



Solvency II public reporting

Getting over the line

December 2017

kpmg.com/uk



Executive summary

Our impressions

The new regulatory regime for insurance companies in Europe, Solvency II, became effective from 1 January 2016. One of the three pillars of Solvency II requires insurers to be transparent and provide comprehensive quantitative and qualitative information around their regulatory financial position and capital management. This information is made public through the Solvency and Financial Condition Report (SFCR) which insurers had to publish for the first time earlier this year.

As required by the Prudential Regulatory Authority (PRA), the Valuation for Solvency Purposes and Capital Management sections of the SFCR were subject to audit. As one of the leading audit firms for the FTSE 100 insurance sector, we reviewed a significant share of the SFCRs published in the UK. Additionally, for the purpose of this report, we reviewed a sample of SFCRs which were not audited by KPMG in order to obtain a broader view of the market.

While the structure and content of the SFCR are prescribed in detail under Solvency II regulation, the rules leave much room for interpretation when it comes to the length and depth of narrative disclosures. Overall although we found that most insurers had provided the necessary disclosures to meet the reporting requirements, we also noted substantial variance in the extent and depth of disclosures.

The better SFCRs tended to be those that presented a good balance between quantitative and qualitative information. While longer narrative disclosures do not always mean good quality, we found through our benchmarking that disclosures around the following areas could be improved:

- Adequate quantitative disclosures to explain the key differences between valuation for statutory financial reporting purposes and valuation for solvency purposes
- Identification of assets and liabilities which are valued using alternative valuation methods, the assumptions used and description of the valuation uncertainty
- Information on capital management objectives and policies
- Description of the degree of subordination of own fund items other than ordinary share capital
- Availability of own funds around the group

As insurers prepare for the second year of publishing the SFCR, we hope this publication will assist them in focussing on the areas where they can add value by improving their disclosures.



Contents

Benchmarking approach	3
Valuation for solvency II purposes	5
Capital management	9
Looking ahead	13

Benchmarking approach



Our focus

The objective of Solvency II public disclosure is to provide various stakeholders a sound understanding of insurers' solvency positions.

In particular, the disclosures relating to valuation for solvency II purposes and capital management are of primary importance due to their inclusion in the scope of audit. Therefore for the purpose of this analysis, our focus is on these two sections only.



Benchmarking approach

In order to quantify our observations for trend analysis, we have set up a catalogue of questions against which we have benchmarked the disclosures. Those questions reflect areas where we observed differences in approach between insurers during the course of our audits of the relevant elements of the SFCR.



Data

We applied those questions to a sample of 30 solo and 10 group UK-based insurance undertakings. Our sample was split equally between life and general insurance businesses and comprised both KPMG and non-KPMG audit clients.

Our analysis addresses only the data published in the SFCRs with financial year end 2016.





Valuation for solvency II purposes



“Only half of companies in our sample provided full and clear numerical disclosures explaining adjustments between IFRS or local GAAP and Solvency II”

Bases, methods and assumptions

All insurers were required to provide disclosures around the bases, methods and assumptions underlying the valuation of their non-technical assets and liabilities.

However, we noted great variability in depth and substance of those disclosures, with some companies providing exhaustive and detailed explanations and others providing just enough information to cover the requirement.

The disclosures of bases, methods and assumptions could be improved by clearly explaining the sources of the differences between IFRS or local GAAP and Solvency II, rather than leaving those differences open for interpretation.

We also noted that the disclosures of the basis of valuation for certain material classes of assets and liabilities were sometimes grouped together into a single note and this did not allow for sufficient level of detail to be provided for each line item individually.

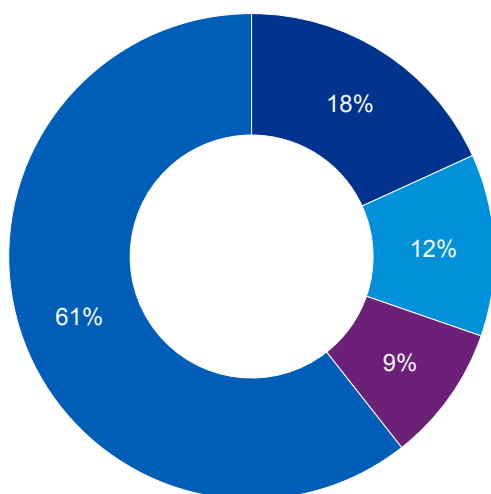
Quantitative disclosures

The objective of the numerical disclosures is to provide the reader with an understanding of the material differences between IFRS/ local GAAP and Solvency II.

