
Following the success of our groups' special edition published last year, we return to our usual format for this fourth edition of KPMG's insurance regulatory newsletter, covering a range of topical regulatory items.

In this edition, we start with an article discussing the approaches firms are adopting to improve their understanding of customers' specific circumstances and characteristics to help demonstrate that they are delivering fair outcomes.

We also consider the creation of the Senior Insurance Managers Regime and its impact on governance arrangements and given the increased regulatory attention on outsourcing arrangements, we discuss the challenges for insurers in our article on Outsourcing Risk.

From a Solvency II perspective, following the PRA's feedback on their review of the Own Risk and Solvency Assessment reports, we pick up on one of the points made and explore how firms are demonstrating that the *Standard Formula* is appropriate for calculating their Solvency Capital Requirements.

We end with our usual section providing an overview of the main regulatory developments that UK insurers should be aware of.

If you should like to discuss any of the matters raised in this issue, please contact any of the authors.

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## Achieving fair outcomes for vulnerable customers

We have moved a long way from the days of *caveat emptor*. Firms are increasingly expected to demonstrate that their customers are getting a fair outcome and the FCA is requiring firms to consider customer needs at every stage of the product lifecycle - from product design through to claims handling. Customers, the FCA and shareholders are expecting clear evidence that insurers put the customer at the heart of their business.

*What does this mean for the Industry?*

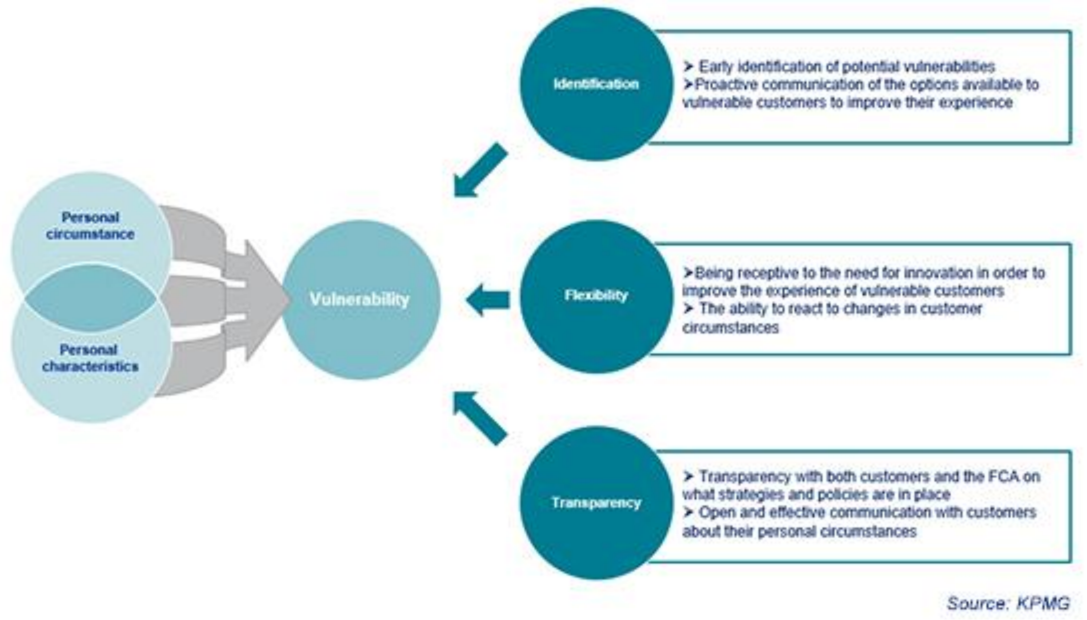
Firms must demonstrate a clear balance between customer needs and commercial ambition. They must put themselves in their customer's shoes, understand their wants and needs, and react to this by being honest, transparent and most importantly, fair.

What must continue is the development of the mind-set that not all customers are the same, nor should they be treated the same. Their ability to understand financial services depends on many factors and, as the scope and use of digital platforms increases, insurers must take into account the changing needs and financial capability of their customers. The FCA expects firms to understand more about their customers, their capabilities and the impact that their decisions have on different customer segments. It wants to drive a consumer-focused culture in firms through proactive supervision, concentrating on the key areas highlighted in its business plan, including customer awareness.

The complexity and importance of insurance products mean that certain customers are particularly susceptible to poor treatment. Firms are expected to create and put into practice appropriate strategies to address the needs of customers in vulnerable circumstances.

