KPMG

Illuminate

KPMG's insurance regulatory newsletter

In our last edition of *Illuminate* before the EU Referendum vote, we included an article on the implications for insurers in the event of Brexit. Now we know the outcome, insurers will need to give much greater thought to what this means for their business models and strategies if the exit terms do not include something akin to current passporting rights. For many UK insurance groups, this might involve moving European business into a European insurance entity (either within the group or newly established), but this will not be a quick process given the volume of insurers (both within the UK and the rest of Europe) who will be considering their options. While 'wait and see' is one option, it does run the risk of having insufficient time to put the solution into place if every group tries to do this at the same time.

If you haven't already done so, we would encourage you to register for KPMG's EU Referendum Forum which contains links to the latest information and presentations on the impacts of Brexit on insurers.

In the meantime however, we look in this edition at some of the other regulatory concerns.

This year, we saw an unsurprising increase in the volume of Solvency II related disclosures. While these disclosures vary across companies, our first article shares some interesting observations.

The Prudential Regulation Authority (PRA) has also provided clarification around the application of the EU Audit Reform requirements in relation to audit committees. This covers both the extent to which UK insurers must have their own audit committee and the extent to which the directors must be independent. We cover these requirements in our second article, including a useful flowchart of the requirements.

Moving to conduct, we look at the important changes introduced by the Insurance Act 2015, which apply from 12 August. The changes to commercial insurance contracts have implications for the systems and processes, as well as information sharing, within insurance companies.

Our final article discusses the evolutions we have seen in the area of capital management within the non-life sector. As groups turn their minds to their Brexit contingency plans, this will remain highly topical. We will be covering the life sector developments in the next edition.

Finally, we complete this edition with an overview of important future regulatory milestones that UK insurers may need to address.

If you would like to talk to anyone about any of the topics covered, please contact the respective author or your usual KPMG contact.

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Solvency II Voluntary Disclosures

Listed European insurance groups provided some numerical Solvency II information in their 2015 annual reports. We have analysed the nature and extent of disclosures made by 17 major insurance groups and include this analysis below.

Extent of disclosures

The vast majority of groups disclosed their Solvency II cover ratio, own funds, solvency capital requirement (SCR) and surplus at the group level. Only a few firms provided detailed analyses of the change in these metrics from prior periods.

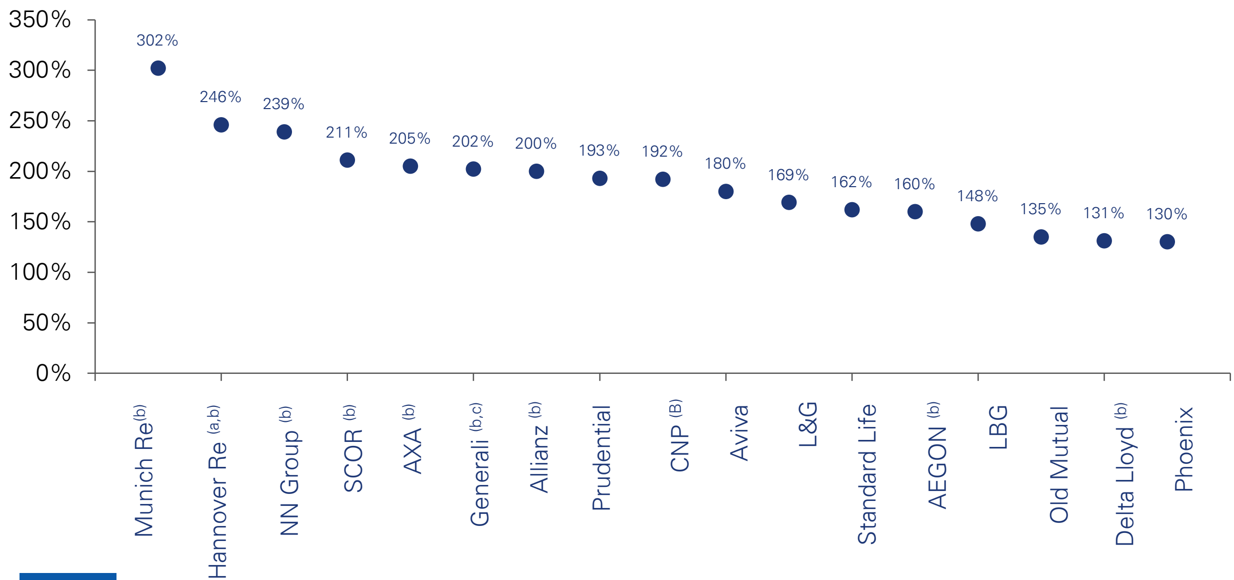
All groups clearly stated whether the SCR had been calculated using the standard formula or full or partial internal model. The latter category also specified which elements of the SCR were determined on a standard formula basis.

