine amortization patterns.

These latter, generally more conservative, practices result in net reserves (benefit reserves less deferred acquisition cost balances) which are normally greater than those reserves described earlier. They do not release a substantial portion of expected total income in the year of issue, but rather

release interest spreads only as those spreads are realized. While these practices may not adhere to a strict interpretation of the Audit Guide and are not intended to address the liquidity of the supporting invested asset portfolio, such conservatism may be warranted in the event the achievement of desired interest spreads is uncertain, the persistency of contracts is unknown, and the liquidity of the invested portfolio is in doubt.

Proposed Accounting Recommendations

These proposed recommendations do not redefine the existing GAAP accounting model for stock life insurance companies. These recommendations have been developed in an effort to clarify the manner in which the present stock life insurance company generally accepted accounting principles may be specifically applied to single premium deferred annuity contracts. As noted above, existing literature does not adequately address the application of these principles to those SPDA's which might be offered and remain inforce during a wide variety of substantially different economic and contractholder activity environments. The purpose of these proposals is to establish a framework within which existing principles may be applied, regardless of the particular economic climate or operating circumstances present when the contracts are issued.

As noted, the Committee believes that the existing accounting model can be applied to single premium annuity contracts. However, as indicated by the Audit Guide's matter-of-fact references to the level of investment and termination risks, it is imperative that an appropriate framework for determining assumptions and related provisions for adverse deviation be constructed. Therefore, the primary purpose of these recommendations is to

provide guidance with respect to the determination of assumptions and provisions for adverse deviation.

Assumptions concerning expected experience are generally established based on a review of past and anticipated future experience for the same or similar products. In addition, the design and expected performance of the product is also considered, as are the characteristics of the target marketplace and the manner in which the business will be sold and administered. In many instances, and certainly single premium deferred annuity business is a case in point, relevant prior experience may not be available by which to judge the reasonableness of prospective expectations. In such instances, a considerable degree of professional actuarial judgment is necessary in order to establish realistic, but conservative, assumptions concerning those factors most significantly affecting the financial outcome of the business. In the case of single premium deferred annuity business, these factors are predominantly the declared and earned interest rate relationships and the expected termination activity.

The determination of basic, most likely assumptions and the closely related level of provision for adverse deviations are not separate tasks and cannot be performed independently. As a result of the analytical and judgmental processes leading to the selection of most likely assumptions, appropriate margins for adverse deviation will also be established. This entire process, but especially the determination of the necessary margins for adverse deviation, is essentially based on the predictability of future experience and the level of confidence that can be associated with the ability to realize expected earnings (prior to the release of provisions for adverse deviation).

The application of the existing accounting model for life and annuity products to the determination of reasonable most likely assumptions and provisions for adverse deviation requires that extreme care be exercised when evaluating those current and prospective circumstances and conditions which might influence the profitability of the business. The determination of specific provisions for adverse deviation is the responsibility of the actuary, but such provisions should be reasonably related to matters such as:

1) The degree of stability and predictability inherent in current and expected future investment markets.

2) The stability and predictability of current and expected future policyholder activity.

3) The level of competition, both from other insurance companies writing single premium deferred annuities and from other financial institutions offering comparable investment vehicles.

4) The particular investment strategies and practices to be implemented with respect to funds supporting the single premium deferred annuity policyholder liabilities.

5) The design of the particular SPDA product.

In those instances where investment performance and policyholder activity are relatively predictable, can be estimated with reasonable accuracy, and are likely to be realized, the utilization of assumptions and provisions for adverse deviation which report a substantial portion of anticipated total income as a level percentage of premium may not be unreasonable. However, as the estimates of expected future experience become less certain and contain

a greater element of risk and speculation, the principles enunciated in the Audit Guide, professional judgment, and prudence suggest that provisions for adverse deviation should become relatively larger than in those instances where future experience can be estimated with a relatively high degree of accuracy. For example, if the ability to achieve required investment and policyholder termination objectives is in doubt, greater provisions for adverse deviation should be adopted. In such cases, it would be expected that a relatively smaller portion of total expected income (prior to the release of provisions for adverse deviation) would be reported as a level percentage of premium revenue. In many instances, circumstances may be such that reasonable projections of investment performance and policyholder activity cannot be made. In such situations, the application of the existing accounting model for life and annuity products suggests that provisions for adverse deviation should nearly equal the total difference between potential most likely and reasonably conservative assumptions. As a result, little or none of the potential earnings from favorable investment experience should be reported as a level percentage of premium revenue. In the current economic and competitive circumstances, it appears that these latter conditions may be generally applicable and, in the absence of specific evidence to the contrary, assumptions and provisions for adverse deviation normally should not lead to a significant portion of total expected income to be reported as a level percentage of premium revenues.

In those instances where future experience is sufficiently unpredictable that the provisions for adverse deviation defer recognition of all, or a substantial portion of, potential earnings from investment experience, it may, nonetheless,

be reasonable and appropriate to defer acquisition expenses. If costs are deferred in such circumstances, their amortization should be associated with and related to the earnings which may be realized in future years as a result of the release of provisions for adverse deviation, charges assessed against premiums and account balances, and other potential sources of income.

Regardless of the accounting procedures adopted, tests should periodically be performed to verify the continued profitability of the existing business. Tests of the need to recognize future losses should be performed in accordance with the guidance provided by the Audit Guide and by the Recommendations and Interpretations of the American Academy of Actuaries. For appropriate segments of existing business, these tests should consider matters such as the current and expected future relationships between the interest rates credited to policyholders and the investment experience of the related invested assets, the effects of policyholder terminations, and the liquidity of the invested asset protfolio supporting the business. In the event that these tests indicate the need to recognize future losses, such losses should be recorded in the current period.

STATEMENT 1982-10

# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

April 22, 1982

TO: Professor Spencer L. Kimball

FROM: American Academy of Actuaries Committee on Life Insurance Financial Reporting Principles

RE: Future Federal Income Tax Charges and Credits

The American Academy of Actuaries Committee on Life Insurance Financial Reporting Principles has considered the January 13 request of the Insurance Statutory Accounting Principles Board for preliminary comments on future federal income tax charges and credits. The Committee also considered its prior comments on the same subject, presented to the NAIC in 1977. The following comments are taken largely from that 1977 submission with some additional comments generated by your specific questions.

As you suggested, the comments are very general and are intended to be preliminary in nature. Also, note that these are comments from the Committee without benefit of input from the entire membership of the Academy. The Committee plans to solicit comments from the membership if the Board moves forward with the project, and at such time would expect to offer more specific comments on any proposal advanced by the Board.

## Comments on Specific Questions

These comments are identified consistent with the format of the January 13 Memorandum.

A. The Committee has no suggestions as to specific changes in statutory accounting practices which should be made to recognize the tax effects of differences between financial and tax reporting. However, it is generally believed circumstances do exist where these differences could be material and should be recognized in the current valuations of the companies' assets and liabilities. These circumstances are likely to exist because of the expanded use of net level reserves for tax purposes under Section 818(c) of the Code, the effect of various reinsurance transactions, and the increased number of companies being taxed on gain from operations thereby increasing the probability of reversal.

B-1-2. We have no addition to your classes of transactions. We believe any recognition of the tax effects should be applied to all classes.

B-3-4. The Committee very strongly believes that the method of recognition should be the liability method and that the time value of money should be recognized.

B-5. We would generally suggest current tax rates be used; however, consistent with the liability method, if it is probable that a different rate will actually apply, that fact should be considered in determining the liability.

B-6. This was discussed in our 1977 paper. These comments are repeated in the general discussion section of this memorandum.

B-7. We have no comment on Schedule P reserves. We would include charges or credits derived from non-admitted assets, if material, in the calculations.

B-8. We believe the interaction of the MSVR should be considered. Our general discussion below does recognize this interaction with respect to common stock investments. We would anticipate commenting further on this rather complex subject if the Board does advance a proposal.

B-9. In general, we believe any offsets for operating losses should consider the time value of money, consistent with our comment on item B-4. The amount of any such offset should be limited to the extent of the future tax liability.

## General Discussion

Balance sheet liabilities have traditionally been determined in a conservative manner. Conservative, in this context, means that policy reserves should anticipate a fairly wide range of contingencies. However, to hold liabilities so great that a company could withstand any conceivable circumstances, no matter how adverse, would imply an excessive level of pricing of the insurance product and good business practice does not encompass such a degree of conservatism. Likewise, a reserve for future taxes should not attempt to provide for all unlikely happenings.

Based on this concept of the statutory balance sheet, it is our opinion, that, if a deferred tax reserve is required in statutory statements, the appropriate calculation method for such reserves is the liability method where the value is based on the probability of payment and the time value of money. The cumulative deferred credit method used under generally accepted accounting principles is totally inappropriate for statutory statements.

Whenever an asset or liability is carried on a different basis for statutory statement and federal income tax purposes a possibility of a future tax effect exists. A discussion of some items which are common to many companies and which are carried on different bases follows:

1. Life Insurance Reserves

For tax purposes life insurance reserves may be calculated on a net level basis (or an approximation thereto), while for statutory statement purposes they may be calculated on a modified preliminary term basis. Deficiency reserves required for statutory statements are not recognized as liabilities for tax purposes.

The reserve increase deduction reported in the statutory statement in any particular year may be greater than or less than the reserve increase reported in the tax return. These differences will depend on the rate of growth of new business, the type of new business written, and the overall persistency of the business.

If the future reserve increase deductions on the tax return are greater than those on the statutory statement, surplus will not be reduced as a result of this difference. Any tax paid on the company's gain from operations from this business will be less than its statutory earnings from this business (assuming no other differences exist).

Even if the future reserve increase deductions on the tax return are less than those of the statutory statement, the tax on the business may still not exceed current earnings. The possibility that taxes exceed current earnings will depend on the tax situation in which the company finds itself in those future years.

Some companies are taxed only on investment income so that differences in future reserve increase deductions between tax and statutory statements would not have any effect on the tax paid.

Because of this variety of situations, it is our opinion that to require all companies to set up uniformly calculated liabilities with respect to this item is neither appropriate nor feasible.

2. Phase III Taxes

Phase III taxes may result if a withdrawal is made from the "policyolders' surplus account", a memorandum account for tax purposes. Such withdrawals will occur if a dividend to stockholders is declared which exceeds the amount available in the "shareholders' surplus account" (another memorandum account), or if the "policyholders' surplus account" exceeds certain maximums.

It appears that no reserve for future taxes should be necessary for withdrawal caused by dividend declaration since that action is entirely elective. Most companies plan their dividend actions so that such phase III taxes will not be paid.

The possibility of a phase III tax resulting from exceeding the maximum limits is also rare. However, if the payment of such a tax is likely or imminent, a reserve for this tax should be established.

3. Bonds or Mortgages Purchased at Premium or Discount

Differing amortization methods can produce differences in tax and statement income. These differences could have a positive or negative impact on future taxes. If material, this impact should be recognized in the reserve for future taxes in the statutory balance sheet.

An example of this might be where a Company invests heavily in deep discount bonds. Here the annual accrual of market discounts in the statutory statement is not reflected in the tax return. At maturity the company may be required to pay a capital gains tax on the amount of the discounts, resulting in a realized value which is less than book by the amount of the tax. Consequently, the statutory surplus would be overstated by the amount of the tax to be paid on the cumulative increase in book value at any given time.

To avoid that overstatement, the impact of the expected future tax could be reflected in an aggregate tax reserve. The impact of the future tax could be set up with due consideration given to possible offsets. Reasonable offsets include losses already recognized through write down of other assets to a level below the tax basis and timely loss carry forwards.

4. Investment Real Estate Depreciation

Real estate does not mature, forcing a gain or loss. However, a different value is carried for statutory statement and tax statements when accelerated depreciation is used for tax purposes. Where such accelerated depreciation has been claimed, the difference in value will be brought into future years' ordinary taxable income and, if material, the impact should be reflected by a credit to the aggregate tax reserve, subject to an appropriate discount for interest.

5. Unrealized Common or Preferred Stock Gains and Losses

Since preferred stocks are generally held on the same basis for both statutory statements and tax returns, no need for deferred tax calculations is apparent, barring unusual circumstances.

In the case of common stocks the gains or losses are offset dollar for dollar within the limits of the common stock component of the MSVR. The effect of this is to adjust the net statutory asset value to no more than cost. Since the tax basis is cost, there is no impact on the aggregate tax reserve. This would not be true if the MSVR is either at zero or at its maximum. In these special cases a credit to aggregate tax reserve may be necessary.

6. Investment Tax Credit

In view of the apparent intent of Congress to encourage capital investment, the full benefit of this credit should be allowed to flow through surplus with no further consideration of future years' tax impact.

7. Not Admitted Assets

Certain assets such as furniture and equipment and agents' balances must be written down to zero in the statutory statement but are not permitted to be recognized as deductions from ordinary tax income until future years. The future tax effect, appropriately discounted, should be allowed as an offset to the aggregate tax reserve.

The items discussed here do not constitute an exhaustive list, nor is the discussion meant to cover every possible consideration.

Most situations will require individual consideration based on the merits of the particular case and the materiality of the future tax effect. While our discussion includes guidelines we believe to be reasonable, we recognize that there are different viewpoints on this most complex subject among members of both the actuarial profession and among members of other professions.

The American Academy of Actuaries
Committee on Life Insurance
Financial Reporting Principles

STATEMENT 1982-11

# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

SUBMISSION ON PENSION TERMINOLOGY

To: Senate Committee on Labor and Human Resources
Subcommittee on Labor

House Committee on Education and Labor
Subcommittee on Labor-Management Relations

Re: Retirement Income Incentives and Administrative Simplification Act (S. 1541 and H.R. 4330)

Date: April 27, 1982

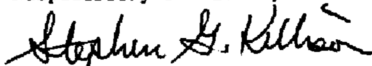
The American Academy of Actuaries is pleased to submit the attached report on pension terminology in connection with the Retirement Income Incentives and Administrative Simplification Act (S. 1541 and H.R. 4330).

As we have indicated in prior testimony, there has been a major project within the actuarial profession for some time to develop a more uniform and consistent pension terminology. Current laws, regulations, and other pension literature contain numerous examples of poorly defined terms, multiple terms for the same concept, and ambiguous terms. This effort within the actuarial profession has resulted in a final report on pension terminology endorsed by all the U.S. actuarial organizations dealing with pension matters (copy enclosed).

The attached material consists of a complete analysis of ERISA and pertinent sections of the Internal Revenue Code. Suggested changes to make the terminology in ERISA and IRC consistent with the terminology report are listed in sequence. The column labelled "BNA Text Page" lists page number references in a source book containing ERISA and pertinent sections of the Internal Revenue Code published by the Bureau of National Affairs (copy enclosed).

We hope that the committees of the Congress dealing with pension matters will incorporate this terminology into existing and future pension legislation. The entire pension community will be well served if clear, consistent, and unambiguous terminology appears in the pension laws of this country.

Respectfully submitted,



Stephen G. Kellison
Executive Director

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 9 | 3(25) | "vested liabilities" | "actuarial present value of vested benefits" |
| 9 | 3(25) | present value | actuarial present value |
| 9 | 3(27) | The term "present value," with respect to a liability, means the value adjusted to reflect anticipated events. Such adjustments shall conform to such regulations as the Secretary of the Treasury may prescribe. | The term "actuarial present value" means the value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of actuarial assumptions. The Secretary of the Treasury may prescribe regulations to carry out this paragraph. |
| 9 | 3(28) | The term "normal service cost" or "normal cost" means the annual cost of future pension benefits and administrative expenses assigned under an actuarial cost method to years subsequent to a particular valuation date of a pension plan. The Secretary of the Treasury may prescribe regulations to carry out this paragraph. | The term "normal cost" means that portion of the actuarial present value of pension plan benefits and expenses which is allocated to a valuation year by the actuarial cost method. The Secretary of the Treasury may prescribe regulations to carry out this paragraph. |
| 9 | 3(29) | The term "accrued liability" means the excess of the present value of a particular valuation date of a pension plan, of the projected future benefits cost and administrative expenses for all plan participants and beneficiaries over the present value of future contributions for the normal cost of all applicable plan participants and beneficiaries. The Secretary of the Treasury may prescribe regulations to carry out this paragraph. | The term "actuarial accrued liability" means that portion, as determined by a particular actuarial cost method, of the actuarial present value of pension plan benefits and expenses which is not provided for by future normal costs. The Secretary of the Treasury may prescribe regulations to carry out this paragraph. |
| 9 | 3(30) | The term "unfunded accrued liability" means the excess of the accrued liability, under an actuarial cost method which so provides, over the present value of the assets of a pension plan. The Secretary of the Treasury may | The term "unfunded actuarial accrued liability" means the excess of the actuarial accrued liability over the actuarial value of the assets. The Secretary of the Treasury may prescribe |

AMERICAN ACADEMY OF ACTUARIES

PENSION TERMINOLOGY REVIEW OF ERISA AND IRC

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 9 | 3(30) (cont.) | prescribe regulations to carry out this paragraph. | regulations to carry out this paragraph. |
| 9 | 3(31) | The term "advance funding actuarial cost method" or "actuarial cost method" means a recognized actuarial technique utilized for establishing the amount and incidence of the annual actuarial cost of pension plan benefits and expenses. Acceptable actuarial cost methods shall include the accrued benefit cost method (unit credit method), the entry age normal cost method, the individual level premium cost method, the aggregate cost method, the attained age normal cost method, and the frozen initial liability cost method. The terminal funding cost method and the current funding (pay-as-you-go) cost method are not acceptable actuarial cost methods. The Secretary of the Treasury shall issue regulations to further define acceptable actuarial cost methods. | The term "actuarial cost method" means a procedure for determining the actuarial present value of pension plan benefits and expenses and for developing an actuarially equivalent allocation of such value to time periods, usually in the form of a normal cost and an actuarial accrued liability. Acceptable actuarial cost methods shall include the unit credit actuarial cost method, the entry age actuarial cost method, the individual level actuarial cost method, the aggregate actuarial cost method, the attained age actuarial cost method, the frozen entry age actuarial cost method, and the frozen attained age actuarial cost method. Terminal funding and pay-as-you-go funding are not acceptable actuarial cost methods. The Secretary of the Treasury shall issue regulations to further define acceptable actuarial cost methods. |
| 11 | 3(34) | gains and losses | actuarial gains and losses |
| 13 | 3(40) ADD | | The term "actuarial gain (loss)" means a measure of the difference between actual experience and that expected based upon a set of actuarial assumptions during the period between two actuarial valuation dates, as determined in accordance with a particular actuarial cost method. |

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 13 | 3(41) ADD | | The term "actuarial value of assets" means the value of cash, investments, and other property belonging to the pension plan, as used by the actuary for the purpose of an actuarial valuation. The Secretary of the Treasury may prescribe regulations to carry out this paragraph. |
| 13 | 3(42) ADD | | The term "actuarial valuation" means the determination, as of a valuation date of the normal cost, actuarial accrued liability, actuarial value of assets, and related actuarial present values of a pension plan. The Secretary of the Treasury may prescribe regulations to carry out this paragraph. |
| 13 | 3(43) ADD | | The term "actuarial assumptions" means assumptions as to the occurence of future events affecting pension costs. The Secretary of the Treasury may prescribe regulations to carry out this paragraph. |
| 13 | 3(44) ADD | | The term "amortization payment" means that portion of the pension plan contribution which is designed to pay interest on and to amortize the unfunded actuarial accrued liability or the unfunded frozen actuarial accrued liability. The Secretary of the Treasury may prescribe regulations to carry out this paragraph. |
| 16 | 103(a)(4)(B) | assumptions and techniques | actuarial assumptions and techniques |

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| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 17 | 103(b)(2) | prior service cost | actuarial accrued liability |
| 19 | 103(d)(3) | accrued liabilities | actuarial accrued liabilities |
| 19 | 103(d)(3) | methods used to determine costs | actuarial cost methods |
| 19 | 103(d)(3) | cost methods | actuarial cost methods |
| 19 | 103(d)(5) | present value of the assets | actuarial value of assets |
| 19 | 103(d)(5) | ...such valuation of present value of assets... | ...valuation of such actuarial value of assets... |
| 19 | 103(d)(6) | ...present value of all of the plan's liabilities for nonforfeitable pension benefits... | ...actuarial present value of all of the plan's nonforfeitable pension benefits... |
| 19 | 103(d)(8) | methods | actuarial cost methods |
| 20 | 103(d) | valuation | actuarial valuation |
| 35 | 204(d)(1) | present value | actuarial present value |

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PENSION TERMINOLOGY REVIEW OF ERISA AND IRC

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 35 | 204(d)(2) | present value | actuarial present value |
| 35 | 204(e)(1) | present value | actuarial present value |
| 37 | 206(a)(3) | actuarially reduced | reduced to the actuarial equivalent |
| 43 | 302(b)(2)(B)(i) | unfunded past service liability | unfunded actuarial accrued liability |
| 43 | 302(b)(2)(B)(ii) | unfunded past service liability | unfunded actuarial accrued liability |
| 43 | 302(b)(2)(B)(iii) | unfunded past service liability | unfunded actuarial accrued liability |
| 43 | 302(b)(2)(B)(iv) | experience loss | actuarial loss |
| 43 | 302(b)(3)(B)(i) | unfunded past service liability | unfunded actuarial accrued liability |
| 43 | 302(b)(3)(B)(ii) | experience gain | actuarial gain |
| 44 | 302(b)(6)(C) | past service liability | actuarial accrued liability |

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PENSION TERMINOLOGY REVIEW OF ERISA AND IRC

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 44 | 302(b)(6)(D) | past service liability | actuarial accrued liability |
| 44 | 302(b)(7)(A) | for plan liabilities | of plan costs |
| 45 | 302(b)(7)(E) | accrued liability | actuarial accrued liability |
| 45 | 302(c)(1) | ...normal costs, accrued liability, past service liabilities, and experience gains and losses shall be determined under the funding method used to determine costs under the plan. | ...normal costs, actuarial accrued liabilities, amortization payments, and actuarial gains and losses shall be determined under the actuarial cost method used for the plan. |
| 45 | 302(c)(2)(A) | ...the value of the plan's assets shall be determined on the basis of any reasonable actuarial method of valuation which... | ...the actuarial value of assets shall be determined on any reasonable basis which... |
| 45 | 302(c)(3) | costs, liabilities | normal costs, amortization payments, actuarial accrued liabilities |
| 45 | 302(c)(3) | actuarial assumptions and methods | actuarial assumptions and actuarial cost methods |
| 45 | 302(c)(4) | accrued liability | actuarial accrued liability |
| 45 | 304(c)(4) | experience loss or gain | actuarial loss or gain |

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PENSION TERMINOLOGY REVIEW OF ERISA AND IRC

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 45 | 304(c)(5) line 1 | funding method | actuarial cost method |
| 45 | 304(c)(5) line 2 | funding method | actuarial cost method |
| 45 | 304(c)(5) line 3 | funding method | actuarial cost method |
| 45 | 304(c)(5) | ...funding method used to determine costs and liabilities under the plan... | ...actuarial cost method for the plan... |
| 46 | 302(c)(7)(A) | accrued liability (including normal cost) | actuarial accrued liability (including normal cost) |
| 46 | 302(c)(7)(A) | entry age normal funding method | entry age actuarial cost method |
| 46 | 302(c)(7)(A) | accrued liability | actuarial accrued liability |
| 46 | 302(c)(7)(A) | funding method | actuarial cost method |
| 46 | 302(c)(7)(B) | value of such assets | actuarial value of such assets |
| 46 | 302(c)(9) | experience gains and losses | actuarial gains and losses |
| 46 | 302(c)(9) | a valuation of the plan's liability | an actuarial valuation |

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PENSION TERMINOLOGY REVIEW OF ERISA AND IRC

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 47 | 304(a) | unfunded liability | unfunded actuarial accrued liability |
| 47 | 304(b)(1) | liabilities | costs |
| 47 | 304(b)(2)(A) | liabilities | costs |
| 47 | 305(a) | a funding method | an actuarial cost method |
| 47 | 305(a) | entry age normal funding method | entry age actuarial cost method |
| 48 | 305(b)(1)(A) | funding method | actuarial cost method |
| 48 | 305(b)(1)(A) | unit credit method | unit credit actuarial cost method |
| 48 | 305(b)(1)(B) | present value | actuarial present value |
| 72 | 1013(d)(1)(C) | unfunded past service liability | unfunded actuarial accrued liability |
| 72 | 1013(d)(2) | unfunded past service liability | unfunded actuarial accrued liability |

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 82 | 6059(b)(1) | funding method | actuarial cost method |
| 110 | 4005(b)(1)(C) | liabilities | actuarial present value of accrued benefits |
| 110 | 4005(b)(1)(D) | liabilities | actuarial present value of accrued benefits |
| 117 | 4008 | evaluation | valuation |
| 120 | 4022(b)(3) line 6 | actuarial value | actuarial present value |
| 120 | 4022(b)(3) line 7 | actuarial value | actuarial present value |
| 120 | 4022(b)(4) | actuarial value | actuarial present value |
| 123 | 4022 A(c)(5)(A)(ii)(II) | unfunded past service liability | unfunded actuarial accrued liability |
| 123 | 4022 A(c)(5)(B)(i)(II) | valuations | actuarial valuations |
| 123 | 4022 A(c)(5)(B)(iii) | valuation | actuarial valuation |
| 126 | 4022 B(a) line 8 | actuarial value | actuarial present value |

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PENSION TERMINOLOGY REVIEW OF ERISA AND IRC

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 126 | 4022 B(a) line 9 | actuarial value | actuarial present value |
| 134 | 4044(a)(6) | benefits | accrued benefits |
| 134 | 4044(b)(2) | present value | actuarial present value |
| 136 | 4045(b)(2)(C) | present value | actuarial present value |
| 136 | 4046(3) | present value | actuarial present value |
| 138 | 4062(b)(1)(A) | current value | actuarial present value |
| 153 | 4211(c)(4)(B) | value | actuarial present value |
| 153 | 4211(c)(4)(C)(ii)(I) | value | actuarial present value |
| 153 | 4211(c)(4)(C)(ii)(II) | value | actuarial present value |
| 153 | 4211(c)(4)(D)(i)(I) | value | actuarial present value |

