



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP43/15

Solvency II: external audit of the public disclosure requirement

November 2015

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Responses are requested by Friday 19 February 2016.

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Contents

1	Overview	5
2	Solvency II public disclosure subject to external audit	7
3	Cost benefit analysis	11
Appendices		14

1 Overview

1.1 This consultation paper (CP) is relevant to firms in scope of Solvency II including the Society of Lloyd's (insurers), auditors and those individuals or firms who are likely to use the Solvency and Financial Condition Report (SFCR). For insurers not in scope of Solvency II (non-directive firms) Prudential Regulation Authority (PRA) Rule 9.6 of The Interim Prudential Sourcebook for Insurers (IPRUINS) will continue to apply. The PRA plans to consult in 2016 Q1 on rules for non-directive firms.

1.2 This CP sets out the PRA's proposal for a policy to require the external audit of elements of Pillar 3 disclosure under Solvency II and seeks feedback on the proposal, draft rules and draft supervisory statement. Under Pillar 3, firms in scope of Solvency II are required to disclose publicly a SFCR. The proposed policy would require external audit of quantitative and qualitative information included in the 'Valuation for solvency purposes' and 'Capital management' sections of the SFCR (relevant elements of the SFCR) of insurers prepared at the solo, group and sub group level.

1.3 Where Solvency II requires the production of a SFCR, the PRA proposes to require the relevant elements to be externally audited, subject to two exemptions. First, the Solvency Capital Requirement (SCR) would be exempt if calculated using an approved full or partial internal model (internal model). Secondly, where Solvency II requires information in the SFCR to be produced using sectoral rules, that information would not be subject to external audit. These exemptions are explained in more detail in paragraphs 2.20 to 2.23 and paragraph 2.18 respectively.

Statutory obligations

1.4 The proposal is compatible with the PRA's statutory objectives under the Financial Services and Markets Act 2000 (FSMA): to promote the safety and soundness of PRA-authorized firms;¹ and in the context of insurance, to contribute to policyholder protection.² This proposal is intended to give users of the SFCR, including investors, policyholders and the PRA, greater confidence in the quality of the disclosure. Investors may need this information to make informed investment decisions, which should contribute to market discipline and the PRA's objectives of promoting the safety and soundness of firms and securing an appropriate degree of protection for policyholders.

Cost benefit analysis

1.5 The PRA is required to perform a cost benefit analysis of the impact in respect of proposed rules. This analysis can be found in Chapter 3.

Impact on competition

1.6 When discharging its general rule-making function, the PRA is legally required, so far as is reasonably possible, to facilitate effective competition in the markets for services provided by PRA-authorized persons in carrying on regulated activities.³ The PRA has assessed whether the proposal in this CP facilitates effective competition. The cost of external audit is small compared to premium income for insurers. The proposal in this CP is expected to contribute to market discipline, a key driver of effective competition.

¹ Section 2B (1) and Section 2B (2) FSMA.

² Section 2C FSMA.

³ Section 2H FSMA.

Regulatory principles

1.7 In making its rules and establishing its practices and procedures, the PRA must have regard to the Regulatory Principles as set out in FSMA.¹ Of these, three principles are of particular relevance:

- *The principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.* The PRA has indicated in the CP the key areas of its judgements in relation to this principle in Section C from paragraph 2.13. The PRA's approach of only proposing the external audit requirement for elements where it is believed to be beneficial is consistent with taking a proportionate approach.
- *The principle that the PRA should exercise its functions as transparently as possible.* In this CP, the PRA sets out the key information relevant to its proposal, and gives respondents the opportunity to comment. In particular the PRA welcomes views from external stakeholders on the type, if any, of assurance work on the SCR that they might find valuable in a public audit report, whether calculated using either the standard formula or an internal model.
- *The desirability in appropriate cases of the PRA exercising its functions in a way that recognises differences in the nature of, and objectives of, business carried on by different persons subject to requirements imposed by or under the Act.* The PRA recognises that there will be a range of group structures and has taken this into consideration when developing its proposal, for example in relation to the application of requirements for information produced using sectoral rules.

Impact on mutuals

1.8 FSMA requires that the PRA assesses whether, in its opinion, the impact of the proposed rules on mutuals would be significantly different from the impact on other insurers.² The PRA does not expect the impact on mutual insurers to be materially different from other insurers.

Equality and diversity

1.9 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.³ To meet this requirement, the PRA has performed an assessment of the policy proposal and does not consider that the proposal gives rise to equality and diversity implications.

