

Policy Statement | PS25/18

Solvency II: External audit of the public disclosure requirement

October 2018



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY





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1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 8/18 ‘Solvency II: external audit of the public disclosure requirement’ (the CP).¹ It also contains the PRA’s final policy, as follows:

- amendments to the External Audit Part of the PRA Rulebook (Appendix 1); and
- updated Supervisory Statement (SS) 11/16 ‘Solvency II: External Audit’² (see also link at Appendix 2).

1.2 This PS is relevant to all UK Solvency II firms (including mutuals), auditors and users of Solvency and Financial Condition Reports (SFCRs).

1.3 In CP8/18 the PRA proposed to remove the external audit requirement for the SFCRs of certain small Solvency II firms, and certain small Solvency II groups (collectively ‘small insurers’). The SFCR is the key public disclosure under Solvency II.

1.4 The PRA received 22 responses to the CP. Respondents generally welcomed the PRA’s proposals to remove the audit requirement for small insurers. However, a number of observations and requests for clarification were made. Responses to comments are set out in Chapter 2.

Changes to draft policy

1.5 Where the final rules differ from the draft in the CP in a way which is, in the opinion of the PRA, significant, the Financial Services and Markets Act 2000 (FSMA)³ requires the PRA to publish:

- details of the difference together with a cost benefit analysis; and
- a statement setting out, in the PRA’s opinion, whether or not the impact of the rule on mutuals is significantly different to that for other PRA authorised firms.

1.6 Following consideration of respondents’ comments, the PRA has made changes to the proposals consulted on in the CP. One of these – the introduction of a two year smoothing mechanism to reduce volatility in application of the rule – is significant in the opinion of the PRA. Further details on this change as well as an impact assessment on firms, and specifically mutuals, are set out in paragraphs 2.23-2.26 of this PS.

1.7 The PRA has made minor changes to the draft instrument in the CP which, in the opinion of the PRA, are not significant. The PRA has not updated the assessment of impact on mutuals or the cost benefit analysis in respect of these changes, which:

- clarify that the currency of reported figures used to determine firms’ scores is to be GBP (converted where necessary);

1 April 2018: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-external-audit-of-the-public-disclosure-requirement>.

2 <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-external-audit-of-the-public-disclosure-requirement>.

3 Section 138J(5) and 138K(4).

- correct a minor inconsistency in the definition of ‘life insurance gross written premium’ compared to other definitions; and
- add definitions for ‘corporate pensions business’ and ‘annual quantitative reporting template’, as have been defined in the Fees Part of the PRA Rulebook.

1.8 The PRA has also made minor clarifications and typographical changes to SS11/16. These changes were not consulted on as part of CP8/18. However the PRA considers that they improve clarity of the PRA’s expectations. The PRA does not consider these changes to the SS to be significant and so has not updated the assessment of impact on mutuals or the cost benefit analysis from CP8/18.

Implementation

1.9 The changes to the External Audit Part of the PRA Rulebook and the amendments to SS11/16 will be effective from Thursday 15 November 2018.

1.10 The policy contained in this PS has been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including changes arising once any new arrangements with the European Union take effect.

2 Feedback to responses

2.1 Before making any proposed rules, the PRA is required by FSMA to have regard to any representations made to it, and to publish an account, in general terms, of those representations and its response to them.⁴

2.2 The sections below have been structured broadly along the same lines as the proposals in the CP, with some areas rearranged to respond to related issues. The responses have been grouped as follows:

- definitions of small insurers;
- volatility in application of the exemption, and timing of the small insurer determination; and
- other responses.

Definitions of small insurers

2.3 The PRA proposed to apply the SFCR audit exemption using a threshold of a firm risk metric (‘score’) based on reported gross written premiums (GWP) and best estimate liabilities (BEL). The score is derived from the methodology used by the PRA to determine PRA fees.⁵ The proposals in the CP defined ‘small firm for external audit purposes’ as a UK Solvency II firm with a score below a specific threshold, and ‘small group for external audit purposes’ as a group in which every UK Solvency II firm in the group is a small firm for external audit purposes.