The FCA's Occasional Paper on Consumer Vulnerability demonstrates the seriousness it attaches to this issue and its Practitioners' Pack offers practical suggestions to help firms. It is clear that assessing the strategies and policies in place to deal with vulnerable customers will now form a key part of the FCA's Firm Systematic Framework (FSF).

The FCA, other regulators and bodies active in the area of consumer vulnerability provide differing definitions of vulnerability. However the common theme is that personal circumstances and personal characteristics, combined with the actions of a firm, can lead to customer vulnerability.

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*What should firms be doing?*

There is a clear expectation that firms act quickly and effectively on this issue. Firms must be able to identify vulnerable customers, while recognising that vulnerability may not be static, be flexible in the way they treat these customers and be transparent about their related strategies and policies.

Fair treatment of vulnerable customers, and increased customer awareness more generally, is at the very core of what the FCA will be focussing on over coming years. The level of fines already levied for failings in these areas demonstrates its seriousness about this issue and insurers need to consider how they can be proactive in supporting these customers.

Improving transparency in customer communications will help address the mistrust which exists within a large part of the general public. There are several examples of insurers taking positive steps towards this – for example, publishing claims feedback on their website and sending texts to policyholders during stormy weather reminding them of contact details in the event of a claim. These sorts of initiatives need to continue and grow for customer trust in the insurance sector to increase.

The strategies and policies a firm puts in place will give the FCA an indication of the culture and general attitude of the firm towards the fair treatment of customers more generally. The FCA's work in this area is allowing them to identify best practice across firms, which will help it to be clearer about the areas where firms need to improve**.**

As time goes on, opinions on the issue will be refined and the FCA will become more focussed. Firms must be proactive in order to succeed in the treatment of vulnerable customers, recognising the important role it will play in the UK over the coming years.

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## Boards, non-executive directors and senior managers in charge of insurers

Following well-publicised failings in the banking sector linked to governance, both UK regulators have been working over several months to develop a new accountability regime aimed at senior individuals in charge of banks and insurers. Some elements of the new Senior Insurance Managers Regime implement Solvency II key functions and governance requirements and will come into force at the beginning of 2016. A separate policy statement released in August introduces a similar framework for smaller, 'non-directive' firms.

### Role of senior management and non-executives

While there will be no presumption of individual culpability for failures, the new regime for insurance senior managers incorporates many requirements that are comparable to those applying to banks. A condensed list of controlled functions emphasises the critical role that certain individuals play in ensuring the safety and soundness of the firm and individuals can expect a more granular and role-specific pre-approval process prior to appointment.

One of the main requirements is that insurers are required to produce a ‘governance map’ aligning individuals to specific key functions and enabling the supervisor to have clear sight of reporting lines and the allocation of responsibilities. While non-executives will oversee whistleblowing and remuneration policies, key function holders will be aligned to exercising specific responsibilities, such as ownership for ORSA, developing the business model and leading the firm’s culture and standards.

### Conduct of senior management

New conduct standards emphasise individuals’ integrity; due skill, care and diligence; and cooperation with regulators. These align loosely to similar fundamental rules which apply to the insurer. Key function holders are expected to ensure effective control of the business, comply with regulatory requirements and standards and delegate only to an appropriate person with oversight. Insurance senior managers must disclose any relevant information to regulators and pay due regard to the interest of current and potential future policyholders.

Assessing fitness and probity will need to go much deeper than merely comparing an individual’s skills and experience against a role description, conflicts of interest and criminal background checks - senior managers need to demonstrate, on an on-going basis, how they meet the individual conduct standards. Insurers will need to review current policies and processes to enable them to comply efficiently.

### Board responsibilities

In May, the PRA issued a further consultation on board responsibilities in respect of corporate governance, with the focus shifting from the individual to the collective. Boards are expected to establish a sustainable business model and take decisions against a clear and measureable risk appetite. An effective board will also comply with regulatory obligations and is responsible for setting a culture that supports prudent management.

Insurers therefore need to ensure that supervisors have a good understanding of their business model, especially as supervisors are increasingly looking beyond pure compliance with the rules, both challenging and clarifying how an insurer can continue to be both profitable and sustainable. We are seeing insurers use a number of models, such as the nine levers of value, to articulate their strategy in a manner that provides a clear framework for supervisors to understand distribution, operational and compliance impacts.

