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ESAP3 RESPONSES TO 2ND ED FORMAL CONSULTATION PROCESS 22 SEPTEMBER 17

Introduction:

The formal consultation on the second Exposure Draft of ESAP3 (ED2) took place during December 2016 to March 2017. Seven response were received – from six member associations and the UK's Financial Reporting Council (FRC).

The six member associations that responded to the formal consultation on ED2 were:

- Česká společnost aktuárů – Czech Republic
- Hungarian Actuarial Society - Hungary
- Institute and Faculty of Actuaries - UK
- Instituto dos Atuários Portugueses - Portugal
- Royal Dutch Actuarial Association – The Netherlands
- Society of Actuaries in Ireland - Republic of Ireland

The AAE is grateful to all these respondents and also to those member associations and other parties which responded to previous consultation exercises in connection with this ESAP 3. The comments received proved very valuable in finalising the text of this new model standard.

Apart from the comments from one member association, the responses were generally supportive of the ED, with only a couple of substantive points being raised.

The response from one member association raised fundamental questions over the principles-based approach taken in drafting the ED, preferring a more detailed document that gave guidance over how to do the relevant work rather than just stating the outcomes required. The AAE understands the point of view of this member association, and is grateful that representatives from it took time to discuss the issues further with some of those involved in the drafting of the ESAP. The AAE wishes to stress that ESAP3, like the other ESAPs which have been issued, are “model standards” and do not apply to any actuary's work unless and until the ESAP is adopted by their actuarial membership body, or standards which are substantially consistent to the ESAP are confirmed to be in place. Furthermore, in choosing to adopt an ESAP, there is nothing to stop a member association producing additional, educational, material to help their members. The AAE therefore chose to retain the principles-based approach in the ESAP and was grateful that the representatives of the member association concerned accepted the decision, recognising the opportunity they had to produce further information themselves.

The purpose of this note is to present the other 6 responses, discuss the comments and suggestions they included, and record how the AAE chose to respond to them.

Background to the consultation:

The 2nd ED issued for the formal consultation starting on 5th December 2016 was very similar to the version issued, a month before, for an informal consultation that was carried out during October 2016. This two-stage approach had been chosen in order to reduce the risk of material new points emerging in the formal consultation.

The formal consultation was issued to all the AAE member associations, along with a list of other relevant bodies and stakeholders. Respondents were invited to complete a comment template that asked the following 4 questions:

1. Do you think that the 2nd ED achieves the following goals:
 - a. Making the scope of the ESAP clear Y/N
 - b. Achieving an appropriate level of balance between core and non-core material for actuarial work Y/N
 - c. Appropriately principles-based guidance Y/N
 - d. Including only guidance that either must be followed or is on a comply or explain basis Y/N
 - e. If not then please indicate your concerns:
2. Is any of the proposed guidance inappropriate for inclusion in ESAP3? If so, please indicate which one(s) and explain why the particular topic(s) should not be included.
3. What other topics should be included in ESAP3? Please indicate which one(s) and explain why you wish guidance in the area(s).
4. Any additional comments

The consultation was intended to run from 5th December 2016 to 5th March 2017. However, the AAE extended the deadline for comments until 10th March, and a couple more responses were received that week.

“No suggestion” responses:

Two of the member associations did not complete the template, but just responded by email to indicate their support for the ED. A third member association completed the comment template, answering yes to the four goals in Q1, confirming that they felt that all of the proposed guidance was appropriate and that they did not propose any additional topics to be covered by the ED or have any additional comments to make.

“Minor comment” response:

The response from a fourth member association answered yes to the four goals in Q1 and no to Qs 2 and 3 (i.e. no suggestions for material to take out or to add). However, they did make one drafting suggestion, similar to what they had said in response to the informal consultation, namely:

“The ESAP states in the purpose section that it “provides guidance to actuaries...” (our emphasis added). There is a risk that using the term ‘guidance’ may cause confusion about the nature of the requirements within the ESAP. Therefore it may be helpful to use different terminology that makes it clear the provisions are intended to be mandatory (once implemented by Member Associations) rather than non-mandatory ‘guidance’”

AAE response:

The text that the member association quoted is from section 1.1 of the 2nd ED, which stated “Purpose – This ESAP provides guidance to actuaries” This form of words mirrors the equivalent section of ESAP 1 which says, in section 1.1, “Purpose – This ESAP provides guidance to actuaries when performing actuarial services ...” Thus, this is a standard form of words for ESAPs and the

AAE believes that it is important to keep consistency between ESAP3 and ESAP1 (and the contents of the ISAPs promulgated by the IAA using a similar language). The AAE therefore chose to retain the ED wording in this respect and explain to that member association why their suggested change of wording was not taken up.

