



**KPMG response to Consultation Paper CP104**

Consultation on External Audit of Solvency II Regulatory Returns / Public Disclosures

**29 July 2016**

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## 1. Introduction

KPMG welcomes the opportunity to respond to the Central Bank of Ireland's ("CBI") Consultation Paper 104 ("CP104") "External Audit of Solvency II Regulatory Returns/ Public Disclosures."

KPMG is a leading provider of professional services in Ireland. We work with clients in all sectors of Irish business, including many of the leading insurers and reinsurers, providing a range of Audit, Tax and Advisory services. Our insurance practice is involved in both professional and industry bodies and takes an active role in pursuing regulatory, accounting and tax issues affecting the industry.

Our response is structured as:

- Key observations
- General observations
- Drafting observations

We would be delighted to discuss our response further with the CBI. Related contact details are set out at the end of this document.

## 2. Key observations

We welcome the overall content of CP104.

The key observations arising from our review of CP104 are as follows:

- We note that the domestic actuarial regime and related governance requirements introduced new responsibilities for the Actuarial Function in relation to technical provisions, including an annual actuarial opinion and reporting on technical provisions by the Head of Actuarial Function ("HoAF"). The requirement for a Peer Review of the actuarial opinion and related actuarial report on technical provisions for high, medium high and medium low impact undertakings at periodic intervals is retained from the previous regime. We also note that CP104 proposes that the external auditor provide a reasonable assurance opinion on certain elements of the Solvency and Financial Condition Report ("SFCR"), including technical provisions. We would consider it good practice that where such requirements are being introduced, a detailed cost benefit analysis of the impact is conducted and a summary of the conclusions are publically disclosed in order to support the proposal.
- Based on the requirements of Solvency II, the domestic actuarial regime and related governance requirements and CP104, the external auditor would be the only party providing an opinion on the SCR calculation. We believe that this is a gap in the overall requirements and would recommend the introduction of additional guidance whereby other function holders could be accountable and provide assurance on the SCR calculation which is in scope of CP104.
- We would recommend that those charged with governance of the undertaking include a directors' responsibilities statement in the SFCR or privately to the CBI, acknowledging their responsibility for the preparation of the SFCR in accordance with the requirements of Solvency II.
- We note that the proposed requirements would bring all captive insurance and reinsurance undertakings within scope. We also note that the majority of captive undertakings use the standard formula and therefore the full Solvency Capital Requirement ("SCR") template would be subject to a reasonable assurance opinion. The captive sector is cost sensitive and a proportionate approach based on the level of risk of a particular undertaking could be considered. There are other approaches that could be adopted by the CBI, which may be more cost effective, such as excluding low risk appetite captives and re-categorising the larger captives.

- For undertakings using approved partial internal models, we are of the view that there is limited additional value to be obtained from scoping in the standard formula elements of the SCR templates. We note that the Prudential Regulation Authority (“PRA”) in the UK has scoped out this requirement. In some cases, the standard formula elements are likely to be a relatively routine calculations (i.e. the operational risk module) and many of the important elements of the SCR calculation for these undertakings will be out of scope. In other cases, where the standard formula element is more significant, it will be a challenge to clarify the scope as noted below.
- Consideration will also need to be given as to how the auditor clarifies the scope of the reasonable assurance engagement for undertakings using full or partial internal models in respect of the elements which are out of scope and the impact on the auditor’s opinion.
- We note that the reasonable assurance opinion on prescribed elements of the SFCR will be a private audit report submitted to the CBI and that the SFCR is a public document. Consideration will need to be given as to how the scope of the engagement and the nature of the opinion in the private audit report are communicated in the public SFCR.

### **3. General observations**

#### *3.1 Levels of assurance*

We note that the Solvency II Directive and Delegated Regulation (EU) 2015/35 contain requirements that insurance and reinsurance undertakings need to comply with in relation to the Actuarial Function. These requirements have been implemented in Ireland as per the European Union (Insurance and Reinsurance) Regulations 2015, the relevant national implementing legislation.

