Update

Financial Reporting Council

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# Joint Forum on Actuarial Regulation: 2016 risk perspective update

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries, and oversee the regulatory activities of the accountancy and actuarial professional bodies.

# Foreword

In 2014 the JFAR, through its discussion paper *Joint Forum on Actuarial Regulation: A risk perspective*, sought views on its identification of risks to the public interest where actuarial work is relevant. The publication was intended to raise awareness of the risks and potential mitigations, seek views on the risks identified, and guide the JFAR's future work. In its 2015 feedback statement *JFAR: A risk perspective*, the JFAR outlined its risk process going forward including the annual commitment to report publicly on its risk perspective and its activities.

Accordingly, JFAR now reports its activities during 2015/16 including its thematic reviews, provides an update on its risk perspective including current risk "hotspots", and outlines its planned work for 2016/17.

Two areas of risk have been prioritised for review in 2016/17: the risks posed to the work of the actuary by the low interest rate environment and the risk to the supply of relevant actuarial support in with-profits life assurance business. Additionally, the JFAR notes that some recent high profile cases have highlighted a number of issues surrounding the management of defined benefit pension schemes. The JFAR recognises that this is an important issue. It will engage actively with parties involved in the ongoing debate, including the forthcoming Green Paper, and monitor closely the output of work undertaken by its members and others in this area to understand any implications for technical actuarial work.

The UK's exit from the EU might affect UK insurers, pension schemes and sponsoring employers. The JFAR will consider emerging issues during 2016/17 as appropriate.

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# 1 Introduction

Actuarial work is central to many financial decisions in insurance and pensions and is an important element in other areas requiring the evaluation of risk and financial returns. High quality actuarial work promotes well-informed decision making and mitigates risks to users and the public; poor quality actuarial work can result in decisions being made which are detrimental to the public interest.

The Joint Forum on Actuarial Regulation (JFAR) was established in 2013 by the Financial Reporting Council (FRC), the Institute and Faculty of Actuaries (IFoA), the Financial Conduct Authority (FCA), the Pensions Regulator (tPR) and the Prudential Regulation Authority (PRA). The JFAR is a collaboration between regulators to co-ordinate, within the context of its members' objectives, the identification and analysis of public interest risks to which actuarial work is relevant.

In October 2014, the JFAR through its discussion paper *Joint Forum on Actuarial Regulation: A risk perspective*, sought views on its identification of risks to the public interest where actuarial work is relevant. The publication was intended to raise awareness of the risks and potential mitigations, seek views on the risks identified, and guide the JFAR's future work.

In its July 2015 feedback statement *JFAR: A risk perspective*, the JFAR outlined its risk process going forward including the commitment in a year's time, and annually thereafter, to report publicly on its risk perspective and its activities. It was emphasised that the JFAR:

- was not necessarily saying there was current evidence of the risk materialising or of poor quality or insufficient actuarial work; and
- did not intend to propose additional regulation to mitigate all the identified risks. Any co-ordinated action would be proportionate and selected from a wide "toolkit".

The JFAR's risk perspective set out:

- high-level risks - broad descriptions of risks to the public interest relating to actuarial work at a high level;
- "hotspots" - areas within each high-level risk identified for co-ordinated analysis. 'Hotspots' can relate to any current or evolving feature of a high-level risk - including sources of risk, difficult aspects of actuarial work, and potential impacts on vulnerable groups;
- common themes - arising in more than one high-level risk or hotspot;
- that reference to the terms "risk" and "risks" include both high-level risks and hotspots; and
- that whilst it identified risks individually, it recognised that the risks can be interrelated. This might result in risks compounding or off-setting and actions taken to mitigate one risk having the potential to increase risk elsewhere in the system.

The Executive Summary in Section 2 outlines the risk perspective, risk categories and the JFAR activities. A more detailed explanation of the changes to the risk perspective, the current hotspots and resulting planned 2016/17 thematic reviews is included in Section 3. Finally, the key findings from the thematic reviews completed during 2015/16 are included in Section 4.

# 2 Executive Summary

## 2.1 Risk Categories

This 2016 update is written against a backdrop of an evolving regulatory, political and economic landscape, nonetheless, a key finding of this update is that the high-level risk categories identified in the July 2015 feedback statement *JFAR: A risk perspective* remain broadly unchanged. However, in light of the IFoA's *Risk Outlook*, a new risk category entitled Professionalism has been added.

The Professionalism risk category captures the consistent message from the IFoA's work that there is a risk that members' ability to exercise their professional judgment is put under pressure by the commercial environment in which they are working.

A summary of the risk categories is set out in Table 1 with more detail on each included in Section 3.3.

