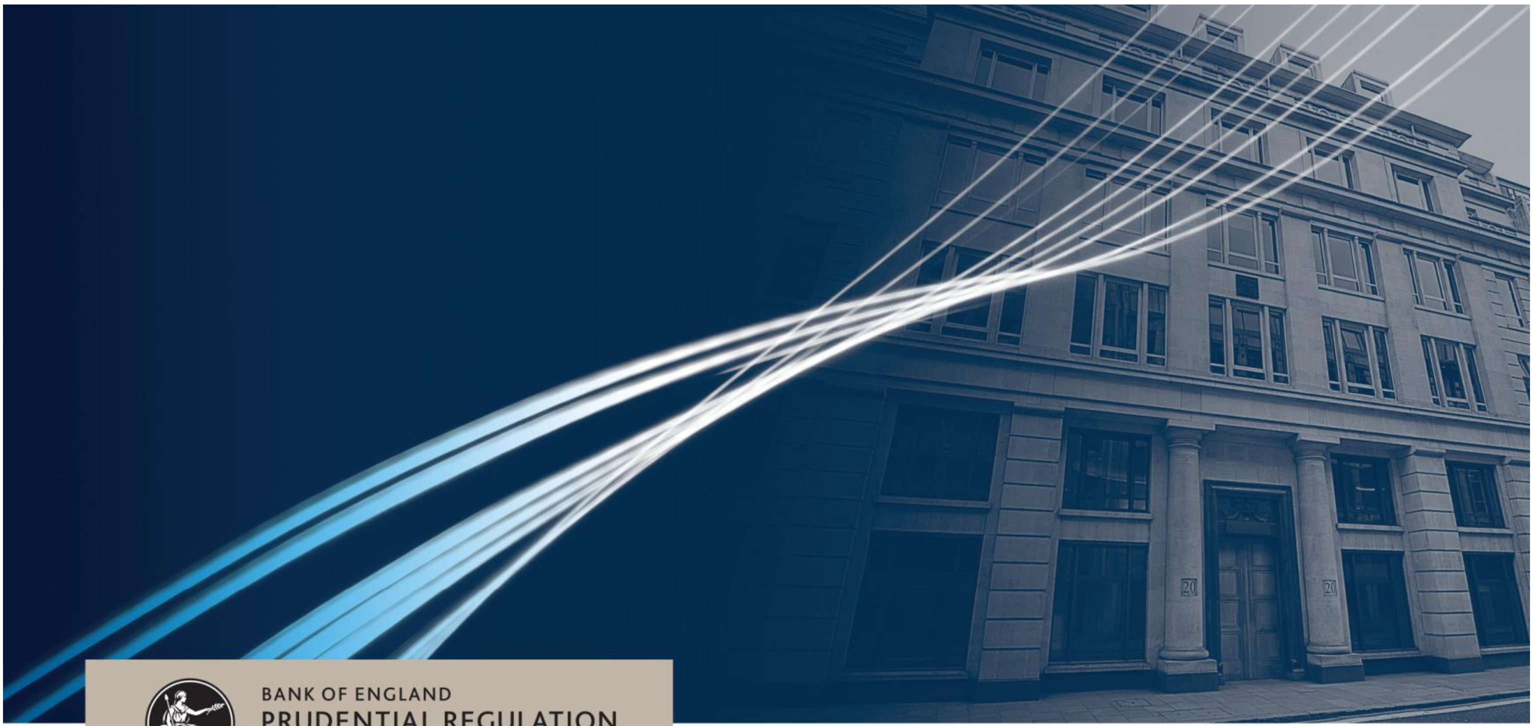

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP8/18

Solvency II: external audit of the public disclosure requirement

April 2018

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Responses are requested by Wednesday 11 July 2018.

Please address any comments or enquiries to:

Accounting and Audit Policy team
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

Email: CP8_18@bankofengland.co.uk

Contents

1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) sets out its proposal to amend the rule that requires the external audit of parts of the Solvency and Financial Condition Report (SFCR).[1] The SFCR is the key public disclosure under Solvency II and is intended to enhance transparency and comparability, through the disclosure of essential information on the solvency and financial condition of a firm. The PRA estimates that the proposed amendments would remove the SFCR external audit requirement from the end of 2018 for more than 150 smaller UK Solvency II firms (including mutuals) and groups. The PRA considers that this change would improve the proportionality of the requirement.