To achieve this objective, the Valuation for Solvency Purposes section provides a reconciliation between the IFRS/local GAAP balance sheet and the Solvency II balance sheet. Only half of our sample companies provided full and clear numerical disclosures explaining adjustments between IFRS and Solvency II. Nonetheless, the level of detail varied and some opted to disclose the bare minimum.

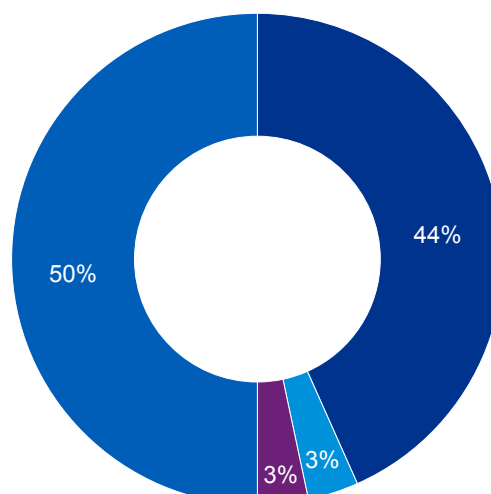
In a significant number of cases, we also noted that the reconciliation did not follow the format of the Balance Sheet QRT, and instead followed the IFRS or local GAAP balance sheet format. This made it difficult for a reader to understand any reclassifications made when going from IFRS/local GAAP to Solvency II.

How well are bases and methods of valuation disclosed?



- Disclosure provided for all material assets and liabilities
- No or little disclosure made
- Disclosure provided for only some material assets and liabilities
- Cross reference made to accounts

How clearly are quantitative differences explained?



- Full table provided with Solvency II line items and referencing/ explanation in narrative section
- Table provided, however GAAP line items used instead of Solvency II taxonomy
- Table provided, however little or no cross-referencing in narrative section to explain differences
- Little or no numerical disclosures provided

“In more than 90% of the SFCRs reviewed, we noted that insurers have used one of the prohibited valuation methods as ‘proxy’ for fair value”

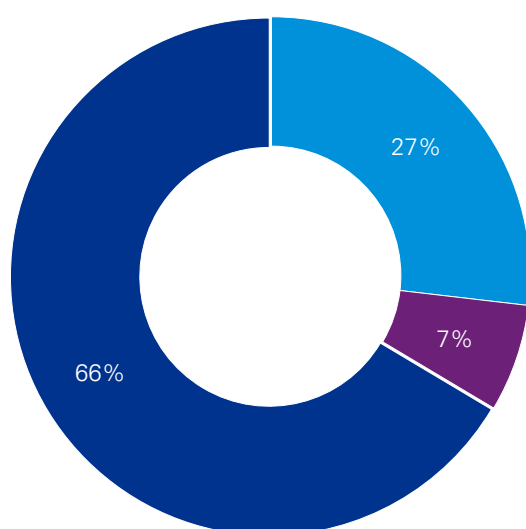
Market consistent valuation

Under Solvency II assets and liabilities should be valued at a market-consistent or fair value. The Solvency II rules specifically prohibit certain valuation methods such as historic cost, depreciated cost or amortised cost.

However, in more than 90% of the SFCRs reviewed, we noted that insurers have used one of the prohibited valuation methods as ‘proxy’ for fair value. For example, the depreciated cost of plant and equipment has been deemed to be materially equivalent to fair value in many cases.

For two-thirds of insurers who used that approximation, an explanation was provided for using a cost method as proxy for fair value, and the dominant rationale was the short-term maturity of the asset/liability. It is worth also highlighting that in most cases, the assets which were valued using this approximation did not form a significant part of the overall insurer’s balance sheet.

Is use of cost approximation method as proxy for fair value justified?



