



Institute  
and Faculty  
of Actuaries

# Working Draft of ESAP 2 – Actuarial Function Report

Response to the Actuarial Association of Europe

4 September 2014

## **About the Institute and Faculty of Actuaries**

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.



Actuarial Association of Europe  
FAO Michael Lucas, Secretary General  
4 Place du Samedi  
B-1000  
Brussels  
Belgium

29 August 2014

Dear Michael

**Working Draft of European Standard of Actuarial Practice 2 (ESAP 2) – Actuarial Function Report under Directive 2009/138/EC**

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to comment on the working draft of ESAP 2. To ensure a comprehensive response that reflects the breadth of areas in which our members work, we have consulted members of the IFoA's Solvency II Steering Group; Life Board; General Insurance Board; Regulation Board and International Board.
2. As outlined in our response to the Groupe Consultatif's previous Exposure Draft (ED) of ESAP 2, the IFoA supports the intentions of this standard.<sup>1</sup> We continue to consider it important that reporting, both in terms of scope and practice, is consistent across Europe in the general application of EU legislation and, particularly, once Solvency II comes into effect.
3. The IFoA is encouraged that many of the points raised in our previous response have been addressed. In particular, it is helpful that the Actuarial Association of Europe (AAE) has documented how the expected requirements of the regulation have generated the specific text of this ESAP. However, we have some remaining concerns in respect of the draft standard. Our key concerns are set out below and we have included an Appendix that contains our detailed drafting comments.

**Principles-based, targeted and proportionate**

4. As commented in our previous response, the IFoA and the Financial Reporting Council (FRC) have implemented a principles-based framework in the UK.<sup>2</sup> This approach has been built in part upon the foundation of Technical Actuarial Standard (TAS) R – Reporting Actuarial Information.<sup>3</sup> We welcome the AAE's similar commitment to a principles-based approach, but we are concerned that the current draft does not always adhere to this approach. We have provided examples in the Appendix where we suggest the standard becomes unnecessarily granular in its level of detail. We recommend the definition of Solvency II Principles does not include Level 2 and 3 text.

---

<sup>1</sup> <http://www.actuaries.org.uk/research-and-resources/documents/consultation-response-GCASP2>

<sup>2</sup> Ibid

<sup>3</sup> [https://frc.org.uk/getattachment/f6888ddc-79a4-4d26-858b-128eb736a8f7/TAS-R-Reporting-Actuarial-Information-version-\(1\).pdf](https://frc.org.uk/getattachment/f6888ddc-79a4-4d26-858b-128eb736a8f7/TAS-R-Reporting-Actuarial-Information-version-(1).pdf)

5. In accordance with the AAE's principle of structuring the Actuarial Function Report (AFR) to meet the needs of the intended user, we would suggest the standard could clarify that the AFR does not have to be a single document. The length and structure of the reporting will be important in determining how much of the AFR is read, understood and ultimately of use to the Administrative, Management or Supervisory Body (AMSB). As written, our interpretation of ESAP 2 is that the Actuarial Function Report (AFR) would be a single document.
6. If the standard were more explicit in making clear the possibility of submitting component reports; the Actuarial Function (AF) could separate the report into 'bite-size' sections that are presented at separate board meetings throughout the year. Such reports would allow a clear focus on the many specific and important elements that are required in the AFR, yet accumulating the entirety of the requirements specified within ESAP 2. We would also suggest the outcome could facilitate greater board engagement.
7. The standard could better serve the interests of the users by focusing on outcomes, particularly with regard to the user's reliance on the report. We would refer again to the use of component reports that would look to engage the users in specific detail at the appropriate time. Excessive prescription may act as a counter to this in making reports unnecessarily long and lacking sufficient focus to engage the AMSB. Care would be needed to balance the requirements of best practice and harmonisation without obscuring the true message being relayed by the AF.
8. In the Appendix, we have also highlighted a number of instances where the use of the word "material" may provide greater clarity for the AF about what the AFR should, or should not, contain. Our objective in doing so is to ensure greater proportionality.
9. The Appendix also contains some suggested revisions that involve the omission of text. We hope this helps to ensure that the standard better reflects the higher level regulatory text.

### **Mandatory provisions**

10. We appreciate the AAE's action, as suggested in our previous response to the ED, to clearly link the provisions back to the original regulation (Directive, Level 2 or Level 3) that give rise to the requirement. We also recognise the difficulties that exist in doing this prior to the publication of final rules. However, in places, we suggest the requirements in the ESAP go beyond what is required by the regulations cited by the AAE as a justification for that requirement.

