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**DISCUSSION PAPER**

# EXPLAINING PROFESSIONALISM TO PRINCIPALS

American Academy of Actuaries
Committee on Professional Responsibility
of the Council on Professionalism

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# Explaining Professionalism to Principals

Have you ever been questioned about the results of your actuarial analysis by a principal? You explain your assumptions and the outcome, and yet the results are not what your principal or other recipients of the analysis want the results to be. Have you felt pressure to change the results?

If so, you are not alone. Many actuaries have experienced that pressure. This paper will help you, as an actuary, think proactively about professionalism, and how to explain its importance to the work you do.

In this paper, we'll outline the professionalism considerations for an actuary in producing a final work product. We also will discuss approaches to convey the underlying professional guidelines embedded in any actuarial work product to the principal, and we will provide case studies to illustrate these approaches. It's in the principal's best interest to understand the professional actuarial standards that are the foundation of the final work product and that support actuarial findings and recommendations. It's also critical that principals understand the importance of these underlying professional standards, regardless of their views of the work product and its conclusions.

## Background

As we begin, it's worthwhile to remind ourselves of our professionalism infrastructure.

The foundation of actuarial professionalism is the Code of Professional Conduct, which sets standards of professional behavior and applies to members of any of the five actuarial organizations that have adopted it. The Code requires actuaries to follow qualification and practice standards for the jurisdictions in which they provide actuarial services.

The U.S. actuarial profession takes its self-regulation seriously and is committed to maintaining the public's trust in the work of actuaries. (For more, see the discussion paper, *Self-Regulation and the Actuarial Profession*.) The Code is foundational to maintaining this trust. The American Academy of Actuaries establishes qualification standards for the U.S. actuarial profession. The Academy also formed and houses the Actuarial Standards Board (ASB), which promulgates actuarial standards of practice (ASOPs), and the Actuarial Board for Counseling and Discipline (ABCD), which provides guidance to actuaries upon request and investigates actuaries who may have violated the Code.

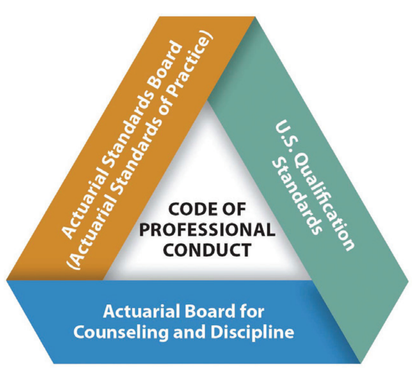
The first paragraph in section 1 of ASOP No.1, *Introductory Actuarial Standard of Practice,* states:

> "The Actuarial Standards Board (ASB) promulgates actuarial standards of practice (ASOPs) for use by actuaries when rendering actuarial services in the United States. The ASB is vested by the U.S.-based actuarial organizations with the responsibility for promulgating ASOPs for actuaries rendering actuarial services in the United States. Each of these organizations requires its members, through its Code of Professional Conduct (Code), to satisfy applicable ASOPs when rendering actuarial services in the United States."

The Code and the ASOPs set the standards for professional behavior and actuarial practice. These standards are purposely and appropriately principle-based and are intended to address all the situations an actuary may encounter.

All actuaries should stay current on, and regularly consider, professionalism principles as they undertake their work.

(For further information about the professionalism infrastructure, depicted in the graphic, see The Academy and the Web of Professionalism series by Tom Wildsmith.)



# The Actuarial Professionalism Toolbox

**Actuaries have many tools and resources available to support and explain their professional responsibilities to principals.**

### The Code of Professional Conduct

The actuary's Code of Professional Conduct is the starting point for conversations around professionalism. The Code covers a wide range of situations from acting with integrity to cooperating with a disciplinary body. It is important to remember, and for principals to understand, that an actuary who violates the Code can be disciplined by the profession. A serious infraction might result in the loss of hard-earned credentials for the actuary and may impact the reputation of the principal as well as the actuarial profession.

