

## A Cautionary Tale for Actuaries

**W**HILE ACTUARIES MAY NOT BE ABLE TO PREDICT the future more reliably than anybody else, we are skilled at modeling the potential consequences of future contingent events. And we know that sometimes even the most unlikely events happen anyway. As actuaries, it behooves us to consider what might happen if we as a profession suffered consequences similar to those that have befallen the accounting profession. In other words, might our own Enron be lurking just around the corner?

Imagine the following scenario. Arlo Actuary works for one of the largest actuarial firms in the United States. In 1999, he decides to strike out on his own. He takes with him one large client, a public employee pension plan. Arlo has been the actuary for the plan for the past six years and the plan has been pleased with the quality of his work and, in particular, with the consulting advice he's given them.

For a number of reasons, there are upward pressures on the plan costs. The client argues that the prior investment rate of return assumption is too conservative. The plan has enjoyed four consecutive years of investment gains. Arlo agrees, albeit somewhat reluctantly, to increase the assumed rate of return on plan assets to 8.0 percent in spite of generally decreasing market trends. After all, 8.0 percent is not a particularly aggressive assumption.

The client is pleased with the result. Plan costs drop considerably below where they would have been without the change of assumption.

Arlo holds the assumption for 2000, 2001, and 2002. During this same period, plan assets decrease by 30 percent. Arlo struggles with doing the actuarial work for such a large plan at his one-person shop. He relies heavily on the client's in-house staff. Finally, in early 2003 he advises

the client that he is simply not equipped to provide the depth of actuarial support the client needs and suggests that the client return to his old firm for actuarial valuation services. He agrees to continue to provide consulting support.

Arlo's old firm picks up the 2003 valuation work in mid-year. To his colleagues' chagrin, they find multiple calculation errors in the work underlying Arlo's prior valuations.

Some of the errors are the product of work done in-house by the plan's inexperienced staff, but other errors are a result of Arlo's lacking the resources and peer review necessary to provide accurate work to a plan of this magnitude. The plan is now seriously underfunded. Costs for 2003 are projected to be 450 percent of 2002 costs.

The plan trustees are beside themselves. They refuse to take that kind of rate increase to the cities, counties, and other political subdivisions that fund

the plan. The actuarial firm suggests that further increasing the assumed rate of return on plan assets would somewhat mitigate the effect of the earlier errors. The markets seem to be recovering, and Arlo's assumed rate of return on assets, as noted earlier, is still not at the aggressive end of "best estimates" used by many actuaries. Moreover, if the trustees agree to allocate more of the plan's assets to equities, there would be further justification for increasing the assumed rate of return.



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In August, the trustees increase the equity allocation from 60 percent to 75 percent of plan assets. In October, the market takes a deep dive in reaction to economic disruptions in Europe. By March 2004, the plan is running short on cash to make benefit payments.

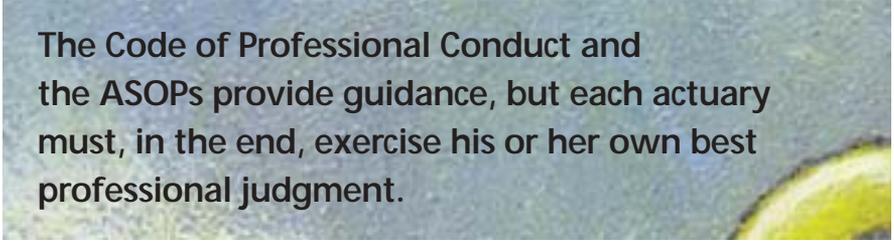
### Focus on Actuaries

The press gets wind of the problem. A statewide story becomes a national story when it's reported that the plan is underfunded by more than \$4.5 billion. The story gains more public attention when it's reported that the plan is running short of cash and the benefits aren't insured by the Pension Benefit Guaranty Corp. The trustees announce that cost-of-living adjustments to retiree pensions will be suspended until the plan is on better financial footing.

Next, it's reported that the sponsors have always contributed to the plan the amount recommended by the plan's actuaries, including its current actuaries, one of the largest, most respected actuarial firms in the United States. The implication of the national stories is that any inadequacy in the plan's funding is solely attributable to mistakes on the part of the plan actuaries.

One of the political subdivisions participating in the plan declares bankruptcy. Responding to pressure from the press and state legislature, the plan trustees are forced to resign. Everyone wants to know how this happened. Who is at fault? The focus is on the actuaries who recommended the amount of contribution. The press and political pundits ask why the actuarial firm didn't "blow the whistle" on Arlo Actuary when they discovered the errors. Can actuaries be trusted to police themselves?

You can use your own imagination from here. A whirlwind of criticism suggests that we, the actuarial community, screwed up. It's our collective fault that the plan is bankrupt and lots of ordinary folks are in danger of losing their pensions or at the least are being asked to forgo cost-of-living increases they count on to buy ever more expensive health care



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and, in particular, prescription medicine. The citizens of the political subdivisions and their progeny for decades to come will bear the financial burden of this boondoggle. Heads must roll!

