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04 September 2015

Dear Michael

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

I am pleased to provide comments from the Financial Reporting Council (the FRC) on the exposure draft of ESAP 2. We have shared our comments with the Institute and Faculty of Actuaries (IFoA).

The FRC sets technical actuarial standards (TASs) in the UK and oversees the setting of ethical and conduct standards (and other regulatory activities) by the IFoA. Our work is supported by an Actuarial Quality Framework.

As a member of the Standard-Setters Round Table we support efforts to develop a set of model standards which national standard-setters can consider adopting.

**Summary**

We suggest that the AAE consider eliminating areas of repetition within ESAP 2 to create a briefer, more focused standard.

Areas of repetition include:

- Repetition of regulatory requirements. We consider that actuarial standards should not repeat or paraphrase regulatory requirements. If necessary, this is more appropriately provided in educational material.
- ESAP 2 repeats a number of requirements of ESAP 1. We consider this is unnecessary.
- There is some repetition of requirements within ESAP 2 itself.

**General**

We welcome the AAE's activities in supporting actuaries across Europe taking on the role of the actuarial function. It is important to those responsible for managing insurance undertakings that they receive comprehensible, clear and relevant information concerning the work that the actuarial function has performed in particular covering:

- reliability and adequacy of the calculation of technical provisions;
- the overall underwriting policy; and
- the adequacy of reinsurance arrangements.

The AAE approved ESAP 1 General Actuarial Practice in October 2014. This will apply to the work of the actuarial function. Section 4.1 of ESAP 1 deals with the comprehensibility and clarity of actuarial reports. Section 4.2 covers the content of those reports.

The Solvency II Directive, the Delegated Regulation, Implementing Regulations and Guidelines – together the Solvency II principles – lay out the work required of the actuarial function including a requirement to report at least annually to those responsible for running the insurance undertaking on the work the actuarial function has performed. The Solvency II principles also include requirements and guidance for the content of that report.

We consider that additional actuarial standards applying to this reporting requirement should only be considered necessary if it is considered that ESAP 1 and the Solvency II principles are insufficient to mitigate the risk to the public interest that might arise if those responsible for managing the insurance undertaking are not clearly informed about the extent of the work performed by the actuarial function and its conclusions.

### **Repetition of regulatory requirements**

The exposure draft is helpful in that it pulls together in one document requirements that are spread across the various component parts of the Solvency II Regulations. However, much of the draft just repeats or paraphrases those requirements. Some examples are included in the attachment to this letter.

As well as repeating requirements of the Solvency II regulations directly, ESAP 2 repeats material indirectly. For example Delegated Regulation art. 272.1(b) requires the actuarial function to:

*...assess the uncertainty associated with the estimates made in the calculation of technical provisions*

Paragraph 3.2.1.3 requires the actuarial function report to:

*The AFR must clearly state the sources and degree of uncertainty the AF has assessed in relation to the estimates made in the calculation of the Technical Provisions.*

Given that the actuarial function is required to perform the task, the function is required by art. 272.8 to report on the results of the task.

There are a number of similar indirect repetitions of regulatory requirements including paragraphs 3.2.1.2, 3.2.5.4, and 3.2.6.5

We do not consider that it is the role of an actuarial standard to repeat regulatory requirements although it may be appropriate in educational material. We therefore suggest that inclusion in ESAP 2 of the direct and indirect material taken from the Solvency II principles is reconsidered.

### **Repetition**

There is repetition within the standard. For example the paragraph 3.1.3 is repeated in paragraph 3.2.1.1 in a slightly expanded form.

3.1.3	3.2.1.1
<i>The AFR must express a conclusion from the AF on the adequacy and reliability of the Technical Provisions</i>	<i>The AFR must clearly state the conclusions of the AF with regard to its analysis of the adequacy and reliability of the Technical Provisions.</i>

Similarly 3.1.4 is repeated in 3.3.1.1 and 3.1.5 is repeated 3.4.1.1.

We suggest that it is unnecessary to repeat requirements.

### **Replication of ESAP 1 requirements**

ESAP 2 repeats a number of generic requirements included in ESAP 1. For example:

- ESAP 2 3.1.2 deals with form, structure style and level of detail of the AFR and replicates ESAP 1 4.1.1. The same paragraph permits the AFR to consist of several component reports which is already covered by ESAP 1 4.2.4.
- ESAP 2 3.1.11 requires the authors of the AFR to identify themselves. This is already covered by ESAP 1 4.1.4.f Function is required to identify or state things “clearly”. This replicates the ESAP 1 4.1.1 requirement that the actuary should word each communication to be clear.

