Accounting and Audit Policy Team
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

June 2018

AFM Response to PRA consultation 8/18 "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 proposals in this consultation.

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 £19.6 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 impose any significantly different consequences for mutual businesses[2].

[1] ICMIF, https://www.icmif.org/publications/market-insights/market-insights-uk-2016
[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted

4. In addition, the Bank of England and Financial Services Act 2016 now provides an additional Diversity clause for FiSMA, to require the PRA and FCA to take account of corporate diversity and the mutual business model in all aspects of their work[3].

5. AFM welcomes PRA's ongoing programme to make the Solvency 2 regime more proportionate. Where we have already seen some thoughtful proposals put forward that streamline some aspects of the regime, the issues debated in this paper were the most significant for our members, and the area that we placed first on the list of reforms that would make Solvency 2 more proportionate for smaller insurers, including AFM members.

6. Indeed, we stressed this in response to PRA's two consultations (CP43/15 and CP23/16), which proposed all Solvency 2 firms should have their SFCR externally audited. At the time we identified that the proposal was the clearest sign of gold plating by UK regulators of the Directive, and that the rationale used- that the requirement would give confidence to markets and investors- did not apply to mutual insurers.

7. We are pleased therefore that PRA agreed to review its approach, and that it has been keen to listen to our evidence in the last 12 months.

8. By our assessment, all AFM members would be exempted from requiring their SFCR to be externally audited under these proposals. As the table below indicates, the system of points proposed are significantly greater than those needed for even our largest members:

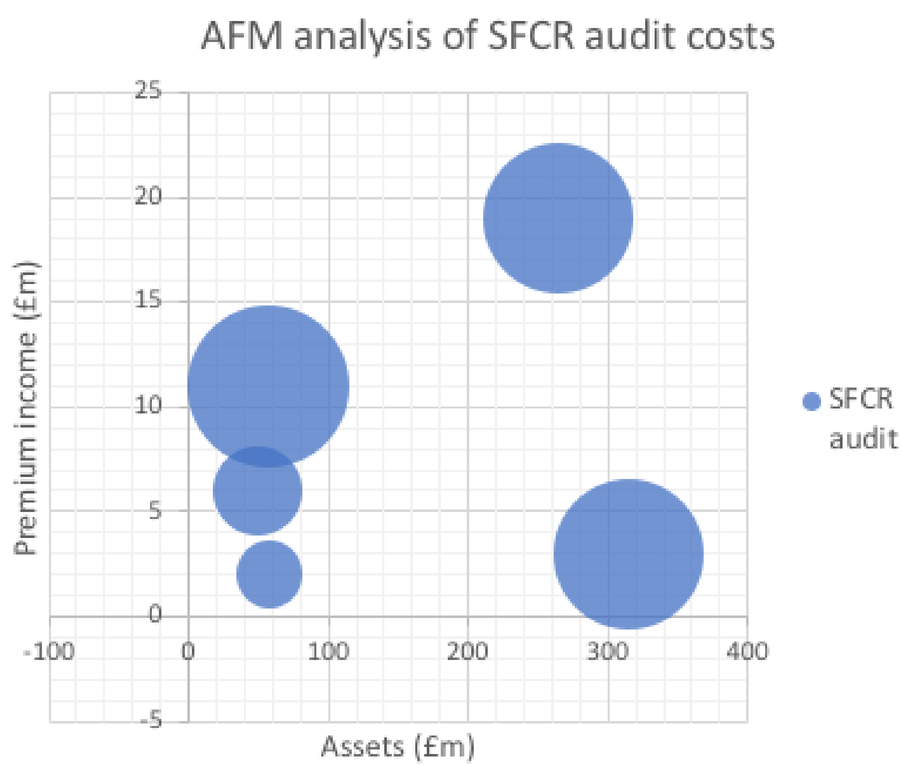
	Premiums	(GWP)		
	£10m	£100m	£120M	
GI	6.71	67.1	80.52	
	Liabilities	(BEL)		
	£100m	£500m	£1 billion	
	3.97	19.85	39.7	
	Premiums	(GWP)		
Life	£10m	£100m	£130M	
	3.11	31.1	40.43	
	Liabilities	(BEL)		
	£100m	£1 billion	£2 bn	£5bn
	1.18	11.8	23.6	59

[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

The highlighted numbers combined equate to a firm around the threshold for either general or life insurers.

9. We are therefore supportive of this position, though we are not clear on the rationale proposed for setting a points threshold. This appears to establish a target by PRA for the number of firms it planned to exclude from the requirement and we query whether a simpler position might have been achieved simply by exempting all Category 4 and 5 firms. This would have the advantage of using PRA's existing infrastructure, as well as bringing in an assessment of risk as well as scale.

10. We agree however that PRA's proposed method is likely to exclude firms from the audit requirement that have witnessed higher relative costs for audit, and lower usage of the SFCR. As AFM's research on cost and usage, presented to PRA in November, demonstrates, the cost of the audit typically bears little comparability to the size of the business, as the audit market has established a floor cost for this work:



11. As we also established in our research, the cost paid to auditors was only one component of the impact on small firms: higher actuarial costs, significant management time and business disruption have also been associated with the requirement. We saw a sellers' market, with only a small number of the largest audit firms capable of doing the work. There was also a significant impact on the timings within the reporting cycle,

with finance directors reporting very tight timescales, and protracted liaison between actuaries and auditors within the tight timescales expected for publishing the SFCR. It is no coincidence therefore that there has been a significantly higher turnover of staff in the finance departments within our sector in the last two years.

12. Our November research also highlighted that readership of the SFCR did not justify the high costs involved in auditing them, particularly for mutuals. By our assessment, the average cost of audit, per reader of the SFCR, was at least £1,000: for small mutuals in particular, who work hard to produce a report and accounts that is relative and readable for their members, the SFCR provides little added value. The readership of the SFCR is therefore almost entirely confined to competitor organisations and consultancies, who might be expected to gain confidence in the extra assurance provided by external audit, but who were never intended to be the primary users of the SFCR (according to PRA's analysis in CP43/15 and CP23/16).

13. We therefore agree therefore that after two cycles of audit, the boards of mutual insurers will have gained an appreciation of the key elements of the SFCR and how they seek assurance on the robustness of the numbers and the relevance of the narrative.

14. We would expect that even where exempted from the current requirement, there will be a continuing need for boards to satisfy themselves that the SFCR is properly presented, in light of their important responsibility for approving the SFCR. We expect that assurance can be delivered more cost effectively and in greater sympathy to the challenges of reporting on time.

15. For example, a great deal of the work needed to prepare the SFCR is undertaken in small insurers by a qualified and independent actuary who, reflecting the standards laid down by the Institute of Actuaries, will continue to carefully review and rigorously test data prior to publication. As a trade association we will continue to benchmark outs from public disclosure to provide support to our members.

16. We note that PRA will continue to use a range of tools to monitor the quality of regulatory reporting and public disclosure. We recognise this might include thematic reviews and other supervisory tools, but also skilled persons reviews. Given the high cost of this latter process we would encourage PRA not to adopt this as a regularly used solution, and not without a thorough review of the evidence in regulatory returns.

17. We would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals