



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP34/15

Implementing audit committee requirements under the revised Statutory Audit Directive

September 2015

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Responses are requested by Friday 18 December 2015.

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1 Overview

1.1 This consultation paper (CP) sets out the Prudential Regulation Authority's (PRA's) proposed rules to implement the audit committee requirements of article 39 of the Statutory Audit Directive¹ as amended by Directive 2014/56/EU (Amending Directive).²

1.2 The requirements under article 39 apply to all public interest entities (PIEs)³. These include entities with transferable securities admitted to trading on a regulated market in the EU (for the purposes of this CP, 'listed entities'), Capital Requirements Directive (CRD) credit institutions⁴, and insurance undertakings that are subject to Solvency II, including the association of underwriters known as Lloyd's (the Lloyd's market). The draft rules (see Appendix 1) seek to implement these requirements for those PIEs that the PRA is responsible for regulating.

1.3 This CP will be of primary interest to banks, building societies and UK Solvency II insurance and reinsurance firms (for the purposes of this CP, 'Solvency II insurers'). It is proposed to apply the requirements of article 39 to the Lloyd's market by applying the requirements to the Society of Lloyd's and managing agents. The PRA also proposes to extend the scope of the requirements to UK designated investment firms.

1.4 The Statutory Audit Directive is a minimum harmonisation measure. Member states may impose more stringent requirements. The Amending Directive removes the discretion to exempt unlisted PIEs from the audit committee requirements which was previously available.

1.5 The Financial Conduct Authority (FCA) published a consultation on 4 September 2015⁵ on amendments to the Disclosure and Transparency Rules (DTRs) to give effect to certain requirements under the article which have changed as a result of the Amending Directive and which apply generally for listed entities. If a firm falls within the scope of the FCA and PRA audit committee rules, it will need to comply with both; the PRA's proposals are consistent with but more prescriptive than those of the FCA. The Department of Business, Innovation and Skills (BIS) and the Financial Reporting Council (FRC) will be separately consulting on other aspects of the Statutory Audit Directive, including on aspects related to governance.

1.6 The proposed requirements will apply to financial years commencing on or after 17 June 2016.

Summary of content

1.7 Article 39 sets out requirements on audit committee composition and the functions that audit committees should perform. It also contains a number of member state discretions and derogations (collectively referred to as options). To ensure an appropriate quality of governance the PRA proposes not to take the options available in the article, with one exception (see paragraph 1.10). The PRA believes that high standards of governance help to advance its statutory objectives to promote the safety and soundness of regulated firms and to contribute to ensuring that policyholders are appropriately protected. An independent audit committee that can probe and challenge management contributes to good governance.

¹ Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32006L0043&from=EN>.

² Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts: <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0056&from=EN>.

³ As defined in Directive 2006/43/EC – article 2(13) and revised by the Amending Directive – article 1(2)(f).

⁴ Credit institutions that have their registered office (or if they don't have a registered office, their head office) in an EEA State, excluding those credit institutions to which the CRD does not apply under article 2 of the CRD.

⁵ www.fca.org.uk/static/documents/consultation-papers/cp15-28.pdf.

1.8 The PRA proposes to apply the requirements in a proportionate manner, with the most significant and complex firms being subject to the highest standards.

1.9 Article 39's provisions can be grouped into four distinct themes: scope, structure, membership and functions. The proposals (which are set out in more detail in Chapter 3) are summarised below. A summary table is provided in Appendix 2.

Scope

- Audit committees will generally be required for: CRD credit institutions; Solvency II insurers, the Society of Lloyd's and managing agents; and UK designated investment firms.
- Subsidiaries of EEA parents that have an audit committee in accordance with article 39 do not need to have an audit committee, unless those subsidiaries are significant (see paragraph 1.11). If the non-executive directors (NEDs) of the significant subsidiary are the same as those of the parent, then the significant subsidiary does not need to have an audit committee.

Structure

- The audit committee must be a sub-committee of the board.

Membership

- The audit committee of a significant firm should consist entirely of independent non-executive directors (independent NEDs). For other firms (lower impact firms) audit committees must consist entirely of NEDs provided that a majority, and the chairman, are independent NEDs.

Functions

- The audit committee must carry out the responsibilities prescribed by article 39. In addition, the audit committee of a lower impact firm is allowed to be combined with, and carry out the functions of, the risk committee.

1.10 The PRA has considered the options in the following manner:

- Scope: it is proposed that the option to exempt credit institutions that do not have listed shares and have issued less than €100 million of listed debt is not taken. It is proposed that the option to exempt subsidiaries of EEA parents applying the article at group level is taken, except for significant subsidiaries that do not have the same NEDs as their EEA parent. The PRA proposes going beyond the article's scope by applying the requirements to UK designated investment firms.
- Structure: the PRA does not propose taking any of the options allowing the audit committee to not be a committee of the board (which could allow the committee to be a stand-alone committee or another body or allow for an SME to have the committee's functions performed by the board).
- Membership: it is proposed that all members are NEDs (thus not taking the option that allows members who have been appointed by a general meeting) and that for lower impact firms the audit committee is majority independent (not taking the option to exempt the committee from being majority independent when all members are members of the administrative body). For significant firms the PRA proposes going beyond the article's requirements to require that the audit committee is fully independent.

1.11 For the purpose of the proposed rules a firm is considered significant if its size, interconnectedness, complexity and business type give it the capacity to cause very significant or some disruption to the UK financial system (and through that to economic activity more widely) by

failing or by carrying on its business in an unsafe manner.¹ Insurers may also be considered significant if their size (including number of policyholders) and type of business mean that there is very significant or significant capacity to cause disruption to the interests of a substantial number of policyholders.²

1.12 The PRA proposes to lay out certain considerations for firms in scope to have regard to in order to determine whether a member of an audit committee is independent. This will be consistent with existing guidance issued by the FRC.

1.13 Chapter 2 sets out the PRA's approach to implementing the requirements.

Statutory obligations

1.14 The proposals here are compatible with the PRA's statutory objectives under the Financial Services and Markets Act 2000 (FSMA) to promote the safety and soundness of PRA-authorised firms;³ and in the context of insurance, to contribute to policyholder protection.⁴ The audit committee proposals seek to advance the PRA's statutory objectives by encouraging good corporate governance and by providing greater clarity as to its expectations with regard to independence.

1.15 When discharging its general functions, the PRA is legally required, so far as is reasonably possible, to facilitate effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.⁵ The PRA has assessed whether the proposals in this CP facilitate effective competition. The PRA expects the audit committee proposals may impact competition, but mainly for smaller Solvency II insurers. The proposals would introduce additional costs for smaller Solvency II insurers which may subsequently introduce added difficulty in entering or maintaining position in the marketplace. The PRA expects however that the cost will be offset by the benefits to competition. An audit committee may introduce greater confidence from market participants in the financial information and position of the firm through the added independent oversight. Such confidence in their financial information may allow smaller Solvency II insurers to more easily enter the marketplace and compete.

Impact on mutuals

1.16 FSMA requires that the PRA assesses whether, in its opinion, the impact of the proposed rules on mutuals will be significantly different from the impact on other firms.⁶ The proposed rules will affect firms that are mutuals. The PRA does not expect the effect on mutuals to be significantly different from the impact on other firms.

Equality and diversity

1.17 In making its rules and establishing its practices and procedures, the PRA must have regard to the Regulatory Principles as set out in the Financial Services and Markets Act 2000 (FSMA).⁷ The PRA may not act in an unlawfully discriminatory manner. It is required, under the Equalities Act 2010, to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.⁸ The PRA has not identified any equality or diversity implications arising out of these proposals.

1 See the 'PRA approach to banking supervision':
www.bankofengland.co.uk/publications/Documents/praproducts/bankingappr1406.pdf.

2 See the 'PRA approach to insurance supervision':
www.bankofengland.co.uk/publications/Documents/praproducts/insuranceappr1406.pdf.

3 s.2B(1) and s.2B(2) FSMA.

4 s.2C FSMA.

5 s.2H FSMA.

6 Section 138K of FSMA.

7 s.2H and s.3B FSMA.

8 Equalities Act 2010, section 149(1).

Cost benefit analysis

1.18 The PRA is required to perform a cost benefit analysis of the impact of its policy proposals, specifically on the introduction of any new rule. Analysis is provided in chapter 4.

Responses and next steps

1.19 This consultation closes on Friday 18 December 2015. The PRA invites feedback on the proposals set out in this consultation. Responses should be sent to CP34_15@bankofengland.co.uk.

2 Approach to implementation

2.1 In this chapter the PRA sets out the current audit committee approach and explains the rationale underlying the proposed changes.

Current approach

2.2 The audit committee requirements in the original Directive are implemented in the UK under the FCA's DTRs. The DTRs are complemented by the FRC's UK Corporate Governance Code ('FRC Code')¹ which applies to Premium listed companies on a 'comply or explain' basis and by the FRC's Guidance on Audit Committees ('FRC Guidance').² The FRC plans to consult in September. These arrangements will continue, with changes made for the Amending Directive.

The PRA's principle behind the proposals

2.3 Promoting good governance advances the PRA's statutory objectives of promoting the safety and soundness of regulated firms and contributing to ensuring that policyholders are appropriately protected. The firms which the PRA supervises should be aiming for high standards of governance and the PRA proposes underpinning those high standards with well-defined rules. The PRA regards an audit committee's ability and willingness to probe and independently challenge as the key to its success, and in its view these proposals will help to ensure that audit committees are able to do this. In particular, the PRA considers that the independence of an audit committee is key to its ability to fulfil its functions.