Given that ESAP 2 1.2.2 explicitly assumes compliance with ESAP 1, we suggest that it is unnecessary to repeat these requirements.

### **Other**

#### *Paragraph 3.1.8*

We are uncertain what this paragraph adds to the standard. For the purposes of Solvency II, the responsibilities of the actuarial function are set out in the Directive article 48. We do not consider that these need repeating in the AFR. We appreciate that in some organisations, the actuarial function may be responsible for other activities. However, unless these cause a conflict of interest with the Solvency II responsibilities we do not understand their relevance to the reporting requirement under Solvency II which we consider relates to the defined responsibilities of the actuarial function prescribed by article 48. As paragraph 3.1.9 explicitly deals with the identification and management of conflicts of interest we suggest that paragraph 3.1.8 is unnecessary.

#### *Paragraph 3.1.12*

This is guidance and adds nothing to the standard. Given that competency is a professional requirement under the AAE’s Code of Conduct then those actuaries contributing to the report are required to have the relevant knowledge and experience. We suggest that this paragraph is deleted.

*Paragraph 3.1.13*

We consider greater clarity on the deficiencies required to be identified by this paragraph would be helpful. The requirement to identify deficiencies in the reliability of technical provisions is already provided by 3.2.1.1, identification of deficiencies in the underwriting policies in 3.3.1.4, and deficiencies in reinsurance arrangements in 3.4.1.3. Does this paragraph therefore refer to other material deficiencies for example in the work performed by the actuarial function or its resourcing?

*Paragraph 3.1.15*

We do not understand the need for this paragraph. ESAP 1 4.1 requires communications to take the needs of the intended user into consideration. The proportionality principle is explicit within the Solvency II principles.

*Paragraph 3.3.7.1*

Given that undertakings will have potentially many policies by which they manage their business, we suggest that consistency of the underwriting policy is judged only against other relevant policies.

*Paragraph 3.2.4.1*

We consider that it is good practice for the actuarial function to have a documented policy on its processes which has been agreed with the AMSB. We suggest that, in such circumstances, it should not be a requirement to include this documentation within the actuarial function Report.

*Paragraph 3.2.6.5*

We noticed a small typographical error in the middle of the second line. A “do” should be inserted between “provisions” and “not”.

*Paragraph 3.2.8.1*

We consider that the actuarial function’s documented policy on its processes which has been agreed with the AMSB will include its processes to compare best estimates with actual experience. In such circumstances we do not consider that it should be a requirement to include this documentation within the actuarial function report.

*Paragraph 3.3.3*

Greater clarity on the requirement to conclude whether premiums are sufficient would be helpful. In particular the level at which the actuarial function should opine (eg at an overall portfolio level for line of business or at a more granular level), and whether the premiums need to be sufficient to maintain solvency or to avoid loss making business.

*Paragraph 3.4.3.1*

One of the issues in UK non-life reinsurance currently is the treatment of Periodic Payment Order (PPO) liabilities given their long-term nature and uncertainty of claims occurrence and inflation. Consideration might be given to extending the list of stressed scenarios to include stresses of very long-term liabilities.

*Paragraph 3.5.2*

Given the nature of the actuarial function's role in implementing the risk management system is a subordinate one and the responsibility for its effective implementation lies with the risk function, we suggest that it is not necessary for the AFR to summarise the main findings. However, providing recommendations on how the risk modelling can be improved is relevant. We suggest that the paragraph is amended to reflect this.

Yours sincerely

A handwritten signature in blue ink that reads "John Instance". The signature is written in a cursive style with a large initial "J".