*Table 1: Summary High-level Risk Categories*

| | |
|---|---|
| Environmental conditions | R1 - Changes in the external environment<br>R2 - Economic outlook - impact on insurers and pension schemes<br>R3 - Competitive pressures on insurers<br>R4 - Legislative pressures |
| Inherent factors in actuarial work and its use | R5 - Modelling<br>R6 - Group Think<br>R7 - Understanding of risk and return |
| Characteristics of markets in which actuarial work is used | R8 - Product design and distribution<br>R9 - Financial reporting<br>R10 - General insurance claims provisions<br>R11 - Management of Defined Benefit pension schemes |
| Professionalism | R12 - Professionalism |

## 2.2 Hotspots

Within each of the 12 categories the JFAR identifies areas of potential high risk, referred to as hotspots. These hotspots relate to current or evolving features of a risk - including sources of risk, difficult aspects of actuarial work, and potential impacts on vulnerable groups. The JFAR prioritises areas for co-ordinated analysis and thematic reviews based on these hotspots.

As part of the update process each of the hotspots identified and discussed within the original risk perspective was reviewed to ensure its continuing relevance. It was felt that none of those hotspots should be removed at this time. A number of additional hotspots were identified. (See Appendix 1 for full list).

The key new hotspots identified were: (see Section 3.4 for detail)

- Actuarial issues around the embedding of the Solvency II framework for insurers;
- Risks relating to actuarial work where low interest rates may have an effect;
- Competitive pressures on insurers, especially the rate reductions and coverage expansion seen in the continuing soft market cycle in general insurance;
- Implementation of pension freedoms legislation giving people more flexible access to their pensions savings;

- Greater use of “big data”, granular pricing and price optimisation techniques to analyse and segment portfolios into highly defined risk groupings;
- Risk surrounding the management of defined benefit pension schemes; and
- Risks to the supply of relevant actuarial support for the future management in the public interest of life assurance with-profits business.

Following the referendum vote in favour of the UK leaving the EU, UK insurers, pension schemes and sponsoring employers will need to consider the consequential risks and potential impacts of uncertainties in the political and economic environment on their businesses and members. The JFAR will consider any emerging Brexit issues during 2016/17 as appropriate.

## 2.3 Thematic Reviews 2016/17

In light of the changes in the risk perspective and new hotspots, two areas of risk have been prioritised for review during 2016/17.

*“R2 - Economic outlook - impact on insurers and pension schemes”*

The JFAR will undertake a review to understand the risks posed by the low interest rate environment to the work of the actuary in pensions and insurance e.g. there may be a risk to the quality of actuarial work if actuaries are required to set assumptions for the valuation of innovative/non-traditional and/or complex assets with little data and complex structures.

*“R12 - Professionalism”*

JFAR will consider the role of the actuary in with-profits life assurance business and whether there are any risks to the supply of relevant actuarial support for the future management of with-profits business.

Section 3.5 provides more detail of the work planned in each of these areas.

## 2.4 Thematic Reviews 2015/16

In 2015/16, the JFAR reviewed three hotspots where feedback suggested the risks were evolving with the objective of understanding them more fully.

*“R4 - Legislative pressures”*

The FRC published on behalf of the JFAR a review of Defined Benefit (DB) to Defined Contribution (DC) transfers in light of the pension freedoms. (*JFAR: Review of transfers from DB to DC Schemes*)

The review found that although the level of transfer activity had increased, the actual number of transfers is low. The JFAR concluded that it will continue to monitor the level of transfer activity and any actuarial issues arising in this area.

*“R6 - Group Think”*

The IFoA led and published JFAR’s review into the risks of group think in the actuarial community which acknowledged the dangers of group think and provided practical guidance for actuaries and those working with them (*JFAR Review: Group Think*).

*“R10 - General insurance claims provisions”*

The FRC led a review of a sample of reports by actuaries on general insurance liability provisions and highlighted areas where improved communication could be achieved.

See Section 4 for more details on the 2015/16 thematic reviews.

# 3 Risk Perspective Update

The risk perspective identifies a broad range of areas where there is a potential risk to the UK public interest and in which actuarial work plays a part in the risk or its management.

The JFAR first identified these risks in its discussion paper *Joint Forum on Actuarial Regulation: A risk perspective* and grouped them using high-level risk categories and hotspots in the feedback statement *JFAR: A risk perspective.* During 2016, it has reviewed these risk categories and hotspots to ensure they continue to reflect the current risks relating to actuarial work.

The following section explains the update process, describes the changing environment in which actuarial work is undertaken and sets out the JFAR's current risk perspective, high-level risk categories and hotspots.

## 3.1 Update process

One of the key benefits of the original exercise was co-ordination - bringing together the views of all the members of the JFAR supplemented with the views of practitioners and other stakeholders. This collaborative approach has also informed the update process with input sought from each regulator to understand and capture its current view of risks where actuarial work is relevant. In addition, the IFoA's *Risk Outlook* provided practitioner input from Practice Boards and Regional Communities. (Further detail on the update process is contained in Appendix 2.)