We also note that the CBI has formalised Irish requirements in relation to the Actuarial Function and related governance arrangements which apply to all undertakings subject to Solvency II.

These requirements include, but are not limited to an annual actuarial opinion and reporting on technical provisions by the HoAF and the requirement for a Peer Review of the actuarial opinion and related actuarial report for high, medium high and medium low impact undertakings. The Peer Review is required to take place in periodic intervals of between 2 to 5 years depending, on the impact rating of the undertaking. Overall, we would consider the Irish requirements for the Actuarial Function, together with the various external reviews, to be at the higher end of the spectrum of requirements across the EU.

We note that CP104 proposes that the external auditor provide a reasonable assurance opinion on certain elements of the SFCR, including technical provisions. While we welcome the overall content of CP104, we would consider it good practice that where such requirements are being introduced that a detailed cost benefit analysis of the impact is conducted and a summary of the conclusions are publically disclosed in order to support the proposal. We note that in the UK, the PRA is required to perform a cost benefit analysis of the impact of proposed rules.

We also note that the Peer Review reporting timeframe is not consistent with the annual reporting timeline for the HoAF and external auditor and their reporting to those charged with governance of the undertaking. Consistency will be of critical importance in order to maximise the value of the assurance and opinions being provided.

### *3.2 Accountability and assurance on the SCR calculation from within the undertaking*

We note that under the Irish actuarial regime and related governance requirements under Solvency II, there is no requirement for an undertaking's function holders to provide an opinion or report on the SCR.

The main focus of the HoAF responsibilities under the Irish actuarial regime, in addition to those areas contained within Article 48 of the Solvency II Directive on the actuarial function, is the requirement to provide an actuarial opinion on technical provisions and an actuarial report supporting the actuarial opinion. We also note that the Peer Review requirement for high, medium high and medium low impact undertakings includes a Peer Review of the actuarial opinion and related actuarial report.

Based on the proposed requirements in CP104, the external auditor would be the only party providing an opinion on the SCR calculation, where it is calculated using the standard formula or in the case of those undertakings using an approved partial internal model, those elements of the SCR which are calculated using the standard formula.

We believe that this is a gap in the overall requirements and would recommend the introduction of additional guidance whereby other function holders could be accountable and provide assurance on the SCR calculation which is in scope of CP104. This extension would bridge this gap so that the external auditor is not the only party providing an opinion on the SCR, where applicable.

### *3.3 Directors' responsibilities statement*

We would recommend that those charged with governance of the undertaking include a directors' responsibilities statement in the SFCR or privately to the CBI, acknowledging their responsibility for the preparation of the SCFR in accordance with the requirements of Solvency II.

It would also maintain consistency with practice in relation to the financial statements and past practice in relation to annual regulatory reporting. The clarity of responsibilities is beneficial for both users and external auditors in providing a reasonable assurance opinion.

### *3.4 Captive insurance and reinsurance undertakings*

We note that the CP104 requirements cover all insurance and reinsurance undertakings regulated by the CBI. This would bring captive insurance and reinsurance undertakings within the scope of external audit requirements. We also note that the majority of captive undertakings use the standard formula to calculate the SCR and therefore the full SCR template would be subject to a reasonable assurance opinion from the external auditor. The captive sector is cost sensitive and current audit fees are very competitive. We anticipate that additional fees to address the scope of CP104 for a captive undertaking could be a multiple of the existing financial statement audit fee (between 2 to 4 times the current fee).

We also note that captive insurance and reinsurance undertakings tend to have low impact ratings, reflecting the fact that they are not deemed to be a significant risk to financial stability and consumers and are consequently subject to a lower level of regulatory supervision.

We understand that the International Monetary Fund Report on Observance of Standards and Codes for the Irish insurance sector in May 2015 ("IMF ROSC") noted a number of observations in relation to the supervisory review and reporting of low impact undertakings. The IMF ROSC noted that the "reactive supervision mode for low impact (re)insurers is reflective of CBI's supervisory risk appetite, including reputational risks. It is important that this risk appetite is monitored based on adequate information and regularly updated." The IMF ROSC highlighted that a "qualitative assessment of the risk probability is an important factor for the on-going monitoring of CBI's risk appetite" which should include low impact undertakings "in a proportionate manner rather than a one-size-fits-all exclusion of

such (re)insurers,” and in relation to regulatory returns, “a proportionate coverage of low rated (re)insurers in terms of independent supervisory verification of their returns (rather than a complete carve out) will provide better assurance that supervisors may rely on the regulatory returns as a reasonable trigger for action.”

We recommend that the CBI perform a cost benefit analysis of the impact of the proposed requirements contained within CP104 on the captive insurance and reinsurance sector in Ireland. It may be more appropriate to take a proportionate approach to the captive sector. There are other approaches that could be adopted by the CBI, which may be more cost effective, such as excluding low risk appetite captives and re-categorising the larger captives.

### *3.5 Standard formula element of SCR calculation for undertakings using partial internal models*

The CP104 requirements propose to include elements of the SCR template which are calculated using the standard formula as part of the reasonable assurance opinion. The other elements of the SCR template calculated using an approved partial internal model would be excluded.

We note that in the UK, the PRA consultation paper CP23/16 “Solvency II: external audit of public disclosure requirements” has scoped out templates relating to the SCR for undertakings/ groups using both the standard formula and partial internal model from the reasonable assurance opinion.

We understand that the PRA is of the view that the external audit of the SCR calculated using an internal model or partial internal model would not provide the same degree of confidence that the SCR has been properly prepared in all material respects with Solvency II requirements, as the audit of the SCR calculated using the standard formula. The PRA also notes that any audit work on the SCR calculation using a full or partial internal model would need to be against an insurer’s basis of preparation rather than Solvency II. This is due to the fact that models are based on an undertakings specific risks as approved by the regulator and not on a basis contained within Solvency II. The full and partial internal models are also subject to ongoing regulatory supervision and the undertaking’s independent internal validation process.

For undertakings using approved partial internal models, we are of the view that there is limited additional value to be obtained from scoping in the standard formula elements of the SCR templates. In some cases, the standard formula elements are likely to be a relatively routine calculations (i.e. the operational risk module) and many of the important elements of the SCR calculation for these undertakings will be out of scope. In other cases, where the standard formula element is more significant, it will be a challenge to clarify the scope as noted below.

### *3.6 Scope of the reasonable assurance engagement for full and partial internal models*

We note the dependency between the SCR and the calculation of the risk margin within technical provisions. In scoping out the SCR calculated using a full internal model or elements of the SCR calculated using a partial internal model, the SCR element for calculating the risk margin would also be outside the scope of external audit. We understand that this may lead to a potentially material element of the valuation of technical provisions in the Solvency II balance sheet outside the scope of external audit.

Consideration will need to be given as to how the auditor clarifies the scope of the reasonable assurance engagement for undertakings using full or partial internal models and the impact on the auditor’s opinion in respect of the elements which are out of scope.

### *3.7 A private reasonable assurance opinion on a public report*

We note from CP104 that the reasonable assurance opinion on prescribed elements of the SFCR will be a private audit report submitted to the CBI. We also note that the SFCR is a public document and that the intention of these proposals are “to give users of the SFCR, including investors, policyholders and the Central Bank, greater confidence in the quality of information disclosed in the SFCR.”

Consideration will need to be given as to how the scope of the engagement and the nature of the opinion in the private audit report are communicated in the public SFCR.

## **Drafting observations**

We believe that the following sections of the consultation paper, which were either unclear to us or may be open to interpretation, would benefit from more detail and further explanation.

### *4.1 Addressee of the auditor’s report*

We note that CP104 makes reference to the reasonable assurance report being “made to the Central Bank”. However, the intended addressee of the auditor’s report is not clear.

We are of the view that the appropriate addressee of the auditor’s report should be the insurance or reinsurance undertaking whose SFCR is subject to audit. This view is consistent with the approach adopted by the UK’s PRA in CP23/16 and the PRA will not be an addressee of the auditor’s report.

### *4.2 Reasonable assurance opinion*

We note that CP104 makes reference to a reasonable assurance opinion on the relevant elements of the SFCR which are within scope of external audit. However, it is not clear what the CBI’s expectations are with regard to the wording of the reasonable assurance opinion.

We would expect that the opinion will be on whether the relevant elements of the SFCR have been “properly prepared, in all material respects” in accordance with the Solvency II regulations. This wording is aligned with auditing standards.

### *4.3 Auditor’s opinion on consistency of other information in the SFCR*

We note that CP104 is not clear on the scope work required of the auditor on the qualitative information contained within the SFCR. Para. 6.14 is particularly open ended in terms of scope and we would expect the language used in this paragraph to confirm to auditing standards. For example, we would expect that the auditor’s work in relation to qualitative information will be limited to that required to enable the auditor to identify whether any elements of the specified qualitative information are materially inconsistent with information made available to the auditor during the course of the external audit of the SFCR and within the audit of the financial statements, rather than with any information that the auditor may have access to.

Separately, Appendix 2 (for solo entities) and Appendix 3 (for groups) of CP104 note relevant qualitative information in the SFCR that the auditor may wish to consider. We are of the view that this qualitative information is appropriate for undertakings using the standard formula to calculate the SCR. It would be helpful to understand the scope of the qualitative information in the SFCR for where a full or partial internal model is used in the calculation of the SCR.

#### *4.4 Clarification regarding QRTs for long term guarantees*

Para. 6.16 notes that the QRTs relating to long term guarantees are in scope of the reasonable assurance opinion. However, we note that there is no reference to these QRTs in Appendix 2. We would welcome clarification as to whether the QRTs relating to long term guarantees are in scope or not.

#### *4.5 Clarification regarding claims “look back” period*

Para. 6.12 notes that the 10 year “look back” period for claims paid triangles in respect of QRT S19.01.21 is restricted in the first year of audit to the previous 2 years (i.e. the first period audited for the purposes of the claims paid triangle would be the year ended 31 December 2014). We would welcome clarification as to whether the intention is to provide this exemption in the first year of audit only or whether it is intended that 31 December 2014 will be the first year end audited in subsequent years.

#### *4.6 Approvals, waivers and supervisory determinations*

We would welcome clarity from the CBI in relation to approvals, waivers and supervisory determinations and the auditor’s responsibility in relation to these matters. We note that in the UK, the PRA’s CP23/16 has clarified that “the auditor is not expected to express an opinion on the validity of an approval, waiver or other supervisory determination. Instead approvals, waivers and supervisory determinations provided by the competent authority should be considered as part of the framework against which the audit opinion is being given.

#### *4.7 Timing of implementation*

We note that CP104 is drafted on the assumption that all insurance and reinsurance undertakings have a 31 December 2016 financial year end. However, there are some insurance and reinsurance undertakings with financial year end dates falling before 31 December 2016 (i.e. 30 June 2016).

We would welcome clarification from the CBI regarding the timing of implementation of the proposed requirements for insurance and reinsurance undertakings with financial year ends prior to the 31 December 2016, taking into consideration that professional guidance for auditors will have to be developed and finalised after the determination of the final policy position by the CBI by the end of September 2016.

**ENDS**





For any queries please contact:

**Hubert Crehan**

Partner, Head of Financial Services Audit  
KPMG  
1 Harbourmaster Place  
IFSC  
Dublin 1

**Brian Morrissey**

Partner, Head of Insurance  
KPMG  
1 Harbourmaster Place  
IFSC  
Dublin 1

**Niall Naughton**

Director, Financial Services Audit  
KPMG  
1 Harbourmaster Place  
IFSC  
Dublin 1

**Brian Medjaou**

Director, Financial Services Audit  
KPMG  
1 Harbourmaster Place  
IFSC  
Dublin 1