THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

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Your ref:

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Dear Sir

Proportionality principle, supervisory reporting and disclosure requirements in Solvency 2

The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to provide some views and raise some concerns on proportionality principle, supervisory reporting and disclosure requirements in Solvency 2.

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Introduction

We have set out below our views and concerns specifically in relation to proportionality, supervisory reporting and disclosure requirements. We would also note in overview that the CEIOPS proposals in many instances have, understandably, interpreted the requirements of the directive in a cautious manner. However the aggregate effect of this on firms is a very significant additional burden (resources, processes, capital, expertise) that may not be in line with the original spirit and intention of the Directive. We would recommend that consideration is given to an easing of the requirements in line with the Directive and, in particular, for smaller insurers we would hope to see the requirements being brought back to more reasonable levels through a sensible and appropriate application of the proportionality principle.

In addition, since the key user of Solvency II are supervisors it would be helpful for them to provide some numerical guidance upon what they consider material. This could then act as a benchmark for helping to define the amounts that are used for applying proportionality.

With regard to the specific purpose of this paper, in section 1, the ICAEW provides some views and raises some concerns on the application of proportionality. We believe that the ICAEW is one of the few

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organisations with a perspective that can consider the wider implications on applying proportionality in Solvency 2 especially by small to medium sized insurance companies.

In section 2 we raise some specific concerns on supervisory reporting and disclosure requirements as provided in CP 58 Draft level 2 advice on supervisory reporting and disclosure such as the level of detail required and the format for reporting. We also cover issues such as materiality and confidentiality.

Section 1 Proportionality Principle in Solvency 2

1. The Directive applies requirements that will apply to a highly diverse population of firms, ranging from some of the biggest and most complex financial services groups in the world to some very small and simple entities providing specialised services to local communities, trades or special interest groups.

2. This leads to a problem in drafting requirements that meet the objectives of the Directive, will be appropriate to large complex entities and which do not apply undue burdens and costs to smaller entities. While the explicit objective of the Directive is enhancing the single market and the protection of policyholders there is arguably an implicit objective provided by the Treaty and by the Lisbon Strategy of enhancing innovation and promoting the competitive position of Europe. The Directive should maintain a balance between these objectives and measures to protect policyholders have to be justified in the light of fostering growth and innovation.

3. The Directive addresses the problem of varying scale and complexity through introducing the principle of **proportionality**. In summary the approach taken is that Level 1 Directive requirements are set out in a way which is ostensibly neutral to size and it is left to Level 2 measures to set out how these requirements should apply to firms of varying size and complexity.

4. We note that while discussion often focuses on *simplification*, recital 14 of the preamble indirectly clarifies that this requirement is symmetrical and is equally intended to facilitate the exercise of additional or more extensive supervisory powers over the more complex entities and groups.

> **Recital 14** The supervisory authorities of the Member States should therefore have at their disposal all means necessary to ensure the orderly pursuit of business by insurance and reinsurance undertakings throughout the Community whether carried on under the right of establishment or the freedom to provide services. In order to ensure the effectiveness of the supervision all actions taken by the supervisory authorities should be proportionate to the nature and the complexity of the risks inherent to the business of an insurance or reinsurance undertaking, regardless of the importance of the undertaking concerned for the over-all financial stability for the market.

5. For the vast majority of firms however the key concern is appropriate simplification. Recital 14(a) below and Article 28 make clear that the principle is intended to result in a reasonably close match between complexity and scale of the firm and the complexity and scale of regulation and supervision. The recital also goes on to deal with the application of solvency requirements to niche firms and the public policy justification of a lighter touch for captives and reinsurers.

> **Recital 14a.** The new solvency regime **should not be too burdensome for small and medium-sized insurance undertakings**. One of the tools to achieve this objective is a proper application of the proportionality principle. This principle should apply both to the requirements on the insurance and reinsurance undertakings and on the exercise of supervisory powers.

6. CEIOPS CP24-08: Draft advice on the principle of proportionality in the Solvency II Framework Directive Proposal sets out advice to the Commission on proportionality. Unfortunately CEIOPS starts from a different interpretation of Article 28 which (see paragraph 11 of the CP below) argues that standard provisions apply unless it would be *disproportionate* to do so.

> Proportionality does not mean the introduction of automatic and systematic simplifications for certain undertakings. The principle will be applied where it **would be disproportionate** to the nature, scale and complexity of undertakings' business to apply the general rules (quantitative and qualitative) **without relief**. The individual risk profile should be the primary guide in assessing the need to apply the proportionality principle[1].