### **Reliance and responsibility**

11. Notwithstanding paragraph 3.1.10, which introduces the concept of reliance on others, our concerns outlined in response to the previous draft remain. There may be some tasks addressed in the ESAP that are already carried out by another area within a firm, such as the reinsurance, underwriting and risk management functions. This may be particularly true in non-life firms. It is possible that such firms could incur additional costs through duplication of work.

12. If you wish to discuss any of the points raised please contact Philip Doggart, Policy Manager ([philip.doggart@actuaries.org.uk](mailto:philip.doggart@actuaries.org.uk)/ 01312401319) in the first instance.

Yours sincerely

A handwritten signature in black ink that reads "David Hare". The signature is written in a cursive style with a long horizontal flourish underneath.

David Hare  
**Institute and Faculty of Actuaries, Immediate Past President**

## Section 2 Definitions

- 2.11 We note that there is a definition of “Model”; we suggest that providing a definition of ‘Method’ would also be beneficial. We recognise there may be a distinction implied; however, the absence of an explicit distinction may cause some confusion given the words appear to be used interchangeably.

The definition of ‘Model’ also contains an embedded definition of ‘Data’. Inserting the definition of ‘Data’ in a separate section, while removing it from 2.11, would add clarity.

## Section 3 Appropriate Practices

### 3.1 General Principles

- 3.1.1 We recommend the replacement of “include” with “bear in mind the requirements of”. The current wording is strong.
- 3.1.4 We note that there has been no distinction made between the adequacy of the underwriting policy and the successful implementation of the policy. As such, we have assumed that the ESAP refers to both adequacy and implementation. We would welcome clarification if this view were not accurate.

There are a number of sections where the requirements are more specific than would normally be expected for general principles. In some cases, there may be a need for a disproportionate amount of work in order to comply with the standard. In particular, we note the following:

- 3.1.7/8 We suggest that compiling a long list of all elements of the work undertaken by the AF would not automatically add to the understanding of the intended users. As noted in our covering letter, an aggregate report that refers to previously submitted component reports can reference the tasks and responsibilities without distracting from the most significant aspects of the report. Such an approach would be consistent with Principle 4. We would suggest a similar approach for 3.2.4.
- 3.1.9 We would encourage the elaboration of anticipated conflicts of interests. However, we would not expect these to appear in the standard, but rather in the accompanying European Actuarial Note (EAN).
- 3.1.11/2 We are not clear why this information is needed for intended users.
- 3.1.13 We would suggest that restricting the AFR’s coverage to significant issues will keep it manageable and more relevant for the users. However, any significant deficiencies, or areas for improvement, could be included within a supplementary report. In addition within 3.1.13 (and elsewhere, for example 3.2.1.1), any opinion stated should be with regard to the adequacy and reliability of the calculation of technical provisions. This would ensure consistency with the Directive.
- 3.1.16 The phrase “set out” suggests that all data used would form part of the report. This could make it unmanageable and difficult to read. Using alternative words, such as summarise or describe, might be better.

It would also be helpful to expand on "areas of uncertainty". For example, the intended user should be able to distinguish between "normal" areas of uncertainty, such as future experience arising from market volatility, as opposed to an unusual

element of uncertainty, such as a specific change in legislation. The same comment applies to 3.2.1.3.

Rather than refer to all factors 3.2.2.1 should highlight the key scenarios, with particular concentration on changes since the previous report.

### **Section 3.2 Technical Provisions**

The AFR might be more easily understood by intended users if it had a strong focus on changes to data, assumptions and methodology. Including standing information which is quite likely to remain unchanged from year to year could clutter the report. Again, the use of component reports would solve this challenge. Some of our members have identified 3.2.5.3/4 and 3.2.6.1/2 as sections where this could be an issue.

3.2.3.1 In addition to the current wording, it would be useful if the commentary were to include the implications as to how the experience between the opening and closing positions had been taken into account.

3.2.5.1. We do not believe that the wording of this section is sufficiently clear. Some of our members commented that the wording could demand an assessment of the data that was too detailed. However, others interpreted the wording less stringently. In order to clarify this matter, we would suggest the following alternative wording:

“The AFR must include an overview of the controls surrounding the data used in the calculation of Technical Provisions and an explanation of how the AF is comfortable that the data is appropriate, accurate, reliable and complete.”

Such an approach would allow the focus to be on any understood weaknesses within the data rather than having too much detail about good data. This would also apply to 3.2.7.1.