## 3.2 The economic, regulatory and commercial environment

Since the original publications, there have been significant developments in the environment within which actuarial work is undertaken. Some key developments are set out below:

- Insurers implemented Solvency II on 1 January 2016. Preparation for the implementation of the framework placed additional demands on actuarial departments. Insurers have now moved from a period of preparation for implementation to a period where operating under Solvency II is becoming business as usual. However, the outcome of the Treasury Committee EU Insurance Regulation inquiry may lead to further change and pressure on actuarial resource.
- Insurers continue to prepare for the implementation of IFRS 17. The publication of the standard is expected in the first half of 2017 and for it to be effective for annual periods beginning on or after 1 January 2021.
- The pensions sector has seen the implementation of a number of legislative changes including the introduction of legislation effective from 6 April 2015 giving individuals greater flexibility on how and when they access their savings. The forthcoming Green Paper may prompt further changes.
- The low interest rate environment persists and rates are now at historic lows - this presents issues for both insurers and defined benefit pension schemes:
    - for insurers, there is continued pressure on margins when pricing products; pressure on life companies to reconcile low yields with investment guarantees and reconciling the search for yield with the requirements of Solvency II; and
    - for many pension schemes, the low interest rate environment has resulted in increased funding deficits.

- There have been some high profile cases, for example, in relation to the BHS and Tata Steel pension schemes, which highlight the issues associated with the management of defined benefit pension schemes in challenging times.
- There has been political uncertainty around the UK's continued membership of the EU. There is now uncertainty as to how the UK will exit the EU. There has been downward pressure on sterling and uncertainty in the outlook for growth.
- The IORP Directive text was approved by the European Parliament on 24 November 2016, but its impact on the UK is not clear following Brexit.

## 3.3 Risk categories

A key finding of this update is that the high-level risk categories identified in *JFAR: A risk perspective* remain broadly unchanged.

However, in light of the IFoA's *Risk Outlook*, a new risk category entitled Professionalism has been added. There was a consistent message from the IFoA's work that there is a risk that members' ability to exercise their professional judgment is put under pressure by the commercial environment in which they are working.

The risk category "Rapid change in the pensions market" has been renamed "Legislative pressures" to extend the scope of the category, and the category on Economic Outlook for each of insurance and pensions has been combined into one category.

Following the update exercise, the JFAR risk categories are as follows:

| Environmental conditions |
|---|
| **R1 - Changes in the external environment** - Risk of inadequate response to changes in the external environment (for example from political or legislative changes, or economic or demographic shifts) |
| **R2 - Economic outlook - impact on insurers and pension schemes** - Risks to insurers arising from a relatively low interest rate environment persisting for an extended period and the risk that the uncertain economic outlook could challenge affordability for pension scheme sponsors or a market move could threaten the pensions system as a whole |
| **R3 - Competitive pressures on insurers** - Risk that the UK insurance sector's competitive commercial environment, pressures on premium rates and low investment returns may drive firms to seek out too much risk |
| **R4 - Legislative pressures** - Risk that the rapid change in the market due to legislative developments and new initiatives leads to inappropriately designed products or inadequate financial management |
| **Inherent factors in actuarial work and its use** |
| **R5 - Modelling** - Risk of inappropriate model design, implementation, use, or poor communication of actuarial modelling work (including model limitations) resulting in poor decisions being made and detriment to the public interest |
| **R6 - Group Think** - Risk of actuarial group think / herd-like behaviours resulting in poor conduct or systemic business failures |
| **R7 - Understanding of risk and return** - Inadequate understanding of risk and return by actuaries and users of actuarial work may result in poor decisions |
| **Characteristics of markets in which actuarial work is used** |
| **R8 - Product design and distribution** - Risk that companies using actuarial information do not design products that respond to consumers' real needs or do not promote transparency on financial products and services |
| **R9 - Financial reporting** - Risk that reporting of actuarial information in the annual report and accounts is not fair, balanced and understandable to investors |
| **R10 - General insurance claims provisions** - Risk that inadequate claims provisions combined with inadequate premium rates reduces the robustness of a general insurer |
| **R11 - Management of DB schemes** - Risk that liability and risk management actions of pension schemes results in some scheme members being disadvantaged or exposed to excessive risk |
| **Professionalism** |
| **R12 - Professionalism** - Risk that actuaries are not adequately prepared or fail to act in a professional manner |

## 3.4 Hotspots

The JFAR identifies areas of potential high risk, referred to as hotspots. These hotspots relate to current or evolving features of a risk - including sources of risk, difficult aspects of actuarial work, and potential impacts on vulnerable groups.

As part of the update process each of the hotspots identified and discussed within the original risk perspective was reviewed to ensure its continuing relevance. It was felt that none of those hotspots should be removed at this time.

A number of additional hotspots were identified. The key new hotspots are described below:

| **R1 - Changes in the external environment** | **Embedding Solvency II** |
|---|---|

The Solvency II framework for insurers became effective on 1 January 2016, including a number of transitional measures. The decisions exercised by those charged with governance of insurers in implementing Solvency II rely significantly on actuarial work and accordingly actuaries and their exercise of judgement are central to effective implementation. The JFAR has identified the following areas of risk:

- the approach to model changes - there may be incentives to prioritise model changes that reduce the Solvency Capital Requirement (SCR) resulting in model drift and reduced protection for policyholders;
- the impact on solvency of recalculating the transitional measure on technical provisions particularly in light of recent post referendum market volatility and the complexity of the calculations;
- the impact of changing market conditions on the SCR and risk management;
- the impact of the volatility of low interest rates on the risk margin; and
- the evolution of the risk function particularly in general insurance.

The JFAR notes that the PRA is working with insurers in the above areas and the JFAR does not consider that there is a need for it to look further at any of these issues at this time. As part of the JFAR's terms of reference, the PRA will report to the JFAR on actuarial matters arising in these areas.

The Treasury Committee EU Insurance Regulation inquiry will explore the impacts of the Solvency II directive and the options available to the UK following Brexit. Its conclusions and recommendations may lead to further change and pressure on actuarial resource. The JFAR will maintain a watching brief in this area.

| **R2 - Economic outlook - impact on insurers and pension schemes** | **Low interest rates** |
|---|---|

The current low interest rate environment has persisted for some years with mixed views about whether, and if so when, interest rates will increase. The low interest rate environment continues to pose challenges for both insurers and pension schemes.

The JFAR has identified the following risks relating to actuarial work for insurers where low interest rates may have an effect:

- search for yield - potential shift to riskier and less well understood asset classes with the risk that the higher potential returns are not realised;
- strained business models due to reduced investment income - reduction in insurance profitability and solvency levels with the risk of an insurer failure increasing as a result;

- impact on balance sheets - higher insurance technical provisions as a result of lower discount rates;
- impact on pricing - more expensive products particularly annuity contracts for individuals and bulk purchases; and
- impact on solvency ratios of the increased cost of long term guarantees.

The JFAR has identified the following risks relating to actuarial work for pension schemes where low interest rates may have an effect:

- search for yield - potential shift to riskier and less well understood asset classes with the risk that the higher potential returns are not realised;
- weakening sponsor covenants - affordability issues and increased insolvency risk;
- pressure on contribution levels - reduced sponsor risk appetite and focus on the contribution rate may lead to pressure to use less prudent actuarial assumptions; and
- scheme maturity - risk that the investment strategy may be restricted resulting in lower investment returns.

The JFAR has agreed to undertake a review to identify the potential risks for insurers and pension schemes and their sponsors of the low interest rate environment persisting for a long period.

| **R3 - Competitive pressure** | **Continuing soft market in GI** |
|---|---|

There are potential actuarial issues associated with the continued soft market in general insurance. The soft cycle is characterised by reducing premium rates and ready availability of insurance. It can result in less prudent reserving and a lower ability to use investment returns to offset any underwriting losses.

The quality of actuarial work and robustness of judgements could be affected by these pressures on margins on pricing and reserving. Additionally, consideration of alternative risk management transfer options with greater complexity and potential capital arbitrage could result in suboptimal decisions as a result of a poor understanding of the risks. These risks can result in solvency issues.

The JFAR notes the Risk Alert recently issued by the IFoA which highlights the risk of insolvency of insurers/reinsurers due to the underestimation of reserves in challenging market conditions due to cycle effects, and the July 2016 PRA's Dear CEO letter to general insurance firms covering observations from year-end reporting.

| **R4 - Legislative pressures** | **Implementation of pension freedoms legislation** |
|---|---|

There are a number of areas arising from the implementation of the pension freedoms legislation where actuaries are likely to be involved e.g. product pricing and design. There is a risk that the products designed to cater for the new legislation and their potential risks are not communicated clearly to the public resulting in poor understanding.

During 2015/16 this hotspot was considered in relation to the risks arising to the public interest from DB to DC transfers. The review found that although the level of transfer activity had increased, the actual number of transfers is low. The JFAR concluded that it will continue to monitor the level of transfer activity and any actuarial issues arising in this area.

| R8 - Product design and distribution | Use of "big data" |
|---|---|

There are a number of potential actuarial issues associated with a greater use of "big data" in insurance - for example, more granular pricing and price optimisation techniques which may reduce the "pooling effect" of insurance. Models designed to more accurately segment, price and manage risk could eventually lead to individual risk pricing and insurance coverage that is too expensive or unavailable for some members of the public.

