

Attention:
Mr Pat Brennan
General Manager
Policy Development
Australian Prudential Regulation Authority

APRA Discussion Paper - The role of the Appointed Actuary and actuarial advice within insurers

Dear Mr Brennan,

I would like to provide the comments set out below on areas where I believe the current APRA proposals could be improved. In doing so, I wish to state that my background has been in Life Insurance. My suggestions may therefore need some modification to be appropriate to other fields of insurance.

Yours sincerely,

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LIMITING CONFLICTS OF INTERESTS

The current APRA Discussion Paper acknowledges that some conflicts of interest are inherent in the role envisaged for the Appointed Actuary. In Section 2.3.1 APRA essentially proposes leaving it to each insurer and its Appointed Actuary to manage those conflicts on an ad hoc basis. I submit it would be better if APRA includes more commentary in their final guidance. In fact, I would go further and suggest that APRA should take a stand in some areas and attempt to formulate rules that would limit the potential conflicts. This need is developed further in the points below.

FIRST AND SECOND LINES OF DEFENCE

APRA's Discussion Paper points out that the role of Appointed Actuary may overlap what is described in APRA's *Prudential Practice Guide CPG 220 Risk Management* as the first and second lines of defence. Section 2.3 of the Discussion Paper includes the wording "*There is no clear consensus from stakeholder feedback as to which line of defence the Appointed Actuary role should be assigned.*" My view is that it is impossible to assign the Appointed Actuary role in an exclusive way to either the first or second line of defence. It would be better if APRA explicitly noted that they expect each Appointed Actuary to act in both lines of defence in certain circumstances.

CPG 220, section 5, says "*The first line of defence comprises the business management who have ownership of risks.*" The Appointed Actuary must always own the setting of valuation assumptions, the valuation IT systems, the methodology and interfaces for extracting

valuation data from the insurance company's day to day administration systems and the responsibility for producing the required valuation results and FCR according to the prescribed timetables. There are clear risks to the insurer if performance standards fail to be met in any one of those areas and the Appointed Actuary must be the owner of those risks. Hence, this narrow part of the Appointed Actuary's responsibilities is inescapably within APRA's definition of the first line of defence.

CPG 220, section 8, says *"The second line of defence comprises the specialist risk management function(s) that are functionally independent of the first line of defence."* Section 2.1 of the APRA Discussion Paper discusses the development of a purpose statement for the role of the Appointed Actuary, noting that *"The Appointed Actuary plays a significant role in providing independent and unbiased advice on issues that are material to the financial condition of the company, including by providing effective challenge on decisions."* The draft purpose statement in section 2.1.1 uses the words *"impartial actuarial advice and review"* which I believe are equivalent in meaning to *"independent and unbiased advice"*. This puts the majority of the Appointed Actuary's responsibilities inescapably within APRA's definition of the second line of defence.

CLARIFICATION NEEDED ON THE APPOINTED ACTUARY'S ROLE IN RELATION TO COMPANY STRATEGY

In Chapter 1 of the discussion paper, APRA notes in regard to the current review *"This should allow the Appointed Actuary greater capacity to play a strategic role within insurers."* In Section 2.1.1 APRA mentions *"its expectation that the Appointed Actuary is to be a strategic advisor to the board"*. I believe these comments need more clarification. I contend that the Appointed Actuary should not accept any responsibility for developing strategy. His or her role should be one of providing the insurer with independent and impartial review and challenge to the strategy proposals of operational management. APRA notes explicitly in section 2.3 that *"Conflicts arise, for example, where an individual reviews their own work undertaken in a first line capacity as part of a second line review and challenge role."* Such conflict would be unavoidable if the Appointed Actuary was involved in developing company strategy, as well as in reviewing it. It would be much better to eliminate such conflicts wherever possible. It would aid understanding if APRA indicated that the AA role should be separated from the development of strategy, making it clear that the AA should consider strategy only from a second line of defence perspective, and advise the board of the insurer accordingly.

An example may make this clearer. Suppose the strategy developed by operational management included an aim to increase sales of a certain product line. Steps that could be taken with the intention of increasing sales volumes could include any or all of: a decrease in price; a relaxation of underwriting standards; making product terms more generous; or, improving commission payments or terms to salespeople. If the Appointed Actuary was part of the first line decision process to try to increase sales, there might arise a suspicion that he or she would come under pressure to support the company taking steps such as I have mentioned that could increase sales volumes. That would amount to a suspicion that the Appointed Actuary could no longer provide impartial and unbiased second line advice to the board on those factors.

SEPARATION OF RESPONSIBILITIES

I believe it follows from the previous point that the Appointed Actuary should act as far as possible at arm's length from operational research within the insurance company and the decisions that flow from that research. It would follow that the actuary (or actuaries) developing proposals for pricing terms for a product (for example, as in my example in the previous note) should be in a separate reporting line from the Appointed Actuary. That seems necessary for the Appointed Actuary to retain the envisaged independence to conduct a review of the proposed pricing terms and provide impartial advice to the Board. It would be beneficial for APRA to comment explicitly on their preference for the degree of separation of responsibilities.

For completeness, I will add two caveats to the above comment.

- I believe it follows from my comment that the pricing team and the Appointed Actuary's team should each share openly the results of research they have undertaken and which they are relying upon to form their views on suitable assumptions. In many insurance companies it is likely, for example, that the Appointed Actuary's team will obtain earlier, or fuller, information on the company's internal experience results through their valuation work. That information is likely to be relevant to the pricing team in setting assumptions. If the pricing team thinks that other experience data will be more relevant for future pricing, it will be helpful for it to know where and how the external data differs from the Company's own data, to be ready to respond to challenge as to why their particular assumption set has been recommended.
- In the case of a very small company, for example a new insurance company starting up, the degree of separation of duties that is possible internally may be less than would be expected in a larger or longer established company. However, the small company may still be able to obtain a second source of opinion, from the company's reinsurance provider or from an external firm of actuaries.

