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Valuation Actuary's dilema - a case study on professionalism

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Content

- Background
- Objective
- Professional issues in this case
- Options / alternatives available to the VA
- What would we have done if we were the AA of the Company?
- Conclusion
- References

Background

- You are the Valuation Actuary of a listed life insurance company in India, reporting to the Appointed Actuary of the Company. In recent years, your company has grown successfully, selling non-participating savings products providing high level of long term investment guarantees. Your Company's disclosures and stock movements are tracked regularly by analysts and investors.
- For the valuation as at 31 March 2019, your CFO has requested you to release 'excess' margins (in addition to that required as per APS7) for prudence in the valuation basis, so that he can show a good earnings performance for the financial year and maintain the dividend payout for the financial year. He argued that the 'excess' prudence is indeed for such situations and in a good year, you can always strengthen the reserves if necessary.
- You do not think it is appropriate to release the 'excess' margins as the demographic assumptions used in the valuation are not backed by credible operating experience and your company hasn't invested in derivative instruments to hedge the investment guarantees.
- Also, this being a new product, you have some concerns over the accuracy and completeness of the data, valuation model etc. and want to keep some buffer in case there are issues in these.

Background

- You have discussed this matter with the Appointed Actuary. However, the Appointed Actuary also shares the same view as the CFO.
- Finally, you reluctantly agree to meet the demands by the CFO and release the ‘excess’ margins for the valuation as at 31 March 2019. The Company maintains the dividend for the year and all the analysts and investors praise the insurer for a successful year.
- Soon after the year end, before the next published quarterly valuation dated 30 June 2019, you carried out analysis of internal experience and established that you need to lower the lapse assumptions used in the valuation as policyholders are not surrendering their policies given the long term guarantees they provide.
- This change, if reflected, would change the reserves as at 31 March 2019 itself to be higher- same as the original level (before releasing the ‘excess’ prudence).
- You raise this issue with the Appointed Actuary, who suggested that to avoid unnecessary attention from the internal and external stakeholders, you defer taking any actions until the year end – 31 March 2020. He argued that ultimately it is the year-end numbers that drive the shareholder dividend payouts and therefore one doesn’t need to take action during the year.

Objective

- Discuss the various professional issues in this case
- Discuss the options / alternatives available to you as the Valuation Actuary
- What would you have done if you were the Appointed Actuary of the Company?

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A Professional issues in this case

Professional standards

Guidance on professional conduct

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Professional conduct standard 3.0 (PCS)

- The PCS gives guidance on professional conduct in addition to that is provided under the Act and Rules & Regulations made thereunder and Other Guidance to which all members must conform in both the spirit and the letter.
- The PCS sets out general principles and standards, which must be adhered to when interpreting professional guidance.

Professional Issues

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1 **Proper regard to any relevant professional guidance**

- AA/VA should ensure that the assumptions used in the valuation models are in full compliance with APS7.
- Only minimum MADs from APS7 have been kept, but APS7 guides to use judgement in case higher than minimum MADs are needed.
- AA/VA should disclose and justify if assumptions used are not in compliance with APS7.

Relevant point(s) from the PCS to be considered for this situation

Standards for advice

- An actuary is expected to use best judgment in formulating advice, whilst paying proper regard to any relevant professional guidance or other guidance.

Professional Issues

2

Sufficient investigation before finalizing assumptions

- It is not evident if AA asked VA to carry out sufficient investigations for reasonability while finalizing the assumption for both – year-end and quarterly reporting.

Relevant point(s) from the PCS to be considered for this situation

Standards for advice

- An actuary must consider the extent to which it is appropriate to carry out investigations to assess the accuracy and reasonableness of any data being used.

Professional Issues

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3 **Effective communication of actuarial results**

- It is not evident if the valuation report contains the AA's decision on removal of 'excess' MADs along with AA's justification for reasonableness of results and parameters/data used.
- The CFO and other senior management should be informed about the likely impact of change in lapse assumptions in quarter end valuation and/or the decision to defer changing the lapse assumption.

Relevant point(s) from the PCS to be considered for this situation

Standards for advice

- Advice should normally include sufficient information and discussion about each relevant factor and about the results of the actuary's investigations to enable the intended recipient of the advice to judge both the appropriateness of the recommendations and the implications of accepting them.

