EIOPA Interim Solvency II Requirements - Preparing the Actuarial Function

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EIOPA's Consultation Paper on guidelines to regulators for the implementation of the System of Governance requirements includes a requirement to establish an Actuarial Function with Solvency II responsibilities. This update describes the key issues for companies to address.

INTRODUCTION

On 27 March 2013, the European Insurance and Occupational Pensions Authority (EIOPA) launched a consultation on guidelines for the preparation for Solvency II (the guidelines). The aim of the guidelines is to introduce specific aspects of Solvency II requirements into national supervision from 1 January 2014, in advance of the full implementation of the Solvency II regime.

During this 'interim phase,' (re)insurance undertakings will need to meet the interim Solvency II requirements in addition to the need to continue to comply with existing Solvency I requirements.

The guidelines on System of Governance will require (re)insurance undertakings to put in place an Actuarial Function, amongst other things. In this briefing note, we consider what this will mean for companies both in terms of preparing for the interim requirements and in meeting the requirements during the interim phase.

The Central Bank of Ireland has indicated that it intends to issue guidelines that will largely mirror the EIOPA guidelines, which will apply to regulated (re)insurance undertakings with an Irish head office. These will be issued very shortly after EIOPA has issued the final version of its guidelines, expected to be at the end of September or the start of October.

ACTUARIAL FUNCTION RESPONSIBILITIES

The minimum responsibilities of the Actuarial Function under Solvency II are set out in article 48 of the Solvency II Directive.[1] The guidelines for the interim phase are based on article 48 and cover:

- Technical Provisions
- Data quality
- Test against experience
- Underwriting policy & reinsurance arrangements
- Pre-application for internal models
- Preparation of an annual report

The responsibilities of the Actuarial Function will need to include the specific responsibilities set out in the guidelines but could also include other responsibilities, provided that any potential conflicts of interest are addressed. This point is considered further below.

In any event, the work of the Actuarial Function will essentially straddle all three pillars of Solvency II – contributing to the calculation of pillar 1 figures, contributing to the *Forward Looking Assessment*[2] under pillar 2 and providing input to at least some of the quantitative reporting templates under pillar 3.

[1] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

[2] "Forward Looking Assessment of the undertaking's own risks (based on ORSA principles)"

WHAT NEEDS TO BE DONE TO PREPARE?

Governance, organisational & HR matters

It will be necessary to define the Actuarial Function in terms of responsibilities, personnel and reporting lines.

As noted above, the Actuarial Function could have additional responsibilities over and above those set out in the guidelines, provided that any potential conflicts of interest are addressed. Examples of conflicts that could arise include calculation of Technical Provisions in addition to coordinating the calculation, product development, negotiating reinsurance arrangements and so on. Clearly, this is not an exhaustive list.

Conflicts of interest could be addressed through a variety of approaches such as segregation of personnel, independent reviews, oversight committees, etc., depending on the nature of the conflict in question.

The Actuarial Function is likely to comprise personnel from existing actuarial departments (or potentially a single department in the case of smaller or less complex organisations), which could be internal or outsourced. However, the Actuarial Function might not correspond directly to existing actuarial departments, depending on the responsibilities allocated to the Actuarial Function.

Companies will need to consider who will be responsible for the Actuarial Function and what the reporting lines will be. The person with responsibility for the Actuarial Function could be, for example, the same person as the current Chief Actuary, the Appointed Actuary (for life insurers) or the Signing Actuary (for non-life insurers and reinsurers) if different to the Chief Actuary or indeed another actuary provided that he or she meets the fitness & probity requirements. It also worth noting that the possibility of dividing the responsibilities of the Actuarial Function among multiple people does not appear to be precluded, provided that there is clarity regarding individual responsibilities.

Once the Actuarial Function has been defined, roles and responsibilities should be documented, e.g., via terms of reference. Where the Actuarial Function is outsourced, it will be necessary to ensure that it is outsourced on a basis that is consistent with the written outsourcing policy.

During the interim phase, the existing Solvency I regime will continue to apply in addition to Solvency II requirements, which will put pressure on resources. Furthermore, preparatory development work will be required in order to be able to meet the new Solvency II requirements; the extent of preparatory work required will vary by company and will depend on the current level of preparedness. Additional actuarial resources might therefore be required, depending on existing capacity, during the interim phase.