Responses and next steps

1.10 This consultation closes on Friday 19 February 2016. The PRA invites feedback on the proposal, draft rules and draft supervisory statement set out in this consultation paper. Please address any comments or enquiries to cp43_15@bankofengland.co.uk

1.11 This proposal does not contain detailed guidance for auditors. The Financial Reporting Council (FRC) is aware of the proposal and is considering what guidance may be appropriate for auditors. Any guidance considered necessary can only be developed when the PRA rules are finalised. The FRC may consult on draft guidance to support assurance reports on the SFCR

¹ Section 2H and 3B FSMA.

² Section 138K FSMA

³ Section 149 (1) Equalities Act 2010

with the aim of finalising it in time for the external audit of insurers with years ending on or after 31 December 2016.

2 Solvency II public disclosure subject to external audit

2.1 It is the PRA's view that external audit can underpin confidence in the audited information. This chapter explains the PRA's proposed policy regarding the external audit of Pillar 3 public disclosure under Solvency II.

2.2 The PRA's proposal is set out in Section A. Section B gives background and Section C sets out why the PRA has taken this approach. The draft rules are in Appendix 1 and the PRA's expectations regarding the level of assurance for the external audit and the external audit guidance that it expects auditors to follow are included in the draft supervisory statement in Appendix 2.

A. Proposal

2.3 Where Solvency II requires the production of a SFCR, the PRA proposes to require relevant elements to be externally audited, subject to two exemptions. First, the Solvency Capital Requirement (SCR) would be exempt if calculated using an approved internal model. Secondly, where Solvency II requires information in the SFCR to be produced using sectoral rules, that information would not be subject to external audit. These exemptions are explained in more detail in paragraphs 2.20 to 2.23 and paragraph 2.18 respectively.

2.4 Under Solvency II a SFCR is required at solo and, where relevant, at group and sub group levels. The PRA proposes that whenever the SFCR is published, the relevant elements should be externally audited. Appendix 3 lists the elements of the SFCR and provides a high level summary of the PRA's proposed approach to each of these. Paragraph 3.1 of the draft supervisory statement explains that auditors would be expected to provide a reasonable assurance opinion that the 'Valuation for solvency purposes' and 'Capital management' sections of the SFCR have been properly prepared, in all material respects, in accordance with Solvency II, subject to the exemptions noted above.

Application

Timing of implementation

2.5 The requirements for external audit would be implemented from 30 June 2016, for those firms reporting under Solvency II. Therefore it would first affect insurers for accounting years ending on or after 30 June 2016.

Policy review

2.6 There are a number of future developments that are likely to have an impact on the factors that the PRA has considered in developing its proposal external audit of relevant elements of the SFCR. For example, when international accounting standard, IFRS 4 Insurance Contracts phase 2 is implemented, the basis of the calculation of the technical provision in the externally audited financial statements will change. This may change the way the financial statements and the SFCR are used. There is also likely to be further consideration of whether, and if so to what extent, banks' risk weighted assets should be subject to external assurance. The PRA's supervisory approach to the SCR calculated using an internal model is also expected to evolve. Consistent with the PRA's policy review process, the PRA will review this policy with the aim of ensuring that the regime remains effective and proportionate, at the latest, by the

time the international accounting standard IFRS 4 Insurance Contracts phase 2 is implemented.¹

B. Background to the PRA's proposal

2.7 Solvency II comes into force from 1 January 2016. Solvency II has three main areas (Pillars). Pillar 1 consists of quantitative requirements (for example, the amount of capital insurers should hold). Pillar 2 sets out requirements for the governance, risk management and the effective supervision of insurers. Pillar 3 focuses on requirements at a solo and group level for public disclosure and private reporting to the PRA.² The public disclosure is the SFCR.

2.8 The SFCR will consist of quantitative and qualitative information on insurers' business and performance, system of governance, risk profile, valuation for solvency purposes and capital management.³ The public disclosure is intended to enhance the quality and comparability of insurers' public disclosure across the EU.

2.9 The private reporting to the PRA, under Pillar 3 of Solvency II, will cover the insurers' strategy, projections, expected risks and additional quantitative reporting templates. In addition the insurer will provide privately to the PRA its own risk and solvency assessment (ORSA) supervisory report, which will provide insight into the future development of the insurer's solvency and financial condition.

2.10 Currently in the UK, some of the insurer regulatory returns have been subject to external audit by the statutory auditor. IPRU INS Rule 9.35 sets out a requirement that various public and private forms within the insurers' regulatory returns must be audited. This audit ranges from reasonable assurance on some returns (such as those that provide more analysis on the accounting balance sheet) to limited procedures (such as on the group capital adequacy return). In auditing these returns, auditors follow guidance issued by the FRC. Insurers' Internal Capital Adequacy Assessment Process (ICAAP) is not subject to external audit and is not published.