7. This key paragraph sets the overall CEIOPS philosophy which we see is (a) proportionality is not a right but an exception and (b) the criteria governing the application of proportionality is neither scale nor complexity but risk.

8. The drafting approach throughout the various tranches of advice on Level 2 measures follows these basic presuppositions. The advice produces standard measures and where prompted by the level 1 text, gives some suggestions of how these standard measures might be relaxed. Proportionality can therefore be viewed as a concession under this approach rather than a basic principle.

9. There is also what appears to a discrepancy in how the Directive introduces the concept of risk into proportionality and how CEIOPS interprets this. Article 28 (below) requires supervisory measures to be proportionate to a number of factors including risk. It is clear that the primary objective for the measure is economic in nature, keeping compliance costs proportionate. CEIOPS however appears to regard risk as almost the sole criteria. Generally we do not see implementing measures following the spirit of Article 28(3a) below.

> **Article 28**
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> 28(3). Member States shall ensure that the requirements laid down in this Directive are applied in a manner which is proportionate to the nature, complexity and scale of the risks inherent in the business of an insurance or reinsurance undertaking.
>
> 28(3a). The Commission shall ensure implementing measures include the principle of proportionality, thus ensuring the proportionate application of this Directive, in particular to very small insurance undertakings.

10. High level recommendations:

- The application of the proportionality principle should not be in the form of a concession from a standard set of requirements;
- Requirements, including the supervisory approach to be followed, should be clearly drafted where possible to clearly outline specific requirements that are appropriate for varying degrees of scale and complexity;

- There should be criteria published, perhaps based on turnover measures and business type, which allow firms to understand whether they are complex, standard or low impact. Based on this, the tailored provisions above would apply automatically and not as a concession or waiver from the standard requirement.

Ceiops advice on the proportionality principle

Pillar 1

11. The Directive recognises, in Recital 39 below, that the standard model is complex and that a simplified approach is appropriate, purely on the basis of the size of the firm.

> Recital (39). In order to reflect the specific situation of small and medium sized undertakings, simplified approaches to the calculation of the Solvency Capital Requirement in accordance with the standard formula should be provided for.

12. CEIOPS advice agrees that a simplified regime for the application of the standard model is appropriate. However the proposals for simplification are in relation to the methods for the valuation of technical reserves as opposed the design of the model itself.

13. It is arguable that there is a spurious accuracy in the design of the standard model – it is a complex process to produce a relative arbitrary number which cannot be easily justified and which might therefore be produced no less validly by being much simpler. Part of the complexity of the model is in catering for such issues as the valuation of subsidiaries and intra group transactions which do not feature for smaller entities.

14. Where simplified measures are considered[1], CEIOPS advice is that further prudence is built into the calibration. While the supervisory rationale for this reasoning is understood, it appears to contradict the proportionality principle. Where a firm is sufficiently small and low risk such that simplified measures are appropriate, the justification for adding additional margins in the calculation is not understood. Nor can we see how it is justified to add additional costs, and therefore a material economic disadvantage, to smaller entities who already struggle to compensate for the economies of scale enjoyed by larger firms.

15. The advice also notes that it would be desirable to develop metrics for risk, nature, scale and complexity which collectively might be used to identify lower risk firms. CEIOPS-DOC-73/10 published on 29 January discusses this further and looks at how the various metrics might be combined to identify low risk firms. The discussion however is at the conceptual level and does not explain how these measures might be calibrated.

16. The paper is also notably cautious and reinforces the notion that the application of proportionality will be viewed as an exception requiring justification, against the underlying presumption of caution.

17. We have already seen some anecdotal evidence of supervisory caution in practice. Firms have the right to use a standard model unless that is not appropriate to their circumstances. Recently, we understand from contact between professional advisers and their client that some small firms have

[1] Now published in CEIOPS-DOC-73/10 and CEIOPS-DOC-72-10

been asked to justify why they think an internal model is not appropriate. This clearly reverses the burden of proof on firms.