Proportionate application of PRA's principle

2.4 The PRA proposes a differentiated approach. The PRA proposes imposing the highest standards regarding audit committees for the biggest, most complex and highest impact firms, those that are referred to as 'significant' in this CP. It proposes to allow more flexible arrangements for lower impact firms – arrangements that the PRA considers will still result in effective audit committees for such firms. This is consistent with the PRA's general approach to the proportionate application of policy.

How the PRA's proposals align with existing related guidance

2.5 The PRA's proposals are complemented by, and consistent with:

- the FRC Code and the FRC Guidance, which recommends that large listed firms (FTSE 350) should have an audit committee of at least three members (two for smaller listed firms) of which at least three (two for smaller listed firms) are independent NEDs;
- the PRA's CP18/15 on board responsibilities,³ which sets out guiding principles of good governance including that the boards of smaller firms should have at least two independent NEDs;
- the Basel Committee on Banking Supervision's guidelines on 'Corporate governance principles for banks',⁴ which cover listed and unlisted banks and recommend that the audit committee "should be made up entirely of independent or non-executive board members". They also propose that an audit committee should be "required for all systemically important banks and is strongly recommended for other banks based on an organisation's size, risk profile or complexity";

¹ www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf.

² www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-September-2012.aspx.

³ PRA Consultation Paper 18/15 'Corporate governance: Board responsibilities' May 2015:

www.bankofengland.co.uk/pru/Pages/publications/cp/2015/cp1815.aspx.

⁴ Basel's guidelines on 'Corporate governance principles for banks': www.bis.org/bcbs/publ/d328.pdf.

- CRD, which requires the separation of functions between the audit committee and risk committee for significant institutions; and
- the Walker Report, ‘A review of corporate governance in UK banks and other financial industry entities’,¹ which states that “best practice in a listed bank or life assurance company is for the establishment of a board risk committee separate from the audit committee”.

Comparison with the FCA’s proposals

2.6 The FCA’s rules and proposals on audit committees apply to listed entities. The FCA proposes an approach that, broadly speaking, does not limit the flexibility permitted by article 39 and is consistent as far as possible with the existing DTRs.

2.7 The PRA’s proposals apply to CRD credit institutions, Solvency II insurers, the Society of Lloyd’s and managing agents, and UK designated investment firms, regardless of whether or not they are listed. As previously stated, if a firm falls within both the scope of the FCA and PRA audit committees rules, it will need to comply with both; the PRA’s proposals are consistent with but more prescriptive than the FCA’s. In particular, the PRA proposes that significant firms have separate audit committees that are entirely composed of independent NEDs. This proposal recognises the value that the PRA places on the independent challenge and scrutiny that an audit committee can provide in the context of promoting sound and effective governance structures for firms, consistent with the advancement of its statutory objectives.

Independence

2.8 Independence is not defined in the Statutory Audit Directive. However, the PRA would like firms in scope to have regard to certain considerations that would be relevant when assessing whether a member of an audit committee is independent. These are set out in paragraph 2.9. The objective of laying out such considerations is to set out the PRA’s expectations on independence clearly, and thus create a level playing field of information for all firms. The PRA does not propose to define independence formally for the purposes of setting rules around audit committee requirements.

2.9 The PRA recognises that the board is responsible for assessing the independence of an audit committee candidate, both in terms of fact and appearance. While independence of mind is key to creating an effective audit committee, independence in appearance (perceived independence) is also important to consider. Independence may be compromised when the candidate:

- has recently been an employee of the firm or group within the last five years (but a non-executive director is not to be regarded as an employee for this purpose);
- has held a material business relationship with the firm within the last three years, for example as an external audit partner;
- receives remuneration or other fees from the firm for other work not related to their role as director;
- has close family ties with the firm’s senior management or other directors;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;

1 The Walker Report, ‘A review of corporate governance in UK banks and other financial industry entities’: http://webarchive.nationalarchives.gov.uk/+//http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

- represents a significant shareholder; or
- has served on the board for more than nine years from the date of their first election.

2.10 The above considerations are based on expectations in the FRC Code but the PRA proposes to clarify that an employee does not include a non-executive director for the purpose of determining whether a member of an audit committee is independent.

Application date

2.11 In accordance with the Directive and subsequent clarification from the European Commission on the Q&A available¹ on its website, the intention is that the requirements proposed will apply to financial years commencing on or after 17 June 2016. The PRA proposes to amend Supervisory Statement 21/15 on internal governance² to ensure that it is aligned with these requirements.

