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Actuary- Actuarial Judgement & approach for resolving issues in past work

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Our Guide: An introduction

Ms. Subbulakshmi V is a Fellow Member of Institute of Actuaries of India. She is an independent Consulting Actuary with over two decades of experience in the Financial Services industry. She has experience in designing and valuation of Employee Benefits across the US, UK and Indian markets and has worked in Life Insurance, General Insurance and Financial Services industries as a consultant.

Case Study

Case Study (1/2)

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You are a newly qualified actuary who recently joined ABC actuarial services & consulting company. You joined the pensions team as the new lead, and you are very excited for this role. The previous actuary in this role is very well known in the company and professional circles for his great work and vast experience. You have been very fortunate to have him as your mentor while writing exams and often took career advice from him.

Your team performs regular valuations of defined benefit pensions schemes and they approached you with the valuation report for a large pension scheme for your review and sign off. The pension scheme belongs to a client who has been with ABC for many years, you are also told that the report needs to be delivered in two weeks' time. You start to review the results and find that the previous year results appear out of trend. Upon asking the team for further analysis, previous year files and reports, you discover the following issues in previous year calculations:

Case Study (2/2)

(a) One of the files had used an incorrect percentage parameter for spouse's pension resulting in <u>material</u> underestimation of liabilities.

(b) The assumptions used for post-retirement mortality were not updated in the calculations even though the report shows the updated mortality assumption in the commentary. You also analyse and conclude that the impact of not updating the assumptions on the results is <u>not very material</u>.

Discuss how you will address each of these errors (a) and (b) by considering the following

i. Given that the previous actuary was your mentor and a well-known senior actuary and also since he is not part of ABC company anymore, you are not sure if and how to approach him. Will you approach the previous actuary or the client or both?

ii. Do you need to rectify errors that happened in the previous year valuation, and do you need to rectify errors that happened before you took the lead role? What professional guidance and other implications will you take into consideration?

iii. How will you present your concerns to the senior management of ABC?

Professional Guidance: An overview

Actuarial Practice Standards (APS) and Guidance Notes (GNs) (1/2)

<u>What are APS and GNs</u>

APS /GNs are used to enhance the reputation of the profession and to increase appreciation by the public of both quality and utility of the profession's work.

<u>Relevant APS to the scenario</u>

APS 27 applies to actuarial work related to pensions or other employee benefits. It provides the checklist for pension work completion, review and sign-off.

APS 34 is the general standard. It provides the guidance to actuaries on general actuarial practices while performing actuarial services. The appropriate practices under APS 34 that are applicable to the given scenario are-:

- ❖ **<u>Materiality</u>**-: In case of omissions, understatements or overstatements, the actuary should assess whether the effect is material. If it is material, the actuary should disclose this in any report to which it is applicable.

Actuarial Practice Standards (APS) and Guidance Notes (GNs) (2/2)

- **Process Controls**-: The actuary should consider to what extent, if any, the procedures used to carry out the work should be controlled, and if so, how.

- **Reasonableness checks**-: The actuary should review the results produced by the selected assumptions and methodology for overall reasonableness.

- **Internal consistency of Assumptions-**: The actuary should determine if the assumptions used for different components of work are materially consistent.

- **Communication**-: Any communication should be appropriate to the circumstances and take the skills, understanding, level of technical expertise and needs of the intended user into consideration to allow the intended user to understand the implications of the communication.

- **Data Quality**-: The actuary should take reasonable steps to review the consistency, completeness and accuracy of the data used. This can be done by comparing the data to those of a prior period(s).

- **Model Governance-:** The actuary involved in using models should be satisfied that there are appropriate actions to mitigate model risk such as adequate model validation, documentation and process controls.

Professional Code of Conduct

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What is Professional Code of Conduct

The Professional Conduct Standards provides guidance on Professional conduct in addition to that is provided under the Act and Rules and Regulations.

Relevant PCS to the scenario

- ❖ The actuarial profession has an obligation to serve the public interest within the context of building and promoting confidence in the work of actuaries and in the actuarial profession.
- ❖ The members should inform all the stakeholders which he or she is in contact with. Members have a duty to always act honestly and with integrity.
- ❖ The actuaries must ensure that their professional judgement is not compromised by any bias, conflict of interest or the undue influence of others.
- ❖ The issues where a member is not sure of the steps, he should seek advice from peer or senior actuary.

Question 1: Approaching the senior actuary and / or the client

Breaking down the question

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- ❖ Determining whether to approach the senior actuary for spouse’s pension percentage parameter value (issue 1) or post-retirement mortality assumptions (issue 2) or both?
- ❖ Determining whether to approach the senior actuary or client or both for either or both issue 1 and issue 2?
- ❖ Given that it is required to approach the senior actuary, determining how to approach him?

Whether to approach for issue 1 (1/2)

- Get a clear and sure knowledge of the circumstances:
  - Whether the parameter value set was incorrect (technical error), or
  - There were justifications in setting the parameter value in the last valuation exercise.