Responses raising more substantial issues:

The remaining two responses raised more challenges.

One of these respondents answered yes to the four goals in Q1, but also suggested three areas where they would like to see changes to the text. They answered no to Q2 (re material to take out of the ESAP), but, under Q3, suggested adding a new sub-section between 3.1.3 and 3.1.4. They also made 6 proposals re small “tweaks” to existing ED2 text.

Q1 – suggestion 1

The suggestion from the respondent was:

“As just a small note to article 1.2 and its second paragraph. We don’t think there is such an important difference between the two approaches in designing and effecting ORSA process as suggested by this paragraph. Either ORSA process is completely new or it comes from connecting and possibly extending existing management procedures, but one way or another at the end there is defined ORSA process which must comply with SII requirements and should be covered by ESAP3.

We agree both ways to the ORSA process can be acknowledged in the standard, but we would maybe write that the standard is equivalently relevant to both. Also many management processes are newly built or extended based on the SII requirements in other areas and connecting and utilizing them also for ORSA is a good way to efficient SII implementation. It also limits the risk of inconsistency between the risk management approaches presented in ORSA and those used in real risk management as discussed in article 3.1.4. We therefore see the implicit preference of the specific ORSA process in the standard as a bit unfortunate.

We also believe that, based on what we see, the approach of connecting and extending existing procedures to form ORSA process is more common than creating new specific ORSA process.

We would actually suggest that effective utilisation of existing processes and documentation should be exercised by an actuary working on ORSA. We propose to consider inclusion of an article regarding this to the standard as suggested in section 3 below.”

AAE response:

The respondent would seem to have read the wording in a different way to what was intended. The text was meant to recognise that a “virtual ORSA” rather than an explicit, identifiable, ORSA process could satisfy the regulations. However, they seem to have put weight on the “specifically developed” text and read it as not including re-using existing processes and reports within the explicit ORSA process. It was therefore decided not to re-write 1.2, but to add “or amended” after “specifically developed” and then add some additional commentary in this respect to the educational note that the AAE is intending to publish to support actuaries and others wishing to follow ESAP3.

Q1 – suggestion 2

The suggestion from the respondent was:

“We also see some problem in the introduction to Section 3.1 which says it should relate to the actuary’s role in designing the ORSA process, but in individual subsections it is sometimes difficult to say whether they relate to the actuary responsible only for the design

of that part of the process or also its execution. Maybe the section 3.1 could be named "Quality of ORSA process" and the initial sentence/paragraph could be without words "the design of" leaving just "... material involvement in, or responsibility for, the ORSA process ..."

AAE response:

This would seem to be a mis-reading of the text. 3.1 is about assessing whether or not the process covers the necessary areas BY DESIGN. It is not about carrying out the different aspects. The AAE believes that the distinction between design and performance should be retained, and so no change was made to the ED text in this regard.

Q1 – suggestion 3

The suggestion from the respondent was:

"Last point relates also to the section 3.1, where it is said that "... it is envisaged that the scope of his or her work will cover each of the sub-sections within 3.1" We would probably prefer not to envisage any specific scope of the actuary's ORSA related work in the standard but instead say something like "... he or she must, in proportion to the responsibility assigned to him or her, ensure that the ORSA process covers appropriately each of the subsections within 3.1." We believe the sub-sections of section 3.1 are good selection and undertaking having actuary working on ORSA process and obeying ESAP3 should have additional benefit in those areas.

AAE response:

This is a similar point to a concern raised by the final respondent covered in this note. The ED envisaged that, if an actuary "has material involvement in, or responsibility for, the design of the ORSA process", then their work will encompass all 4 sub-sections of 3.1 – i.e. it will cover all of:

- Establishing a structured approach to uncertainty
- Derivation from Solvency II balance sheet approach and methodology
- The ORSA consideration period
- Inconsistency with the undertaking's risk management approach

and also every bullet in the list in 3.1.1. This approach was taken in order to avoid having the ESAP applying to every actuary involved in any way with the ORSA work. However, a consequence of this was that the ED did not allow for the situation where an actuary has material involvement in, or responsibility for, PART of the design of the ORSA process – for example, say, the stress and scenario testing to be carried out, and the projections work. In such a case, the ED would require the actuary to "take reasonable steps to ensure that the [whole of] the ORSA process follows an appropriately structured approach to uncertainty" unless the actuary could argue that the ESAP did not apply to their work at all since it was not sufficiently significant for the actuary to be considered to have "material involvement in, or responsibility for, the design of the ORSA process".