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<b>Examples of replication of regulatory requirements</b>			
Paragraph	ESAP 2 Wording	Solvency II Regulations Source	Solvency II Wording
3.1.1	The Actuarial Function (AF) must produce a written report (the Actuarial Function Report (AFR)) to be submitted to the administrative, management or supervisory body (AMSB), at least annually.	Delegated Regulation art.272.8	The actuarial function shall produce a written report to be submitted to the administrative, management or supervisory body, at least annually.
3.1.3	The AFR must express a conclusion from the AF on the adequacy and reliability of the Technical Provisions	Delegated Regulation art.272.5	Information submitted to the administrative, management or supervisory body on the calculation of the technical provisions shall include at least a reasoned analysis on the reliability and adequacy of their calculation and on the sources and the degree of uncertainty of the estimate of the technical provisions.
3.1.4	The AFR must express an opinion on the overall underwriting policy of the undertaking	Directive Art48(g)	Insurance and reinsurance undertakings shall provide for an effective actuarial function to.....express an opinion on the overall underwriting policy
3.1.5	The AFR must express an opinion on the adequacy of reinsurance arrangements	Directive art 48(h)	Insurance and reinsurance undertakings shall provide for an effective actuarial function to..... express an opinion on the adequacy of reinsurance arrangements
3.1.7	The AFR must document a summary of all major tasks that have been undertaken by the AF and their results.	Delegated Regulation art.272.8	.....The report shall document all tasks that have been undertaken by the actuarial function and their results,.....
3.1.13	The AFR must clearly identify any deficiencies and give recommendations as to how such deficiencies should be remedied.	Delegated Regulation Art 272.8	The report shall.....identify any deficiencies and give recommendations as to how such deficiencies should be remedied.

3.2.9.1	The AFR must report on the results of an analysis of the sensitivity of the Technical Provisions to each of the major risks underlying the obligations which are covered in the Technical Provisions.	Delegated Regulation art.272.5	Information .... shall include at least a reasoned analysis on the reliability and adequacy of their calculation ..... That reasoned analysis shall be supported by a sensitivity analysis that includes an investigation of the sensitivity of the technical provisions to each of the major risks underlying the obligations which are covered in the technical provisions.
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Drafting suggestions		
Paragraph	ESAP 2 Wording	Suggested Wording
3.1.13	The <b>AFR</b> must clearly identify any deficiencies and give recommendations as to how such deficiencies should be remedied.	The <b>AFR</b> must clearly identify any deficiencies in the work performed by the <b>AF</b> or its resourcing and give recommendations as to how such deficiencies should be remedied.
3.2.4.1	The <b>AFR</b> should include a broad overview of the overall process employed in respect of the calculation of the <b>Technical Provisions</b> .	The <b>AF</b> should have a documented policy on its processes which has been agreed with the <b>AMSB</b> in respect of the calculation of the <b>Technical Provisions</b> .
3.2.6.5	The <b>AFR</b> should indicate if the <b>AF</b> assesses that the information technology systems used in the calculation of technical provisions not sufficiently support the actuarial and statistical procedures.	The <b>AFR</b> should indicate if the <b>AF</b> assesses that the information technology systems used in the calculation of technical provisions <u>do</u> not sufficiently support the actuarial and statistical procedures.
3.2.8.1	The <b>AFR</b> must include an overview of the process used to compare best estimates against actual experience and draw attention to any concerns the <b>AF</b> has in regard to the effectiveness of this process.	The Actuarial Function should have a documented policy which has been agreed with the <b>AMSB</b> including its processes to compare best estimates with actual experience. The <b>AFR</b> must draw attention to any material concerns the <b>AF</b> has in regard to the effectiveness of this process.
3.3.3.1	The <b>AFR</b> must conclude whether the premiums are expected to be sufficient in the light of the operation of the <b>underwriting</b> policy. [...]	The <b>AFR</b> must conclude whether the premiums are expected to be sufficient across the portfolio of business in the light of the operation of the <b>underwriting</b> policy. [...]
3.4.3.1	The <b>AFR</b> should include assessments of how the reinsurance arrangements, including any <b>SPVs</b> , might respond in a number of stressed scenarios. The scenarios might include: <ul style="list-style-type: none"> <li>– catastrophic claims experience;</li> <li>– risk aggregations;</li> <li>– reinsurance defaults; and</li> <li>– reinsurance exhaustion.</li> </ul>	The <b>AFR</b> should include assessments of how the reinsurance arrangements, including any <b>SPVs</b> , might respond in a number of stressed scenarios. The scenarios might include: <ul style="list-style-type: none"> <li>– catastrophic claims experience;</li> <li>– risk aggregations;</li> <li>– reinsurance defaults;</li> <li>– stresses to very long-term liabilities; and</li> <li>– reinsurance exhaustion.</li> </ul>