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Our ref: ICAEW Rep 70/10

Karel van Hulle
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Insurance and Pensions, Financial Institutions
European Commission
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Dear Mr van Hulle

Audit of Solvency II information

The ICAEW welcomes the opportunity to provide its views as the European Commission develops its policies towards the audit of Solvency II information.

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We provide our views on the audit of Solvency II in the appendix. These were developed with input from our Insurance Committee members and Solvency II working party members, both of which include preparers and auditors. We consulted with members of the FEE insurance working party. Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

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AUDIT OF SOLVENCY II INFORMATION

MAJOR POINTS

1. We gave our initial thoughts on the proposed reporting and disclosure requirements with regard to Solvency II in our response to Consultation Paper 58 (CP58). In this submission we highlight some of the considerations around the provision of audit. Based on informal discussions with EU Commission representatives, our understanding is that the particular areas of attention being considered for audit work at this time are the solvency balance sheet and the calculation of the Solvency Capital Requirements (SCR) and Minimum Capital Requirement (MCR). If the proposals around what may be audited are indeed now focused on a narrower range of information this would be consistent with our response to CP58, and we would welcome this as we consider it to be more proportionate. We would be happy to provide more concrete views in due course, but would wish to see a draft of what is being proposed.
2. We wish to emphasise that whilst certain information is clearly capable of being audited, it does not follow that annual audits should be mandated for this or any other information. We are concerned that extensive mandatory audit requirements for all insurers may represent a move away from the principles underpinning Solvency II, which is intended to be a risk-based approach to managing solvency and may be seen as substitute for what should properly be covered by Supervisory review. Periodic reviews of specific Solvency II information produced by some or all insurance firms may be sufficient to support the regulatory process, leaving firms to decide whether to commission additional external assurance on the information they produce or for Supervisors to request such information.
3. As insurers will already be incurring compliance costs to meet Solvency II requirements, it is essential that any further increase in insurers' third party expenditure is commensurate and reasonable. The likely overlap between the audit of disclosures made under International Financial Reporting Standards and for Solvency II reporting purposes will limit the extent to which incremental audit costs increase.

DETAILED COMMENTS

General assurance considerations

4. The role of an audit is to provide independent external assurance to those to whom the audit report is addressed regarding the information covered by the audit certificate. Whilst recognising that an audit opinion can provide supervisors and other readers with additional confidence in Solvency II information, there are a number of issues that would first need to be addressed, including those below.

The information upon which users seek independent external assurance

5. Potentially, independent external assurance could be provided on the public disclosures in the Solvency and Financial Condition Report (SFCR) or on the information provided to supervisors in the Report to Supervisors (RTS) and Quantitative Reporting Templates (QRT).
6. We do not consider there to be significant demand amongst policyholders for Solvency II information to be audited. We think that policyholders will gain more assurance from knowing that the insurance company is appropriately regulated.

7. Turning to supervisors, consideration needs to be given to the work that they themselves undertake. Whilst assurance can be valuable in some areas, in others the supervisors will have performed enough work themselves not to need the additional assurance provided (for example in relation to model design) or there may be no need for independent assurance (for example in verifying the entire list of investments held). Even if assurance is required, we would suggest that supervisors consider applying a risk-based approach which involves requesting a report on specific companies' information in a particular year, rather than establishing an annual requirement for all firms.
8. We are aware that in Germany a private long-form report which is audited is made to supervisors. This type of approach might form a useful model for Solvency II if the Commission decides there is information which needs to be audited annually.