The final respondent made a similar point (see below), that the ESAP should only give guidance to actuaries "to the extent relevant to the actuary's involvement and responsibilities" and suggested adding text to this effect in the Purpose section (1.1).

One could perhaps argue that "take reasonable steps" could be interpreted to mean something less onerous with regards to areas outwith the actuary's responsibility, in which case the ED wording in 3.1 would not need to be amended to take account of this feedback. However, it was felt that a more direct approach to this issue would be preferable, and so the following new text was added to 3.1, based on the preamble text at the start of section 3, as follows:

"Where the actuary has material involvement in, or responsibility for, the design of the ORSA process, it is envisaged that the scope of his or her work will cover each of the sub-sections within 3.1. Where the actuary has material involvement in, or responsibility for,

the design of parts of the ORSA process, but not all of it, the actuary should confirm with his or her principal (ideally as early in the process as possible or practical) the extent to which the scope of his or her work includes the topics addressed within the sub-sections within this Section and, in the case of sub-section 3.1.1, which of the areas mentioned in the bullet points fall within the scope of their work.”

As a consequence, the preamble text to Section 3 in the ED (i.e. the text that currently appears before the table of Appropriate Practices) was removed from the final ESAP3.

A third change to the ED in response to this feedback was to add the words “to the extent relevant to the actuary’s involvement and responsibilities” to the bold text in 3.1.1, as follows:

“The actuary must take reasonable steps, to the extent relevant to his or her involvement and responsibilities, to ensure that the ORSA process follows an appropriately structured approach to uncertainty.

A fourth change was considered, to add the same text to the first sentence after it, as follows:

In considering whether the ORSA process follows an appropriately structured approach to uncertainty, the actuary should take into account, to the extent relevant to his or her involvement and responsibilities, whether it: ...”

but it was felt that this would be too much duplication. Thus, this fourth potential change was not adopted for the final ESAP3.

Q3 – suggested new sub-section

The suggestion from the respondent was:

“We propose to consider insertion of a new article between current articles 3.1.3 and 3.1.4 which would deal with building on existing processes and documentation. Mostly for the reasons given above. We also believe that for example Actuarial Function Report should form critical input for the ORSA process. The article may go along following lines:

Building on existing processes and documentation

To foster efficient embedding of the risk management and ORSA into business as usual the actuary must consider and utilize existing processes and documentation produced within the undertaking in the areas relevant for his/her part in ORSA process if those are of sufficient quality.

In cases where those existing processes and documentation are insufficient the actuary should propose necessary adjustments or extensions.

The documentation and processes likely relevant for the ORSA process which should be utilized include but are not confined to:

- *Actuarial Function Report*
- *Internal audit reports”*

AAE response:

It was felt that this was going to a level of detail too great for a principles-based standard. The “re-use existing material” point already mentioned had been addressed with the revision to 1.2 mentioned above. Thus, the AAE chose not to add the new section suggested.

Q4 – drafting suggestion 1 of 6

The suggestion from the respondent was:

“In article 3.1.2 in the first sentence we would suggest limiting actuary’s responsibility just to the areas where he/she is involved as we see that “any aspect of balance sheet” as bit too wide.

AAE response:

The AAE did not agree that the ED wording was too wide in this context. The intention of this wording was that, where the actuary has material involvement with, or responsibility for, the choice of measurement bases used for assets and liabilities in the ORSA projections, he or she should be aware of how they differ from what is used for S2 solvency reporting. Thus, it was not believed that it would be appropriate to narrow the focus down to only parts of the balance sheet, and so the ED text in this regard was left unchanged.

Q4 – drafting suggestion 2 of 6

The suggestion from the respondent was:

“In article 3.1.3 we would like to specify bit more what is meant by expected and unexpected changes in the economic environment as those things quite often raise misunderstanding about usefulness of considered scenarios. We suggest to extend last two bullets in a following way:

- Expected changes in the economic environment, i.e. those which are considered very likely to happen.*
- Unexpected changes in the economic environment, i.e. those which are considered possible and plausible, but currently not considered likely.”*

AAE response:

It was felt this was a helpful suggestion. However, in order to avoid using words that would then need to be defined, an alternative form of the proposed form was adopted. The ED text in the two bullets in 3.1.3 were therefore changed for the final ESAP as follows:

“changes in the economic environment which are considered likely to happen; and changes in the economic environment which are considered possible and plausible, but currently not considered likely.”

Q4 – drafting suggestion 3 of 6

The suggestion from the respondent was:

“In article 3.1.4 we agree with the purpose of the article we would however prefer bit more constructive formulation requiring actuary to, besides communicating the situation, make some efforts to remedy the situation or at least to propose how the situation could be rectified. Also this probably links back to the approach to ORSA process discussed in article 1.2 and above. Inconsistency as in article 3.1.4 is more likely to emerge when ORSA is designed as a specific standalone process than when ORSA is built on connecting and extending other running processes in which case the room for inconsistency is largely reduced.”

AAE response:

The relevant text in the ED just required that “Where the actuary has reasonable grounds for believing that there is a material shortcoming in the projections that render the ORSA unsuitable for its purpose, then the actuary must ensure that such shortcoming is appropriately communicated.” This does not preclude what the respondent suggesting. However, it was not felt that it was appropriate to add a requirement to do this, particularly not using the verb “must”, if the actuary’s role profile in the undertaking did not already require that. Thus, the AAE chose not to make the suggested change to the ED text in this regard.

Q4 – drafting suggestion 4 of 6

The suggestion from the respondent was:

"In article 3.2.1 we would suggest to extend the title to explicitly cover also quantitative risk assessment, e.g. "Quantitative risk assessment and financial projections" and change the first sentence to "...to ensure that the risk quantifications and financial projections used ...". The reason is to make the section 3.2 in certain sense complete as we have there "Financial projections" and "Qualitative risk assessment" which makes quantitative risk assessment to look missing."

AAE response:

This was felt to be another helpful suggestion, and so the suggested text was incorporated into 3.2.1 in the final ESAP.

Q4 – drafting suggestion 5 of 6

The suggestion from the respondent was:

"We would also stress the role of other calculations used in ORSA not necessarily only projections. We would change the sentence opening the bullet list to "In assessing whether calculations and projections are...", we would change the first bullet to "... significance of a material risk drivers or risks;" and we would change the last bullet to "... significance of a material risk drivers or risks.". We would also add one more bullet to the end of the list reading "The projections and calculations uncertainty increases for the periods further in the future.""

AAE response:

Distinguishing between "risk drivers" and "risks" themselves was felt to be helpful. However, it was not felt necessary to add the suggested extra bullet point, regarding uncertainty increasing with future time periods, since such considerations were already covered elsewhere in the ED. Thus, the AAE made the first change to 3.2.1, but did not add the proposed new final bullet.

Q4 – drafting suggestion 6 of 6

The suggestion from the respondent was:

"In article 3.2.2 we would suggest to limit the scope for ensuring the appropriateness of the qualitative risk assessments just to the area of actuary's responsibility. There may be many risks assessed qualitatively many of which might be quite correctly well outside of actuary's sight. We would change the initial sentence of sub-section 3.2.2 to "... qualitative risk assessments within his area of responsibility used in ORSA process are ...".

AAE response:

The AAE agreed with the point made and appropriate text was added to 3.2.2.

Response from the final respondent

The final respondent answered yes to two of the four goals in Q1, regarding "appropriately principles-based guidance" and "including only guidance that either must be followed or is on a comply or explain basis". Indeed, they were very complimentary of the ED, saying *"We consider that the changes made to the 2nd ED draft for ESAP3 move significantly towards achieving the goals described above. In particular, we consider that the 2nd ED is appropriately principle based."*

However, the respondent answered no to the first two goals in Q1, regarding "making the scope of the ESAP clear" and "Achieving an appropriate level of balance between core and non-core material for actuarial work", and made a suggestion in respect of each of these goals.

Under Q2, the respondent again took the opportunity to praise the ED, saying: *"We consider the changes to ESAP 3 to simplify the guidance and remove duplication of the Solvency II requirements*

are appropriate.” They also raised two points under Q2 where they suggested small changes to the draft text. They also made one suggestion, under Q3, regarding an additional requirement to add to the ED.