### Impact on firms

Many insurers will have already implemented new governance arrangements and risk policies in advance of Solvency II. These arrangements must now also align to the increasing PRA requirements.

Group and entity boards need to be able to clearly articulate, and demonstrate how they individually and collectively exercise, their responsibilities. Some individual board members may need to challenge strategy while wearing a number of different group and entity ‘hats’ and groups will need to manage the allocation of responsibilities and potential conflicts more proactively where an individual cannot effectively do this.

While questions around governance are frequently raised as part of the supervisory process, these subtle enhancements to PRA policy set clear expectations which all firms will need to develop to build credibility in the eyes of the supervisor.

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## Outsourcing Risk – Responding to increased regulatory scrutiny

Outsourcing governance is a key issue with the UK regulators (both the PRA and FCA) and has significant impact across the insurance and other financial services sectors.

The FCA is also focused on ensuring resilient service provision to clients and reliable operation in the markets and the impact for the customer. This agenda is important to the PRA due to its relevance to financial stability and it has been closely associated with Recovery and Resolution Planning (RRP) in the banking industry. The largest UK banks were required to review their risks in relation to the third party suppliers and their IT resiliency, with investment managers posed the same challenge through a 'Dear CEO' letter in relation to oversight and resiliency of its service providers.

Insurers too have been experiencing regulatory challenges, both as part of Solvency II governance requirements and also life insurance thematic reviews that focussed heavily on the use of outsourcing.

More broadly, both regulators remain acutely interested in visible and demonstrable management ownership of key risks and oversight of arrangements to manage those risks.

### Impact on insurers

The regulatory rules on outsourcing have not changed significantly, but the emphasis has and the bar has been raised. The increased regulatory scrutiny poses significant challenges for insurers as many are seen as having a limited perspective of how their supplier-related risks impact on the end customer.

The FCA has specifically identified issues relating to delegated authorities and the use of investigators for claims, where there has been due diligence or oversight, and there are many examples of where third parties (for example, coverholders and third party administrators) are not acting in line with insurers' expectations. This links closely to Solvency II Pillar II's outsourcing risk management requirements.

Firms with intra-group outsourcing and those relying on service provision by the parent or other group entities are facing greater regulatory scrutiny to meet expectations around outsourcing governance and related controls, especially where the service is provided from overseas.

Firms have seen capital charges raised and skilled person reviews commissioned where there is a perceived lack of clarity on their outsourcing related risks. Concerns identified in outsourcing arrangements have in some cases led to UK regulators extrapolating their focus on wider governance issues.

### The key areas of UK regulatory focus include:

- Increased robustness of the controls and risk ownership at Board level;
- Defining and identifying 'critical or important' outsourcing and corresponding risk assessments;
- Role of 1st, 2nd and 3rd lines of defence in outsourcing risk management and
- Adequacy and effectiveness of risk assessment, tools and methodologies.

### How can insurance firms respond to the increased regulatory scrutiny?

Insurers and reinsurers should be honest and proactive in assessing their outsourcing related risks before any regulatory intervention. KPMG suggested actions include:

- Clear executive level ownership of outsourcing risks;
- Independent assessment of the outsourcing governance against SYSC8.1 and SYSC13.9 regulatory requirements;
- Risk assessment of the 'critical and important' outsourcing arrangements;
- Clear articulation of outsourcing risk appetite and key risk indicators in place to measure and manage these risks;
- Adequate participation of first, second and third line in the assessment of Outsourcing related risks and
- Robust first line operating model which includes consideration of strategy, policy, people, process, tooling and a regular programme of supplier assessment/assurance.

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## Standard Formula – how do you evidence appropriateness?

As the number of Standard Formula firms increases, with some firms that had originally preferred an internal model approach now adopting (at least initially) the Standard Formula approach instead, the need to evidence the appropriateness of this approach for its business and risk profile has increased. In its 15 June letter providing feedback on the Own Risk and Solvency Assessment (ORSA) reports it had so far reviewed, the PRA again highlighted this and also the need for the ORSA report to demonstrate how this will be monitored on an ongoing basis.

