Illuminate

KPMG's insurance regulatory newsletter

With so much focus on the implications of Brexit on all sectors of the economy, it is sometimes hard to remember there are other risks and opportunities to be dealt with. The world of regulation has not stood still, with greater Europe-wide harmonisation of pre-sales information through the Insurance Distribution Directive (IDD) and the PRA's Senior Managers and Certification Regime (SMCR) both due to become effective later this year. EIOPA has now issued its final set of advice regarding proposed changes to Solvency II, although it is unclear when the Commission will turn these into rules. The proposals around harmonisation of approaches to the calculation of the loss absorbing capacity of deferred taxes in particular could require some changes in approach by UK insurers.

We have a number of features in this edition of Illuminate, covering a range of regulatory matters. We start with an update on some of the practical considerations and challenges that many UK insurers face arising from Brexit. The ever-increasing regulatory attention on pricing in the general insurance sector is the subject of our second article. We follow this with an update on the world of cyber risk and its implications for the insurance sector and our final article provides our thoughts regarding the first set of public Solvency and Financial Condition reports, which includes some helpful reminders before this year's reports are finalised. We close with our usual look forward to some of the key regulatory matters that insurers will need to address in the coming months.

I hope you find these articles informative. If you would like to discuss any of the matters covered, do please contact the author or any of your usual KPMG contacts.

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Much of the focus of both UK and EU insurers around Brexit has been how to restructure their operating models to enable continued access to both markets. As these exercises progress, other matters are arising that need to be considered. We set out below some of the key challenges we have been discussing with our clients.

Servicing existing business

Establishing an EU insurer to sit alongside the UK insurer is an effective way of addressing future sales. However, it remains unclear whether existing policies sold pre-Brexit can be legally serviced by the UK insurer or whether these need to be transferred to the new EU carrier.

Solvency II did not harmonise rules regarding remote servicing of insurance contracts, with divergent approaches applying across Europe. While the UK has announced it will legislate if necessary to ensure insurance contracts can continue to be met, to date there has been no softening in the EU position. There is therefore a risk that if a UK insurer continues to service these contracts post-Brexit, it could be found of being in breach of authorisation requirements in some countries.

To avoid this risk, we are seeing an increase in activity to effect portfolio transfers before Brexit. There are a number of practical considerations, including availability of independent experts, regulators and court time as well as determining which policies are affected and how to address pan-EU contracts that include (currently) the UK.

Local substance and cross-border activity

While insurers would like as minimal disruption to their current operating model as possible, EIOPA is concerned that there needs to be sufficient substance to any newly created EU insurers, so that the relevant European regulator can supervise them effectively. This raises challenges both in terms of 'feet on the ground' and the ability to effectively outsource activities or reinsure significant levels of exposure back to the UK.

Generally, EU regulators are being receptive to insurers' proposals provided they can demonstrate that decision-making will truly reside in the local head office and if functions are outsourced that the head office is able to properly supervise the outsourcing arrangements.

There are however a number of potential threats to proposed models. The key ones we perceive are:

- Outsourcing arrangements: the current review of the European Supervisory Authority (ESA) regulations proposes that all significant outsourcing arrangements are notified to the relevant ESA, introducing a risk that EIOPA could disagree with arrangements accepted by national authorities.

- Data exchange data across the UK/EU border: while the UK is expected to remain close to the requirements of the General Data Protection Regulations, the timing of any adequacy assessment is unclear. Any restrictions to data flow would have significant implications for operating models.

Timeline

Despite the EU's draft withdrawal agreement which includes proposed transitional arrangements lasting until December 2020, most UK insurers are continuing with their plans to have their new EU insurer authorised and operational by March 2019.

Transitional arrangements would (once certain), however, offer more time to effect portfolio transfers and any other arrangements that rely on European legislation (for example cross-border mergers and migration of Societas Europaea (SE) companies).