### ASOPs

ASOPs are developed by the ASB to identify what should or must be considered, documented, and disclosed for any actuarial work product and provide guidance for performing various types of actuarial work. The ASOPs provide room for exercising actuarial judgment when performing actuarial work while establishing broad-based guidelines for actuaries. The ASOPs range from the very general applicable to all actuarial work, such as ASOP No. 23, *Data Quality,* to the very specific applicable to a particular actuarial work product, such as ASOP No. 35 on measuring pension liabilities. Each ASOP is developed by actuaries who are experts in the topic and is subject to review by the profession before being formally implemented. It is very important for actuaries to stay abreast of new ASOPs and changes in ASOPs, as required by the Code.

The ASOPs Applicability Guidelines also help an actuary determine which standards apply to a particular assignment. Unlike ASOPs, which are issued by the ASB and are binding on actuaries, the Applicability Guidelines are published by the Academy's Council on Professionalism and are not binding on actuaries. It is ultimately the actuary's responsibility to determine which ASOPs apply to an assignment.

## Request for Guidance from ABCD

An important tool available to actuaries is the Request for Guidance process, administered by the ABCD. If an actuary is involved in a situation wherein the actuary is uncomfortable or uncertain of what to do, the actuary can confidentially discuss the situation with an ABCD member, who is an experienced actuary with relevant subject matter expertise. This third-party perspective may give the actuary the confidence to go forward with the work or may reveal something the actuary had not previously considered. This valuable tool, uncommon in other professions, is critical for maintaining the high standards of the actuarial profession.

## Peer review

It's important for actuaries and principals to understand the value of peer review to a quality and professional actuarial product, even one that has received thorough self-review. Actuaries and principals can benefit from review by another party, whether the work product in question is applied to an internal deliverable in a corporate setting or to work completed by a consultant for a client. Presenting and discussing assumptions, methodology, outcomes, and results with a peer reviewer can improve documentation, ensure additional perspectives are considered, and offer the actuary additional support for recommendations when the work product is presented to principals. Even when actuaries disagree, the conversation about differing views may add support to the recommendations.

## Reliance statements

Actuaries regularly rely on data or information developed by someone else when creating an actuarial work product. Principals should be informed of this reliance, and it's critical that actuarial documentation includes reliance statements from the information source regarding the use and limitations of the information, following the guidance included in ASOPs. Reliance statements doesn't let actuaries off the hook, though. Actuaries should consider, document, and disclose the reasonableness of the information and any risks, especially for items from non-actuarial sources or technology-driven analysis, such as items created using machine learning. Discussing this reliance with principals can provide them with a deeper understanding of the complexity of actuarial work to foster a better appreciation for the actuary's perspective and recommendations.

### Documentation and caveats

There is inherent uncertainty in any actuarial estimate. Realized results may be materially different from the initial projection. That is the nature of the actuary's work. As such, it is important that the actuary document and disclose all relevant assumptions, methods, and considerations underlying any actuarial determination.

Documentation and caveats of actuarial work ensure assumptions, recommendations, and results are clear to the preparer, the principal, and those who might review, revise, rely on, update, or consult the work in the future. Documentation should reference appropriate ASOPs, which often provide guidance on what should be documented. When actuarial judgment deviates materially from ASOPs, the documentation should include reasons for the deviation and why the deviation is appropriate for the situation.

Caveats help principals use the work product appropriately and in an informed manner, as well as acknowledge the limitations of the work. Caveats also increase the likelihood that principals realize the complexities and nuances of the actuarial work product.

## Non-Actuary Principals and Professionalism

Discussing professionalism with an actuary principal, such as a peer, an actuarial manager, or the chief actuary, is straightforward. Both parties should be familiar with the ASOPs and the Code, and both understand and care about actuarial professionalism. A principal who is not an actuary probably isn't familiar with the ASOPs or the Code, and because they are unaware, may not concern themselves with such things. An actuary might provide services to two types of non-actuary principals. One is a non-actuary principal who works in insurance, employee and retiree benefits, or risk management such as a chief executive officer (CEO), chief financial officer (CFO), chief human resources officer (CHRO), operations executive, asset manager, or underwriter. The other is a non-actuary principal who does not work directly in insurance, employee/retiree benefits, or risk management, but has a role in managing or overseeing companies offering those services. Some examples of this type include company board members, state legislators, government agencies, employers and trusts managing employee benefits, health care provider organizations, or the public.

