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Re: Board Oversight of Key Assumptions

Dear Title Surname,

The Central Bank of Ireland (“the Central Bank”) initiated a review of key Life Insurance pricing and reserving assumptions (“the review”) in June 2016. As a result of this review we have found that Boards are generally not fulfilling their role in relation to oversight and governance of the assumptions. Therefore, we would like you to ensure that you and your Board Members are properly undertaking this role in relation to your entity.

In a Solvency II environment the Board is ultimately responsible for oversight of the assumptions and ensuring compliance with the regulations in accordance with Regulations 43 and 44 of the European Union (Insurance and Reinsurance) Regulations 2015 (S.I. No. 485 of 2015). It is not possible for the responsibility for the assumptions to be delegated to the Head of Actuarial Function (“HoAF”). Therefore, as firms move to embed the new regulatory regime we expect Boards to request sufficient information to be provided in order to be in a position to adequately challenge the key assumptions, expert judgements and results relating to the experience analysis and assumption setting process.



Particular areas of concern that have been highlighted in this review include:

- Delegation of assumption setting to the HoAF with insufficient Board oversight
- Insufficient information being provided to the Board on the key judgements underlying the HoAF's recommendations
- Overviews presented to Boards or Committees with insufficient rationale for significant deviation in experience compared to assumptions or changes in key parameters or methodology
- Very detailed information being provided without sufficient highlighting of the most material parameters or risks
- Insufficient highlighting of cross subsidies when looking at market-related pricing decisions

Therefore, it is important that the Board should have visibility of the key judgements made in the assumption setting process in order that they can be understood and robustly challenged. This does not necessarily mean that all the technical detail involved in carrying out the assessment should be provided, only that which is sufficient for the Board to provide adequate challenge on the key assumptions and judgements.

This visibility should lead to ongoing challenge from the Board on the consistency of assumptions between reserving, the ORSA and business plans, with regular Board information on the most significant assumptions with sufficient stress testing to provide context.

To facilitate the Board taking responsibility for oversight of the key assumptions and monitoring the strategy the appendix to this letter outlines actions for HoAFs to undertake when carrying out experience analysis, communicating opinions and recommending assumptions to the Board. We expect the feedback to be addressed in a proportionate manner, focusing on the most material and financially significant assumptions for the firm.



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Please approach your normal supervision contact if you would like to discuss any of the points raised in this letter.

Yours sincerely

Sylvia Cronin

Director of Insurance



Appendix: HoAF's Responsibilities for Providing Guidance on Key Assumptions to the Board

- **HoAF's Responsibility for Communicating Guidance on Key Assumptions**

The Central Bank requires that the HoAF provides an overview of the experience analysis results and key expert judgements used in the assumption setting process to ensure the Board is in a position to provide sufficient challenge and oversight. It is no longer appropriate for the Board to rely on the HoAF for setting the assumptions without the Board having sufficient oversight of the key expert judgements being made. While the Board may delegate some of the work involved in assumption setting, responsibility for oversight of the assumptions remains with the Board.

While we note that the format and contents of the communication of key assumptions will vary depending on the nature, scale and complexity of each firm, the following outlines some guidance based on the submissions we have received to date. The nature and content of the communication on the key assumptions should be tailored to the specific needs of the firm but should be sufficient to satisfy the requirements of the Board when making decisions based on the recommendations of the HoAF.

We consider that the information provided to the Board or relevant sub-committee of the Board might include a summary and/or graphical presentation of key results of the experience analysis, trends in the experience and assumptions over time and key expert judgements being made. We expect the HoAF to provide visibility of the key judgements made in the assumption setting process but not necessarily all the technical detail involved in carrying out the assessment.

The HoAF should outline key judgements made in the process for deriving his or her recommended assumptions that have a material impact on results. Such key judgements might include the choice of method for experience analysis and assumption setting, the time period



chosen for the analysis, any material adjustment that is applied, an allowance for events not in the data etc. It is important that there is transparency around the material expert judgements used in the process rather than the emphasis being solely on the output or recommendations. This will facilitate Board challenge on these items and reduce reliance on the advice of the HoAF.