The JFAR notes the FCA's work in this area with its November 2015 *Call for Inputs: Big Data in retail general insurance* and that an IFoA working party has been established to look at this area. The JFAR may consider the matter again following the September 2016 publication of the FCA's feedback statement *FS16/5* and in light of any findings from the IFoA working party.

| R11 - Management of Defined Benefit schemes | Management of schemes in challenging circumstances and potential Systemic risk |
|---|---|

The management of pension schemes in the current environment is challenged by a number of factors including:

- impact of interest rates on the measurement of scheme funding liability;
- increasing deficits leading to higher deficit recovery contributions and/or longer periods of contribution;
- effect of improving longevity;
- impact of the changing profile of pension scheme members resulting from closure to new entrants and future accruals; and
- pressure on employer covenant in a challenging economic climate.

Actuaries typically undertake one of two distinct roles - as Scheme Actuary providing advice on funding and other matters or as corporate advisor providing advice to the sponsoring employer. There have been a number of high profile cases which highlight risks associated with the management of DB schemes.

The JFAR has identified the following risks in respect of actuarial work relating to DB pension schemes:

- pressure on assumptions used for Scheme Funding to reduce contribution requirements;
- investment risks including the development and use of more complex and innovative products;
- difficulties in assessing employer covenant; and
- potential issues associated with sponsors asking trustees to take greater investment risks.

These risks and the difficulties in assessing and communicating them may lead to decisions that adversely impact scheme members.

As noted in the following section, the JFAR has decided to monitor developments and initiatives undertaken by its members and others in this area.

| R12 - Professionalism | With-Profits - the supply of relevant actuarial support for the future management of with-profits business. |
|---|---|

The With-Profits Actuary is a regulatory role related to the review of the discretion exercised in the management of with-profits funds and the fair treatment of policyholders. Recently there has been a decline in new with-profits funds with a large number of funds in run-off. There is a potential risk that younger actuaries are not involved in this business and that over time, there will be a shortage of actuaries with the level of expertise necessary to fulfil the role resulting in the unfair treatment of policyholders.

The JFAR has decided to undertake a short review in this area with a view to assessing any risk mitigation actions that may be required. The JFAR will investigate the current level and potential development of expertise along with an assessment of the evolving demand for that expertise.

## 3.5 Thematic Reviews 2016/17

In light of the key findings discussed in this update, the JFAR has selected the following topics for thematic reviews during 2016/17.

### *3.5.1 Low interest rates*

The PRA and tPR will undertake a review of areas of potential concern in order to understand the impact of the low interest rate environment on the work of the actuary in pensions and insurance. The review will cover three aspects as detailed below:

- Assumption setting - The low interest rate environment may result in pension schemes and insurers investing in riskier, higher-yielding assets. The review will consider the actuary's understanding of the risk-return profile of these non-traditional and more complex assets particularly when considered as part of determining discount rate assumptions. It will also consider a concern that in some circumstances actuaries come under pressure to assume higher yields, for example, to maintain prices.
- Actuaries' ability to challenge assumptions - There is a need for actuaries to challenge the assumptions being made. The review will consider the extent to which individual actuaries have the tools and processes to challenge assumptions.
- Support for actuaries in challenging assumptions - The review will consider the extent to which actuaries need more support in challenging assumptions. It may also consider a potential concern that if individual actuaries speak up then it can be detrimental to their careers.

### *3.5.2 Supply of relevant actuarial support for the future management of with-profits business*

The IFoA will lead a review to investigate the issue and identify any actions to be taken. It has decided to undertake a short review looking at the potential risk to the supply of suitably qualified actuaries to work in with-profits.

### *3.5.3 Management of defined benefit schemes*

The JFAR notes that some recent high profile cases have highlighted a number of issues surrounding the management of defined benefit schemes. The JFAR recognises that this is an important issue and will monitor closely the output of work undertaken by its members and others in this area. The JFAR notes that a number of initiatives are underway including work by the Pensions Regulator, the PLSA Defined Benefit Task Force and the forthcoming Green Paper. It intends to discuss the risks on an ongoing basis.

# 4 Thematic Reviews 2015/16

From the risks identified in the July 2015 feedback statement *JFAR: A risk perspective* three areas were chosen to be the main focus of JFAR's work in 2015/16. These are areas where actuarial work is in the public interest, is central and where feedback indicated that the risks to the quality of actuarial work were developing.

The risks considered in more depth were:

- DB to DC transfers in light of the pension freedoms;
- Group think; and
- General Insurance Reserving.

The first two of these topics resulted in separate publications (*JFAR: Review of transfers from DB to DC Schemes* and *JFAR Review: Group Think* respectively). The main conclusions are set out below along with a summary of the results of the review led by the FRC on general insurance reserving.