Companies will have flexibility in how they allocate resources to Solvency I and Solvency II requirements. For example, one company could have a preference for involving all actuarial personnel in both Solvency I and Solvency II work; another company might prefer to allocate Solvency I work to one team and Solvency II work to another. Clearly, hybrids of these models would also be options. Consideration should be given to reviewing the objectives of the personnel involved.

When determining the responsibilities of the Actuarial Function, consideration will also need to be given to how the function will interact with the Risk Management Function. The guidelines envisage the Actuarial Function providing input to the *Forward Looking Assessment*, at a minimum in terms of calculating Technical Provisions. The guidelines also specifically require input from the Actuarial Function with regard to modelling solvency capital requirements for companies in the pre-application process for an internal model.

The Actuarial Function could have a greater level of interaction with the Risk Management Function, depending on how a company wishes to allocate responsibilities and again subject to addressing potential conflicts of interest. For example, this could include a greater involvement in the *Forward Looking Assessment*, input to the modelling of solvency capital requirements for standard formula companies, etc.

For some companies it might be possible to integrate the Actuarial and Risk Management Functions, either fully or partially. We understand that factors such as the nature, scale and complexity of the company and the level of resources available in terms of ability to segregate duties within the integrated function would be important considerations for the Central Bank of Ireland. Similar issues as outlined above would need to be addressed in respect of the integrated function, i.e., definition of function and responsibilities, addressing potential conflicts of interest, reporting lines, etc.

Checklist

- *How will the Actuarial Function be defined?*
- *What will be its responsibilities?*
- *If conflicts of interest arise, how will these be addressed?*
- *What personnel will comprise the Actuarial Function?*
- *Who will be responsible for the Actuarial Function?*
- *If the Actuarial Function is outsourced, does it comply with the written outsourcing policy?*
- *What level of resources will be required to meet the parallel requirements of Solvency II during the interim phase?*
- *What additional resources will be required for preparatory work?*
- *How will Solvency I and Solvency II work be allocated during the interim phase?*
- *Will the Actuarial Function and Risk Management Function be integrated, either partially or fully?*

Technical Provisions

The Actuarial Function will be responsible for coordinating the calculation of Technical Provisions on a Solvency II basis. We understand that coordination of the calculation will include setting methodologies and assumptions but that the calculation of the Technical Provisions could then be undertaken by another function. Alternatively, the Actuarial Function could also calculate the technical provisions, provided that appropriate measures are taken to address conflicts of interest.

A ‘best efforts’ basis is expected to be acceptable the first time that the Technical Provisions are calculated during the interim phase. Most companies will have participated in QIS5 and are likely to have done so on a ‘best efforts’ basis, and so a similar level of effort may be required to calculate the Technical Provisions for the first time during the interim phase. However, greater rigour will be required subsequently and so companies will need to move towards industrialisation of the calculation of Solvency II Technical Provisions.

The extent of preparatory work required will depend on how much has already been done in preparing for Solvency II. The preparatory work required could potentially cover:

- Assessing the quality of data used to calculate Technical Provisions against the Solvency II data quality standards.
- Developing/refining the process for setting assumptions including validation of assumptions as best estimate.
- Developing/refining the methodology for calculating Technical Provisions and documenting this as well as documenting the procedures for calculating Technical Provisions. This will require assessment of whether a stochastic methodology is required and documentation of this assessment.
- Developing and automating the valuation model for calculating Technical Provisions. In most cases, the Technical Provisions will be calculated as the sum of a Best Estimate Liability (BEL) plus a Risk Margin (RM). It will be necessary to calculate the Solvency Capital Requirement (SCR) before calculating the RM and so calculation of the Technical Provisions will involve a three stage process: calculation of the BEL, followed by calculation of the SCR, followed by calculation of the RM.
- Modules of the SCR will involve shocking the balance sheet including the Technical Provisions. Given the number of runs required to calculate the SCR and the reporting timescales, it will be important to automate this process as efficiently as possible. The Actuarial Function is likely to be heavily involved in this work, whether or not it is ultimately involved in the calculation of the SCR.
- Similarly, it will be necessary to project the development of the SCR in the future for the *Forward Looking Assessment*. This will involve complex modelling given that the calculation of the SCR at each point in time requires multiple shocked valuation runs (combined with formula-based calculations for other risk modules).

Again, the Actuarial Function is likely to be heavily involved in this work.

- Developing a process for analysing the reasons for differences between the actual Technical Provisions at a balance sheet date versus the expected Technical Provisions.

