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Materiality and expert judgement frameworks

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What we will cover today:

- Background
- What are the objectives of good frameworks?
- How can these be practically built?
- What we have seen in the industry



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Background

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The pain of model validation without a materiality framework

Many, many questions from external approvers/regulators:



- What if you chose a different:
 - Index?
 - Data period?
 - PDF?
 - Method?
- Could you sensitivity test all of these assumptions?
- What's the combined effect of these assumptions?



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What is expert judgement?

Methodology

Risk universe, aggregation method, PDF and method of fitting, tax overlay, ...

Data

Dataset and time period, use of overlapping data, adjustments, internal/external data, ...

Assumptions

Experience parameters, future profitability for DTA calcs, renewal of service agreements, ...

There is no 'right' answer



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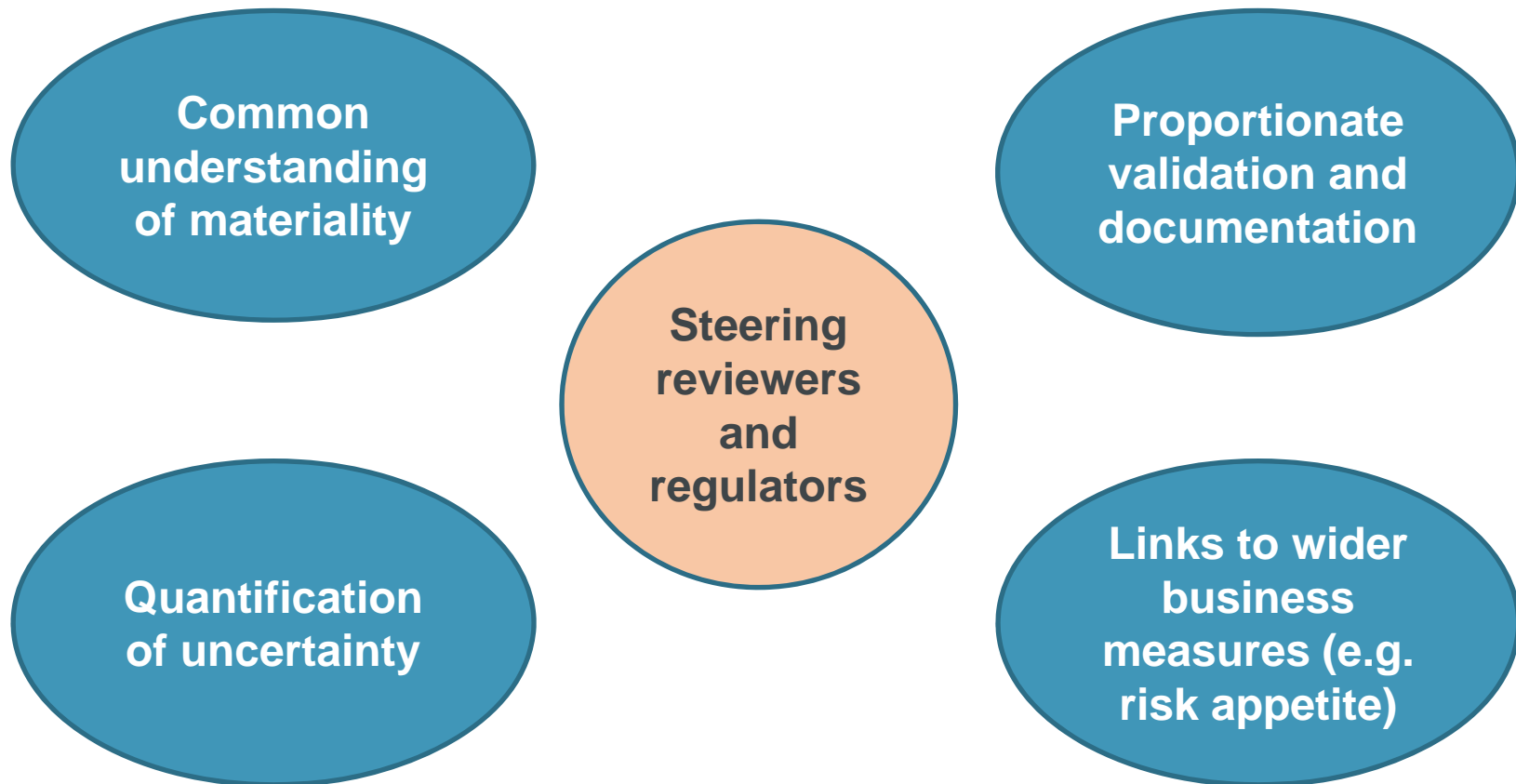