## 4.1 DB to DC transfers

"Rapid change in the pensions market" was identified as an issue and in particular, the pension freedoms, effective from 6 April 2015, as a key change which may give rise to risks. The JFAR identified DB to DC transfers as an area for further examination.

The FRC published the review on behalf of the JFAR in March 2016. The review found that although the level of transfer activity had increased, the actual number of transfers is low. It is possible that transfer activity and promotion activity by sponsors will increase over time as awareness of the freedoms grows and issues with the advice process and market for transferred funds are resolved. It is also possible that over time other actuarial issues may arise in relation to changes in transfer experience.

The JFAR concluded that it will continue to monitor the level of transfer activity and any actuarial issues arising in this area. To date, based on informal monitoring there is no evidence of any cause for concern in relation to actuarial matters.

## 4.2 Group Think

"Group Think" is the inclination to behave in the same way as others do without sufficient justification. It was identified in *JFAR: A risk perspective* as an issue of public interest concern and a risk which could result in poor conduct or systematic business failures. In order to explore the issue and how it affects the actuarial profession, the IFoA led the JFAR review of group think in 2015, publishing the results of the review in June 2016.

The key findings were that group think is a risk in the actuarial community but there is no evidence to suggest it is peculiar to the actuarial profession. In particular, the review concluded that:

- regulators can have a role in addressing group think by their choice to follow either principles or rules based regulatory approaches; and
- the risks associated with group think are significantly reduced simply by understanding the propensity to participate in group think in the first place.

The publication included practical guidance for actuaries and those working with them on how to address group think when it arises. The findings on how to manage the issue, were tailored to the various stakeholder perspectives and included encouraging careful analysis of situations on a case-by-case basis, questioning and justifying the use of benchmarks, encouraging diversity of opinion, promoting good governance and a culture of healthy and robust challenge.

A key take away for regulators and individual actuaries alike, is the need to continue to support "speaking up" environments as part of the solution to promoting positive working environments and organisational cultures.

## 4.3 General Insurance reserving

The feedback statement *JFAR: A risk perspective* identified the high-level risks "general insurance reserving" and "financial reporting" and noted the risk that inadequate claims provisions combined with inadequate premium rates caused by a very competitive market reduces the financial soundness of a general insurer. The UK general insurance market accounts for one quarter of insurance gross written premium (OECD, 2014) and employs 14% of the IFoA's members (IFoA, 2015). As such, the JFAR has undertaken a review of GI Reserving to gain a deeper understanding of the related risks.

This included reviewing a small sample (seven reports) of reserving reports prepared by internal actuaries to support year-end reserving decisions by Boards. The JFAR recognises that its review is limited by its size.

Based on its observations from the review, there are a number of points which the JFAR would like to remind actuaries, in all practice areas, to take into account when reporting on their work:

- Reports should clearly state the purpose, users and who commissioned the report to satisfy Paragraph 3.3 of *TAS R: Reporting Actuarial Information*. Where the report includes the reserves set by management and/or the Board (the management or booked reserves) alongside the actuary's estimate, the actuary should ensure that it is clear what he/she is responsible for and what management or the Board is responsible for.
- It is expected that either, all the information required for TAS compliance be contained within a single report, or for that report to specify the component reports which contain the information required for TAS compliance. (Paragraphs C 2.1 - C 2.5 of *TAS R: Reporting Actuarial Information)* Component reports could cover areas such as the detailed reporting of the data, assumptions or methods and measures.
- Reporting of data should provide sufficient detail for the user to understand the data, its source and any limitations. Similarly, the core assumptions, such as development factors, tail assumptions or Initial Expected Loss Ratios, methods and measures should be stated and their rationale explained. (Paragraphs C 4.1, C 4.3, C 4.4, C 4.6, C 5.2, C5.8 *TAS R: Reporting Actuarial Information)*
- Comparisons of the valuation result with the previous result need to set out a clear reconciliation between both results. (Paragraphs C 5.17 *TAS R: Reporting Actuarial Information)*
- It is expected that all reports contain a compliance statement (Paragraphs C 3.11 *TAS R: Reporting Actuarial Information).* The option for a user to determine that the work does not need to comply with the TASs is not available for Reserved or Required work (Paragraph 24 *Scope and Authority of Technical Actuarial Standards*) and the JFAR believes that actuarial work to support the Board in setting year-end reserves is Required work.

Although the observations above are referenced to the current TAS structure the requirement for clear, comprehensive and comprehensible communications will continue in the revised TASs. Communications must cover the scope and purpose of the work as well as describing the methods, measures, data and assumptions underlying it.