While many UK insurers disclosed whether they received supervisory approval to use the various long-term guarantee measures (transitional deductions from technical provisions, matching adjustment and the volatility adjustment), they did not disclose their impact.

Groups also disclosed where non-EEA business in an equivalent regime had been included using local rules.

Results

The diagram below shows the disclosed solvency ratios for the companies included in our review.



	Munich Re	Hannover Re	NN Group	SCOR	AXA	Generali	Allianz	Prudential	CNP	Aviva	L&G	Standard Life	AEGON	LBG	Old Mutual	Delta Lloyd	Phoenix
Own funds (bn)	30.0	9.3	9.8	6.8	43.7	30.5	53.6	20.1	17.0	21.8	13.5	5.5	14.8	n/d	6.0	2.9	5.8
SCR (bn)	10.0	3.8	4.1	3.2	21.2	15.1	26.8	10.4	8.9	12.1	8.0	3.4	9.2	n/d	4.4	2.2	4.5
Surplus (bn)	20.1	5.5	5.7	3.5	22.4	15.3	26.8	9.7	8.1	9.7	5.5	2.1	5.5	3.2	1.6	0.7	1.3

Note: (a) Economic Capital Q3 2015 figure

(b) Please note that the information presented here was disclosed in EUR and we have converted to GBP at the exchange rate as at 31 December 2015

(c) Economic Capital view rather than the Solvency II view

Solvency II ratios tended to be lower for life insurers included in the analysis than for their non-life counterparts in spite of the availability of long term guarantee measures for such groups.

Some companies presented a 'shareholder view' of the results, excluding the contribution from with-profits funds and staff pension schemes. Others presented both this and a Solvency II view or stated the impact of adopting a Solvency II view. Where both figures were presented, the 'shareholder view' was approximately 10%-15% higher than pure Solvency II ratios.

Disclosure of diversification benefits and risk capital splits tended to be at a very high level and it was difficult to compare the sensitivity information provided due to the absence of standardised metrics across the industry.

Other economic value disclosures

New business reporting was another area of inconsistency, with the underlying valuations calculated on a pricing, embedded value (EV) or Solvency II basis. The definition of cash generation differed between firms, including from cash remitted to group, IFRS earnings, change in Solvency II surplus and EV profits.

Levels of disclosure also varied, ranging from extensive cash profile projections to limited disclosures, with only a minority of firms starting to bridge their Solvency II capital generation to cash and ultimately to dividend payments.

Some groups took the opportunity to announce their intention to stop embedded value reporting in the future, while others stated that they have aligned (partially or fully) their EV basis to Solvency II.

Future Solvency and Financial Condition Report (SFCR)

Companies will need to publicly disclose detailed information set out in annual Quantitative Reporting Templates (QRTs) as part of their SFCR for financial years ending on or after 30 June 2016. For 31 December year-end reporters, this means that the first set of QRTs will be published in May 2017 in respect of their 2016 year-end. The PRA’s audit requirements will start from financial years ending on or after 15 November 2016.

The analysis above reveals how challenging it will be to conduct meaningful comparisons across groups without a comprehensive understanding of the business. Firms that have yet to make any public statement will need to consider whether, and if so when, they will provide any insights in advance of their public SFCR. All firms should consider whether any additional disclosure will be needed to enable a proper understanding of their results.