Distribution and customer retention

There is already some evidence that brokers, quite rightly, want to understand insurers' Brexit plans before placing business with them. Insurers that are slow to establish their new operating model could therefore find themselves at a competitive disadvantage.

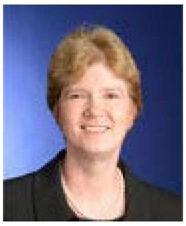
It remains unclear how policyholders will react and whether this could affect retention rates.

Pricing

It is unlikely that renewal can be made directly into the new EU insurer without explicit policyholder consent. In addition to ensuring no regulatory breach arises, care will need to be taken in pricing the renewal, as the EU insurer will not have knowledge of policyholders' history.

Next steps

The continued Brexit mantra that "*nothing is agreed until everything is agreed*" means insurers would be advised to continue implementing their restructuring plans. In so doing, it will be important that policyholder implications remain in the forefront of Boards' thinking.



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General Insurance Pricing Practices

There is increasing scrutiny of insurers' pricing practices – from consumers, media and regulators. Whilst the FCA is not a "price regulator", it is clear that it expects "*high quality, good value products… [that are] competitively priced*". In our view firms need to do more to evidence that this approach is at the heart of their pricing strategy.

Why is this important?

Quite rightly, claims are viewed as the "moment of truth" that influences customer experience. However, the majority of customers don't make a claim in any given year and so price can have a greater influence on customer engagement. A clear pricing strategy that balances commercial and customer experience objectives, while managing conduct risk effectively, is critically important. It is too easy for pricing strategy to become disconnected from an insurer's overall goals.

Insurers often point to the fact that the personal lines insurance market is extremely competitive, with switching easy and barrier-free due to the prevalence of price comparison websites. Undoubtedly this is true for many customers, but for some vulnerable customer segments, access and ability to switch is not so easy. Insurers should also consider whether it is reasonable that customers should need to regularly switch to obtain value for money.

Recent developments

General insurance pricing is rarely out of the personal finance sections of the newspapers which means Boards need to consider their appetite for reputational risk.

The FCA has acted in some areas already and is exploring the potential for action elsewhere:

- Policy Statement 16/21 requires firms to provide certain information on renewal notices, including disclosing last year's premium. It is not yet clear that this has increased levels of switching so there is potential for further regulatory initiatives.

- The 2017 General Insurance Value Measures pilot defined measures of value for certain products for a number of insurers, intended to increase transparency, but its effectiveness is unclear. The FCA continues to be active in this area, including a current study into Home Insurance pricing.

Government interest is also high, with the Chair of the Business and Energy Select Committee demanding that the insurance sector "is giving customers a fair deal".

Looking beyond insurance, in the energy sector price controls limit the margin firms can charge over the wholesale price for the most vulnerable customers, with further action proposed to extend coverage. Could we see similar regulatory initiatives introduced for insurance?

What should insurers be doing?

We believe insurers need to be on the "front foot" in this area:

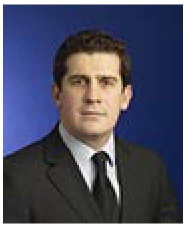
- Clearly defining their pricing strategy and what value-for-money means, in particular establishing their risk appetite for cross-subsidies between customer segments, core products and optional extras.

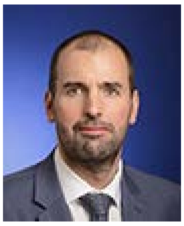
- Testing actual pricing against this strategy and identifying value-for-money hotspots where action might be required or the FCA could challenge the fairness of approach. Insurers need to be able to establish what practices they can, and cannot, justify – for example differentiated pricing based on proximity to renewal date. This should be a two-way test, enabling insurers to identify where the value-for-money being offered is too great to meet commercial objectives.

- Considering pricing practices for new and renewing customers, addressing the growing consumer sentiment that insurers' renewal pricing approaches can effectively act as a penalty for loyalty. Do insurers create the wrong cultural impression by emphasising phrases such as 'price optimisation' and 'propensity to buy'?

