CALL FOR INPUT ON THE SOLVENCY II REPORTING AND DISCLOSURE REVIEW 2020

EIOPA's call for input can be found here

Accountancy Europe decided to respond to the assurance/ audit related question (i.e. Q24).

We submitted our response online.

Q24. What are in your view the advantages/disadvantages of the external audit requirements of the SFCR, namely what is the impact on the quality of the Report?

ACE response:

Accountancy Europe perceives solvency reports as a source of transparency and market discipline. It indeed allows insurance undertakings to actively engage in consistent, comparable and high quality communication with their stakeholders on their solvency and financial condition. We believe that assurance requirements on solvency reports should be harmonised across Europe under Solvency II in a way that meets public expectations and enhances the quality of private and public reporting. The availability of assurance reports on elements of the Solvency and Financial Condition Report (SFCR) will enhance reliability, confidence, transparency and market discipline across Europe, and therefore contribute to a level playing field in this area.

A common approach to assurance has indeed numerous advantages to the users of the solvency reporting, which are explained below in more detail. Users include policyholders, customers considering purchasing insurance policies and their advisers, investors, financial analysts, national and EU wide supervisors and other insurance companies.

Auditors are qualified to carry out an external audit of a sensibly selected subset of the SFCR across the EU, also considering the application of the internationally recognised assurance framework or, where appropriate, of the nationally accepted standards on auditing or assurance engagements to arrive at an opinion on the publicly disclosed information.

Benefits of level playing field

One of the objectives of Solvency II is to harmonise the approach to the supervision of European insurers. This should include harmonising the requirements for obtaining independent assurance from auditors on the public and private solvency reports. Current practice varies greatly in this respect between different national regulators.

Accountancy Europe conducted a survey published in December 2016 concerning the scope of audit of solvency II reporting by insurance undertakings (https://www.accountancyeurope.eu/wp-content/uploads/1612_Scope_of_Audit_of_Insurance_v2.pdf).

The survey results show that in 12 countries (out of 13) the audit profession is involved in the audit of or assurance on regulatory reporting within the Solvency II regime. We are not aware of any major changes in those 13 jurisdictions since end 2016, except for Italy where the assurance scope has been extended to the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR).

There is however a clear divergence in the NCA (National Competent Authorities) requirements on audit or assurance on regulatory reporting, which may create doubts about the level of reliability and quality of public disclosures across Europe. In some countries the scope of the statutory audit of insurance undertakings was expanded, while in some other countries the NCAs have decided to leave the decision for an audit of or assurance on Solvency II reporting to the discretion of the insurance undertakings. Furthermore, we have identified that there is a difference in the scope and level of assurance for regulatory reporting requirements.

Concerning the scope, although most countries in our survey require an audit of elements of the SFCR, such as the Solvency II balance sheet, Own Funds (OF), SCR and the MCR, the set of elements varies widely across countries. For instance, in two countries only the balance sheet is subject to an audit.

The internal model design as approved by the NCA should be out of audit scope, in line with EIOPA's recommendation, and as such should be relied on by the independent auditor as part of the Solvency II framework, like a standard formula. The focus of the audit should be on the correct application of the NCA's approved internal model as regards the data and the reasonableness of the related outcomes.

We also noted different levels of assurance for regulatory reporting requirements. Positive and negative assurance represent different approaches in terms of the procedures and opinion issued by the auditor. Positive assurance means that certain facts are reasonable and fairly stated and therefore free from material errors. On the contrary, negative assurance means that certain facts are believed to be accurate since no contrary evidence has been found.

Inconsistent audit/ assurance requirements not only impact the fairness of approaches across jurisdictions, they can also distort competition and create entry barriers to cross-border activity or complicate matters for large multinational insurance groups. For example, a subsidiary may be subject to assurance requirements when the wider group is not, and the auditor of that subsidiary may not support a treatment that is allowed at the unaudited group level. In addition, as noted above, different assurance requirements across Europe might confuse users of the SFCR, making it more difficult to compare insurers' solvency information across different Member States.

A harmonised approach concerning the requirements for external audit or assurance would favour the reliability, comparability and quality of the regulatory reporting and disclosures of the insurance undertakings across Europe, and therefore contribute to a level playing field in this area, which is another important advantage.

Enhancing quality of reporting

The role of auditors includes increasing confidence in information by providing independent assurance. One of the objectives of Solvency II, through Pillar 3, is that market discipline can play an important role in regulating behaviour. In order for the market to impose discipline, it needs good quality, reliable information.

Work of auditors can enhance the quality of solvency reports, which is a major advantage. Both the public SFCR and private RSR (Regular Supervisory Report) contain some complex, subjective information that requires judgement to be exercised by preparers. Solvency II information includes measurements that are based on forward-looking assumptions. This is consistent with developments in financial reporting, where estimates of current values are used including forward-looking assumptions particularly in estimating insurance liabilities.