The Standard Formula approach to calculating the Solvency Capital Requirement (SCR) was once viewed as the default method, with firms having to actively choose to apply to use an Internal Model (or for non-life insurance, an Undertaking Specific Parameter (USP)). However, the PRA has on many occasions made it clear that use of the Standard Formula is also an active choice and Boards need to understand the underlying rationale behind it. The challenge is whether firms can get comfortable that the Standard Formula appropriately and adequately reflects the risks in the business.

Correctly allowing for inadequacies in the Standard Formula would require development of a Partial Internal Model (PIM) or USP. Such options are expensive, take significant time to develop and involve extensive regulatory dialogue to gain approval. In the short term, there may be no choice but to continue to use the Standard Formula, hold additional capital through the Pillar 2 assessment process and accept a Pillar 1 capital add-on to address the deficiency. This also applies to firms intending to use an internal model but who are proposing the use of the Standard Formula as a contingency option if their internal model application is not approved.

However, the PRA has already stated that it believes the Standard Formula is appropriate for 90% of UK firms. Most firms should therefore be able to avoid the risk of capital add-ons by presenting a strong case regarding the appropriateness of the Standard Formula to the PRA.

### Evidencing appropriateness

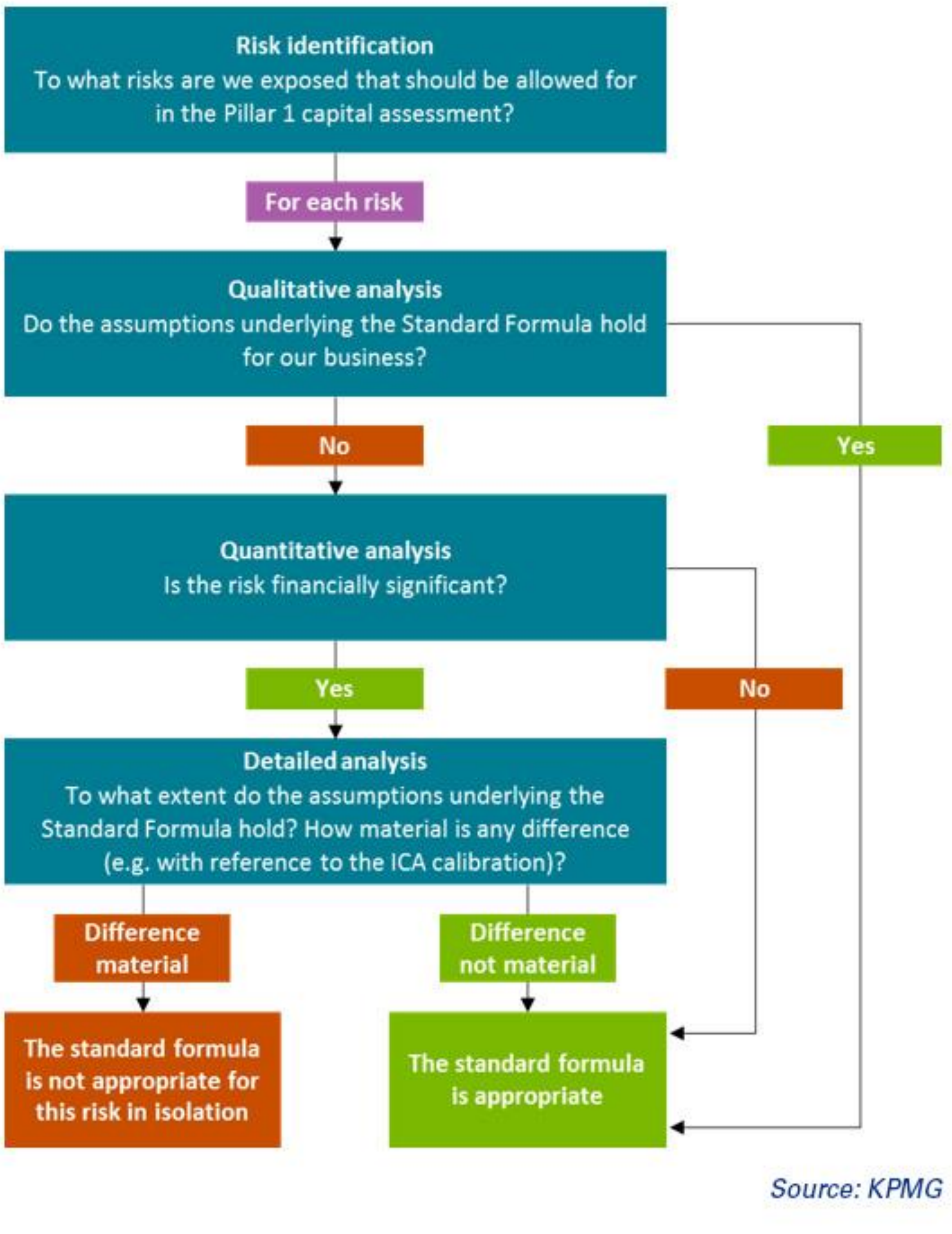
In 2014, most firms commissioned Board papers to consider the issue and draw a conclusion, which was submitted to the PRA as part of their ORSA submissions. The key question addressed was whether the Standard Formula adequately reflects the risks in the business.