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| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 153 | 4211(c)(4)(D)(i)(II) | value | actuarial present value |
| 154 | 4211(c)(4)(E)(i)(I) | value | actuarial present value |
| 154 | 4211(c)(4)(E)(i)(II) | value | actuarial present value |
| 155 | 4213(c)(A) | value | actuarial present value |
| 158 | 4219(c)(1)(A)(ii) | assumptions | actuarial assumptions |
| 162 | 4223(c)(3)(A)(i) | value | actuarial present value |
| 168 | 4235(e)(2)(A) | value | actuarial present value |
| 168 | 4235(e)(2)(B) line 2 | value | actuarial present value |
| 168 | 4235(e)(2)(B) line 3 | value | actuarial present value |
| 169 | 4235(g)(1) | value | actuarial present value |

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PENSION TERMINOLOGY REVIEW OF ERISA AND IRC

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 170 | 4241(b)(9)(A) | value | actuarial present value |
| 170 | 4241(c) | value | actuarial present value |
| 171 | 4243(b)(1)(A)(ii) | entry age normal funding method | entry age actuarial cost method |
| 173 | 4243(d)(1)(B)(i) | entry age normal funding method | entry age actuarial cost method |
| 177 | 4244 A(d)(2) | benefits | accrued benefits |
| 179 | 4281(b)(1) | value | actuarial present value |
| 179 | 4281(c)(1) | value | actuarial present value |
| 180 | 4281(c)(2)(D) | value | actuarial present value |
| 183 | MPPAA 108(e)(2)(A) | present value | actuarial present value |
| 183 | MPPAA 108(e)(3)(A) | actuarial report | actuarial valuation |

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 193 | 401(a)(11)(G)(iii) | the actuarial equivalent of | actuarially equivalent to |
| 193-194 | 401(a)(14)(C) | ...not less than the benefit to which he would be entitled at the normal retirement age, actuarially reduced under regulations... | ...not less than actuarially equivalent to the benefit to which he would be entitled at the normal retirement age, as determined under regulations... |
| 207 | 402(e)(2) | current actuarial value | actuarial present value |
| 213 | 404(a)(1)(A)(ii) | ...the remaining unfunded cost of their past and current service credits distributed... | ...the excess, if any, over the actuarial value of assets of the actuarial present value of projected benefits distributed... |
| 213 | 404(a)(1)(A)(ii) | ...but if such remaining unfunded cost with respect to... | ...but if such actuarial present value excess with respect to... |
| 213 | 404(a)(1)(A)(ii) | ...of such remaining unfunded cost, the... | ...of such actuarial present value excess, the... |
| 213 | 404(a)(1)(A)(ii) | ...amount of such unfunded cost attributable.. | ...amount of such actuarial present value excess attributable... |
| 213 | 404(a)(1)(A)(iii) | ...if past service or other supplementary pension or annuity credits are provided by the plan, an amount necessary to amortize such | ...if the plan has an unfunded actuarial accrued liability, an amount necessary to amortize such unfunded actuarial |
| | | credits in equal annual payments... | accrued liability in equal annual payments... |
| 213 | 404(a)(1)(A)(iii) | funding method | actuarial cost method |

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PENSION TERMINOLOGY REVIEW OF ERISA AND IRC

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 213 | 404(a)(1)(B) | funding method | actuarial cost method |
| 213 | 404(a)(1)(B)(i) | present value of all unamortized liabilities | unfunded actuarial accrued liability |
| 214 | 404(a)(3)(A) | actuarially | using an actuarial cost method |
| 249 | 412(b)(2)(B)(i) | unfunded past service liability | unfunded actuarial accrued liability |
| 249 | 412(b)(2)(B)(ii) | unfunded past service liability | unfunded actuarial accrued liability |
| 249 | 412(b)(2)(B)(iii) | unfunded past service liability | unfunded actuarial accrued liability |
| 249 | 412(b)(2)(B)(iv) | net experience loss | net actuarial loss |
| 250 | 412(b)(3)(B)(i) | unfunded past service liability | unfunded actuarial accrued liability |
| 250 | 412(b)(3)(B)(ii) | net experience gain | net actuarial gain |
| 250 | 412(b)(6)(C) | past service liability | actuarial accrued liability |

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 251 | 412(b)(6)(D) | past service liability | actuarial accrued liability |
| 251 | 412(b)(7)(A) | liabilities | actuarial accrued liabilities |
| 251 | 412(b)(7)(E) | accrued liability | actuarial accrued liability |
| 251 | 412(c)(1) line 2 | funding method | actuarial cost method |
| 251 | 412(c)(1) line 6 | funding method | actuarial cost method |
| 251 | 412(c)(1) | accrued liability | actuarial accrued liability |
| 251 | 412(c)(1) | past service liabilities | actuarial accrued liabilities |
| 251 | 412(c)(2)(A) | value | actuarial value |
| 251 | 412(c)(3) | costs | normal costs |
| 252 | 412(c)(3) | liabilities | actuarial accrued liabilities |

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PENSION TERMINOLOGY REVIEW OF ERISA AND IRC

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 252 | 412(c)(4) | experience loss or gain | actuarial loss or gain |
| 252 | 412(c)(5) line 1 | funding method | actuarial cost method |
| 252 | 412(c)(5) line 3 | funding method | actuarial cost method |
| 252 | 412(c)(5) line 4 | funding method | actuarial cost method |
| 252 | 412(c)(5) line 5 | funding method | actuarial cost method |
| 252 | 412(c)(5) | costs | normal costs |
| 252 | 412(c)(5) | liabilities | actuarial accrued liabilities |
| 252 | 412(c)(7)(A) line 1 | accrued liability | actuarial accrued liability |
| 252 | 412(c)(7)(A) line 4 | accrued liability | actuarial accrued liability |
| 252 | 412(c)(7)(A) | entry age - normal funding method | entry age actuarial cost method |

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PENSION TERMINOLOGY REVIEW OF ERISA AND IRC

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 253 | 412(c)(9) | a valuation | an actuarial valuation |
| 253 | 412(c)(9) | liability | actuarial accrued liability |
| 253 | 412(d)(3)(e) | unfunded liability | unfunded actuarial accrued liability |
| 254 | 412(f)(1) | liabilities | actuarial accrued liabilities |
| 254 | 412(f)(2)(A) | liabilities | actuarial accrued liabilities |
| 254 | 412(g)(1) | funding method | actuarial cost method |
| 254 | 412(g)(1) | entry age normal funding method | entry age actuarial cost method |
| 254 | 412(g)(2)(A)(i) | funding method | actuarial cost method |
| 254 | 412(g)(2)(A)(i) | unit credit method | unit credit actuarial cost method |
| 254 | 412(g)(2)(A)(ii) | present value | actuarial present value |

AMERICAN ACADEMY OF ACTUARIES

PENSION TERMINOLOGY REVIEW OF ERISA AND IRC

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 269 | 418(b)(3) | plan's unfunded... | plan's unfunded actuarial accrued liability for... |
| 270 | 418(b)(7)(A)(i) | the value | the actuarial present value |
| 270 | 418(b)(7)(A)(ii) | the value | the actuarial value |
| 270 | 418(b)(7)(C) | unfunded... | unfunded actuarial accrued liability for... |
| 270 | 418(c) | a value | an actuarial present value |
| 271 | 418B(b)(1)(A)(ii) | entry age normal funding method | entry age actuarial cost method |
| 273 | 418B(d)(1)(B)(i) | entry age normal funding method | entry age actuarial cost method |
| 273 | 418B(d)(1)(B)(ii)(I) | value | actuarial present value |
| 273 | 418B(d)(1)(B)(ii)(II) | value | actuarial present value |
| 312 | 6059(b)(1) | funding method | actuarial cost method |

STATEMENT 1982-12

# AMERICAN ACADEMY OF ACTUARIES

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STEPHEN G. KELLISON, M.A.A.A.
EXECUTIVE DIRECTOR

May 26, 1982

TO: Members, Senate Committee on Finance
Members, Senate Committee on Labor and Human Resources
Members, House Committee on Education and Labor
Members, House Committee on Ways and Means

FROM: Stephen G. Kellison
Executive Director
American Academy of Actuaries

RE: Reliance Language Contained in
PERISA/PEPPRA bills: S. 2105 and S. 2106
H.R. 4928 and H.R. 4929
ERISA simplification bills: S. 1541 and H.R. 4330

## I. Summary

The American Academy of Actuaries continues to support the "mandatory reliance" language ("shall rely") which is contained in the ERISA simplification bills (S. 1541 and H.R. 4330) as well as in the PERISA/PEPPRA bills (S. 2105 and S. 2106; H.R. 4928 and H.R. 4929). The Academy has offered both written and oral testimony during the 97th Congress reiterating this position as to a number of these bills.

In brief, the reliance language now contained in each of these bills ("shall rely") makes mandatory the reliance by accountants on the enrolled actuary's work under pension plans, and similarly makes mandatory the reliance by the enrolled actuary on the accountant's work.

In contrast to the proposed legislation, the current ERISA law makes reliance voluntary ("may rely") and in practice the phrase, "may rely" has not become operational as Congress intended and has resulted in "no reliance."

## II. Summary of Reasons for Making Reliance Mandatory

1. A clear Congressional intent for a division of responsibilities between the two professions is evident from Section 103 of ERISA, which carefully delineates the duties of the enrolled actuary from the accountant. Indeed, the statute specifies the content of the accountant's report in great detail, but nowhere does it indicate that actuarial

information is to be reflected therein. Likewise, the statute does not anticipate the actuary reviewing the financial status of the pension fund, but rather leaves that to the accountant.

2. We believe that Congress also intended with its "voluntary reliance" language that, in fact, reliance would frequently be the result in practice under normal circumstances. However, professional guidelines issued by the AICPA have resulted in such reliance by accountants on actuaries not happening in practice.

3. The enrolled actuary is required to certify his work product by signature on IRS/DOL Form 5500 Schedule B. Moreover, he assumes personal and professional liability that this work product meets the "best estimate" criterion of ERISA.

4. The enrolled actuary's work product is both <u>regulated</u> and <u>reviewed</u>.

   - Regulations issued subsequent to ERISA carefully set parameters which the enrolled actuary must meet.

   - IRS review of the enrolled actuary's report is commonplace.

   - The enrolled actuary is subject to regulation by the Joint Board for the Enrollment of Actuaries (a federal agency) including its disciplinary mechanism.

   - Actuarial present values (benefit liabilities) on a pension plan financial statement are computed in accordance with professional standards articulated by the American Academy of Actuaries, which were developed in conjunction with the Financial Accounting Standards Board and the Department of Labor.

5. To have an auditor re-examine the work of the enrolled actuary under this set of facts is duplicative and does not appear to be necessary for the protection of plan sponsors and plan participants.

6. Such redundant review of the enrolled actuary's work by the auditor results in increased costs of administering the pension plan. Mandatory reliance would streamline the operation of pension plans and would keep both auditing and actuarial costs incurred by plan sponsors to a minimum.

7. Finally, disagreements between actuaries and auditors put plan sponsors in a very awkward position, since they are not in a position to effectively resolve such disagreements. Mandatory reliance prevents such problems from arising by making each of the two professionals serving a plan responsible for items within two well-defined areas of expertise.

## III. Further Background

### Accountant's Opinion

Section 103 of ERISA details the responsibilities of the accountant *vis-a-vis* ERISA-regulated plans and describes the areas to be examined by the accountant in formulating the required financial statement and opinion under that section.

While the statutory language outlining the areas the accountant is to examine is quite extensive, it is totally void of reference to actuarial values. The language of that section provides:

> "In offering his opinion under this section the accountant may rely on the correctness of any actuarial matter certified to by an enrolled actuary..."

### Actuary's Opinion

Similarly, Section 103 outlines the enrolled actuary's responsibility under ERISA as to the required actuarial opinion. That language places responsibility for the actuarial opinion with the enrolled actuary. The section also provides that:

> "In making a certification under this section, the enrolled actuary may rely on the correctness of any accounting matter... as to which any qualified public accountant has expressed an opinion..."

It is clear that Congress intended a clear division of responsibilities between accountants and actuaries. However, in practice the "may rely" language has been ignored, and an audit of the enrolled actuary's work is commonplace. The Academy is not suggesting that current law prohibits this practice; we do contend, however, that it is an unnecessary duplication of effort performed at the expense of the plan sponsors and beneficiaries.

### SAS #11

The problem is exacerbated by the AICPA Statement on Auditing Standards No. 11 (SAS #11, December 1975) which relates to using the work of a specialist. SAS #11 provides generally that when an auditor expresses an unqualified opinion, the auditor should not refer to the work or findings of the specialist (in this case the enrolled actuary). It further provides that if reliance on a specialist is expressed, the opinion must be qualified. However, it should be clear that this is a self-imposed "affliction" which the accounting profession could remedy quite easily.

# STATEMENT 1982-13

STATEMENT TO THE

SUBCOMMITTEE ON AGRICULTURAL PRODUCTION,
MARKETING, AND STABILIZATION OF PRICES

SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

SUBMITTED BY

STEPHEN G. KELLISON, EXECUTIVE DIRECTOR

AMERICAN ACADEMY OF ACTUARIES

JUNE 3, 1982

The American Academy of Actuaries ("Academy") appreciates this opportunity to present written comments for the record of the oversight hearings on the federal crop insurance program held on May 20-21, 1982. The Academy is interested in commenting on the federal crop insurance program because of the actuarial activity which is performed in the operation of the program. Attached as Appendix A is some background information on the Academy.

The Academy testified at various hearings on proposed crop insurance legislation which ultimately resulted in the Federal Crop Insurance Act of 1980. In our prior testimony we stressed the following points:

- Actuarial techniques are an essential ingredient in any private or public insurance program in assuring that current costs are properly determined, adequate reserve levels are established, and projections of future trends in costs are recognized.

- The interest of the actuarial profession is with the proper financing of such programs and not with the allocation of costs among various parties. Thus, the Academy does not have a view on how the costs should be borne by various individuals or groups in the private or public sector (i.e., the level of federal subsidy).
- It is important that the actuarial work on these programs be done in accordance with generally accepted actuarial principles and practices by qualified actuaries.

In connection with these present oversight hearings we were pleased to see the recognition of the actuarial dimension of the federal crop insurance program contained in Mr. Sprague's testimony. This recognition is a key ingredient in assuring the ongoing financial integrity of the crop insurance program.

The Federal Crop Insurance Act of 1980 specifies that premiums for insurance should be set at a level actuarially sufficient to cover claims for losses and to establish a reasonable reserve against unforeseen losses. If rates are set at an adequate level, the cost of the program over the long run would be the premium subsidy specified in the Act plus the cost of administering the program. These costs can be controlled by Congress through the normal budgeting process. However, if the rates charged are not adequate, the federal government ultimately pays a "hidden subsidy," equal to the difference between the rates actually charged and the actuarially sound rates.

While overall rate adequacy is very important, rate equity is of equal importance in ensuring a viable program. Rates should be developed so that one state does not subsidize another state, and one crop does not subsidize another crop, etc. Employing modern actuarial techniques to the extent possible can ensure that rates are set on an equitable basis. If rates are not equitable, those producers who stand the most to gain will tend to participate, while others will tend to drop out of the program. This drives up the average level of rates and results in higher premiums for everyone.

The Academy appreciates the opportunity to present this statement. We would be happy to answer any questions or provide further information to the Subcommittee if that would be useful to you.

ATTACHMENT A

BACKGROUND INFORMATION ON THE

AMERICAN ACADEMY OF ACTUARIES

The American Academy of Actuaries is a professional association of actuaries which was formed in 1965 to bring together into one organization all qualified actuaries in the United States and to seek accreditation and greater public recognition for the profession. The Academy includes members of three founding organizations - the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, and the Society of Actuaries.

The Academy serves the entire profession. Its main focus is the social, economic, and public policy environment in which the actuarial profession functions. Its primary activities include liaison with federal and state governments, relations with other professions, the dissemination of public information about the actuarial profession and issues that affect it, and the development of standards of professional conduct and practice.

Over 6,600 actuaries in all areas of specialization belong to the Academy. These members are employed by insurance companies, consulting actuarial firms, government, academic institutions, and a growing number of industries. Actuarial science involves the evaluation of the probabilities and financial impact that uncertain future events - birth, marriage, sickness, accident, fire, liability, retirement, and death - have on insurance and other benefit plans.

Membership requirements can be summarized under two broad headings: education and experience. At present, the educational requirements can be

satisfied either by passing certain professional examinations sponsored by the Casualty Actuarial Society or the Society of Actuaries, or by becoming an enrolled actuary under the Employee Retirement Income Security Act of 1974 (ERISA). The experience requirement consists of three years of responsible actuarial work.

# STATEMENT 1982-14

STATEMENT OF THE

AMERICAN ACADEMY OF ACTUARIES

TO THE HOUSE SELECT COMMITTEE ON AGING

JUNE 7, 1982

On behalf of the American Academy of Actuaries, thank you for the opportunity to submit testimony in conjunction with the June 7th hearing of the House Select Committee on Aging on pension funding problems. This statement will respond to questions raised in a letter dated April 20, 1982 from Representative Claude Pepper to the American Academy of Actuaries.

The questions raised in Congressman Pepper's letter relating to pension funding are of deep concern to all actuaries in the United States, most of whom are members of the American Academy of Actuaries. We will limit our comments to those questions that are related to the actuarial profession. This statement will discuss the role of the actuary in regard to the funding of pension plans, the impact of the federal government on the funding of pension plans, the role of the accounting profession on the funding of pension plans as viewed by our profession, and the growth of unfunded actuarial liabilities.

## The Role of the Actuary

At present, there are several professional designations for actuaries, each based on varying education and experience requirements. The classification most germane to pension funding is the "enrolled actuary." The Employee Retirement Income Security Act (ERISA) created the

designation enrolled actuary; it requires that the applicant pass government-sponsored examinations and have experience in the field. There are other actuarial designations (i.e., a Fellow of the Society of Actuaries) in existence which require broader qualifications than the minimum standards set by ERISA. Enrolled actuaries are eligible for membership in the American Academy of Actuaries and, in fact, over 80% of enrolled actuaries are members of the association. The Academy has been active in promulgating standards of practice for actuaries working on pension plans. These standards, contained in the Academy's Year Book, are both pervasive and comprehensive.

The enrolled actuary is qualified to perform the various technical requirements to determine the actuarial liabilities, normal costs, funding requirements, funding standard accounts, and other determinations for pension plans. These requirements include the collection of appropriate data, the statistical studies that are necessary for mortality rates, disability rates, retirement ages, and other factors which will affect the cost of pension plans. In addition, it is necessary to study investments, inflation, and wage and salary increases in order to make reasonable estimates of the economics affecting pension plans. As a result of these studies and calculations, the actuary is in a unique position to advise plan sponsors on the funding of their pension plans. They can advise plan sponsors on the minimum and maximum amounts of contributions that can be made to the plan in order to meet requirements of ERISA or other sound objectives. The studies will also enable the actuary to advise the plan sponsor on the financial status of his plan, the projected costs and benefit payments, and other related financial matters.

In sum, the actuary possesses unique skills involving future probabilities of events which allow him to make reasonable estimates of the costs to meet pension plan commitments.

One of the determinations made by the actuary is the amount of the "unfunded actuarial liability" of the pension plan. The term "unfunded actuarial liability" has been used by both actuaries and the public to mean three distinct financial items. I will therefore define these three different and distinct items that have been classified as "unfunded actuarial liabilities."

The first item is the amount of the actuarial liability of the plan in excess of the actuarial value of the assets. There are several acceptable funding methods in use today to determine the actuarial liability of a pension plan. Without going into too great detail, a funding method is a system to divide the ultimate cost of the plan between two costs -- that allocated to service prior to the current date, and that allocated to service after that date. The latter is funded by a series of annual contributions called "normal costs," while the former is called the "actuarial liability." How this is divided depends on factors such as the weights given to years of service, prior earnings, coverage under the plan, and other items. ERISA mandates that these amounts be determined to establish the required contribution to the plan.

The excess of the actuarial liability over the actuarial value of assets is the "unfunded actuarial liability," a figure which appears in the funding standard account of ERISA. This is not a liability in the accounting sense (an amount that is due and unpaid at any time);

rather, it is a tool for providing a means to level out the future costs of a pension plan. Each year the company must contribute an amount equal to the normal cost of the plan, plus a sufficient amount to fund the unfunded actuarial liability over not more than 30 years from its inception. A plan sponsor may also contribute up to the amount necessary to fund this unfunded actuarial liability over ten years from its inception. In this way it provides a plan sponsor not only a means of leveling out cost, but also provides flexibility so that somewhat larger or lower contributions can be made over time. Contributions within this range may be claimed as a tax deduction.

Increases in the unfunded actuarial liability occur when a plan is amended to provide increased benefits. Increases can occur also as the result of losses from the operation of the plan, e.g., the assets do not increase as expected, or participants live longer than anticipated. It should be emphasized that this item is a funding tool and does not measure the current financial status of the plan.

The second definition of "unfunded actuarial liability" is a measure of the financial status of the plan. In the profession, we prefer not to use the term "unfunded actuarial liability" for this figure, but rather we refer to it as the excess of the present value of accumulated plan benefits over the current value (market value) of the plan assets. In this context, we determine for each participant in the plan what benefits he can expect to receive in the future, and discount these benefits for the probability of receiving the benefits and for the expected interest earned between the current date and when the benefit must be paid. This

then becomes the present value of accumulated plan benefits. Only the benefits that have been credited up to the date of the calculations are included.

Comparing this present value with the current assets presents a picture of how well the plan is funded as of the valuation date. If assets equal or exceed the present value, all the credited benefits have been funded. The Financial Accounting Standards Board Statement No. 36 now requires that this measure of the financial status be included in a footnote of the corporate financial statement. This is a statement of the financial condition as of a certain time. This figure also appears on Form 5500 which is filed under ERISA.

The third "unfunded actuarial liability" figure is a result of the Pension Benefit Guaranty Corporation. Under Title IV of ERISA, certain benefits are guaranteed to plan participants in the event of plan termination. These benefits are typically somewhat less than the plan's vested benefits. Thus, the third financial figure is the unfunded actuarial liability for pension benefits guaranteed by the PBGC. This figure is important to plans that are or may be terminated.

One of the questions raised by your Committee was the impact of high interest rates on the unfunded actuarial liability. First, consider the unfunded actuarial liability that is used for the funding standard account and discussed above. In selecting the assumptions to be used in valuing the plan, the actuary must be consistent. The economic assumptions with regard to wage and salary increases, investment income, and future inflation must be consistent with one another. If the actuary expects

high investment rates, he will also anticipate high wages and salary rates, as both are related to high inflation. High investment rates will decrease pension plan costs. However, high wage and salary rates will directly or indirectly increase pension plan costs because pensions generally keep up with the levels of wages and salaries. Since higher investment rates decrease pension costs, and higher salary and wage rates increase pension costs, the two tend to offset one another.

The investment rate generally has a stronger impact than the salary rate, so that if both increase by the same amount, the net effect will be a decrease in the unfunded actuarial liability. However, the size of the decrease will vary significantly from plan to plan depending on the type of benefit formula, the extent the plan is funded, the proportion of participants who are retired, and several other factors. Therefore, the impact of higher interest rates will probably but not certainly decrease the unfunded actuarial liability, and the size of that decrease is unknown. (The above discussion assumes constant benefits in retirement. If a plan provides indexed benefits after retirement, then the effects are quite different.)

On the other hand, the impact of higher investment rates of return on the unfunded present value of accumulated plan benefits will more likely result in a decrease in the unfunded amount. Future wages and salaries and inflation generally do not affect the present value of accumulated plan benefits. Accumulated plan benefits represent the benefits that have been credited to the employees up to the date of the calculations. Future salaries and wages do not enter into these calculations. Thus, an increase in the investment rate of return is not offset by a

corresponding increase in expected future wages and salaries. This is consistent with the requirements of Financial Accounting Standards Board Statement No. 35 and 36. If higher investment rates are expected in the future, it is quite likely that the current value of the assets in the fund will decrease.

There has been a significant problem with investing in bonds in the past several years. As interest rates have climbed, the value of the bonds in the pension portfolios have decreased significantly. Therefore, higher interest rates have lowered the present value of accumulated plan benefits but have also lowered the value of the assets. The difference between the two, the unfunded present value of accumulated plan benefits, could go either way, but generally results in a decrease.

The Role of the Government

Prior to ERISA, the principal role of the government with respect to pension plans was exercised through the Internal Revenue Service, its tax laws and regulations. There were and are today two principal purposes for these tax laws. One is to limit the amount of contributions made to pension plans that can be claimed as a tax deduction. In actual practice, this is a tax deferral rather than a tax deduction since taxes eventually must be paid on these contributions. However, the Treasury Department was vitally interested in keeping large contributions from being made to pension plans and claimed as tax deductions. Thus, the maximum tax deductible limit was set to be the normal cost of the plan plus amortization of the past service cost in no less than ten years.

The second primary objective of these tax laws was to control the abuses that the Treasury Department perceived in private pension plans. These

took the form of requiring broad coverage of pension plans and disallowing plans that were strictly for the benefit of highly paid personnel. The impact on the funding of the IRS laws and regulations was to inhibit somewhat the funding of pension plans. Many plans might have paid off their unfunded actuarial liabilities more rapidly if they had obtained tax deductions for these higher contributions. Also, any losses that occurred in the operation of the plan from any sources could not be made up by contributions at once, but again had to be spread over several years.

For the IRS, ERISA had small impact on the funding of pension plans. Plan sponsors are still prohibited from funding the unfunded actuarial liabilities faster than over ten years. The flexibility of the contributions that can be made to qualified plans remains, but it is somewhat more restricted in that the minimum contributions have been raised. Also, some new restrictions have been placed on the amount that can be contributed on a tax deductible basis under what is known as the Section 415 limits. This section limits the amount that can be contributed under defined benefit and defined contribution plans to certain maximum amounts. These are dollar amounts adjusted for inflation which cannot be fully advance funded because of certain technical requirements. While not major items, these are irritants in the funding of pension plans.

Generally, I believe ERISA has resulted in slightly stronger funding. However, whether in pre- or post- ERISA times, the real test of funding and a final answer to benefit security is the profitability of the plan sponsor. If the plan sponsor continues to operate on a profitable basis, the plan will be adequately funded, and all benefits will eventually be

paid. However, businesses do terminate and pension plans do go out of existence. Hence, we have the PBGC to guarantee certain minimum benefits in the event that these plans are terminated.

It is interesting to note that a recent study has shown that 98% of all the plans that terminated had assets sufficient to cover all the benefits guaranteed by the PBGC. These results testify to the fact that the present system is providing adequate funding for private pension plans. Inadequate funding is the exception. It cannot be avoided in some circumstances in the early years of a plan or under adverse economic conditions.

