Discussion paper on roles of actuaries in relation to IFRS 17

Actuarial Association of Europe

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1 IFRS 17 endorsement in Europe

The Actuarial Association of Europe (AAE) welcomes many aspects of the improvements targeted by the IFRS 17 regime including its market consistency, allowance for risk, greater anticipated consistency and comparability across the accounts of different insurers and reinsurers, and release of profits in line with the underlying earnings profile. The AAE however recognises many complexities in the new regime and calls for a prominent role for qualified actuaries both in entities required to comply with IFRS 17 and in auditors in carrying out their assurance work relating to relevant insurance companies.

As we have pointed out in previous AAE communications, IFRS 17 as a principle based standard leaves considerable room for interpretation and inconsistency in assumptions and methodology between entities in relation to elements such as

- illiquidity premium,
- discount rates,
- contract boundaries,
- amortisation of Contractual Service Margin (CSM),
- onerous contracts test and allocation of loss,
- transition treatment,
- coverage units,
- risk adjustments,
- cost allocation and deferral,
- mutual business treatment,
- applicability of Premium Allocation Approach (PAA), and
- Other Comprehensive Income (OCI) approach

This room for interpretation could lead to very different treatments and methodologies applying to different parameters from company to company in the absence of an underlying application of consistent approaches from professionals who are qualified through education and experience in this area and who are guided by consistent standards. The AAE observes that one way of dealing with the complexity associated with the principles listed, and securing a more harmonised approach, is to encourage the use of standardised methodologies and actuarial principles in assessing the value of insurance liabilities.

The AAE believes that actuaries will be central to the preparation of IFRS 17 accounts. This is being borne out for most companies in the prominent positions which actuaries are occupying in implementation of the Standard. As a result, the AAE believes that actuaries should be required to have a defined statutory role in preparing and auditing accounts under IFRS 17. We expect that this would contribute to a consistency in methodology and interpretation which would support some of the key aims of the Standard. The requirement of an actuary to discharge the responsibility conferred by a statutory role would strengthen the reliability of IFRS 17 outcomes.

In 2018, the AAE briefly outlined two suggestions describing the obligations of actuaries envisaged in such statutory roles at that point in time

i. *Obligations on the actuary in the company:*
In our view, in order to allow the management of the insurer to have the necessary insight and understanding of the work of the actuary in relation to IFRS 17, the actuary who is responsible for the work should be required to prepare an internal report to the management of the insurer covering at least the applied methodology, the assumptions used, the data used, identification of the judgments applied, and the results including their sensitivities. The report should also address required disclosures.

ii. *Obligations on the actuary as the auditor*:

Further, in making judgements and drawing conclusions in order to perform audits of financial statements prepared under IFRS 17, the auditor should be required to have a report prepared by the auditor's actuarial expert in order to ensure that the nature and complexity of the actuarial contribution to the audit work is fully reflected. This report should reflect the auditor's requirements and should cover at least the areas mentioned in i above.

As the endorsement process in the EU approaches, the AAE will develop its proposal in order to specify in more detail proposed requirements of the statutory roles envisaged and set out here. We will address what the roles should mean in practice, and how they would affect the work of actuaries both in preparers and in cooperation with auditors.

This paper discusses in more detail how the endorsement of IFRS 17 in the EU could accommodate statutory roles of actuaries, under the following headings:

- What are the tasks of the actuary?
- What are the responsibilities of the actuary?
- What standards and regulation define the roles?
- Which actuary holds these roles?
- What requirements must the actuary meet?

For each of the two proposed roles, the following sections address these questions.

2 The actuary in the insurance company[1]

In many aspects, the IFRS 17 valuation of insurance liabilities involves similar methodologies and assumptions to those required in calculating technical provisions for Solvency II. Despite technical differences, many companies will strive to harmonise principles, definitions and calculation techniques.

As a starting point, parallels for a statutory role for actuaries working on IFRS 17 in the insurance company could be drawn from the existing Solvency II regulation, which introduces a requirement for the actuarial function to fulfil specific requirements. Certain countries which are subject to Solvency II have taken this further and imposed additional statutory requirements relating to the actuarial function, and review of the work of this function. For instance, the Head of Actuarial Function is a statutory role in Ireland and the holder is required to provide an opinion and report on technical provisions every year.

[1] One member of the WG disagreed with the need for a statutory role in the reporting entity

In addition, the statutory role of an Appointed Actuary exists in some jurisdictions. Our ambition in this paper is to focus on the role of the actuary in relation to reporting responsibilities under IFRS 17. We will discuss synergies with and seek inspiration from other existing statutory roles of actuaries, but it is not our intention to suggest changes in or to unify these roles (other than for reasons of proportionality) in relation to their current responsibilities.

For discussion purposes, we introduce the term "Reporting Actuary" in this section to describe the statutory role of the actuary in an entity reporting under IFRS 17.

The task

Currently, the Solvency II regulatory framework requires the actuarial function and the key function holder to coordinate and control the calculation of the technical provisions used for computation of capital requirements and to determine the solvency position, as well as other tasks relating to risk management, underwriting and reinsurance.

The results of the IFRS 17 financial reporting process are expected to be derived based on similar assumptions to those in Solvency II calculations. These assumptions impact materially on outcomes and are important for investors and other stakeholders in defining the basis for profit, dividends, company valuation and other important measures.

Consequently, the measurement of insurance liabilities for IFRS 17 purposes is very important to entities preparing IFRS 17 accounts We consider that a Reporting Actuary could add value, quality and consistency (with Solvency II and with approaches of other preparers) to the process by

- (i) having an active statutory responsibility in preparing the measurement of insurance liabilities in the accounts, and
- (ii) providing assurance to the Board around assumptions, parameters and methodologies used.

We therefore propose that the function of Reporting Actuary should be introduced in Europe as a required role in the accounting of IFRS 17.

We also propose that, where the responsibility of the Reporting Actuary and the Solvency II actuarial function are delegated to two different individuals within a company, they should have a mutual obligation to ensure that parameters, assumptions and methodologies used for the different calculations are coordinated and harmonised where feasible.

Entities preparing IFRS 17 reports

Regulation (EC) no 1606/2002 of the European Parliament and of the Council specifies those entities which must (Article 4) or can (Article 5) prepare IFRS consolidated accounts and/or their annual accounts. Those entities which prepare the consolidated accounts and must apply IFRS 17 may have several insurance companies or branches and in several countries. Thus, they have several Actuarial Functions and/or Reporting Actuaries across a number of subsidiaries.

Accountability at Group level for preparing IFRS accounts is expected to be in a central function in any Group, usually in the Group Financial Department (or similarly titled function) whose head is usually the Group CFO. It can be the case that there is no entity-wide actuarial function. For IFRS 17 reporting, we propose that one Reporting Actuary at Group level should have the requirement to have overview of approaches adopted across the Group and to collate and report to the Group Board on the Group IFRS 17 numbers.

Proportionality

The Reporting Actuary fulfils a function that is not directly defined in the Solvency II framework. The actuarial function is by definition a second line of defence function. In comparison, the Reporting Actuary is a first line of defence function, responsible for preparing and conducting the calculation of insurance liabilities.

However, the implementation of the actuarial function under Solvency II differs from company to company due to proportionality as well as the way in which Solvency II is implemented locally, which is often based on the historical development in different jurisdictions.

In smaller companies with simple lines of business, we often see that only one actuarial competence centre exists, and the separation between first and second line of defence under Solvency II may not be organisationally distinct. In such minimum settings, the actuarial department handles both preparation of the technical provisions and control of the technical provision by applying a "four eyes principle".

In larger entities with more complex business models, the Solvency II actuarial function is often a second line function, with separate organisational setup.

When considering proportionality, and in order to avoid unnecessary complexity, the AAE envisages the specific role and responsibility of the Reporting Actuary could be assigned to the Solvency II actuarial key function holder, at least for smaller companies with simple lines of business.

The responsibility

The Board of an insurance company or group has overall responsibility for the IFRS and Solvency II financial statements. Therefore, AAE suggests that the Board is responsible for appointing a Reporting Actuary in order to ensure that adequate actuarial skills are involved in preparing the financial statements of an insurance company.

As part of the responsibility, the Reporting Actuary should report to the Board and should prepare an internal actuarial report to the Board to support financial statements, covering at least the applied methodology, the assumptions used, the data used, identification of the judgments applied, the results including their sensitivities in relation to the valuation of insurance liabilities and any material risks, uncertainties, limitations and recommendations. In carrying out this responsibility, the Reporting Actuary is likely to have interaction with other actuaries who are involved in various aspects of the preparation of the financial statements. It will be helpful for the Board to have access to one report which can bring all aspects together and give assurance around consistency of approach and control environment across the required strands of work.

An important part of the Reporting Actuary's work would be the preparation of a report to the directors setting out the approach taken to computing the actuarial elements of the IFRS 17 accounts and the material assumptions utilised. It may be appropriate to focus particularly on rationale for deviations from assumptions and methodology used in relation to Solvency II calculations. In this respect, coordination with the Solvency II actuarial function will be important. The Reporting Actuary should also recommend suitable disclosure for certain relevant elements of IFRS 17 accounts.

It is possible that more than one Reporting Actuary will be required to provide results for an insurance company because of the need to report at both company and group level. This could lead to different methods and assumptions being adopted. In these circumstances, the Reporting Actuaries should liaise to ensure that data and realistic assumptions agree, even if the profiles of the different companies require different figures to be included in the calculations, for example owing to a differing approach being taken to margins.

Regulation

The AAE recommends that the tasks and the responsibility of the Reporting Actuary should be defined as part of the accounting regulatory framework for insurance companies and groups reporting under IFRS 17. The AAE envisages that this framework would ideally be defined as part of the EU IFRS 17 endorsement process.

The requirements of the actuary

In line with earlier references to the Solvency II regulation, the minimum requirements of the Reporting Actuary would be the Solvency II "fit & proper" requirements that currently apply to the actuarial key function holder.

In addition to the fit & proper requirement, the required qualifications of the Reporting Actuary could be extended in accordance with qualifications of "a fully qualified actuary" defined by the AAE and its member associations.