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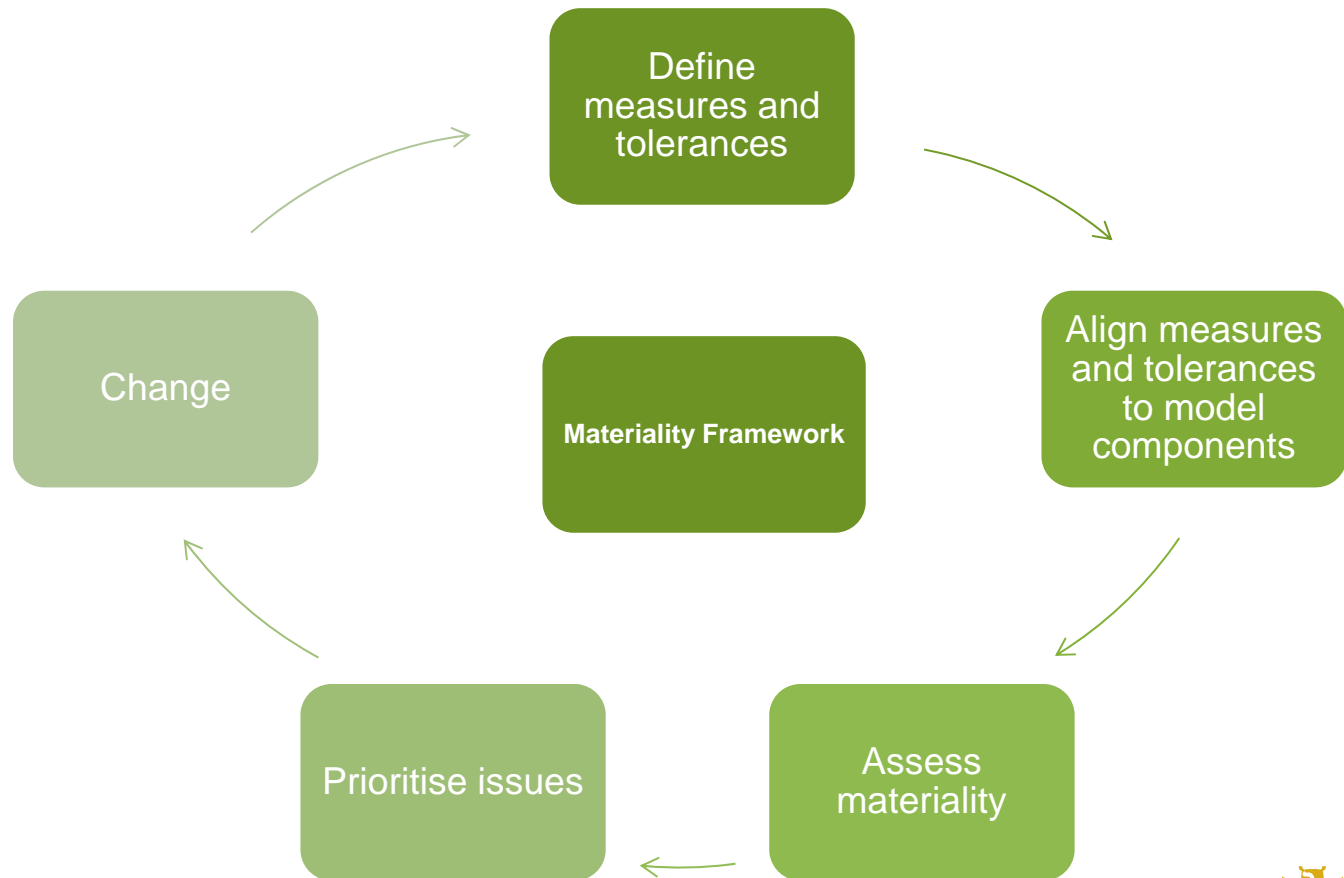
What are the objectives of good frameworks?