The Role of the Accountant

The accountant's impact on the funding of pension plans, if anything, is only indirect. His particular role is the reporting of information of interest to plan participants, stockholders, and the like. However, through public disclosure of the financial status of the plan, the accountant does have indirect impact on how well the plan becomes funded. At present, Financial Accounting Standards Board Statement No. 36 requires that the following information be provided: 1) actuarial present value of vested accumulated plan benefits; 2) actuarial present value of non-vested accumulated plan benefits; 3) the plan's net assets available for benefits; 4) the assumed rates of investment income; and 5) the date at which the benefit information was determined. The sum of the first and second items minus the third item is the unfunded actuarial present value of accumulated plan benefits. These five items are shown in the footnotes to the corporate financial statements.

Accountants and actuaries have worked closely together to develop significant information for the public for many years. A committee of actuaries worked closely with the Accounting Principles Board back in the 1960s to develop Opinion No. 8. We have continued to work closely with the accountants to develop their various statements since that time.

Increase in the Level of Unfunded Actuarial Liabilities

The Committee has asked us to comment on the increase in the level of unfunded actuarial liabilities. It is our opinion that generally, the increases that have occurred are not significant when they are related to the overall economy. Unfunded actuarial liabilities have increased in line with other economic indicators such as, for example, the increase in the size of home mortgages. Generally the increase is a result of having to increase the pension benefits in order to keep up with the current increases in salaries, wages, and cost of living. Many plan sponsors have increased the benefits to currently retired participants to assist them in keeping up with the increases in the costs of living. These benefit increases have resulted in increases in unfunded actuarial liabilities. As stated above, though, this is not of serious concern as long as the plan sponsors continue to remain profitable. Thus, the security of private pension plans is closely tied in to the total economy of the United States.

Increases in unfunded liabilities occur through two different events: 1) amendments to the plan which are a deliberate action on the part of the plan sponsor and, as indicated above, generally to keep the benefits current with current conditions; 2) losses due to adverse experience,

which can result from unforeseen circumstances. These can arise because inflation was greater than expected or assets did not increase as much as anticipated.

Summary

Thus, we can state the following:

1) the actuary, through his training and experience, reinforced by the profession and the laws, is qualified to advise plan sponsors on the proper level of contributions to adequately fund their pension program;
2) pension plans generally are being adequately funded under the present laws;
3) some amendments to ERISA would improve the ability of plan sponsors to more rapidly fund their plans;
4) in most situations, the growth in unfunded actuarial liabilities is not by itself a cause for alarm, but rather is the result of our overall economic conditions.

# STATEMENT 1982-15

Presentation to the NAIC Task Force
on
Manipulation, Lapsation, Dividend Practices and Annuity Disclosure
June 8, 1982

I am John Harding, Senior Vice President and Chief Actuary of National Life of Vermont and Chairman of the American Academy of Actuaries' Committee on Dividend Principles and Practices.

On June 2, 1981, I gave a report to your Task Force on the results of our work. There were three major areas to consider:

1) Academy adoption of Dividend Principles and Practices.
2) Suggestions to you with respect to related consumer disclosure.
3) Suggestions to you with respect to related disclosure in Schedule M of the Annual Statement.

The full text of this report can be found in your June, 1981 proceedings. However, I would like to focus on the key elements.

1) Dividend Principles and Practices. Starting with the 1982 dividend scale, the mutual company actuary must write a report to his company that discloses the basis for the recommended scale and its conformance with the Principles and Practices.
2) Consumer Disclosure. The intent of our consumer disclosure system is to educate the buyer about different kinds of policies and to provide insight into differences in costs. The existence of the Dividend Principles and Practices provides the opportunity to give more informative, reliable cost comparisons. Our suggestions are made for the purpose of allowing you to take advantage of this opportunity.

3) Schedule M Disclosure. While the Academy of Actuaries can require the actuary to make a written report to company management about a recommended dividend scale, the Academy cannot require the company to accept that dividend scale. Therefore, to assure that policyholders are being treated fairly and that dividend illustrations are in fact what they appear to be, we suggest that the actuary be required to disclose the facts in the annual statement. Our suggestion includes a summary of the practices used, a highlighting of any changes in practices, a quantification of changes in a dividend scale and certification by the actuary that the dividends have been determined, except as disclosed, in accordance with the Academy Principles and Practices. I believe that this Schedules M disclosure is critical to the continued fair treatment of policyholders and to the integrity of any cost disclosure system which relies on the use of dividends.

While there has been some progress since last June, we would antagonize only those who regret the passage of time. There are several areas of progress:

First, our suggestions to you were circulated to Academy of Actuaries membership for informational purposes. While no comment was asked for nor received, actuaries are not normally reticent about voicing objection.

Second, the Board of the American Council of Life Insurance voted to endorse our suggested modification of Schedule M. John Montgomery has expressed some concern with the form, though not the content, of our suggestions. Tony Spano of the ACLI has

discussed the problem with John, and we had hoped to resolve the problem with him during this meeting. Since John could not be here, Tony will work with him for resolution before your next meeting.

Third, our suggestions with respect to consumer disclosure were also endorsed by the ACLI Board. The proposal made this morning at the Life Cost Disclosure Task Force incorporates the Academy suggestions. It should work well. I must emphasize, however, that the credibility of dividend illustrations incorporated in that disclosure will be impaired until Schedule M disclosure is mandated.

While we work to resolve the dividend issues, there are those who say that we are at best deciding what color to paint a dinosaur. The pricing issues are similar for such products as Universal Life and Indeterminate Premium Life. A committee of the Society of Actuaries is actively working on the development of Principles and Practices for pricing of these emerging products. They hope to publish their report this fall. At the appropriate time the Academy will commence work similar to what we have done with the dividend issues.

However, we should not wait for the resolution of these emerging issues. We should proceed as soon as possible with the dividend problem, establishing regulatory support in Schedule M and enhancing consumer disclosure.

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# STATEMENT TO THE HOUSE COMMITTEE ON WAYS AND MEANS BY DOUGLAS C. BORTON, ON BEHALF OF THE PENSION COMMITTEE OF THE AMERICAN ACADEMY OF ACTUARIES

June 10, 1982

The American Academy of Actuaries ("Academy") appreciates the opportunity to testify on H.R. 6410, the Pension Equity Act of 1982. These comments are being offered on behalf of the Subcommittee on Tax Matters of the Pension Committee of the Academy.

Academy members are vitally interested in this bill since a large segment of our membership consists of actuaries providing services for private pension plans in this country. Over 80% of the enrolled actuaries under ERISA are members of the Academy. Attachment A contains additional background information about the Academy.

We will confine our testimony today to actuarial aspects of the bill; other aspects of the bill are being extensively discussed by other witnesses. However, since the introduction of this bill, we have received an outpouring of concern from our membership. In fact, the concerns we have heard from our members are the most extensive on any proposed piece of pension legislation during the post-ERISA period.

Legislation in the pension area is quite complex and thus is one of the most challenging areas for the Congress to deal with effectively. The long and difficult period following the passage of ERISA in 1974 is ample evidence of just how difficult, sensitive and complex an area this really is.

For several years now, extensive efforts toward a comprehensive ERISA improvements bill have been underway. This has resulted in the Retirement Income Incentives and Administrative Simplification Act (S. 1541 and H.R. 4330). These two bills and their predecessors have received extensive analysis and commentary over a period of time which has allowed many desirable improvements to be incorporated. We feel that this process is the proper road to good legislation in such a complex and difficult area as pensions.

And yet here we are today discussing a sweeping proposal which has had virtually no input from the private pension community and for which much less than even one month has been granted for analysis of the bill's ramifications (which we believe are extensive). We seriously question whether this is the way to obtain thoughtful and effective pension legislation.

It is well documented that ERISA had an unintended and unexpected adverse effect on plan terminations and new plan formations from which the private pension system is only recently recovering. However, this proposed bill might well cause another round of increased plan terminations and reduced new plan formations. The present environment is not the time to introduce a

new deterrent to the private pension system, particularly in view of the financial difficulties facing Social Security. There is little doubt that greater reliance on the private pension system in the future will be necessary regardless of how the current Social Security difficulties are resolved by Congress. This fact coupled with the demonstrated need for more private investment capital, which our economy needs and which private pensions can deliver, make this a most inopportune time to hamper the development of the private pension system.

There are two specific areas of the bill we would like to address. The first is the reduction in maximum benefit limitations. Let us preface our remarks in this area with the observation that the level at which these should be set (if, indeed, they should exist at all) is a social policy issue and not an actuarial one. Therefore, we will not comment on the proposed level of these limitations.

However, we would offer the following general observations about the proposal:

1. The apparent motivation of the bill is to reduce the benefits for highly paid employees. However, what is apparently overlooked is the fact that across-the-board reductions affecting the rank-and-file employees as well as the highly paid employees will frequently be the result of this proposal.
2. The removal of any indexation will result in continually reducing "real" limits (after inflation) which will produce a greater and greater restriction with the

passage of time. This seems inconsistent with the indexation which Congress itself has legislated for Social Security and for the major federal employee retirement systems.

3. The required actuarial reduction in benefit limitations for retirement before age 65 seems harsh again in comparison with major federal employee retirement systems. For example, the federal Civil Service Retirement System does not impose an actuarial reduction factor down to age 55. Although many plans do in fact have actuarial reduction factors for early retirement, we do not see a rationale for mandating a reduction in benefit limitations on those plans which do not impose such an actuarial reduction for early retirement.

4. Higher paid employees would in many cases be able to do an "end run" around the new requirements by setting up unfunded deferred compensation programs. This would hardly seem to be a desirable result to encourage, since ERISA funding standards do not apply to such plans and since investment capital for the economy is not generated by such plans.

The second area we would like to address is the area of integration of plans with Social Security. There is no doubt that current Social Security integration requirements are complex and that some simplification would be desirable. Also, they are outdated in some respects, e.g., they fail to recognize the 1977 amendments to the Social Security Act.

Nevertheless, they have been in effect for a good many years and have operated successfully during this period. We seriously doubt that the "quick fix" suggested in this bill would be any improvement over the admittedly imperfect current system. This is an area that deserves considerable study and analysis before any legislation should be adopted.

The problems with the proposal are many. Among them are:

1. Any workable approach to integration should be able to be based on the benefit formula in the plan as a whole. However, this bill would set up a system in which individual calculations for each employee would be involved. This is administratively inconvenient and costly. A system by which the benefit formula in the plan can be judged as a whole is greatly preferable.
2. The results of such individual calculations would have an illogical pattern to them. For example, longer service employees would have smaller benefits than shorter service employees since the employer has paid more Social Security taxes for the former.
3. The "safe harbor" limitations of $30,000 and $60,000 seem totally arbitrary and unrelated to anything. The current Social Security wage base is $32,400 and rising each year.
4. The proposals are not definitive in how the various types of formulas (flat benefit, final average, career average, offset, etc.) would be affected. There are many unanswered questions that would require subsequent

regulation to answer. In the meantime, however, considerable uncertainty and disruption would be created for plans that did not know whether they were in compliance or not.

In fact, the rationale for these proposed changes in integration requirements is unclear. Current integration requirements are already tight enough to produce a combined Social Security/private plan benefit which decreases as a percentage of pay as salary increases. Is the purpose of the proposal to require an even greater "tilt" in favor of the lower paid employees? If so, this result is in sharp contrast with the federal Civil Service Retirement System in which Social Security is not provided and which provides benefits proportional to salary.

The Retirement Income Incentives and Administrative Simplification Act (S. 1541 and H.R. 4330) contains a revised framework for Social Security integration (Section 4811). Although we are not endorsing the particular details of any particular integration formula, we find the general approach taken in those bills to be a more workable approach than that taken in H.R. 6410. We would encourage that that approach be used as a general framework to consider legislative changes in integration requirements.

In closing, we would point out that many plans would have to be amended to bring them into compliance with this bill. This is a time-consuming process resulting in significant additional administrative costs to plans.

We also think that additional opportunity for analysis and commentary on the bill should be granted to those affected by it if the Congress retains an interest in legislation of this type. The time available since the bill's introduction on May 19, 1982 has simply not been adequate to ascertain all the likely ramifications and effects of the bill.

ATTACHMENT A

BACKGROUND INFORMATION ON THE
AMERICAN ACADEMY OF ACTUARIES

The American Academy of Actuaries is a professional association of actuaries which was formed in 1965 to bring together into one organization all qualified actuaries in the United States and to seek accreditation and greater public recognition for the profession. The Academy includes members of three founding organizations - the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, and the Society of Actuaries.

The Academy serves the entire profession. Its main focus is the social, economic, and public policy environment in which the actuarial profession functions. Its primary activities include liaison with federal and state governments, relations with other professions, the dissemination of public information about the actuarial profession and issues that affect it, and the development of standards of professional conduct and practice.

Over 6,600 actuaries in all areas of specialization belong to the Academy. These members are employed by insurance companies, consulting actuarial firms, government, academic institutions, and a growing number of industries. Actuarial science involves the evaluation of the probabilities and financial impact that uncertain future events - birth, marriage, sickness, accident, fire, liability, retirement, and death - have on insurance and other benefit plans.

Membership requirements can be summarized under two broad headings: education and experience. At present, the educational requirements can be

satisfied either by passing certain professional examinations sponsored by the Casualty Actuarial Society or the Society of Actuaries, or by becoming an enrolled actuary under the Employee Retirement Income Security Act of 1974 (ERISA). The experience requirement consists of three years of responsible actuarial work.

# STATEMENT 1982-17

# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

STEPHEN G. KELLISON, M.A.A.A.
EXECUTIVE DIRECTOR

June 10, 1982

CORRECTED SUBMISSION

Auditing Standards Division
File 3155
American Institute of Certified
Public Accountants
1211 Avenue of the Americas
New York, New York 10036

Gentlemen:

I am pleased to submit these comments in response to the AICPA Exposure Draft on Auditing Property and Liability Reinsurance dated March 15, 1982. These comments are being offered on behalf of the Academy Task Force on Reinsurance Accounting, chaired by Ronald E. Ferguson.

The Academy Task Force has filed four previous sets of comments on this subject with the AICPA dated:

1. January 8, 1980,
2. July 1, 1980,
3. January 8, 1981, and
4. July 10, 1981

Copies of all four prior submissions are attached.

The Academy Task Force has reviewed the Exposure Draft and does not have any further comments to add to those already submitted. We do request that our previous comments be given further consideration.

The Academy Task Force appreciates the cooperative discussions on reinsurance accounting and auditing which have been held between Academy and AICPA representatives. The Task Force stands ready to be of further assistance to the AICPA on other aspects of the overall reinsurance project.

Respectfully submitted,

Stephen G. Kellison

SGK:mv

cc: Ronald E. Ferguson

## STATEMENT 1982-18

BACKGROUND

MEETING BETWEEN AICPA AND AAA OFFICIALS
NEW YORK - DECEMBER 22, 1981

PRELIMINARY DISCUSSION AT LAST MEETING
OF THE AICPA/AAA JOINT COMMITTEE
ORLANDO - JANUARY 12, 1982

THREE ISSUES IDENTIFIED

1. EXPRESSION OF RELIANCE WHICH WOULD IDENTIFY THE ACTUARY.

2. WORKING RELATIONSHIPS BETWEEN ACTUARIES AND AUDITORS (I.E., SAS 11).

3. THE INDEPENDENCE/SELF REVIEW ISSUE.

IT WAS AGREED THAT IT WOULD NOT BE FRUITFUL TO PURSUE #3 AT THIS TIME, BUT THAT CONTINUING DISCUSSIONS ON #1 AND #2 SHOULD PROCEED.

ACTUARIES AGREED TO DEVELOP A PROPOSAL FOR WHAT THEY WOULD LIKE TO SEE.

REASONS TO PURSUE ISSUES #1 AND #2

1. IT IS IN THE PUBLIC INTEREST FOR USERS OF FINANCIAL STATEMENTS TO HAVE THE BENEFIT OF IDENTIFICATION OF THE ACTUARY TAKING RESPONSIBILITY FOR THE APPROPRIATENESS OF ACTUARIAL ENTRIES IN FINANCIAL STATEMENTS OF INSURANCE COMPANIES AND BENEFIT PLANS.

2. IT WOULD RELIEVE THE AUDITOR OF RESPONSIBILITY (AND LIABILITY) FOR REVIEWING WORK WHICH IS EXTREMELY DIFFICULT FOR A NON-ACTUARY TO FORM A VALID JUDGMENT UPON.

3. THERE COULD BE IMPROVED WORKING RELATIONSHIPS BETWEEN ACTUARIES AND AUDITORS IN PRACTICE.

4. IT WOULD BE BENEFICIAL TO BOTH PROFESSIONS TO REDUCE AND HOPEFULLY ELIMINATE OUR PUBLIC DISAGREEMENTS BEFORE GOVERNMENT AND THE MEDIA.

ARE ACTUARIES DIFFERENT FROM OTHER SPECIALISTS?

MOST ACTUARIES FEEL THEY ARE DIFFERENT FROM OTHER SPECIALISTS MENTIONED IN SAS 11 (APPRAISERS, ATTORNEYS, ENGINEERS, GEOLOGISTS) AND THUS REQUIRE SPECIAL TREATMENT (WHICH HAS ALREADY BEEN DONE FOR ATTORNEYS VIA SAS 12).

RATIONALE:

1. PROFESSIONAL OBJECTIVITY

   THIS IS THE TRADITIONAL CORNERSTONE EXPECTED OF ALL ACTUARIES REGARDLESS OF EMPLOYMENT. TO QUOTE FROM THE OPINIONS AS TO PROFESSIONAL CONDUCT OF THE ACADEMY:

   > "A REQUIREMENT COMMON TO ALL ACTUARIAL PROCEDURES IS THAT ASSUMPTIONS AND METHODS BE SELECTED AND APPLIED WITH INTEGRITY, INFORMED JUDGMENT, AND PERSPECTIVE IN RELATION TO THE PURPOSE FOR WHICH THE RESULTS ARE INTENDED."

2. FUTURE PERSPECTIVE

   THE ACTUARY IS CONCERNED WITH QUANTIFYING THE PRESENT FINANCIAL IMPACT OF FUTURE CONTINGENT EVENTS OFTEN OVER LONG PERIODS OF TIME. OTHER SPECIALISTS ARE PRIMARILY CONCERNED WITH THE MEASUREMENT OF PRESENT PHYSICAL QUANTITIES AND PAST EVENTS.

3. MEASUREMENT OF UNCERTAINTY

THE FUTURE EVENTS WHICH THE ACTUARY MUST QUANTIFY ARE UNCERTAIN ONES SUBJECT TO CONSIDERABLE STATISTICAL VARIABILITY. ALTHOUGH ALL FINANCIAL REPORTING ENTITIES FACE UNCERTAINTY, NONE DO TO THE DEGREE OF THOSE WITH WHICH THE ACTUARY DEALS IN WHICH UNCERTAINTY IS THE VERY REASON FOR EXISTENCE.

4. MATERIALITY

THE MAGNITUDE OF ACTUARIAL NUMBERS IN FINANCIAL STATEMENTS OF INSURANCE COMPANIES AND BENEFIT PLANS IS QUITE MATERIAL. IN FACT, THEY ARE OFTEN THE MOST SIGNIFICANT ELEMENTS IN THOSE FINANCIAL STATEMENTS.

5. LEGAL REQUIREMENTS

WITHIN THE PAST 8 YEARS LEGAL REQUIREMENTS HAVE BEEN IMPOSED ON ACTUARIES WHO TAKE RESPONSIBILITY FOR NUMBERS WHICH APPEAR ON FINANCIAL STATEMENTS:

A. ERISA CERTIFICATIONS ON PRIVATE PENSION PLANS - 1974
B. NAIC STATEMENTS OF OPINION - LIFE AND ACCIDENT AND HEALTH - 1975
C. NAIC STATEMENT OF OPINION - FIRE AND CASUALTY - 1980

NEITHER THE U.S. CONGRESS NOR THE NAIC HAS SEEN THE NEED TO IMPOSE AN INDEPENDENCE REQUIREMENT ON ACTUARIES PROVIDING THESE OPINIONS.

6. PROFESSIONAL STANDARDS

THE ACTUARY TAKING RESPONSIBILITY FOR NUMBERS WHICH APPEAR ON FINANCIAL STATEMENTS IS SUBJECT TO PROFESSIONAL

A. STANDARDS OF CONDUCT - GUIDES AND OPINIONS

B. STANDARDS OF PRACTICE - RECOMMENDATIONS AND INTERPRETATIONS

7. EDUCATION REQUIREMENTS

THE ACTUARIAL EDUCATION AND EXAMINATION PROGRAM INCLUDES SIGNIFICANT FORMAL TRAINING IN ACCOUNTING MATTERS. THIS IS NOT THE CASE WITH MOST OTHER SPECIALISTS.

## CONCLUSION OF TASK FORCE (LONG TERM)

AFTER CONSIDERABLE DISCUSSION THE AAA TASK FORCE HAS ARRIVED AT THE VIEW THAT THE ULTIMATE GOAL SHOULD BE SOMETHING ALONG THE LINES OF

### DIVISION OF RESPONSIBILITY

THIS WOULD:

1. ADDRESS THE 4 REASONS TO PURSUE THIS DISCUSSION LISTED EARLIER.

2. PROVIDE STRONGER FINANCIAL STATEMENTS FOR THE USERS, NOT WEAKER ONES.

3. ESTABLISH A SYSTEM IN THE U.S. MORE NEARLY COMPARABLE TO THAT IN CANADA AND THE U.K.

4. RETURN TO AN APPROACH FREQUENTLY USED IN THE U.S. PRIOR TO THE STOCK LIFE INSURANCE AUDIT GUIDE. SEE ERNST AND WHINNEY SURVEY - IN 1972 THE PERCENTAGE OF AUDITORS REFERRING TO ACTUARIES WAS

| | |
|---|---|
| STOCK | 24% |
| MUTUAL | 29% |

PENSIONS - PLAN STATEMENT

SECTION 103 OF ERISA IN DEFINING THE CONTENT OF THE AUDITOR'S REPORT AND THE ACTUARY'S REPORT INDICATES THAT THE CONGRESSIONAL INTENT WAS FOR A DIVISION OF RESPONSIBILITY.

THE "MAY RELY" LANGUAGE FURTHER INDICATES THAT CONGRESS INTENDED "CROSS RELIANCE" TO BE USED, PERHAPS SHOULD EVEN BECOME THE NORMAL PATTERN.

IN PRACTICE, THE CONGRESSIONAL INTENT HAS NOT BECOME OPERATIONAL BECAUSE OF SAS 11.

THE AAA TASK FORCE RECOMMENDS THAT APPROPRIATE STEPS BE TAKEN TO MAKE THE "DIVISION OF RESPONSIBILITY" AND "CROSS RELIANCE" CONCEPTS AS INTENDED BY CONGRESS OPERATIONAL IN PRACTICE.

PENSION - SPONSOR STATEMENT

FINAL RESOLUTION IN THIS AREA SHOULD BE DEFERRED PENDING COMPLETION OF CURRENT MAJOR FASB PROJECT.

IN THE INTERIM, THE ACTUARY PROVIDING THE ACTUARIAL NUMBERS FOR FASB 36 DISCLOSURES SHOULD BE IDENTIFIED BY NAME IN THE FOOTNOTES TO THE PLAN SPONSOR'S FINANCIAL STATEMENTS.

INSURANCE - STATUTORY

ALTHOUGH IN CONCEPT, A "DIVISION OF RESPONSIBILITY" APPROACH WOULD APPEAR TO BE EQUALLY APPROPRIATE FOR STAT AND GAAP, THE CONTEXTS ARE QUITE DIFFERENT.

THUS, THE AAA TASK FORCE FEELS STAT SHOULD BE ADDRESSED FIRST, THEN GAAP.

STAT PROVIDES A CLEAR BASIS FOR THE AUDITOR TO DIVIDE RESPONSIBILITY WITH THE ACTUARY OR TO RELY ON THE ACTUARY:

1. LEGAL - THE NAIC STATEMENT OF ACTUARIAL OPINION.
2. REVIEW - THE PERIODIC INSURANCE DEPARTMENT EXAMINATIONS (WHICH REVIEW THE WORK OF THE ACTUARY)

DISCUSSIONS IN THIS AREA MAY NEED TO INVOLVE THE NAIC AT SOME POINT.

INSURANCE - GAAP

GAAP IS MORE DIFFICULT SINCE:

1. THE LEGAL (NAIC STATEMENT OF ACTUARIAL OPINION) AND REVIEW (INSURANCE DEPARTMENT EXAMINATION) FEATURES OF STAT ARE ABSENT.

2. BLESSING OF THE SEC FOR GAAP WOULD PRESUMABLY BE MORE DIFFICULT TO ACHIEVE THAN BLESSING OF THE NAIC FOR STAT.

ALTHOUGH THE LONG TERM GOAL HERE IS THE SAME AS IN OTHER AREAS, FOR NOW ATTENTION SHOULD BE FOCUSED ON:

OBTAINING INCREASED RECOGNITION AND IDENTIFICATION OF THE ACTUARY IN THE FOOTNOTES TO THE GAAP FINANCIAL STATEMENTS.

## THE ROLE OF THE AUDITOR

UNDER THESE PROPOSALS WE SEE THE CONTINUING ROLE OF THE AUDITOR AS:

1. SATISFYING HIMSELF AS TO THE QUALIFICATIONS OF THE ACTUARY;
2. SATISFYING HIMSELF THAT THE ACTUARY DID INDEED CONSIDER ALL APPROPRIATE FACTORS THAT HE SHOULD HAVE (CHECKLIST?);

BUT STOPPING SHORT OF "OBTAINING AN UNDERSTANDING OF THE METHODS AND ASSUMPTIONS" USED BY THE ACTUARY.

## SAS 11

WHAT IS IT THAT ACTUARIES DO NOT LIKE ABOUT SAS 11?

1. THE REQUIREMENT THAT THE AUDITOR "OBTAIN AN UNDERSTANDING OF THE METHODS AND ASSUMPTIONS" OF THE ACTUARY.
2. THE RESULT THAT ANY REFERENCE TO AN ACTUARY IN AN AUDITOR'S OPINION MAKES IT A "QUALIFIED" OPINION.
3. THE "ADDITIONAL PROCEDURES" REQUIREMENT FOR NON-INDEPENDENT ACTUARIES IS VERY VAGUE.