Transitional measures

2.12 The PRA recognises the potential burden some firms may face in implementing the audit committee requirements for the first financial year in which they are applicable. The PRA is interested in the challenges that lower impact firms may face in appointing suitable NEDs. In light of responses to this CP, the PRA may consider whether it is appropriate to introduce a limited transitional period whereby some of the member state options in the article are exercised allowing, for example, for a firm's board to perform the audit committee functions.

¹ Q&A on Statutory Audit Directive implementation: http://ec.europa.eu/internal_market/auditing/docs/reform/140903-questions-answers_en.pdf.

² PRA *Supervisory Statement 21/15 'Internal governance'* April 2015:
www.bankofengland.co.uk/pru/Pages/publications/ss/2015/ss2115update.aspx.

3 Proposals for forming audit committees

3.1 Article 39 requires that member states ensure that an audit committee be formed for, *inter alia*, PIEs that are credit institutions and insurers. The following paragraphs describe how the PRA proposes to transpose these requirements. The Statutory Audit Directive is minimum harmonising and grants member states a number of options, which are discussed below. The PRA is proposing to extend the requirements to UK designated investment firms and also to require that the audit committee of significant firms should be composed entirely of independent NEDs, rather than be comprised of NEDs, a majority of whom are independent (see further paragraph 3.20).

Scope

3.2 Article 39 applies to PIEs. PIEs are credit institutions as defined in CRD¹ (other than those referred to in article 2 of that Directive) and insurance undertakings within the meaning of the Insurance Accounts Directive.² Member state options are available in respect of certain subsidiaries. The PRA proposes that the rules in relation to article 39 apply to UK designated investment firms also, whether listed or not.

PIEs – credit institutions

3.3 The Statutory Audit Directive definition of a PIE cross refers to the CRD definition of credit institutions and specifically excludes credit unions.

3.4 The Statutory Audit Directive includes a member state option (article 39(3)(d)) that allows member states to exempt credit institutions that do not have listed shares provided they have, “in a continuous and repeated manner, issued only debt securities admitted to trading in a regulated market”, of a value of less than €100 million. In implementing the Statutory Audit Directive the PRA does not propose to apply this exemption. In the PRA’s view the existence of, and arrangements for, an audit committee should be determined by a firm’s significance to the financial stability of the UK, and not by whether the firm is listed, or the type or value of the listed instrument.

PIEs – insurers

3.5 The definition of PIE includes insurance undertakings. In light of the transition to the Solvency II regime on 1 January 2016, for the purposes of the Statutory Audit Directive, insurance undertakings that are PIEs are those firms in scope of Solvency II, including the Lloyd’s market.

3.6 In implementing the article in relation to the Lloyd’s market the PRA proposes to apply the same principles that were applied in determining the application of the Solvency II regime to Lloyd’s. Those principles were that: (a) Lloyd’s policyholders should benefit from the same level of policyholder protection as other Solvency II policyholders do; and (b) in general, Directive requirements should be applied at the level where the risk is managed. Taking this into account, the PRA proposes to apply the article to the Lloyd’s market at the levels of: (a) the Society of Lloyd’s; and also, (b) managing agents in respect of the syndicates for which they are responsible.

Subsidiaries

3.7 Article 39(3)(a) provides that subsidiaries can be exempted from the requirement to have an audit committee provided that they have a parent entity in the EEA that is subject to the audit committee requirements of article 39 for that entity at group level. Subsidiaries without an EEA

¹ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:En:PDF>.

² Directive 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (as amended): <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:31991L0674&from=EN>.

parent that applies article 39 (for example, their immediate parent is incorporated outside the EEA) will not meet the conditions of this exemption.

3.8 The PRA proposes to exempt lower impact subsidiaries of EEA parents that are subject to the audit committee requirements at group level as in its view a requirement for an audit committee would not be a justifiable burden for such firms. For significant subsidiaries with boards that have the same NEDs as the board of their EEA parent, the PRA would expect audit committee matters related to the significant subsidiary firm to be covered at the level of the group by those same individuals and therefore requiring a separate audit committee for those firms would not be proportionate. Those significant subsidiaries do not need to have a separate audit committee.

3.9 Each firm in scope is required to have its own audit committee (subject to other exemptions outlined above). Because of this, an audit committee that serves a number of firms within a group but which is composed of different directors from different firms will not meet the requirements of the article.

UK designated investment firms

3.10 The PRA regulates nine UK investment firms. Those firms are not PIEs as defined by the Statutory Audit Directive and therefore do not fall within the intended scope of article 39. Given their systemic relevance the PRA proposes to include these firms in the scope of the proposed rules.

Structure of an audit committee

3.11 Article 39(1) allows member states to permit audit committees to be either stand-alone committees or a committee of the administrative body or supervisory body. The PRA proposes not to allow firms to have stand-alone committees. This is consistent with current UK board and governance structures in accordance with the FRC Guidance.