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PRA guidance on audit committee requirements

As firms will be aware, the changes to the Statutory Audit Directive came into force on 17 June 2016. The most commonly cited elements relate to mandatory auditor rotation for certain companies and rules regarding the provision of non-audit services by auditors to their clients, however this article considers the audit committee independence requirements.

The PRA introduced additional rules and guidance applicable from 17 June 2016 explaining how these requirements should apply to financial services firms. The PRA guidance does not extend to non-Solvency II firms. In particular, the guidance covers whether a firm needs to establish an audit committee separate to its group audit committee and whether all of its non-executive directors must be independent or not.

The impact will potentially be greatest for Solvency II insurers that are Category one or two firms. Firms will need to review the structure and composition of their audit committee, as well as the timing of Board meetings and responsibilities, to ensure they comply with the new requirements. In some cases, terms of reference may need updating.

Separate audit committee

A separate audit committee is required for each insurer, other than:

- non-significant subsidiaries of an EEA parent which complies with the audit committee requirements or
- significant subsidiaries of such a parent where the parent's governing body is composed of the same non-executive directors as the insurer.

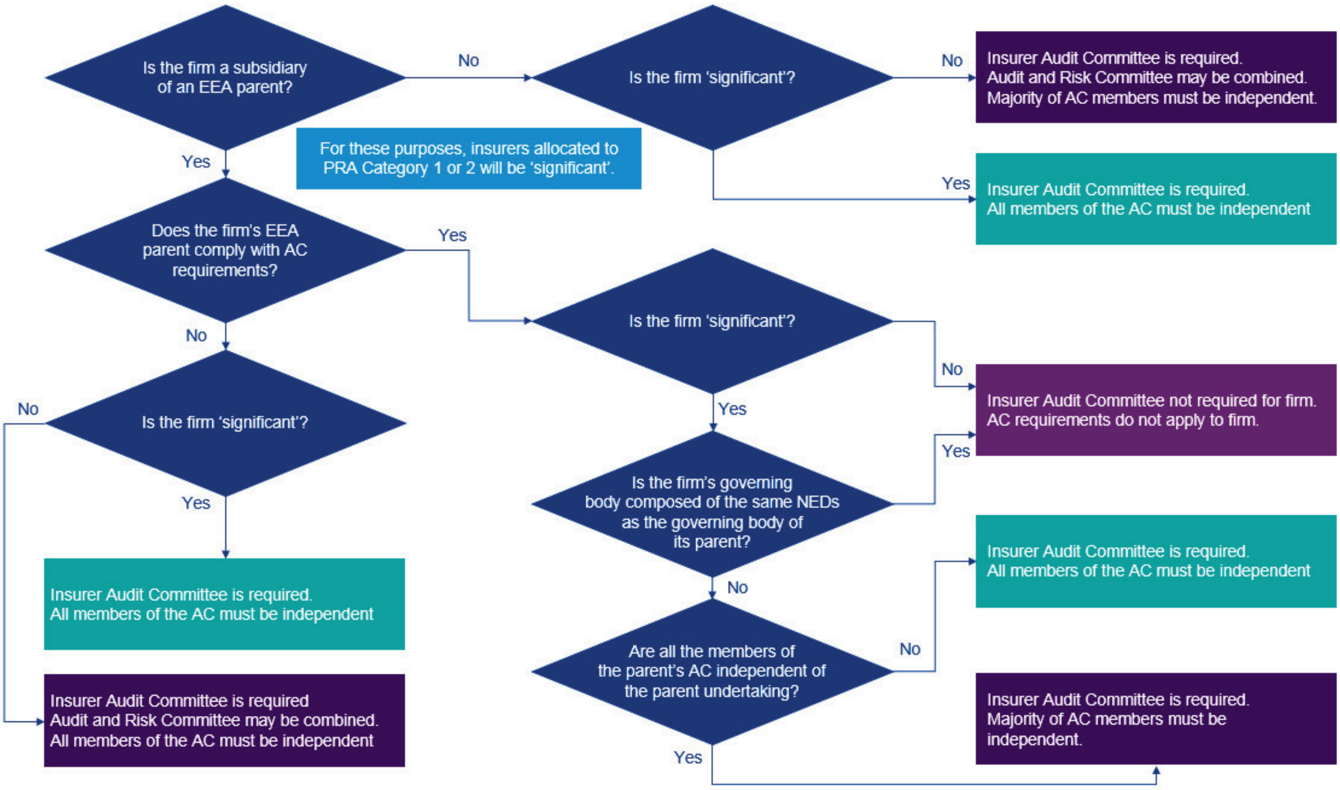
(see diagram below)