## SUMMARY OF RECOMMENDATIONS

1. A STRUCTURE BE FOUND TO WORK ON PROPOSALS ALONG THE LINES OF THESE RECOMMENDATIONS, I.E., TOWARD DIVISION OF RESPONSIBILITY.

2. THE TWO PROFESSIONS TRY TO RESOLVE THEIR DIFFERENCES PRIVATELY RATHER THAN PUBLICLY.

3. SAS 11 IS NOT ADEQUATE TO DEAL WITH ACTUARIES.

4. IN SPECIFIC APPLICATION AREAS
   - HIGHER PRIORITY
     - PENSION PLAN STATEMENTS
     - INSURANCE STAT STATEMENTS
   - LOWER PRIORITY
     - PLAN SPONSOR STATEMENTS
     - INSURANCE GAAP STATEMENTS

5. AAA WILLING TO WORK WITH AICPA TO PROVIDE ASSURANCES ON
   - QUALIFICATIONS OF ACTUARY
   - CHECKLIST OF THINGS THE ACTUARY MUST CONSIDER

   AS TRADE-OFF TO AUDITOR "OBTAINING AN UNDERSTANDING OF THE METHODS AND ASSUMPTIONS."

STATEMENT 1982-19

# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

STEPHEN G. KELLISON, M.A.A.A.
EXECUTIVE DIRECTOR

June 23, 1982

Mr. Russell J. Mueller
Actuary
House Committee on Education and Labor
112 Cannon House Office Building
Washington, D.C. 20515

Dear Russ:

On April 27, 1982 the *Academy Committee on Pension Terminology formally* submitted an 18-page report containing proposed terminology changes in ERISA and selected sections of the Internal Revenue Code. These changes were being proposed to bring the statutes into accord with the final report of the Joint Committee on Pension Terminology dated July 31, 1981. As you know, this latter report has received the endorsement of the governing boards of all U.S. actuarial organizations dealing with pension matters.

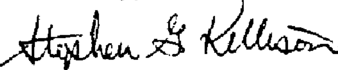
The Committee has reviewed its April 27 submission and has identified a small number of corrections. These are listed on the attached three pages as follows:

Additions
Changes
Deletions

We hope that you will incorporate these few corrections into our prior submission, so that it is one cohesive package.

If you have any questions or if you would like any further information, please let me know. We greatly appreciate your efforts to help move federal law toward more consistent, unambiguous terminology. If we can be of further assistance to you, do not hesitate to ask.

Yours truly,



Stephen G. Kellison
Executive Director

SGK:mv

cc: Committee on Pension Terminology

AMERICAN ACADEMY OF ACTUARIES

ADDITIONS

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 249 | 412(b)(2)(B)(iv) | experience loss | actuarial loss |
| 250 | 412(b)(3)(B)ii | experience gain | actuarial gain |
| 251 | 412(c)(1) | experience gains | actuarial gains |
| 252 | 412(C)(7) A Line 6 | funding method | actuarial cost method |
| 252 | 412(c)(4) | experience gain | actuarial gain |
| 252 | 412(c)(4)(B) | accrued liability | actuarial accrued liability |
| 252 | 412(c)(4)(B) | experience loss | actuarial loss |
| 253 | 412(c)(9) | experience gains | actuarial gains |

AMERICAN ACADEMY OF ACTUARIES

CHANGES TO LIST

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 9 | 3(31) | The term "advance funding actuarial cost method" or "actuarial cost method" means a recognized actuarial technique utilized for establishing the amount and incidence of the annual actuarial cost of pension plan benefits and expenses. Acceptable actuarial cost methods shall include the accrued benefit cost method (unit credit method), the entry age normal cost method, the individual level premium cost method, the aggregate cost method, the attained age normal cost method, and the frozen initial liability cost method. The terminal funding cost method and the current funding (pay-as-you-go) cost method are not acceptable actuarial cost methods. The Secretary of the Treasury shall issue regulations to further define acceptable actuarial cost methods. | The term "actuarial cost method" means a procedure for determining the actuarial present value of pension plan benefits and expenses and for developing an actuarially equivalent allocation of such value to time periods, usually in the form of a normal cost and an actuarial accrued liability. Acceptable actuarial cost methods shall include the unit credit actuarial cost method, the entry age actuarial cost method, the individual level actuarial cost method, and individual spread gain actuarial cost method, the aggregate actuarial cost method, the attained age actuarial cost method, the frozen entry age actuarial cost method, and the frozen attained age actuarial cost method. Terminal funding and pay-as-you-go funding are not acceptable actuarial cost methods. The Secretary of the Treasury shall issue regulations to further define acceptable actuarial cost methods. |
| 253 | 412(c)(9) | liability | actuarial present value |
| 254 | 412(f)(1)<br>412(f)(2)(A) | liability | actuarial present value |

AMERICAN ACADEMY OF ACTUARIES

DELETIONS TO THE LIST

| BNA TEXT PAGE | COMPLETE ERISA OR IRC REFERENCE | EXISTING TERM | CHANGE TO |
|---|---|---|---|
| 269 | 418(b)(3) | plan's unfunded . . . | No change |
| 270 | 418(b)(7)(A)([illegible]) | the value | No change |
| 270 | 418(b)(7)(C) | unfunded . . . | No change |

# STATEMENT 1982-20

STATEMENT OF STEPHEN G. KELLISON

EXECUTIVE DIRECTOR OF THE AMERICAN ACADEMY OF ACTUARIES

TO THE ADVISORY COMMITTEE OF THE

JOINT BOARD FOR THE ENROLLMENT OF ACTUARIES

JUNE 23, 1982

My name is Stephen G. Kellison and I am the Executive Director of the American Academy of Actuaries. I appreciate the opportunity to make a few comments today.

The Academy has not been an active participant in activities of the Joint Board and its Advisory Committee since the institution of joint sponsorship several years ago. This results from the fact that we are not involved in the education and examination process for actuaries in this country.

However, the Academy retains a vital interest in the entire process for two reasons. First, we are interested in qualification standards for actuaries to practice in all areas of specialization, including pensions. Many of you may be aware of extensive recent activity in other areas of actuarial practice such as NAIC statements of actuarial opinion, both life and casualty, and the on-going effort to better define qualified health service corporation actuaries. The Academy is now in the process of forming a task force to look at qualifications of pension actuaries. Second, Academy membership is open to enrolled actuaries, so we have an obvious interest in the qualifications of such individuals who apply for membership.

I am not here today to discuss some of the problems which have arisen in connection with joint sponsorship such as the nature of the examination itself (i.e., type of questions asked) and the difficult task of setting pass marks. The Academy was originally a supporter of joint sponsorship and we hope that the problems which have arisen in these areas can be resolved. We would hate to see a return to multiple education and examination tracks for pension actuaries in this country with all the variation in standards and duplication of effort that would inevitably result. Thus, we wish you well in making the system work.

However, I would like to address the content and scope of the education and examination program for enrolled actuaries. Let me clarify that much of what I am about to say is my personal view and not necessarily the view of the Academy. Although some of these points have been discussed in Academy forums and I have heard little or no disagreement on them, no Academy committee nor the Board has adopted them as policy positions.

My main concern is that enrolled actuaries are widely perceived within the actuarial profession and to some extent outside the profession, as well, as not being "real actuaries". I am sure we have all heard such epithets as "second class citizens", "para-professionals," and "pension technicians" applied to enrolled actuaries. I am dismayed at this, since it is often demeaning to such individuals and since it has been disruptive within the actuarial profession.

Moreover, I am even more worried about the general public. Does not the public expect and deserve to have enrolled actuaries be <u>fully qualified</u> pension actuaries? After all, their economic security in retirement is in the hands of enrolled actuaries. Surely Congress did not intend that enrolled actuary status should denote some sort of minimal level of technical proficiency in actuarial calculations, but rather intended that such individuals would indeed be fully qualified pension actuaries.

In analyzing why this attitude is so widespread, I have reached the conclusion that it is not because the examinations are too easy to pass (because the new ones are, in fact, quite difficult to pass), but rather because the scope of material covered is much too narrow.

Let me cite some examples:

- One of the most important functions of an enrolled actuary is to set "best estimate" assumptions. Some of the most important and volatile assumptions are the economic ones. Yet enrolled actuaries are not examined on economics, finance, and investments.

- In connection with the other assumptions ; such as rates of mortality, disability, retirement, termination of employment, etc.; there is no coverage of experience analyses or even how to arrive at standard tables which are appropriate to use.

- There is no coverage of Social Security, yet how can any enrolled actuary do the job right without an extensive knowledge of Social Security?

- An enrolled actuary needs a strong background in pension plan design, which is not required today.

I am certain those closer to the education and examination system could cite many additional examples. My point is simply----- should not the scope of material be broad enough that those who complete it are, in fact, fully qualified pension actuaries? Would this not be in the public interest and compatible with Congressional intent?

The early days of enrollment were different. There was a legitimate concern originally about depriving people of their livelihood and also about the supply of enrolled actuaries. Congress clearly recognized these problems by specifying lower

standards prior to January 1, 1976 than thereafter. However, now 6 1/2 years later these are problems of the past. I see nothing in ERISA nor in the committee reports to discourage a major expansion in the scope of what an enrolled actuary is expected to have learned. In fact, given the increased concerns in the media about the status of the funding of pension plans in this country and the economic volatility which has arisen since 1974, I see a considerable broadening of the educational background of newly qualified enrolled actuaries as strongly in the public interest.

Although the primary thrust of my comments are directed toward educational content, there are related issues on the examination side. I am not at all certain that going from two examinations to one is the right direction. If anything, maybe we should consider more examinations, not fewer.

- Requiring demonstration of basic actuarial knowledge independent of specialty is highly appropriate. The public has the right to know that any professional specializing in an area has satisfied reasonable basic "core knowledge".

- From an educational point of view more screens rather than fewer are to be preferred. No examination is, or ever can be, a perfect indicator of knowledge of a subject area. More than one examination helps to cancel out the "random error" of people who, for whatever reason, score too high or too low on just one examination.

- I am not persuaded that examples from other professions (e.g. one bar examination) are relevant. Invariably, the training in other professions involves extensive work at colleges and universities involving a whole series of screens over many years. A comparable system simply does not exist for the large majority of new enrolled actuaries.

I would also like to briefly address a totally different matter, the issue of pension terminology.

As you are probably aware, uniform pension terminology does not exist today. There are numerous examples in the pension literature of multiple terms having the same meaning, one term having multiple meanings, and terms with ambiguous meanings. In fact, the terminology appearing in ERISA itself contains inconsistencies.

In reaction to this situation, the actuarial profession launched a major project several years ago to try to develop a more consistent lexicon that was as close as possible to existing terms in prevalent usage. This effort culminated with the final report of the Joint Committee on Pension Terminology on July 31, 1981. The report has been endorsed by the governing boards of all U.S. actuarial organizations dealing with pension matters.

The Academy's Committee on Pension Terminology has reviewed ERISA and the relevant sections of the Internal Revenue Code, as well as the proposed legislation affecting public employee plans to suggest changes to bring them into accord with the terminology report. These have been submitted to both the House Committee on Education and Labor and to the Senate Committee on Labor and Human Resources. In fact, the public employee bills have been voted out of the House Committee on Education and Labor onto the House floor with the terminology changes included.

We hope that the Joint Board and the Advisory Committee will support the use of the new terminology and work it into the educational materials and examinations for enrolled actuaries.

If you have any questions, I would be happy to discuss these comments further.

# STATEMENT 1982-21

# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

STEPHEN G. KELLISON, M.A.A.A.
EXECUTIVE DIRECTOR

July 9, 1982

The Honorable John H. Chafee, Chairman
Subcommittee on Savings, Pensions, and
Investment Policy
5229 Dirksen Senate Office Building
Washington, D.C. 20510

Re: S. 2105 and S. 2106 (PERISA/PEPPRA)

Dear Senator Chafee:

This letter concerns two bills which you introduced, S. 2105 and S. 2106 (the Public Employee Retirement Income Security Act). More specifically, it addresses the question of pension terminology contained in these bills.

As you are aware, the corresponding House bills, H.R. 4928 and H.R. 4929, were recently voted out of the House Committee on Education and Labor. The bills advanced by the House Committee contained a number of terminology changes.

The terminology changes in question are summarized in an attachment. We support these changes and hope that the Senate version will incorporate them along with the House version. We consider these changes to be non-controversial "friendly amendments" to your bills. They are editorial in nature and do not make any changes in policy.

We thought you might be interested in why these changes are being proposed. Uniform pension terminology does not exist today. There are numerous examples in the pension literature of multiple terms having the same meaning, one term having multiple meanings, and terms with ambiguous meanings. In fact, the terminology appearing in ERISA contains certain inconsistencies. Moreover, there are differences between these PERISA bills and ERISA.

The actuarial profession launched a major project several years ago to try to develop a more consistent lexicon that was as close as possible to existing terms in prevalent usage. This effort culminated with the final report of the Joint Committee on Pension Terminology on July 31, 1981 (copy also enclosed). The report has been endorsed by the governing boards of all U.S. actuarial organizations dealing with pension matters.

We hope that you will be able to support these proposals. We feel that everyone both in and out of government will benefit from more consistent, uniform terminology.

If you have any questions or would like any additional information, please let me know. Thank you again for your consideration.

Yours truly,

Stephen G. Kellison
Executive Director

SGK:bjn
enclosures

# AMERICAN ACADEMY OF ACTUARIES

## PROPOSED CHANGES IN S.2105

## CONCERNING PENSION TERMINOLOGY

JUNE 24, 1982

Section 1002

Delete the following subsections which provide definitions of the corresponding terms in their entirety:

| | | |
|---|---|---|
| p.7 | ( 2) | actuarial present value |
| p.8 | ( 3) | actuarial valuation method |
| p.8 | ( 4) | actuarial value of assets |
| p.10 | ( 7) | annual actuarial value |
| p.10 | (10) | combined actuarial value |
| p.20 | (33) | supplemental actuarial value |
| p.21 | (34) | unfunded supplemental actuarial value |

Substitute in their place the following new subsection:

(b) For purposes of this Act-

(1) The term "actuarial accrued liability" means that portion, as determined under a particular actuarial cost method, of the actuarial present value of plan benefits and expenses which is not provided for by future normal costs.

(2) The term "actuarial cost method" means a procedure for determining the actuarial present value of plan benefits and expenses and for developing an actuarially equivalent allocation of such value to time periods, in the form of a normal cost and, if applicable, an actuarial accrued liability. For purposes of this paragraph, one amount or series of amounts shall be considered "actuarially equivalent" to another amount or series of amounts if they are of equal actuarial present value.

(3) The term "actuarial present value" means the value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of actuarial assumptions.

(4) The term "actuarial value of assets" means the value assigned by the actuary to the assets of a plan for the purposes of an actuarial valuation performed under section 109.

(5) The term "amortization payment" means that portion of the unfunded actuarial accrued liability or the unfunded frozen actuarial accrued liability (whichever is applicable) assigned, by an amortization process, to the current period.

(6) The term "credited projected benefit" means that portion of a participant's projected benefit based on an allocation taking into account service to date determined in accordance with the terms of the plan and based on anticipated future compensation.

(7) The term "frozen actuarial accrued liability" means that portion of the actuarial present value of projected benefits which is separated as of a valuation date and frozen under certain actuarial cost methods and which is the sum of an initial unfunded actuarial accrued liability and any increments or decrements in the actuarial accrued liability established subsequently as a result of changes in pension plan benefits or actuarial assumptions.

(8) The term "normal cost" means that portion of the actuarial present value of plan benefits (including that portion of benefits provided by participant contributions) and expenses which is allocated to a valuation year under the actuarial cost method used by the plan (excluding any amortization of the unfunded actuarial accrued liability).

(9) The term "projected benefits" means those benefit amounts under a plan which are expected to be paid at various future times under a particular

set of actuarial assumptions, taking into account, as applicable, the effect of advancement in age and past and anticipated future compensation and service credits.

(10) The term "unfunded actuarial accrued liability" means the excess of the actuarial accrued liability over the actuarial value of assets of a plan.

(11) The term "unfunded frozen actuarial accrued liability" means that portion of the frozen actuarial accrued liability remaining after the addition of interest and the deduction of any amortization payments.

Section 1106

In subsection (b)(1)(B) on p. 35 lines 11-12 delete:

"unfunded supplemental actuarial value"

and substitute:

"unfunded actuarial accrued liability or unfunded frozen actuarial accrued liability"

Section 1107

1. Subsection (c)(7)(B)(i) p.45 lines 6-7

delete "actuarial valuation method"

substitute "actuarial cost method"

2. Subsection (c)(7)(B)(ii) p.45 lines 8-14

delete entire subsection

substitute "if computed, the normal cost, the amortization payment (including a description of the method of calculating the amortization payment), and the unfunded actuarial accrued liability or unfunded frozen actuarial accrued liability, whichever is applicable, and"

3. Subsection (c)(8)(A) p.46 lines 1-2

delete "future plan benefits"

substitute "all projected benefits"

4. Subsection (c)(8)(B) p.46 lines 7-8

delete "accumulated plan benefits"

substitute "credited projected benefits"

5. Subsection (c)(8)(C) p.46 lines 11-12

delete "total projected plan benefits"

substitute "total projected benefits"

STATEMENT 1982-22


# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

STEPHEN G. KELLISON, M.A.A.A.
EXECUTIVE DIRECTOR


MEMORANDUM

TO: Senate Committee on Labor and Human Resources
House Committee on Education and Labor

RE: Section 6058 of Internal Revenue Code

DATE: July 12, 1982

Attached are some comments on Section 6058 of the Internal Revenue Code prepared by the Committee on Pension Actuarial Principles and Practices of the American Academy of Actuaries. A literal reading of subsection (b) of this section requires the enrolled actuary to make a certification as to conditions that will exist 30 days after the date of the certification, which is not possible to do.

We ask that the remedies suggested in the attached comments be considered by the congressional committees in connection with any further action taken on S. 1541 and H.R. 4330, the Retirement Income Incentives and Administrative Simplification Act. We appreciate your consideration of these comments.

Respectfully submitted,

Stephen G. Kellison
Executive Director

SGK:bjn
enclosure

COMMENTS ON SECTION 6058 OF IRC
COMMITTEE ON PENSION ACTUARIAL PRINCIPLES AND PRACTICES
AMERICAN ACADEMY OF ACTUARIES
JULY 12, 1982

We are writing to call attention to a technical problem created by §6058(b) Actuarial Statement in Case of Merger, Etc. of the Internal Revenue Code.

We believe this problem can be corrected in the ERISA legislation currently under consideration and suggest alternative methods of correction -- one requires a change in the statute and the other requires a clarifying comment in the legislative history.

## The Nature of the Problem

IRC §6058(b) provides:

"Not less than 30 days before a merger, consolidation, or transfer of assets or liabilities of a plan described in subsection (a) to another plan, the plan administrator (within the meaning of section 414(g)) shall file an actuarial statement of valuation evidencing compliance with the requirements of section 401(a)(12)."

IRC §401(a)(12) provides:

"A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that in the case of any

merger or consolidation with, or transfer of assets or liabilities to, any other plan after September 2, 1974, each participant in the plan would (if the plan then terminated) receive a benefit immediately after the merger, consolidation, or transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger, consolidation, or transfer (if the plan had then terminated). The preceding sentence does not apply to any multiemployer plan with respect to any transaction to the extent that participants either before or after the transaction are covered under a multiemployer plan to which title IV of the Employee Retirement Income Security Act of 1974 applies."

The problem is in the interpretation of the 30 day requirement. Thirty days before what event?

A literal interpretation might require the actuary to state that the conditions specified in §401(a)(12) will exist 30 days after he signs the statement. It is not possible to make such a statement with certainty.

We are aware of three different methods that are being used by actuaries to comply with §6058(b):

- Some make an exact determination as of the effective date of the merger, consolidation, or spinoff and necessarily make their calculations and prepare their statement after such date.

- Others make their calculations and prepare the statement before the effective date of the merger, consolidation or spinoff and necessarily base the calculations on data (including asset market values) that are not as of the effective date.
- A third group conclude that there are actually two dates: an effective date and a later cash transaction date. Calculations are made after the effective date using data as of such effective date and then the statement is filed 30 days before the cash transaction date.

We believe that each of these methods has merit and that these three probably do not exhaust the reasonable possibilities. However, we also believe that any method the actuary may choose can be criticized as inconsistent with the letter of the law. The uncertainty created by this ambiguity in §6058(b) is undesirable.

## How Might the Statute be Changed to Eliminate the Uncertainty?

One solution is to amend §6058(b) to provide explicitly that the statement be prepared after the facts on which it is based are known. A natural approach is to define the date in relation to the plan year containing the transaction. For example, the statute could be amended to read:

> "Within 90 days after the close of a plan year in which there occurs a merger, consolidation, or transfer of assets or liabilities of a plan described in subsection (a) to another plan, the plan administrator (within the meaning of section 414(g) shall file an actuarial statement of valuation evidencing compliance with the requirements of section 401(a)(12)."

This would provide time to prepare a statement based on all relevant facts and would provide assurance that §401(a)(12) was observed.

## How Might the Intent of the Current Statute be Clarified without Amendment?

Although we prefer the statutory solution described above, the alternative of an interpretative statement in the legislative history would also provide relief.

Based on our understanding of the intent of §6058(b), we believe that such an interpretive statement might provide that the statement be filed 30 days before the date the transaction is recorded in the accounts of the trustee and that such recording date will normally be after the effective date of the merger, consolidation or spinoff.

Such an interpretation would provide sufficient time for the actuary to make an accurate determination as required under §401(a)(12), but also provide 30 days in which any objection

to the merger, consolidation, or spinoff can be registered, with assurance that it would be possible to reverse the merger, consolidation or spinoff and restore the prior status of the plan.

We would be pleased to amplify our suggestion or to answer any questions you may have.

# STATEMENT 1982-23

STATEMENT ON S. 2204

THE FAIR INSURANCE PRACTICES ACT

PRESENTED TO THE SENATE COMMITTEE

ON

COMMERCE, SCIENCE AND TRANSPORTATION

JULY 15, 1982

AMERICAN ACADEMY OF ACTUARIES

COMMITTEE ON RISK CLASSIFICATION

## INTRODUCTION

In August 1980, the American Academy of Actuaries ("Academy") was asked by the House Subcommittee on Consumer Protection and Finance to undertake a study of the economic impact of H.R. 100 (a House bill with provisions nearly identical to those of S. 2204). Following that request, the Academy's Committee on Risk Classification began a study of the economic impact of H.R. 100.

That study was completed in the spring of 1981, and was presented in summary form on May 20, 1981 to the House Subcommittee on Commerce, Transportation and Tourism in conjunction with hearings on H.R. 100. The summary was followed by a detailed report supporting the study's conclusions, which was filed with the House Subcommittee on July 29, 1981. A copy of both the summary and the detailed report has been previously provided to this Committee.

Because the relevant (in terms of economic impact) provisions of S. 2204 are identical to those of H.R. 100, the Committee on Risk Classification believes the conclusions reached under the H.R. 100 study are equally applicable to S. 2204.

This report then summarizes briefly our analysis of the economic impact of S. 2204. Our assessment of the bill's impact should be considered approximate rather than precise. No study of the potential impact of such far-reaching legislation can accurately

gauge the practical effects of implementing regulations, marketplace reactions, judicial interpretations, etc. Nevertheless, we can give you a general assessment -- our best judgment as to the probable impact.

The American Academy of Actuaries is a professional association of actuaries which was formed in 1965 to bring together into one organization all qualified actuaries in the United States and to seek accreditation and greater public recognition for our profession. The Academy includes members of three founding organizations -- the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, and the Society of Actuaries. A more extensive description of the Academy as well as further elaboration on the Committee on Risk Classification is set forth as appendix to this statement.

The following report is divided into two general parts: (1) major conclusions and (2) a specific analysis of the economic impact of S. 2204.

## MAJOR CONCLUSIONS

1. Many aspects of S. 2204 would have little economic impact -- specifically, provisions relating to race, color, religion, and national origin; and provisions relating to the availability of insurance without regard to sex.

2. Provisions relating to pricing differences by sex and the mandating of pregnancy benefits would have some significant effects. The impact on individual insurance consumers varies by type of insurance and depends on individual circumstances. The effects on individual male and female purchasers is summarized in the following table:

| | % Change In Price Increase (+) Or Decrease (-) | | | | | |
|---|---|---|---|---|---|---|
| TYPE OF INSURANCE | MALE AGE 20 | MALE AGE 40 | MALE AGE 65 | FEMALE AGE 20 | FEMALE AGE 40 | FEMALE AGE 65 |
| Life Insurance | -2% | -3% | N/A | +6% | +11% | N/A |
| Health Insurance | | | | | | |
| - Medical Expense | | | | | | |
| Unisex Rating | +18 | +13 | 0 | -12 | - 7 | 0 |
| Full Maternity | +38 | + 1 | 0 | +26 | + 1 | 0 |
| Total | +56 | +14 | 0 | +14 | -6 | 0 |
| - Disability | | | | | | |
| Unisex Rating | + 4 | + 2 | 0 | -26 | -21 | 0 |
| Full Maternity | +20 | - | 0 | +20 | - | 0 |
| Total | +24 | + 2 | 0 | - 6 | -21 | 0 |
| Automobile Insurance | -20 | 0 | 0 | +37 | 0 | 0 |
| Individual Annuities | + 6 | + 6 | + 6 | - 6 | - 6 | - 6 |

3. Extrapolating from individual effects to totals of insurance in force, we project the following total annual dollar impact:

| TYPE OF INSURANCE | Increase (+) Or Decrease(-) AGGREGATE ANNUAL COST IMPACT ON MEN | AGGREGATE ANNUAL COST IMPACT ON WOMEN |
|---|---|---|
| | ($ in millions) | |
| Life Insurance | -$360 | +$360 |
| Health Insurance | | |
| - Medical Expense | | |
| Unisex Rating | + 69 | - 69 |
| Full Maternity | + 82 | + 85 |
| Total | + 151 | + 16 |
| - Disability | | |
| Unisex Rating | + 37 | - 37 |
| Full Maternity | + 57 | + 7 |
| Total | + 94 | - 30 |
| Automobile Insurance | - 700 | + 700 |

4. The impact on pension plans would most likely be to mandate benefit increases to women under defined contribution type plans, and to men in certain circumstances under defined benefit type plans. It is not clear to us whether men or women would gain more in pension benefits from S. 2204.