Each of these areas could be a significant workstream in its own right, depending on the current level of preparedness, with consequent resource implications.

Checklist

- *Has the data to be used for calculating Technical Provisions been assessed against the Solvency II data quality standards?*
- *Has the methodology for setting assumptions been determined and documented?*
- *Has the methodology for calculating Technical Provisions been determined and documented?*
- *Has the procedure for calculating Technical Provisions been documented?*
- *Has an automated valuation model for calculating Technical Provisions been developed?*
- *How efficient is the process for shocking Technical Provisions for the purposes of calculating the SCR?*
- *Is the capability to project Solvency II numbers, including in particular the SCR, in place?*

Other Responsibilities

Article 48 of the Solvency II Directive requires the Actuarial Function to provide an opinion on the underwriting policy and an opinion on reinsurance arrangements. The guidelines for the interim phase require that the Actuarial Function at solo entity level take into consideration the underwriting policy and reinsurance arrangements when calculating Technical Provisions, but do not explicitly require the Actuarial Function to provide opinions on both the underwriting policy and the reinsurance arrangements.

It might not yet therefore be necessary to develop approaches to providing these opinions. On the other hand, the guidelines do require opinions on underwriting policy and reinsurance arrangements at Group level, and so the Actuarial Function at solo entity level is likely to be called on to contribute to these. It is also worth bearing in mind that the guidelines are currently draft guidelines and it is possible that the final guidelines could require the opinions to be provided at solo entity level.

The Actuarial Function will need to prepare an annual report for the Board covering *"all tasks that have been undertaken [by the Actuarial Function] and their results,"* clearly identifying *"any deficiencies"* and providing recommendations as to how "*such deficiencies could be remedied."* Preparatory work will include developing the structure, format and content for the report. The Groupe Consultatif Actuariel Europeen, which is a European association of actuarial bodies, is developing guidance to help actuaries in this regard.

As outlined above, the guidelines stipulate minimum responsibilities for the Actuarial Function and recognise that the Actuarial Function could have additional responsibilities provided that any potential conflicts of interest are addressed. In particular, it is expected that the Actuarial Function will contribute to the effective implementation of the Risk Management System. This could include:

- Contributing to the calculation of the SCR
- Assisting in the modelling and analysis of financial projections for the *Forward Looking Assessment*
- Assisting with the development of the capital management policy and the medium-term capital management plan required by the guidelines.
- Commenting on or contributing to other aspects of the Risk Management System including market risk and asset liability matching

Clearly, this is not an exhaustive list.

TIMESCALES

The Central Bank of Ireland has announced its intention to apply the guidelines to regulated entities based on its PRISM model.

For High and Medium High ranked firms, a Solvency II Actuarial Function will be required from 1 January 2014 and the various responsibilities of the Actuarial Function will apply from that date.

On the face of it, Medium Low and Low firms will have an additional year before they are required to put in place an Actuarial Function that can meet all of their required responsibilities, i.e., from 2015. For firms that are part of Groups however, it will be important to also factor in the requirements of the Group when planning for implementation of the guidelines.

For example, it will not be necessary to calculate Solvency II Technical Provisions at local level in 2014 but it might be necessary to do so in order to contribute to a Group *Forward Looking Assessment* in 2014. It may therefore be necessary to implement aspects of the Actuarial Function in 2014 after all.

One area of concern for companies was that the first analysis of actual versus expected Technical Provisions would require a retrospective calculation of expected Solvency II Technical Provisions. This would require calculation of prior year Solvency II Technical Provisions to then be rolled forward, allowing for new business. However, the Central Bank of Ireland has confirmed that it will not require the analysis of actual versus expected Technical Provisions the first time that calculation of Solvency II Technical Provisions is required.

SUMMARY

There has been considerable uncertainty over the last couple of years regarding the timing of Solvency II implementation. This has made it challenging for firms to prepare efficiently for Solvency II. While the date for full implementation of Solvency II is still uncertain, there is now clarity regarding the requirements and timescales for interim implementation.

This provides a basis for companies to develop firm implementation plans. The level of work required will depend on the current level of preparedness, and the first step is to identify the gaps that need to be addressed. In addition to identifying what needs to be done, companies will also need to quantify resource requirements, bearing in mind that the existing Solvency I regime will continue to apply during the interim phase and preparation for full Solvency II implementation will need to continue.

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