⁴ Sections 138J(3); 2L; and 138J(4) of FSMA.

⁵ ‘PRA fees and levies: model transaction fees, fees and FSCS levies for insurers and fees for designated investment firms’, August 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/pra-fees-and-levies>.

Use of the 'score' metric concept

2.4 Six respondents suggested that, in place of the proposed score methodology, the threshold for the audit exemption should be based on the PRA's impact categories. Three of the six respondents commented that the impact categories were well understood and provided a better measure of risk to the PRA's objectives. The other three respondents commented that the score methodology was complex and may introduce uncertainty around whether or not the exemption would apply. One respondent further considered the score metric to be easily calculated and not subjective.

2.5 Having considered this feedback, the PRA will not amend the policy. The PRA does not consider the metric to be unduly complex, and considers that it is in the interest of Solvency II firms for the application of the SFCR audit exemption to be based on an objective and transparent metric. As set out in the PRA's approach to insurance supervision,⁶ the impact categories reflect a degree of supervisory judgment.

Treatment of unit-linked business in the score methodology and other suggested revisions to the definitions

2.6 Respondents made several comments relating to how the proposed metric was determined and how it applied to different business models. These are set out below.

2.7 Five respondents commented on unit-linked business. They said that the proposed score methodology seemed to assume that the GWP and BEL of unit-linked business would generate the same risk to the PRA's objectives as other insurance business.⁷ These respondents considered that unit-linked business generates lower risk to the PRA's objectives than other types of life business and suggested alternative methodologies including limiting, or removing, the impact of unit-linked business in the score methodology and using case-by-case waivers. One respondent recommended that the PRA keeps the score metric open to further consideration or review to reflect developments in the PRA's fee methodology. Respondents noted that the PRA will review the fee methodology in 2018/19 and has explicitly mentioned considering the treatment of unit-linked business as part of this review.⁸

2.8 One respondent observed that corporate pensions business is excluded from the definition of the 'life insurance best estimate liability' and 'life insurance gross written premiums'. Therefore a firm focussing on the corporate pensions market could write significant amounts of this business but its regulatory returns would not be subject to external audit.

2.9 One respondent proposed refinements to the definition of small insurer, suggesting that the metric could take into account additional factors, such as the split of business between retail and wholesale.

2.10 Two respondents questioned whether the score methodology should be applied differently to run-off firms. This is because such firms are not writing new business and therefore might in their view be incorrectly scoped out of the audit requirement, which is weighted more towards GWP than BEL.

6 Available at: <https://www.bankofengland.co.uk/news?NewsTypes=65d34b0d42784c6bb1dd302c1ed63653&Taxonomies=973f7bc68fd74abca30287f8a0a15fa3&Direction=Latest>.

7 With the exception of corporate pensions business which has a zero risk weighting under the score methodology.

8 December 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/pra-fees-and-levies>.

2.11 Two respondents suggested excluding from the exemption from audit those insurers whose regulatory solvency position is below a particular threshold (eg less than 110% solvency capital requirement coverage or significantly below the absolute minimum capital requirement).

2.12 The PRA has considered these comments and considers that the methodology set out in CP8/18 continues to reflect best an objective and transparent measure of risk to the PRA's objectives. The PRA does not, at this stage, wish to introduce a different measure to that used to measure risk for the purpose of determining PRA fees. In addition, the PRA does not wish to add complexity to the measure by, for example, treating retail and wholesale business differently. The PRA noted in the CP that it would continue to assess the score methodology to determine whether it remains in alignment with risks to the PRA's objectives.

2.13 As the PRA stated in the CP, for those firms where SFCRs are no longer subject to external audit, the PRA would continue to monitor the quality of regulatory data and public disclosure. Where the PRA considers it appropriate, it would use other supervisory tools, including skilled persons reviews under FSMA Section 166,⁹ carried out on an individual or thematic basis.