2.11 Though there is no requirement under Solvency II for external audit of the public or private disclosure under Pillar 3, the European Insurance and Occupational Pension Authority (EIOPA) 'believes that to ensure high quality public disclosure for Solvency II purposes, external audit of that information can ... be a powerful tool. In order to make best use of external audit in the context of the SFCR, EIOPA is of the view that at individual and group level, the main elements of the SFCR (balance sheet, own funds and capital requirements) of all insurance and reinsurance undertakings could fall within the scope of an external audit.'⁴

2.12 Banks' equivalent regulatory reporting is not currently subject to external audit, although the PRA has encouraged work on whether there might be a role for external assurance of some of the regulatory information for banks.⁵

¹ The Prudential Regulation Authority's approach to insurance supervision June 2014, Chapter 5, Paragraph 239 <http://www.bankofengland.co.uk/publications/Documents/praproach/insuranceappr1406.pdf>

² PRA Rulebook, SII Firms, Reporting, <http://www.prarulebook.co.uk/rulebook/Content/Part/213121/08-01-2016>

³ Articles 293, 294, 295, 296 and 297 respectively. [https://eiopa.europa.eu/Pages/Consultations/Public-consultation-on-the-Set-2-of-the-Solvency-II-Implementing-Technical-Standards-\(ITS\)-and-Guidelines.aspx](https://eiopa.europa.eu/Pages/Consultations/Public-consultation-on-the-Set-2-of-the-Solvency-II-Implementing-Technical-Standards-(ITS)-and-Guidelines.aspx). And Article 359 Group solvency and financial condition report, for groups.

⁴ EIOPA, *Need for high quality public disclosure: Solvency II's report on solvency and financial condition and the potential role of external audit*,

https://eiopa.europa.eu/Publications/Other%20Documents/EIOPA_high%20quality%20public%20disclosure_Solvency%20II.pdf

⁵ ICAEW, *Reporting on regulatory capital: choices for assurance*, <http://www.icaew.com/en/technical/financial-services/inspiring-confidence-in-financial-services/reporting-on-regulatory-capital-choices-for-assurance>

C. The PRA's approach to its proposal

2.13 Investors and other stakeholders have historically relied on insurers' published regulatory returns for undertaking analysis across the insurance sector and this is likely to continue. There are two main reasons for this. Firstly, much of the information in the SFCR is not available in other forms to external stakeholders. For example, the calculation of technical provisions in the Solvency II balance sheet may be substantially different from that in the externally audited IFRS or Generally Accepted Accounting Practice in the UK (UK GAAP) financial statements.

2.14 Secondly, one of the main elements investors analyse is the insurer's solvency and financial condition. At present, insurance accounting under UK GAAP and IFRS allows a variety of practices. The new IFRS accounting standard, IFRS 4 Insurance Contracts, has not yet been completed and may not be effective until at least 2019, whereas under Solvency II, the SFCR will be presented by insurers on a consistent basis. It is expected that the SFCR will, therefore, continue to be used by investors and others for a number of years.

2.15 External audit has provided users with confidence that the disclosed information has been properly prepared by management. In the UK, there is an expectation that auditors will continue to provide a verification role in enhancing the reliability and credibility of insurers' regulatory information. The PRA's discussions with investors have indicated that market consistent public solvency disclosure is likely to be an important source of information for analysis and decision-making.

2.16 In addition, the PRA will use the SFCR to assist it in its supervision of insurers and in meeting its objective of policy holder protection. External audit can enhance the reliability of insurer reporting and disclosure. The insights that auditors obtain in undertaking an external audit of the Solvency II disclosure may also contribute to an effective auditor-supervisor dialogue.¹

Elements of Solvency II not in scope for external audit

2.17 The PRA does not propose external audit of Solvency II disclosure in the following scenarios:

Where the public disclosure requirement is extended to other financial sector entities

2.18 Part 4.2 of the proposed rules and paragraph 3.3 of the draft supervisory statement state that where information for the group SFCR is compiled in accordance with sectoral rules e.g. for credit institutions and investment firms (as required under Solvency II), the group auditor should undertake an assessment of whether that information has been properly extracted in accordance with the relevant sectoral rules, from information provided to the insurer by other undertakings of the insurance group and from the insurer's own records. On balance, the PRA does not propose to require sectoral information to be externally audited. Currently the PRA does not require external audit of other financial sector entities' capital requirements. The PRA believes that the need to avoid introducing an external audit requirement for the public disclosure of such undertakings that are part of insurance groups, but not for those that are not part of an insurance group, justifies the cost of having different levels of assurance in some group SFCRs.