5. Implementation costs would be approximately $1.3 billion. The longer the period allowed for implementation, the smaller would be the marginal implementation costs. The 90-day implementation period called for by the bill is not possible at any cost.

6. Much of the immediate implementation costs could be avoided by having S. 2204 affect future insurance contracts only.

7. Most of the economic effects of S. 2204 -- both direct costs and potential marketplace disruptions -- could be avoided by prohibiting only those sex-distinct pricing differences which are not supported by statistically demonstrated cost differences.

## ANALYSIS OF

## ECONOMIC IMPACT OF S. 2204

### A. Overall Approach

Insurers do not now generally differentiate in insurance pricing or availability on the basis of race, color, religion, or national origin. Insurers also do not generally differentiate between the sexes as to the availability of insurance. The greatest effect of S. 2204, therefore, would be the prohibition of differences between the sexes in the pricing of insurance, and we have confined our analysis to the economic impact of that prohibition and to the mandating of full maternity benefits in all health policies. In our view, the economic impacts of the other aspects of S. 2204 are not significant.

There are four areas of major potential impact:

1) Changes in insurance costs to individuals;
2) "Ripple" effects on private insurance markets;
3) Financial effects on the insurers (both insurance companies and other insurers);
4) The administrative costs incurred in implementing S. 2204.

We have examined these effects separately for four major types of insurance -- life insurance, health insurance, casualty and property insurance, and retirement insurance (i.e., pension plans). There are significant differences between the risks covered by these types of insurance, in the way sex is used in pricing, and

in the way the insurance is sold or otherwise provided to the consumer. Consequently, the impact of S. 2204 on each type is different.

B. Changes in Individual Insurance Costs

Much of the insurance coverage in this country is provided to individuals through group plans. For example, at least 75% of private hospital/medical insurance to those under age 65 is on a group basis. Virtually none of the property-casualty coverage (automobile insurance in this context) is provided on a group basis. Except for group pension plans, where the impact of S. 2204 is somewhat complicated, the effect of S. 2204 on the insurance costs paid directly by individuals covered under group plans or on the size of their benefits would be negligible. Consequently, our analysis of the impact on individual pocketbooks pertains largely to insurance sold directly to individuals -- i.e., not through group plans.

For some types of insurance, S. 2204 would cause women to pay less and men more; for other types men would pay less and women more. The impact of S. 2204 on any particular individual or family would vary widely according to the particular insurance coverage involved and the particular circumstances of the persons insured -- in addition to their sex. Broadly, however, the average effects are summarized in the following table.

| TYPE OF INSURANCE | MALE AGE 20 | MALE AGE 40 | MALE AGE 65 | FEMALE AGE 20 | FEMALE AGE 40 | FEMALE AGE 65 |
|---|---|---|---|---|---|---|
| | | % Change in Price Increase (+) Or Decrease (-) | | | | |
| Life Insurance | - 2% | - 3% | N/A* | + 6% | +11% | N/A* |
| Health Insurance | | | | | | |
| - Medical Expense | | | | | | |
| Unisex Rating | +18 | +13 | 0 | -12 | - 7 | 0 |
| Full Maternity** | +38 | + 1 | 0 | +26 | + 1 | 0 |
| Total | +56 | +14 | 0 | +14 | - 6 | 0 |
| - Disability | | | | | | |
| Unisex Rating | + 4 | + 2 | 0 | -26 | -21 | 0 |
| Full Maternity** | +20 | - | 0 | +20 | - | 0 |
| Total | +24 | + 2 | 0 | - 6 | -21 | 0 |
| Automobile Insurance**** | -20 | 0*** | 0 | +37 | 0*** | 0 |
| Individual Annuities***** | + 6 | + 6 | + 6 | - 6 | - 6 | - 6 |

*Relatively little life insurance is sold on an individual basis to people age 65.

**This is the impact of requiring full maternity coverage (i.e., coverage for normal pregnancies and deliveries, as well as coverage for complications of pregnancy).

***Some insurers now charge women between the ages of 30 and 64 who are the sole operators of their cars approximately 10% less than similarly situated men. The price of auto insurance for these women would increase slightly but the impact is difficult to predict and would be small in any event.

****Effects shown are for men and women who are principal drivers of the insured car.

*****Payments commencing at age 65, with refund features.

Extrapolating these individual effects to totals of insurance in force, we project the following total annual dollar impact:

| TYPE OF INSURANCE | Increase (+) Or Decrease (-) AGGREGATE ANNUAL COST IMPACT ON MEN | AGGREGATE ANNUAL COST IMPACT ON WOMEN |
|---|---|---|
| | ($ in millions) | |
| Life Insurance | -$360 | +$360 |
| Health Insurance | | |
| - Medical Expense | | |
| Unisex Rating | + 69 | - 69 |
| Full Maternity | + 82 | + 85 |
| Total | + 151 | + 16 |
| - Disability | | |
| Unisex Rating | + 37 | - 37 |
| Full Maternity | + 57 | + 7 |
| Total | + 94 | - 30 |
| Automobile Insurance | - 700 | + 700 |

C. Effect on Pension Benefits

The impact of S. 2204 on pension plans would be somewhat different. Most pension plans are provided through employer sponsorship; ERISA regulations, collective bargaining agreements, and paragraph (c) (2) of Section 4 of S. 2204 make it likely that the major effect of S. 2204 on pensions would be a mandated increase in benefits for either men or women -- depending on the specifics of the plan.

In general, periodic payments to women would increase under defined contribution plans.

Under the more prevalent defined benefit plans, the effects would be mixed. In these plans, standard benefits at normal retirement age for similarly situated men and women are identical; however, benefits at early retirement and most optional forms of benefits are often higher for women. Therefore, in plans which now use sex-differentiated option and early retirement factors, S. 2204 would require benefits at early retirement and benefits elected in most optional forms of payment to be increased for men.

The cost of the increased benefits in both types of pension plans would be significant -- approximately $5.5 billion per year in mandated extra benefits for all plans combined. It is not clear to us how much of the additional $5.5 billion per year would accrue to men and how much to women; further study would be needed to gain some insight into this question.

D. Administrative Implementation Costs

These are the costs involved in such activities as establishing new "unisex" rates, amending insurance policies and contracts, changing computer programs and other systems and procedures, and recalculating benefits where necessary. The administrative cost impact depends very heavily on the time frame mandated for implementation. The 90-day implementation period called for by S. 2204 is simply not possible at any cost. In view of the amount of internal work

insurers would have to perform and the extensive state regulatory filings required, a longer implementation period would allow the changes to be made largely in the context of normal product updating cycles. We have analyzed in our report the approximate administrative cost for a timetable midway between the impossibly short and the low-impact long -- a 2-3 year lag between passage of the bill and its effective date. These costs are summarized as follows:

| TYPE OF INSURANCE | ($ IN MILLIONS) |
|---|---|
| Life Insurance | $ 870 |
| Health Insurance | 200 |
| Casualty & Property Insurance | 75 |
| Retirement Plans | 200 |
| Total Costs | $1,345 |

One way to reduce the administrative costs would be to have S. 2204 affect insurance contracts issued only after its effective date. The retroactive features of the bill generate much of the administrative implementation costs, since those features require revisions to millions of outstanding insurance policies and contracts.

E. Marketplace Effects

The impacts of S. 2204 on insurance markets are very difficult to predict and impossible to quantify precisely. Mandated changes in pricing practices often have unexpected effects, and, although these effects are not entirely quantifiable, they are nonetheless potentially very significant and worthy of consideration. Here are some of the more important possible effects, summarized very briefly:

A. An increase in the average price of insurance in general, as insurers are forced to take on the additional risk that the sex distribution of those insured will be different from what is assumed in pricing, among other things;

B. Increased emphasis on selling insurance for the arbitrarily overpriced risks, along with possible steps to avoid selling insurance for risks that are known to be relatively under priced;

C. Increased regulatory efforts and costs to assure equal availability of coverage, especially to those for whom insurance prices are arbitrarily reduced;

D. The search for new classification factors or product modifications, which may have the effect of differentiating risks by sex;

E. Diversion of resources to the implementation of unisex rating, at the expense of new insurance product development efforts or investigation of other new pricing techniques.

F. Financial Effects on Insurers

It is important to note that the "insurers" affected by S. 2204 include not only private insurance companies but also organizations which "self-insure," through specially established trust funds or other means. Among others, "insurers" in this context include various levels of government -- federal, state, and local -- and a variety of other self-insurers, in many cases pension or welfare funds established through collective bargaining agreements.

While S. 2204 allows for changes in prices, it also stipulates that benefits may be increased but may not be decreased. This stipulation could have particularly serious adverse consequences to the insurers of retirement plans -- not just insurance companies but also all other "insurers." The extra money required to increase retirement benefits to men or women, depending on plan specifics, would have to come from somewhere -- additional appropriations in the case of many pension plans for government employees, additional contributions from employers or their employees in the case of private sector plans, etc.

Conclusions

From our analysis of this particular legislation, we draw several general conclusions:

1. S. 2204 would have a significant economic impact if enacted.
2. The effect on individual insurance consumers would differ according to their individual circumstances and according to the type of insurance coverage involved. On balance, it appears that women as a whole would pay more for insurance (life, health, and automobile) if S. 2204 is enacted.
3. The effect on pension benefits is unclear. S. 2204 will mandate increases in benefits. Under defined contribution plans, women's benefits would increase; under most defined benefit plans, early retirement benefits and optional forms of benefits for men would increase.
4. The 90-day implementation period stipulated is not practical. The longer the implementation period, the smaller would be the additional implementation costs.
5. Much of the immediate administrative costs could be avoided by having S. 2204 affect only insurance contracts issued or renewed on or after the act's effective date. The other economic effects would still be felt, some to a lesser degree.

6. Virtually all of the economic impact could be avoided by changing S. 2204 to prohibit only sex-distinct pricing which is not supported by statistically demonstrated cost differences.

Congress, the courts, and the public must at some point decide what are fair practices in the context of insurance. There are no objective tests which can differentiate with certainty an individual's insurance risk from that of a group with similar risk characteristics. It is precisely this uncertainty that leads to the need for insurance. Therefore, some aspects of fair practices applicable in other contexts may not be appropriate or possible in the insurance context.

It is generally the position of the actuarial profession that insured individuals are treated fairly if they are charged prices which reflect the value of the risks they transfer to the insurance pool -- not simply as a matter of theoretical preference but as an important condition to the sound operation of insurance programs. Determining the value of the risks transferred necessarily involves the use of averages and classification variables; making the use of averages and class groupings essential to insurance. Consideration of what is fair or unfair in insurance should take place within that conceptual framework.

Jay C. Ripps, FSA, MAAA, EA
Chair
Committee on Risk Classification
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## APPENDIX A

## BACKGROUND INFORMATION ON THE AMERICAN ACADEMY OF ACTUARIES

The American Academy of Actuaries is a professional association of actuaries which was formed in 1965 to bring together into one organization all qualified actuaries in the United States and to seek accreditation and greater public recognition for the profession. The Academy includes members of three founding organizations - the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, and the Society of Actuaries.

The Academy serves the entire profession. Its main focus is the social, economic, and public policy environment in which the actuarial profession functions. Its primary activities include liaison with federal and state governments, relations with other professions, public information about the actuarial profession and issues that affect it, and the development of standards of professional conduct and practice.

Over 6,600 actuaries in all areas of specialization belong to the Academy. These members are employed by insurance companies, consulting actuarial firms, government, academic institutions, and a growing number of industries. Actuarial science involves the evaluation of the probabilities and financial impact that uncertain future events - birth, marriage, sickness, accident, retirement, and death - have on insurance and other benefit plans.

Membership requirements can be summarized under two broad headings: education and experience. At present, the education requirements can be satisfied either by passing certain professional examinations sponsored by the Casualty Actuarial Society or the Society of Actuaries, or by becoming an enrolled actuary under the Employees Retirement Income Security Act of 1974 (ERISA). The experience requirement consists of three years of responsible actuarial work.

## COMMITTEE ON RISK CLASSIFICATION

This Committee has the responsibility for keeping the membership of the Academy advised of major developments relating to risk classification that affect retirement plans, welfare plans and insurance, both governmental and private. It may also conduct or sponsor research on issues related to risk classification. It will also prepare reports, as appropriate, on such issues for dissemination to the membership and for submission to appropriate organizations, both governmental and private.

# STATEMENT 1982-24

August 18, 1982

Mr. Timothy Lucas
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Re: Review of Tentative Conclusions

Dear Tim:

I have reviewed the "Tentative Conclusions" draft which you recently distributed, at least in a broad overview fashion and have several comments to make. These written comments will confirm and expand upon the comments made at the Task Force meeting on Friday.

As I have stated on many occasions before, both to you and to the Board, while applauding the objectives of FASB to establish a sound conceptual framework for accounting for pensions (as well as other elements in the financial statement), the procedure should not proceed in a vacuum, and must recognize the practical effects of conclusions drawn. Unfortunately, I feel that the "Tentative Conclusions", taken as a whole, will lead to rather dramatic effects on both income statements and balance sheets of many corporations. The effects are not one-sided, but will vary widely from one corporation to another. In some situations pension expense and liabilities will become a critical element of the corporate income statement and balance sheet. The general areas I would like to discuss are indicated in the following paragraphs.

## Pension Expense Method

As you and the Board are well aware, there is no generally accepted single cost method favored by either actuaries or accountants, and in fact, there may be a variety of cost methods used for valuation of similar kinds of plans. However, generally the results produced by the family of projected benefit methods fall within a fairly narrow range for a given set of assumptions and single amortization period. While as an actuary I feel the desirability of flexibility in the selection of a cost method for both funding and expense determination, I understand the Board wishes to focus on a single cost method for pension expense accrual purposes.

I would think, however, that the desirable characteristics of a pension expense method are not that far different from a pension funding method, so the experience over the past 30 or 40 years of plan sponsors and actuaries in the selection of actuarial cost methods would seem be relevant for pension expense as well. However, the Board has selected the projected unit credit method for final average pay plans, which is probably the least-used cost method among the companies that will be affected by the FASB statement (probably used by at most 1% - 2% of such companies). The implications of adopting the proposed method are that 99% of the corporations affected by the statement either, (1) will have to adopt a dual accounting system, one for pension expense and one for funding, or (2) will have to change the funding method to that used for determining pension expense. The former could lead to considerable confusion as well as duplication of expense and effort by keeping two sets of books, while the latter could lead many companies to adopt weaker funding standards, leading to a lower benefit security for participants.

## Final Pay Versus Career Average

Even if one accepts the selection of the projected unit credit method for final pay plans as a single expense standard, I do not see the rationale for switching to the "unprojected" unit credit method for determining the pension expense for a career average plan. Final pay plans and career average plans are basically similar, the difference being only the pay base. Hence, I believe whatever method is used for final pay plans should be used for career average plans as well. Both plans are influenced by the effect of future pay changes, so why recognize it in final pay plans and not in career average plans? Also at what point does a final pay plan becomes a career average plan, or vice versa. I have worked with plans with "final" averaging periods of 3, 5, 10, 15 and even 30 years in determining the pay base. At what point does one have a final pay plan and what point is it a career average plan?

## Pension Expense Determination

If I understand correctly "Expense Recognition" in paragraph 9 of the draft, the pension expense for year" X" could not be determined until the actuarial valuation of the plan at the end of fiscal year X had been completed. This is totally impractical, since many valuations for larger corporations are not completed until 6 to 8 months following the completion of the fiscal year, or many months after the publication of the Company's financial statement. Companies need to know, at least reasonably closely, the amount of pension expense they will be accruing during the year, and need to know the exact number shortly after the close of the fiscal year in order to close their books for the year. This is the same problem that arose when an earlier exposure draft of FASB #35 also required year end valuations, however, the Board changed this.

Asset Value

Paragraph 13 of the statement refers to statement #35, which requires measurement of assets at "fair value" for pension expense determination. In general, most actuaries (as well as company management), believe that the single market value at a given date is not an appropriate measurement either for pension funding purposes or for pension expense purposes, since pensions are truly a long term obligation and costs should not respond totally to day-to-day fluctuations in market value. This is a reason why actuaries over the years have developed a number of suitable smoothing methods for asset values. While there may be some argument in favor of reporting a market value for disclosure purposes in connection with the pension plan financial statement, I think it is inappropriate to require the use of market value of assets for pension expense determination, particularly when combined with some of the other features of this draft.

The use of fair market value in some situations would have a dramatic effect on the amount of pension expense of a company for the year, as well as its reported liabilities on the balance sheet. The impact on the income statement could be substantial, particularly for an overfunded plan, and have a major influence on company profits, the value of company stock, incentive compensation payments to key executives, contributions to employee profit sharing plans, etc. Because use of market value will be so influential in determining the pension expense for the year, such a decision could have a significant effect on capital markets. An assistant trust officer sitting in the Gotham City office of the Citmorchase Trust Company may well be determining the incentive compensation bonus to the Chief Executive of his client for the following year by his investment strategy. The proposal would seem to encourage plan sponsors to move their funds into investments that would show considerable stability, such as insured guaranteed investment contracts. The broad rules adopted by the Internal Revenue Service for the valuation of assets for minimum funding purposes would seem much more appropriate for determining pension expense.

Past Service Amortization

The proposed methodology for determining the pension expense related to past service amortization will produce some very unexpected results and produce chaos on some companies' financial statements. Considering the length of time and the depth of various philosophical and theoretical discussions concerning the determination of pension expense, it is surprising to see an arbitrary "Rule of 200" proposed for determination of a key part of the pension expense.

As I understand it, the first step in the process of determining the amortization payment is to determine the average future work life expectancy of the covered group of employees, taking into account future withdrawals, early retirements, deaths, disabilities, etc. Further, the draft states that the determination is to include retired employees, which I presume would be entering the computation as "0" future working life expectancy. This number is then divided into 200 to determine the percentage of the intangible asset that is written off as an expense each year. Thus, if the average future working life expectancy turned out to be 10 years for a group, this part of the equation would call for writing off 20% of the intangible asset in the first year.

In addition to this write-off of the intangible asset, the pension expense for the year is based upon the increase in the net liability during the year, which means that interest on the unfunded liability would be included as a part of the pension expense. Thus, if a plan were using a 7% interest rate, using the example above, the total "past service" expense for the year would amount to 27% of the unfunded liability, which is approximately double the amount that could be taken as a tax deduction by the employer.

In addition to the fact that this approach would never result in reducing the intangible asset to zero (because it is a constant percentage of diminishing balance), the major problem I see in this is a very practical one. The average future working lifetime for some employee groups, particularly ones that include a mature retired group, can be very short.

We have made a number of tests on various employee groups and various assumed turnover rates, in order to get some feeling of the potential impact of this rule. Further, in the case of a few very large clients we estimated the effect of the rule to determine what the impact on the pension expense would have been if applied to 1981.

We first tested some of our commonly used service tables representing moderate, intermediate and high turnover against three groups of employees who might be characterized as young (average age 32), typical (average age 41) or old (average age 49); the age 32 and age 49 groups would, in fact, be extremes. We assumed that with the young group there would be 15% of total employee group retired, for the average group 25% would be retired, and for the old group about 40% retired. All of these tests were made assuming that there were no subsidized early retirement benefits, so that all employees who did not withdraw (vested or non-vested), die, or become disabled would work until age 65. For illustrative purposes, we assumed a valuation rate of interest of 7% in determining the interest portion of the expense. The results of our analysis are shown in Exhibit A attached.

Based on these illustrative situations, we estimated that for the very youngest group, the amortization factors applicable to the intangible asset (initially equals the unfunded liability) for expense purposes would generally range from about 25% - 30%. For the average age group, more typical of most plans, the range in past service amortization would typically be from approximately 24% to 30%. For the relatively old group, the past service contribution would generally be close at 30%. Considering that the maximum past service amortization permitted for a method that determines an accrued actuarial liability under the Internal Revenue Code amounts to approximately 14 to 15% of the accrued liability (including interest), it appears that for a number of years at least, the pension expense determined by this formula would always exceed the maximum amount permitted as a deduction for tax purposes. Thus, we can conclude that every company would have to have at least two sets of books in determining its pension expense and funding levels.

On a more realistic level we have calculated the specific average future work life expectancies for two of our largest clients, which are among the largest in the country. One of these companies is currently contributing at the maximum rate permitted for tax deduction purposes under the Internal Revenue code. The company is in an industry that has experienced cutbacks in employment and currently has a sizeable group of laid-off or furloughed employees (about 25% - 30%), many of whom would become vested on final termination. The pertinent statistics are as follows:

| | | Hourly | Salaried |
|---|---|---|---|
| 1. | Average Attained Age - Actives | 46.3 yrs. | 44.3 yrs. |
| 2. | Average Work-Life Expectancy | | |
| | a. Actives Only | 8.0 yrs. | 8.8 yrs. |
| | b. Actives, Retired & Terminated Vested | 3.4 yrs. | 5.1 yrs. |
| | c. Item b. + Layoffs, Leaves and Transfers | 3.0 yrs. | 4.4 yrs. |
| 3. | "Rule of 200" Factors | | |
| | a. Actives Only | 25.0% | 22.7% |
| | b. Actives, Retired & Terminated Vested | 58.8% | 39.2% |
| | c. Item b. + Layoffs, Leaves and Transfers | 66.7% | 45.5% |
| 4. | Total Amortization of Intangible Asset (Including 7% Interest) | | |
| | a. Actives Only | 32.0% | 29.7% |
| | b. Actives, Retired & Terminated Vested | 65.8% | 46.2% |
| | c. Item b. + Layoffs, Leaves and Transfers | 73.7% | 52.5% |
| 5. | Ratios: Proposed FASB Expense 1/ ÷ Actual 1981 Pension Expense 2/ | | |
| | a. Actives Only | 1.41 | 1.34 |
| | b. Actives, Retired & Terminated Vested | 2.95 | 1.77 |
| | c. Item b. + Layoffs, Leaves and Transfers | 3.30 | 1.92 |

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1/ Based on current assumptions (including 7% interest) and FASB recommended funding methods for each plan.

2/ Based on aggregate cost method; maximum tax deductible contribution.

The increase in pension expense based on Item 5.c. represents 8% of the sales of the operating unit (which has over $2 billion in sales).

In a second case, we have examined the hourly plan of a company, and, following the same procedures outline above, we found an average future work-life expectancy of 11.1 years for actives, or 8.1 years for actives and retired combined. This would result in a total amortization factor of 31.7% of the unfunded. In the salaried plan, the write-off similarly calculated would be approximately 28%. We have not calculated the direct dollar effect of the salary plan (because it involved a revaluation on a different funding method), but in the case of the hourly plan we estimate that the pension expense determined by the FASB method would be approximately 235% of the current pension expense, which is determined by what would otherwise be deemed to be a reasonably conservative funding approach.

In the case of two other very large U.S. corporations, we have a reverse effect, created by the requirement that the pension expense for career average plans be determined by the "unprojected" unit credit. In both cases, it is estimated that the pension expense for 1981 would be less than half of that recorded.

In summary, I believe that the tentative conclusions of the Board will produce unforeseen and unnecessary aberrations in company earnings statements and balance sheets. The "Rule of 200" is probably the most objectionable feature. There are a number of alternative approaches which could be used to amortize the intangible asset (unfunded actuarial liabilities), such as spreading as a percentage of the future compensation of employees, using a fixed amortization period related to the average future working life expectancy, and/or establishing a maximum percentage of the intangible asset that will be recognized in any fiscal year.

I hope that these comments will be of help to you in your consideration of these issues.

Sincerely,

Edwin F. Boynton
Actuary

EFB:da

Attachment

Exhibit A

## Determination of Future Work Life Expectancies and Amortization Expense under FASB Tentative Conclusions, Assuming Normal Retirement Age 65 and No Early Retirement

| | | Young Group | Average Group | Old Group |
|---|---|---|---|---|
| 1. | Average Age- Actives | 32.2 | 41.1 | 49.0 |
| 2. | Average Work Life Expectancy - Actives (w/o early retirements) | | | |
| | a. Moderate Turnover | 16.1 yrs. 1/ | 14.4 yrs. | 12.6 yrs. 2 |
| | b. Intermediate Turnover | 12.6 yrs. | 12.2 yrs. 2/ | 11.8 yrs. |
| | c. Heavy Turnover | 10.2 yrs. 2/ | 10.7 yrs. | 11.2 yrs. 1 |
| 3. | Assumed Ratio of Retired and Inactives | 15% | 25% | 40% |
| 4. | Work Life Expectancies Adjusted for Retired and Inactives | | | |
| | a. Moderate Turnover | 14.0 yrs. 1/ | 11.5 yrs. | 9.0 yrs. 2 |
| | b. Intermediate Turnover | 11.0 yrs. | 9.8 yrs. 2/ | 8.4 yrs. |
| | c. Heavy Turnover | 8.9 yrs. 2/ | 8.6 yrs. | 8.0 yrs. 1 |
| 5. | "Rule of 200" Factors (200 ÷ Item 4) | | | |
| | a. Moderate Turnover | 14.3% 1/ | 17.4% | 22.2% 2/ |
| | b. Intermediate Turnover | 18.2% | 20.4% 2/ | 23.8% |
| | c. Heavy Turnover | 22.5% 2/ | 23.3% | 25.0% 1/ |
| 6. | Total Intangible Asset Amortization Factor, Assuming 7% Interest | | | |
| | a. Moderate Turnover | 21.3% 1/ | 24.4% | 29.2% 2/ |
| | b. Intermediate Turnover | 25.2% | 27.4% 2/ | 30.8% |
| | c. Heavy Turnover | 29.5% 2/ | 30.3% | 32.0% 1/ |

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1/ Unlikely combinations.
2/ Most likely combinations.

# STATEMENT 1982-25

No. 82-52

IN THE
**Supreme Court of the United States**
OCTOBER TERM, 1982

ARIZONA GOVERNING COMMITTEE
FOR TAX DEFERRED ANNUITY
AND DEFERRED COMPENSATION PLANS,
STATE OF ARIZONA, *et al.*,
*Petitioners,*
v.

NATHALIE NORRIS, on behalf of herself and
all others similarly situated,
*Respondents.*

**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

**BRIEF OF AMERICAN ACADEMY OF ACTUARIES AS AMICUS CURIAE IN SUPPORT OF THE PETITION**


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In The
# Supreme Court of the United States
October Term, 1982

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No. 82-52

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Arizona Governing Committee
For Tax Deferred Annuity
And Deferred Compensation Plans,
State of Arizona, *et al.*,
*Petitioners*,
v.