18. Recommendations on relation to Pillar 1

- A published scale on which firms are assessed as either of "*standard* scale and complexity", *low, very low* or *enhanced/high*. In line with the Directive criteria, the scale should be primarily based on scale and complexity but it would be appropriate to allow some recognition of risk.
- It is reasonable to distinguish between low and very low. For instance a very small mutual with a turnover just above the directive minimum (article 4) of €5M which is capitalised to the directive standard is very different in scale and complexity to a firm which perhaps supplies motor insurance with a turnover of €25M. The latter is still small and simple but perhaps operates at a noticeably different level;
- Design of a significantly simplified standard model for firms that are either low or very low on the scale;
- Guidance on simplified standards both for the design of an internal model and the approval process that is appropriate for low and very low firms;
- Guidance must enshrine the right to simplified measures (such as use of the standard model) where appropriate;
- Removal of compensating loadings built into simplifying measures.

Pillar 2

19. Overall, we recognise the Directive provisions are naturally scalable and that CEIOPS advice on Pillar 2 is reasonable and proportionate.

20. The key subjectivities are around the ORSA, process documentation and supervisory review where the scale of the burden will depend in part on supervisory discretion. We would therefore urge guidelines which help ensure that supervisory requirements for the documentation and evidencing of the normal operation of risk and governance functions in smaller entities are not onerous.

21. Dealing with routine supervisory enquiries and ad hoc requests is a very significant component in the cost of compliance and to some extent it is disproportionately burdensome for small firms. We would expect to see guidance on how regulators would interpret proportionality in the course of routine supervision. So far this has been absent.

Pillar 3

22. The CEIOPS advice paper on supervisory reporting (CEIOPS-DOC-50/09) apparently recognises proportionality explicitly. However the key concession is that firms do not have to supply information that does not apply to them. This appears in the final analysis to be a concession merely not to submit forms otherwise containing zeros.

23. The beneficial effects of market discipline from disclosure are less persuasive for smaller entities and the cost benefit rationale of reporting requirements for smaller entities is therefore different. We would therefore have expected to see this reflected in reduced and simplified requirements which go significantly beyond the CP50/09 proposals.

24. We propose :

- Design of simplified reporting forms for firms that are either low or very low on the scale (using the same principle as for instance company accounts in the UK);
- The cost benefit case for reporting by smaller entities should be kept under review by EOPIC and accounted for periodically to the Parliament;
- Extended reporting deadlines for firms that are either low or very low on the scale.

Section 2

Supervisory reporting and public disclosure requirements (Former CP58)

25. The level of detail within the Solvency and Financial Condition Report (SFCR)

25.1 Article 51 has an extensive list of disclosures that are required in the SFCR that must be disclosed in the public domain, much of the language describing the level of detail within the disclosures is ambiguous. Mostly the requirement is for descriptions but to a fairly detailed level.

25.2 CEIOPS have taken these requirements and added a lot of detail to exactly what is required to the basic article 51 requirements. Although it does not seem unreasonable for most of this detail to be provided to supervisors, CEIOPS have taken the approach of putting the vast majority of the reporting requirements into the SFCR and therefore into the public domain.

25.3 This is significantly in excess of the public reporting required of banks in the EU, despite that being a sector where there have been significant recent problems. It is therefore unclear what it is that justifies this high level of disclosure.

25.4 The potential volume of information in the SFCR will be time consuming and potentially expensive to prepare and edit in a format suitable for making available to the public, where there is less scope for interaction and discussion than there is with supervisors, so potentially greater disclosure required to ensure it is properly understood.

25.5 The amount of information required in the SFCR is potentially excessive for the public to be able to readily review and understand and the key information could potentially be obscured by the level of detailed disclosure required. This information is likely to run into at least tens of pages for small insurers and may run into hundreds for a large group. There is little evidence to date that views of potential readers other than supervisors have been assessed to ascertain what information they would find helpful. In addition, there is no clarity on what information should be audited.

26. Detailed format

26.1 The requirement for a detailed format for the SFCR and Report to Supervisors (RTS) broken down into 7 main headings and 35 sub-headings is highly prescriptive. We recognise this provides important consistency across reports for supervisors and other readers; however this may not readily sit with the way a business manages and reports its risk management for other purposes. This may potentially add to the preparers costs and require extensive reporting that elements are not applicable.

27. Proportionality

27.1 Although proportionality and materiality are recognised as important in the advice this is still a difficult area in which to assess its impact.

27.2 Materiality is defined in terms of influencing the decisions of users in 3.50 with supervisors being specifically mentioned as a user in 3.51 (CEIOPS DOC 50/09). As the potential key user it is important for supervisors to articulate their vision of what is material. The materiality typically used when preparing and auditing financial statements may be considered excessive by supervisors either at an overall level of solvency or when applied to sub-levels of risk and disclosure. Without articulation this mismatch may be significant. In addition, if supervisors require information to be audited at a more granular level than applies in the financial statements audit, this will have cost implications for insurers/insurance groups.