To whom the auditors would owe a duty of care

9. Auditors take great care to ensure that the scope of the work on which they report is clearly articulated and that their responsibility relates solely to those to whom the report is addressed and not to the population at large. Audit reports on financial statements for example, are addressed to the shareholders of a company; they are the ultimate owners of the company and seek comfort that the disclosures made give a true and fair view of the position of the company at the end of the year and of its activities throughout the year. In respect of statutory audit reports on the financial statements, UK audit firms generally include a paragraph clarifying that they have no responsibility to anyone else that reads the financial statements and audit opinion and who seeks to place reliance on them.
10. However, currently audit opinions relating to UK regulatory returns are addressed to the directors of the company, as a body, since the regulator places the obligation on the company to file the returns and requires them to obtain an audit opinion in relation to them. Usually audit firms include a paragraph, where relevant, recognising that regulator(s) will also place reliance on the opinions formed, but excluding any duty of care to any other user of such statements (the returns being publicly available).
11. The key consideration should therefore be regarding who will seek to place reliance on the disclosures and whether this is reasonable from an auditor's perspective. In this case, it does not appear to be the directors or shareholders that are the intended audience, but rather supervisors and potentially even policyholders (or more likely those advising actual and potential policyholders).

The form of assurance to be provided

12. Assurance can take the form of positive assurance (for example 'fairly state', 'properly prepared'), negative assurance (for example 'nothing has come to our attention to suggest') or limited assurance (for example 'based on the procedures performed'). It is likely that different elements of the required disclosures will lend themselves to different forms of opinion. Different procedures can provide valuable assurance but carry less risk for the auditor, and are therefore likely to be easier for auditors to perform and report on. In addition, there may be some areas where it will be impractical for any assurance to be given at all (for example assurances as to whether any breaches of Solvency Capital Requirements (SCR) and/or Minimum Capital Requirement (MCR) occurred during the year).
13. Notwithstanding this, we can see the potential benefit in selected external audit work in relation to Solvency II reporting, but feel it is important that the information to be audited and the nature of the opinions required are given careful consideration to ensure any requirements are clearly understood by all parties and that the assurance work is valuable to users.

Ensuring the assurance work adds value: establishing the purpose of the work

14. Were information to be required to be routinely audited as part of Solvency II requirements there are a number of questions that would need to be addressed:

i) What are risks if the work is not performed?

In respect of supervisor's requirements for audited information within the RTS or QRT, a decision needs to be taken as to whether they perceive there to be a significant risk of inaccurate or inadequate reporting if the information is not audited. If so, is this pervasive across the industry or in relation to certain companies? If the latter, then this may be best addressed through a specific request for a tailored report, rather than a routine audit requirement for all companies.

ii) How will assurance affect what supervisors do?

If information is audited will this allow the supervisor either to do less checking themselves of the returns or less intensive inspections of insurers? If this is so, will this reduce supervisory charges to insurers?

On the subject of the relationship between auditors and regulators, assurance work should clearly not be a substitute for poor regulation. Additional assurance work would not be an appropriate response to concerns about the general quality of regulation across the EEA.

Furthermore, assurance work may assist regulators, but should not replace a sound understanding within the regulator of the entities they regulate, nor allow supervisors to seek to abrogate their responsibilities.

iii) Is reporting on public information necessary?

In respect of public disclosure under the SFCR (including relevant extracts from the QRT), one question that needs to be considered is whether there is significant demand from the public for assurance of such information and whether there would be a lack of public confidence if the information were not to be audited. As we mentioned above, we are not convinced that there is clear demand for the audit of public disclosures.

iv) Powers to commission specific work

Should the audit requirement be routine for all insurers or only when the regulator has expressed a concern regarding a particular insurer or the information they have provided? In the UK the FSA can (and does regularly) request a tailored report, which would be known as a "Report by a Skilled Person" under section 166 of the Financial Services and Markets Act 2000. While we appreciate that this approach is not used widely throughout the EEA we could see that providing such powers to supervisors could be desirable. It would increase flexibility and be consistent with a risk-based approach to solvency.

Considerations relevant to routine audit requirements

15. If after the above questions are addressed it is felt that routine audit of certain information produced by insurers would be beneficial, the following issues require consideration:

i) Overlap with financial statements audit work

The extent to which the information has already been subject to full external audit would have a significant bearing on the level of additional audit work required to provide an opinion on the relevant Solvency II information. For example, many insurers (particularly the larger companies) prepare or will prepare financial statements under IFRS; as such they will be required to make various disclosures in their financial statements regarding risks in accordance with IFRS 7, Financial Instruments: Disclosures and IFRS 4, Insurance Contracts. A number of other accounting standards also require disclosures regarding risk. It is therefore likely that audit work will have been undertaken

in various cases regarding disclosures of risks and values, often with reference to Solvency II evaluations within the financial statements. Provided the level of disclosure required for Solvency II reporting that auditors are required to report upon is not significantly more than the risk disclosure levels in the financial statements, it should be possible to provide additional assurance without undertaking a significant amount of additional audit work.

ii) Scope of work

- There would need to be clarity on the precise scope of external assurance work to be performed, with agreement of the form and addressees to whom the assurance report will be issued. Any required external assurance from auditors should be clearly defined by reference to relevant professional standards such as International Standards on Auditing (ISA) or International Standards on Review Engagements (ISRE) issued by the International Auditing and Assurance Standards Board.
- Consideration should be given to whether any reporting by external auditors should be private reporting to supervisors or public reporting on elements of the SFCR (including relevant extracts from the QRT). Auditors will wish to manage their liability, particularly in respect of public reporting, and the type of opinion they are required to give will be a factor in this.
- Is there likely to be appropriate evidence to support the required opinion? For example, it may be difficult for the company to provide sufficient evidence to support its assumptions at the tail of the distribution curve.
- Proportionality could have a significant impact on the approach adopted by companies in some areas. The impact of materiality and proportionality will need to be clearly understood so that the auditor and reader have a consistent understanding of the potential for error within the opinion.
- Would the auditor's opinion address largely quantitative information or also significant qualitative narrative information?
- Would the opinion relate only to specific information disclosed or will it also be required to cover the process of generating the numbers, including assumptions made? For example would the opinion address whether an amount is correctly extracted from the model and entered onto a report, or would the opinion address whether the (whole) model used for calculating the numbers meets all requirements of Solvency II (a far more detailed piece of work)?
- Is the wording to be in the manner of a positive "reasonable assurance" confirmation or "limited assurance" e.g. "nothing that we are aware of would make the statement incorrect"? The second form of opinion may be more practical in some areas (for example, where it is difficult to test for completeness).

iii) Frequency of reporting

Would the assurance requirements extend only to annual information? To what extent would the auditors need to assess underlying processes? If the quarterly QRT were to be subject to audit, would the work be of value to supervisors, given that it may have been prepared on the basis of a company's best endeavours?

Considerations in relation to the solvency balance sheet

16. As discussed in our opening paragraphs, we understand that the solvency balance sheet and calculation of the MCR and SCR are being considered as areas which would be subject to assurance. We set out below particular considerations concerning this information .
17. It should be relatively straightforward to provide assurance as to whether the balance sheet has been valued according to Solvency II principles for most assets and liabilities, although this would be more challenging for technical provisions. The scope, work and opinion could probably be expressed in relatively straightforward terms and could be expressed as a positive confirmation.
18. Where the company prepares its financial statements based on International Financial Reporting Standards (IFRS) the extent of changes to produce Solvency II figures should not be very extensive

other than for technical provisions. Where the financial statements are not prepared under IFRS the conversion to Solvency II may be more complicated in the short term although convergence with IFRS may occur across Europe in the longer term. An audit of balance sheets for the purposes of Solvency II is therefore likely to be commensurate with audit work required for financial statements, although for life insurers this may be more difficult, particularly in relation to insurance contracts treated as investment contracts under IFRS. With the exception of technical provisions which are more complex, assurance could be provided to supervisors without too much additional audit work (and cost). This should also allow supervisors to reduce the extent of their review of this area and thereby reduce their costs and time spent making enquiries of insurers.

19. As noted above, the audit of balance sheet technical provisions will present more of a challenge. If it is assumed that there is a new IFRS standard in place for insurance contracts, the current diversity of approaches to assessment of technical provisions should reduce. However, this will not address those insurance contracts treated as investment contracts under IFRS and unfortunately it appears unlikely that any IFRS will produce a technical reserve that is the same as that for Solvency II, although the underlying approaches may be quite similar.
20. Both requirements are likely to require a best estimate of liabilities as a core element of the technical reserves. Provided this is the case it may be possible for the technical provisions in relation to insurance contracts to be audited without too much additional work, but this will depend on the level of granularity applied in the Solvency II disclosures, which could be more detailed than that included in the financial statements. It is likely that the new IFRS will in any case lead to additional audit work being required in connection with technical provisions within the financial statements. The audit work should then be able to concentrate on ensuring that any specified factors required by Solvency II, such as discount factors and risk margins, have been correctly applied. Another concern will be whether the insurance contracts IFRS will either mandate or allow the use of the unearned premium approach on short duration contracts, which is inconsistent with Solvency II valuation principles.