As the PRA's paper shows, this should not be treated as a once-off exercise, with an on-going process developed to ensure that these assessments are kept live and maintained to reflect changes to the business and its risk profile. In 2015, firms need to review their previous Board papers, updating for business/risk changes and to align with PRA expectations.

We are seeing from PRA feedback on 2014 submissions that in general more detail is needed on the allowance for the relevant risks, rather than agreement with the existing internal quantification of these.

As the Standard Formula is designed to apply across a wide range of firms across Europe, individual firms can expect the calibration to be prudent for some of their risks and optimistic for others. Such inconsistencies at individual risk level do not necessarily invalidate the overall appropriateness, so long as they are not individually significant and they broadly offset each other. The extent of analysis needed should relate to the materiality of the risk and the extent to which the assumptions made in the calibration of the Standard Formula hold true for that firm's business.

### Example decision making flowchart

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### Understanding the Standard Formula assumptions

When reviewing these justification papers, the most important factor is whether the assumptions underlying the Standard Formula hold true. Often this is not as simple as it seems. For example, a risk might be included in the Standard Formula, but the subtly different ways that a company is exposed to that risk might not be adequately allowed for. Simple examples include:

- The longevity risk module is calibrated to population data which might not reflect the experience of enhanced annuity writers
- The property risk module is calibrated to commercial property indices which might not reflect the nature of a portfolio weighted towards residential property exposure
- The premium risk module might not reflect the risk profile of a niche insurer.

In addition, the Standard Formula does not allow for certain risks as it makes an assumption that these are not material. For example, there is no allowance for inflation risk on benefit payments or interest rate volatility. Firms should ensure that their justification papers go far enough to demonstrate that these ‘not material’ assumptions hold for their business, or illustrate the extent to which they do not hold.

### Addressing deficiencies

If following the above analysis, firms identify that the Standard Formula is not appropriate for certain risks, consideration is needed of how to proceed. It may be that quantitative arguments can be invoked, comparing Standard Formula results to internal ICA or economic capital assessments to conclude that areas of offsetting prudence and optimism exist and that the Standard Formula is appropriate in the round.

However, there will be cases where the overall conclusion is that the Standard Formula is not appropriate. This is particularly likely to be the case for Internal Model firms demonstrating the appropriateness of the Standard Formula as a contingency option. In such instances, comparisons with internal assessments can be helpful in influencing the regulator to apply no more than an appropriate capital add-on as a short term solution. The longer term solution should also be considered, which might include developing a PIM or calibrating a USP. These options come with their own challenges, which firms need to ensure have been thought through as part of contingency planning. For example, using a PIM would require work to develop the methodology to aggregate Internal Model and Standard Formula components.

### Key next steps for 2015

- Review Standard Formula justifications prepared last year to ensure there is sufficient focus on the extent to which the assumptions underlying the Standard Formula reflect the firm’s current risk profile.
- If the analysis concludes that the Standard Formula is not appropriate, consider what are the best options in the short and long term.

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## Future regulatory milestones