3.2.5.4 We would recommend the text should not differ from the Level 2 text.

3.2.6.4 Both of these matters could be covered by a statement from the AF within the AFR that the method has been verified as appropriate. Typically any areas of dispute could have been identified and remedied within a component report. These comments are also applicable to 3.2.6.6.

3.2.6.5 We would recommend the text should not differ from the Level 2 text.

3.2.6.6 We refer to our previous comment in 2.11 about the definition of “Method”. Non-life Technical Provisions rarely depend on models; stochastic approaches add to the discussion of variability/uncertainty rather than to the discussion of the point estimate. Non-life Technical Provisions almost always depend on multiple methods, rather than models.

We would note that the US ASOP states the actuary must disclose any situation where the conclusion is based ONLY on a single method. With this in mind, interchanging “Method” and “Model” could put a significant burden on any non-life AF (as per our comments in 2.11).

### **Section 3.3 Opinion on underwriting policy**

3.3.1 We refer to our comment about 3.1.4 in that we have interpreted this to mean the opinion should cover the adequacy and the implementation of the underwriting policy. With regard to the adequacy of the policy, we would welcome clarification that it should consider the ability to meet liabilities as they fall due and the sufficiency of Technical Provisions rather than other matters such as, IFRS profits being different from the levels predicted.

- 3.3.1.2. We would welcome clear examples of what an actuarial opinion on the overall underwriting policy might say; however, such examples would be better placed in an EAN rather than in a principle based standard.
- 3.3.1.4 We would suggest the insertion of “material” before “deficiencies”.
- 3.3.3.1 We would recommend confirmation that the sufficiency of premium only applies to business written during the period covered by the AFR. It does not apply to business written retrospectively which is already covered in the Technical Provisions.
- 3.3.4.2/3The Standard adds text to the AF duties that goes beyond the Level 2 text (“gold plating”). It also duplicates work that will be undertaken elsewhere in the firm by the Risk Management Function (“duplication”). We would suggest that these sections are amended to reflect these comments, or that some of the text is included instead within an EAN.
- 3.3.4.3 A firm may be willing to accept some risks rather than take mitigating action, which would be in line with its risk appetite, or preferences. We would suggest that this section would be improved by adding “may include”. This would focus attention on the material risks that are reasonably foreseeable and where further management attention is most likely to be beneficial.
- 3.3.5.1 We suggest that there would be limited added value if the report included all areas where premiums have been "adjusted". Similarly, there is unlikely to be added value by including all cases where premiums have not been “adjusted”.

Overall, it is not clear what is meant by the section. We assume the intent here is application to long term life business with reviewable premiums. Non-life premiums are regularly adjusted in the light of experience. For non-life business, there are two obvious examples, large risk experience rated policies and no claim discounts for which reporting would be onerous.

- 3.3.6.1 Anti-selection may take many forms; therefore, the standard should only require the AF to include those forms which are most likely to occur and which would have a material impact.
- 3.3.7.1 We would suggest the addition of “relevant” before “policies” as firms will have many other policies, in some cases 50 or more.
- 3.3.7.2 The inclusion of “risk appetite” and “risk profile” appears to go beyond the requirements of the quoted regulation. We suggest it is not clear how to assess consistency with risk profile, which is a consequence of the underwriting policy amongst other things.
- 3.3.7.3. This sentence adds the “business plan” to a lengthy number of reports that should be reviewed. There could be a practical issue with such a review if the timing of business plan updates is not coordinated with the update of the underwriting policy. It is not clear that the duties placed on the AF in this regard are distinct from those of the Risk Management Function.

### **Section 3.4 Opinion on the adequacy of reinsurance arrangements**

- 3.4.1.3 The standard adds text to the AF duties that goes beyond the Level 2 text (“gold plating”). It also duplicates work that is being done elsewhere in the firm by the Risk Management Function (“duplication”). We would recommend deletion of this section or move some of the material into an EAN.

- 3.4.1.4 It would appear unreasonable to consider alternatives for in-force reinsurance arrangements. A more appropriate factor is to consider whether the arrangements are appropriate given current capital constraints.
- 3.4.1.4. We would recommend the insertion of “material” in this section, as providing a description of any alternative reinsurance arrangements considered could be onerous and does not add value.
- 3.4.2.1 The inclusion of Technical Provisions in the list implies that the actuary should highlight the inconsistencies between the current reinsurance arrangements and the historical arrangements which are used to determine the net Technical Provisions for older underwriting years, or accident years. However, Technical Provisions are to be shown gross of reinsurance in the Solvency II balance sheet, with reinsurance recoverables shown as an asset. Given that, it is not apparent past reinsurance arrangements would be relevant to Technical Provisions. We recommend clarification of this point.