Smaller firms may combine their audit and risk committees if they are comfortable that the members of the combined committee have the knowledge, skills and expertise to perform the function of both audit and risk committees.

Independence of audit committee members

The independence requirements depend on a number of factors, which we have summarised in the decision tree below.

Is a separate audit committee (AC) required?



Source: KPMG, August 2016

Individual requirements

The final rules are intentionally silent on the assessment of 'independence' of individual non-executive directors, with the PRA not wishing to create binding rules. The original consultation paper did though set out some indicators of where the independence could be compromised. The indicators should not be viewed as conclusive, nor should the list be seen as exhaustive. These included:

- having been an employee of the firm or group within the last five years
- having held a material business relationship with the firm within the last three years
- receiving remuneration from the firm for other work not related to their role as director
- having close family ties with senior management or other directors
- holding cross-directorships or having significant links with other directors through involvement in other companies or bodies
- representing a significant shareholder
- having served on the board for more than nine years from the date of their first election.

Firms should review each member's independence in light of their professional experience and personal and business interests carefully. Evidence obtained should be capable of withstanding fair and reasonable challenges from the supervisor.

Recent supervisory challenges appear to have focused on 'double-hatting' of individuals sitting on both group and subsidiary boards.

Practical considerations

Where the guidance results in insurance subsidiaries establishing new audit committees for the first time, there will be a number of important considerations in selecting members. This will include whether the individual has the appropriate skills to perform the role and PRA approval as Chairman of the Audit Committee (SIMF 11) or FCA approval as a non-executive director (CF2).

Other considerations include the timing and frequency of meetings, form of deliverables, reviews and sign-offs required, and both financial and regulatory reporting submission deadlines. The commencement of Solvency II audits from November 2016 also needs to be taken into account.

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Insurance Act 2015: implications for commercial insurance contracts

The Insurance Act 2015 will apply to new commercial contracts of insurance as well as variations to existing contracts of insurance from 12 August 2016. Boards of insurers which write commercial lines will want assurance that their legal and compliance teams have appropriately reflected the changes into policy documentation and that underwriters and claims teams understand how the changes impact their decisions.

Firms will also need to consider how the changes are communicated and implemented across their different distribution channels, preferably explaining the changes made to the policy terms well in advance of renewal.

Key requirements relate to disclosure and misrepresentation, insurance warranties, insurers' remedies for fraudulent acts and the 'utmost good faith' principle. We outline the main requirements and implications for insurers below.

Misrepresentation

The Act establishes a duty on policyholders of commercial contracts to disclose all matters relating to risk which the policyholder knows (or ought to know) that would influence an insurer's decision to underwrite the risk and on what terms. Policyholders should provide sufficient information to enable a prudent insurer to make further enquiries about matters which may affect the underwriting decision. Disclosure is not required where the insurer's awareness of the circumstances can be reasonably presumed (for example information already held).

Insurers will need to establish internal policies and guidance for identifying matters where further enquiries should be sought. They will also need to consider the systems and processes required to evidence the information disclosed by their clients and ensure that agents and intermediaries are fully aware of the importance of passing this information to them.