Where information is subject to private reporting

2.19 Where the regulators are the primary external users of reporting e.g. the ORSA, the PRA's view is that its needs can generally be served through ongoing supervision and other more

¹ PRA supervisory statement LSS7/13, *The relationship between the external auditor and the supervisor: a code of practice*, <http://www.bankofengland.co.uk/publications/Documents/other/prapolicy/2013/codeofpracticelss7-13.pdf>

risk-focused tools which are more cost effective in these circumstances. When external assurance is needed, it can be obtained through the use of skilled persons under Section 166 FSMA.

Where requiring external audit may be less meaningful to users

2.20 The PRA is of the view that external audit of the SCR calculated using an internal model would not provide users with the same degree of confidence that the SCR had been prepared in accordance with Solvency II, as external audit of the SCR calculated using the standard formula. Any audit work on the SCR calculated using an internal model in this area would likely need to be against an insurer's basis of preparation rather than Solvency II. This is because the model is based on the insurer's specific risks, as approved by the PRA, not a basis contained directly within Solvency II. The PRA does not currently believe that an opinion against the basis of preparation, with the basis being a firm-specific, non-public document, would be meaningful to investors and brokers.

Where information is required by Solvency II or the PRA and is subject to alternative verification

2.21 Under Solvency II an insurer will have to obtain approval from the PRA to use an internal model. For the PRA, external audit of an insurers' internal model would duplicate work already required to be carried out through an insurer's internal validation and the PRA's independent supervisory review process.

2.22 In addition, the PRA's approach to supervision under Solvency II will ensure that the PRA has sufficient, reliable information to enable it to fulfil its regulatory functions. The PRA can assess whether the internal model continues to be appropriate through its individual supervision of the firm, the use of sector analytics, periodic reviews of key areas of the model and thematic reviews across the sector.

2.23 As independent internal validation is not required under Solvency II for firms which use the standard formula, the PRA believes that external audit of the SCR calculated using the standard formula is necessary to provide assurance that the inputs to, application and outputs of the standard formula are appropriate.

Implications of exclusion of the SCR calculated using an internal model from the external audit requirement

2.24 Given the dependency between the SCR and the calculation of the risk margin in technical provisions, scoping out the SCR calculated using an internal model would mean that the SCR element for calculating the risk margin would also be outside the scope of external audit for those firms who have approval to use an internal model. This would mean that a potentially material element of the valuation of technical provisions in the Solvency II balance sheet (which is different from that in the externally audited financial statements), included in the SFCR would not have been subject to external audit. The PRA anticipates that any guidance to be developed by the FRC would consider the potential impact on the audit of the SFCR, the most appropriate assurance framework to support engagements of this type and on the opinion that the auditor gives.

2.25 The PRA believes that, even for those firms whose SCR is calculated using an internal model, where the SCR would be out of scope of external audit, there is value in requiring an external audit of the rest of the Solvency II balance sheet given it is a foundation for determining capital resources. Auditors would still undertake audit procedures around the other elements in the calculation of the risk margin. The PRA appreciates that its proposed approach, to exclude the SCR calculated using an internal model, would limit the scope and

therefore the likely value of the external audit of the risk margin in the Solvency II balance sheet for insurers using internal models to calculate their SCR. The PRA welcomes views from external stakeholders on the type, if any, of assurance work on the SCR that they might find valuable in a public audit report, whether calculated using either the standard formula or an internal model. For example, for internal models, this may include assurance that the model operates in accordance with the relevant approvals, or that the governance and controls around model change and operation are operating effectively.

3 Cost benefit analysis

3.1 This cost benefit analysis (CBA) compares, for the insurers in scope for Solvency II, the differences between the position if the proposed rules are made and if there was no requirement for external audit of the SFCR. However, there is a requirement for external audit under the current regulatory reporting requirements for insurers.¹ This is therefore also considered in discussion on the analysis of costs. The analysis makes the assumption that the statutory auditor would undertake the external audit of the relevant elements of the SFCR.

3.2 The proposed rules and draft supervisory statement would apply to all those in scope for Solvency II, which sets prudential requirements for around 400 insurers in the UK. It does not include insurers below the threshold defined in Article 4 of Solvency II.² As a result the smallest insurers would not be in scope of this requirement.

3.3 The Financial Service Authority's consultation papers, Transposition of Solvency II parts one and two, analyse the quantitative impact of disclosure under Solvency II on the insurance market in detail.³ The analysis in this CP deals with the cost of an external audit of the public disclosure.

3.4 The current cost of auditing insurer solo UK regulatory returns ranges between approximately 0.002% (large life insurer) and 0.04% (small non-life insurer) of premium income.