### Code of Conduct

But why blame the whole profession for the actions of one actuary and the inaction of one firm? There are lots of reasons. Start with the fact that actuaries are a mystery to most people. There are fewer actuaries in the United States than there were professionals in Arthur Anderson. None of our biggest firms are household names. We don't have an identifiable Big Five. Consequently, if a member of the press or the public learns of actuaries for the first time from an incident of this sort, that person probably will have no other favorable impressions of actuaries to balance the negative implications of an event of this sort.

Further, pension actuaries are federally licensed and, thus, subject to direct federal jurisdiction and oversight. Notwithstanding the role that the plan trustees played in the events described above, pension actuaries are widely thought in the federal legislative and regulatory arena to have special expertise that brings with it a duty to protect the interests of plan participants. Inevitably, federal legislators and regulators would question how an event of this sort could have occurred and whether pension actuaries were receiving adequate oversight.

Our Code of Professional Conduct requires that we do not undertake assignments for which we're not qualified. It can be argued that Arlo Actuary didn't have the capacity to handle the actuarial valuation for a large public pension plan, although the issue may have been less one of whether he had the necessary educa-

tion and experience to do the work than whether he had the required time and resources.

Our code also requires that we report findings of failure to comply with the code. One of our largest, most respected firms didn't report the errors found when Arlo Actuary's work was reviewed. Maybe the members of the actuarial firm fully intended to report him to the ABCD in the near future, but they did nothing but compound the problem before it blew up in their face.

And consider for a moment the likely remedy: new and tighter federal control and oversight of enrolled actuaries. Just as the Enron incident was part of a pattern of events that led Congress to set up a new oversight board for accountants, the scenario described here might well lead to the promulgation of more laws, regulations, and mandatory procedures. What's good for pension plans might logically be extended to actuarial work for health and other benefit plans. The trust in our profession would be severely harmed. Our ability to exercise professional judgment in doing best for our clients could be severely restricted.

### Professionalism Matters

Interesting story perhaps, but what is the lesson? What could have or should have been done?

Let's start with the second question first. I don't think there's anything we as a profession could do differently that would prevent this or a similar scenario from ever happening under any circumstances. This isn't the tale of a maverick actuary ignoring generally accepted actuarial practices. It's the tale of a combination of events and circumstances coming together with tragic consequences.

We cannot police the actions of each

of our individual members. Actuaries, like other professionals, in complete good faith, sometimes overestimate their capabilities. Errors happen. Actuaries, like other professionals, also attempt to meet the needs of their clients and may find that responses that seemed reasonable when made appear less reasonable when viewed with the benefit of hindsight. We need to accept the possibility, however unlikely, that we, the actuarial community, could have to deal with our own Enron-like event someday.

As to the lesson we might take from this, I think there are two. First, as a profession we must continue our emphasis on professionalism. The Code of Professional Conduct, qualification standards, and Actuarial Standards of Practice are not meant to be treated as dust-covered tomes to be pulled out and looked at for their historical value from time to time. They should be part of our daily professional lives. They provide meaningful, useable guidance intended to make us better professionals.

This doesn't mean you have to begin each day reading ASOP 23 on Data Quality, but it does mean that each time you have a new assignment you should consider whether you meet the qualification standards; you should determine which ASOPs might be applicable to the assignment and perhaps re-familiarize yourself with them if need be, and you should refer to the code as necessary to resolve questions that arise around your professional practice.

Second, we must remember that the Code of Professional Conduct and the ASOPs provide guidance, but each actuary must, in the end, exercise his or her own best professional judgment. Errors of judgment will occur. The Actuarial Board for Counseling and Discipline, the ABCD, is our own resource for guidance in addressing difficult situations before they evolve into professional problems.

It's entirely appropriate that most of what the ABCD does is counseling rather than recommending discipline. (The ABCD does not itself do any disciplining; discipline is the purview of each actuarial or-

ganization.) In a case of this kind, the ABCD would almost certainly be called upon to investigate Arlo Actuary and his former firm, either because other members of the profession called the situation to the ABCD's attention or because the ABCD learned about the case through the media and decided on its own to investigate.

Depending on what its investigation revealed, the ABCD might find that the errors Arlo Actuary committed were relatively minor (notwithstanding the adverse publicity to the profession). In that case, the ABCD might well conclude that Arlo Actuary did not materially breach the Code of Professional Conduct and that the actuarial firm was, therefore, not remiss in failing to report him. However, the ABCD might well conclude that Arlo Actuary or his colleagues at the actuarial firm would benefit from counseling to improve their business practices and sensitivity to professionalism issues. If the ABCD found a material breach of the

code, the ABCD would advise the appropriate membership organizations of its findings and recommend discipline.

In any case, the lesson to be learned is that it could happen to us. And though it's more likely to be the result of inattention or overreaching rather than deliberate malfeasance, the consequences would be equally devastating. Arlo Actuary would have done well to think twice about taking on work he was unable to perform in a professional manner. The actuarial firm would have done well to consult with the ABCD as to whether Arlo Actuary's errors should be reported.

Most important, the entire actuarial profession would do well to remember that a single member of the profession can, with the best of intentions and totally foreseen consequences, do harm to the whole profession's reputation and credibility.

Professionalism—at all times and at all levels—matters. ●

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