The introduction of IFRS 17 *Insurance Contracts* (combined with IFRS 9 *Financial Instruments* for investments), which encompasses a 'fair value' model for insurance liabilities, will decrease the differences in terms of preparing and auditing between the IFRS financial reporting and the Solvency II framework, particularly for life insurance businesses. Providing assurance on elements of the solvency reporting will therefore be similar (not identical) to aspects of the audit of financial statements of insurance undertakings. This could result in an improved understanding and insights in the events and drivers underpinning the two sets of calculations. This alignment could also result in an overall reduction in audit costs, particularly in case of the Solvency II balance sheet.

It is probable that the most effective and efficient way to provide assurance on the regulatory reporting would be to request the external auditor of an insurance undertaking to perform such an audit also because of the efficiencies and synergy effects that can be realised as the external auditor can build on his already existing knowledge of the insurance undertaking. In effect, part(s) of the auditor's work on financial statements' audits can be used as a starting point for the audit of regulatory reporting (e.g. the auditor may use the assessment of the internal controls used in the audit of financial reporting).

The assurance process provides independent challenge to the judgements involved. It can also increase the attention placed upon that judgemental information by senior management and ensure that the processes involved in generating that information are more robust. While supervisors can satisfy themselves about the processes involved in preparing the solvency returns through direct enquiry, other users of the SFCR are not able to do this. Assurance from independent auditors on critical information in the SFCR would give those users greater confidence in the reliability and quality of that information.

Independent assurance on the SCR and the Solvency II balance sheet line items is focused on the quality of the underlying data and the process robustness for example of calibration of actuarial and risk management models. Insurance undertakings could benefit from recommendations provided by the independent auditor on these matters.

Experience from those countries where at least the Solvency II balance sheet is audited shows that processes and controls have significantly improved over time leading also to an improvement in reporting quality. Quality and consistency also have improved since both, Solvency II balance sheet questions but as well questions relating to other elements of SFCR and RSR have been subject to local consultations and the dialogue between supervisors and auditors. Last but not least the increased interest by analysts as well as journalists – both of them analysing on behalf of policyholders and investors respectively – contributes to market discipline as the original purpose of pillar III (as stated above) even if there is currently room for further improvement in transparency and comparability (preparers and regulators) as well as for further learning processes and familiarity (users and intermediaries). The so created value will increase with the establishment of multiyear comparatives. On the other hand, some regulators and other observers expressed concerns about a lack of quality and consistency with respect to statements within non-audited SFCR.

Meeting user expectations

The SFCR provides information about systems, risk and capital. The general public expects auditors to consider these issues and to report on them and may therefore expect auditors to review and provide assurance on certain sections of the SFCR. Providing independent assurance on the SFCR might help to meet public expectations, which constitutes another advantage.

Users also should know clearly what information has been subject to independent assurance from auditors and what has not. There is a potential expectation gap of the users of information on solvency and financial position published by the insurance undertakings within the EU. This may arise because:

- Information in the SFCR at least partially appears similar to information included in the audited financial statements.
- Some information in the SFCR will be identical to/extracted from the audited financial statements while other may have a different basis.

Consequently, the users of the SFCR may be confused as to the level of assurance provided on the various sets of information covered by the SFCR when audited and unaudited information is not clearly separated. It is important to avoid users placing reliance on an assumption that auditors have reviewed information, when that information is, in fact, unaudited.

With a view on market discipline, the level of confidence provided by assurance - to reinforce comparability and limit consequences of a lack of high quality of solvency reporting - should sufficiently satisfy the users.

Cost benefit considerations

The involvement of auditors in solvency reporting should be subject to a cost benefit analysis. Additional costs will be involved in the Member States where at present no assurance is provided at all on supervisory reporting. This disadvantage (i.e. these additional costs) should be set against the added value of having assurance provided to sensibly identified parts of the solvency information. A consistent approach to solvency reports will eventually result in less costly compilation of information, particularly in case of multinational insurance groups.

Moreover, independent assurance on solvency information will ensure that supervisors are provided with consistent and high quality information that will enable them to focus on risk related issues as their primary responsibility. External audit and scrutinizing by the supervisor are indeed complementary. This shows the ongoing dialogue between auditors and supervisors in certain countries focused to enable supervisors to understand more deeply what auditors are doing and how they report on these procedures.

If users are not satisfied with the quality and perceive a lack of comparability of solvency reports, additional consequences like a lack of trust in the markets may occur.

Conclusion

Accountancy Europe believes that there are advantages to requiring auditors to provide assurance on components of solvency reports, particularly the public SFCR. Accountancy Europe thinks that the audit and the auditor continue to have an essential role to play in supporting stable capital markets. Independent assurance provides a common platform for consistency and transparency of reporting across the Member States, and as such contributes to a level playing field in this area.

Additional costs will be incurred when providing assurance on supervisory reporting. We however believe that the numerous advantages, mentioned above, will outweigh this disadvantage.

It will be necessary to define a subset of the SFCR (for example the main elements of the SFCR (balance sheet, own funds and capital requirements)) that will be subject to assurance from an independent auditor, resulting in a reasonable assurance opinion, i.e. a level of assurance that is commonly associated with financial statements. The audit profession together with the users and preparers can assist the supervisors, both national and European, in defining the subset in detail so that there is a clear benefit from assurance assignments for the wide public, in particular investors and insurance industry customers.