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The Role of the Actuary in Risk Oversight

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MY WORK AS AN ACTUARY FOR CANADA'S FEDERAL REGULATOR OF FINANCIAL INSTITUTIONS (OSFI) has recently been focused on a more formal assessment of the actuarial function of insurers. The lessons learned from this work may be of interest to many members of this section as they relate to the role of the actuary in providing risk oversight.

RELIANCE VS. USE

OSFI's risk-based supervisory framework was amended in 2011 to add the "actuarial function" (AF) to the list of insurer independent oversight functions (i.e., along with internal audit, compliance, risk management) which are important in the mitigation of an insurer's inherent risk. This change reflects a continuation of the shift from "reliance" to "use" of the work of the actuary by OSFI. This is in line with the importance placed on the work of the actuary by regulators and the attendant need for independent oversight.

Actuaries are employed in a variety of roles in insurers due to their education, skills, experience and professionalism (e.g., pricing, product design, underwriting, claims management, investment, financial reporting, capital management, executive positions, etc.). The scope of an AF assessment may vary for each insurer but clearly, most actuarial roles are important to the ultimate protection of policyholders.

The assessment of the AF attempts to validate important aspects of the actuary's work so that OSFI can have confidence in using the work of the actuary. To be clear, under normal circumstances, this shift is not intended to replace the work of the company actuary (e.g., full modeling, data validation, recalculation, assumption setting, etc.).

Assessing the AF seeks to measure the key qualitative and quantitative aspects of, and outputs from, the actuarial function throughout the insurer/group (as appropriate) and between companies. While the regulator will not be resourced to verify all such qualitative and quantitative outputs, it will seek to determine the reasonableness, consistency and comparability of material outputs, with emphasis on those related to key risks.

The complexity, size and nature of the risks assumed by insurers have highlighted the need for insurers, and the actuaries who play key roles within them, to demonstrate sound practices in risk governance and management. Therefore, OSFI expects active involvement in risk management to be a key component of the actuarial function.

INDEPENDENT OVERSIGHT

The need for independent oversight functions is well known. However, individual insurers will adopt different approaches taking into account the nature, scope, complexity and risk profile of their operations. For larger, more complex insurers/groups/financial institutions, fully independent risk management functions, internal audit and compliance functions are expected. For smaller institutions, it would be useful to focus on the principles of independence, rather than the structure, to maximize functional independence. For example, do the control function personnel have clear performance objectives/incentives that link to the management of risk rather than targets related to profit, revenues and volume? Is their incentive compensation calculated independently of the results of the business unit they oversee?

Boards and management should do more than rely on "gut and instinct" when assessing management. "Gut and instinct" are good things, reflective of the degree of experience and judgement of those performing such assessment.

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However, arranging for third-party reviews from time to time of the financial institution's oversight functions will help boards and management (not to mention the regulator) to benchmark the institution's risk management practices and processes.

Given the importance of the work of actuaries in insurers, it seems only fitting that the AF provide independent risk oversight within the insurer. However, in practice, the answer may vary substantially from insurer to insurer. In some insurers the scope of the AF itself may not be well defined and the connections between areas such as product pricing, ALM, financial reporting and risk management may not be clear. In some insurers it may be difficult to define the head of

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the AF. Even if the head of the AF is well defined, to what extent does that person provide independent risk oversight? Is their role also combined somehow with an operational role? For example, it is difficult to provide independent risk oversight to a hedging program if the individual is also responsible for its design and operation.

Work of the external auditor and peer review processes help to provide independent reviews of parts of the actuarial function and confirm its reliability but they may not be comprehensive enough for the regulator. Some examples might include:

- While the external auditor performs some recomputation of actuarial outputs, independent oversight of actuarial results is important given their complexity and significance to an insurer
- Increasing use of sophisticated internal models warrants independent oversight of their design, calibration and use
- The need to demonstrate effective linkage between activities such as pricing, ALM, valuation, capital models, etc.

In the event (hopefully rare) that the AF of an insurer is not seen to provide sufficient independent risk oversight, the onus falls to the other insurer oversight functions to assume those duties.

Does your AF provide sufficient independent risk oversight? ■