FEE
Federation of European Accountants
Fédération des Experts comptables Européens

# Briefing Paper

*Standing for trust and integrity*

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## Insurance

## Enhancing the Quality of Solvency II Public Reporting
## Benefits of Harmonising Auditor Reporting for the Users

***FEE (Fédération des Experts-comptables Européens - Federation of European Accountants) stresses the importance of addressing the users' expectations by recommending harmonisation of the requirements for independent assurance on regulatory disclosures for insurance undertakings in the European Union under the Solvency II framework.***

## 1. Background

Solvency II introduces a revised comprehensive framework to define required capital levels and to implement procedures to identify, measure, and manage risk levels in insurance undertakings and to report on financial condition in the context of these issues. The set of revised requirements will be European Union wide and is currently expected to be fully effective and binding for insurance undertakings from 1 January 2014. A new solvency framework is needed for insurers as sophisticated risk management systems have been developed since the introduction of the Solvency I rules in the 1970s.

Solvency II consists of three pillars:
- Pillar 1 - quantitative requirements (including the amount of capital to be held by an insurance undertaking);
- Pillar 2 - requirements for governance and risk management;
- Pillar 3 - disclosure and transparency requirements.

The reporting on Solvency II (solvency reports) can be split into:
- **public reports** - Solvency and Financial Condition Report (SFCR);
- **private reports** – Regular Supervisory Report (RSR).

Users of the public solvency reports include policyholders, customers considering purchasing insurance policies and their advisers, investors, financial analysts, national and EU wide supervisors and other insurance companies.

The EU wide supervisor – the European Insurance and Occupational Pensions Authority (EIOPA) – is currently working on the Solvency II quantitative reporting templates including those to be added to the SFCR.

There are currently wide differences across Europe over the extent of auditor involvement in the public and private regulatory reporting by insurers. Present practices vary from auditors' involvement being limited to private "exceptions reporting" to supervisors to certain parts of regulatory returns being subject to auditor's assurance opinions which are made available to the public (e.g. UK, Netherlands).

## 2. Issues

We understand that currently it is not proposed by the European Commission to harmonise the requirements for auditors to provide assurance on public or private solvency reports, but that this will be left to the discretion of the EU Member States. We question whether the current inconsistent approach in this matter should continue under Solvency II.

A common approach to assurance has numerous benefits to the users of the solvency reporting as well as to the supervisors.

### 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. Both the public SFCR and private RSR 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. Providing assurance on elements of the solvency returns is therefore similar to aspects of the audit of financial statements of insurance undertakings.

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.

## Meeting user expectations

The SFCR will provide 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. More engagement is needed with potential users of the SFCR to better understand their needs and the value that they would place upon independent assurance on the SFCR.

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:

1. Information in the SFCR will appear similar to information included in the audited financial statements.
2. Some information in the SFCR will be identical to/extracted from the audited financial statements while other may have a different basis. Reconciliation may help users to understand the relationship between the financial statements and solvency information.
3. Both audited financial statements and elements of the solvency financial information may be published by the undertakings together in one document.

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 the 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.

## 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.

Inconsistent requirements not only impact on the fairness of approaches across jurisdictions, they can also distort competition and create entry barriers to cross-border activity or complicate matters for large multi-national 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.

***FEE perceives solvency reports as a source of transparency and market discipline. It believes 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.***

## 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. These additional costs should be set against the added value of having assurance provided to sensibly identified parts of the solvency information institutionalising the auditors' messages on risk and financial condition. Consistent approach to solvency reports will eventually result in less costly compilation of information, particularly in case of multi-national 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 which are their primary responsibility.

If users are not satisfied with the quality and possible lack of comparability of solvency reports, additional consequences need to be taken into account like lack of trust in the markets.

## 3. Wider developments

***The audit profession operates within an internationally recognised assurance framework. FEE believes that such framework enables it to provide consistent assurance on a sensibly selected subset of the SFCR across the EU, which is consistent to the assurance provided on other public financial reporting.***

Solvency reports include valuation estimates based on forward-looking models and assumptions. There are ongoing discussions on the auditability of such information and what level of assurance needs to be provided to enhance market discipline.

Financial reporting gradually developed from a statement of historical facts and events to statements that include measurements of current value, including measurements using forward-looking estimates of future cash flows. Consequently, financial reporting cannot just be regarded as historical financial information and the developments of IFRS phase 2 in case of *Insurance Contracts* as well as Solvency II add further importance to forward-looking information.

Financial reporting, particularly in the financial services sector, includes forward-looking cash flow estimates that obtain their context from proper presentation and disclosure, as well as the quality of models, controls and governance. All these elements form the three pillars that have been formalised in the Solvency II framework.

### EC Green Papers on Audit Policy and Corporate Governance

The *EC Green Paper on Audit Policy: Lessons from the Crisis* specifically asks for *better external and internal communication between the auditors and other stakeholders and hence to raise the perception of the value added by an audit.*

*The EC Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies* makes recommendations about the independent auditor's role in relation to financial institutions. It suggests *reviewing the role that external auditors should play more generally with regard to risk-related information in financial institutions*. In particular, it suggests that *the external auditor could validate a greater range of information which is relevant to shareholders than it does at present in order to improve investor confidence in this type of information, thereby encouraging the proper functioning of the markets.*

Reporting on forward-looking information and financial health, as well as the connection to governance, processes and controls, and models has been formalised in Solvency II. Public information related to those areas needs more attention. Defining a role for auditors in providing assurance on solvency returns is consistent with the policy suggestions for the role of auditors.

***FEE, like the European Commission, believes 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.***

## 4. A way forward

FEE believes there are advantages to requiring auditors to provide assurance on components of solvency reports, particularly the public SFCR.

It will be necessary to define a subset of the SFCR 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[1]. 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.

This Paper does not particularly address provision of assurance over the Regular Supervisory Report (RSR) because supervisors can make their own decisions as to the required level of assurance and which party should provide such assurance.

[1] In the EU Fourth Directive providing assurance to financial statements is described as statutory audit.

# Briefing Paper

> ***FEE recommends defining specific requirements for assurance by independent auditors on a subset of the SFCR that are applicable in all Member States.***

FEE is looking forward to a fruitful dialogue with all the stakeholders and, as the European accountancy and audit profession representation, is willing to proactively contribute to:

- the EU-wide consistency and transparency of solvency information;
- improving the users' and the wider public's confidence in complex, judgemental information, including solvency requirements by increasing auditors' independent involvement in line with the suggestions included in the EC Green Papers.

## FEE and its Members


## About FEE

FEE (Fédération des Experts-comptables Européens - Federation of European Accountants) represents 45 professional institutes of accountants and auditors from 33 European countries, including all 27 EU Member States. In representing the profession, FEE recognises the public interest. FEE has a combined membership of more than 500.000 professional accountants working in different capacities in public practice, small and larger firms, business, public sector and education, who all contribute to a more efficient, transparent, and sustainable European economy. Based on the practical experience gained in this daily involvement in all aspects of the economy and the set of values underpinning the profession's practice, FEE believes it has a contribution to make in this public policy debate.