Nathalie Norris, on behalf of herself and
all others similarly situated,
*Respondents.*

---

**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

---

## BRIEF OF AMERICAN ACADEMY OF ACTUARIES AS AMICUS CURIAE IN SUPPORT OF THE PETITION

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This brief is filed on behalf of the American Academy of Actuaries, as amicus curiae, in support of the petition for certiorari filed in this case. Consent from counsel for both sides has been filed with the Clerk of this Court.

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## INTEREST OF THE AMICUS

The American Academy of Actuaries (the "Academy") was formed in 1965 as a national accrediting organization by three existing national actuarial organizations—Casualty Actuarial Society, Conference of Actuaries in Public Practice, and Society of Actuaries (the "founding organizations"). The Academy and its founding organizations, or their predecessors, have represented the actuarial profession in the United States for over 90 years. There are currently more than 7,000 members of the Academy. A substantial number of these actuaries are engaged in the determination of the value of annuities offered by insurance companies, in the design and administration of employee retirement plans, and in helping to ensure the financial soundness of those plans.

This case involves those provisions of Title VII that make it unlawful for an employer "to discriminate against any individual with respect to his compensation . . . because of such individual's race, color, religion, sex, or national origin . . . ." 42 U.S.C. § 2000e-2(a)(1) (1976). At issue is how this phrase is to be interpreted where part of the amounts paid to an employee in return for services are not received by the employee currently but are received at a later time and may be contingent upon continued employment for a given period or upon how long the employee lives. In this context, "compensation" can mean either the amounts paid or set aside by the employer at the time the work is performed for the purpose of making payments in the future, or the retirement benefits or amounts received by the employee at or after retirement, or, conceivably, both. The issue is a subtle and intricate one. Its correct determination, we believe, requires a full understanding of the relationship between the dollar amounts received by the employee and the cost to the employer of providing those benefits. This relationship is central to the work of the actuary who practices in the pension area.

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Actuarial work requires special training and experience and an understanding of a branch of mathematics—actuarial science, which includes the theory of probability and statistics—without which anyone dealing with averages and the classification of risks can fall rather easily into serious error. We are, accordingly, in the unique position of being able to offer the Court accurate information about the structure and operation of employee retirement plans that would be helpful in the consideration, and perhaps essential to the correct resolution, of this case.

## REASONS FOR GRANTING THE WRIT

The decision below extends significantly the decision of this Court in *Los Angeles Department of Water & Power* v. *Manhart*, 435 U.S. 702 (1978). That case involved a contributory defined benefit pension plan which required greater contributions by women employees than by men. Plans of that kind had almost never been adopted by private corporations and only infrequently by governmental entities. This case involves a voluntary savings and investment arrangement that permits employees of the State of Arizona to accept reduced current compensation in exchange for payments at a later time, a plan generally known as a deferred compensation plan. See I.R.C. § 457 (Supp. IV 1980). These plans are in widespread use and are significant in themselves. The decision below, however, if allowed to stand, will almost surely apply to an even more important class of retirement plans, namely, defined contribution pension and profit sharing plans.[1] It is also very likely to affect the structure of a still broader type of retirement plan,

---

[1] It is under these plans that employers provide benefits for similarly situated men and women that have an actuarially equal present value but may be paid to the employees in monthly amounts that are not equal.

4

namely defined benefit pension plans.[2] It may also apply to still other forms of insured plans.[3]

The practical implications of the application of the decision to these broader classes would be serious. For example, many owners of small businesses and many governmental bodies have adopted defined contribution plans because they believe it essential to fix precisely and in advance the cost of providing retirement benefits for their employees. If the decision is allowed to stand, those employers are likely to refrain from providing benefits in the form of annuity payments that would last for the lifetimes of their employees—something which, had the decision below been different, could have been done without the danger of undesired and unexpected increases in cost. It was precisely those kinds of lifetime annuity benefits, however, that Congress sought to foster by providing favorable tax treatment for these plans. If the decision below stands, many hundreds of thousands, perhaps millions, of employees may well enjoy less attractive retirement benefits because their employers, unable to provide an annuity option without adding to the cost of the plan, will decide to drop the option. In addition, many thousands of employers who had justifiably believed that their plans were fully funded will be required to pay substantial additional amounts.

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[2] Statistics compiled by the American Council of Life Insurance indicate that by the end of 1980 the assets of trusteed pension and profit sharing plans amounted in the aggregate to $256,898,000,000. American Council of Life Insurance, 1981 Pension Facts 19. By far the largest part of this huge sum is held under defined benefit pension plans. These plans are ordinarily adopted by larger and medium-sized corporations. They have, for the most part, provided for pensions in identical monthly amounts for similarly situated retired men and women employees. Title VII is likely to affect such plans to the extent that they provide optional forms of retirement benefits, however, since such annuity options are often based on sex-distinct factors.

[3] See *infra* note 4.

5

Affected also will be private insurance companies, the efficient conduct of whose businesses requires that the prices charged for the assumption of risks be related as closely as possible to the costs resulting from the several classes of persons transferring those risks.[4]

It may be that Congress adopted a law that compels these results. But the decision below reflects a serious lack of understanding of the subject matter and, for that reason, does not provide the authoritative interpretation of the applicability of Title VII to employee retirement programs that is essential to those engaged, as we are, in the design and administration of those programs. Because *Manhart* applied only to a narrow and not very significant class of plans, it also did not provide that interpretation. This case, however, applies to retirement programs of far greater practical significance and provides the opportunity for such an interpretation. A decision by this Court would bring clarity to an area that is now confused and uncertain.

[4] A direct result, if the decision below stands, is likely to be a substantial reduction in the business of life insurance companies, resulting from the decreased provision by employers of lifetime benefits. Indirect impacts may be much greater. To take one example, state insurance laws and regulations require that group life and health insurance contracts provide a terminating employee with the right to convert to an individual life or health insurance policy at individual rates used by the insurer. These individual rates are always sex-distinct, that is, they are different for males and females for the same coverage. An insurer could not merely create a set of unisex rates for such conversion while using sex-distinct rates on other individual insurance since that, too, would be in violation of state law. If the decision below extends to such plans, and there is reason to believe that it might, escape from this quandary will be difficult and would result in a major change in the way insurance companies conduct their business, notwithstanding the disclaimer of such a result in *Manhart*.

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## CONCLUSION

For the reasons set forth above, the writ of certiorari should be granted.

Respectfully submitted,

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August, 1982

STATEMENT 1982-26

# AMERICAN ACADEMY OF ACTUARIES

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WILLIAM A. HALVORSON, M.A.A.A., President
c/o MILLIMAN & ROBERTSON, INC.
200 EXECUTIVE DRIVE
BROOKFIELD, WI 53005
414/784-2250

August 19, 1982

The Honorable Roger Day
Vice President and Chairman
Executive Committee
National Association of
Insurance Comissioners
Commissioner of Insurance
State of Utah
326 S. Fifth Street
Salt Lake City, Utah 84102

Dear Roger:

The Academy appreciates your continued interest in hearing our ideas of forming a multi-professional advisory or consultative group to the NAIC's Executive Committee. As we discussed with you, first in Oklahoma City and later in Salt Lake City and Philadelphia, this Group would be a consultative resource to the Executive Committee on the broad implications of possible changes in insurance regulation to the extent that such changes had either actuarial implications or would affect solvency of companies or plans.

Because of this Group's broad interests, it would not be expected to be an operating committee, but it would be able to provide an overview function in monitoring the progress of various technical subcommittees or professional advisory committees. The Chairman of the Executive Committee could then call on this group to give reactions or to input new ideas on issues involving actuarial matters, solvency or guaranty funds. He could also expect to receive advice on structuring various task forces involving non-state staff personnel so as to maximize responsiveness to short and long range problems.

Perhaps a brief outline of this proposal would be of help.

Name of Committee

Actuarial Liaison Group to NAIC Executive Committee

Reports to Chairman, Executive Committee

The Honorable Roger Day
August 19, 1982

Description of Duties

At the request of the Chairman of the Executive Committee, the Actuarial Liaison Group would provide reactions and ideas relating to actuarial matters or solvency issues. In addition, the Group would monitor the progress of various non-state professional or industry task forces or special committees, and advise the EC Chairman on structuring of such committees to assure maximum progress on addressing short and long range actuarial or solvency issues. The Group would also be prepared to take on other relevant tasks, as requested by the EC Chairman.

Need for This Actuarial Liaison Group

The last few years of high inflation and interest rates has had a major impact on the viability of life, health and casualty insurers, and has created an atmosphere of dynamic changes in the competitive and regulatory environment. Rapid change has strained the actuarial and other resources of the NAIC and of the professional and industry groups that advise it. The presence of the Actuarial Liaison Group should provide the NAIC with both long range insights and short range pragmatism in better coping with the changing environment.

Composition of the Group

3 members from the American Academy of Actuaries (probably the chairmen of its insurance steering committees of life, health, and property and liability)
2 insurance department examiners
2 insurance department staff actuaries
2 attorneys in private insurance practice

The Group chairman would be selected by Chairmen of the Executive Committee. Because of the need for active participation by actuarial professional groups, the Academy believes that it can help facilitate Executive Committee discussion of actuarial issues by being available directly to the Chairman of the Executive Committee. It is likely that the same belief is held by both insurance department examiners and actuaries. The presence of private practice attorneys experienced in solvency and actuarial matters will help provide the balance needed in advising on regulatory matters.

Date of Implementation

The Actuarial Liaison Group would meet at the December 1982 meeting of the NAIC, and subsequently at the pleasure of the Executive Committee Chairman.

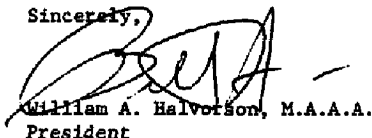
The Honorable Roger Day
August 19, 1982

Summary

To a certain extent, Roger, this may appear to be somewhat like a "kitchen cabinet" for the Executive Committee Chairman, and perhaps it is. As such, it can be effective, without publicity, and its informality has led me to call it a liaison or consulting group, rather than a committee.

Please feel free to react to these preliminary thoughts. We stand ready to discuss this or any other arrangement that would help you or the Executive Committee.

Sincerely,



William A. Halvorson, M.A.A.A.
*President*

WAH/bh

cc: William Hager, AAA General Counsel
& Director of Government Relations
P. Adger William, AAA President-Elect
Stephen D. Kellison, AAA Executive Director

# STATEMENT 1982-27

# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

WILLIAM D. HAGER
GENERAL COUNSEL AND DIRECTOR
OF GOVERNMENT RELATIONS

August 24, 1982

Administrator, Health Care Financing Administration
Department of Health & Human Services
P. O. Box 17073
Baltimore, MD 21235

Re: BPP-91-FC
HCFA Medicare Supplemental Certification Program

This letter is submitted on behalf of the Academy's Committee on Health Insurance pursuant to the invitation at 47 FR 32390 to provide additional comments with respect to HCFA's interim final regulations relating to the federal program of certification for Medicare supplemental health insurance policies. As the record in this matter shows, the Academy has previously submitted extensive comments with respect to the regulations, and we commend HCFA for its careful consideration of the comments we provided at that time.

Since the publication of the proposed Medicare regulations, the Academy has initiated a new program which is relevant here. To assist regulators in evaluating the qualifications of individuals who are not members of the American Academy of Actuaries, but who are performing actuarial services for health service corporations, the Academy recently prepared a voluntary program for recognition of such individuals as qualified health service corporation actuaries. Recent developments indicate a potential need for regulatory officials to know who should be considered a qualified actuary both with regard to statements of opinion on actuarial items in the annual statement blanks (of the NAIC) for health maintenance organizations and for hospital, medical, and dental service and indemnity corporations and with regard to filings of Medicare supplemental policies. That program has now been implemented.

We believe those individuals who have passed the Academy's health service corporation exam (including the requirement of at least 7 years full-time actuarial work) show proficiency to provide the actuarial opinion contemplated under § 403.258. We would like to bring the program to your attention and also urge that domiciliary commissioners give positive consideration to such individuals as "a person who has otherwise demonstrated his/her actuarial competence to the satisfaction of the commissioner...."

In the event HCFA determines this program to be appropriate for full consideration, we suggest you may wish to consider the following amendatory language to section 403.258:

> "A member in good standing of <u>or a person otherwise recognized by</u> the American Academy of Actuaries, or a person who has otherwise demonstrated his/her actuarial competence to the satisfaction of the commissioner..."

I have attached to these comments a full description of the program including the syllabus, its focus, method of implementation, and final application.

Yours very truly,

William D. Hager
General Counsel and
Director of Government Relations

WDH:jlh

Attachment

# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

December 1981

To Whom It May Concern:

Recent developments indicate a potential need for regulatory officials to know who should be considered a qualified actuary both with regard to statements of opinion on actuarial items in the annual statement blanks for health maintenance organizations and for hospital, medical, and dental service and indemnity corporations and with regard to filings of Medicare supplement policies.

To assist regulators in evaluating the qualifications of individuals who are not members of the American Academy of Actuaries but who are performing actuarial services for health service corporations, the Academy has prepared a voluntary program for recognition of such individuals as qualified health service corporation actuaries. This will be available to persons who meet experience and examination criteria set by the Academy.

We ask for your help in promulgating the notification of this program to persons who may wish to participate in it. The attached pages contain more detailed information about the program.

Committee on Health Qualifications

# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

The American Academy of Actuaries has prepared a voluntary program for recognizing individuals as qualified Health Service Corporation Actuaries. This program is open to persons who are not members of the American Academy of Actuaries who meet the following experience criteria as of the examination date:

> The equivalent of at least seven years of full-time responsible actuarial work, including the equivalent of at least three years of full-time responsible actuarial work for Health Service Corporations.

For these purposes, "Health Service Corporation" includes any organization providing hospital, medical, or dental benefits on a service basis, and, therefore, specifically includes Blue Cross and Blue Shield Plans, Delta Dental Plans, health maintenance organizations, and similar institutions.

Persons meeting these experience criteria are eligible to submit an application to take an examination to exhibit adequate knowledge of actuarial principles and practices in the following areas:

- Principles of Insurance, Underwriting and Professionalism
- Ratemaking
- Financial Statements
- Mathematics of Finance and Insurance
- Social Insurance

The examination will be jointly administered by the Society of Actuaries and the Casualty Actuarial Society. Current plans call for the Ratemaking and Financial Statements portions of the examination to be essay, with the balance multiple choice. A minimum standard for passing will apply to each subject, as well as to the examination as a whole.

A candidate who successfully completes the examination will be recognized as a qualified Health Service Corporation Actuary by the American Academy of Actuaries. Note that this is special recognition and is not equivalent to membership in the American Academy of Actuaries.

A person who meets the experience requirements and is interested in taking the examination should complete the attached application, have it signed by two members of the American Academy of Actuaries, and submit it along with the required $25.00 non-refundable application fee to the American Academy of Actuaries' office. For persons wishing to sit for the examination in May 1982, the application must be received in the American Academy of Actuaries' office no later than February 1, 1982. The examination will be repeated at least once, but probably no more than three times.

All applications will be reviewed for completeness by the American Academy of Actuaries. Applicants who do not establish adequate proof of meeting

experience criteria will be so notified. Applicants who do meet all experience criteria will receive an examination syllabus, sample examination questions, and notification of time and places that the examination will be given. This material should be available in February 1982. An additional fee will be required to take the examination.

To assist potential applicants in evaluating the type of material the examination will cover, a preliminary reading list has been attached to this notice. Applicants should be advised that this preliminary reading list is intended to assist them in evaluating the scope of material to be covered. However, it may be revised over the next several months. An order form for study material is also attached.

AMERICAN ACADEMY OF ACTUARIES
APPLICATION TO DETERMINE ELIGIBILITY OF APPLICANT TO TAKE THE WRITTEN EXAMINATION FOR THE RECOGNITION OF HEALTH SERVICE CORPORATION ACTUARIES

To be eligible for recognition as a qualified Health Service Corporation Actuary, the candidate, as of the examination date, must have completed the equivalent of at least seven years of full-time responsible actuarial work, including the equivalent of at least three years of full-time responsible actuarial work for Health Service Corporations. For these purposes, "Health Service Corporation" includes any organization providing hospital, medical, or dental benefits on a service basis, and, therefore, specifically includes Blue Cross and Blue Shield Plans, Delta Dental Plans, health maintenance organizations, and similar institutions. A $25.00 non-refundable application fee must be enclosed with this application.

Applicant's Name ______________________________

Applicant's Position ______________________________

Employer Name ______________________________

Employer Address ______________________________

Business Phone No. ______________________________

Home Address ______________________________

Home Phone No. ______________________________

Attach a list of position(s) held, in chronological order, describing the actuarial function(s) you performed and the level of responsibility you held. The position description should include:

Employer

Dates Employed

Title and description of position held in detail indicating level of responsibility

Are you now or have you ever been a member of the American Academy of Actuaries? ________

I hereby affirm that the information contained in this data form is correct and you have my permission to make any inquiries deemed necessary for verification.

Date ________________ ______________________________
Signature of Applicant

AMERICAN ACADEMY OF ACTUARIES
APPLICATION TO DETERMINE ELIGIBILITY OF APPLICANT TO TAKE THE WRITTEN EXAMINATION FOR THE RECOGNITION OF HEALTH SERVICE CORPORATION ACTUARIES

Sponsor's Certification

I certify that to the best of my knowledge the applicant has honestly and accurately described his or her actuarial experience.

| Sponsor's Name and Signature | Company Affiliation | Date of Academy Membership |
|---|---|---|
| 1. ______ | | |
| ______ | | |
| 2. ______ | | |
| ______ | | |

Return with non-refundable application fee to:

American Academy of Actuaries
208 South LaSalle Street
Chicago, Illinois 60604

# AMERICAN ACADEMY OF ACTUARIES

## Health Service Corporation Actuaries Examination Study Material Order Form

Quantity

☐ SOCIETY OF ACTUARIES STUDY NOTES - $12.00

| | |
|---|---|
| 10GB-103-77 | Group Insurance Dividends and Experience Refunds |
| 10GB-101-72 | Group Insurance Premium Development |
| 7BA-105-76 | Gross Premiums from Group Life and Health Insurance |
| 10GB-104-79 | Group Experience Studies |
| 10GB-304-78 | Morbidity Investigations and Tables |
| 10GB-302-81 | Individual Health Insurance Loss Ratios |
| 10GB-303-81 | Gross Premiums for Individual Health Insurance |
| 10GB-210-81 | Life Insurance Company Accounts |
| 9GB-117-78 | The Blue Cross and Blue Shield System in the U.S. |
| 9GU-202-76 | HMOs Self Insurance and Certain Group Coverages in the U.S. |

☐ REPRINTS - SOCIETY OF ACTUARIES - $6.00

| | |
|---|---|
| TSA XXXI | Group Dental Expense Insurance Experience |
| TSA XXXI | The Individual Accident and Health Loss Ratio Dilemma |
| TSA XVI | Health Insurance Claim Reserves and Liabilities |
| RSA 6 | Impact of Inflation in Group Insurance |

☐ REPRINTS - CASUALTY ACTUARIAL SOCIETY - $6.00

| | |
|---|---|
| PCAS LX | A Survey of Loss Reserving Methods |
| PCAS LXIV | Loss Reserve Adequacy Testing: A Comprehensive, Systematic Approach |

☐ REPRINTS - AMERICAN ACADEMY OF ACTUARIES - $2.50
- Guides to Professional Conduct
- Exposure Draft - Qualifications Standards
- Exposure Draft - Blues and HMOs Statements of Actuarial Opinion

☐ REPRINT - BLUE CROSS/BLUE SHIELD ASSOCIATION - $4.50
- Competitive Underwriting (Chapters 1-3)

☐ REPRINTS - NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS - $4.00
- Blank for Hospital, Medical, and Dental Services and Indemnity Corporations with Instructions
- HMO Blank with Instructions
- Guide to Health Insurance for People with Medicare

☐ REPRINTS - VARIOUS READINGS ON HMOs - $6.00

☐ REPRINTS - VARIOUS READINGS ON CONTINGENCY RESERVES - $3.00

☐ TOTAL PACKAGE CONSISTING OF ALL THE ITEMS LISTED ABOVE $36.00

Return this form with payment to: American Academy of Actuaries
208 South LaSalle Street
Chicago, Illinois 60604

American Academy of Actuaries

Preliminary Reading List for Examination
for Health Service Corporation Actuaries

Note: No questions will be asked on life or loss-of-time (disability income) coverages, though references to these coverages may be contained in the reading material.

Part 1. Principles of Insurance, Underwriting and Professionalism 20 Points

Guides to Professional Conduct, American Academy of Actuaries

Life and Health Insurance Handbook, Third Edition, by Davis W. Gregg and Vane B. Lucas, Chapters 3 (pp 27-34), 24 and 29. (Chapters 21 and 28 provide valuable background information.)

Competitive Underwriting, by Blue Cross and Blue Shield Associations, Chapters 1 through 3.

Study Note - "HMOs, Self Insurance, and Certain Group Coverages in the U.S." S.O.A. 9GU-202-76, (pages 1-12 only).

Study Note - "The Blue Cross and Blue Shield System in the United States" S.O.A. 9GB-117-78.

Exposure Draft - Qualification Standards to sign statements of actuarial opinion on NAIC annual statement blanks.

Exposure Draft - Statement of actuarial opinion language for other annual statement blanks.

Preliminary Reading List for Examination (cont'd)

**Part 2. Ratemaking** **30 Points**

Study Note - "Group Insurance Dividends and Experience Refunds" S.O.A. 10GB-103-77

Study Note - "Group Insurance Premium Development" S.O.A. 10GB-101-72

Study Note - "Gross Premiums for Group Life and Health Insurance" S.O.A. 7BA-105-76

Study Note - "Group Experience Studies" S.O.A. 10GB-104-79

Study Note - "Morbidity Investigations and Tables" S.O.A. 10GB-304-78

Study Note - "Individual Insurance Loss Ratios" S.O.A. 10GB-302-81

"Group Dental Expense Insurance Experience" by R.E. Ullman, T.S.A. XXXI, pp 287-317

Study Note - "Gross Premiums for Individual Health Insurance" S.O.A. 10GB-303-81 (exclude Section 4)

"Impact of Inflation in Group Insurance Record" S.O.A. Volume 6, pp 787-806

"The Individual Accident and Health Loss Ratio Dilemma" by J.B. Pharr, T.S.A. XXXI, pp 373-387

HMO Rating Information - Sources to be identified later.

Preliminary Reading List for Examination (cont'd)

Part 3. Financial Statements 30 Points

Note: A basic understanding of accounting is assumed. Elementary Accounting by Royal D.M. Bauer and Paul Holland Darby, College Outline Series No. 150, or any similar text, may be studied, if necessary. No questions will be asked that directly relate to such material, however.

Study Note - Introductory study note on NAIC Blanks - to be developed

Copy of Convention Blanks with Instructions - Blank for Hospital, Medical and Dental Service and Indemnity Corporations and Blank for Health Maintenance Organizations

Study Note - "Life Insurance Company Accounts" S.O.A. 10GB-210-81, 10LB-604-81

Study Note - "Financial Reporting and the Actuary" S.O.A. 10LB-601-76 (excluding the appendix)

"Health Insurance Claim Reserves and Liabilities," by John M. Bragg, T.S.A. XVI, Part I

"A Survey of Loss Reserving Methods," by Wayne H. Fisher, P.C.A.S. LX

"Loss Reserve Adequacy Testing: A Comprehensive Systematic Approach," by Richard E. Sherman and James R. Berquist, P.C.A.S. LXIV

Contingency Reserve Evaluations - source to be identified later

HMO Accounting - sources to be identified later

Preliminary Reading List for Examination (cont'd)

Part 4. Mathematics of Finance and Insurance 10 Points

Fundamental Mathematics of Life Insurance, by Floyd S. Harper and Lewis C. Workman, Chapters 3 through 6.

Part 5. Social Insurance 10 Points

Social Security, Second Edition, by Robert J. Myers, Chapters 6, 8 (pp 465-485), 9 (pp 500-507), 10 (pp 551-563), 11 (pp 614-617), and appendix D.

Determination of Reasonable Charges Under Part B of Medicare, A Basic Text, U.S. Department of Health, Education and Welfare Health Care Financing Administration.

Medicare Supplement Information Handbook, Department of Health and Human Services and National Association of Insurance Commissioners.

STATEMENT 1982-28

# AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

WILLIAM D. HAGER
GENERAL COUNSEL AND DIRECTOR
OF GOVERNMENT RELATIONS

August 25, 1982

David Rosenauer
Senior Legislative Assistant
1026 Longworth Building
Washington, D.C. 20515

Re: Amendments to H.R. 6114

Dear David:

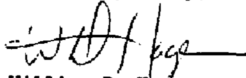
We enjoyed meeting you earlier this year in connection with H.R. 6114, and again at the education forum on June 23rd. In response to the request issued at that June meeting, the Academy has enclosed with this letter its suggested amendments to improve H.R. 6114. We are commenting at this time only on the qualifications of the actuary, and not other aspects of the bill.

I have also enclosed a brief memorandum that outlines the foundation and reasoning behind our proposed amendments.

We may provide further comments on the bill at a future date. We are examining certain definitions within the bill. We are also interested in meeting with you to review loss reserving standards within the actuarial professional generally.

As always, if any of the material raises any particular questions, please let me know.

Yours very truly,



William D. Hager
General Counsel &
Director of Government Relations

WDH:jlh

Attachment

AMENDMENT OFFERED BY THE AMERICAN ACADEMY OF ACTUARIES

to

H.R. 6114

August 25, 1982

1. Amend page 2, lines 14-17 as follows:

   "(A) an amount determined by ~~an independent~~ a qualified actuary or other person recognized as a qualified loss reserve specialist by any state insurance department using generally accepted actuarial ~~methods~~ principles as the appropriate contribution to the trust or reserve account. A qualified actuary is a member of the American Academy of Actuaries."

MEMORANDUM

TO: David Rosenauer

FROM: William D. Hager

RE: Memorandum in Support of Proposed Academy H.R. 6114 Amendment

DATE: August 25, 1982

This memorandum is designed to accompany Academy comments and proposed amendatory language with respect to H.R. 6114. These comments are submitted on behalf of the Committee on Property and Liability Insurance ("Committee") of the Academy (Attachment A provides a further description of both the Academy and that Committee).