3.12 Article 39 also contains member state options that allow the board or another body to perform the audit committee functions in certain circumstances. The PRA does not propose to use them. Taking each member state option in turn:

Option to allow SMEs to have their audit committee functions fulfilled by the board

3.13 Article 39(2) first sub-paragraph permits member states to allow a PIE that is a small or medium enterprise (SME) and is a ‘company with reduced market capitalisation’¹ to assign the audit committee’s functions to the board as a whole on the condition that, if the chairman of the board is an executive member, he or she will not act as chairman whilst the board is performing the functions of the audit committee. The PRA does not propose to take the option, given that it is not compatible with our proposals that audit committees solely consist of non-executive members (see paragraph 3.19).

Option to permit or require the board to perform audit committee functions

3.14 The PRA does not propose to allow the board to perform the audit committee’s functions, which is a member state option under article 39(2) second sub-paragraph.

1 In summary, this will be the case if a firm meets at least two of the following three criteria:

- an average number of employees during the financial year of less than 250;
- a total balance sheet not exceeding €43 million; and
- an annual net turnover not exceeding €50 million

and in addition, has an average market capitalisation of less than €100 million on the basis of end-year quotes for the previous three calendar years.

3.15 While the PRA recognises that there is cost associated with not allowing this option, it takes the view that to be effective and retain their independence, audit committees should remain separate from management and from executive board members.

Option to allow a body or bodies that perform equivalent functions to an audit committee to fulfil the functions of the audit committee

3.16 The PRA does not propose to allow a body or bodies that perform equivalent functions to fulfil the functions of the audit committee, which is a member state option under article 39(4). In this context a body means any management committee or even the board itself. The PRA's rationale is given above. It considers that the audit committee should be separate from management and composed of NEDs.

Membership of an audit committee

3.17 Article 39 sets out a number of requirements and options in relation to the membership of an audit committee.

3.18 Requirements, that the PRA proposes transposing in full, are as follows: at least one member of the audit committee shall have competence in accounting and/or auditing (article 39(1)second subparagraph); the audit committee as a whole shall have competence relevant to the sector in which the audited entity is operating (article 39(1) third subparagraph); and the chairman of the audit committee is required to be appointed by the board and must be independent of the firm (article 39(1) last subparagraph).

3.19 The PRA proposes to restrict membership of the audit committee in all cases to NEDs. Article 39 allows for audit committees to be composed of members who are either non-executive members of the board and/or members who have been appointed by a general meeting of shareholders or, for entities without shareholders, by an equivalent body (article 39(1) first subparagraph). The PRA considers that its proposal provides a necessary level of independence for the audit committee to carry out its role, being separate from day-to-day decision-making.

Independence of membership

3.20 Article 39(1) last subparagraph requires the majority of members of an audit committee to be independent. The PRA's approach to independence is discussed in chapter 2. In this respect, the PRA proposes to go beyond the minimum requirements set out in article 39 and require that for significant firms all audit committee members should be independent.¹ The PRA considers this to be consistent with its expectations that firms that have the capacity to cause disruption to the UK financial system and/or in the case of insurers have capacity to cause disruption to the interests of a substantial number of policyholders should hold themselves to the highest standards of corporate governance.

3.21 Article 39(5) allows member states to provide that the audit committee is to be exempt from the requirement to have a majority of independent members in certain circumstances. The PRA considers that an audit committee needs to be independent to be effective and therefore it does not propose to provide for this exemption in its rules. Thus the audit committees of significant firms must consist entirely of independent NEDs. For other firms the audit committee must consist entirely of NEDs, with a majority of independent NEDs. The chairman must be independent in both cases.

¹ Unless the significant firm is a subsidiary of an EEA parent that is subject to the article and it has the same NEDs as that parent (see para 3.8).

Election of the chairman

3.22 Article 39(1) last sub-paragraph allows member states to require the chairman of the audit committee to be elected annually by shareholders, in addition to their election as director to the board. This is a new option that was not previously available in the original Directive. The PRA does not propose introducing a requirement for the audit committee chairman to be elected annually by shareholders.

3.23 It is not current practice in the UK for a chairman of an audit committee to be elected by shareholders. The FRC Code expects that all directors appointed between general meetings are submitted for election at the first subsequent AGM and then for re-election at regular intervals. The chair of the audit committee is appointed by the board members separately from the director appointment and election process. Whilst the accountability of the audit committee chairman to the shareholders is important, the PRA regards the balance of skills and expertise on the audit committee to be more appropriately considered and achieved by the board rather than the shareholders.

Functions of an audit committee

3.24 There are provisions in article 39(6) that set out a non-exhaustive list of audit committee responsibilities. The audit committee shall, among other responsibilities:

- inform the administrative or supervisory body of the audited entity of the outcome of the statutory audit and explain how the statutory audit contributed to the integrity of financial reporting and what the role of the audit committee was in that process;
- monitor the financial reporting process and submit recommendations or proposals to ensure its integrity;
- monitor the effectiveness of the undertaking's internal quality control and risk management systems and, where applicable, its internal audit, regarding the financial reporting of the audited entity, without breaching its independence;
- monitor the statutory audit of the annual and consolidated financial statements, in particular, its performance, taking into account any findings and conclusions by the competent authority;¹
- review and monitor the independence of the statutory auditors or the audit firms,² and in particular the appropriateness of the provision of non-audit services to the audited entity in accordance with article 5 of EU Regulation 537/2014; and
- be responsible for the procedure for the selection of statutory auditor(s) or audit firm(s) and recommend the statutory auditor(s) or the audit firm(s) to be appointed.³

3.25 The PRA proposes to implement the functions by transposing the relevant text of article 39(6) into the PRA Rulebook (see paragraph 2.4 of the proposed rule instrument in Appendix 1).

3.26 With the concept of proportionality in mind, the PRA proposes to allow the audit committees of lower impact firms to also carry out the risk committee functions. This will enable lower impact firms to operate a combined audit and risk committee, as a sub-committee of the board, provided the committee complies with all relevant structure and membership requirements.

¹ Pursuant to article 26(6) of Regulation (EU) No 537/2014

² In accordance with articles 22, 22a, 22b, 24a and 24b of Directive 2014/56/EU and article 6 of Regulation (EU) No 537/2014

³ In accordance with article 16 of Regulation (EU) No 537/2014 except when article 16(8) of Regulation (EU) No 537/2014 is applied

4 Cost benefit analysis

4.1 The cost benefit analysis (CBA) is an assessment of the differences between the position if the proposed rules are made and the position if they are not. The baseline for this CBA is current practice.

Benefits

4.2 The benefits of the audit committee requirements have been discussed in this CP. The PRA is of the view that audit committees are necessary in order to provide adequate, independent challenge to management and to help promote effective corporate governance, in line with the PRA's statutory objectives. This is the case irrespective of the size of the firm. Nevertheless, the PRA has applied its proposals in a proportionate manner, with the highest standards required from the largest and most complex firms, and less stringent requirements applied to other firms.

Costs

4.3 Using a survey of NED fees from companies listed on the London Stock Exchange performed by PwC,¹ the PRA estimates the cost of forming an audit committee compliant with the composition requirements to be between £130,000 and £180,000 per annum for significant firms and between £50,000 and £60,000 per annum for other firms. This is based on the assumption that all firms already have one independent NED who will be a member of the audit committee.

4.4 The PRA does not envisage a significant cost to the majority of firms that are in scope of these requirements.

Banks and building societies

UK banks and building societies

4.5 Most UK banks and all building societies² already have audit committees. Those UK banks that may not have an audit committee are subsidiaries.

Subsidiaries

4.6 Analysis was conducted on a subset of subsidiaries of non-EEA parents, all of which were found to have an audit committee. Though they may not meet membership requirements set out in these proposals, the PRA does not envisage a significant cost for those subsidiaries in meeting the additional requirements. The analysis may not be representative of all subsidiaries of non-EEA parents; however the PRA does not expect the practice to differ materially outside the subset of subsidiaries surveyed. Where subsidiaries of EEA parents are able to rely on their parent's audit committee (see paragraphs 3.7 – 3.8) there will be no additional cost.

Insurers

Significant parents and stand-alone insurers

4.7 The cost for significant insurers that are either a parent of a group or a stand-alone firm is not expected to be significant because the PRA considers it is likely they already have audit committees. Though they may not fully meet the independence requirements as set out in the PRA's proposals, the associated cost in meeting those requirements is not expected to be significant.

1 PwC Non-executive Director Fees 2014 Review: <http://pwc.blogs.com/files/pwc-non-executive-director-fee-review-jan-2015.pdf>.

2 The 1962 Building Societies Act requires all building societies to have an internal audit function. Following the failure of Grays Building society in the 1980s the then regulator (The Registry of Friendly Societies) required that building societies must have an audit committee so as to perform their internal audit function. This practice has continued. Similarly, for newly authorised banks there is a strong supervisory expectation to have an audit committee or at a minimum, a joint audit and risk committee.

Significant subsidiaries

4.8 The requirement to have an audit committee composed as set out in this CP may affect significant insurance subsidiaries. Based on internal analysis, the PRA estimates that up to 60% of subsidiaries of significant groups rely on the audit committee of their parent. However, the PRA is of the view that few of these subsidiaries will themselves be considered significant.