1.2 The proposals in this CP have been developed by the PRA as part of its work on reviewing aspects of the insurance prudential framework in light of experience following the United Kingdom's implementation of Solvency II.[2]

1.3 This CP is relevant to all UK Solvency II firms (including mutuals), auditors and users of SFCRs.

Background

1.4 The PRA consulted on the requirement for elements of the SFCR to be subject to external audit in CP43/15 and CP23/16,[3] and made the rule with effect for financial years ending on or after Thursday 15 November 2016.[4]

1.5 In compliance with requirements set out in the Financial Services and Markets Act 2000 (FSMA), the PRA published an estimated cost benefit analysis (CBA) for the audit requirement in CP43/15. Following the implementation of the rule and the first year of public disclosure (2016 year ends), the PRA collected quantitative data from UK Solvency II firms on audit costs incurred, and met with stakeholders such as audit firms, investors, insurers, and insurance trade bodies. In light of the findings, the PRA makes the proposals in this consultation.[5]

Implementation

1.6 The PRA proposes that any amendments would be effective for financial years ending on or after Thursday 15 November 2018.

Responses and next steps

1.7 This consultation closes on Wednesday 11 July 2018. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP8_18@bankofengland.co.uk.

1 Rule 2 of the External Audit Part of the PRA Rulebook.
2 See News Release 'PRA launches series of improvements to the implementation of solvency II', 25 October 2017: www.bankofengland.co.uk/news/2017/october/pra-launches-series-of-improvements-to-the-implementation-of-solvency-ii.
3 CP43/15 'Solvency II: external audit of the public disclosure requirement', November 2015: www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-external-audit-of-the-public-disclosure-requirement (see page 3 of 3); and CP23/16 'Solvency II: external audit of the public disclosure requirement', July 2016: www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-external-audit-of-the-public-disclosure-requirement (see page 2 of 3).
4 PS 24/16 'Solvency II: external audit of the public disclosure requirement', September 2016 www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-external-audit-of-the-public-disclosure-requirement.
5 In CP43/15, the PRA committed to perform a full review of the SFCR audit policy at least by the time the new insurance contracts accounting standard (IFRS 17) would be implemented. The findings presented in this CP do not alter the PRA's intention to conduct further review of the policy in the future.

2 Proposal

Removing the external audit requirement for the Solvency II public disclosure requirements of Small Insurers

2.1 The PRA proposes to amend Rule 1.1 of the External Audit Part of the PRA Rulebook to remove the external audit requirement for the Solvency II public disclosures of certain small Solvency II firms, and certain Solvency II groups. The PRA proposes that this amendment would be applicable for all financial years ending on, or after, Thursday 15 November 2018. The proposed amendments to the rule, including definitions for 'small firm for external audit purposes' and 'small insurance group for external audit purposes' (collectively 'Small Insurers'), are set out in Appendix.

2.2 This proposal reflects the PRA's conclusion that, following two years of audit, the public disclosure audit requirement can be removed for Small Insurers. The proposal would remove the audit requirement for most of those insurers that pose less risk to the PRA's objectives, and for which the costs of the audit requirement were relatively higher than expected. The PRA considers that excluding Small Insurers from the external audit requirement would support a transparent and more proportionate application of the public disclosure audit policy.

2.3 The PRA recognises that there are benefits associated with the external audit of the Solvency II public disclosures. 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, carried out on an individual or thematic basis.[1]

2.4 Following the proposed amendments, Small Insurers would still be subject to PRA rules regarding the firm's governing body's responsibilities in respect of the ongoing appropriateness of the information disclosed, and approval of the SFCR.[2] Equally, the PRA would continue to expect Small Insurers to follow Chapter 2 of Supervisory Statement (SS) 11/16.[3] The SS sets out that the governing body is expected to acknowledge and evidence in writing its responsibility for the SFCR and make this available to potential readers by signing it, and attaching the written acknowledgment to it.