New insurers

2.14 One respondent noted that the proposals did not include provisions to address cases of newly incorporated small insurers, or those that become UK Solvency II firms due to their increased size. Unlike most existing small insurers, the SFCRs of these new small insurers would not have been subject to two years of audit, and therefore the benefits of the PRA's 2016 audit policy¹⁰ would not have been realised, and might as a result be higher than the costs involved.

2.15 The PRA has considered this comment and has decided not to amend the proposals. As set out in the CP, where SFCRs are not subject to external audit, the PRA would continue to monitor the quality of regulatory data and public disclosure. In addition, the PRA would, where it considers it appropriate, use other supervisory tools, including skilled persons reviews, carried out on an individual or thematic basis. This applies equally to new insurers as it does to those existing insurers no longer subject to the external audit requirement. The PRA also draws firms' attention to guidance for new insurers and the New Insurer Start-up Unit.¹¹ As the PRA's consideration of further developments relating to the authorisation of new insurers continues, it may consider this point further.

Foreign currency

2.16 One respondent noted that the reporting templates that form the basis of the score methodology are reported using each insurance firm's reporting currency. The respondent suggested including a provision in the policy requiring firms to translate values into GBP, where appropriate, so that firms' scores are not skewed by their reporting currencies.

2.17 The PRA agrees that the final rules should be clear that values in the reporting templates should be converted to GBP (where they are not already prepared in GBP) for the purpose of calculating a firm's score. A provision to that effect has therefore been added.

9 Section 166 of FSMA gives the PRA the power to require any regulated firm to provide an independent review by a skilled person on any supervisory matter.

10 PS24/16 'Solvency II: external audit of the public disclosure requirement', September 2016: <http://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-external-audit-of-the-public-disclosure-requirement>.

11 <http://www.bankofengland.co.uk/prudential-regulation/new-insurer-start-up-unit>.

Use of private reporting templates

2.18 Two respondents commented that some of the templates that provide input into the score are reported privately and therefore do not make the determination of the score transparent to market participants.

2.19 The PRA does not intend to change the policy. The primary goal of the transparent metric was clarity for firms as to the application of the policy. The PRA further notes that, while the exact templates and references that contribute to the score are not all publicly available, aggregated GWP and BEL values are disclosed publicly, and they could in some cases be used by market participants to estimate which firms are likely to be above or below the threshold.

Other amendments to the definitions

2.20 One respondent noted that the draft instrument in the CP included a minor inconsistency for the life insurance GWP definition compared to the other definitions.

2.21 The PRA has considered this comment and agrees that there is an inconsistency in the definition of life insurance GWP. This has been amended in the final rule.

Volatility in application of the exemption, and timing of the small insurer determination

2.22 The PRA proposed that firms would determine whether they were small insurers, based on data as at the end of a financial year. This would then determine whether the insurer was exempt from the audit requirement for that financial year.

Volatility in application of the exemption

2.23 Five respondents commented that the rigid nature of the threshold could result in firms with scores close to the threshold moving in and out of the requirement on a year-by-year basis. Various approaches were suggested to address this concern.

2.24 The PRA considered the comments, and, while PRA analysis suggests that few firms would currently be in this position, the PRA accepts that it is a possible scenario. As a consequence, the PRA has decided to introduce a two year smoothing mechanism similar in operation to the small company audit exemption under the Companies Act.¹² This smoothing mechanism will not take effect for the first SFCR reported after the application of this amendment. However for subsequent SFCRs, where, on its balance sheet date, a firm or group newly meets (or does not meet) the threshold, this will change whether it qualifies as a small insurer only if it occurs in two consecutive financial years. A firm will no longer require an audit only if it remains a small insurer for audit purposes for two consecutive years, and a firm will need to have its SFCR audited only if it is above the threshold for two consecutive years.

2.25 As the revised approach applies to both the requirement to have an audit and the exemption from the requirement, when compared with the original proposal, the difference in overall costs of audit over time will be minimal. The PRA understands that firms see value in having greater predictability of the SFCR audit requirement. In addition, the PRA considers that audits may be more efficient if carried out for at least two years and that the smoothing mechanism will be less disruptive for firms whose premiums or liabilities might temporarily increase or decrease. In comparison to the original proposal, the introduction of this mechanism could achieve some of these efficiency related cost savings. When firms' SFCRs are not subject to audit, the PRA would, where it considers appropriate, use other supervisory tools to ensure the integrity of SFCRs.

¹² Sections 477 and 832 of the Companies Act 2006.

2.26 In the PRA's opinion the impact of the final rule on mutuals is not significantly different to the impact that the draft rule would have had on mutuals, or the impact that the final rule will have on other PRA-authorised firms.

Timing of the small insurer determination

2.27 Five respondents commented that firms would be sure that they were above or below the threshold only after the balance sheet date and that this could prove problematic for audit planning. Alternative suggestions included using inputs from the previous balance sheet date, using pro-rated mid-year data, and using impact categories to determine scope of audit requirement.

2.28 The PRA has considered these comments and does not propose to amend the policy. The PRA notes that the introduction of a two year smoothing mechanism will assist firms' audit planning. The PRA does not propose to make further amendments.

Other responses

Supervisory statement

2.29 One respondent commented that SS11/16 may require updating to reflect the changed requirements for small insurers and the continuing applicability of parts of that SS to small insurers despite their exemption from the SFRC audit requirement.

2.30 The PRA has considered this response and agrees that minor amendment to SS11/16 would be of benefit to firms. These amendments are set out in the new Annex of the updated SS. At the same time, the PRA is making some minor editorial corrections. The PRA confirms that the changes proposed are clarificatory in nature and do not represent a change to the PRA's expectations.

Continued monitoring

2.31 One respondent commented that the PRA should set clear expectations for those insurers that will no longer be subject to SFCR audit and to provide details of the ongoing PRA monitoring to which they will be subject. Another respondent suggested metrics that could be used to determine which firms should be the focus of further review.

2.32 The PRA has considered these comments and does not propose to set out further expectations or provide details of ongoing monitoring. The PRA notes that CP8/18, and this PS, already reference the PRA's expectations around the use of other supervisory tools where appropriate. The PRA also reminds firms of the expectations in Chapter 2 of SS11/16.

Use of skilled persons (section 166) reviews

2.33 Two respondents commented on the high cost of section 166 reviews, encouraging the PRA not to adopt this as a regularly used solution, and not without a thorough review of regulatory returns.

2.34 The PRA has considered this comment and notes that, while skilled persons reviews are a supervisory tool, they are not the only intervention available. The PRA intends to continue to use skilled persons reviews where they are appropriate.

Responsibility for calculation

2.35 One respondent commented that the current wording of the requirement is silent as to which party is responsible for the calculation.

2.36 The PRA has considered this comment and considers it is sufficiently clear that it is the responsibility of the firm to determine whether the SFCR audit exemption would apply. The rules requiring SFCR audit apply to the firm and not to the auditor or the PRA.

Non-Directive firms

2.37 Two respondents commented that the policy proposal would not remove the audit requirement for the regulatory returns of non-Directive firms. They recommended that the PRA considers whether arguments for relaxing the audit requirement for small firms would also apply for non-Directive firms.

2.38 The PRA has considered the views of these respondents and will take them into account in any future review of the audit requirements for non-Directive firms.

Certification

2.39 One respondent suggested that professional certification could help maintain transparency and public confidence in the results within the SFCR, instead of external audit. This could include, for example, certification from the relevant Chief Actuary that the technical provisions had been reviewed and were considered appropriate.

2.40 Having considered the recommendation, the PRA does not see a case for amending the policy. The PRA does not consider this additional certification necessary, given the requirements under Solvency II and the expectations set out in Chapter 2 of SS11/16.