For a non-actuary principal working in insurance, risk management, or employee/retiree benefits, the importance of actuaries' adherence to the ASOPs and the Code should be conveyed to them in a context that relates to the principal's own professional goals, such as maintaining the financial well-being of the company. Given the importance of the realized outcome of actuarial estimates on the financial well-being of a company, those running the company will want to be assured that any estimates of prices, future assets and liabilities are as reliable as possible. Adherence to ASOPs and the Code ensure that the actuary has completed their due diligence in terms of contemplating, documenting, and disclosing the underlying assumptions, and that the actuary followed accepted and sound actuarial practices. This adherence also provides a framework for a consistent approach year-to-year. It provides the best method of systematically measuring and documenting risks over time.

For a non-actuary principal who doesn't work in risk, benefits, or insurance, the desire for and importance of reliable and sound estimates are the same as for the non-actuary insurance principal; however, the explanation of the importance of adherence to ASOPs and the Code may be different. For example, consider a state legislator who is on a committee crafting legislation that will impact that state's insurance market. The legislator's primary concern may be that all insurance companies in the state are adequately funded, with all future liabilities properly accounted for, and surplus properly stated. For this broader point of view, encompassing the financial health of all companies in the state, the ASOPs can provide reassurance to the legislator principal that actuaries representing all companies in the state are bound by the same standards that, theoretically, should provide consistent treatment of future liabilities for all companies.

Now let's look at some case studies in an insurance company setting and some of the principals involved. Regardless of the nature of the specific actuarial work involved, these case studies lay out how to apply general professionalism considerations to a variety of situations.

Hypothetical Case Study Number 1

### Part 1: Questioning the Reserves (Internal Review)

It's year-end reserving time for Super Kool Insurance Company. Casey, the reserving actuary, and his team have set reserves following all the requirements of the Code, ASOPs, National Association of Insurance Commissioners (NAIC), and accounting standards, as well as reflecting the experience of the business. Carolyn, the Super Kool CFO, who has questioned Casey about being conservative in the past, schedules a meeting with Casey to discuss reserves. During the meeting, Carolyn tells Casey that the financial results using the established reserves are causing the company to be behind financial targets, which affects corporate bonus payments. Carolyn then asks Casey to eliminate any excess conservatism in the Super Kool reserves, so the CEO doesn't get worried.

What should Casey consider? What might Casey do?

## The Principal's Perspective: The CFO

As a first step, Casey should listen carefully to Carolyn's concerns and be careful not to disregard her opinion or be too quick to accept her view of reality. If he has not already done so, Casey may wish to discuss the situation with the chief actuary. Both Casey and the chief actuary may recognize that where professional judgment is involved, differences of opinion among actuaries can arise. As ASOP No. 1 indicates, actuaries can reach different but reasonable conclusions under the same set of facts.

It also may help to ask for time to review the assumptions and methodology again. Even the best actuaries and most thorough processes and peer review may miss an important nuance in the data or use an outdated dataset. Another review may uncover new information that affects the results. If Casey is willing to go back and review results before insisting that he is right, he may go a long way toward establishing a better working relationship with Carolyn. Casey also may seek additional peer review from a colleague for another point of view and perspective.

During this process, Casey may want to submit a Request for Guidance to review the situation with an experienced actuary who is a member of the ABCD. The ABCD member may have specific suggestions for dealing with the situation.

After this review, Casey may find that he is able to make a change to the reserves, while still meeting his professional responsibilities. However, he should be comfortable with the results himself and not allow Carolyn to think she can dictate results that fall outside of Casey's range of reasonable estimates.

