External certification of Solvency II: more than just good governance

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With Solvency II now implemented, a significantly increasing number of insurers have already disclosed their opening Solvency II coverage ratios.

However, the next challenge, in the short term, is the public disclosure of more detailed solvency and financial condition information, which is required by Solvency II.

In June 2015, the European Insurance and Occupational Pensions Authority (EIOPA) expressed its opinion that external audit of such information can be a "powerful tool" in ensuring high-quality public disclosures under Solvency II. In July 2015, EIOPA indicated that it would take further regulatory action in case the quality and comparability of the public disclosures were found to be insufficient. EIOPA is of the view that in order to make best use of external audit in the context of the Solvency and Financial Condition Report (SFCR), at individual and group level, the main elements of the SFCR (balance sheet, own funds and capital requirements) of all insurance and reinsurance undertakings could fall within the scope of an external audit. Hence the scope has been defined in this way by some local supervisors.

In this article we explore the extent to which different countries have adopted or promoted practices or requirements for external audit or certification of the Solvency II results. Some examples will be provided of countries where these requirements are already well defined and confirmed (for example, Portugal) or are in consultation at present (for example, Ireland and the UK).

As mentioned, there are some member states that have already confirmed they will require external audit or have confirmed their intention to make external audit an official requirement.

In Figure 1 on page 2, these countries are shown either with the agreed scope or the proposed scope of the external audit to be performed and, in some cases, who should be responsible for performing this external audit.

The supervisors of Estonia, Finland, Greece, Lithuania, and Latvia have indicated that they are **not going to make external audit an official requirement**. They have not given any signs either that it might be required in the near future.

The supervisors in **France and Sweden do not currently have the mandate by law** to enforce external audit as an official requirement but are working on this matter and might require an external audit in the near future. In France, the body that can enforce this requirement is the Treasury. The French insurance supervisor (APCR) supports an external audit of at least some parts of the SFCR, such as the balance sheet, eligible own funds and capital requirements.

Croatia, Czech Republic, Denmark, and Slovakia have **confirmed limited external audit requirements** but might require external audit of a broader scope in the near future. The supervisor in Croatia will require an audit firm to assess the adequacy and completeness of the SFCR. Czech Republic has stated that in the case of deficiencies in insurance and reinsurance activities an external audit of the system of governance and of the information in the SFCR is required. The kinds of deficiencies that are considered here have yet to be defined. As for Denmark, an external audit will be required only for the data in the Solvency II reporting that also appears in the financial statements. In Slovakia, the supervisor has communicated that audited data is to be welcomed and that the issue will be discussed further during the review process.

There are differences in the scope required, or proposed, by each local supervisor but what most supervisors agree on is that the main elements of the SFCR should be audited.

FIGURE 1: COUNTRIES CONFIRMING THE NEED FOR EXTERNAL CERTIFICATION/AUDIT

COUNTRY	CONFIRMED VIA	SCOPE OF THE EXTERNAL AUDIT
Austria	Communication by regulator	▪ Balance sheet, own funds, SCR, and MCR in SFCR. ▪ Effectiveness of the internal control system, risk management system, and internal auditing. ▪ Effectiveness of the procedures and control mechanisms. ▪ Some other items not specific to Solvency II.
Belgium	Communication by regulator	▪ SFCR. ▪ Core QRTs.
Germany	Communication by regulator	▪ Solvency II balance sheet.
Ireland	Currently under public consultation	▪ The external audit requirement would be for all financial years ending on or after 31 December 2016. ▪ An audit report is required which should include reasonable assurance on the elements of the SFCR relevant to the balance sheet, own funds, and capital requirements. ▪ It is expected that external audit guidance will be developed in the near future, including the format of the audit report. ▪ Does not apply to capital requirements calculated using an approved internal model.
The Netherlands	Communication by regulator	▪ Subset of the annual QRTs (balance sheet, technical provisions, premiums, claims and expenses, own funds, SCR/MCR, and financial statements)—for both group and solo companies. ▪ First audit has to be performed on annual QRTs during 2016 on opening Solvency II figures. ▪ Agreed procedures already used for Day 1 reporting Solvency II.
Poland	Communication by regulator	▪ Scope of the audit is still under discussion.
Portugal	Included in regulation	▪ Annual SFCR including quantitative information to be disclosed with this report. ▪ Annual QRTs and RSR. ▪ Technical provisions, including the application of the volatility adjustment, matching adjustment, and transitional measures applied. ▪ Recoverables from reinsurance contracts or any other risk mitigation contracts. ▪ The different components of the capital requirement calculation under Solvency II.
Slovenia	Communication by regulator	▪ Scope hasn't been defined yet. It is likely that all public disclosures will be in scope of the audit.
Spain	Communication by regulator	▪ The scope of the audit will be determined later this year. ▪ External audit of Solvency II data planned for 2017 based on 31 December 2016 results.
United Kingdom	Public consultation finalised but final requirements have not been published yet	▪ The proposal is to require an audit for the following: the valuation for solvency purposes and the capital management sections of the SFCR (SCR calculated by standard formula); balance sheet and relevant QRTs; and capital requirements. The scope of the external audit also includes technical provisions; impact of transitional measures and long-term guarantees and own funds. ▪ An external audit report is required. ▪ Capital requirements calculated using an approved internal model or partial internal model, or where Solvency II requires information in the SFCR to be produced using sectoral rules are excluded from scope. ▪ The requirements for external audit would be implemented from accounting years ending on 15th November 2016 onwards, for those firms reporting under Solvency II. The external audit should be performed whenever a SFCR is published, that is potentially at the group, solo, and subgroup level.