The only remedy an insurer currently has when a policyholder has misrepresented facts is to avoid the policy, regardless of whether the breach was innocent, deliberate or a reckless mistake. The Act introduces a range of proportionate remedies, with the onus on the insurer to demonstrate what action it would have taken had it been provided with a fair presentation of the risk.

This will require insurers to be able to evidence that they have acted proportionately, including supporting any assertion that they would have acted differently had they been cognisant of the full facts. Firms will need to consider carefully the amount of potentially commercially sensitive information it needs to provide around underwriting decisions.

Warranties

A breach of warranty will no longer automatically result in the insurer being able to avoid the insurance contract. Instead the insurer's liability (in respect of any losses occurring after the breach of a warranty) will be suspended while the policyholder remains in breach, but coverage can be restored if the breach is subsequently remedied.

Pre-contractual representations cannot convert into warranties in commercial contracts. Also, insurers cannot rely on the non-compliance to exclude, limit or discharge its liability if the policyholder can demonstrate that the non-compliance with that term could not have increased the risk of the loss.

Insurers should ensure that warranty terms are connected to the risks being underwritten. Where warranties are material to the risks, these should be brought to the policyholder's attention.

Fraudulent acts

Insurers may terminate policies from the date of a fraudulent claim (at its sole discretion). However, an insurer must honour genuine claims made prior to the fraudulent claim as well as the losses of innocent parties insured under a group policy. Insurers may also recover sums paid in respect of fraudulent claims. No return of premium is required.

Insurers should have an internal policy that clearly establishes the period when the insurer is on risk (and to which parties under group policies) under this new regime. They will need adequate resources (both people and systems) dedicated to investigating fraudulent claims and pursuing recovery of monies.

'Utmost good faith'

While insurance contracts will be based on the duty of 'utmost good faith', parties to a commercial insurance contract will not be able to avoid their obligations under the contract where the other has breached this duty.

Contracting out

Except for the provisions relating to warranties and representations and fraudulent claims, parties to a commercial contract may contract out of the Act's provisions, provided that less favourable terms and their consequences are made clear before the contract enters into effect.

Insurers may want to use this opportunity to review their terms and exclusions in general. A review focussing on compliance with legal obligations under the Insurance Act in a vacuum is unlikely to deliver significant value to an insurer. Firms that adopt a more strategic approach by considering how processes can be adapted to build and document customer insight through the pre-contractual stages of underwriting will help insurers develop a better differentiated product offering.

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Capital management: evolution in the general insurance sector

Capital management is increasingly seen as key in providing management with a holistic approach to maximising shareholder value. Over the past few years, the capital management landscape has evolved from mainly meeting regulatory requirements to assisting in running the business in a proactive way. We see companies increasingly linking capital management to a number of other areas within the business.

Volatility and various return on equity (ROE) measures are now considered in individual pricing decisions, rather than simply being used in high level portfolio management. Models are evolving to be more dynamic and inform underwriters on capital consumption and accumulations at the point of underwriting.

Capital efficiency is increasingly becoming an important driver in making business decisions. A key driver of recent M&A activity was capital efficiency, achieved either through diversification benefit or corporate restructuring. Many general insurers are seeking to expand into emerging markets to increase their geographic footprint and to diversify exposures, making their capital work harder. Reinsurers have seen their ROEs reduce significantly. Without building sufficient margins in the catastrophe-free years, they will find it increasingly difficult to protect their capital and achieve their target ROE over a cycle. This is leading to a move to diversify into direct markets, either via alternative platforms or managing general agents (MGAs).

Increasingly, general insurers are incorporating different platforms within their structures to manage risk more efficiently. For example, Lloyd's syndicates provide a capital efficient way for writing certain business through Lloyd's worldwide licences. Sidecars, joint ventures or special purpose syndicates are other avenues that insurers are increasingly using to make their capital base more flexible. These structures enable insurers to target investors with specific risk appetites who wish to participate in particular segments of the insurer's portfolios (depending on their own risk/return profile) – whereas a traditional equity investor seeks an average ROE across the entire company.