Academy Membership

The Academy proposal, modest in nature, finds significant precedent at both the federal and state level. The language we propose recommends Academy membership (or alternatively, recognition as a loss reserve specialist by any state insurance department) for those who sign the statement of actuarial opinion on the adequacy of loss reserves.

Lest some conclude that this proposal is simply an attempt at "organization aggrandizement," it may be worthwhile to emphasize the following in connection with the actuarial opinion contemplated under H.R. 6114: (1) There is no relevant state or federal licensure of actuaries such as that found in the medical, dental and legal professions; (2) professional actuarial societies have filled the "licensure" role, and bestow widely recognized professional designations; (3) the Academy represents the relevant designation-granting organizations and their constituency; and (4) as a result, Academy membership (M.A.A.A.) has been frequently recognized by reference in governmental qualification matters.

Comparable Examples Using Academy Designation

The use of Academy designation for qualification purposes finds precedent at both the federal and state level:

1. Most recently, the Health Care Financing Administration (HCFA) designated Academy membership as the qualification to sign a required statement of actuarial opinion with respect to health insurers loss ratios. For more explicit details and the specific language HCFA used (which is parallel to our proposal here), see Attachment B.

2. The key financial filing required of all U. S. insurance companies, the NAIC annual statement blank, in addition to the usual provisions in a financial statement, contains a statement of actuarial opinion as to the adequacy of the casualty loss reserves, with Academy membership

qualifying the signing actuary (see Attachment C). The language we offer is parallel to that used in the NAIC opinion. Similar requirements are found in the NAIC blank for life and health insurance companies (see Attachment C-2).

Exemplary Language

3. The Vermont Captive Insurers Act requires a statement of actuarial opinion by an Academy member (note this is in addition to an audited financial statement; see Attachment D).

4. Georgia Insurance Department regulations on workers compensation self-insurance similarly require an annual statement of actuarial opinion by an Academy member (see Attachment E).

Self Regulation

Finally, it may be helpful to emphasize that the Academy has met the professional responsibility of assuring competency among those who sign such opinions. Attachment F contains the standards the Academy requires of all actuaries who sign the related NAIC opinions. Attachment G contains information about our professional disciplinary process.

WDH:jlh

# STATEMENT 1982-29

STATEMENT OF STEPHEN G. KELLISON

EXECUTIVE DIRECTOR OF THE AMERICAN ACADEMY OF ACTUARIES

TO THE

NAIC RISK RETENTION TASK FORCE

OCTOBER 20, 1982

My name is Stephen G. Kellison and I am the Executive Director of the American Academy of Actuaries. We appreciate the opportunity to make a few comments on the Model Product Liability Risk Retention Act you are considering today.

The Chairman of the Academy's Committee on Property and Liability Insurance, Jerome Scheibl, would like to have been able to appear before you today, but he did have a scheduling conflict and is unable to appear. The two of us believe that our comments today are broadly representative of the views of the actuarial profession, but the Academy Committee has not been able to meet to formally adopt them as policy positions of the Committee in view of the short time since the notice of this meeting.

We wish to commend the work which has gone into this Model Act. Congress clearly intended that risk retention groups be regulated by the state insurance commissioners, and we are pleased that the NAIC is fulfilling its regulatory responsibilities with the development of a Model Act.

In particular, we applaud the attempt in this Model Act to apply a similar regulatory framework to risk retention groups as to insurance companies. The concept of a "level playing field" for all providers

of insurance is in the public interest.

Our statement today concerns financial solvency regulation. Risk retention groups are one example, among many, of a growing trend in which insurance is being provided outside the traditional insurance company mechanism (other examples are multiple employer trusts, health maintenance organizations, and a variety of self-insurance arrangements). Financial solvency regulation for such entities is at least as critical as it is for commercial insurers and, in fact, may well be more critical for two reasons:

1. Such entities are less likely to have the same level of insurance management expertise as commerical insurers.
2. Since most of these programs are smaller than commercial insurers, the risk of volatile adverse claims experience is greater.

The key to financial solvency regulation is to require adequate reserves, undoubtedly the most difficult item to establish at an appropriate level on the balance sheet.

The opinion of a qualified actuary on the adequacy of reserves is an important regulatory tool that should be available to the commissioner. By way of background, a provision for such an actuarial statement of opinion at the discretion of the domiciliary commissioner was added to the Instructions of the NAIC Fire and Casualty Annual Statement Blank in 1980.

Also, the committee reports on the Product Liability Risk Retention Act of 1981 (P.L. 97-45) specifically sanction that any chartering state

for a risk retention group may require such a statement of actuarial opinion (Senate Report No. 97-172, p. 11 and House Report No. 97-190, p. 13).

Although Section 13 of your proposed Model Act provides for "Examination for Financial Inpairment," it does so in a very general fashion. If a risk retention group gets into financial difficulty it is very likely to do so through inadequate reserving.

Thus, one way of strengthening the statutory basis for financial solvency regulation in the Model Act would be to more explicitly address the need for adequate reserves. Also, explicit recognition of an actuarial statement of opinion as anticipated by both the NAIC in the Annual Statement Blank and by the Congress in the Committee Reports on P.L. 97-45 would further strengthen the commissioner's hand in dealing with financial solvency problems.

Lest we sound too self-serving, we should remember that the use of such a tool would remain optional with the insurance commissioner. However, explicit recognition of this tool would serve two salutary purposes:

1. It would eliminate any ambiguity as to whether or not the commissioner had the power to ask for such a statement of opinion from a risk retention group.
2. Such statutory language would heighten the level of attention that the managements of risk retention groups will give to the need for adequate reserves.

Thank you for the opportunity to appear before you today. The Academy would be pleased to work with you further on this Model Act if we can be of assistance.

STATEMENT 1982-30

# AMERICAN ACADEMY OF ACTUARIES

WILLIAM D. HAGER, General Counsel and Director of Government Relations

MEMORANDUM

TO: Beth Kravetz, NAIC Washington Counsel

FROM: William D. Hager

RE: Inclusion of Actuarial Certification in NAIC Model Product Liability Risk Retention Act

DATE: November 8, 1982

Consistent with our prior discussions, I have set out for you the language the Academy would urge be included in the above bill with respect to actuarial certification.

I have also attached a copy of a prior memorandum which sets out the authority for the state (NAIC) to extract a statement of actuarial opinion from risk retention groups. I believe the legislative history of the Risk Retention Act (see Senate Report No. 97-172, p. 11 and House Report No. 97-190, p. 13) makes it unequivocally clear that in fact commissioners (of the chartering state), if they like, may extract such an opinion. As a result we make the following recommendation:

As to Section 3, add an additional paragraph to the drafting comment as follows:

> "In addition, the legislative history of the risk retention act (see Senate Report No. 97-172, p. #11, and House Report No. 97-190, p. #13) also permits the commissioner of the chartering state to require the risk retention group to submit a statement of actuarial opinion as to the adequacy of the loss and loss adjustment expense reserves of the group. Such opinion should conform to that currently set forth in the Fire and Casualty Annual Statement Blank."

As to Section 13 of the act, add a paragraph to the drafting comment identical to that set out above.

WDH:jlh

1835 K STREET, N.W. SUITE 515 WASHINGTON, D.C. 20006 (202) 223-8196

# STATEMENT 1982-31

STATEMENT OF STEPHEN G. KELLISON

EXECUTIVE DIRECTOR OF THE AMERICAN ACADEMY OF ACTUARIES

TO THE ADVISORY COMMITTEE OF THE

JOINT BOARD FOR THE ENROLLMENT OF ACTUARIES

NOVEMBER 17, 1982

My name is Stephen G. Kellison and I am the Executive Director of the American Academy of Actuaries. I appreciate the opportunity to comment briefly on your continuing deliberations regarding the training program for new enrolled actuaries. These comments supplement my earlier comments of June 23, 1982.

Although the Academy is not a direct participant in the education and examination process for enrolled actuaries, we remain vitally interested in that process since enrolled actuaries qualify for membership in the Academy. Moreover, the Academy is on record as supporting joint sponsorship of the examinations.

Although there have been discussions within Academy forums about the training program for enrollment, no specific policy recommendations have been adopted by an Academy committee or by the Board of Directors. Thus, you should interpret my comments today as essentially personal ones, although they are compatible with the informal views I have heard expressed.

In connection with EA-1, there have been a variety of suggestions presented for consideration here today. I do not have a specific suggestion to make, since I am not close enough to the examination to be able to evaluate it. I have become aware that there is dissatisfaction with it in certain quarters.

I would observe as a general proposition, however, that requiring an enrolled actuary to demonstrate proficiency in basic actuarial mathematics, independent of specialty, is quite appropriate. The public has the right to expect any professional in whatever field to have mastered basic "core knowledge."

In connection with EA-2, my concerns are that the examinations are too narrow in scope to train someone as a fully qualified pension actuary. As I indicated on June 23, the educational program does not cover such important areas to the pension actuary as the setting of assumptions, experience analysis, plan design, and Social Security. These and other topics would be desirable additions to broaden the educational program for enrollment and are, in my opinion, compatible with the statutory language contained in ERISA.

One final observation I would make is that I do not feel that the Joint Board and its Advisory Committee need to feel wedded to two examinations with a total of eight examination hours. If it decides that a thorough coverage of the subject areas needed to qualify as an enrolled actuary require more examinations and/or examination hours, that would not be inappropriate. For example, consider two other types of professionals that practice under ERISA; namely, lawyers and CPAs. My understanding of both the bar examinations and the CPA examinations is that they both involve 2-3 days of total examination time. Thus, no one could claim that a significant expansion of examination content and time for enrolled actuaries is per se unreasonable.

Thank you for the opportunity to make these oral comments. I would be happy to answer any questions.

STATEMENT 1982-32

No. 82-52

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1982

ARIZONA GOVERNING COMMITTEE
FOR TAX DEFERRED ANNUITY
AND DEFERRED COMPENSATION PLANS,
STATE OF ARIZONA, *et al.*,
*Petitioners,*

v.

NATHALIE NORRIS, on behalf of herself and
all others similarly situated,
*Respondents.*

**On Writ of Certiorari to the
United States Court of Appeals for the Ninth Circuit**

## BRIEF OF AMERICAN ACADEMY OF ACTUARIES AS AMICUS CURIAE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November 24, 1982

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*Teamsters* v. *United States*, 431 U.S. 324 (1977) ....... 27

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Civil Rights Act of 1964, Title VII, § 703(a) (1), 42 U.S.C. § 2000e-2(a) (1) (1976) ....... *passim*

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Bergmann & Gray, *Equality in Retirement Benefits: The Need for Pension Reform*, 8 CIV. RTS. DIG. 25 (1975) ....... 14

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Lautzenheiser, *Sex and the Single Table: Equal Monthly Retirement Income for the Sexes?*, 2 EMPLOYEE BENEFITS JOURNAL 1 (1976) ....... 14

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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1982

Arizona Governing Committee v. Norris
No. 82-52

Brief of The American Academy of Actuaries
as Amicus Curiae

ERRATA SHEET

P. 15, lines 4 and 6: Change "eighty" to "160."

P. 20, line 5: Change "women" to "men."

Lawrence J. Latto

Shea & Gardner
1800 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 828-2000

Counsel for the Amicus

December 8, 1982

In The
# Supreme Court of the United States
October Term, 1982

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No. 82-52

---

Arizona Governing Committee
for Tax Deferred Annuity
and Deferred Compensation Plans,
State of Arizona, *et al.*,
*Petitioners,*
v.

Nathalie Norris, on behalf of herself and
all others similarly situated,
*Respondents.*

---

**On Writ of Certiorari to the
United States Court of Appeals for the Ninth Circuit**

---

## BRIEF OF AMERICAN ACADEMY OF ACTUARIES AS AMICUS CURIAE

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Consent to the filing of this brief has been given by counsel for both sides. Letters to this effect have been filed with the Clerk.

## INTEREST OF THE AMICUS

The American Academy of Actuaries (the "Academy") is a national accrediting organization for the actuarial profession. It was formed in 1965 by three existing national actuarial organizations—the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, and the Society of Actuaries. The Academy and these three founding organizations or their predecessors have represented the actuarial profession in the United States

for over 90 years. The Academy currently has over 7,000 members.

The actuarial profession plays a central role in the design and administration of employee retirement plans.[1] We are, accordingly, in the unique position of being able to offer the Court information about the structure of such plans and to describe the potential effect of this Court's decision on the various types of plans.

## INTRODUCTION AND SUMMARY: THE OBJECTIVE AND STRUCTURE OF THIS BRIEF

In *City of Los Angeles* v. *Manhart*, 435 U.S. 702 (1978), this Court held that the contributory defined benefit pension plan of the City of Los Angeles violated Section 703(a)(1) of Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e-2(a)(1). That plan was unusual in that it required women to contribute, during their working years, larger amounts than were required of similarly situated men. The Academy filed a brief *amicus curiae* in that case that urged neither affirmance nor reversal. We represented to the Court that a decision that the City's plan violated Title VII would not have a widespread effect if it were limited to the particular kinds of provisions then before the Court. An affirmance in the case now before the Court, however, would have major impact on a great variety of plans currently in use.

Since *Manhart*, there have been five decisions by Courts of Appeals dealing with these other types of plans.[2] All

---

[1] Over 85% of those persons who have qualified as "enrolled actuaries" under the Employee Retirement Income Security Act of 1974 (ERISA) are members of the Academy. That Act provides, for defined benefit pension plans, that an enrolled actuary must submit an annual statement which reports on critical financial information about the plan.

[2] We take the liberty of omitting citations that will be readily available in the many briefs that will be filed in this action.

3

but one has concluded that a retirement plan that provides for lifetime benefit payments in unequal monthly amounts to similarly situated men and women violates Title VII. Without regard to the correctness of these decisions, they reflect a less than complete understanding of the nature of the several types of retirement programs and of the ramifications of the decisions. These plans have strikingly different characteristics that may be relevant to deciding how Title VII should be applied in the context of employee retirement plans.

Part I of this brief, accordingly, describes the major types of retirement plans and the distinctions that are made between men and women in the administration of these plans. It concludes with a description of the features of the plan at issue here that we regard as material.[3]

Under one major type of plan, if benefits in the form of lifetime monthly payments are to be provided, they are virtually always provided by the purchase of annuities from an insurance company. Insurers, in fixing the prices of these annuities, and of insurance products generally, employ procedures known as the pooling and classification of risks. Part II of this brief describes why actuaries take account of the fact that women as a class live longer than men as a class in connection with these procedures.

In Part III we examine several ways in which Section 703(a) of Title VII might be applied to the provision of lifetime benefits under employee retirement plans. We set out briefly the arguments that have been advanced in favor of and against each of these interpretations. We describe the impact that the adoption of each of these

[3] Regrettably, many of these plans are complex, and any summary description is subject to the infirmity that it is necessarily incomplete. Although running the risk of making statements that may not always be wholly accurate, we have omitted factual detail or qualifying comment where irrelevant to the issues in this case.

interpretations would have on the employers, actuaries, and insurance companies that administer these plans and on the employees and retirees covered by them.

Finally, in Part IV we consider the relief that has been granted by the courts below in this and some other cases.

## ARGUMENT

### I. DESCRIPTION OF THE MAJOR TYPES OF RETIREMENT PLANS

Congress has sought to encourage private employers to sponsor retirement plans for their employees and particularly plans that provide benefits in the form of periodic payments that continue as long as the employee lives.[4]

Women as a class live longer than men as a class. The difference is significant and is not decreasing.[5] Accordingly, it costs more to provide life incomes or annuities to women than it does to provide similar benefits to men who retire at the same age. Quite different accommodations have been made to this fact under different types of plans.

#### A. Defined Benefit Plans

In a defined benefit plan, the principal undertaking on the part of the employer is to pay a specified benefit to the employee upon retirement. Although the employee cannot determine in advance the precise number of dol-

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[4] For example, for non-governmental plans "qualified" under § 401 of the Internal Revenue Code, contributions made in a given year by an employer are deductible from the employer's income but are not includible in the taxable income of employees until distributed as benefits.

[5] The life expectancy of a woman born in 1920 was 54.6 years. A man born the same year had a life expectancy of 53.6 years. By contrast, the life expectancy of a woman born in 1979 was 77.8 years, compared to 69.9 years for a man born in that year. 1981 STATISTICAL ABSTRACT OF THE UNITED STATES at 69.

lars he or she will receive, the formula by which that amount will be determined is set forth in advance.[6]

Because the benefit to be received is the focus of these plans, contributions made by the employer are generally not segregated into individual employee accounts. The amount of these contributions is based upon an actuarial valuation of how much money must be contributed during the working years of the employees covered by the plan in order to fund the promised benefits. It is not particularly meaningful, therefore, to ask what amount is being contributed on behalf of a particular employee, or what amount is being contributed on behalf of women as opposed to men. However, the actuary will take into account the individual characteristics of employees, such as age and sex, in advising the employer what his contribution should be to fund the promised benefits.[7]

Virtually all defined benefit plans provide for a "normal" retirement age and for a "normal" benefit in the form of monthly payments for the life of the employee that are identical for similarly situated men and women. Plans subject to ERISA are required to provide the option of a joint and survivor pension that will continue until the deaths of the employee and his or her spouse and that will automatically be provided in the absence of a contrary election by the employee. Many plans also give employees the option to retire earlier or later than the normal retirement age.

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[6] A plan might provide, for example, that the annual pension will equal 2 percent of the sum of the employee's total earnings; or a similar percentage of the employee's final year's earnings multiplied by the number of years of employment.

[7] The accumulated contributions plus the earnings thereon are held for the sole benefit of the employees. The amount of the pension received by the employees is not a function of the rate of earnings, however. Rather, the amount of the pension is simply a function of the formula referred to above. A higher rate of earnings results in reducing the employer's cost, not increasing the employee's benefits.

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If an optional benefit is elected, many plans provide for an adjustment of the amount of the monthly payment. The amount of the adjustment is frequently determined with the objective of making the cost of the optional benefit approximately equal to the cost of the normal benefit. For this reason, if a joint and survivor pension is elected, the amount of the adjustment depends, among other things, upon whether the retiring employee is a man or a woman. Similarly, early or late retirement may result in different adjustments for men and women, as was the case in *Retired Public Employees* v. *State of California*, 677 F.2d 733 (9th Cir. 1982), *petition for cert. filed Aug. 14, 1982*, 51 U.S.L.W. 3212 (Sept. 28, 1982) (No. 82-262). The difference results when the greater longevity of women is taken into account in determining the optional benefit.[8]

Under a defined benefit plan, while the contributions made by the employer each year are intended to provide adequately for the promised benefits, the amount contributed is an estimate based upon an anticipated rate of earnings, employee turnover, mortality rates, inflation, and other factors. The ultimate cost to the employer is uncertain.[9]

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[8] In addition to the optional benefits described above, some defined benefit plans provide a number of additional forms in which benefits can be taken. These include (a) a life income or annuity paying a monthly amount for as long as the employee lives but with payments guaranteed for a minimum period (*e.g.*, 10 years) even if the employee dies before the end of that period; (b) monthly payments over a stated number of years irrespective of when the employee dies; and (c) a lump sum option.

[9] This uncertainty in the past has been more acceptable to larger corporate employers. Smaller corporations and partnerships have turned to defined contribution plans to give them better control over what the cost of their pension plan will be. Recently some larger employers have sought to change from defined benefit to defined contribution plans in order to achieve better control over pension costs. See, *e.g.*, BUSINESS WEEK, November 8, 1982 at 85.

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### B. Defined Contribution Plans

Defined contribution plans specify the amount of the contributions made by the employer rather than the level of benefits to be provided to the employee upon retirement.

Contributions are made and accounts are maintained on behalf of each individual employee. It is very rare for a defined contribution plan to provide that different contributions will be made for male and female employees who are otherwise similarly situated.[10] At the time of retirement, therefore, a man and a woman with identical years of employment and salary histories, whose accounts have been invested in the same way, will have accumulated identical amounts in individual accounts.

These plans often provide for the payment of the accumulated amount to the employee in a lump sum. They also generally provide for lifetime monthly payments. In the latter case payments are almost always provided through the purchase, by the plan administrator, of an annuity from an insurance company. Since insurance companies recognize that women live longer than men, they provide smaller periodic payments to women than to men for the same accumulated amount.

### C. The Plan at Issue in this Case

The plan at issue in this case is a type of defined contribution plan, known as a deferred compensation plan. It offers the employees of the State the option, on a strictly voluntary basis, of deferring the receipt of a portion of their compensation. Each participating employee designates the amount by which his or her current salary will be reduced. Each employee then desig-

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[10] Retirement plans may or may not be "contributory" and provide for employee contributions in addition to those of the employer.

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nates which of the funding media selected by the State (including an insurance company, a mutual fund, and a credit union) will invest the deferred compensation. In order to secure the tax advantages which are the principal motivation for the plan, however, the funds remain assets of the State and are subject to the claims of the State's general creditors.[11]

When an employee reaches retirement age, the amount credited to his or her account may be withdrawn in full as a lump sum. If the employee prefers to have a lifetime annuity, the insurance company designated under the plan will assume the contractual obligation to make the annuity payments. Alternatively, the employee may elect a lump sum and purchase an annuity from some other insurance company, but if that is done the employee forgoes part of the tax advantage that results from the plan.[12]

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[11] Deferred compensation plans such as this one offer significant tax advantages to the employee. The amounts deferred are not subject to tax at the time of deferral, so that the full pre-tax amount of this compensation can be invested in the funding medium (i.e. \$200 pre-tax per month rather than \$140 for a person in the 30% bracket). Because the funds are still technically the funds of the State, the earnings on these deferred amounts are not taxed at the time they are earned. When the employee retires and receives his or her benefits under the plan, these amounts (including both the compensation deferred and the earnings thereon) are taxable to the employee—but often at rates that are lower than the rates applicable to the employee's income during his or her working years.

[12] If an employee has had his or her account held in the mutual fund, for example, and the funds are transferred to the insurance company at retirement, they are still not deemed to have been received by the employee and the employee is taxed on the *monthly* annuity payments as received. If the funds are transferred to an insurance company not designated under the plan, however, the funds are deemed to have been received by the employee at that point and are taxable in full.

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This plan is not the State's retirement plan for its employees. The role of the State in the administration of this plan is a very limited one. It selects, at the outset, funding media for the plan. It reduces each employee's salary to the desired level and transfers the difference to the particular funding medium the employee has designated. But it is barred by statute from contributing any money to the plan on its employees' behalf. The State was thus not in a position to accept the financial uncertainty of funding life annuities. It had no general funds available in the event its particular employees happened to live longer than the mortality tables predicted. As a consequence, the only way the officials responsible for the plan could comply with the authorizing statute and offer this benefit was by transferring the risk to an insurance company by the purchase of annuity contracts.

The next section of this brief describes how an insurance company is able to accept this risk.

## II. THE POOLING AND CLASSIFICATION OF RISKS

The risk that the insurance company accepts when it undertakes to write life annuities arises because it is impossible to predict in advance how long any single individual will live. But if this risk is assumed with respect to a group of persons, the rate and frequency of deaths within that group can be reliably predicted based on the past mortality experience of similar groups. This permits the insurer to set the amount of monthly annuity as members of the group retire at a level that will not exhaust the total fund available for the payment of annuities until the last person in the pool has died.

Although the insurer must in this way substitute the predictability of the group for the uncertainty surrounding the life span of the individual, the focus on the individual is not lost. Through the process of risk classification, the insurer evaluates the likelihood that a particular individual will have greater longevity than the average. This is accomplished by evaluating the

specific characteristics of the individual which correlate statistically with longevity. The two most common in connection with annuities are sex and age.

There are two important reasons for this practice.

First, it is a principle of long standing in the insurance context that fairness and equity are achieved when individuals are classified according to the likelihood that they will experience the risk being insured. Under this view, fairness and equity are achieved when each individual under an employer-sponsored retirement plan receives benefits that are "actuarially equivalent" to the benefits received by others. In the present context, the monthly amount paid to a woman is lower than that paid to a similarly situated man. The difference is in an amount that will make equal in value the two income streams, which differ in duration because of the greater longevity of women.

Second, risk classification is essential to the successful operation—to the financial soundness—of an insurance arrangement. Where people have the right to decide whether or not to purchase insurance or to accept a life annuity, the similar treatment of persons with different risk characteristics would invite low-risk persons to decline coverage or to decline the annuity in favor of alternatives which provide them benefits more commensurate with the risk they represent. A frequently cited example of the danger of ignoring this "adverse selection" phenomenon is found in the experiences of the early "burial societies." These societies paid a benefit upon the death of one of their members out of premiums and assessments that were set without regard to the age of the individual member. As the average age of the members increased, and mortality experience worsened, the frequency of assessments increased and the established associations were unable to attract the younger members necessary to keep down the level of payments. Ultimately, these insurance mechanisms collapsed, leaving many mem-

bers without the protection for which they had contributed over a number of years.

Another consequence of requiring by law that an identical premium be charged or an equal periodic benefit be paid for groups involving different risks is that it creates incentives that may not be desirable. Insurers that are more successful in attracting the low risk group will realize greater profit. They may seek to do this, for example, by focusing their advertising so as to reach primarily members of the low-risk group. Market pressures may also discourage other companies from assuming the higher risks at all, with a resultant narrowing of the breadth of insurance coverage that is available to persons in the high risk group.

The extent to which adverse selection is a significant factor varies considerably depending upon the type of insurance that is offered and the existence of other factors that affect the choice of the persons in the insured group. It does not operate at all if there is no choice. If the individuals in a group of insureds do have an election but it is not one that they are likely to exercise, then the problem posed by adverse selection may not be significant. In general, however, experience has shown that where an opportunity for adverse selection is provided, a substantial number of persons may take advantage of that opportunity.

## III. INTERPRETATION AND APPLICATION OF SECTION 703(a) OF TITLE VII

### A. An Actuarial Perspective on the Theories Advanced on this Issue

We offer here, in summary fashion, brief comment from an actuarial perspective on several issues that have been raised in this and related cases.

In *Manhart* the fact that a woman received a lower take-home pay than a similarly situated man was regarded as unlawful discrimination on the basis of sex.

A much more difficult question is whether a non-contributory defined contribution plan—or a contributory plan where equal contributions are required of similarly situated men and women (so that take-home pay is equal)—would violate Title VII if the monthly lifetime payments received by women were smaller than those received by men.