Determinants and basis of cost

3.5 The cost of an external audit requirement of the relevant elements of the SFCR is most likely to depend on:

- the type of business – technical provisions and the asset side of the balance sheet tend to be more complex for life insurers compared to non-life insurers;
- whether the firm calculates its SCR using an internal model;
- the extent to which the auditor is able to place reliance on the systems, controls and processes in place at the firm when determining the type and level of evidence required to give an opinion; and
- the firm's group structure – jurisdiction of members, number and nature of the subsidiaries (e.g. whether they are insurers) and method of consolidation.

¹ IPRU (INS) 9.35, http://media.fshandbook.info/Handbook/IPRU-INS_PRA_20140526.pdf

² Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF>

³ The Financial Service Authority's Consultation Paper, Transposition of Solvency II, http://www.fsa.gov.uk/pubs/cp/cp11_22.pdf, and Transposition of Solvency II – Part 2, <http://www.fsa.gov.uk/static/pubs/cp/cp12-13.pdf>

3.6 The analysis was conducted using feedback and estimated values provided by the largest audit firms and two mid-tier audit firms. Significant outliers were excluded from the analysis. The considerable uncertainty and variability in the estimates mean the analysis should be treated as indicative only. The estimates in the CBA are based on annual ongoing costs. It is likely that the costs of a ‘first year’ external audit could be substantially higher.

Costs of external audit requirement

3.7 The PRA has estimated a cost range of 0.01% (large solo life insurer) to 0.1% (small solo life or non-life insurer) of premium income under the proposed requirement. The cost is greater than the current cost of auditing regulatory returns. This is as a result of the greater scope and breadth of coverage of the SFCR compared to current regulatory reporting requirements. The table below provides an indication of how the external audit fee is split between the respective elements of the SFCR for a solo insurer.

Element of the SFCR	% of External audit fee
Balance Sheet and Own Funds	54 - 59
SCR (Standard Formula firms) and MCR	39 - 42
Narrative	2 - 4

3.8 If the SCR calculated using an internal model were in scope, audit firms indicated that the costs of external audit for solo insurers would be somewhat higher compared to the costs of auditing the SCR for insurers using the standard formula. This was on the basis that the model would have been independently validated by persons free from influence from those responsible for the development and operation of the internal model, approved by the PRA, and that the auditor could place reliance on that validation and approval. However, it is likely that given the complexity of those firms using internal models, the costs of external audit of the SCR for those firms would be at the higher end of the estimated ranges.

3.9 The estimates of external audit costs for the relevant elements of a group SFCR is subject to even greater uncertainty. The PRA’s work indicates an additional increase in cost of between zero and 85% of the cost for solo insurers and is likely to be higher for firms that use an internal model to calculate their SCR. The range of costs would also be driven by those factors noted in paragraph 3.5 above.

3.10 Discussion with insurers indicates that, even if the PRA were to impose no requirement for external audit, before making any public disclosure many firms would seek some external assurance from the audit firms of their SFCR. Therefore the incremental costs of imposing an external audit requirement may not be as high as indicated in paragraphs 3.7 to 3.9. It is difficult to estimate the extent and cost of any voluntary external assurance as the scope of these engagements would be agreed on a case-by-case basis by insurers and auditors.

Impact on competition

3.11 These estimates should be treated with caution and although the costs expected are a relatively insignificant percentage of premium income, they may be greater for some smaller insurers. Smaller insurers are more likely to have a SCR calculated using the standard formula which is in scope for external audit unlike the SCR calculated using an internal model. However, costs are expected in most cases to be proportionate to the nature and complexity of insurers. The PRA believes that where Solvency II mandates that a firm should prepare an SFCR, it is proportionate to require the relevant elements to be externally audited. The requirements should not have an adverse effect on competition and could facilitate effective

competition by supporting market confidence in the information insurers make available publicly.

Benefits of external audit requirement

3.12 External audit can bring discipline to the disclosure preparation process and underpin trust in the information reported. Solvency II public disclosure will be important for investors' analysis and decision-making at a solo and group level. Confidence that the information has been prepared on a consistent basis and verified, aids users' decision making and assists in the efficient operation of the market. If, without external audit, material information such as that which highlights under-reserving were undetected, and then were an insurer to fail, costs could be imposed on policyholders and other insurers via the Financial Services Compensation Scheme.