Disclosures in the SFCR

2.41 One respondent recommended that small insurers should be required to label their SFCRs as unaudited in the interests of transparency to investors and policyholders. The respondent suggested that the SFCR audit opinion should clarify that it was provided in accordance with the PRA Rulebook and that the firm did not benefit from the exemption given to small insurers. The respondent further suggested that the audit opinion should clarify that the firm itself is responsible for calculating its score and whether an audit is required in any given year; and that the information used to calculate this score is based on private information which is not subject to audit.

2.42 Having considered the feedback, the PRA has not amended the rules. The PRA agrees that the firm is responsible for calculating its score and whether an audit is required in any given year, but does not find further disclosure on this point in the audit opinion to be of significantly increased benefit.

Coefficients in the score metric

2.43 One firm requested clarification on what drives the coefficients used in the score methodology in order to improve transparency of the policy.

2.44 The PRA confirms that the metric is designed to estimate risk to the PRA's objectives in a similar manner as the PRA's fee methodology. The coefficients reflect the relative significance of different insurance metrics in determining this risk, and are normalised to set a threshold at 100. This threshold would exempt those firms that tended to experience higher than anticipated SFCR audit costs as a proportion of their GWP and have fewer SFCR users. Generally these firms and groups would pose at most only a limited risk to the PRA's objectives.

Cost benefit analysis

2.45 Three respondents noted that the benefits of the policy change may be overstated in the PRA's cost benefit analysis set out in the CP. One respondent noted that, even without the audit requirement, some firms would still seek assurance on their SFCRs in order for the governing body to have confidence in their compliance. Two respondents noted that, under the Financial Reporting Standard (FRS) 103, insurers are permitted to use Solvency II technical provisions in their (audited) statutory accounts and, where they do so, the reduction in audit cost would be less significant.

2.46 The PRA has considered these responses and accepts that the benefits of the proposals may be lower than originally stated if some firms choose to continue auditing their SFCRs. However, based on the feedback from the industry, the PRA considers that this will only apply in a very small number of cases and consequently does not consider it is necessary to adjust the CBA in CP8/18.

Small insurers in single group SFCRs

2.47 Three respondents sought clarification on SFCR audits for small insurers that are part of groups, particularly where a group presents a single group SFCR that is subject to the audit requirement.¹³ Respondents sought clarity on whether firms that would have been below the threshold on a solo basis would remain subject to audit where their information is presented within a single group SFCR.

2.48 The PRA has considered these comments and does not propose to amend its approach. The CP proposals exempt entire SFCRs from audit (whether solo or group) and not parts of SFCRs. Where an SFCR is subject to audit then all of the relevant information within that SFCR should be audited.

Request to lobby the European Insurance and Occupational Pensions Authority (EIOPA)

2.49 One respondent asked the PRA to consider lobbying EIOPA for a total exemption of SFCR production for small firms.

2.50 Having considered the feedback, the PRA will not take action. The PRA considers public disclosure to be a key pillar of Solvency II, and of regulatory regimes in general.

Request to amend the reporting timetable

2.51 Two respondents requested changes to the reporting timetable to ease the burden on small insurers.

2.52 Having considered the comment, the PRA will not seek to amend the reporting timetable. The submission timelines, which will shorten each year under the transitional arrangement until 2020, are defined in the Solvency II Directive and the PRA does not have the ability to change them.

¹³ Because the group contains at least one UK Solvency II Firm that would be subject to audit at a solo level had permission to prepare a single group SFCR not been granted.

Appendices

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- 1** PRA RULEBOOK: SOLVENCY II FIRMS AND NON-AUTHORISED PERSONS: EXTERNAL AUDIT AMENDMENTS INSTRUMENT, available at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-external-audit-of-the-public-disclosure-requirement>
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- 2** Update to Supervisory Statement 11/16 'Solvency II: External audit of, and responsibilities of the governing body in relation to, the public disclosure requirement', available at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-external-audit-of-the-public-disclosure-requirement-ss>