Lower impact firms

4.9 The PRA considers that there is likely to be a greater cost for lower impact Solvency II insurers. Based on internal analysis, the PRA estimates that up to 30% of lower impact Solvency II insurers may not have an audit committee. CP18/15 set out proposed expectations that smaller firms should have at least two independent NEDs on their board.¹ Where these proposed expectations are already being met, the PRA envisages there to be no additional cost, though the PRA recognises that this may not reflect current practice.

¹ PRA Consultation Paper 18/15 ‘Corporate governance: Board responsibilities’, May 2015:
www.bankofengland.co.uk/pru/Pages/publications/cp/2015/cp1815.aspx.

Appendices

- 1 Draft rule instrument PRA Rulebook: CRR Firms and Solvency II Firms: Audit Committee Instrument [YEAR]**
- 2 Summary table of proposals**

Appendix 1**PRA RULEBOOK: CRR FIRMS AND SOLVENCY II FIRMS: AUDIT COMMITTEE INSTRUMENT [YEAR]****Powers exercised**

- A. The Prudential Regulation Authority ("PRA") makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):
 - (1) section 137G (the PRA's general rules); and
 - (2) section 137T (general supplementary powers).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

Pre-conditions to making

- C. In accordance with section 138J of the Act (Consultation by the PRA), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

PRA Rulebook: CRR Firms and Solvency II Firms: Audit Committee Instrument [YEAR]

- D. The PRA makes the rules in the Annex to this instrument.

Commencement

- E. This instrument comes into force on [DATE].

Citation

- F. This instrument may be cited as the PRA Rulebook: CRR Firms and Solvency II Firms: Audit Committee Instrument [YEAR].

By order of the Board of the Prudential Regulation Authority

[DATE]

Annex

In this Annex, the text is all new and is not underlined.

Part

AUDIT COMMITTEE

Chapter content

- 1. APPLICATION AND DEFINITIONS**
- 2. AUDIT COMMITTEE**
- 3. LLOYD'S**

Links

1 APPLICATION AND DEFINITIONS

- 1.1 Unless otherwise stated, this Part applies to:
- (1) a *CRR firm*;
 - (2) a *UK Solvency II firm*;
 - (3) in accordance with Insurance General Application 3, the *Society*, as modified by 3; and
 - (4) in accordance with Insurance General Application 3, *managing agents*, as modified by 3.
- 1.2 This Part does not apply to a *firm* which is a *subsidiary undertaking* of a *parent undertaking* where the *parent undertaking* complies at group level with Chapter 2 or with requirements implementing Article 39 of the *Statutory Audit Directive* in any other *EEA State* and with Articles 11(1), 11(2) and 16(5) of the *Statutory Audit Regulation*, provided that:
- (1) the *firm* is not significant; or
 - (2) if the *firm* is significant, its *governing body* is composed of the same *non-executive directors* as the *governing body* of that *parent undertaking*.

[Note: Art. 39(3)(a) (part) of the *Statutory Audit Directive*]

- 1.3 In this Part, the following definitions shall apply:

audit committee

means a committee established in accordance with 2.1.

Statutory Audit Directive

means Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC.

Statutory Audit Regulation

means Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC.

syndicate aggregate accounts

means the aggregate accounts required to be prepared by the *Council* under regulation 18 of the Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008 (SI 2008/1950).

syndicate statutory accounts

means the *syndicate*'s annual accounts and underwriting year accounts for a financial year prepared under regulations 5(2)(a) and 6(1) of the Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008 (SI 2008/1950).

2 AUDIT COMMITTEE

2.1 Subject to 2.3, a *firm* must have an *audit committee* which meets the criteria set out in 2.2 and which is responsible for performing the functions set out in 2.4.

[Note: Art. 39(1) (part) of the *Statutory Audit Directive*]

2.2 The criteria referred to in 2.1 are:

- (1) the *audit committee* must be a committee of the *governing body* of the *firm*;
- (2) the *audit committee* must be composed only of *non-executive directors*;¹
- (3) at least one member of the *audit committee* must have competence in accounting and/or auditing;
- (4) the members of the *audit committee* as a whole must have competence relevant to the sector in which the *firm* is operating;
- (5) subject to (6), a majority of the members of the *audit committee* must be independent of the *firm*;
- (6) all members of the *audit committee* of a *firm* that is significant must be independent of the *firm*; and
- (7) the chairman of the *audit committee* must be appointed by its members and must be independent of the *firm*.

[Note: Art. 39(1) (part) of the *Statutory Audit Directive*]

2.3 A *firm* may combine its *audit committee* with its risk committee (if applicable) provided that:

- (1) the *firm* is not significant; and
- (2) the members of the combined committee have the knowledge, skills and expertise required for the exercise of the functions of the risk committee and the *audit committee*.

