Ellie Goodsall
Audit and Accounting Policy
Bank of England
Threadneedle Street
London
EC2R 8AH

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Dear Ellie,

AFM Response to Consultation Paper CP43/15, *Solvency 2: external audit of the public disclosure requirement*

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

   - Comment on the nature of PRA's proposals; and
   - Highlight the limited nature of PRA's analysis of competition and corporate diversity, and the absence of a clear rationale for its proposals.

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £16.4 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules

[1] ICMIF, http://www.icmif.org/global-mutual-market-share-2013

impose any significantly different consequences for mutual businesses[2].

4. AFM supports Solvency 2, and the actions taken by PRA in general to ensuring that the Directive is implemented practically and proportionately in the UK. We have worked with our members to encourage the adoption of high governance standards, both in response to the Directive, and in our own Annotated Corporate Governance Code. Through the latter in particular, we firmly believe that transparency is key to ensuring good behaviour in financial services, and that companies, and senior managers in specific, should satisfy themselves that information produced for public consumption is appropriate for its intended users.

5. The Code requires a mutual's auditors to review the standards of compliance in general, and extensive parts of the Code are subject to auditor review[3]. From this year there is a new requirement that firms also provide a viability statement as part of their report and accounts, and that this is also reviewed by the auditor. This new review is likely to require the auditor to assess supporting evidence from a range of risk management aspects, as well as the ORSA and reverse stress tests.

6. Paragraph 2.1 indicates that "it is the PRA's view that external audit can underpin confidence". We agree with the sentiment in general, as can we witnessed by the extensive audit our members already commit to. However, the PRA statement is not in itself a full objective or justification for the new rules. As a consequence, we believe the paper fails to provide a thoughtful and persuasive rationale for an approach which goes beyond that expected by EIOPA. We provide more detailed comments by reference to the headings in the PRA consultation.

PRA's statutory obligations

7. Paragraphs 1.5 to 1.9 provide PRA's response to its statutory obligations. We have considered PRA's views with regards to its duties in relation to competition and for mutuals; we do not consider these areas to have been fully or properly addressed:

    a. With regard to competition, PRA's focus is on market discipline and the information needs of investors. However, these are not valid issues for mutuals, who do not generally have external

[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted
[3] For more, see: http://afmgovernance.co.uk/news/corporate_governance_guidance_note

investors. By the same token, the term 'market discipline' is generally used, both by the PRA and more broadly, to explore the capacity of the market to act appropriately in response to information intended to inform on the prospects and riskiness of a business: on the assumption that the market will reward good behaviour via market price. In the case of mutuals such market discipline does not apply as they have no market price.

The same paragraph presumes the cost of external audit is low for insurers: though as later described in paragraph 3.4, for smaller insurers the current cost can be 20 times more expensive in relative terms. As we explore above, costs of audit are already increasing for other purposes.

Barriers to entry are another aspect of the impact of regulation on competition. This is not considered in the consultation, but in our view the application of a further external cost to a new business, or for an insurer seeking to move from non-directive to directive status, would have an impact of their ability to compete.

To illustrate this point, we reviewed the cost of external audit of a group of AFM members just above PRA's threshold for Solvency 2 compliance (£5 million). We found audit costs typically of between £25,000 and £30,000, or around 0.5% of premium income. As a proportion of operating expenses this might amount to 2 or 3%: a substantive amount.

b. Paragraph 1.8 indicates the costs involved would not vary materially for mutuals. However, as we stated in response to PRA's recent consultation on the structure of audit committees (CP34/15 [4]), our assessment of FSMA s138K is that the regulator should consider both the implementing cost and the ongoing costs of new requirements, as well as those relative to scale and the derived value to the business.

Mutuals will currently be auditing data for their report and accounts and for regulatory returns as required. PRA describes how practice in the listed world goes beyond this, in part because the relative cost of incremental work is lower, and as there is potential for a market reward. Hence, the starting point for mutuals will be different to an equivalent PLC, so in our view the impact is materially different.

[4] http://www.financialmutuals.org/files/files/AFM%20response%20to%20PRA%20on%20audit%20committee%20requirements.pdf

As we discuss in the previous section, the market disciplines for mutuals are not the same as for PLCs. Hence the additional costs imposed on mutuals do not produce the presumed benefit of improved intelligence by the financial markets. This of course means that the analysis under the first regulatory principle provided in paragraph 1.7 is incomplete.

Equally, as mutuals tend to be smaller organisations, they see a disproportionately higher cost of implementation. This may be particularly the case when all aspects of audit are outsourced: as the cost benefit case accepts, the relative costs of audit for mutuals/ small insurers may be twenty times higher. As the owners of a mutual are its customers, there is no option but to pass on higher costs to policyholders.

Concerns about the way in which both PRA and FCA have failed to properly embrace the expectations under FSMA s138k led to a recent discussion in the House of Lords, and amendment to the Bank of England Bill, to place a sterner test on the regulators in assessing the impact on mutuality, both in setting new requirements and in the way they undertaking their general responsibilities[5]. We look forward to further engaging with PRA on how this can be achieved.

PRA Proposal

8. Section A of chapter 2 sets out what PRA's proposal is, without providing a clear rationale. Paragraph 2.6 puts this into some context against potential developments in accounting elsewhere. Such uncertainty might offer an opportunity for the regulator to avoid making further changes now which might be negated in the future.