Professional Issues

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4 **Breach of professional guidance?**

- VA didn't discuss with the AA the reasonability and judgement behind the decisions to
  - release the 'excess' margins at year-end
  - not update the lapse assumption
- AA may have valid reasons for his decisions but VA did not discuss with the AA any possible (intentional/unintentional) breach of professional guidance, practice standards and regulations.

Relevant point(s) from the PCS to be considered for this situation

Standards for advice

- If the member decides that the nature of the breach is such that action is called for, the member must, in the first instance, consider discussing the apparent breach with the other member.

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B Options / alternatives available to the VA

Options/Alternatives (1)

available to the VA

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Understand AA's view about release of 'excess' margins

- VA could have discussed with AA the need for 'excess' margins:
  - Demographic assumptions used in the valuation are not backed by credible operating experience
  - No current investment in derivatives to hedge the investment guarantees
  - New product - concerns over the accuracy and completeness of the data, valuation model etc.
- VA could have referred to **regulations/practice standards** to support his claim of holding 'excess' margins during the year-end valuation.

APS 7
Section 7 defines the minimum MAD's to be applied and also clearly mentions:
*The scenarios specified above are the minimum scenarios that the Actuary must consider. However, **if considered necessary in his professional judgement, the Actuary must adopt more adverse scenarios than those specified above, while setting the MADs***

IRDAI Regulations (Assets, Liabilities, and Solvency Margin of Life Insurance Business), 2016
*Schedule II, Para 2, sub-para 4 states that the determination of the amount of liability under each policy shall be based on prudent assumptions of all relevant parameters. The **value of each such parameter shall be based on the insurer's expected experience and shall include an appropriate margin for adverse deviations***

Options/Alternatives (2)

available to the VA

Communicate his own view on lapse assumption to the AA

- Lapse assumption should be set as per APS7 and regulations.
- While setting the assumption, focus should be on current experience, future expectations, level of margin and product features – not only shareholder earnings.

APS 7 - *The Actuary is required to* ***exercise professional judgement in determining the appropriate level of MADs****. The prime consideration must be the protection of the interests of existing policyholders, including the reasonable expectations of participating policyholders ("PRE").*

IRDAI Regulations (Assets, Liabilities, and Solvency Margin of Life Insurance Business), 2016
Schedule II, Para 5 states that in establishing the expected level of any parameter, ***any likely deterioration in the experience shall be taken into account****.*
Schedule II, Para 6 further states that lapse rate, if considered for valuation, should be a prudent assumption ***based on past experience of the product or similar products; and shall have regard to the expected future experience based on the nature of the products****, target market, distribution channel etc.*

Options/Alternatives (3)

available to the VA

Additional factors to consider in lapse rate study

- VA could have supplemented his analysis with external sources – due to lack of credibility of internal experience.
- VA could have compared the current lapse rates with the market/industry experience for similar products to present a stronger case to AA.
- Adjust lapse recommendation to allow for likely future economic/investment scenario.

Scenario/stress testing

- In order to better evaluate adverse scenarios, VA could have performed a sensitivity/scenario analysis for important assumptions, such as persistency and investment returns, to assess impact on reserves. These can be then documented and included in the valuation report.
- VA could have considered and reported the impact on solvency, income statement, Embedded Value (EV) to AA.

Options/Alternatives (4)

available to the VA

Compliance

- VA could have ensured if they (AA and VA) are collectively ensuring compliance with all relevant regulations and practice standards, while releasing margins and not updating lapse assumptions.
- For example: APS7's 'professional compliance questionnaire' can be used as a guide to check compliance.

Professional guidance

- VA could have asked for professional guidance, without disclosing confidential information, from other senior actuaries/IAI/Peer Reviewer on how to address the situation where he is not comfortable accepting AA's decisions
  - to release 'excess' margins
  - to defer updating the Lapse assumption at annual reporting

C

What would we have done if we were the AA of the Company?

Our approach as AA (1)

Communicate to the senior management

Purpose of reserves

- CFO stated: *"excess prudence is indeed for such situations and in a good year, you can always strengthen the reserves if necessary".*
- We would have tried to explain to the CFO that:
  - reserves are for policyholder protection and excess margins should not be viewed as support for better earnings
  - reserves should be based on sufficient margins as per APS7 and not just the minimum margins

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Our approach as AA (2)

Communicate to senior management

Other ways to show and improve company's performance

- Instead of good dividends, there are other measures like Embedded Value, New Business Margins etc. that analysts use to measure performance.
- Dividends shall be paid out of existing free surplus rather than manipulating assumptions to release reserves.
- Discuss measures, with the CFO, to optimize company's expenses, investment strategy, launching products with higher margins, improve sales etc. as ways to maintain dividend, instead of manipulating reserves.