Definition of Small Insurers

2.5 To support the above proposal, the PRA proposes to introduce definitions to address the concept of a 'Small Insurer' into the External Audit Part, based on a firm risk metric ('Score'). This metric applies a risk factor to reported gross written premiums (GWP) and best estimate liabilities (BEL). As discussed in CP16/17, the PRA considers that a combination of GWP and BEL is a reasonable indicator of the risk that firms pose to the PRA's objectives.[4]

2.6 Using a similar methodology to the fee approach, firms would be able to calculate their Score by multiplying their GWP and BEL by these specific risk factors. The PRA proposes a threshold Score of '100' as a ceiling below which firms would be defined as Small Insurers.

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1 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.
2 Reporting 6.1(2) and Reporting 6.2(1) Parts of the PRA Rulebook.
3 'Solvency II: external audit of the public disclosure requirement', September 2016: www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-external-audit-of-the-public-disclosure-requirement-ss.
4 'PRA fees and levies: model transaction fees, fees and FSCS levies for insurers and fees for designated investment firms', August 2017: www.bankofengland.co.uk/prudential-regulation/publication/2017/pra-fees-and-levies (see page 2 of 2).

2.7 The PRA proposes to also add a definition to the External Audit Part for 'small insurance group for external audit purposes' as a group or sub-group where no UK-authorised firm within the group individually exceeds the Score threshold. The PRA considers this a pragmatic and consistent approach to ensure that larger group SFCRs are audited, without requiring a complex Score consolidation exercise.

2.8 The PRA estimates that as a result of this proposal, more than 150 smaller UK Solvency II firms (including mutuals) and groups would no longer be subject to the public disclosure audit requirement.[1] The firms and groups preparing these SFCRs would be those that report lower values of GWP and BEL. They would also tend to be those that experienced higher than anticipated audit cost per GWP and have fewer SFCR users. Generally these firms and groups would pose at most only a limited risk to the PRA's objectives. The PRA would continue to assess the Score methodology to determine whether it remains in alignment with risks to the PRA's objectives.

Rationale for proposal

2.9 Following the implementation of Solvency II public disclosures (2016 year-ends), the PRA revisited the CBA in CP43/15 that supported the rule requiring external audit of the SFCR (the 2015 CBA). This work drew on quantitative data from firms on audit costs incurred, and the views of stakeholders such as audit firms, investors, insurers, and insurance trade bodies. The objective of the work was to determine whether the policy remained proportionate in light of the actual costs incurred.

2.10 The PRA found that smaller firms tended to experience somewhat higher SFCR audit costs as a proportion of GWP than had been estimated in the 2015 CBA. By contrast, larger firms experienced lower SFCR audit costs per GWP than were anticipated because their actual audit costs were generally lower than had been estimated.

2.11 The PRA identified that for smaller firms, key benefits of the audit requirement included providing comfort over the implementation of Solvency II, of setting up SFCR processes, and of the production of higher quality SFCRs. Following two years of SFCR audits, the PRA considers that these benefits would be largely realised, and therefore the audit requirement would provide reduced incremental benefit in future years. While this may also be true to an extent for larger firms, as well as posing more risk to the PRA's objectives, they may also have users who will benefit from ongoing assurance provided by the external audit requirement.

2.12 This means that compared to the 2015 CBA, the balance of cost and benefit has shifted for smaller firms relative to larger firms. The burden for smaller firms is higher than anticipated, and many of the key benefits of the policy would be realised after the first two years of audit. This evidence supports removal of the audit requirement for Small Insurers for all financial years ending on, or after, Thursday 15 November 2018. For larger firms, the audit remains a valuable source of assurance. Costs are lower than anticipated and a significant part of the benefits of the SFCR audit will continue in future years.