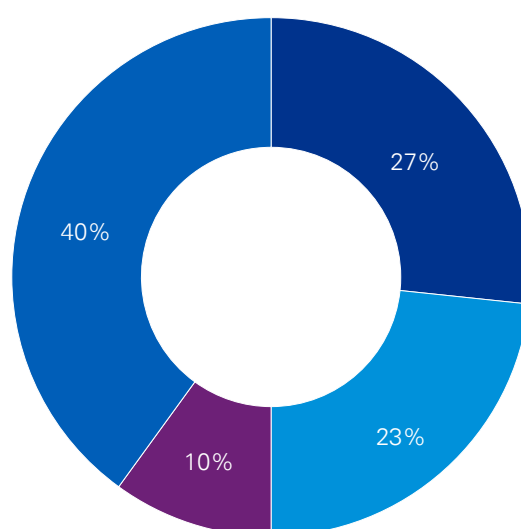
- Reason for using cost approximation disclosed
- Reason for using cost approximation not disclosed
- No cost approximation valuation method applied

Fair value hierarchy

Under Solvency II, assets and liabilities are valued using a valuation hierarchy, with quoted market prices in active markets being the default method of valuation. Around 73% of insurers in our analysis provided some form of disclosures on valuation hierarchy and over half of them provided an explanation of how they assess that the market they derived inputs from is an active market.

However, we also noted that around one in ten insurers instead used the IFRS 13 Fair value hierarchy as disclosed in the IFRS financial statements. Although the Solvency II hierarchy is similar to IFRS 13 fair value hierarchy, there are some key differences, notably in the second level of the hierarchy where Solvency II is more stringent around the requirement for prices to come from ‘active’ markets, whereas IFRS 13 allows a valuation model to be used as long as the inputs are observable.

How was valuation hierarchy disclosed?



- Disclosed Solvency II fair value hierarchy with explanation of active markets
- No reference made to fair value hierarchy
- Disclosed Solvency II fair value hierarchy however with no definition of active markets
- Used IFRS 13 fair value hierarchy instead of Solvency II fair value hierarchy

“Around 40% of the insurers in our analysis disclosed that they did not use an Alternative Valuation Method”

Alternative valuation methods (AVMs)

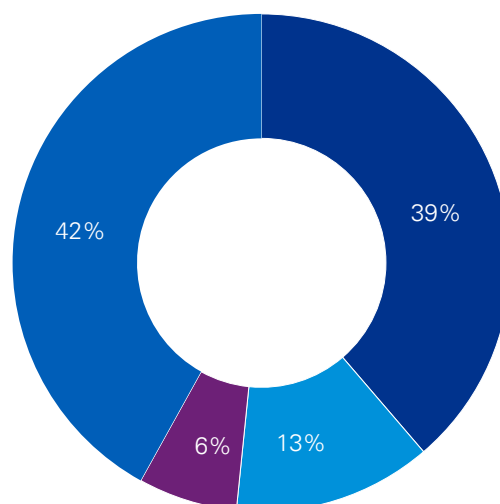
80% of insurers in our analysis who used an AVM provided disclosures around the basis and method of valuation as well as the valuation uncertainty associated with their chosen valuation method. Insurers used AVMs mostly for valuation of property, derivatives or subordinated liabilities.

Half of the companies that disclosed that they used AVMs also disclosed assumptions and reasons for using these AVMs. These disclosures were presented within particular notes in sections D.1 Assets, D.3 Other Liabilities or D.4 Alternative Valuation Methods of the SFCR.

Around 40% of the insurers in our analysis disclosed that they did not use an AVM. This is because the assets on their balance sheets comprised either assets and liabilities for which quoted market prices were available or where the assets and liabilities were short term in nature.

We have noted that some companies disclosed in section D.4 that they have not used AVMs when in fact they did. Based on the disclosure notes in section D.1 or D.3 we could infer that the company valued, for example, property or investments in unlisted equities by using valuation methods that would qualify as AVMs. These inconsistencies suggest that companies may still struggle with the disclosure requirements and approach regarding AVMs and this is an area for further improvement in future SFCRs.

How well have the alternative valuation methods been explained?