3.13 For the PRA, external audit enhances the reliability of the information disclosed and can be more effective and efficient than direct supervisory verification. The insights that auditors obtain in undertaking an external audit of the relevant elements of the SFCR may also contribute to an effective auditor-supervisor dialogue.¹

¹ PRA supervisory statement LSS7/13, *The relationship between the external auditor and the supervisor: a code of practice*, <http://www.bankofengland.co.uk/publications/Documents/other/prapolicy/2013/codeofpracticelss7-13.pdf>

Appendices

- 1 Draft Instrument - PRA Rulebook: Solvency II Firms and Non-Authorised Persons: External Audit Instrument 2016**

- 2 Draft Supervisory Statement XX/16 – Solvency II: external audit of the public disclosure requirement**

- 3 Solvency II public disclosure – narrative sections and templates**

Appendix 1

PRA RULEBOOK: SOLVENCY II FIRMS AND NON AUTHORISED PERSONS: EXTERNAL AUDIT INSTRUMENT 2016

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);
 - (2) section 137T (General supplementary powers); and
 - (3) section 340 (rules regarding appointment of and duties on Actuaries)
- 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: Solvency II Firms and Non Authorised Persons: External Audit Instrument 2016

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

Commencement

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

Citation

- F. This instrument may be cited as the PRA Rulebook: Solvency II Firms and Non Authorised Persons: External Audit Instrument 2016.

By order of the Board of the Prudential Regulation Authority
[DATE]

Annex A

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

Part

EXTERNAL AUDIT

Chapter content

- 1. APPLICATION AND DEFINITIONS**
- 2. EXTERNAL AUDIT OF RELEVANT ELEMENTS OF THE SFCR**
- 3. APPOINTMENT OF AUDITORS**
- 4. DUTIES OF THE EXTERNAL AUDITOR**

1 APPLICATION AND DEFINITIONS

1.1 Unless otherwise stated, this Part applies:

- (1) to a *UK Solvency II firm*;
- (2) to the *Society* in accordance with General Application 3; and
- (3) at the level of a *group*, to which Group Supervision 2.1(1) or (2) applies and where the *PRA* is the *group supervisor*, to a *relevant insurance group undertaking*; and
- (4) to an external auditor of such a *firm* or *group* In this part, the following definitions shall apply:

delegated act

means Commission Delegated Regulation (EU) 2015/35 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II);

relevant elements of the SFCR

means the templates and information in 2.2;

SFCR Implementing Technical Standard

means *Commission Implementing Regulation (EU) No. of XXX laying down implementing technical standard with regard to the procedures, formats and templates for the disclosure of the solvency and financial condition report according to Directive 2009/138/EC of the European Parliament of the Council*

2 EXTERNAL AUDIT OF RELEVANT ELEMENTS OF THE SFCR

2.1 A *firm* or a *relevant insurance group undertaking* must ensure that the external auditor provides a report which includes an opinion about the *relevant elements of the SFCR* in accordance with 4.

2.2 The *relevant elements of the SFCR* are:

- (a) Subject to (3), (4) and 4.2, the information that a *firm* and a *group* discloses pursuant to Article 296, 297, and 359(d) and (e) of the *delegated act*;
- (b) Where appropriate, the following templates that are provided in the [*SFCR Implementing Technical Standard*];
 - (i) S.02.01.02
 - (ii) S.12.01.01
 - (iii) S.17.01.02
 - (iv) S.22.01.21
 - (v) S.22.01.22
 - (vi) S.23.01.01
 - (vii) S.23.01.22
 - (viii) S.25.01.21
 - (ix) S.25.01.22
 - (x) S.28.01.01
 - (xi) S.28.02.01

(xii) S.32.01.22.

(3) Where the information in (1) and (2) relates to the *SCR*, that information shall only be subject to external audit for *firms* calculating their *SCR* using the *standard formula*.

(4) Where the information in (1) and (2) relates to the *group SCR*, that information shall only be subject to external audit for *relevant insurance group undertakings* calculating their *group SCR* using the *standard formula*.

3 APPOINTMENT OF AUDITORS

3.1 A *firm* or a *relevant insurance group undertaking* must:

(1) appoint an external auditor in accordance with Auditors 2, 3 and 4 to perform the functions in 2; and

(2) submit the report to the *PRA* and disclose it publicly with the *firm's SFCR*.

4 DUTIES ON THE EXTERNAL AUDITOR

4.1 Subject to 4.2, an external auditor appointed by a *firm* or *relevant insurance group undertaking* pursuant to 3 must:

- (a) undertake a reasonable assurance engagement on *relevant elements of the SFCR* in accordance with current auditing guidance as published by the Financial Reporting Council;
- (b) produce a report that includes an opinion addressed to the *governing body* and the *PRA* confirming that, in relation to *the relevant elements of the SFCR*, all the information that is required to be disclosed pursuant to Reporting 3 (including as it applies at the level of the *group* as provided by Group Supervision 18 and 20), the *Solvency II Regulations* has been disclosed and that:
 - (a) the disclosed information meets the requirements of the applicable *PRA rules* and *Solvency II regulations* on which it is based;
 - (b) the descriptions, assessments, statements, explanations, valuations and quantifications, as required to be disclosed in the *relevant elements of the SFCR* are appropriate; and
 - (c) the *relevant elements of the SFCR* do not omit anything that is required to be taken into account; and
- (c) assess whether all information disclosed by the *firm* in its *SFCR* that is not a *relevant element of the SFCR* is consistent with the *relevant elements of the SFCR* and any other information to which the auditor has had access.