| Date | Activity | Impact on industry |
|---|---|---|
| **August 2015** | PRA consultation papers on Set 2 of the Solvency II technical standards (ITS) and guidelines and use of its discretion related to Solvency II regular quantitative reporting. | The ITS and guidelines papers were issued by EIOPA as Final Reports on 30 June.<br>The guidelines are subject to the 'comply or explain' process at national level, with regulators making every effort to comply. In advance of the PRA CP, insurers should assume that the PRA will aim for full compliance.<br>The European Commission is currently reviewing the ITS and will convert these into Commission Implementing Regulations (expected end September). |
| **1 September 2015** | Date of implementation of final rules relating to Guaranteed Asset Protection (GAP) insurance products as set out in the FCA's policy statement issued in June 2015. | The final rules will require GAP insurance distributors to provide customers with prescribed information to help them make more informed decisions and will introduce a deferral period which will prohibit GAP insurance to be introduced and sold on the same day. |
| **7 September 2015** | Final equivalence decision due regarding Switzerland | This covers full equivalence in relation to all three areas – articles 172, 227 and 260. |
| **14 September 2015** | Deadline for feedback on PRA consultation paper on corporate governance exercised by boards of insurance companies. | See article on Boards, non-executive directors and senior managers in charge of insurers. |
| **October 2015** | FCA PS to CP15/13 on proposed remedies in relation to sale of general insurance add-ons | General insurers will need to assess whether any changes are required to current practice. |
| **October 2015** | Matching adjustment decisions | PRA will inform all firms simultaneously. Successful firms will then need to realign their investment portfolio as appropriate. |
| **November 2015** | 3rd Quarter reporting by undertakings under Solvency II Preparatory Phase (first week of January 2016 for groups). | Final opportunity to dry-run the quarterly reporting procedures, albeit on a subset of reporting templates. Insurers with non-December year-ends should refer to the timetables on the PRA website. |
| **November 2015** | PRA response to EIOPA note on Solvency II audit expected | EIOPA indicated on 7 July the value of an audit of Solvency II publicly disclosed information. In order to give sufficient time for industry to respond to any UK audit requirement, we expect a consultation paper in November. |
| **15 November 2015** | The Higher Loss Absorbency (HLA) is due to be finalised by the International Association of Insurance Supervisors (IAIS) for presentation at the G20 summit. | Current application is only applicable to the nine identified global systemically important insurers (G-SIIs), although this number may change as the reinsurers are assessed (expected in H2 2015). |
| **December 2015** | PRA internal model decisions confirmed to all applicants. | Unsuccessful firms will need to evoke their contingency plans. |
| **7 December 2015** | Provisional Equivalence decision on Article 227 in respect of Australia, Bermuda, Brazil, Canada, Mexico and the USA | Article 227 relates to the aggregation of third country (re)insurers within the group solvency calculation on a local regulatory basis. |
| **31 December 2015** | Deadline for the PRA's Step 2 assurance reports for participating non- internal model firms. | Firms should take account of the feedback provided by the PRA on 12 June. |
| **31 December 2015** | All PRA approvals and modifications relating to day 1 Solvency II application must be in place. | There are several other areas of application, including USP, ancillary own funds and various group related matters. |
| **31 December 2015** | PRA expects firms to have resolved all issues relating to the use of subordinated guarantees. | Where a firm has not yet made adjustment to its capital resources and has not provided the PRA with its detailed plans, these should be submitted as a priority. |
| **1 January 2016** | Solvency II implementation date. | First day of new solvency regime for European insurers. |
| **1 January 2016** | First tranche of PRA's SIMR and FCA changes to Approved Persons Regime for | See article on Boards, non-executive directors and senior managers in charge of insurers. |

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| | Solvency II firms come into force. | |
| **7 March 2016** | Second tranche of PRA's SIMR and FCA changes to Approved Persons Regime for Solvency II firms, and all non-Solvency II firms requirements, come into force | See article on Boards, non-executive directors and senior managers in charge of insurers. |
| **20 May 2016** | Submission of Day 1 reporting to the PRA for those insurers and insurance groups with a 31 December year-end (plus 6 weeks for group information). | Insurers with non-December year-ends should refer to the timetables on the PRA website. |
| **26 May 2016** | First PRA Solvency II quarterly submission for those insurers with a 31 December year end. | Insurers with non-December year-ends should refer to the timetables on the PRA website. |
| **31 December 2016** | Packaged Retail and Insurance-based Investment Products (PRIIPS) comes into force. | Life insurers will need to ensure that they have amended their point of sale processes to meet the requirements of the Key Information Document. |
| **20 May 2017** | First PRA Solvency II annual submission (including National Specific Templates) for those insurance firms with a 31 December year end (plus 6 weeks for group information). | Insurers with non-December year-ends should refer to the timetables on the PRA website. |
| **End 2017** | The insurance Distribution Directive (IDD) is expected to come into force | All insurers and insurance intermediaries will need to ensure that their processes have been amended, including relating to point of sale disclosures. |

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