DELEGATION OF AUTHORITY TO COVER TEMPORARY ABSENCES OF THE APPOINTED ACTUARY

I agree that a temporary delegation process is necessary to address problems that may otherwise arise if the company's full time Appointed Actuary is temporarily unavailable. However, I believe APRA may need to consider more deeply the possible causes of absence. The proposals in the Discussion Paper would not work well in all circumstances and appear to need some modification. The current proposal in Section 2.2.1.3 of the Discussion Paper is that:

"In the event that the current Appointed Actuary will be absent, the insurer must notify APRA in writing that:

Person A is to cease functioning as the Insurer's Appointed Actuary from X date to Y date and in that period, Person B is to hold the office of the Appointed Actuary.

A single notification by letter to APRA, ahead of the change, can suffice ..."

Form of notification. The proposal mentions “*notification in writing*”, but also “*notification by letter*”. It would be preferable to make clear that a signed letter, forwarded electronically, would be acceptable to APRA. This would accord with modern business practice.

Copy of the advice to be provided to Company Officers. APRA may wish to mandate that the current Appointed Actuary, the delegate and the Company Secretary (subject to the point next following) should each be provided with a copy of any delegation advice given to APRA. That process would avoid any doubt as to who holds the Appointed Actuary authority at any given time. A clear, auditable, trail is also desirable in case a question should arise at a later date regarding compliance with legal requirements under the governing legislation and regulations.

Who should sign? Notification is to be given by “the insurer”. Is it sufficiently clear who would be acceptable as a signatory? For example, can it only be the Company Secretary? Or, could the CEO, the current Appointed Actuary or the Chairman of the Company also be acceptable as the signatory on the notification to APRA?

Notice ahead of the change. (a) Does APRA need to specify a preferred period of intended notice (such as, say, 2 business days prior)?
(b) Notice in advance may not always be possible, for example if the current Appointed Actuary suffered a stroke, becoming instantly unable to carry out statutory duties.

Advance notice of the end date. If an illness occurs, either a temporary illness such as a bout of influenza, or a serious illness such as a stroke or heart attack, it may not be clear at the outset exactly how long the current Appointed Actuary will be unable to carry out the required duties. Could an open ended advice be provided, such as “*from X date until further notice*”?

Notification of the end of a delegation. If my suggestion is accepted and an open ended delegation period is permitted, then it would follow that the insurer should be required to advise APRA when the delegation does actually terminate. The end of the delegation entails a handover of responsibility as the Appointed Actuary, just as occurred at the start of the delegation. If the end date of the delegation was originally uncertain, advice of the hand-back should be advised to APRA in the same way.

Causes of Absence. Two examples are given of causes of absence that might lead the insurer to delegate their Appointed Actuary responsibilities to a substitute. APRA might wish to consider changing the wording in Section 2.2.1.3 from “*for example, sickness or leave*” to “*inter alia, sickness or leave*” to make it even clearer that there may be a wider range of circumstances which would lead an insurer to exercise the delegation power. For instance, an insurer may also do so because of the temporary absence overseas of the Appointed Actuary. Several insurers have parent companies in Asia, Europe or America. Differences in time zones complicate communications with an Appointed Actuary visiting there from Australia and the insurer might prefer to set up a temporary delegation of authority to cover the period of absence.

APRA REQUEST FOR A PEER REVIEW OF AN ACTUARIAL REPORT

Section 2.4.2.3 of the Discussion Paper says “APRA proposes to include a general provision to allow APRA to request a peer review of a specified actuarial report by an independent actuary, in circumstances where APRA considers this appropriate.” I accept as a general principle that APRA should have very wide powers to take whatever steps it considers necessary to carry out its prudential regulatory function. Circumstances where APRA might wish to engage an independent actuary to carry out a peer review might include a time when APRA’s internal resources were overstretched or where the external actuary was thought to have expertise specially relevant to the actuarial report in question. There are some points it would be helpful for APRA to clarify in relation to such peer reviews.

Request or compulsion? The use of the word “request” in the above quotation raises some questions. If APRA means that they want the insurer to have the peer review undertaken, at the insurer’s cost, then I would expect that to be an obligation imposed on the insurer, not a “request” which the insurer could choose not to act upon. However, it seems more likely that APRA will be the party who engages the independent actuary to conduct the peer review, at APRA’s cost. In that case also, “request” seems too weak a word and it may be better to say “allow APRA to commission a peer review”.

Will the public learn about the peer review? APRA’s decision that a peer review by an independent actuary is needed will always carry with it the prima facie implication that APRA is concerned about the quality of the original actuarial report given to the insurer. This implication is strengthened by the observation made in the Discussion Paper that “APRA anticipates that the power would be used infrequently.” Care will be needed to ensure that the fact a peer review is being obtained does not immediately become public knowledge. Leakage of knowledge that a specific peer review is taking place would carry reputation risk to the insurer and may even damage public confidence in the insurer. There is also reputational risk to the actuary who signed off the original report. If the peer review supports the conclusions of the original report, it would usually be best if knowledge that the peer review has been conducted never becomes public. However, if the peer review reaches a different conclusion from the original report, then APRA may seek remedial action from the insurer and the remediation steps may involve APRA publicising the findings in some fashion. In severe cases, if the peer review discovers a breach of professional standards by the original actuary, the follow up would presumably include reporting the apparent misconduct to the Disciplinary Board of the Institute of Actuaries for their consideration. I consider it is incumbent upon APRA to add information to that already in the Discussion Paper spelling out the possible range of actions that may result from the conduct of a peer review as described.