Solvency II and market dynamics have led to some companies examining their legacy books. Traditionally, legacy portfolios were seen as the generators of reserve releases, keeping companies' results healthy. However, the opportunity cost associated with the capital locked in by some legacy books is often now viewed as too high, leading to disposals, portfolio transfers and adverse development covers. Part VII transfers remain a key tool for UK insurers to deal with run-off and the uncertainty caused by Brexit will likely see greater use of this tool in the run-up to the UK's formal exit from the EU.

The reinsurance market's current soft cycle is good news for buyers as both rates and terms and conditions are very favourable. Insurers are increasingly using reinsurance to manage their capital more efficiently, either by utilising group reinsurance to release capital from subsidiaries or buying additional cover from the market to reduce their capital requirements. Over the past 18 months, larger groups have also begun consolidating their reinsurance programmes to rationalise costs and make their reinsurance programmes more capital efficient.

Insurers should ensure that warranty terms are connected to the risks being underwritten. Where warranties are material to the risks, these should be brought to the policyholder's attention.

Looking forward, it is more important than ever that insurance executives think in a forward-looking manner. Capital management should not only be about the current health of the balance sheet and capital base, but also its long-term sustainability. For example, dividend policy needs to consider possible outcomes over the next 2-3 years to manage volatility in dividend payments. Capital models therefore need to be able to model over a multi-year horizon. It is also not sufficient to just look at regulatory capital (which is often the bare minimum). Most companies use economic capital and required capital, driven by the rating agency models, to manage their business.

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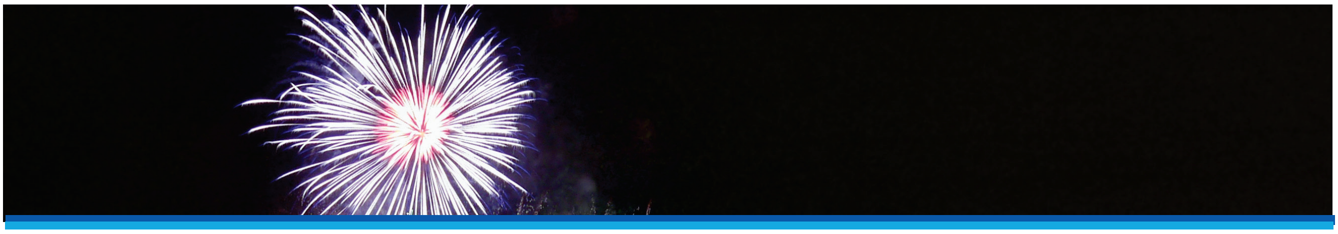
Future regulatory milestones



Date	Activity/Topic	Impact on industry
Solvency II		Reporting dates shown below relate to insurers whose year-end date is 31 December. Insurers whose financial year ends on a different date should consult the PRA website.
4 August 2016	Response deadline for PRA Consultation Paper on Solvency II: external audit of the public disclosure requirement (CP23/16)	CP23/16 updates the PRA proposals set out in CP43/15. The audit scope remains unchanged, but there are a number of key clarifications, including: • Solvency II audit requirement start date delayed to year-ends on or after 15 November 2016 (originally 30 June 2016) • PRA expects governing body to evidence in writing their responsibility for the Solvency and Financial Condition Report (SFCR) • Clarification that where firms use a partial internal model (PIM) to determine their solvency capital requirement (SCR), the entire SCR is excluded from the audit scope • PRA will not be an addressee in the auditor's report. No update has been provided regarding whether the calculation of the transitional deduction from technical provisions (TDTP) will be scoped out of the audit. [The calculation works by comparing the Solvency II and ICA basis, which has never been subject to audit.]
5 August 2016	Response deadline for PRA Consultation Paper on Solvency II: Changes to internal models used by UK insurance firms (CP19/16)	This paper clarifies the PRA's expectations regarding the process for making a major change to an insurer's internal model. These include: • early engagement as soon as firms consider that an application is likely • notification should contain a summary of planned changes, reasons for these, potential impact and intended timescales for implementation • explanation of how model changes have been identified and prioritised • depending on the complexity of model changes proposed, a pre-application review may be offered • no more than one model change application per year • board approval prior to submission of application.
5 August 2016	Response deadline to PRA Consultation Paper on Solvency II: consolidation of Directors' letters (CP20/16)	This paper proposes consolidating existing Solvency II guidance previously set out in directors' letters within supervisory statements. There is no substantial change in policy.