# Appendices

## Appendix 1 - Updated list of risk categories and associated hotspots

| Risk Categories | Hotspots (new shaded grey) |
|---|---|
| **R1 - Changes in the external environment**<br>Risk that changes in the external environment (for example from political or legislative changes, or economic or demographic shifts) are not adequately responded to | Limits to growth |
| | Climate change |
| | Retrospective changes or changes in practice |
| | Slow to respond or communicate change |
| | Technological shifts |
| | Cyber risks |
| | Pressure on actuarial resources - particularly after Solvency II but also due to pressures on margins and expense savings |
| | Embedding Solvency II - including model changes, transitional arrangements, impact of changing market conditions, evolving of the risk function, particularly in GI |
| | Longevity and medical developments |
| | Brexit |
| | Lack of intergenerational fairness |
| **R2 - Economic outlook - impact on insurers and pension schemes**<br>Risks to insurers and pension schemes arising from a relatively low interest rate environment persisting for an extended period<br>Risk that the uncertain economic outlook could challenge affordability for pension scheme sponsors or a market move could threaten the pensions system as a whole | Annuity pricing and valuation |
| | Uncertainty in future interest rate movements |
| | Long-term business models of life insurers in a low interest rate environment |
| | Ability of scheme sponsors to meet their long-term obligations |
| | Advice to pension trustees in a low interest rate environment |
| | Stress testing of economic assumptions |
| **R3 - Competitive pressures on insurers**<br>Risk that the UK insurance sector's competitive commercial environment, pressures on premium rates and low investment returns may drive firms to seek out too much risk | Balance sheet structuring |
| | Continuing soft market in GI - impact on pricing, reserving and potential consideration of alternative risk management transfer options with greater complexity and potential capital arbitrage |
| | Management actions may not work |
| **R4 - Legislative pressures**<br>Risk that the rapid change in the market due to legislative developments and new initiatives leads to inappropriately designed products or inadequate financial management | Issues from pensions freedoms - DB to DC transfers, new product design |
| | Regulatory complexity and pension scheme taxation |
| **R5 - Modelling**<br>Risk of inappropriate model design, implementation, use, or poor communication of actuarial modelling work resulting in poor decisions being made and detriment to the public interest | Insufficient use of stress-testing and scenario analysis |
| | Internal capital models |
| | Long-term assumptions |
| | General Insurance personal lines pricing |
| | Governance of models, including communication of assumptions, output etc |
| **R6 - 'Group think'**<br>Risk of actuarial 'group think' / herd-like behaviours resulting in poor conduct or systemic business failures | Herding around assumptions and modelling |
| | 'Group think' in investments |
| | Life expectancy |
| | Failure to speak up |
| | Smaller financial institutions |
| | Lack of diversity of actuaries |
| | Over-confidence in use of models |
| | Role of regulators |
| | Employer culture |
| | Communications on savings and pensions business, including projections assumptions |

| Risk Categories | Hotspots (new shaded grey) |
|---|---|
| **R7 - Understanding of risk and return**<br>Inadequate understanding of risk and return by actuaries and users of actuarial work may result in poor decisions | Retirement income changes |
| | Understanding of alternative assets - and Equity Release Mortgages in particular |
| | Short-termism in investment decisions in insurance companies and pension schemes |
| | Quality of capital - greater appetite in insurers for lower quality of capital |
| **R8 - Product design and distribution**<br>Risk that companies using actuarial information do not design products that respond to consumers' real needs or do not promote transparency on financial products and services | Annuity and retirement income products |
| | General Insurance personal lines products and pricing including premium increases on renewals |
| | Health and care products |
| | Product distribution mechanisms |
| | Legacy products and TCF - setting bonus rates, surrender values |
| | Advice gap - how do individuals make informed decisions |
| | Robo-advice type models |
| | Big data and its use in more granular pricing and price optimization techniques |
| **R9 - Financial reporting**<br>Risk that reporting of actuarial information in the annual report and accounts is not fair, balanced and understandable to investors | Estimating insurance liabilities |
| | Auditing |
| | Life insurance accounting |
| | Accounting for pension costs |
| **R10 - General insurance claims provisions**<br>Risk that inadequate claims provisions combined with inadequate premium rates reduces the robustness of a general insurer | Influence of actuaries |
| | Settlement of general insurance claims via PPOs |
| | Provisioning methodologies , particularly as high level of releases this year - perhaps related to GI pricing pressures |
| **R11 - Management of DB schemes**<br>Risk that liability and risk management actions of pension schemes results in some scheme members being disadvantaged or taking on excessive risk | Transfers out of DB schemes |
| | Asset Backed Contributions |
| | Investment assumptions for closed schemes |
| | Systemic risk leading to pressure on the PPF |
| | Management of schemes in challenging circumstances |
| | Quality of governance - over-reliance on the actuary, failure of the trustees to challenge advisers and sponsors, approach to integrated risk management, lack of clarity on the role of the actuary e.g. in respect of employer covenant |
| **R12 – Professionalism (new category)**<br>Risk that actuaries are not adequately prepared or fail to act in a professional manner | Actuaries fail to maintain appropriate levels of competence |
| | Lack of ability to communicate complex issues clearly and concisely |
| | Failure to speak up or adhere to professional opinion when they should |
| | With profits actuarial skills - potential risk to the supply of suitably qualified actuaries |
| | Failure of the actuarial profession to speak out on matters of public interest |

## Appendix 2: Risk perspective update process

One of the key benefits of the original exercise was co-ordination - bringing together the views of all the members of the JFAR supplemented with the views of practitioners and other stakeholders.