Considerations in relation to calculation of the MCR and SCR

21. Supervisors should have obtained a high level of confidence in an insurer's own model as part of their approval of the model for use in determining the SCR. The model approval process of the supervisor could include requesting confirmation that a review has been conducted on behalf of the insurer by parties external to those producing the model. On this basis we do not recommend further external audit review, which would simply duplicate this work. However, assurance could be given on the reasonableness of assumptions made in producing the year end information. Where changes have been made to a model there may be a stronger case for independent assurance of the model.
22. It could potentially be difficult to define the scope of the assurance work unless the report is based on specific agreed-upon procedures, with a limited assurance opinion. Such an approach would help to avoid a significant increase in the level of audit work required when an insurer has used its own model rather than the standard formula, to determine the SCR.
23. If the audit opinion were to refer to amounts in the MCR or SCR being correctly extracted from the model or standard formula calculation and referring to certain specific checks made it would be feasible to provide assurance without very extensive additional audit work.
24. The audit requirement should be expressed in such terms that auditors can rely on the work of other internal or external experts at the insurer or commissioned by the insurer to avoid duplication of effort. Where the insurer uses an internal model to determine its SCR, the auditors should also be able to rely on the approval of the internal model by the supervisor. If the opinion wording necessitated additional actuarial work to be undertaken in order for auditors to provide their opinion this would potentially significantly increase costs.

Group considerations

25. It should be noted that whilst the above comments have been structured primarily by reference to disclosure requirements of solus EEA (re)insurers, there could be significant challenges regarding the audit of group disclosures. There are likely to be many variations of group partial internal models in place, all requiring a mix of both local and non-EEA input from around the group. Worldwide group disclosures could be particularly challenging. It is assumed at this point that, in the event of equivalence, any disclosures would fall under the local equivalent regulatory requirements and not be subject to audit within the EEA, although it is unclear at present how the role and extent of audit in any equivalence assessment will be determined. However, in the absence of equivalence, Article 262 of Directive 2009/138 leaves it for Member States to decide, on a case by case basis, whether to apply the Solvency II group rules in their entirety or to adopt “other methods” of group supervision. This may lead to a lack of clarity and consistency as to the scope of audit requirements. Also, if the groupings do not fit closely with the reporting groups for risks in financial statements this may increase the additional audit work for Solvency II reporting.
26. Where different entities within a group have different auditors this is likely to give rise to additional issues (eg. as concerns cost and efficiency).
27. We would not support a solution which mean that scrutiny was being conducted at the level of the individual company and then duplicated at the group level.

Technical Skills

28. We are aware that additional specialist skills will be needed to prepare and audit Solvency II information. Indeed, as a Faculty we are currently organising our next Solvency II workshop on measurement and reporting for late September. Such courses will help skills develop over time, but in the short to medium term the lack of suitably trained and experienced audit staff might easily increase the cost or duration of the review.

Conclusion

29. In conclusion it appears likely that some audit work with regard to figures within the QRT (provided they are carefully defined and scoped) could provide some useful comfort for supervisors with regard to balance sheet values used in Solvency II. This could also be extended to certain elements of the calculation of the MCR and SCR. There should, however, be clarity regarding what is subject to audit, to ensure that only work that adds value is performed. Assurance work will be more justified where it will reduce the need for supervisors to regularly check and enquire into information produced by insurers.
30. We would need to have further information as to the precise areas where external audit may be required and the possible nature of assurance sought in order to give a more specific response as to how the scope and style of any audit opinion can be formulated to provide the necessary degree of assurance for users at an appropriate cost. We would however be happy to provide further input should you wish us to.

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