3 The actuary as part of the audit process[2]

It requires a certain set of skills for the auditor to review the valuation of insurance liabilities under IFRS 17. Most notably, actuarial skills are required for the audit process.

The audit profession has developed international standards for auditing accounting estimates and valuations based professional judgements, the ISA 540, and standard for using non-audit experts in the auditing process, the ISA 620.

Today, it is common for auditors to use actuarial experts when auditing insurance liabilities of insurance companies, and applying the ISA 540 and ISA 620 is widely recognised among auditors. Further, the EU has considered recognising the ISAs as part of the statutory EU accounting regulation.

In relation to the endorsement of IFRS 17, the AAE supports the motion to implement ISA 540 and ISA 620 as part of the statutory EU requirements when preparing financial statements under IFRS 17.

The task

ISA 540 and ISA 620 set appropriate standards for auditing valuations based on professional judgement as well as the auditor’s use of non-audit technical experts.

The AAE would like to encourage cooperation between auditors and actuaries in relation to the audit of insurance companies under IFRS 17. Together, the two professions can ensure quality in the audit process at a level that none of the professions would be able to by itself. The actuary in this context is employed or engaged by the auditor and should comply with the ISA 620 and ISA 540 standards of auditors.

The audit of insurance liabilities is a significant part of the audit of insurance companies. Consequently, the AAE envisages that it should become mandatory for the auditor to use actuarial expertise when auditing the insurance liabilities and the AAE proposes that the auditor is required to refer to the work of the actuary as part of the auditor's report. In all other aspects, the specifications of the process in ISA 620 and ISA 540 seems adequate and relevant.

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[2] All members of the WG agreed on the feasibility and need for at statutory role of the actuary as part of the audit process

The responsibility

ISA 620 clearly governs the split of responsibility between the auditor and the expert used in the audit of financial statements, and clarifies that the auditor cannot delegate any part of the responsibility for the financial statement. The AAE does not propose any changes to this relationship, and consequently, the proposal does not suggest that actuary should co-sign the audit opinion or any other external documentation.

In the audit process, the actuary should work under the instruction of the auditor under the same conditions as are widely used today.

Regulation

The AAE supports the motion to endorse ISA 620 and ISA 540 as part of the endorsement process of IFRS 17. In addition, the AAE proposes that the endorsement of IFRS 17 requires the auditor of insurance companies reporting under IFRS 17 to engage with actuarial experts. The AAE suggests that this requirement should be mandatory for audit of all insurance companies reporting under IFRS 17. It should be possible to consider proportionality in the operation of the requirement.

The requirements of the actuary

ISA 620 and the audit profession already set standards in relation to professional skills that must be complied with by those who form part of audit activities. As part of the cooperation between the actuarial and the audit profession, the AAE proposes to comply with the existing framework used by auditors today.

4 Standards for actuarial profession

The actuarial profession has already developed a number of standards for actuaries. Both the general ESAP 1 and ISAP 1 and the more specific ISAP 4 targeting actuaries preparing the measurement of insurance liabilities under IFRS 17 apply in this context. They are non-binding model standards. Several full member associations of AAE have adopted them, either in full or in modified form, as binding actuarial standards. In addition, the profession has developed the actuarial note IAN 100 in relation to accounting for insurance liabilities under IFRS 17.

The AAE suggests that, unless it is in conflict with other regulation, it should be mandatory for the Reporting Actuary to apply ESAP 1/ISAP 1 and ISAP 4 when preparing financial statements under IFRS 17.

This position paper deals only with the role of actuaries in applying IFRS 17 and does not make any comments of proposals in relation to other financial reporting standards. Many actuaries are involved in and experienced in other kinds of customer contracts and their accounting, including IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers* and IAS 19 *Employee Benefits.*

5 The way forward

As mentioned earlier, the AAE welcomes many aspects of the improvements targeted by the IFRS 17 regime including its market consistency, allowance for risk, greater anticipated consistency and comparability across the accounts of different insurers and reinsurers, and release of profits in line with the underlying earnings profile.

The AAE firmly believes that actuaries can and should be required to take statutory roles relating to the preparation by insurance companies and groups of IFRS 17 accounts, and that the involvement of actuaries in this way would add professionalism and consistency to the valuation of insurance liabilities under IFRS 17. The AAE believes that such roles should be defined as part of the accounting regulatory framework for insurance companies and groups reporting under IFRS 17. The required involvement of actuaries in this way will enable the generation of credibility of IFRS 17 accounting from the outset.

In considering the audit of IFRS 17 accounts, the AAE recognises the auditors' statutory roles and responsibilities in relation to preparing and auditing financial statements. We propose to cooperate with the audit profession to define the best possible statutory framework for actuaries and auditors to cooperate in the best interest of stakeholders of the European insurance industry and society in general. This should in our opinion involve a requirement for auditors to engage with actuarial experts in auditing IFRS 17 insurance liabilities.

The AAE will be available to expand on the proposals in this paper, as well as to define further the framework which might apply for required roles of actuaries in preparers and auditors, and to consider additional education and standards which might be useful for its members to help them discharge their requirements.