- Full explanation provided including assumptions and reasons
- Some explanation provided around basis and method of valuation
- Cross reference made to fair value disclosures in the accounts
- No AVM to disclose





Capital management



“Larger insurers tended to have more formal capital management policies compared to smaller insurers”

Capital management objective and policy

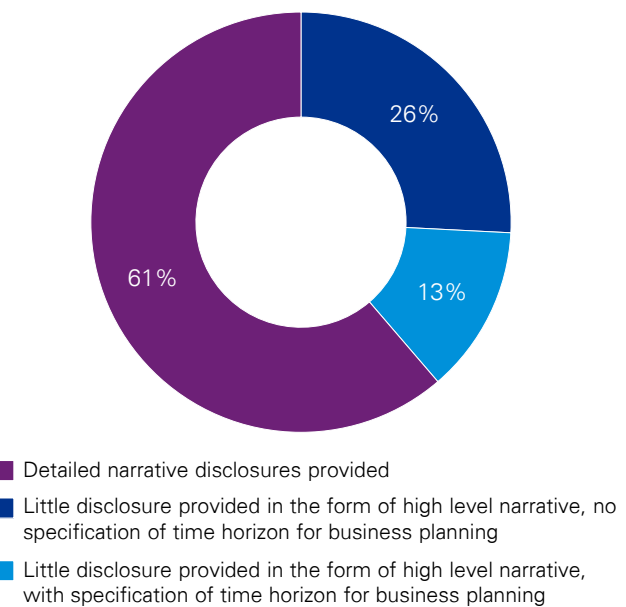
Just over 60% of companies in our sample provided detailed disclosures in this area, with some showing an in-depth analysis of their policies and capital strategy, including discussions of target capital structure, return on equity and growth strategies. The remaining 40% provided just enough narrative disclosures to meet the requirements.

The narrative disclosures varied in length and depth, and reflected the size and complexity of the insurer’s business. We noted that larger insurers tended to have more formal capital management policies while smaller insurers’ capital management strategies and processes were more informal in nature.

Although it is difficult to compare the quality of narrative disclosures given the requirements are not prescriptive in this area, our expectation is that this section should be completed with at least a comparable level of detail as is provided in the capital management disclosure note in the insurer’s financial statements.

Some insurers cross-referred to other parts of their SFCR or to their published annual report for disclosures regarding their capital management policies. There were also instances, whereby a cross reference was made to the insurer’s ORSA, which is not appropriate given the ORSA is not publicly available.

How well have the capital management objectives been described?

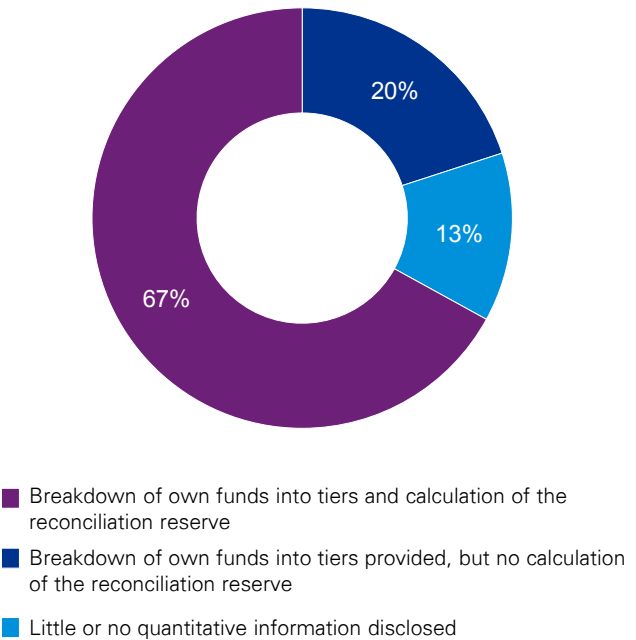


Breakdown of own funds into tiers

The majority of insurers in our sample (87%) provided a clear breakdown of own funds into tiers and two thirds also provided a detailed breakdown of the Reconciliation Reserve.

For the remaining 13%, no quantitative information was provided and the narrative in relation to the classification of certain instruments into their relevant tiers lacked clarity.

How appropriately has the tiering of own funds been presented?