Those who would answer this question in the affirmative argue that a monthly payment of $90 cannot be regarded under any circumstances as equal to a monthly payment of $100. Those who would answer the question in the negative argue that the compensation to the employee, whether viewed at the time of retirement or, during the employee's working years, as incremental additions to each wage payment, is the right to receive a stream of monthly payments that will continue until he or she dies. This stream of payments has a present or discounted value which, in situations where it is necessary, can be and is ascertained.[13] Such income streams are, of course, bought and sold in the market as annuities and, when they are, a given purchase price will buy a stream of level monthly payments that are lower for a woman than for a man. The two streams of payments are actuarially equivalent in value, however, and that is why they cost the same amount. That is also why, the argument runs, men and women should be regarded as receiving equal compensation.

A number of different responses are made to this argument.

1. *Sex as a predictor of longevity.* It is contended by some that sex is not a reliable basis for predicting future longevity. Although conceding that in the past women as a class have lived longer than men, they assert that this difference will disappear as women engage in

[13] It is done, for example, for tax purposes. See, e.g., Treas. Reg. § 20.2031-10(b) (1970), 26 C.F.R. § 20.2031-10(b) (1982).

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more hazardous occupations and share more widely with men habits such as smoking.

The available evidence does not support this contention. Women have made greater gains in longevity over this past century than have men.[14] A recent U.S. census report projects that those gains will continue through the first half of the 21st century notwithstanding the report's assumption that women will increasingly enter the work force during this period.[15]

2. *The availability of other indicia of longevity.* A second argument urges that actuarial equivalence that is based upon classification by sex should be rejected as a measure of equality because it does not consider other factors, in addition to age and sex, that are known to correlate with longevity—smoking habits, departures from normal weight, the longevity of parents and grandparents, etc. At best, these persons argue, actuarial equivalence based on sex is a sham; at worst it is a pretext for discrimination based on sex.

This argument has a superficial appeal. But we think it is wrong. Two classes of persons with observable differences in longevity may be treated as a single class if the relevant differences, though identifiable, are relatively small. The minor "unfairness" involved may be outweighed by the added expense of treating the two cases differently. Small differences do not give rise to significant adverse selection and so are acceptable from a business standpoint. Further, some of the alternative grounds for classification are also fairly difficult to apply. For example, persons who smoke heavily may deny it.

[14] See *supra* note 5.

[15] Female life expectancy is expected to rise from 78.3 years in 1981 to 83.6 years in the year 2050, while male life expectancy is expected to rise from 70.7 years to only 75.1 over the same period. U.S. BUREAU OF THE CENSUS, POPULATION ESTIMATES AND PROJECTIONS (Series P-25, No. 922, October 1982).

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What is more important, however, is that were these other longevity factors employed, sex would continue to be a significant factor in accounting for longevity differences. So far as the available evidence shows, for example, women who smoke live longer than men who smoke.[16] Any insurer who, in fixing the prices for annuities, used these other factors but ignored sex would, in a competitive market, be subject to adverse selection as men sought the more attractive benefits offered by other companies free to take sex into account. If these or other factors provided a superior alternative to sex as a classification, insurers would have every business incentive to employ them.[17]

3. *The Overlap Theory.* Yet another argument that the provision to men and women of benefits that are actuarially equivalent should not satisfy Title VII has come to be called the "overlap theory." It was first advanced by Professors Bergmann and Gray.[18] They point

[16] The United Nations Demographic Yearbook reports, with limited exceptions, significantly lower mortality rates for women than for men throughout the world, in a wide variety of cultures. UNITED NATIONS DEMOGRAPHIC YEARBOOK 1970, TABLE 20 at 710-729 (1971). Where mortality studies are limited to individuals who work for pay outside the home, the differential between male and female mortality is greater than for individuals who do not. Lautzenheiser, *Sex and the Single Table: Equal Monthly Retirement Income for the Sexes?*, 2 EMPLOYEE BENEFITS JOURNAL 1 (1976). An analysis of data gathered in 1965 in California concluded that after adjusting for 16 risk factors (including occupation, smoking, alcohol use, physical activity, church and group membership, and life satisfaction), male mortality continued to exceed female mortality. In fact, the analysis found that the combined effect of adjusting for all 16 variables was to increase the difference in relative mortality risk for men and women. Wingard, *The Sex Differential in Mortality Rates: Demographic and Behavioral Factors*, 115 AMER. JOURNAL OF EPIDEMIOLOGY 205-16 (1982).

[17] For example, a handful of companies began to classify successfully risks on the basis of smoking habits. Offering lower premiums to non-smokers is now a widely used life insurance practice.

[18] Bergmann & Gray, *Equality in Retirement Benefits: The Need for Pension Reform*, 8 CIV. RTS. DIG. 25 (1975).

out that in a group made up equally of men and women all 65 years of age, say 1000 of each, for about 84 percent—or 840 men and 840 women—the years of their deaths can be matched one for one. However, eighty men will die in the early years of the group unmatched by deaths among the women, and eighty women will die in the later years unmatched by deaths among men. The argument asserts that the use of sex-distinct tables allows the savings in annuity costs for the 8 percent of the group consisting of men who die early to be entirely monopolized by men, while the extra burdens imposed by the 8 percent of the population consisting of women who die later are entirely borne by the women.

The persons who make these assertions conclude that this is inherently unfair and inequitable. The flaw in this contention is that it looks at mortality retrospectively. Purchase rates for annuities, however, must be fixed prospectively. It cannot be determined in advance who will fall into the unmatched long-lived group. The probability that any woman chosen at random will fall into the unmatched long-lived group—to which relatively large aggregate payments will be made—is .16, while the probability that any randomly chosen man will fall into that group is zero. It is equitable, therefore, to charge each woman a higher amount for the same benefit.[19]

These arguments also fail to recognize the financial significance of the important fact that the unmatched male deaths occur early and the unmatched female deaths occur later. For example, in a retirement pool of 1,000 females and 1,000 males, each receiving $10,000 a year for life beginning at age 65, it would take $41 million more to provide the benefit for females than for males.

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[19] The unsoundness of the concept may also be demonstrated by looking at an analogous example. If the deaths of a large group of 60-year-old women were to be matched against the deaths of a group of 65-year-old women, a similar overlap of 80.7 percent would exist. Yet few would argue that it is inherently fair to charge 60-year-old women the same price for life insurance or annuities as is charged 65-year-old women.

The arguments, finally, relate only to the fairness or unfairness of providing actuarial equity. The conclusion drawn by the proponents of this theory, that unisex mortality tables should be employed, ignores the resultant adverse selection discussed at pages 10-11, *supra*, and 18-19, *infra*.

**B. The Probable Impact of the Court's Decision**

In Part IV of this brief, we discuss the question of whether the Court's decision, if it is one that makes necessary a change in existing practices, should be retroactive or only prospective. In this section we predict, as best we can, what the practical impact will be on the various types of plans of a Court decision adopting one or another of the various interpretations of Title VII that will be urged upon it. For this purpose we make the assumption that any relief granted by the Court would be prospective in nature and that actuaries would continue to be able to classify prospective insureds by their sex when fixing the prices charged for life insurance and annuities.

Although this case could be reversed on rather narrow grounds, a broader ruling on reversal or on affirmance would almost surely apply *a fortiori* not just to other deferred compensation plans like this one but also to other types of defined contribution plans and possibly to defined benefits plans as well. Therefore, we deem it appropriate to set out for the Court the impact of alternative resolutions on these other kinds of plans.

**1. *If equal monthly payments are mandated***

a. *Defined contribution plans.* Plans that provided *only* lifetime pensions could be administered so as to provide equal monthly payments without regard to the sex of the retiring employee and still carry out the employer's original objective of fixing its costs in advance. The amounts accumulated for each retiring employee could be used, as they are today, to purchase annuities. In fixing

the prices for those annuities, actuaries of the insurance companies that chose to continue to participate in this market would have to utilize mortality tables that are appropriate for each particular plan.[20] These would be "unisex" tables in the sense that the monthly benefit derived using the table would be the same for a similarly situated man and woman. But in developing the unisex table for each plan, the actuary would still have to take into account whether the annuitants will be primarily men or primarily women and in what proportions. An undertaking to furnish annuities to an employer whose retiring employees are likely to be made up of 90 percent men and 10 percent women must use a different table than the table that must prudently be used if the employees were 60 percent women and 40 percent men. Thus even a "unisex" table would reflect the differing mortality experience of men and women.

In addition, we would expect with such a plan that the current practice of guaranteeing annuity purchase rates long in advance would likely have to be modified, so that as the composition of each employer's work force changed, mortality tables could be adjusted and the level of monthly payments made to employees retiring after that date modified accordingly.

Plans that offer an election between a lump sum payment and an annuity upon retirement would be harder to handle, because of adverse selection. Sponsors of these plans might respond by eliminating one or the other of the options. Dropping the annuity option would defeat a principal objective of the Congress in granting favorable tax treatment to employer-sponsored pension plans—to encourage employers to provide life annuities as a supplement to Social Security benefits.[21] In the case of de-

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[20] See *infra* pages 18-19 for the reasons that might lead some insurers to withdraw from the market.

[21] Employees are likely to object to the elimination of the lump sum option, which provides them with desirable flexibility.

ferred compensation plans, such as that involved in this case, a substantial tax advantage would be lost if the annuity option were to be dropped.

If both options are retained, an insurance company desiring to continue in this market would have to fix annuity rates that took into account not only the sexual composition of the work force but also the probability that there would be extensive adverse selection. The insurance company chosen by the employer cannot ignore this latter factor because once it begins using unisex tables, men close to retirement can be expected to seek more attractive arrangements by electing the lump sum option and then purchasing from other insurance companies annuities that would be priced using sex-distinct tables. These would of course provide the men with larger monthly payments.

To respond, the actuary for the plan's insurer might well have to use a mortality table that assumed that most of the employees electing annuities under the plan would be women. The result of all this, therefore, might be that retiring women would receive annuities under the plan with monthly amounts that were not materially better than are now provided using existing sex-distinct tables. Men would continue to receive larger benefits but with the additional expense of transferring their lump sum benefit to an insurance company outside the plan.

The impact of mandating equal monthly payments for these plans could be even more far-reaching. Because insurers now use sex in their risk classification process, they need not be concerned about the mix of men and women who purchase annuities from them. An insurer required to use unisex rates, however, must assume the financial risk that the sex distribution of its annuitants will differ materially from that of the mortality table it used for pricing its product and determining benefits. There may be inconsistencies with other state and federal laws and regulations that will be difficult to resolve. More

generally, the prohibition of business practices that have valid economic justification often results in market dislocations that cannot wholly be predicted in advance. Some insurers may choose to withdraw from this market altogether.

b. *Defined benefit plans.* A decision that equal monthly payments are mandated would have little effect upon defined benefit plans so far as the "normal" pension benefit is concerned, since this form of benefit already pays equal monthly amounts to similarly situated men and women. However, if this Court in *Retired Public Employees* v. *State of California*, No. 82-262, *supra*, (petition for certiorari pending) were to decide that equal monthly payments are mandated by Title VII for optional benefits as well, this would prohibit the frequently employed although not universal practice of using sex-distinct annuity tables in computing the amounts payable under those options.

Actuaries would continue to take into consideration the sexual composition of the work force and, in addition, statistical data concerning the extent to which men differ from women in electing the available options. In computing the benefits payable under the options, they would use a mortality table appropriate to the sexual composition of the work force under the particular plan.[22] This would mean that the benefits paid under various plans might differ. To take one example, a 65 year old male or female employee of employer X, whose spouse is also 65, and who is entitled to a normal pension benefit of $1,000 a month, might be entitled to a joint and survivor pension of $875. A similarly situated employee of employer Y with the same $1000 a month normal benefit might be entitled to a joint and survivor pension of $925 per month. But the men and women employed by each employer would be treated identically.

[22] This would not be possible in plans with few participants. A prudent actuary for such a plan might well feel compelled to anticipate that each employee will elect the most costly option.

For those defined benefit plans which provide a lump sum benefit or for benefits payable for a fixed number of years, the amount of these benefits would prudently have to be set at a level that was the actuarial equivalent of the normal pension for women. If they were set at a higher level the likely result would be that many men would elect the lump sum benefit and purchase annuities from an insurance company, thereby increasing the employer's cost. It can be expected that many employers would prefer to drop these optional forms of benefits.

#### 2. *If actuarial equivalence using sex-based classifications is mandated*

a. *Defined contribution plans.* If the Court were to decide that actuarial equivalence using sex-distinct annuity tables was mandated by Title VII, thereby restricting its decision in *Manhart* to the narrow facts of that case—unequal take-home pay violates Title VII—defined contribution plans could continue to be designed and administered much as they are today. Women electing an annuity option would receive monthly payments lower than those received by men unless and until the difference in the longevity of the two classes disappeared or narrowed considerably.

b. *Defined benefit plans.* A decision that actuarially equivalent pensions are required under defined benefit plans would have serious consequences. At present similarly situated men and women who are covered under defined benefit plans receive normal pensions of identical monthly amounts which are, accordingly, not actuarially equivalent. A decision that women should be given a normal pension that is the actuarial equivalent of the normal pension now given to men would pay them substantially lower benefits than they now expect to receive and might impair contractual rights to such benefits. A decision that men should receive normal pensions that are the actuarial equivalent of the normal pensions now provided to women

would impose very significant new costs upon employers. Either decision is, as a matter of fact, practically precluded because of the inherent structure of a defined benefit plan.[23] Although not an issue in this case, it is an issue that is not far distant from that in *Retired Public Employees*, No. 82-262, *supra*, and we feel obligated to advise the Court of the possible ramifications of an opinion in this case that is phrased without awareness of this possible consequence.

### 3. *If equal contributions by the employer are mandated*

a. *Defined contribution plans.* These plans would be little affected by an interpretation of Title VII that mandated only that the employer's contributions into the plan for similarly situated men and women be equal. Virtually all of these plans already follow this practice.[24]

b. *Defined benefit plans.* An "equal contribution" interpretation of Title VII makes little sense in the context of defined benefit plans since there is no real "contribution" on behalf of any particular employee or group of employees under these plans. The focus of these plans is instead upon the benefits that are payable upon retirement.

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[23] It would either require adopting a benefit formula based upon sex (*e.g.*, 2% of aggregate salary for men and 1.92% of aggregate salary for women) or determining the normal pension benefit for employees of one sex and providing employees of the other sex with the actuarially equivalent normal benefit.

[24] This interpretation would not focus on the payments received by the employee under a life annuity since it is not the employer who provides these payments. Each employee's account is a separate one. For the employer to take the amount credited to a particular employee and give in exchange the employer's promise to make payments for life would, in effect, be entering into the business of insurance. This is exactly what the employer and particularly the smaller employer decides not to do by adopting a defined contribution plan.

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**4. *If different obligations are mandated for different types of plans***

There may be a consideration that is material to the decision of this Court that has largely been ignored in the extensive commentary that has followed the *Manhart* decision. If the issue ultimately comes down to what is "equal" compensation, then one might look at the differing nature of the plans for any guidance it provides on this issue. If this is done, the striking difference between various types of plans may suggest an interpretation of the statute that is somewhat different for each major type of plan.

a. *Defined benefit plans.* As we pointed out in our earlier description, the contributions made by the employer under a defined benefit plan are not made by individual employee or even by groups of employees (*i.e.*, men and women). Consequently, an interpretation of Title VII that focused on the contributions of the employer and tried to determine whether they were nondiscriminatory would be very difficult if not impossible to apply.

An interpretation that looks to the benefits received is more consistent with the structure of defined benefit plans, which focuses on the pension the employee will receive when he or she retires. The interpretation of Title VII, in this context, would seem to call for identical monthly payments, at least for the "normal" pension benefit. Moreover, as *Manhart* has already held, this requirement could not be undercut by requiring unequal contributions from men and women.

The issue is not as clear with respect to the optional benefits under these plans. For larger plans, if identical monthly payments are required, employers could provide desirable optional benefits, thereby increasing the flexibility available to employees under the plan, and could still fix the amount of these benefits so that the employer

would neither incur any substantial additional cost nor save any money as the result of the election. This could be accomplished with the same practices but also the same problems as described at pages 19-20. For smaller plans, where reliable estimates of cost are much harder to make, and for plans which include optional lump sum benefits, requiring identical monthly payments would have a much greater disruptive effect than would be true for larger plans.

b. *Defined contribution plans.* Under these plans, the focus is not upon the benefits that will ultimately be received by the employee. Defined contribution plans are structured around what the employer contributes on a periodic basis during the employee's working years—contributions credited to the employee's own individual account and invested in a manner over which the employee often has considerable control. An interpretation of Title VII that requires that contributions be equal for similarly situated men and women would be consistent with the structure of these plans.[25]

### C. The Plan Before this Court

If the substance rather than the form of the Arizona plan is viewed as controlling, the fact that Arizona is regarded, for purposes of federal income taxation, as the

[25] The understanding of both employees or employee unions and employers—the parties to the compensation arrangement—as to what constitutes "equal compensation" might also be a consideration that bears upon how Title VII should be interpreted in this context. While there are no studies available and no polls have been taken, it may be a fair inference that men and women covered by a defined benefit plan, who are not knowledgeable about the employer's contributions or the funding mechanism, understand that they will receive identical wages and an identical monthly pension. Employees covered by a defined contribution plan are told about their employer's contributions and know that the identical amounts set aside for men and women will be the source of their benefit. It could be argued that those common understandings support the interpretation described above.

legal owner of the amount of the compensation that is deferred until it is actually received by the employees may be entitled to very little weight. Arizona, before adopting the plan, had agreed to pay its employees certain salaries. Participation in the plan was voluntary. If an employee chose to participate, he or she designated the amount by which his or her salary would be reduced. Arizona did not pay the participating employees one cent of additional compensation. Its contribution was merely to collect the salary reductions, transmit them to the funding media selected by the employee, and keep records. In this context, Arizona might well be regarded as having paid its employees simply the wages to which they were originally entitled plus the costs of administration. Those amounts were provided without discrimination between men and women.

Arizona did offer its employees a means of facilitating the purchase of annuities, in order to enable them to extend the tax deferred feature of the arrangement past their retirement dates. Those annuities were paid in different monthly amounts for similarly situated men and women. Whether this limited involvement is distinguishable from the open-market purchase of annuities said by the Court in *Manhart* not to violate Title VII we leave to others.

If this Court holds that the *Norris* plan violates Title VII, then the issue of the form of the relief will remain to be decided.

## IV. THE APPROPRIATENESS OF THE RELIEF GRANTED BY THE COURT

The relief granted by the District Court in this case and affirmed by the Court of Appeals directed in part that "annuity payments to female employees who have retired shall be equal to similarly situated male employees." 486 F. Supp. 645, 652 (D. Ariz. 1980). Both courts seemed to contemplate that this relief would be

retroactive, in that it would apply to employees currently receiving benefits. Equality of payments could be achieved, consistent with the contractual obligations of the insurer, only by "topping off"—raising benefits paid under a particular option to the level of the higher paid sex.[26] Such relief has in fact been ordered in *Retired Public Employees* v. *State of California*, *supra.*[27]

If this Court were to affirm the decision below, and thereby adopt both an equal monthly payments rule and a rule favoring retroactive relief involving "topping off" existing benefits, its decision would apply *a fortiori* to defined contribution and defined benefit plans as well. Because "topping off" requires an increase in benefits unforeseen when the assets that support a plan were

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[26] The annuity payments to both men and women could be adjusted to a point somewhere between the higher monthly amounts previously paid to one and the lower amounts paid to the other—using a mortality table appropriate for the plan and its particular mix of men and women. This form of relief probably could not be implemented, however, because current annuitants have enforceable contractual promises by the insurance company that existing payments will continue to be made. For a similar reason, achieving equality by lowering the levels of monthly payments now made to the favored sex down to the level of the less-favored sex would also be barred.

[27] There, the plan provides equal monthly annuity payments to similarly situated men and women who retire at age 60. Where such employees retire early, however, the women receive slightly higher benefits, and, conversely, in the case of late retirement, the men receive slightly higher benefits. The relief ordered was to increase the payment of all benefits to the level of the most favored employees. This relief was made retroactive to the date of this Court's decision in *Manhart*, requiring a lump sum retroactive adjustment very much like the back pay award that this Court rejected in *Manhart*. But even if the district court's order were effective only from the date of its own decision, the order would still require a change in the benefits of employees who have already retired.

set aside, such relief would in fact require a very large additional infusion of capital into a great number of plans. The impact on individual plans could range from negligible to the point that the continuation of the plan would be brought into doubt. For some plans, this increased burden could result in the termination of the plan. The cost to retirement plans as a group has been estimated at anywhere from in excess of $1 billion to several times that amount annually.

We have noted that employers electing defined contribution plans tend to be those employers (often of rather modest size) for whom it is extremely important to control their pension costs. Retroactive "topping off" relief would wholly frustrate this objective. As to deferred compensation plans such as the plan in this case, the required additional funds could only come from the employer. Yet the very essence of the plan was that it was to be funded wholly out of voluntary contributions by the employees, with the State merely administering the plan. We should note that Arizona responded to the *Norris* decision by simply discontinuing the annuity option.

Should the Court conclude that the Arizona deferred compensation plan is in violation of Title VII, the granting of relief only on a prospective basis avoids the financial consequences described in the previous two paragraphs, and would be consistent with the position taken by this Court in *Manhart*. Because Arizona offered a plan in which it had a limited role, it could reasonably have concluded that its arrangement came within the open market exception articulated in *Manhart*. As this Court said in *Manhart*, "[W]e must recognize that conscientious and intelligent administrators of pension funds, who did not have the benefit of the extensive briefs and arguments presented to us, may well have assumed

that a program like the Department's was entirely lawful." 435 U.S. at 720.[28]

There are several ways prospective relief can be defined. One form of prospective relief would require that the payment of benefits be altered only for employees who retire after the date of the Court's order.[29] The benefits for all employees now still working would be based on unisex factors. If such an order were made, widespread and substantial adjustments of currently anticipated benefits would be required, and the cost of the benefits in many instances would be increased. A less significant impact would result if only benefits that accrued after the date of the Court's order, or benefits based on contributions made after that date, were required to be altered. Under such an order, part of the employees' benefits would be based on unisex factors and part on sex-distinct factors. The least impact would result if the Court's order applied only with respect to employees hired after the date of the order.

[28] As this Court has previously recognized in fashioning remedies under Title VII that may affect "the expectations of innocent parties," the courts "must 'look to the practical realities and necessities inescapably involved in reconciling competing interests.' in order to determine the 'special blend of what is necessary, what is fair, and what is workable.'" *Teamsters* v. *United States*, 431 U.S. 324, 375 (1977), *quoting Lemon* v. *Kurtzman*, 411 U.S. 192, 200-201.

[29] For some plans (*e.g.*, those that have purchased units of annuity with each contribution), any reduction in benefits might encounter existing contractual obligations to persons not yet retired.

## CONCLUSION

We do not take any position as to how Title VII should be applied in this or in any other case. We recognize that, in resolving the issues presented by this and related cases, the Court must consider a number of factors some of which are not dealt with in this brief and are not matters on which actuaries have particular expertise. We do suggest, however, that the nature and structure of the retirement plans involved and the practical consequences that may result should be relevant to the Court's decision.

Respectfully submitted,

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November 24, 1982

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December 17, 1982

Mr. John E. Hart, Chairman
Reinsurance Auditing and Accounting Task Force
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10038

Dear Jack:

File Ref. No. 3155

Thank you for the opportunity to review the AICPA's discussion draft on "Accounting for Foreign Property and Liability Reinsurance."

As a general observation, it would appear that some or all of the accounting problems discussed in the AICPA draft exist in areas other than foreign property and liability reinsurance. Many of these problems can exist for insurance and for reinsurance, whether domestic or foreign.

Looking to accounting and actuarial principles and practices, there would appear to be no justification for the three year basis of accounting. No where is it written that three years is the appropriate length of time for insurance or reinsurance information to mature. While three year accounting has been the practice in the UK for many years, there is simply no basis in fact or in actuarial science to support it. The three year basis might be right for some lines or types of business but surely not right for other lines and types.

There is a considerable body of actuarial and accounting literature devoted to the estimation of various components of the revenue and expense (broadly defined) streams. We see no reason why these techniques and practices should not be employed in foreign property and liability reinsurance - to close the gap between reported and expected results. Clearly, the results of such forecasting or estimation routines can be wide of the mark, especially when the underlying data are volatile and/or sparse. It is our view, however, that such conditions do not relieve us of the obligation to develop the best possible estimates. It seems to us that profits and other elements of the revenue stream as well as the expense or outgo items should be recognized once they are reasonably assured based on reasonable and conservative estimation techniques.

In summary, looking to actuarial and accounting principles supports the periodic method of accounting subject to the usual materiality considerations and reasonable assessments of the costs and benefits to be obtained.

Sincerely,

Ronald E. Ferguson, Chairman
AAA Task Force on Reinsurance Accounting

REF:jw

cc: S. G. Kellison
W. D. Hager
A. N. Crowder, III
AAA Task Force Members

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December 20, 1982

Mr. Tony Biele
Coopers & Lybrand
1251 Avenue of the Americas
New York, New York 10020

Re: Draft Issues Paper - Accounting for Health Maintenance Organizations and Associated Entities

Dear Mr. Biele:

Lloyd Mathwick, Chairman of our Subcommittee on Health Maintenance Organizations, and I have reviewed the above-captioned paper. We did not have an opportunity to gather comments from other members of the Subcommittee, however. We would like to do so on a later draft and expand upon our comments at that time.

As I mentioned to you on the telephone, our only comment of substance relates to the accrual of health care costs as discussed in paragraphs 17 and 18 on pages 8 and 9 of the paper. While we agree that it is not appropriate for a health maintenance organization to accrue the cost of all services in connection with a specific disease, condition, or accident, we do believe that the accrual of health care cost should include the cost of services to be rendered for which the HMO is obligated if subsequent premiums are not paid. Clearly, this obligation will vary from HMO to HMO depending on the contractual language which is used.

All of our other comments are minor and concern primarily generalizations made in the descriptive parts of the paper. We will be glad to forward these comments to you in relation to later drafts, if you wish. I will mention one other comment now, however. In the overview a list of advantages of federal qualification is given. We believe that a list of the disadvantages would also be appropriate.

We appreciate the opportunity to comment and will be glad to comment on any later drafts.

Sincerely yours,

Robert H. Dobson, F.S.A., M.A.A.A.
Chairman
Committee on Health Insurance

cc: Loren Kramer
HMO Subcommittee
William D. Hager
Stephen G. Kellison
W. H. Odell