[Note: Art. 76(3) CRD]

2.4 A *firm* must ensure that its *audit committee* performs at least the following functions:

- (1) informs the *governing body* of the *firm* of the outcome of the statutory audit and explains how the statutory audit contributed to the integrity of financial reporting and what the role of the *audit committee* was in that process;
- (2) monitors the financial reporting process and submits recommendations or proposals to ensure its integrity;

¹ This definition has been made and will come into force on 7 March 2016. See PRA Rulebook: CRR Firms Non-CRR Firms: Individual Accountability Instrument 2015: http://www.prarulebook.co.uk/rulebook/Media/Get/bcddf60e-603a-4610-a9a5-e2dde91e1909/PRA_2015_6/pdf.

- (3) monitors the effectiveness of the *firm's* internal quality control and risk management systems and, where applicable, its internal audit, regarding the financial reporting of the *firm*, without breaching its independence;
- (4) monitors the statutory audit of the annual and consolidated financial statements, in particular, its performance, taking into account any findings and conclusions of the [competent authority]¹ pursuant to Article 26(6) of the *Statutory Audit Regulation*;
- (5) reviews and monitors the independence of the statutory auditor or the audit firm in accordance with [UK Implementation of articles 22, 22a, 22b, 24a and 24b of the Statutory Audit Directive] and Article 6 of the *Statutory Audit Regulation*, and in particular the suitability of the provision of non-audit services to the *firm* in accordance with Article 5 of the *Statutory Audit Regulation*;
- (6) is responsible for the procedure for the selection of the statutory auditor or audit firm and recommends the statutory auditor or the audit firm to be appointed in accordance with Article 16 of the *Statutory Audit Regulation* except when Article 16(8) of the *Statutory Audit Regulation* is applied.

[Note: Art. 39(6) of the *Statutory Audit Directive*]

3 LLOYD'S

- 3.1 This Part applies to the *Society* and *managing agents* separately.
- 3.2 For the purposes of complying with 2, a *managing agent* must establish an *audit committee* which meets the criteria set out in 2.2 and which is responsible for performing the functions set out in 2.4 in respect of:
 - (1) each *syndicate* it manages; and
 - (2) any *syndicate* in respect of which it was the last *managing agent* to manage during the preceding year and which has no *managing agent* on 31 December where *syndicate statutory accounts* are required to be prepared.
- 3.3 For the purpose of:
 - (1) 2, as applied to the *Society*, references to “*governing body*” are to be interpreted as references to the *Council*.
 - (2) 2.4, as applied to *managing agents*,
 - (a) references to “*statutory audit*” and “*statutory audit of the annual and consolidated financial statements*” are to be interpreted as references to the audit of the *syndicate statutory accounts* in accordance with the requirements of the Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008 (SI 2008/1950); and

¹ This will refer to the relevant competent authority designated under Article 20 of Regulation (EU) No 537/2014.

- (b) references to “statutory auditor” or “audit firm” are to be interpreted as a reference to the statutory auditor or audit firm responsible for the audit of the *syndicate statutory accounts* referred to in 3.3(2)(a);
- (3) 2.4(3), as applied to *managing agents*, the reference to “the financial reporting of the *firm*” is to be interpreted as a reference to the financial reporting in respect of each *syndicate* referred to in 3.2 for which the *managing agent* is responsible; and
- (4) 2.4(4), as applied to the *Society*, the reference to the “consolidated financial statements” is to be interpreted as a reference to the *syndicate aggregate accounts*.

Summary table of proposals

	Significant firms	Lower impact firms
Scope	Audit committee is required for: CRD credit institutions; Solvency II insurers, the Society of Lloyd's and each Lloyd's managing agent; and UK designated investment firms Unless: the firm is a subsidiary of an EEA parent subject to the article and that parent has a board with the same NEDs	Audit committee is required for: CRD credit institutions; Solvency II insurers, the Society of Lloyd's and each Lloyd's managing agent; and UK designated investment firms Unless: the firm is a subsidiary of an EEA parent subject to the article
Structure	The audit committee must be a sub-committee of the board and separate from other committees of the board	Same as for significant firms
Membership	The audit committee must consist entirely of independent NEDs	The audit committee must consist entirely of NEDs, with a majority being independent NEDs, provided that the chairman is also independent
Functions	The audit committee shall, among other responsibilities: <ul style="list-style-type: none"> • report on aspects of the statutory audit to the board; • monitor the financial reporting process; • monitor the effectiveness of the firm's internal quality control and risk management systems and, where applicable, its internal audit; • monitor the statutory audit; • review and monitor the independence of the statutory auditors; • be responsible for the procedure for the selection of statutory auditor(s) 	Same as for significant firms. In addition the audit committee can be combined with, and carry out the functions of, the risk committee as long as the structure and membership rules are still met