Date	Activity/Topic	Impact on industry
17 August 2016	Response deadline for PRA Consultation Paper on Solvency II: Monitoring model drift and standard formula SCR reporting for firms with an approved internal model (CP22/16)	For internal model firms, the paper clarifies the PRA's expectations regarding monitoring internal model drift. This requires insurers to provide annual reporting to the PRA of their SCR and pre-corridor minimum capital requirement (MCR) calculated on a standard formula basis, net written premiums and best estimate liabilities.
September 2016	Ultimate Forward Rate (UFR) decision	Following public consultation of its proposals, EIOPA aims to publish its final position in September 2016. The current UFRs are not expected to change until at least the end of 2016, so there should be no immediate impact on insurers.
15 November 2016	UK Solvency II audit requirements start	See 4 August entry above.
20 May 2017	First solo annual reporting	Submission comprises QRT templates, Regular Supervisory Report (RSR) and public Solvency and Financial Condition Report (SFCR).
1 July 2017	First group annual reporting	For EEA parented groups, this will comprise the QRT templates, RSR and SFCR. For non-EEA parented groups, reporting will be either the same or in accordance with the 'other methods' requirements agreed.
Senior Insurance Managers regime (SIMR		Although the SIMR mainly came into effect on 1 January 2016, some elements of the regime are yet to become effective.
Second half of 2016	PRA consultation on extension of Senior Manager Certification Regime to insurers	Following the Bank of England and Financial Services Act 2016 which extends the SMCR to insurers, the PRA will consult on further rules to implement these rules to insurers. The new regime is expected to be implemented in 2018.
7 September 2016	Solvency II firms and large non-directive firms (NDFs)	Deadline for setting out the scope of responsibilities of Significant Influence Function holders and implementing the whistleblowing rules.
March 2017	Small NDFs	Scope of responsibilities deadline for Significant Influence Function holders.
FCA reviews		This section provides a brief overview of recent developments in key FCA initiatives. It does not represent a comprehensive list of all FCA thematic reviews.
2016	Fair treatment of long-standing customers in the life insurance sector	The FCA released the findings of its thematic review (TR16/2) in March 2016, with a 3 June 2016 deadline for feedback. Further guidance is possible later in 2016.
22 July 2016	Appointed representatives	FCA published the findings from its work on appointed representatives in the general insurance sector (TR16/6). This identified significant shortcomings in relation to insurance firms' control and oversight of appointed representatives' activities, with examples of potential mis-selling and customer detriment found. The FCA plans further follow up, but all insurers using appointed representatives (including life companies) should assess whether the findings could also arise in their companies.