In the follow-up discussion with Carolyn, Casey may lay out some of the relevant aspects of actuarial professionalism, such as:

Precept 1: *"An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession's responsibility to the public and to uphold the reputation of the actuarial profession."*

- All relevant ASOPs and how he complied with each of these standards, such as ASOP No. 5, *Incurred Health and Disability Claims;* ASOP No. 23, *Data Quality;* ASOP No. 28, *Statements of Actuarial Opinion Regarding Health Insurance Liabilities and Assets;* ASOP No. 41, *Actuarial Communications;* ASOP No. 52, *Principle-Based Reserves for Life Products under the NAIC Valuation Manual;* etc.
- The appointed actuary, who is appointed by the company's board of directors, must comply with all statutory, regulatory, and professional requirements. The appointed actuary must file a Statement of Actuarial Opinion (SAO) with state insurance regulators certifying the adequacy of statutory reserves.

Casey may spend some time explaining the process he used to arrive at the assumptions that drive results, including consultation with, and reliance on, others in setting assumptions. For example, the investment department was likely consulted on expected returns in the short and long term. Similarly, the claims and underwriting departments likely provided input on any unexpected experience that is developing. Actuaries need to address uncertainty related to assumptions about the future; demonstrating that other departments with relevant input were consulted may help the CFO be more comfortable with the results. Hearing this information also will help Carolyn gain a better understanding of the environment in which actuaries are working.

Going forward, Casey may want to establish a standing meeting in the weeks before reserves are due to review the assumptions with Carolyn and other relevant parties.

Hypothetical Case Study Number 1

### Part 2: Questioning the Reserves (External Review)

It's a new year, and Casey is preparing the year-end reserves for the Super Kool financial statements that will be filed with the state insurance department, following all guidance and requirements as before. Casey and his team also completed all requirements for the signed actuarial opinion to accompany the financial statement, and they are working on the actuarial memorandum.

Now Casey has additional principals to consider: Super Kool's board of directors, external auditors, and the state insurance department regulator. What should Casey consider?

## The Principal's Perspective: Board and Senior Management

The board of directors (the board) and senior management of a company taking insurance risk regularly rely on actuaries to opine on actuarial matters to manage the company and meet their fiduciary obligations. Often these principals are not actuaries themselves and therefore may be unfamiliar with actuarial professionalism standards and governance.

The specific subject matters reviewed with the board can vary widely by practice area and company and might include reserve and capital determination and analyses, policy illustration certifications, rate determination, or funding determinations. Regardless of context, the underlying importance of professionalism is the same. Casey may wish to prepare a document for the company leaders describing the role of, and requirements for, the appointed actuary and present this information at a regular meeting prior to year-end work to allow time for discussion and to help company leaders understand the value of these professionalism standards for their company. Casey may want to remind the board of these requirements as year-end financials are finalized. Casey likely will need to repeat this process each year with the board, both to educate new members and to refresh the knowledge of continuing members.

## The Principal's Perspective: External Auditor

Internal leaders and the board may apply pressure to lower reserves to improve financial results. An external auditor may be equally concerned that the reserves are neither too high nor too low. Setting the reserves too high would lead to deferred declared profits and tax payments, while setting reserves too low could result in future solvency issues. To this end, it is not uncommon for an external auditor to have its own actuaries verify the work of the company's actuary.

The auditor may want to override Casey's judgment. If so, Casey will want to have detailed discussions with the auditor and consider the auditor's point of view. Both Casey and the auditor will be concerned about ASOPs and may even discuss adherence or concerns related to ensuring ASOPs are appropriately considered. At the end of the day, Casey must certify the reserves, so it is imperative that he adhere to sound principles and practices and document and disclose all actuarial assumptions, methodologies, constraints, and reliance in the actuarial opinion, memorandum, or report.