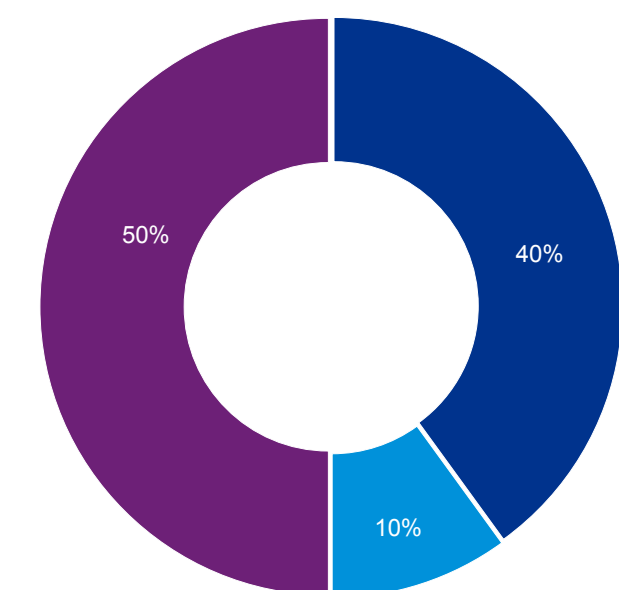
“Less than half of the insurers in our sample included a level of detail in the commentary to explain reconciling items”

Reconciliation to IFRS

Insurers are required to present a reconciliation along with commentary to explain material differences between the equity as shown in the undertaking's financial statements and the excess of assets over liabilities as calculated for solvency purposes.

The majority of insurers in our sample met the requirement to provide the reconciliation (90%), but less than half included a level of detail in the commentary to explain the reconciling items.

Has appropriate IFRS to Solvency II reconciliation been provided?



- Reconciliation provided, however with little or no commentary
- Reconciliation provided with detailed commentary
- Reconciliation not provided

Ring fenced funds

Although the concept of ring fenced funds (RFFs) applies mainly to with-profits business, this does not preclude the existence of RFFs in other situations. Any instance where a specific pool of assets is dedicated to cover specific liabilities can give rise to a RFF. A RFF can therefore arise in both a life or a non-life insurer.

Within our sample, there were 6 out of 15 life insurers who wrote with-profits business. All of them treated their with-profits policyholder funds as RFFs and made a deduction to own funds to reflect restricted own funds arising from the RFFs.

They also discussed arrangements such as materiality, volatility and risks arising from the RFF amounts. We also noted that some companies defined the likely impact of the RFF on the calculation of the SCR due to the reduced scope for diversification.

Out of 15 non-life insurers in our sample, two had RFFs, owing to their overseas branches.

As for the remaining companies that did not have RFFs, most did not explain how they had come to the conclusion that there are no RFFs in their business.

“Only 2 groups in our sample disclosed the potential impact of local solvency requirements on the availability of own funds at group level”

Consolidation methods

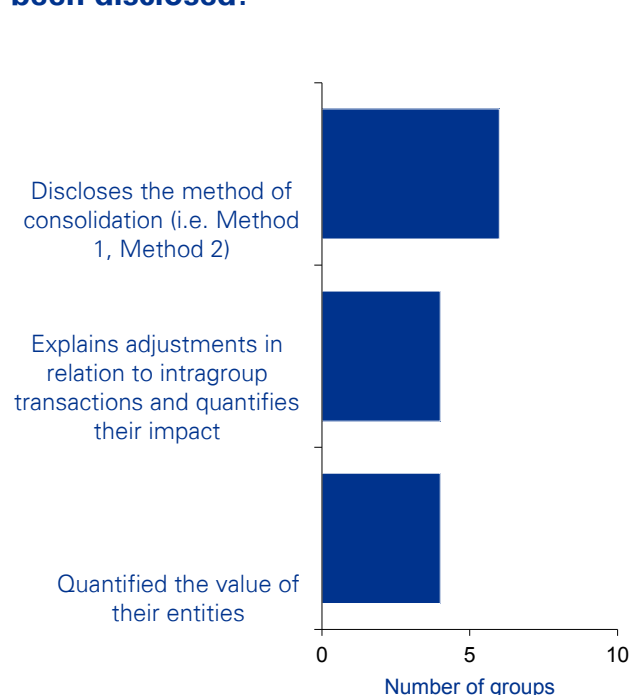
Disclosing the method of consolidation: Four groups in our sample of ten used a combination of Method 1 (Accounting Consolidation Method) and Method 2 (Deduction and Aggregation). These groups provided a description of both methods.

The remaining six groups in our sample used Method 1 only. However, only two of those six groups provided an explanation how they applied that consolidation method.