27.3 We believe that guidance on materiality could possibly be linked to a proportion of MCR.

27.4 The extensive detailed advice regarding matters to be covered in the SFCR and RTS, even if only to state a matter is not relevant or not material, potentially requires an extensive amount of negative reporting that matters are not relevant for smaller simple insurers. The form of audit opinion connected with negative statements also needs to be considered, as it may be difficult to ensure that there really is no disclosure required.

27.5 It does not seem to be clear what the expected scale of documentation required to be prepared for all of the different elements of reporting will aggregate to across the industry. To help firms put this in perspective, it would be helpful for CEIOPS to make an estimate of how many pages they estimate a small simple company through to a large complex group will eventually need to produce for reporting purposes. This could include both the actual reporting requirements (SFCR, RTS and reporting templates). This would assist in clarifying the level of detail supervisors are likely to expect for the various reports and highlight if there is significant aggregation and duplication as is suspected by many potential preparers.

27.6 One other area that we would request be reconsidered is the need for a full RTS every year, regardless of the level of change. CEIOPS has, helpfully in our view, suggested that a full SFCR should only be required every five years if there is no significant change, with a change document approach adopted in the intermediate years. We fully support this approach, which we believe applies with the proportionality principle. However, if a full RTS continues to be required, then given the large degree of overlap between the detailed requirements in the SFCR and the RTS, it is difficult to see how this will significantly reduce the reporting burden.

27.7 In respect of the reduced SFCR, this seems slightly incongruous with CEIOPS's wish to have the SFCR as complete stand-alone documents (for example, it does not accept the ability to include hyperlinks to other documents). If change only SFCRs could be produced for up to 4 years, this could potentially require readers to have to consult several years of SFCR to be able to fully assess the situation.

28. Confidentiality

28.1 The clearance process proposed for not disclosing confidential information in the public domain is potentially very cumbersome and only really suitable for excluding a very specific matter such as possibly the full details relating to a single major dispute.

28.2 Although the final format of the reporting templates remains to be finalised, they are all anticipated to be part of the SFCR with some elements being in the public domain. Certain of the forms potentially contain information that may be commercially sensitive and therefore should only be required as part of RTS. We would welcome production of the final forms for discussion at an early opportunity. In particular, the requirements for group disclosure need to be able to be assessed in the context of multi-jurisdiction groups (including in third countries, many of which will not be equivalent). This may make the production of the group templates difficult if very detailed information is required.

29. Overlap with financial statements

29.1 There is potential for duplication and confusion between reporting of risks and their management in the financial statements as well as in the SFCR. For many readers the financial statements are the primary source of information on a company and may lead to confusion if a very different set of numbers and risk reporting are also required to be reported upon without linkage between the two reports. We believe the financial statements should be the primary reporting with any solvency reporting in the public domain primarily focussed on reconciling the adjustments to the financial statements necessary to produce the solvency result. Highly granular reporting in the public domain of solvency numbers prepared on a different basis will potentially be confusing or of little use to many readers. We believe CEIOPS should consult with potential users to ascertain how they would wish this information to be presented.

29.2 The quantitative and qualitative reporting templates required should also aim to start from financial statements rather than solvency calculations if they are to be meaningful to readers in the public domain.

30. Stand alone documents

30.1 The requirement for both the SFCR and RTS to be stand alone documents, although attractive and logical for the recipient is a further potential burden for the preparer.

30.2 If the SFCR were permitted to be a rather briefer overview document rather than providing all of the detail that the regulator may require, as currently proposed, the burden of this being a stand alone document would decrease.

30.3 However, if as currently proposed the SFCR continues to be required to contain most of the required disclosures, the additional information in the RTS should be modest. In such circumstances for preparers it would be easier to prepare the additional RTS information as an appendix to the SFCR and cross referenced to the body of the SFCR. This should not be significantly more difficult or time consuming for the supervisor to review.

30.4 It would be helpful to confirm that if it is intended to utilise financial statement disclosures to avoid duplication that since hyperlinks are not permitted by the proposals it would be acceptable to include financial statements as, say, an appendix to the SFCR or RTS and cross reference to them from the body of the SFCR/RTS. We would also welcome clarity regarding whether links to other documents may be acceptable if the SFCR and all supporting documentation are contained on a self-contained area of a firm’s website. Whilst this would still require production in full for any paper SFCR requested, this could significantly reduce the admin burden on firms.