- Developing a plan for future customer pricing changes, ensuring that the control environment is appropriate - with processes aligned to the pricing strategy and relevant pricing measures incorporated into Conduct Risk reporting.

We also encourage insurers to ensure their approach is “fit for the future”, addressing new opportunities and challenges, for example from the exponential growth in data and development of new pricing techniques using advanced analytics and machine learning.





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Mounting cyber threats and regulatory scrutiny

In the last five years, there has been an increasing volume of data breaches and business crippling incidents publicly reported. Regulators are reacting to this higher risk climate by increasing scrutiny and introducing legislation.

In the last two years, both the FCA and the PRA have been assessing the cyber security posture of insurance companies and have taken action where necessary. In some cases the Bank of England, FCA and PRA have been promoting realistic threat-led assurance testing of cyber resilience (CBEST) that they have previously used with organisations in the banking sector.

In terms of specific regulations the European Union General Data Protection Regulation (GDPR) will come into force on 25 May 2018. The GDPR is designed to protect personal data of EU citizens and contains specific data security requirements. It introduces steep fines (up to 4% of a company's global turnover) for data breaches attributed to non-compliances.

Cyber risk and insurance companies

According to KPMG's recent survey of insurance CEOs, 57 percent of insurers are only `somewhat' prepared for a cyber event. Further findings showed that only 26 percent put cyber security as one of their `top of mind' risks, and just 28 percent will `significantly increase' investment into cyber security in the next three years.

The numbers suggest that more needs to be done to protect insurance companies, especially as they further embrace technology to be competitive, have their brand more exposed when offering cyber insurance and need to be able to withstand the increasing sophistication of attacks that we are witnessing over time.

What can be done?

Those in a risk, compliance and oversight function can play a key role in promoting cyber security in an organisation which in turn can reduce the likelihood of a cyber security incident or regulatory action.

Cyber security is a relatively new risk and its connection to technology, with its own language and culture, makes it difficult to grasp for many business executives and senior managers. The cultural and technological challenges posed are even more significant for insurance companies as they are reliant on business practices, processes and technology established in times when cyber security risk was not a priority.

Our experience with leading insurance companies has identified a number of actions that we believe all insurers should be considering:

1. **Improve the understanding and awareness of cyber risk at the executive and board level.**
   Those in an executive or board position need to have a good understanding of their company's cyber security risk, in order to be able to set the appropriate risk appetite and fulfil their roles effectively. To achieve this, specific training should be delivered, with non-executive directors or independent special advisors with cyber security and technology risk experience engaged regularly.

2. **Prepare for the likely eventuality that the company will suffer a debilitating attack.**
   Boards and executive teams should be running regular 'desktop' exercises that simulate a cyber security attack and think carefully about how they would react and respond. Conducting these exercises in a safe and controlled environment will allow decision-makers to move quickly and decisively when an attack does occur.

3. **Perform a realistic test.**
   Realistic, scenario based, technical cyber security tests (also called red team testing) should be periodically performed to challenge the company's ability to protect, detect and respond to a cyber security attack. Often the results of these tests can help senior stakeholders to understand the magnitude of cyber security risk to which their organisation is exposed and drive remediation activity before a malicious attacker takes advantage of the weaknesses it finds.

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Solvency II Public Disclosures: Much ado about nothing?

February 2017 was a busy and at times worrying month for all those responsible for the preparation of the new Solvency and Financial Condition Report (SFCR). Unlike its predecessor (PRA return prepared under the Solvency I regime), every insurer across Europe would need to publish its SFCR publically, providing both an unprecedented amount of disclosure into how it manages its business and regulatory capital position, but also much greater opportunity for peer comparisons to be made.