1 Based on 2016 year-end figures.

3 The PRA's statutory obligations

3.1 In carrying out its policy making functions, the PRA is required to comply with several legal obligations.

3.2 Before making any rules, FSMA[1] requires the PRA to publish a draft of the proposed rules accompanied by:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed rules is compatible with the PRA's duty to act in a way that advances its general objective,[2] insurance objective[3] (if applicable), and secondary competition objective;[4]
- an explanation of the PRA's reasons for believing that making the proposed rules are compatible with its duty to have regard to the regulatory principles;[5] and
- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons.[6]

3.3 In addition the Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[7]

3.4 Finally, the PRA is also required by the Equality Act 2010[8] to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.5 The proposed change to the public disclosure audit requirement set out in this CP is intended to reduce the burden on Small Insurers, a benefit to these firms. The PRA does not consider there to be any additional costs to firms in relation to the proposals contained within this CP. Any supervisory actions, for example the use of skilled persons reviews, would be considered on their own merits. The PRA may incur increased costs as a result of this policy, for example, more targeted supervision, and in determining where skilled person reviews are required, but such costs are unlikely to be significant.

3.6 The PRA considers that there would be some costs, reflecting the reduction in benefits that are associated with the external audit of Solvency II public disclosures. These include a reduction in the assurance provided to users of the disclosures over the interpretation and implementation of Solvency II, the embedding of processes around regulatory reporting in firms, and a reduction in the quality of quality public disclosures.

3.7 The PRA considers that for the firms affected by the proposed amendments to its policy, this reduction in benefits would be limited. Following two years of external audit of the Solvency II public disclosures, a significant proportion of the benefits of the audit requirement

1 Section 138J of FSMA.
2 Section 2B of FSMA.
3 Section 2C of FSMA.
4 Section 2H(1) of FSMA.
5 Sections 2H(2) and 3B of FSMA.
6 Section 138K of FSMA.
7 Section 30B of the Bank of England Act 1998.
8 Section 149.

would have been realised. In addition, the cost of reduced assurance for users of the SFCR is further limited for smaller firms where there are relatively few users.

Compatibility with the PRA's objectives

3.8 In discharging its general function of making rules, the PRA must, so far as reasonably possible, act in a way that advances its general objective to promote the safety and soundness of PRA-authorised persons;[1] and in the context of insurance, to contribute to policyholder protection.[2] The PRA considers that the proposals in this CP are compatible with these statutory objectives. The proposed change may reduce the assurance that the PRA can take that the reported Solvency II data for Small Insurers is free from material errors. However, the proposed threshold has been chosen such that the audit requirement is removed mainly for those firms that pose a limited risk to the PRA's objectives. As set out above, the PRA expects to use increased and more targeted supervisory intervention where it requires further assurance to meet its objectives.

3.9 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-authorised persons in carrying on regulated activities.[3] The PRA has assessed whether the proposal in this CP facilitates effective competition and considers that the proposal in this CP fully aligns with the secondary competition objective. The existing audit requirement places a comparatively higher cost on smaller insurers than on larger insurers. The PRA considers that the proposals in this CP represent a more proportionate approach.

Regulatory principles

3.10 In developing the proposals in this CP, the PRA has had regard to the regulatory principles as set out in FSMA. The PRA considers that three of the regulatory principles are of particular relevance to this CP:

- The principle that a burden which is imposed on a person should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden. The PRA's proposal is consistent with this principle as it removes the audit requirement for Small Insurers for which, in future years, the benefits are no longer expected to be proportionate to the costs.

- The principle that the PRA should exercise its functions as transparently as possible. The PRA has consulted with stakeholders, including insurance trade bodies, in developing the proposals contained in this CP, and sets out the key information relevant to its proposal, giving respondents the opportunity to comment.

- 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 FSMA. The PRA recognises that there are a range of group structures and has taken this into consideration when developing its proposal, for example the Score measure uses objective metrics to assess the risk that insurance business poses to the PRA objectives. Other non-insurance activities performed in the group would not affect whether or not that group would meet the definition of a small group.

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1 Sections 2B (1) and Section 2B (2) of FSMA.
2 Section 2C of FSMA.
3 Section 2H of FSMA.

Impact on mutuals

3.11 Proportionally more mutuals are expected to meet the definition of Small Insurers than is the case for firms more widely. In the PRA's opinion, the impact of the proposed rule changes is therefore expected to result in relatively more mutuals benefiting from the external audit exemption – and so reduced fixed costs – compared to other firms.