- Have discussions with the team on the issue if the issue was a technical error or the value was set after discussions with the senior actuary or the client. Don’t approach the senior actuary and the client yet

- Conduct independent verification:
  1. Scanning the report for any commentary on the parameter value by senior actuary
  2. Looking through industry journals
  3. Looking through email correspondences for the past exercise between the senior actuary and the client

Whether to approach for issue 1 (2/2)

- Technical Error in setting the parameter value:
  - The senior actuary may not be approached as it is clearly established that the parameter value was set incorrectly
  - The client needs to be approached immediately and findings need to be presented to the top management in an appropriate way (to be addressed in Question 3).
  - The senior actuary may be approached to check if the parameter error will lead to material change in some other parameters

- Justifications in setting the parameter value:
  - Assess the reasonableness of the justifications from the discussions with the team and independent verification
  - The senior actuary may not be approached if the justifications seem reasonable.
  - The senior actuary may be approached if the justifications look unreasonable or not clear
  - The client should be approached formally to obtain confirmation on the justifications, especially if the justifications are being relied upon disclaiming responsibility

Whether to approach for issue 2

- There is no requirement to approach the senior actuary or the client for issue 2:
  - It is already evident that the post-retirement mortality assumptions are not updated from the commentary stating the same in the report.
  - The effect of updating the post-retirement mortality assumption is not material. However, it needs to be checked if updating the post-retirement mortality assumptions leads to change in any other assumptions

- If the senior actuary needs to be approached for issue 1, further clarifications may be sought for issue 2 along with issue 1

How to approach the senior actuary?

- Obtain prior approval from the client
- Request an informal call with the actuary. This should be quickly acted upon
- Structure the agenda well before the call
- Gather all evidence and information at one place for quick reference during the discussion. However, the evidence or information may not be shared with the actuary
- Restrict the discussion to only the past exercise
- Keep in mind to always maintain the confidentiality of the client throughout the call
- Capture the discussion as accurately as possible

Question 2: Rectification of Error

Identification of error

- Two errors that have come to light
  - Percentage parameter of spouse pension
  - Difference in Mortality rates reported and actually used for valuation

- Additional checks to be performed

- Should the errors be rectified?

Considerations while deciding whether to rectify the error

- Professional Guidance
- Materiality
- Funding status of the scheme
- Impact of the rectification on Financial Statements
- Impact on various stakeholder (will be covered later by Prakhar)

Recommendations for Valuation process (1/2)

- Doer-Checker-Reviewer process
- Reasonableness checks on data, assumptions and results
- Analysis of any abnormalities noticed
- Review of existing checklist, update with additional checks to make it exhaustive

Recommendations for Valuation process (2/2)

- Check assumptions and data of previous year signed reports

- Peer review/ independent review of existing models/working files

- Highlight to senior management as one-off case

Question 3: Presentation to Senior Management of ABC

Communication to senior management

- Initial written communication to indicate that there is a concern with the historical valuation report for the client.
- Background of the activity being carried out for the client
- Brief about the review carried out and the findings of the same
- Reasons for the possible errors and steps taken to rectify the same
- Discuss impact of changes on account of rectifying these errors
- Discuss materiality of changes and the decision criteria used to determine the materiality
- Additional checks and balances to be put in place to ensure accurate results
- Discuss the plan to communicate changes to the client while ensuring timelines are adhered to
- Discuss the manner of communication to the client

Background of the activity and review

- The senior management should be informed immediately as soon as the error is discovered in case they have any immediate inputs for the same.

- Relevant background provided to all members regarding the client, the work that we do for them, period since which the engagement has been active and since we have been working with the client.

- A discussion should be scheduled with all relevant members, mentioning the agenda to be discussed. Any additional items for discussion to be requested from the management group.

Discussion of review

- Walk the management through the steps that were carried out to review the pensions management report with details of factors and their importance.
- Discuss the reasonableness checks that were carried out and the deviation in trend that was observed. The importance of reasonableness checks needs to be emphasized here.
- Discuss the exact errors that were found and the possible implications of each as highlighted in the earlier sections
- Highlight the decision criteria used to judge the materiality of the errors
- Check with management for historical precedent regarding such events and what actions and guidance were undertaken then.

Plan of action

- The steps to rectify the report and ensure no further errors would need to be informed to the management. It needs to be confirmed whether it would be possible to submit the report within the timeline or if there are going to be any delays on account of additional steps, if any.

- Clarify that the report would be accompanied with a subnote explaining the reason behind the abnormal change in the liability valuation for this year with detailed reasons for the same. Additionally, guidance to be provided around how to account for the same.

- To ensure that future errors like this do not take place, discuss the change in procedures to be implemented at ABC in general for ensuring adequate checking of any reports being sent as mentioned in the earlier section

Stakeholder impact

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- ❖ Highlight the various stakeholders who would be affected by the changes in the valuation
  - ❖ Client management
  - ❖ Scheme beneficiaries
  - ❖ Regulator who would be checking financial stability
  - ❖ Shareholders, if any
- ❖ Client would have to be advised on how to disclose the information to explain the deviation in the valuation to each of these stakeholders. Understand from the management whether this could lead to a risk for the relationship with the client going forward.
- ❖ Highlight the plan to discuss the report with the client through a separate discussion explaining the deviations and reasons for the same as a change in assumptions. The client will also be informed of all possible current and future impacts of the deviation.

Most important communication

- Ensure that during any discussions, the professional reputation of the previous actuary is not tarnished and no blame is placed.

- Focus to be on the solution and steps ahead to reassure client of the reliability of results

Q & A