31. The level of detail for groups

31.1 Although the latest version of advice on CP58 clarifies some aspects of the different levels of reporting for groups and recognises slightly extended timetables for certain group reporting there still appears to be potential for significant repetition of SFCR and RTS disclosures at solo and group levels.

31.2 Until the reporting templates for groups are available, it is difficult to assess how burdensome these will be to produce. We welcome the fact that CEIOPS has recognised that additional time will be required to collate the groups information, but believe this could still be burdensome on groups with significant non-EEA subsidiaries, who will need to collect very granular information from these companies to enable some of the disclosures to be made. This will be more difficult for those groups that do not have a groups internal model approved.

31.3 We also seek clarification regarding the extent of disclosure (SFCR, RTS and templates) required in respect of the ultimate worldwide group, where this is not within the EEA. As drafted in the Directive, the reporting requirements do not appear to apply, so that it will be for supervisors to determine the reporting they require to enable their supervision to be effective. We believe that this should result in a reduced RTS and templates and no SFCR.

32. Branches of non-EEA insurers

32.1 We note that CP 58 did not address the question of branch and third country insurer disclosure at all. In this regard, we note that Article 162 is the best source of information regarding the requirements of third country insurers. However, this does not address disclosure.

32.2 In this regard, we believe that supervisors will need to use Article 168 and Article 34 in the Level 1 Directive in order to obtain information relevant to their needs to supervise the branch. As with the ultimate worldwide group, we believe this should result in no SFCR, but requirements for a reduced RTS and templates.

32.3 It is important for such firms to understand the level of disclosure likely to be required in respect of the third country insurer itself. In this regard, it may be possible for proportionality to apply, so that the detailed requirements relate only to the EEA branch, with information on the third country insurer limited to an assessment of its solvency (on a Solvency II basis).

32.4 Since Article 168 in the Level 1 Directive is being used to determine the requirements, we would also seek confirmation that the reporting timelines outlined in CP58 and its Final Advice would not apply. In the UK, where we have existing branch and legal entity FSA Returns, a number of firms have received extensions to the filing deadline in relation to the legal entity Returns, and we would like to see similar flexibility remain, which will not be possible if the filing deadlines are hard coded.

32.5 We believe that there should be consistency across the EEA in relation to the treatment of EEA branches of third country insurers, and those insurers themselves, and welcome some early clarifications in this area.

33. Audit

33.1 We believe that an auditor’s confirmation should ideally only be required for elements of the SFCR, RTS or related forms where there is a high perceived risk of error or significant savings can be made in the costs of supervisory review as a result of their ability to reduce detailed checking of documentation if it has been audited. In addition for public domain information there may be certain key information that readers would consider important to be audited. However, this may potentially be quite limited and there is little evidence to date that views of potential users other than supervisors have been assessed to ascertain what information should be audited.

33.2 As information in insurer's financial statements will have already been subject to an audit. If audited documentation for solvency can be based upon financial statements as far as possible, the need to audit a second set of figures and the related cost will be reduced.

33.3 There is potentially a significant amount of qualitative rather than quantitative information within the returns that is currently expected to be audited. It is often more difficult to clearly express audit opinions upon narrative rather than figures. It is important that the supervisors adequately understand and review an entity's risk management processes as part of their supervisory responsibilities. It would therefore seem logical that supervisors will undertake significant review of the effectiveness of risk management procedures, including approval of models. In such circumstances the additional cost of audited narrative information may provide little reduction in the work undertaken by the supervisors.

33.4 There are several different types of audit opinion, including negative assurance (eg nothing has come to our attention to cause us to believe that the following do not apply), and not all of the proposed elements included in CP58 as requiring an audit will fit neatly into one form of opinion. We therefore recommend that there is close liaison with FEE to ensure that audit requirements are practicable and reporting will be easily understood by readers. In particular it will be important to readily identify which information has and has not been audited and any limitations to the scope of the audit work.

34. Timetable

34.1 Even though the reporting timetable has been relaxed for the first two years the timescales still appear very challenging, particularly for groups where there may be varying degrees of aggregation of reporting required.

34.2 The quarterly reporting timetable also still looks very challenging if anything other than a relatively brief overview is required. Often quarter end numbers are not finalised until the end of the following month at the earliest, particularly where there are no stock market reporting requirements.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

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