HM Treasury recommendation letter

3.12 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles set out in FSMA.[1]

3.13 The aspects of the Government's economic policy most relevant to the proposals in this CP are competition and diversity. These aspects have been considered in the 'Compatibility with the PRA's objectives' and 'Regulatory principles' sections above.

3.14 It is possible that this proposal would also increase competitiveness. Small firms in the United Kingdom would see reduced costs of audit (both direct and indirect) compared to some other European jurisdictions.

Equality and diversity

3.15 The PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications.

1 Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at www.bankofengland.co.uk/about/people/prudential-regulation-committee.

Appendix: PRA Rulebook: Solvency II Firms and Non-Authorised Persons: external audit amendments instrument

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PRA RULEBOOK: SOLVENCY II FIRMS AND NON-AUTHORISED PERSONS: EXTERNAL AUDIT AMENDMENTS INSTRUMENT 2018

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 and Auditors).

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 Amendments Instrument 2018

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: Solvency II Firms and Non-Authorised Persons: External Audit Amendments Instrument 2018.

By order of the Prudential Regulation Committee
[DATE]

Amendments to the External Audit Part

Annex

In this Annex, new text is underlined.

1 APPLICATION AND DEFINITIONS

1.1 Unless otherwise stated, this Part applies:

(1) to a *UK Solvency II firm* <u>that is not a *small firm for external audit purposes*</u>;

…

(3) at the level of a *group*, <u>that is not a *small group for external audit purposes*,</u> to which Group Supervision 2.1(1) or 2.1(2) applies and where the *PRA* is the group supervisor, to a *relevant insurance group undertaking*; and

…

1.3 In this Part, the following definitions shall apply:

…

<u>*general insurance best estimate liability*</u>

<u>means:</u>

<u>(1) the sum of items entered under row codes R0010, R0370, R0380, R0410 and R0420, column code C0180, of the *annual quantitative reporting template* S17.01.01; plus</u>

<u>(2) the sum of items entered under row codes R0010 and R0030, column codes C0090, C0140 and C0190, of the *annual quantitative reporting template* S12.01.01,</u>

<u>in each case as required to be reported to the *PRA* for the relevant financial year end.</u>

<u>*general insurance gross written premium*</u>

<u>means the total of items entered under row codes R0110, R0120 and R0130, as expressed in column code C0200 where this column is completed for those row codes, of the *annual quantitative reporting template* S.05.01.01, in each case as required to be reported to the *PRA* for the relevant financial year end.</u>

…

<u>*life insurance best estimate liability*</u>

<u>means:</u>

(1) the sum of items entered under row codes R0010 and R0030, column codes C0150 and C0210 of the *annual quantitative reporting template* S12.01.01; minus

(2) the sum of items entered under row codes R0010 and R0030, column codes C0090, C0140 and C0190 of the *annual quantitative reporting template* S12.01.01; minus

(3) *corporate pensions business* reported under column code C0180 of the *annual quantitative reporting template* S14.01.01,

in each case as required to be reported to the *PRA* for the relevant financial year end.

life insurance gross written premium

means:

(1) the item entered under row code R1410, column code C0300 of the *annual quantitative reporting template* S05.01.01; minus

(2) *corporate pensions business* under column code C0060 of the *annual quantitative reporting template* S14.01.01,

in each case as most recently required to be reported to the *PRA* for the relevant financial year end.

…

score

means for the relevant financial year end the sum of the following:

(1) *general insurance gross written premium* x (6.71×10^{-7});

(2) *general insurance best estimate liability* x (3.97×10^{-8});

(3) *life insurance gross written premium* x (3.11×10^{-7}); and

(4) *life insurance best estimate liability* x (1.18×10^{-8}).

Each of these four components to the calculation of *score* is floored at a zero value, such that where any calculation at (1) to (4) produces a negative number, that number shall be substituted with a zero.

…

small firm for external audit purposes

means a *UK Solvency II firm* where its *score* is less than 100.

small group for external audit purposes

means a *group* in which every *UK Solvency II firm* in the *group* is a *small firm for external audit purposes*.