4.2 Where the *relevant elements of the SFCR* in a *group SFCR* include information relating to a capital requirement:

- (a) that pertains to an *undertaking* that is not a *Solvency II undertaking*; and
- (b) that information has been prepared in accordance with

- i. *PRA rules* other than those implementing the *Solvency II Directive*; or

- ii. an *EU instrument* other than the *Solvency II Regulations*,

the external auditor shall state in the report under 4.1.(b) that the information has been properly compiled in accordance with the relevant *PRA rules* and *EU instruments* relating to that *undertaking* from information provided by members of the *group* and the *relevant insurance group undertaking*.

Annex B

[Note: This annex amends the Solvency II, Group Supervision Part as follows in the appropriate alphabetical positions. Underlining indicates new text and deleted text is struck through.]

20 THIRD COUNTRIES

- 20.1 When 2.1(3) applies, 4 to 14, ~~and 16 to 19~~ and External Audit 2 to 4 apply with any necessary changes at the level of the *insurance holding company* or *mixed financial holding company* which does not have its head office in an *EEA State*, *third country insurance undertaking* or *third country reinsurance undertaking* unless:
- (1) subject to 20.2, the third country in which that *undertaking* has its head office is assessed to be equivalent under Article 260 of the *Solvency II Directive*; or
 - (2) in the absence of equivalent group supervision referred to in Article 260 of the *Solvency II Directive*, the *PRA* has specified other methods in accordance with Article 262 of the *Solvency II Directive*.

[Note: Art. 262 of the *Solvency II Directive*]

Appendix 2

Draft Supervisory Statement XX/16 – Solvency II: external audit of the public disclosure requirement

Contents

1	Introduction	22
2	Governing body’s responsibility for the SFCR	22
3	Level of assurance and scope	22
4	Audit guidance	23

1 Introduction

1.1 This draft supervisory statement is relevant to firms in scope of Solvency II including the Society of Lloyd's (insurers), third country branches where applicable and auditors. It reminds the governing body of its responsibilities in respect of the ongoing appropriateness of the information disclosed, and that it must approve the Solvency and Financial Condition Report (SFCR). It also sets out the level of assurance expected with respect to the external audit requirement on the SFCR and the audit guidance that the Prudential Regulation Authority (PRA) expects auditors to follow in auditing firms' SFCR. It should be read alongside PRA Instrument xxx.

1.2 This draft supervisory statement expands on PRA Instrument xxx. By clearly and consistently explaining its expectations of insurers and audit firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates, and contributing to securing an appropriate degree of protection for policyholders. The PRA is legally required, so far as is reasonably possible, to facilitate effective competition in the markets for services provided by PRA-authorized persons in carrying on regulated activities. The PRA has considered matters to which it is required to have regard, and it considers that this draft supervisory statement is compatible with the Regulatory Principles and relevant provisions of the Legislative and Regulatory Reform Act 2006. This draft supervisory statement is not expected to have any direct or indirect discriminatory impact under existing UK law.

2 Governing body's responsibility for the SFCR

2.1 The PRA Rulebook sets out that an insurer must have in place a written policy ensuring the ongoing appropriateness of any information disclosed and that an insurer must ensure that its SFCR is subject to approval by its governing body.^{1,2} Therefore the PRA expects the governing body to take responsibility for ensuring that the SFCR has been properly prepared in all material respects in accordance with the requirements of the PRA Rulebook.

2.2 As well as having a written policy in place to ensure the ongoing appropriateness of any information disclosed, the PRA expects that the governing body should be satisfied that:

- (a) throughout the financial year in question, the insurer has complied in all material respects with the requirements of the PRA Rulebook relevant to the SFCR; and
- (b) it is reasonable to believe that, at the date of the publication of the SFCR, the insurer has continued so to comply subsequently, and will continue so to comply in future.

3 Level of assurance and scope

3.1 Unless otherwise stated, external audit of the SFCR refers to the independent external auditor gathering sufficient appropriate evidence to provide an overall reasonable assurance opinion that the public disclosure in scope complies in all material respects with Solvency II. PRA Rule 2.2 describes the relevant elements of the public disclosure in scope in the 'Valuation for solvency purposes' and 'Capital management' sections of the SFCR, subject to the exemptions noted in PRA Rule 2.3 and 2.4.