Those who had the mammoth task of preparing the SFCR for the very first time had very little to guide them. Although there were rules and guidelines to follow, preparers did not even have an illustrative example to follow. Not surprising then that comments have been made about the lack of true comparability these documents actually afford. This was uncharted waters not only for the industry, but also for auditors of insurers in the UK (and some other EEA countries) whose audit report on certain key elements of the SFCR would also become publicly available along with the SFCR.

The majority of European insurers met the filing deadline in May 2017, with a few hundred SFCRs published online.

Did the world take notice? Not really - early market comments seemed to suggest that the SFCR did not really add much to what investors and analysts knew already.

How about policyholders? Unsurprisingly given the average length of the SFCR (around 60 pages with some going well over 100), the feedback gathered from the PRA's industry roundtables and EIOPA's more recent supervisory statement suggest there is little evidence that policyholders are even reading the SFCR.

Despite the concerns that analysts and investors had regarding the actual value added by the SFCR and the lack of engagement from policyholders (the intended audience), there appears little regulatory enthusiasm for a significant reduction in the reporting burden. Although the PRA has proposed amendments to its additional national specific templates, it cannot amend the core pillar 3 requirements while the UK remains bound by EU legislature.

The feedback gathered by the PRA and EIOPA suggests that the SFCR will be considered the main source of detailed public information on an insurer's business, at least until the new IFRS 17 accounting standard arrives in a few years' time. This was despite the loss of some detailed disclosures previously made under the PRA return, such as claims development patterns.

The focus has therefore been more on what improvements could be made to make the SFCR more useful. The regulators' main suggestions are:

- More emphasis on the summary section of the SFCR (which policyholders are more likely to read)
- Integration of the quantitative templates (QRTs), which are mostly presented as a stand-alone appendix to the main SFCR, into the narrative part of the SFCR
- Clearer explanations of the bases, assumptions and methods used for valuing assets and liabilities, in particular items not valued using quoted market prices
- More consistent and comparable sensitivity analysis information, with emphasis on what drives the SCR
- Clearer disclosures to reconcile group level information to the SFCR of the individual insurers in the group.

This was broadly in line with our own benchmarking survey which we published in December (here). Overall we found that, while most insurers had complied with the rules, there was substantial variance in the extent and depth of disclosures made.

The adage "*Let me be that I am and seek not to alter me*" may well be the approach that most insurers are taking to this year's SFCR production. However we would advise that management should take account of the above recommendations and approach the SFCR less from a compliance perspective but rather view it as an opportunity to demonstrate to the external world how well they are managing their regulatory financial position.

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Future regulatory milestones

Date	Activity/Topic	Impact on industry
Solvency II		This section provides an overview of key Solvency II developments, including proposed changes at UK and EU levels.
13 April 2018	Deadline for responses to PRA on CP2/18 on Solvency II reporting changes	The PRA has proposed a number of changes to reduce the reporting burden. In particular, it proposes changes to the scope, content and/or format of eight of the thirteen National Specific Templates (NSTs) from 2018 annual submissions and an extension of the application of the quarterly reporting exemption by offering a 'waiver by consent' to Category 4 and 5 firms (with a 'case-by-case' assessment of its use by Category 3 firms).
'Before December 2018"'	European Commission (EC) review of the standard formula Solvency Capital Requirement (SCR) calculation	EIOPA has provided two sets of advice to the EC (30 October 2017 and 28 February 2018) setting out its recommendations in respect of this review. These reports will now be considered by the EC prior to publishing its SCR review report later this year.
FCA reviews		This section provides a brief overview of recent developments in key FCA initiatives relevant to the insurance sector.
Q2 2018	FCA Final report on Retirement Outcomes Review	The interim report was published in July 2017, with a final report planned for Q2 2018. Key findings highlighted were that pensions freedom has resulted in drawdown become a much more popular option and accessing pension pots early has become 'the new norm' (over half of those accessed having been fully withdrawn). The interim report raised a number of concerns, including for consumers the lack of: advice being sought, shopping around and protection being bought. On the provider side, concerns included annuity providers leaving the open annuity market (reducing competition) and limited product innovation, although since the report was issued, a number of annuity providers have re-focused their business models and strategy towards drawdown.

