



Institute  
and Faculty  
of Actuaries

# CP43/15 SII: external audit of the public disclosure requirement

IFoA response to the Prudential Regulation  
Authority

19 February 2016

## **About the Institute and Faculty of Actuaries**

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.



SII: CP43/15 Response  
Ellie Goodsall  
Audit and Accounting Policy  
Bank of England Threadneedle Street  
London  
EC2R 8AH

19 February 2016

Dear Ms Goodsall

### **IFoA response to CP43/15 SII: external audit of the public disclosure requirement**

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Prudential Regulation Authority's (PRA) consultation paper on the external audit of the public disclosure requirement under Solvency II (SII). The IFoA's Life and General Insurance Boards have been involved in the drafting of this response. Some members of these boards have been actively engaged with the implementation of SII, or are involved in financial reporting roles and corresponding external audit.
2. We welcome the clarity this consultation provides in setting out the PRA's proposals with respect to the external audit of elements of the Pillar 3 disclosures. We also appreciate that the PRA will be working to tight timescales with the external audit requirements proposed to take effect from 30 June 2016.
3. The IFoA supports the overall intention of the proposal, that the quantitative and qualitative information within the 'Valuation for solvency purposes' and 'Capital management' sections of the Solvency and Financial Condition Report (SFCR) be subject to external audit. We recognise the benefits of external audit, in enhancing the reliability and credibility of audited public disclosures.
4. Our main comment on this consultation relates to the proposed exemptions from external audit scope.

### **Exemption for Partial/ Internal Model ('IM/PIM') SCR**

5. Clearly, the Solvency Capital Requirement (SCR) is a fundamental aspect of the SII balance sheet, and SII in general. We believe that the proposed exemption from external audit scope of the SCR, where based on an approved IM/PIM, is flawed.
6. The SCR is almost invariably a material component of an insurer's SII balance sheet. The same can be true of the risk margin which is driven by the SCR. This means that, if these items are outside scope, an external audit would provide less assurance than otherwise. This reduced assurance would also apply to significant elements of the overall balance sheet. Although it is true that the other in-scope elements of the balance sheet form the foundation of the SCR, external audit of the assets and technical provisions is a necessary but not sufficient condition for providing external audit / robust assurance of the overall solvency position.

7. As well as being a significant element of a given balance sheet, SCRs calculated using an IM/PIM are also likely to be significant in absolute terms. Many of the larger UK insurers will have opted for an internal model, and on the ground of materiality there is a particular benefit in their SCR being subject to external audit. Such firms are often complex in nature, which again suggests that being subject to external audit would be particularly useful.
8. Paragraph 2.20 of the consultation paper justifies the exemption of an IM/PIM SCR from external audit scope on the basis that it would be calculated on the insurer's own basis of preparation and so is less comparable between firms. However, this is true of wider aspects of the SII balance sheet; for example, insurers set assumptions using their own choice of bases.
9. Paragraph 2.21 suggests that external audit of an IM/PIM would duplicate work done by the PRA during its own review process. However, we believe that external audit, with appropriate limitations, would complement rather than duplicate the PRA's validation. We understand that the proposed audit in respect of a Standard Formula (SF) firm would consider the correct application and calculation of the (defined) SF parameters at a particular reporting date. We believe that it would be equally relevant that the correct application and calculation of the (approved) IM/PIM would be the subject of audit assurance.
10. We would not, however, propose that the audit firm provide an opinion as to the *appropriateness* of the IM/PIM. We see this as consistent with there being no requirement to provide an audit opinion as to whether the SF continues to be appropriate.
11. We recognise that there are challenges with regards to the reference point against which the audit would be performed. We would expect that the IM/PIM underlying risk calibrations may well have been updated between the basis originally approved and that applied at a subsequent valuation date, and will, in any case, use different nominal parameters as a result of being applied against an updated base balance sheet, with updated assumptions. However, we believe that a reasonable assurance opinion may still be given, against a basis of preparation which encompasses any minor updates in line with the firm's model change policy.
12. We also wonder if the partial internal model exemption may be 'binary' in its application. If a firm's SCR is calculated substantially on the standard formula, why should the full SCR then be exempt from external audit scope as implied by the consultation?

### **Exemption of the Risk Margin**

13. Notwithstanding the possible exemption of the IM/PIM components of the audited SCR, we consider that the calculation of the Risk Margin is an area which contains significant complexity and which has, in some cases, been subject to significant approximations and varying approaches. As such we consider that this is an area in which external assurance would be appropriate.

### **Cost Benefit Implications**

14. The increased scope of the audit implied by the changes suggested above, would clearly lead to an increase in costs for IM/PIM firms relative to the approach envisaged within the consultation paper. We note that the firms affected will tend to be larger; while the nominal

audit costs may be larger than for the smaller SF firms, but we would expect this, on average, to be smaller relative to the size of the firm and hence proportionate.

### Other Points

15. The Chief Actuary will be validating and reporting on the technical provisions alongside the SFCR that is being audited. The question arises over how much of the qualitative components parts of the SFCR are capable of audit. If it is not auditable, then there may be reliance on the validation by the Chief Actuary. The PRA may therefore wish to exclude these matters from the proposed external audit scope.
  
16. A range of SII applications may be relevant to the results within the Pillar 3 disclosures, including transitional adjustments and the matching adjustment, for example. There may be situations where the relevant PRA application approval letter is quite high level, unlike typical waivers under the old regime which often amended rules in a straightforward way. The corresponding detail in today's regime is often in the application and the PRA discussion around it. It is unclear the extent to which an external auditor would have to consider such applications, which may authorise complex calculations or procedures, or have to rely on a basis of preparation which could include, on the public record, fairly sensitive detail of the application's precise workings. For example:
  - a) a transitional measure for technical provisions relies on unaudited ICA results as at 1/1/16 and potentially a recalculation using approximate ICA and Solvency I results under a subsequent reassessment of the transitional deduction
  - b) a matching adjustment application has a wealth of detail including internal rating of stocks, approach to securitisation of certain blocks of assets, acceptability of modified Spens clauses and approach to permissible surrender options.

Again, the PRA may wish to exclude these matters from the proposed external audit scope.

17. We have no concerns in relation to the proposal to exclude information in the SFCR where compiled using sectoral rules.

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager ([steven.graham@actuaries.org.uk](mailto:steven.graham@actuaries.org.uk) / 0207 632 2146) in the first instance.

Yours sincerely



Fiona Morrison  
**President, Institute and Faculty of Actuaries**