¹ Reporting Part, Rule 6.1(2)

² Reporting Part, Rule 6.2(1)

Information in the group SFCR from non-EEA undertakings

3.2 PRA Instrument xxx applies whenever a SFCR is disclosed, whether at the solo or, where relevant, at the group and sub group level. Information from non-EEA undertakings included in the SFCR will therefore be within scope for external audit.

Information in the group SFCR compiled in accordance with sectoral rules

3.3 Where information for the group SFCR is compiled in accordance with sectoral rules (as required under Solvency II), the group auditor should undertake an assessment of whether that information has been properly extracted in accordance with the relevant sectoral rules, from information provided to the insurer by other undertakings of the insurance group and from the insurer's own records.¹ An audit of such information is not required.

Approvals

3.4 Auditors are expected to undertake procedures, as part of their audit, to assess whether the firm is complying with any approval. It would not be the responsibility of the external auditor to express an opinion on the validity of the approvals granted to the insurer by the PRA.

Other information in the SFCR public disclosure

3.5 PRA Rule 4.1 (c) requires that those elements of the SFCR not subject to the reasonable assurance opinion should be read by the external auditor for consistency with the relevant elements of the SFCR and any other information to which the auditor has had access. When complying with this rule, the PRA expects the auditor to follow International Standard on Auditing (UK and Ireland) 720 (Revised October 2012); Section A - The Auditor's responsibilities relating to other information in documents containing audited financial statements.

4 Audit guidance

General

4.1 Auditors should follow best practice guidance on auditing in carrying out the external audit. Until such time as the Financial Reporting Council's Practice Note 20 is revised for the PRA Instrument xxx,² the PRA expects auditors to follow International Standards on Auditing (ISAs) as issued by the International Auditing and Assurance Standards Board (IAASB).

Use of actuaries

4.2 ISAs specify that the auditor shall determine whether, to obtain sufficient appropriate audit evidence, they should use the work of an auditor's expert, and should evaluate the expert's competence, capabilities and objectivity.³ As a minimum, for firms that write life business, the PRA expects that auditors, in undertaking the audit, will obtain and pay due regard to advice from a suitably qualified actuary who is independent of the firm.

¹ See Article 2 (7) of Directive 2002/87/EC. Commission Delegated Regulation (EU) 2015/35, Article 329, 1(a)

² PN 20 (revised), *The Audit of insurers in the United Kingdom*, [https://www.frc.org.uk/Our-Work/Publications/APB/PN-20-\(Revised\)-The-Audit-of-Insurers-in-the-United-Kingdom.pdf](https://www.frc.org.uk/Our-Work/Publications/APB/PN-20-(Revised)-The-Audit-of-Insurers-in-the-United-Kingdom.pdf)

³ ISA 620, *Using the work of an auditor's expert*

Appendix 3

Solvency II public disclosure – narrative sections and templates

The table below lists the elements of the SFCR and highlights which are included in the reasonable assurance opinion. Those elements not subject to the reasonable assurance opinion should be read by the external auditor for consistency with those that are and the knowledge acquired by the auditor in the course of performing the audit of the public disclosure.

Article	Title	Reasonable Assurance
293	Business and performance	No
294	System of governance	No
295	Risk profile	No
296	Valuation for solvency purposes	Yes*
297	Capital management	Yes*
359	Group solvency and financial condition report	Yes* of valuation and capital management sections
Templates		
S.02.01.02	Balance Sheet	Yes*
S.05.01.02	Premiums, claims and expenses by line of business	No
S.05.02.01	Premiums, claims and expenses by country	No
S.12.01.01	Life and Health SLT Technical Provisions	Yes*
S.17.01.02	Non-Life Technical Provisions	Yes*
S.19.01.21	Non-life insurance claims	No
S.22.01.21	Impact of long term guarantees and transitional measures (MCR)	Yes*
S.22.01.22	Impact of long term guarantees and transitional measures (SCR)	Yes*
S.23.01.01	Own funds	Yes*
S.23.01.22	Own funds	Yes*
S.25.01.21	Solvency Capital Requirement - for undertakings on Standard Formula	Yes
S.25.01.22	Solvency Capital Requirement - for groups on Standard Formula	Yes
S.25.02.21	Solvency Capital Requirement - for undertakings using the standard formula and partial internal model	No
S.25.02.22	Solvency Capital Requirement - for groups using the standard formula and partial internal model	No
S.25.03.21	Solvency Capital Requirement - for undertakings on Full Internal Models	No
S.25.03.22	Solvency Capital Requirement - for groups on Full Internal Models	No
S.28.01.01	Minimum Capital Requirement - Only life or only non-life insurance or reinsurance activity	Yes*
S.28.02.01	Minimum Capital Requirement - Both life and non-life insurance activity	Yes*
S.32.01.22	Undertakings in the scope of the group	Yes

* SCR calculated using an internal model is out of scope