Our approach as AA (3)

Risk management for less volatility

Hedging investment risks

- Given the 'high level of long term investment guarantees', we would have discussed with the investment and risk management teams to explore hedging mechanisms using derivatives or other instruments.

ALM strategy review

- Investment guarantees should be matched with assets of appropriate duration and pay-out.
- We would have used ALM to arrive at an optimal investment strategy.

Our approach as AA (4)

Considerations before finalizing lapse assumption

Economic outlook and market study

- Collect market and industry lapse experience for similar products and compare with own experience.
- Check whether the current lapse assumption takes into account expected economic outlook , and whether the current change in experience is expected to continue or could it be a one-off instance.

Possible actions

- Ask VA to perform sensitivities on the recommended lapse assumptions and discuss impact on solvency, income statement and EV.
- Even if not updating lapse assumption on 30th June, reflect these possible expectations in the valuation report for re-consideration during next valuation.

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Our approach as AA (5)

Professional duty

Seek guidance

- We would have discussed with senior actuaries, IAI and the peer reviewer regarding
  - release of 'excess' margins – is it justified
  - lowering of lapse assumption

Disclosure

- Setup a compliance mechanism that ensures that all the work done (quarterly/annual) is within the boundaries of the regulations, Actuaries Act, PCS, and APS.
- Disclose in the valuation reports reasoning for removal of 'excess' margins and deferring the decision to update lapse assumption.

APS2
Section 1.3 states that 'It is the **Appointed Actuary's professional duty to make timely disclosures, both to the company and to the Authority** about the financial viability of the life office. If for some exceptional reason the Appointed Actuary is unable to comply fully with this Actuarial Practice Standard then the report given by him should be suitably qualified

Conclusion

Key takeaways

- Always maintain professional integrity.
- Understand and respect needs of all impacted stakeholders.
- An Actuary shall ensure that Actuarial Services performed by, or under the direction of, himself or another Actuary, satisfy applicable regulations and practice standards.
- Seek professional guidance from other member or professional body while respecting confidentiality.
- Clear communication of methodology and results.
- Whistle blow against malpractices if financial protection of policyholders is compromised.

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References

Regulations

Policyholders' reasonable expectations (PRE)

- The Policyholder expects that the Insurer will fulfill the promises made (investment guarantees in this case) at the time of selling the policy.

- The decision made by the Insurer's management and its operations should be aligned to meet this expectation.

- The Appointed Actuary plays a key role in the protection of policyholder interest. He/She is required to provide impartial advice to the board and contribute expert insight at a senior-management level within the company.

Regulations

References

IRDAI (Appointed Actuary) (Appointed Actuary) Regulations, 2017

Section 9 Duties and obligations of Appointed Actuary

- Para VI: Drawing the attention of management of the insurer, to any matter on which he or she thinks that action is required to be taken by the insurer to avoid - (a) Any contravention of the Insurance Act; or (b) Prejudice to the interests of policyholders.

- Para XII: sub-para (f). Ensuring that the policyholders' reasonable expectations (PRE) have been considered in the matter of valuation of liabilities.

Regulations

References

IRDAI (Assets, Liabilities, and Solvency Margin of Life Insurance Business) Regulations, 2016

- Schedule II, Para 2, sub-para 4 states that the determination of the amount of liability under each policy shall be based on prudent assumptions of all relevant parameters. The value of each such parameter shall be **based on the insurer's expected experience** and shall include an appropriate margin for adverse deviations.

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Practice Standards

Actuarial Practice Standards (APSs) impose additional requirements under specific circumstances.

Actuarial Practice Standard 1 (APS 1)
Appointed Actuary and life insurance business

Actuarial Practice Standard 2 (APS 2)
Additional Guidance for Appointed Actuaries and other Actuaries involved in Life Insurance

Relevant APSs

Actuarial Practice Standard 7 (APS 7)
Appointed Actuary (AA) and Principles for determining Margins for Adverse Deviation (MAD) in Life Insurance liabilities

Actuarial Practice Standard 4 (APS 4)
Peer Review of Appointed Actuary’s work in Life Insurance

Questions

Thank You

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