

March 1, 2015

To: Actuarial Standards Board

RE: Comments on the Second Exposure Draft of the Proposed ASOP on Modeling

I appreciate this opportunity to comment on the exposure draft of the Actuarial Standard of Practice on Modeling.

I am concerned with the scope of the definition of Model in section 2.8 of the draft. I am not quite sure that I understand how the concept of catastrophe modeling evolved into the idea “that almost all actuarial work involves modeling” and that the ASOP should apply to all areas of practice. I have never thought that the work I was doing was modeling or that “simple spreadsheets” were models, but this exposure draft advances the idea that everything that I do involves modeling. I believe that this all inclusive concept of modeling is inappropriate and that we would best be served by a definition of modeling that is more specific.

In the exposure draft, several examples of models are advanced, including catastrophe modeling, ratemaking, and reserving models. While I can see that these examples are clearly models, I do not see how everything else falls into this definition. In addition, if a simple spreadsheet is a model, perhaps EXCEL itself is also a model. Should we be applying the procedures outlined in this exposure draft to EXCEL? To address this situation, I would like to propose the idea that the word “system”, in the definition of model, should also be defined. Systems could be defined as catastrophes, ratemaking and reserving, and thereby reasonably limit the concept of a model and the application of this proposed ASOP.

I was disappointed to read that several commentators on the previous draft suggested that the definition of model is too broad, and that the reviewers responded by saying that the definition is appropriate. I would suggest that the reviewers open their minds to the fact that the unintended consequences of this overly broad definition will not be working to the advantage of the actuarial profession.

I am concerned that the concepts in this proposed ASOP are so broad and so vague that its application will be impossible, for all practical purposes. Consider a complaint to the ABCD that an actuary failed to comply with the requirements of this proposed ASOP. To make a judgment in the case, the ABCD would have to determine what a system is, whether or not the actuarial work explained a system, what a model is, whether or not the actuarial work involved selecting, designing, building, modifying, developing, using, reviewing, or evaluating a model, whether or not full application, partial application, or no application of the guidance in the ASOP was appropriate, and if partial was deemed appropriate, what percentage of application was appropriate. It would then have to proceed to decide the extent of reliance by the intended user and the materiality of the financial effect.

I would also like to point out that “materiality of the financial effect” is a concept that raises a number of troubling issues. “Materiality”, as defined in section 2.6 of ASOP No.1, is suitably vague, in that it defines items as material “if its omission or misstatement could influence a decision of an intended user”. Therefore, materiality is effectively defined by the intended user, not the actuary. Therefore, if defined by the intended user, it would seem to invalidate the “professional judgment” the actuary is to exercise to determine materiality in the next part of section 2.6. The second to the last sentence in section 2.6 is more to the point that “materiality will be determined by an external user, such as an auditor, based on information not known to the actuary.” Having spent some time at a major accounting firm, I understand that “materiality” is a concept that auditors consider to be their own. The actuary is not to determine materiality. In addition, there are a number of different ways in which something may be material. For example, something may be material to an individual, it may be material to a line of business, or it may be material to the company, just to name a few. Asking an actuary to determine materiality may not be a reasonable request, particularly in light of the definition of materiality we are to use.

I would suggest that it would be extremely difficult, if not impossible, for the ABCD to decide whether or not an actuary failed to comply with this proposed ASOP. If the ABCD cannot decide such a case, it is in large part because it will be impossible for the individual actuary to decide “the extent to which guidance in this ASOP applies.”

However, if we rely on the statement in 3.1.1, “If in the actuary’s professional judgment, circumstances are such that applying some or all of the guidance in this ASOP is not warranted for the specific intended purpose as described above, this is not considered a deviation.” This sentence in essence says that if in the professional judgment of the actuary the guidance in this ASOP is not warranted, then failure to apply the ASOP is not a deviation, and the actuary’s professional judgment is the determining factor in the determination of whether or not it is binding. Therefore, can we question an actuary who determines that this ASOP is not binding?

Thank you for your consideration and your efforts.

John P. Frederick
Actuary & Consultant
2608 East Newton Avenue
Shorewood, Wisconsin 53211-2654