Q1 – suggestion 1 (re scope)

The suggestion from the respondent was:

“The further clarity provided on the scope is welcomed. However, we feel that actuaries working on key individual components of the ORSA may be unclear whether ESAP 3 applies or not and the extent to which it applies.

We suggest that the scope of ESAP 3 could be changed to provide additional clarity and suggest the following “This ESAP provides guidance to actuaries who have an involvement in or responsibility for the design or performance of the ORSA process to the extent relevant to the actuary’s involvement and responsibilities.” “

AAE response:

As noted above, this is similar to a point made by another respondent, and is a good one. Appropriate clarification text has been added to 1.2, 3.1, 3.1.1 and 3.2.2 to address it.

Q1 – suggestion 2 (re balance between Core and Non-core actuarial work)

The suggestion from the respondent was:

“We consider that the ESAP appropriately considers core and non-core actuarial work. However, a key component of the ORSA is bringing together risk and capital management considerations across an insurer’s business, which may require actuaries to engage more extensively with non-actuaries in relation to non-core actuarial work. The different perspectives of different teams can lead to different communication of risks and the risk profile and the actuary is well placed to understand such differences.

We suggest that the following is added to paragraph 3.1.4 or as a separate 3.1.5, “Where information provided by the actuary in the ORSA process is inconsistent with or may be interpreted in a different way to information provided by other functions in the ORSA process, the actuary should seek to understand any such differences and ensure any such inconsistency or potentially different interpretation of the assessments provided is communicated and explained clearly.”

AAE response:

It is not felt appropriate for the ESAP to add business responsibilities to actuaries which are not already in their role profile. Following discussion, the respondent accepted that point too. Also, 3.1.4 already requires the actuary to ensure that any material inconsistencies are appropriately communicated. Thus, it could be argued that the ED as drafted did not stop the actuary doing what the respondent had proposed. Thus, no change was made to the text in response to this suggestion.

Q2 – suggestion 1 (re inconsistency with ESAP1)

The suggestion from the respondent was:

“In paragraph 1.3 we suggest changing the first sentence after the brackets to say: “An actuary may depart from the requirements of this ESAP but still comply with it ...” This wording would be consistent with the similar paragraph in ESAP1.”

AAE response:

The text that was used in the ED was the latest version of the equivalent section from IAA standards which, it was understood, would be incorporated into ISAP1 (and hence ESAP1) in due course. In

the interests of maintaining consistency with IAA and other AAE model standards, the text in 1.3 of the ED was not changed, apart from some refinements to 1.3.3 in order to reflect the latest thinking from the IAA.

Q2 – suggestion 2 (re inclusion of regulatory requirements)

The suggestion from the respondent was:

“Paragraph 3.1.2 appears to repeat an element of the EIOPA guidelines (Guideline 9) which may lead to inconsistent interpretation between ESAP 3 and the EIOPA guidelines. We suggest that ESAP 3.1.2 is replaced with a high level principle that “The actuary must ensure that information in the ORSA process clearly communicates on what basis risk and capital assessments have been prepared and that, in aggregate, the documented communication is transparent with regard to material differences between different risk and capital assessment bases and the reasons for those differences.” “

AAE response:

The proposed text from the respondent was felt to have merit. However, in drafting 3.1.2, there had been a deliberate intention to imply that the S2 balance sheet was the one to use unless there were good reasons to use something else. This had led to the strong requirement (using “must”) to document any material deviations from S2 balance sheet measurements.

The respondent accepted this point, and so no change was made to the ED text in this regard.

Q3 – suggested additional requirement

The suggestion from the respondent was:

“We suggest that the last sentence in each of sections 3.2.1 and 3.2.2 is extended to include “...and escalated in line with the undertaking’s risk governance processes”. “

AAE response:

The text in the ED just required that “such shortcoming is appropriately communicated”. It could be argued that this is consistent with the respondent’s suggestion, and certainly does not preclude it. However, as noted earlier, in drafting the text, care has taken not to add business responsibilities to actuaries (particularly using the verb “must”). Thus, where escalation in line with the undertaking’s risk governance processes is not within the actuary’s responsibilities within the undertaking, it would not be appropriate for the ESAP to add this as a requirement. No change was therefore made to the ED text in this regard.

Respectfully submitted

ESAP3 Task Force

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