9. The narrative refers to IFRS 4 phase 2 developments, but these are not expected to be finalised for a number of years. In the short term, most mutuals continue to use UK GAAP reporting, so a better time to implement these changes- from our sector's perspective- is when there is clarity on future accounting requirements.

Background to the PRA's proposals

10. In section B of chapter 2, PRA highlights the expectation that public disclosure will enhance the quality and comparability of data across

[5] http://www.publications.parliament.uk/pa/ld201516/ldhansrd/text/151215-0002.htm

Europe. We agree this will be the case, though analysis provided to us by AMICE suggests nations such as France and Germany will not be insisting on external audit of pillar 3 data, and most others have not yet decided. Even where PRA indicates it, and EIOPA, assume audit is likely in time, we would have liked to see a clear case made by PRA as to why it is not working to a similar timetable to other national supervisors.

11. We consider greater focus on providing a rationale may have yielded clearer benefits for PRA's position. For example, as we state above, most mutual insurers and friendly societies retain UK GAAP accounting. But many large insurers will prefer to use Solvency 1 data to inform their accounting rather than Solvency 2, to give historic consistency. We held a discussion on this issue with our members recently, and with the FRC, to explore whether mutuals may wish to start using Solvency 2 derived data for their accounting now[6]. Given the assumption that Solvency 2 data will be more meaningful, we have encouraged our members to explore this issue on an individual basis.

12. One potential benefit is that by doing so they will avoid the need for expert opinions on two sets of data, and where they undertake an audit of public disclosure data it will be more cost effective as the audit can be combined with that needed for the report and accounts, including, as mentioned above, for the new viability statement. However, it will not be possible to fully eliminate duplication, as PRA's proposals require an audit of historic data such as the year end solvency position, whilst the viability statement is more forward-looking and includes the ORSA, which PRA's review does not.

PRA's approach to its proposal

13. This section highlights the information needs of investors and regulators. As we explain above, customer-owned mutuals do not have external investors. Whilst it is true to say that members of a mutual, as its owners, should expect clear and transparent information about the mutual, in most cases their ownership interest is not material or financial, and this data does not tend to influence their decision on whether or not to become a member/ policyholder.

14. This is not though to suggest that the customers of mutuals should expect lower levels of transparency simply because the provider is not listed. Customers of mutuals rely on much of the financial information that is published, and look for reassurance that the organisation is

[6] A presentation on this issue is available via our website: http://www.financialmutuals.org/files/files/AFM%20Seminar%20SII%20and%20GAAP%20in%20UK.pdf

financially secure, is well-managed and can honour its commitments. This is of course no different to the customers of PLC insurers- but nowhere in the consultation paper does PRA suggest Solvency 2 public disclosure is intended for use by policyholders.

15. The key external users of public disclosure data from mutual organisations are therefore the regulators themselves. Insurer regulatory returns are already extensive, and increase significantly under Solvency 2; some of these are already subject to audit: PRA accepts that where further external assurance is required on regulatory returns it can be obtained through the use of skilled person under Section 166 of FMSA. It is not apparent therefore whether PRA will take any comfort from the external audit of published data for a mutual organisation: it would be helpful to see this set out.

Cost Benefit Analysis

16. As we state earlier, the cost benefit analysis of these proposals indicated very clearly that the costs of implementation will be disproportionately greater for smaller insurers. PRA's analysis shows that currently the relative cost of auditing the current regulatory returns can be up to 20 times higher (paragraph 3.4 indicates a range of 0.002% to 0.040% of premium income for large/ small firms). Estimates from auditors in paragraph 3.7 put the cost of auditing Solvency 2 disclosures at between 0.01% (large insurer) to 0.1% (small). This indicates both that the cost remains disproportionately higher for small insurers, by a multiple of ten, but also that the overall audit cost rises by between 250 and 500% of the current cost. The scale of increase seems remarkably high, and suggests a degree of unscientific estimating from auditors[7]. No specific figure is given.

17. It is surprising therefore that PRA has not considered whether a more proportionate approach might have been taken. It would be useful for example for an expanded rationale to set out the options considered and the basis for the decision made. For example, a more proportionate solution might have considered:

[7] A small mutual with premium income of £10 million in the example given would see estimated additional audit costs of around £10,000, compared to an estimate under Solvency 1 of £4,000, whilst for a large mutual with £1 billion premium income the cost of audit rises from around £20,000 to £100,000. However, as per our early analysis, typical external audit costs for small mutuals are at least £25,000, so presumably the data analysis does not consider very small firms, or the actual fees firms currently pay.

- imposing the requirement only on the largest organisations and retaining the option of additional external assurance in smaller firms only where it is considered necessary; or
- excluding those for whom the perceived benefits are weaker, such as for mutuals; or
- simply allowing the market to settle post-Solvency 2 implementation, once there is stronger agreement across Europe, and once IFRS 4 phase 2 rules are finalised, considering then any new requirements in light of this.

18. In summary, the PRA consultation appears to presume the case for audit is self-evident, and applies equally for all Directive insurers. We support the need for clear scrutiny, but would wish to see more thoughtful analysis of the rationale, to avoid the perception of gold-plating.

19. We would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals