CROSS-PRACTICE ACTUARIAL ADVICE FRAMEWORK WORKING GROUP TECHNICAL PAPER: ACTUARIAL ADVICE FRAMEWORK

30 August 2018

INDEX

1. Status of Technical Paper

This Technical Paper was prepared by the Cross-Practice Actuarial Advice Framework Working Group (**AAFWG**) of the Actuaries Institute. It is not a Professional Standard or Practice Guideline of the Actuaries Institute.

This is the first version of this Technical Paper (TP).

2. Objective

Under *Prudential Standard CPS 320 Actuarial and Related Matters* (**CPS320**), each general insurer, life insurer and private health insurer is required to establish a framework for the provision of actuarial advice. This TP provides information to support actuaries carrying out the following activities related to an insurer's actuarial advice framework (**AAF**):

(a) drafting an insurer's initial AAF or proposing updates to an existing AAF;

(b) providing advice to the Board at time of adoption of the initial AAF, or an updated AAF, covering the suitability and adequacy of the proposed AAF; or

(c) providing advice to the Board via the Financial Condition Report or other reports on the effectiveness of the operation of the AAF over the prior period.

This Technical Paper has been prepared for the purposes of providing information and generating discussion within the Institute's membership on the merits of different practices that may arise in regard to AAFs. Whilst it outlines issues for consideration related to AAFs, the need to apply actuarial judgment in all situations continues to apply.

This Technical Paper aims to provide information to actuaries across the three practice areas of general insurance, life insurance and private health insurance. To the extent possible, the TP has been drafted to cover all three practice areas, although certain issues will have greater or lesser relevance for particular practice areas.

The Technical Paper is structured into the following main sections:

- background;
- roles and responsibilities;
- areas where advice may be required;
- materiality;
- provision of advice;
- conflicts of interest; and

- assessing the effectiveness of an AAF.

3. Background

3.1. Regulatory requirements

The Australian Prudential Regulation Authority (APRA) has issued *Prudential Standard CPS 320 Actuarial and Related Matters* (**CPS320**), which requires each general insurer, life insurer and private health insurer to establish a framework for the provision of actuarial advice. CPS320 requires that the AAF be appropriately documented. In addition, APRA has released *Prudential Practice Guide CPG 320 – Actuarial and Related Matters* (**CPG320**), which provides further guidance related to the AAF.

Throughout the Technical Paper, the term "insurer" is used, however, certain organisations may develop an AAF that applies to multiple entities within a group (potentially including non-insurance entities).

3.2. Principles underlying an AAF

The AAF is a document that defines the scope and nature of issues that require actuarial advice to be considered before decisions are made. The AAF is directed at both the users and providers of actuarial advice.

The AAF will become a component of an insurer's existing operating and risk management framework, which will vary from insurer to insurer. Some of what is suggested within this Technical Paper may already be covered within existing documents. If this is the case, then the benefits of a shorter AAF (relying on existing documents) may be considered against a comprehensive single document (with overlaps to existing documents).

4. Roles and responsibilities

4.1. Business decision makers

The AAF would typically place responsibility for seeking advice on the relevant business decision makers (the management and Board of the insurer). The AAF should be drafted in consultation with relevant business decision makers so that their needs are met and that their obligations under the AAF are clearly understood.

4.2. Appointed Actuary and other actuaries

The role of the Appointed Actuary of the insurer is paramount. In some organisational structures, the Appointed Actuary may report to a Group Actuary or Chief Actuary of the organisation (or business region or division). However, this does not negate the Appointed Actuary's authority to provide over-riding and final advice to the insurer's Board and management on specific prudential matters.

The number and roles of other actuaries in the AAF will vary depending on the size and complexity of the insurer.

For example, a large and complex multi-line insurer may have a number of actuarial departments (the Appointed Actuary's corporate actuarial team, one or more pricing actuarial teams, a reinsurance actuarial team, or a risk actuarial team). Teams may report to other senior management members rather than the Appointed Actuary. Smaller and considerably simpler structures also exist. In some cases, the entire actuarial function may be outsourced to an external actuary. The structure of the insurer's overall actuarial function should be a key consideration in constructing the AAF.

Lines of authority or escalation will also vary depending on the structure of the organisation and nature of Board or management-approved delegations.

4.3. Appointing, monitoring and replacing an actuary

The insurer should have a process in place to ensure that individuals appointed to roles that provide advice under the AAF have the appropriate expertise to provide that advice, or else make available some mechanism to access that expertise on a needs basis.

5. Areas where advice may be required

5.1. Principles

It would be expected that each insurer will take a different approach to defining the areas where actuarial advice may be required, reflecting its own strategy and structure. APRA has set out minimum requirements for each type of insurer, but these are unlikely to cover the full extent to which actuarial advice can contribute towards the achievement of the insurer's goals.

The section of the AAF that defines the areas where actuarial advice may be required would be primarily targeted at the business decision makers as users of actuarial advice. It should enable those making decisions within the insurer to understand the circumstances in which they need to seek actuarial advice. Accordingly, it should be written in terms that are accessible to those people, and relate to situations they would recognise.

Also, while the AAF will set out the areas where the insurer will seek actuarial advice, it should not limit management or the Board from seeking advice from actuaries on other matters.

5.2. Business topics

The decision on what areas for advice should be included in the AAF should reflect the matters that will drive the business or financial condition of the insurer. These are often applicable across the insurance spectrum, and new concepts developed in one sector may often be usefully applied in the others. Examples of generic topic areas that might be considered include:

- insurance liability evaluation;

- prudential capital evaluation;
- financial reporting and budgeting;
- capital management;
- product design and pricing;
- product management;
- reinsurance;
- business strategy;
- investment policy;
- risk profile; and
- data strategy.

To assist insurers in setting their own AAF, Appendix A sets out a non-exhaustive list of matters which could be considered for inclusion.

As a final check, it is also necessary to consider the relevant practice area attachment to CPS320, which sets out a number of topics that must be addressed within the AAF.

6. Materiality policy

6.1. Introduction

The AAF must include a materiality policy that is to be used to determine:

- when a matter is:
  - immaterial and does not require actuarial advice;
  - material and requires actuarial advice; or
  - most material and requires advice from the Appointed Actuary; and
- who should consider the advice (in particular, the circumstances in which it must be considered by the board).

For the purposes of the AAF, the concept of materiality is used to assess the potential impact of a matter on business outcomes, and the value that may be added by considering actuarial advice before making a decision on the matter. The materiality policy component of the AAF should take account of the size, structure and operational complexity of the insurer. It should be aligned with the insurer's risk appetite. It should address both who makes decisions as well as who provides the advice.

It therefore follows that materiality policies will differ amongst insurers, reflecting risk appetite and operational aspects, such as separate business units and lines of management responsibility.

Insurers are already likely to have a range of policies setting out Board delegations for decision making, and to whom actuarial advice, where required, is to be provided. In these cases, insurers may elect to refer to these existing policies in the AAF.

When designing the AAF, a balance will be required such that material advice is appropriately documented while not creating excessive documentation and compliance overheads every time an actuary is consulted or participates in a business management function.

The AAF would typically require increasing levels of ‘advice’ (in terms of the level of detail, degree of documentation, or seniority of actuary providing it) where the scope of business covered is broader or more complex, the impacts on customers, solvency, profitability or downside risks are greater, or more reliance needs to be placed on experience and professional judgement (rather than a mechanical calculation).

The AAF may detail the metrics that should be used to assess the materiality of a particular decision. These metrics should ideally be readily available and relatively easy to apply. Suitable metrics could include:

- expected impact on new and/or existing policyholders;
- expected impact on profit, risk profile (including both acceptance of increased risk or new risks), capital and economic value; and
- business lines/volumes impacted (new business or in-force premium, inflows or outflows, funds under management, customers impacted, etc.).

The metrics could also be graduated to align to different materiality levels. Different materiality levels could apply when determining who makes decisions versus who provides the advice.

6.2. Assessing the materiality policy

In assessing the suitability of the materiality policy, a number of points could be considered including the following:

- Have the thresholds been appropriately determined? The thresholds could be assessed against the potential policyholder impacts, financial metrics and shareholder impacts (profit, capital), risk or uncertainty and current and emerging regulatory and community expectations.
- Is there an appropriate alignment between the significance of the issue, the seniority of the actuary providing the advice, and the level of management making the decision?

Are these thresholds aligned to the insurer's risk appetite and risk management framework?

- The policy should balance detailed financial and other metrics with the need to be reasonably simple to interpret and implement on a day to day basis. Have suitable proxy measures been adopted in determining thresholds to achieve a balance between accuracy and simplicity?

- Does the policy provide the right balance and level of involvement of the Appointed Actuary, so that the aims of CPS320 can be achieved with the Appointed Actuary being more available to provide strategic advice to the Board and senior management?

- Is the policy capable of appropriate implementation, in terms of availability of suitably experienced actuaries (particularly for smaller insurers)?

- Does the policy allow for "grey" areas, such as where there are a number of small changes that collectively should trigger a higher advice and / or approval threshold?

- Is the operation of the policy subject to appropriate documentation and reporting, particularly for those areas where there is a need for advice? The Appointed Actuary will require an appropriate level of documentation to be available in order to assess the operation of the Actuarial Advice Framework in the FCR.

7. Provision of advice

7.1. Process for determining when advice is required

The AAF's materiality policy will define when advice is required.

The AAF could set out the process for determining when advice is required and how the decision-maker goes about seeking advice. For example, the process may commence with an executive informing an actuary of relevant circumstances, and the actuary suggesting what advice may be required; or by a specific request for actuarial advice on a topic; or by some other means. The AAF could contain a flowchart to help ensure this process is well communicated and understood.

It may also be worth emphasising to users of the AAF that if they are concerned about a particular proposed action, but a threshold metric has not been reached, then they should still seek actuarial advice (which may just confirm no advice is required).

7.2. Matters to be addressed when providing advice

The AAF could require that advice provided under it should follow a consistent structure.

Particular attention may need to be given to specifying standard elements setting out the overall circumstances in which the advice is provided, to whom the advice is provided and any limitations on that advice (either by scope, product, or time) and key assumptions (and their source).

Typically, this may include matters such as:

- the purpose of the advice;
- to whom the advice is addressed (and who can rely on it);
- the role of actuary in providing advice (initiating proposal and providing view, or reviewing another's proposal);
- sources and reliability of data and validity of models;
- any limitations on the scope of the advice and the assumptions upon which it is based;
- the time period during which the advice is valid, any triggers for a need to review the advice, or environmental changes which may render the advice inappropriate;
- key assumptions, their sources and key risks or areas of uncertainty in these assumptions;
- financial and other metrics that have been used in forming the advice; and
- how the advice fits within the AAF including reference to the appropriate level of delegation.

It is important that the AAF allows the actuary to exercise professional judgement as to which financial and other metrics are relevant and appropriate. Appendix B sets out a list of potential metrics, which should not be considered to be exhaustive; neither should it be assumed that all pieces of advice should include all of these metrics.

It will usually be appropriate for the advice to describe the sensitivity of key metrics to changes in material assumptions.

The advice will also need to comply with any relevant professional standards.

7.3. Form of advice

In normal business situations, views and opinions of actuaries are regularly sought and provided orally. It is important that the value the actuary brings to a discussion is not impeded by unnecessary restrictions (or compliance overheads) within the AAF. Nevertheless, there may be circumstances where opinions or views initially expressed orally should subsequently be documented.

The AAF may also outline where advice must be provided in a written format – such as formal actuarial advice required under prudential standards.

8. Conflicts of interest

Identification and management of real and perceived conflicts of interest is critical to the effectiveness of the AAF. The AAF should set out the specific process to manage conflicts of interest under the AAF.

8.1. Identification of conflicts of interest

All actuarial advice required under prudential standards must be impartial.

The AAF should recognise that there may be perceived or actual conflicts of interest or duty in the role of the Appointed Actuary (or other actuaries). Delivery of impartial advice is dependent on the identification and management of any such conflicts.

Examples of potential conflicts in the operation of the AAF include:

- the Appointed Actuary performing first line, second line and third line functions, resulting in the Appointed Actuary being required to review and challenge decisions based on the Appointed Actuary's own advice;
- the Appointed Actuary performing other roles or duties for the organisation (such as Chief Financial Officer) that may lead to a conflict in responsibilities and objectives;
- performance objectives, remuneration structures or business reporting lines for actuaries, other than the Appointed Actuary, providing advice under this framework that may impact the ability for that advice to be impartial; and
- an actuary providing advice, other than advice required under prudential standards, who may be required to fulfil an advocacy role as contemplated under Section 4.4.3 of the Code of Professional Conduct.

8.2. Management of conflicts of interest

Control frameworks and strategies to address any actual or perceived conflicts of interest should be documented in the AAF. These could include, for example:

- disclosure of the nature of the potential conflict;
- separation of roles;
- internal peer review or external/independent review; or
- in some circumstances, sourcing a different advice provider.

The AAF should specify who is responsible for identifying and managing conflicts that could raise doubts as to the impartiality of the advice. The AAF could also address whether the recipient of actuarial advice should consider the adequacy of the disclosures made in respect of identification and management of conflicts in their acceptance of the advice provided.

Where a conflict is significant, the recipient of the advice may be required to document their acknowledgment and consideration of this conflict in their reliance on the advice.

The AAF could set out specific conflicts and the actions to take should they arise.

9. Assessing the effectiveness of an AAF

PSxxx addresses specific issues that the Appointed Actuary should consider in assessing the effectiveness of the operation of the AAF over the prior period that is to be included in the Financial Condition Report. In addition to these requirements, the Appointed Actuary could consider the following questions to help form a basis for the overall assessment.

- Have decision-makers clearly understood when actuarial advice should be sought?
- Has actuarial advice been sought when it should have been sought?
- Does the actuarial team have the necessary capacity and capability to provide the advice being sought?
- Has it been clear who should give the actuarial advice?
- Was the actuary provided, in a timely manner, with all necessary data and information to formulate appropriate advice?
- Was the actuary able to deliver appropriate and timely actuarial advice?
- Have any conflicts (perceived or actual) arisen related to the provision of actuarial advice? If conflicts have arisen, were they managed appropriately?
- Was the decision-maker able to consider the actuarial advice before making the relevant decision?
- Have any recommendations given in the actuarial advice been appropriately followed up?
- Where the actuarial advice or recommendation has not been taken up, did the decision-maker justify and document the reasons? Was this outcome transparent to management and if appropriate the Board?
- Were there instances of decisions not covered by the AAF where actuarial advice could have been valuable?
- Have there been instances where the Appointed Actuary has reason to challenge or disagree with advice provided by other actuaries under the AAF?

In performing an assessment of the effectiveness of the AAF, the Appointed Actuary (or any other actuary carrying out the assessment) would not normally be expected to vet advice given by others.

END OF TECHNICAL PAPER

APPENDIX A: BUSINESS TOPICS THAT MAY BE ADDRESSED UNDER AN INSURER'S AAF

Issues or proposals related to the following topics may have a material impact on the insurer or its stakeholders and are therefore candidates for recognition in the AAF.

In considering the list below, please note the following comments.

- The same item may appear under more than one heading, recognising that the same issue may arise under different guises within an insurer.
- This is a non-exhaustive list of situations and/or areas where actuarial advice may be required; it does not deal at all with the process required to ensure that actuarial advice is in fact sought and provided.
- This list includes those items APRA proposes as mandatory for specific insurance segments. The list deliberately does not separate those out, in order to:
  - avoid creating a "compliance" attitude when designing the AAF; and
  - encourage cross-fertilisation of actuarial contributions from the different insurance segments.

<u>Detailed list of potential topics</u>

(1) Insurance liability evaluation

  (a) the insurance liability valuation methodology

  (b) experience analysis

  (c) the determination of best estimate assumptions and risk margins for each class of business

  (d) the calculation of insurance liabilities

  (e) the production of the AVR

(2) Prudential capital evaluation

  (a) the methodology and assumptions for determining the capital base and the prescribed capital amount

  (b) for the purposes of Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge (GPS115), the most appropriate category or categories in which to assign 'other' insurance business that does not fit within the definition of the classes of business in GPS001

  (c) for the purposes of Prudential Standard GPS 116 Capital Adequacy: Insurance Concentration Risk Charge (GPS116), the portion of the net premiums liability provision which relates to catastrophic losses (PL offset) using the method prescribed in GPS116

(d) where the insurer is required to determine the other accumulations vertical requirement under GPS116, the amount of losses within the other accumulations scenario that has already been allowed for in the insurer's net premiums liabilities

(e) for a lenders mortgage insurer that is required to determine the Lenders Mortgage Insurance Concentration Risk Charge under GPS 116, the amount of net premiums liabilities that relates to an economic downturn

(f) ICRC evaluations, cat model usage and process for Nat Cats/Pandemics

(g) the stress margins applied in determining the insurance risk charge

(h) the determination of the stress test amount required for regulatory capital purposes

(3) Financial reporting and budgeting

(a) financial results including profit, dividend, capital, economic value

(b) experience analysis and conclusions

(c) expense apportionments

(d) transparency of product economics

(e) macro pricing and an assessment of historic pricing to assess forecast or budgeting ability

(f) application of accounting standards to actuarial evaluations

(4) Capital management

(a) liquidity and fungibility of capital

(b) changes to corporate structures

(c) management or review of capital model

(d) recovery plan

(e) rating agency capital analysis

(f) fungibility of capital for Group companies

(g) dividends or returns of capital

(h) development of, or changes to, the insurer's ICAAP and/or capital management plan

(i) target surplus policy

(5) Product design and pricing

(a) the proposed terms and conditions on which a policy is to be issued or modified

(b) assessment of alignment with customer expectations (including policyholder reasonable expectations)

(c) new product/coverage development

(d) revisions to an existing product

(e) consideration of public interest

(f) the proposed basis on which surrender values are to be determined

(g) pricing policy

(h) macro pricing and an assessment of historic pricing to assess forecast or budgeting ability

(i) pricing for new products and for changes in products

(j) proposed changes to premium rates

(k) if the insurer is a friendly society, the proposed approved benefit fund rules or modification of the benefit fund rules, and whether the benefit fund rules will result in unfairness to any prospective or existing members of the benefit fund

(6) Product management

(a) experience monitoring

(b) bonus and crediting rate setting

(c) product discounts

(d) retention activities

(e) interpretation of product rules

(f) creation and fulfilment of customer expectations

(g) implications of corporate strategy on financial risk to policyholders

(h) if a policy provides for benefits to be calculated by reference to units, the means by which the unit values are determined

(i) bid/offer spreads for unit pricing

(j) management expense ratios for PDS disclosures

(7) Reinsurance

(a) reinsurance strategy

(b) impact of changes in reinsurance arrangement on capital targets

(c) reinsurance premiums and recoveries

(d) changes to the reinsurance strategy, new reinsurance arrangements, or changes to existing reinsurance contracts, specifically advising on the likely consequences of taking such action

(8) Business strategy

(a) business strategy of the insurer or parent group

(b) strategic risks

(c) business sustainability

(d) strategy of the insurer to optimise risk

(e) business activities of the insurer

(f) mergers, acquisitions and disposals

(g) new business segments

(h) implications of corporate strategy on financial risk to policyholders

(i) new technologies and the ability to use insurance coverage in a way not previously considered

(j) redevelopment or revision of strategic or business plans

(k) business diversification activity

(l) evaluation of customer value for customers, segments, channels, markets

(9) Investment policy

(a) investment strategy

(b) asset-liability management policy (particularly in respect of participating business and business with discretionary participation features)

(c) if the insurer is a friendly society, any change to the investment management or strategy of an approved benefit fund beyond that disclosed in the approved benefit fund rules

(10) Risk profile

(a) risk appetite

(b) reputation risk

(c) material financial risk/policyholder interests or mitigations

(d) assessment of the adequacy of risk management framework including the risk appetite statement

(e) credit risk policy and management – including contingent credit

(f) operation of AAF

(g) redetermination of the risk profile of the insurer

(h) contagion risks for the insurer arising from its position within a group or association of companies

(11) Data strategy

(a) system requirements

(b) management of data, systems and technology – to the extent it materially impacts financial or risk management capabilities

(c) disaster recovery plans

(d) data analytics and other work using large amounts of data, requiring detailed business knowledge, etc.

(12) Events that invalidate or modify previous actuarial advice

(a) triggers for review of the advice or environmental changes where the advice will become inappropriate

(13) Any other event or matter

(a) operational areas

(b) any other event or matter that the insurer or Appointed Actuary reasonably expects to have a significant impact on the financial condition of the insurer or the conduct of the business of the insurer

APPENDIX B: SCOPE OF ADVICE

In providing advice, there are a range of impacts that could be considered. While the relevant impacts may vary by circumstances of the advice provided, they could include:

- revenue and variable product expenses both on an annual basis and over future planning periods;
- claim rates and sources of claim cost;
- reinsurance treaties and reinsurance cash flows;
- management expenses including change in contribution to fixed overheads both on an annual basis and over future planning periods;
- profit margins and/or present value of profit margins;
- value of new business, embedded value and/or economic value;
- product switching and other anti-selective behaviours;
- internal rate of return;
- return on capital (both regulatory and target);
- change in capital requirements (regulatory and target);
- new business or in-force premium;
- inflows, outflows and funds under management; and
- lapse rates and any change in amortisation of deferred acquisition costs.

It is important that the AAF allows the actuary to exercise professional judgement as to which impacts are relevant and appropriate. The list above should not be considered to be exhaustive; neither should it be assumed that all pieces of advice should include all of these items. It will usually be appropriate for the advice to describe the sensitivity of key metrics to changes in material assumptions.

In addition to financial metrics, it may also be appropriate for the proposed advice to include comments on:

- alignment of the proposal to stated risk appetite;
- impacts of proposal on customers (e.g. bonus and policyholder considerations) and their expectations;
- reputational impacts including failing to meet community expectations;

- impacts of proposal on competitiveness (e.g. pricing implications);
- liquidity and capital funding impacts;
- potential strategic issues – future risks, key risks, business sustainability;
- observations or recommendations in prior Financial Condition Reports;
- ICAAP report and the capital management plan; and
- any system or operational requirements that that the actuary may have reason to believe has not already been considered.