Expert judgment under Solvency II

Expert Judgment Registers

Eamonn Phelan, FSAI, CERA

Expert judgment plays a key role in the process by which firms determine technical provisions, their solvency capital requirements and the financial resources they have available to meet these requirements. In this paper, we look at the central role that can be played by an Expert Judgment Register.

There are many key areas in which expert judgment is used, including the choice of methodology (or perhaps approximations) to use for cash flow modelling, the derivation of assumptions, and the adjustments that may be needed to the underlying data.

Expert judgment should play a role in supplementing rather than replacing empirical evidence or data, though, in reality, it is the lack of such empirical evidence or data which often leads to the greatest need to call upon expert judgment.

Solvency II requirements place constraints upon the use of expert judgment, and introduce a number of guidelines which firms are expected to observe. Without a structured approach to the generation, recording and use of expert judgment, it can quickly become an unwieldy process to ensure ongoing compliance with these requirements.

What does Solvency II say about expert judgment?

Article 2 of the Solvency II Delegated Regulation sets out the general requirements in relation to expert judgment, stating that “where insurance and reinsurance undertakings make assumptions about rules relating to the valuation of assets and liabilities, technical provisions, own funds, solvency capital requirements, minimum capital requirements and investment rules, these assumptions shall be based on the expertise of persons with relevant knowledge, experience and understanding of the risks inherent in the insurance or reinsurance business”.

This sets out the breadth of areas in which one might expect to encounter the use of expert judgment, encompassing the whole balance sheet, together with the solvency capital requirements calculations themselves.

Article 2 goes on to set specific regulatory expectations in relation to the communication of expert judgment, stating that undertakings shall inform internal users of such judgments about their “relevant content, their degree of reliability and their limitations”. This points towards the potential usefulness of expert judgment logs or registers, as described in the next section.

EIOPA’s Level 3 guidance papers contain a number of supplementary requirements in relation to expert judgment. These may be found in the guidance on the calculation of technical provisions1 and well as the guidance on the use of internal models2.

The section on expert judgment contained in the internal model guidelines actually applies to all firms, as noted in the guidelines on the valuation of technical provisions, where it states that “it is recognised that expert judgment is a key component of the calculation of technical provisions and it should be applied in setting assumptions to be used in the valuation of technical provisions for insurance and reinsurance undertakings. These guidelines on the valuation of technical provisions should be read together with the Chapter 4 of the Internal Models Guidelines on assumption setting and expert judgment, which are based on Article 2 of Commission Delegated Regulation 2015/35”.

The guidelines on technical provisions set out a number of conditions under which it is acceptable – even expected – to make use of expert judgment, as well as instances in which its use should be restricted. The additional guidelines (which are contained within the broader set of internal model guidelines) consider five specific aspects of the use of expert judgment in the assumption setting process, as follows:

- Consideration of the materiality of the impact of using expert judgment;
- General governance requirements around the process of using expert judgment;
- Communication of key assumptions, including the uncertainty associated with them;
- Documentation of the overall process (including certain specific items to be included); and
- Validation of the process (and the judgments themselves).

Expert Judgment Register

In order to help address the documentation requirements associated with the use of expert judgment, it may be useful to consider developing an Expert Judgment Register. This register can act as a central repository for all expert judgments, and effectively help to demonstrate compliance with EIOPA’s guidelines on the use of expert judgment.

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There are many forms that such a register can take, though in general it should contain a record of the derivation, use, validation and governance process associated with expert judgment. Supporting documentation may then be maintained in order to cover the more detailed considerations associated with each individual judgment.

- Description/name of the expert judgment and why it is required
- The judgment itself and the resulting assumption(s)
- Assessment of the materiality of a given judgment
- The experts involved (including their credentials)
- Rationale supporting the current value
- Period of validity of the judgment
- The reasoning behind the expert opinion (at a level of detail which makes it transparent)
- Where/when it is used (e.g. assumption setting, modelling) and the metrics and reporting bases it affects
- Potential variability of the judgment (i.e. the possible range of values and/or the approaches rejected)
- Impact of change / Sensitivity analysis
- A description of the process by which the judgment was formed & communicated
- When was the judgment last reviewed/updated
- Date of the next review of the expert judgment
- Triggers for an early review of the expert judgment
- Reason for change in expert opinion (if expert judgments have changed post a trigger event)
- Challenge received during validation process and response(s) to that challenge
- Interactions and/or reliance on other expert judgments

Of course, this is not an exhaustive list, and firms need to actively tailor such a register to their own specific situation. Once this register is properly and consistently maintained over time, it can act as a valuable repository of information and an important aid to transparency and governance.

Validation of expert judgment

Whilst the use of expert judgment is often an essential part of Solvency II, its use can expose the firm to additional risks. Aside from the implications of any material inaccuracies in these judgments – and their consequent effect on data, assumptions and model outputs – there may be many additional sources of risk, such as conflicts of interest, over-reliance on key individuals, unintended bias in estimates, and inconsistencies over time or across the business.

The Expert Judgment Register is a key tool in identifying and managing such risks. However, in order to create a robust framework around the use of expert judgment, there needs to be a clear validation process.

EIOPA sets out a number of specific guidelines in relation to validation of expert judgment, stating that it expects that “the process for choosing assumptions and using expert judgment [will be] validated”. The guidance goes on to state that undertakings should also “review the assumptions chosen, relying on independent internal or external expertise”.

External input, in particular, may provide a valuable sounding board for internal expertise, as it can help to improve objectivity by challenging what might be widely held beliefs amongst internal stakeholders. In addition, an external view can add value through, for example, benchmarking to market practice.

Communication

Effective communication of expert judgment is key to creating consensus across the firm, improving transparency and ensuring a common understanding of the incidence and impact of expert judgment.

Firms need to consider how they communicate expert judgments to their Boards (as the Board will need to gain comfort in relation to these assumptions and their impact, and be in a position to properly challenge them).

Similarly, there needs to be a common view across different functions (for example, pricing and financial reporting) when it comes to best estimate assumptions about the future. EIOPA’s guidelines state that “the insurance or reinsurance undertaking should ensure that the assumptions are derived and used consistently over time”.

The Expert Judgment Register can certainly play an important role here.

How Milliman can help?

We have been assisting clients for many years in relation to all aspects of their Solvency II needs.

We can assist you in the development of an Expert Judgment Register, independently review and assess your existing register, advise on how best to utilise it in order to meet your requirements, or discuss current best practices and ongoing developments. We can also assist in the review of the expert judgments themselves, together with the completeness of the process underlying their derivation.

Please contact me or your usual Milliman consultant for further information.