In Ireland, Portugal, and the UK, the external audit requirements have been well defined for some time (see sidebar).

External certification has several obvious advantages:

- **Good governance.** As part of the governance of Solvency II processes, an external certification can add an independent check on the methodology, criteria, and assumptions, and could be a useful tool for internal audit and/or validation functions.
- **High-quality public disclosure.** While external certification will usually give the market some comfort that publicly disclosed information is credible and reliable, the sheer amount of information disclosed under Solvency II makes this objective more important.
- **Check on consistency.** External certification can also act as a method to confirm or compare the consistency of the application of the technical requirements and Solvency II principles with other insurers in the market, something which is still an issue in some markets.

Most importantly, under Solvency II insurers are disclosing more about their capital requirements, risk profiles, and economic values than ever before (especially for insurers that are not already publishing economic values such as Embedded Value). This means that not only do insurers need to be able to assert the credibility of the results, they must also be sure that they are going to be able to explain them and link them to their other communications to the market.

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In addition, the calculations underlying the Solvency II results are complex and based on actuarial, financial, and risk modelling. In order to ensure the correct application and consistency of these calculations to the Solvency II technical requirements, these calculations would need to be reviewed or audited by appropriately qualified professionals, such as actuaries and risk professionals, with experience in economic valuation and economic capital for insurers and reinsurers. In the case of Portugal, this is reflected in the regulations, with a clearly defined division of responsibilities between the auditor of accounts and a responsible actuary. In Ireland, a reviewing actuary should be assigned that needs to review the work of the Head of Actuarial Function's work related to technical provisions. This is not included as part of the external audit guidelines but is included separately in the guidelines describing the role of the Head of Actuarial Function.

At Milliman, we have vast experience in the implementation of the quantitative and qualitative aspects of Solvency II across Europe and in all three pillars. Our proven experience in the practical implementation of the complex calculations required to meet the Solvency II technical requirements, as well as having already carried out a number of internal and non-public certifications of Solvency II results, means that we can add value to your external certification process.

Portugal In Portugal external audit has been included in the insurance regulation so that it is already an official requirement starting from this year. The scope of the external audit has been divided clearly between an official auditor of accounts and an independent "responsible" actuary. The scope of the audit to be performed by the auditor centers mainly on the reported figures and other information in the annual SFCR, annual QRTs, and Regular Supervisory Report (RSR). The scope of the audit to be performed by the "responsible" actuary includes the technical provisions (including the application of the volatility adjustment, matching adjustment, and transitional measures applied), recoverables from reinsurance contracts or any other risk mitigation contracts and the different components of the capital requirement calculation, including the loss absorbency of technical provisions. The responsible actuary must go through an approval process by the Portuguese regulator.

Ireland In Ireland, the regulator is currently in a consultation process about the external audit requirement. While responses on the consultation paper can be sent until July 29, 2016, we understand that for practical purposes there will not be major deviations in the requirements. The suggested scope of the audit includes elements of the quantitative information, the balance sheet, own funds, and capital requirements (except when calculated with an approved internal model) that are part of the SFCR. For the elements of the SFCR an audit report prepared by the external auditor will be required.

United Kingdom In the UK, the regulator is currently in a consultation process about the external audit requirement. The proposed scope of the external audit is: valuation for solvency purposes and the capital management sections of the SFCR (Solvency Capital Requirement [SCR] calculated by standard formula), balance sheet and relevant quantitative reporting templates (QRTs) and capital requirements. An audit report will be required of the external auditor. Capital requirements calculated using an approved (partial) internal model is not in scope of the required external audit. The requirements for external audit would be implemented from 15 November 2016, for those firms reporting under Solvency II.

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