## The Principal's Perspective: Regulator

Insurance is regulated at the state level. A primary responsibility of state insurance departments is to oversee insurer solvency. In the first part of this case study, Carolyn is suggesting that reserve levels are too high, thus lowering the calendar-year profits. Given the concern state insurance regulators have for long-term solvency, they should be concerned with the adequacy of the reserves to be able to provide for future payments for existing liabilities. Therefore, Casey's discussions with the regulator may be the opposite of the discussion with Carolyn. Instead of defending the possibility of "excess conservatism" in the reserves, Casey may find himself having to convince the regulator that the reserves are adequate.

Just as with external auditors, it is possible a regulator may want to override Casey's judgment regarding the appropriateness of actuarial assumptions for the reserves, based on his/her own judgment, ranges of filings by other insurers, or other factors. Actuaries must certify their reserves, so it is imperative that Casey adhere to sound principles and practices. To the extent that regulators may impose constraints on actuarial assumptions or methodologies, Casey may rely on such constraints and would document and disclose such reliance in his actuarial report.

Hypothetical Case Study Number 2

### We're Not Competitive!

The Super Kool Insurance Company board has received complaints from key producers about competitiveness of the company's premium rates, which are not required to be filed with or approved by state regulators. Charles, the CMO, and Carolyn have invited the chief actuary, Cassandra, to discuss the rates with the board. Charles expresses the opinion that because rates don't have the same appointed actuary requirements as reserves, there might be opportunity to lower rates to a more competitive level.

What should Cassandra consider? What might Cassandra do?

Cassandra may be able to propose lower rates while still maintaining her professionalism. Cassandra could ask the pricing actuaries to review the actuarial assumptions and calculations with her and consider scenarios. For example, did the pricing actuaries consider the degree to which additional sales could offset the lost revenue expected when lowering rates? Could they ask Charles' team for competitor rates to provide a new perspective that wasn't previously considered? There may be other changes Cassandra could suggest that, if accepted by the board, would justify lower rates, such as reducing the target profit assumption.

Cassandra may explain the professionalism issues to the board and to Charles, just as Casey previously did with Carolyn. She also might point out that adequate reserves support the long-term solvency of the company and that the company's customers are the "public" to whom the actuary owes responsibility for appropriate rate-setting. Finally, she may wish to make the board aware that, even though she is not certifying the rates to an outside party, her actuarial determination of the appropriate rates is still subject to all the same professionalism requirements.

## PBR: A Reminder for Life Appointed Actuaries

Historically, statutory reserves for life insurance products were largely prescribed — calculated pursuant to formulas, interest rates, and mortality rates prescribed by state law. While aspects of valuation, like asset adequacy testing, involved more of a principle-based approach, formulaic reserves largely drove liability balances. A paradigm shift occurred with the adoption of principle-based reserving (PBR) for life insurance products. PBR compliance for life insurance is still new; with the introduction of PBR, actuarial professionalism is even more critical.

Under PBR, more reliance is placed on company-specific assumptions and models, providing more room for, and reliance on, actuarial judgment. In addition, under PBR, a company's board of directors and senior management are required to satisfy specific corporate governance requirements with respect to determining the reserves. Specifically, under Section VM-G of the NAIC's Valuation Manual, senior management responsibilities include ensuring an adequate PBR governance process, reviewing the valuation, addressing significant issues, and reporting to the board at least annually. Board responsibilities include overseeing the company's PBR governance processes and reviewing reports and certifications. The professionalism of the actuaries responsible for the valuation underpin these additional VM-G requirements. To meet their requirements, the board and senior management rely on the professionalism of the actuaries calculating reserves and ensuring compliance with PBR requirements.

# Conclusion

At its core, maintaining professionalism in the actuarial work product is the actuary's obligation. However, actuarial opinions are used and relied upon by a wide variety of principals. Professionalism standards protect actuaries' principals and serve to engender confidence in actuaries and their work. Therefore, it is important to consider professionalism from the perspective of the principal, who is, after all, the user of the actuary's services.

As the case studies presented demonstrate, when anyone questions the conclusions that actuaries have reached, communications should be thorough, based on fact, and designed to educate the users about actuarial professionalism considerations that support the work product.

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