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Purposes of a materiality framework



Materiality framework





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How can these be practically built?

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Practical components

- Materiality Policy Document
- Clear ownership
- Materiality expert judgement logs
- Defined limits
- Defined processes



A practical materiality framework

- Purpose(s) of framework are clear
- Practical for purpose(s)
- Consider qualitative factors as well as quantitative
 - e.g. complexity of model component, degree of uncertainty
- Consistent
 - Between components
 - Between group and solo entities





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What companies are doing in reality

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Current state



- Frameworks still in their infancy
- Materiality approach tends to be consistent
- No consistent approach yet emerged on expert judgement
- Scope - formal materiality and expert judgement frameworks are typically only used for:
 - SII
 - Economic Capital
 - ICAS / ICAS+



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Materiality metrics

- Materiality metrics tend to be a combination of:
 - Qualitative statements / categorisations
 - % of Balance Sheet Item (SCR or Liability Value)
 - Fixed monetary amount
- Examples of qualitative components/categorisations:
 - *“Will deficiencies in the component will result in the Board and the regulators to conclude that overall, the internal model is not fit for purpose?”*
 - *“Is the component is new and were there substantial changes made in the last 12 months?”*
 - *“How complex is the component?”*



Materiality metrics

- Quantitative and qualitative assessments can then be combined to give an overall materiality assessment:

| Materiality | High | M | H | H |
|-------------|------|---------------------|-----|------|
| | Med | L | M | H |
| | Low | L | L | M |
| | | Low | Med | High |
| | | Implementation risk | | |



Materiality metrics

| Company | Metric | Critical | High | Medium | Low |
|-----------|------------------------------|----------|---|--------|-------|
| Company 1 | Post Diversified SCR | n/a | >5% | 1-5% | <1% |
| Company 2 | Shareholder equity | n/a | 2% , assuming 150% coverage ratio . The materiality target changes with change in the coverage ratio. | | |
| Company 3 | Undiversified SCR | >10% | 5%-10% | 0.5-5% | <0.5% |
| Company 4 | Asset value, Liability value | n/a | >10% | 5-10% | <5% |
| Company 5 | Pre-diversified EC | n/a | >5% | 2.5-5% | <2.5% |
| Company 6 | Surplus | n/a | >5% | 2.5-5% | <2.5% |



Expert Judgement Fundamentals

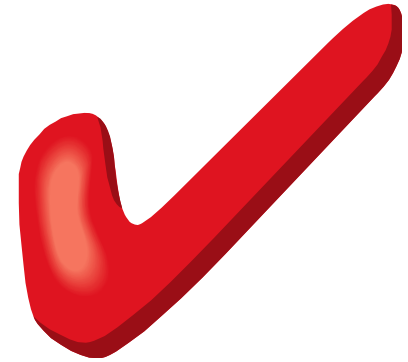


- Who the expert is
- Process for arriving at judgement
- Context of judgment (where used)
- Alternatives to the judgement made
- Under what circumstances would it not be valid
- Materiality of impact of the judgement being wrong (versus alternative view). Sensitivity testing
- Consistency of judgement with similar items



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Advantages



- Provides a consistent view and framework for managing the risks:
 - Clarity of definitions / requirements
 - Triggers for investigations / monitoring
 - Clear view of priorities
- Ability to monitor areas where materiality may be close to limits / expert judgement assumptions validity
- Regulator / senior management buy-in



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Challenges



- Embedding it into the business
- Documentation and Governance
- Rolling out across other areas (IFRS reporting, pricing, .risk appetite..)
- Managing materiality and expert judgement for small entities in a Group
- To demonstrate a judgement is not material – how much effort is enough?

Key considerations

- Clear ownership and responsibilities
- Clarity on how materiality should apply in practice
- Sensitivity testing for EJ is vital to understand the impact if the judgements is
- Ensure the frameworks provide a holistic and consistent basis with other policies (validation etc...)
- Ensure embed within regulator/senior stakeholder communication



Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenters.



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