Intragroup transactions and their impact: Four groups identified and disclosed the impact of intragroup transactions. We noted that two groups explained this impact by giving references to the value of those transactions.

Group SCR: Half of the groups in our sample explained the composition of the Group SCR and which entities in the group gave rise to diversification benefits in the Group SCR. For the other half of groups in our sample, there was little or no explanation to distinguish between the different treatments of entities in the group and how this affected the Group SCR.

How well has the consolidation method been disclosed?



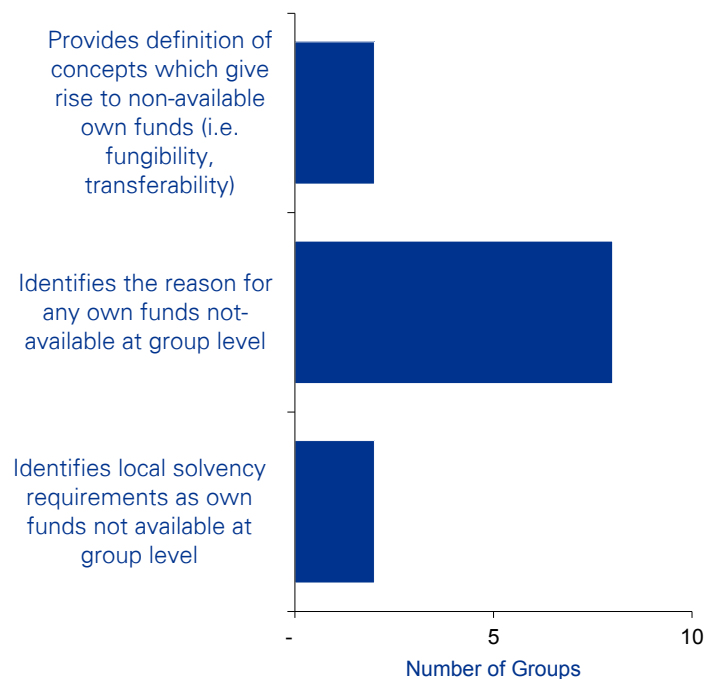
Availability of group own funds

Defining the concept: Only two groups out of the ten in our sample explained the concept of availability restrictions and why it was being considered in the context of their group. Most groups did not explain the concept of availability restrictions on group own funds and instead assumed a reader would understand this.

Types of Instruments: 70% of the groups identified which own fund items were causing restrictions and also described the causes of those restrictions. Examples included disclosures on restriction on remittance of capital from another country and ring-fenced funds.

Local capital and solvency requirements: Only two groups in our sample disclosed the potential impact of local solvency requirements on the availability of own funds at group level.

How did groups disclose their assessment of group own funds availability?



“Eventually there will be more convergence in terms of the depth and quality of disclosures, and areas of best practice will develop as insurers benchmark themselves against peers”

Looking ahead

As insurers prepare for their second year of publishing an SFCR, we consider the following to be areas where they can improve the quality of the disclosures being presented:

- Avoid technical jargon – To the extent that the SFCR is a public document, it needs to be accessible to a wide audience who may not entirely be familiar with Solvency II. Some preparers have used a glossary to explain technical terms and overall we found that using simpler language made the document more readable.
- Use cross referencing wisely – Preparers are allowed to cross refer to other publicly available documents rather than duplicating information that is already in the public domain. For example, some insurers cross referred to fair value disclosures in their financial statements effectively. This however did not work in situations where the document being cross referred to is not public, such as the ORSA.
- Provide numerical information – Some insurers have been reluctant to provide numerical disclosures even though these were required by the rules. In other places where numerical disclosures were optional, these would still have provided more useful information to a reader as opposed to cumbersome narrative explanations.
- Learn from others – The PRA have indicated that they do not want to be prescriptive in terms of the depth of disclosures provided by insurers in their SFCR. Instead, it is expected that eventually there will be more convergence in terms of the depth and quality of disclosures, and areas of best practice will develop as insurers benchmark themselves against peers.
- A window into your organisation – As the SFCR is likely to be annual requirement for many years to come, insurers should approach this less from a compliance perspective and rather consider the SFCR as an opportunity to demonstrate to the external world how well they are managing their regulatory financial position.



kpmg.com/uk



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation..

© 2017 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Designed by CREATE | CRT088238F