The HoAF should ensure that documents he or she provides to the Board on the assumptions and experience analysis set out the materiality of the products and sensitivity impact of the assumptions. This gives a sense of the significance of results so that the Board's attention can be focused on the most material parameters and risks for the firm.

We consider that the application of a management action is a key assumption particularly where it has a material impact on the results. Where this is the case the HoAF should ensure that the management actions are adequately justified, aligned with the business strategy and that emerging experience is compared to assumed in order to detect whether the controls are being implemented and are having the expected impact. There were a number of cases where implicit management actions were assumed and allowed for when setting the assumptions for example, use of a constant per policy expense assumption where business volumes were expected to decrease. Management actions should be justified and supported by an approved management action plan as outlined in Article 23 of the Commission Delegated Regulation (EU) 2015/35 of 10 October 2014. In some cases, we observed that costs associated with implementing the action were not included and these need to be incorporated along with consideration of the implications of applying the management actions.

Expense inflation is another assumption that should be adequately justified. We noted that there was a significant variation in the expense inflation assumption being applied and consequently we require that HoAFs justify the assumption used, ensure that the assumption is aligned with the business plans and consider the need for a stress on expense inflation in the ORSA.



- **HoAF's Opinion on the Use of Marginal Costing in Underwriting**

Where marginal costing, special deals, price matching or market driven prices are used in pricing the HoAF should ensure that there is sufficient consideration of the business mix and that checks are carried out to ensure overall costs are being met when providing the opinion on underwriting to the Board. As part of this opinion, the HoAF should consider whether the business mix remains within the firm's risk appetite, whether the strategy remains appropriate and any material concerns in this regard should be highlighted to the Board. The HoAF should ensure that he or she has an adequate understanding of the differential between the technical price and market price and the implications this has on the business. With the use of marginal costing there is a concern that it may expose the company to changes in business mix that could result in it being unable to fully cover its overhead costs (including group charges or other overheads where applicable). This also could lead to solvency and liquidity issues.

In addition, the HoAF should make clear whether group costs and overheads are included in the profitability and reserving metrics he or she produces as these measures may look very different before and after these costs are accounted for.

- **Ensuring Assumptions Reflect Uncertainties in a Range of Scenarios**

HoAFs must ensure that there is adequate consideration of the uncertainty in various scenarios when setting the reserves and assumptions, otherwise the results may not be reflective of the full range of potential future outcomes including tail events. Article 34 (4) of the Delegated Acts outlines that firms *consider the extent to which the present value of cash flows depend on the expected outcome of future events and developments on how the actual outcome in certain scenarios could deviate from assumed* and it is not evident that all firms have given adequate consideration to this. HoAFs should provide the Board with an understanding of how actual outcomes could deviate from expected in order to provide context for the Board on the liability valuation and so that the Board has an understanding of the uncertainty around the most material assumptions and the significance of the assumptions used. Rather than focus on a single point estimate of the Technical Provisions (TPs) we expect HoAFs to consider a



reasonable range around the expected result by outlining the key sensitivities and uncertainties around the assumptions and valuation of the reserves.

HoAFs should ensure that the assumption setting and methodology for reserving considers a range of future scenarios through consideration of limitations of the data, events not in the data, uncertainties in the future experience and the impact of economic cycles etc. This should encompass consideration of the uncertainty when setting assumptions and deliberation of various scenarios particularly where options and guarantees are offered.

It is important that HoAFs understand the limitations of the data used in the assumption setting and allow for this accordingly in the setting of the assumptions, for example, when experience from a recessionary period is no longer in the data set or where no major mortality events are present in the data set but could reasonably be expected to emerge in future. This ensures that the assumption and TPs are reflective of expected future experience and are not solely a representation of a sub-set of past experience. This is particularly important for assumptions such as lapses where deriving the assumption over a short period might not capture the effect of economic cycles and hence not adequately reflect the expected future experience. Article 22 of the Delegated Acts requires that assumptions in the TPs *must adequately reflect any uncertainty underlying the cash flows*.

In the case where material policyholder options and guarantees are offered careful consideration should be given to the suitability of deterministic approaches to valuing the cost of the options and guarantees.