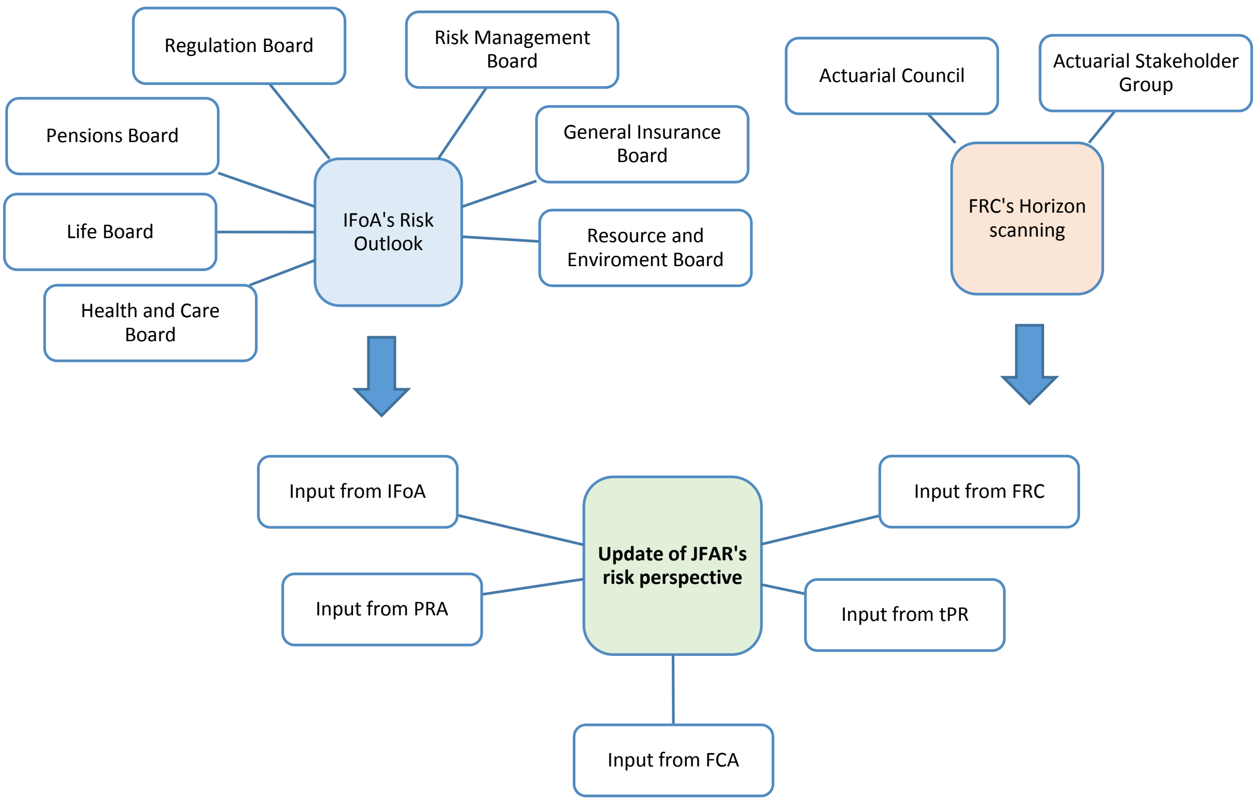
In order to maintain the collective view of risks in developing the JFAR's current view of risk to the public interest where actuarial work is relevant input was sought from individual JFAR members. This input focused on understanding the individual regulators' current views of risks to their individual objectives where actuarial work is relevant.

A key element of the update process was the work the IFoA undertook in developing its own *Risk Outlook*. This work by the IFoA provided the practitioners input to the update process with the IFoA arranging a number of sessions with its Practice Boards and with Regional Communities during 2015/16 to obtain its members' views on potential risks to the public interest as relevant to actuarial activity. This work by the IFoA replaced the work undertaken by the FRC on behalf of the JFAR for the original risk perspective publications.

It is intended that the IFoA's ongoing update of the Risk Alert programme will feed into the JFAR's regular update of the risk perspective.

Input was also sought from the FRC's Actuarial Council and the FRC's Actuarial Stakeholder Group.

The process for updating the risk perspective is summarised below:



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