Date	Activity/Topic	Impact on industry
Mid-2018	FCA expected to complete thematic review of fair treatment of with-profits customers	This review focuses on customer vulnerability, seeking to increase firms' development of innovative financial products that meet their clients' needs.
Autumn 2018	FCA plans to publish its interim report on Wholesale Insurance Brokers Market Study	The review aims to explore how competition is currently working and whether improvements could benefit clients. Focus areas will be market power, conflicts of interest management and broker conduct.
Packaged Retail and Insurance-based Investment Products (PRIIP)		The PRIIP Regulations became effective on 1 January 2018, introducing standardised pre-contractual disclosure requirements across the EEA through the Key Information Document (KID). It applies to all insurance contracts issued with an investment element.
31 Dec 2018	Deadline by which the EC must review the PRIIPs Regulation	The review required by Article 33 will include a general survey of its operation as well as the practical application of the rules, involving consumer testing and consideration of non-legislative options. EIOPA will provide input to the EC, but no advice request has yet been published.
Insurance Distribution Directive (IDD)		The implementation of the IDD (to replace the Insurance Mediation Directive (IMD)) has been delayed and will now not be effective until 1 October 2018.
1 Oct 2018	IDD comes into force	IDD will cover activities of all distributors of insurance products. Insurers will need to ensure that they have a full suite of pre-sale Insurance Product Information Documents (IPID) available to intermediaries and customers before this deadline.
International Association of Insurance Supervisors (IAIS)		The IAIS continues work on updating The Common Framework (ComFrame) including the insurance capital standard (ICS), both of which will apply to Internationally Active Insurance Groups (IAIGs).
16 May 2018	2018 ICS Field testing process launches	The last Working Group meeting to discuss the updated technical specifications will be held on 16-20 April. Data will be due by 31 August.

Date	Activity/Topic	Impact on industry
July to Nov 2018	ComFrame consultation	The IAIS continues its revisions of ComFrame with consultation planned on ICPs 6 and 20 in July/August and a consultation on the entire Framework, including the second version of the ICS (ICS Version 2.0) in August, with responses due in November.
Nov 2019	IAIS to adopt ComFrame including ICS Version 2.0	ICS Version 2.0 will be presented as a stand-alone document, but will form part of ComFrame. ICS Version 2.0 will be applicable for confidential reporting to group supervisors from 2020. It will now be subject to a monitoring period of at least five years before it becomes a prescribed capital requirement (PCR) and subject to public reporting.
UK exit from Europe		The draft withdrawal agreement now includes a transitional phase to 31 December 2020 that (if ratified) would result in little substantive changes for the UK insurance sector until the end of the transition period. Nonetheless, insurers should continue planning for all scenarios, including 'no deal'.
Oct 2018	Withdrawal negotiations expected to complete	End of UK-EU negotiations on withdrawal and draft agreements published: a 'Withdrawal Agreement' and political declaration on the 'framework for the future relationship'.
18-19 Oct 2018	Council ratification	European Council to be presented with finalised deal. UK legislative process starts.
Nov/Dec 2018	European Parliament vote	European Parliament expected to vote on the Withdrawal Agreement.
29 Mar 2019	Formal UK withdrawal date	At the time of writing, there has been no indication that the formal exit date will be extended.
31 Dec 2020	Transition period (if agreed) ends	The UK will no longer be treated as if it were a Member State, instead becoming a 'third country' from the perspective of all EU legislation.

Date	Activity/Topic	Impact on industry
Senior Managers and Certification Regime (SMCR)		
10 Dec 2018	Extension of the Senior Managers and Certification Regime (SMCR) to all sectors of the financial services industry.	The final rules are expected in summer 2018, with implementation to follow in December.

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