Date	Activity/Topic	Impact on industry
Summer 2016	General insurance value measures	In its feedback on general insurance add-ons (FS16/1), the FCA proposed introducing an insurance scorecard to provide policyholders with better information about the products they have purchased/are considering purchasing, covering information such as claims frequencies, claims acceptance rates and average claim pay-outs. The FCA plans to launch these requirements over a two year period, with a pilot in summer 2016 covering a limited number of products.
Late 2016	General insurance renewals	Proposals for greater transparency at renewal are expected later this year, including: • disclosure of last year's premium on renewal notices • additional disclosure in relation to shopping around when customers have renewed the same product four or more times • new guidance regarding renewals processes.
2017	Retirement Outcomes review	The FCA released the terms of reference for this review on 14 July 2016. The review will explore whether competition is working effectively in the retirement income market following the introduction of the pension reforms. The FCA plans to conclude the review and publish its findings in summer 2017.
2017	Ageing population and financial services	The FCA is working towards creating an FCA Strategy on the Ageing Population to be launched in 2017. This strategy will make recommendations about how outcomes for older people can be improved, with a series of recommendations for future action planned.
Packaged Retail and Insurance-based Investment Products (PRIIP)		The PRIIP regulations introduce standardised pre-contractual disclosure requirements, including the Key Information Document (KID). KIDs must comply with both the supporting regulatory technical standards and guidelines issued by the Joint Committee of the European Supervisory Authorities.
19 September 2016	Response deadline to FCA Consultation Paper on Changes to Handbook disclosure rules to reflect the direct application of PRIIPs Regulation (CP16/18)	This paper outlines the changes needed to comply with EU requirements. The FCA may maintain some additional disclosure requirements where these provide additional useful information.
31 December 2016	PRIIP regulations enter into force	All life insurers will need to comply in respect of contracts issued with an investment element. Firms face a significant challenge to meet the pre-sales disclosures required in the prescribed 3-page KID template.
Insurance Distribution Directive (IDD)		The IDD will replace the Insurance Mediation Directive (IMD) in Europe, including requirements for an insurance Product Information Document (IPID).
3 October 2016	Response deadline to EIOPA Consultation Paper on Technical Advice on possible delegated acts concerning the IDD (EIOPA-CP-16-006)	The consultation paper covers product governance and oversight, conflicts of interest, inducements and assessment of suitability and appropriateness and reporting. EIOPA builds on its preparatory guidelines in many areas, reducing the impact on insurers that are already compliant with these.
24 October 2016	Response deadline to EIOPA Consultation Paper on a standardised presentation format for the IPID (EIOPA-CP-16-007)	The paper sets out the proposed presentation of the IPID, including its length and format.

Date	Activity/Topic	Impact on industry
1 February 2017	Delivery of IDD draft technical standards to the European Commission	n/a
23 February 2018	IDD becomes effective	In particular, firms will need to ensure their pre-sales literature will comply with the required IPID referenced above and address the required remuneration disclosures.
EIOPA Stress Test		The 2016 EIOPA stress test considers the insurance sector's vulnerabilities to a combination of market risk adverse scenarios, including a persistent low interest rate environment. The deadline for insurers to submit their results was 15 July. Key remaining deadlines are shown below.
September 2016	EIOPA central validation of results	n/a
December 2016	Publication of EIOPA's report on stress test	The findings could influence regulatory approaches, but given the low interest rate environment already appears to be a long-term feature in the UK, in reality this is already factored into the PRA's approach.
International Association of Insurance Supervisors (IAIS)		The IAIS continues to issue updated material covering both Insurance Core Principles (ICPs) and measures relevant to the global systemically important insurers (G-SIIs) and potential G-SIIs. Key aspects relevant to UK insurers are included below, but this is not comprehensive and reference should be made to the IAIS website for other material.
15 September and 31 October 2016	IAIS field testing deadlines	The field testing exercise relates to the global insurance capital standard (ICS) which will apply to internationally active insurance groups (IAIGs) from 2017.
19 October 2016	Response deadline to IAIS Consultation Paper on the ICS version 1.0	The main focus is on valuation methodologies, qualifying capital resources and the risk based approaches to determine regulatory capital requirements.
10-11 November 2016	IAIS annual conference, Paraguay	Registration can be booked on the IAIS website at http://annualconference.iaisweb.org /2016/home.
mid-2017	Adoption of ICS version 1.0	This will be applicable to the 2017 confidential reporting process for all IAIGs. Public reporting is expected from 2020.
Other key dates		
12 August 2016	The Insurance Act 2015 comes into force	See article on Insurance Act 2015: Implications for commercial insurance contracts]
31 March 2017	Insurance Block Exemption Regulation (IBER)	The IBER exempts certain types of co-operation in the insurance sector from EU antitrust rules under certain conditions and is due to expire on 31 March 2017. This mainly relates to joint compilations, tables and studies and co-(re)insurance pools. A decision on whether to renew or remove the IBER is expected in early 2017.

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