Introduction

The Groupe believes that external audit of the Solvency and Financial Condition Report ("SFCR") is an important part of the overall governance framework for Solvency II. It is in the interest of consumer protection and ensurance of the the soundness of the financial system that there exists a series of checks and balances - and associated public disclosures - so that the public can have confidence in insurers.

The Groupe note that the SFCR (and its external audit thereof) is one component - there are also "checks and balances" between key functions (risk management, actuarial, internal audit), which are nevertheless not disclosed, and in the formalised process of model validation (where an approved internal model is used for SCR). The Groupe believes it is important that a holistic view is taken so that there are not gaps, overlaps, interference or unnecessary expense within the overall framework.

The Groupe is ready to work with stakeholders to set clear links between the audit program and the actuarial profession.

The Groupe is ready to offer its help to draw further guidelines or standards to set a clear way to split between the supervisor role and the external audit role.

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Executive summary

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Solvency II framework

The Solvency II framework aims for greater levels of transparency for supervisors and the public. Supervisors will be served with reports of a more confidential nature (as these include the company's strategy) and the public will have to get its information from the Solvency and Financial Condition Report. Especially the latter will increase the level of disclosure required by undertakings. The SFCR will contain key quantitative and qualitative information on risks the undertaking has accepted.

But most importantly the report will contain the undertakings view on the future. On the basis of that information the general public can get an understanding of the risk profile and risk assessment of the undertaking and the expected development of its capital position.

Based on the available information of all insurance undertakings and comparing these, the general public and, indeed, the market as a whole, may draw conclusions on the solvability of insurance undertakings. And that happens to be one of the main goals of Solvency II.

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Actuarial reporting in the European Union

The Groupe has surveyed its member associations to understand the current variation in practice. The Groupe has identified countries where external actuaries play a public role and countries where there are regulations which put some structure on the role of actuary within an external audit.

For example in the Netherlands, only an external actuary may execute formal sign-off of the technical provisions and of other sections of the financial reports. The overall sign off is done by an auditor. This two explicit system works with a clear set of responsibilities for actuaries and for auditors.

For example in the UK for life business (referred to as long-term business), insurance regulation requires that the external audit must take the advice of an actuary that is independent of the insurer (typically, but not necessarily, this will be complied with by use of an actuary employed by the external audit firm).

Since harmonization is one of the main goals of Solvency II there are several points of attention

1. Regulating role of actuarial role inside external auditor across all member states;
2. Giving freedom for external auditors to decide themselves;
3. Allowing national regulators to choose locally whether they insist on duties or structures for actuarial roles inside external audit firms;
4. Allowing undertaking to choose freely their auditor and their external actuary

The access of the external auditor to the four key functions should be stated as all of them, play specific roles in the system of control under Solvency II.

Especially, the external auditor should receive a copy of the actuarial report written by the Actuarial Function. The auditor will be interested in the information already given by the function to the AMSB as, according to article 48 1e, the actuarial function has to “inform the administrative, management or supervisory body of the reliability and adequacy of the calculation of technical provisions”. Especially, the auditor will see the content corresponding to “The actuarial function shall clearly state and explain any concerns it may have concerning the adequacy of technical provisions.” (article 262 5 of draft IM regulation). The external auditor will also have to take care of the fact that the actuarial report “shall clearly identify any deficiencies and give recommendations as to how such deficiencies should be remedied”. (article 262 8 of draft IM regulation).

“As a reference to good practice, OECD guidelines for insurance governance states that the external auditor and the heads of the control functions should meet periodically (at least

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annually) and as circumstances warrant with the non- executive members of the relevant board committee(s) or of the board without management present."

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Solvency II reporting

The Solvency and Financial Condition Report[1] ("SFCR") shall contain the following, publicly disclosed, information:

a) A description of the business and performance of the undertaking;
b) A description of the system of governance and an assessment of its adequacy for the risk profile of the undertaking;
c) A description of the risk exposure, concentration, mitigation and sensitivity;
d) A description, separately for assets, technical provisions, and other liabilities, of the basis and methods used for their valuation, together with an explanation of any major differences in the bases and the methods used for their valuation in financial statements;
e) A description of the capital management, including at least the following:
    i. the structure and the amount of own funds, and their quality;
    ii. the amounts of the Solvency Capital Requirement and of the Minimum Capital Requirement;
    iii. the option set out in Article 304[2] used for the calculation of the Solvency Capital Requirement;
    iv. information allowing a proper understanding of the main difference between the underlying assumptions of the standard formula and those of any internal model used by the undertaking for the calculation of its Solvency Capital Requirement;
    v. the amount of any non-compliance with the Minimum Capital Requirement during the reporting period, even if subsequently resolved, with an explanation of its origin and consequences as well as any remedial measures taken.

The Groupe has the opinion that, to ensure a consistent audit, all items mentioned in Article 51.1 should be covered in (any) external audit of the SFCR. Especially article 51.1.e.iii – iv will give important information about the solvency and financial condition of an (re)insurance undertaking.

A similar importance should be given to Article 51 2: "The description referred to in point (e)(i) of paragraph 1 shall include an analysis of any significant changes as compared to the previous reporting period and an explanation of any major differences in relation to the value of such elements in financial statements, and a brief description of the capital transferability."

Links with Solvency II directive or with the draft implementing measures (IM) regulation (Risk profile)

[1] Solvency II Directive Article 51.1
[2] Solvency II Directive Article 304: Duration-based equity risk sub-module

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Article 51.1.c requires the undertaking to disclose “a description, separately for each category of risk, of the risk exposure, concentration, mitigation and sensitivity”. Article 286 of the draft IM regulation states that “With regard to risk sensitivity insurance and reinsurance undertakings shall disclose a description of the methods used, the assumptions made and the outcome of stress testing and sensitivity analysis for material risks and events.”

That implies that Article 51.1.b should also be covered as the risk profile is the centre of a risk based prudential regulation.

As a logical consequence the auditing task should not be reserved for statutory auditors whose professional background is primarily in accountancy. The Groupe is of the opinion that it would be better for the readers of the SFCR that all quantitative information should also be assessed by professional experts/actuaries.

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Solvency II external audit

The Groupe is concerned about the potential lack of convergence between the national practices related to external scrutiny and audit process for the purposes of the Solvency II.

The Groupe believes, subject to full consideration of costs and benefits, that an external and independent advice may be desirable for the annual public disclosure, the SFCR.

Furthermore, in the context of the balance of the costs and benefits and taking into account the fact that prudential accounts do not refer to the same model as statutory accounts, the Groupe believes that scrutiny is more adapted than audit process.

This leads to three main questions that the Groupe has considered:

1. What should be the aim of the external audit?
2. What should be the scope of the external audit in regard to this aim ?
3. Who should be playing a role in this external audit ?

AIM OF THE EXTERNAL AUDIT

The Groupe considers that the aim has the only objective to help the public to be confident with the insurance undertaking's SFCR disclosure.

SCOPE OF THE EXTERNAL AUDIT

The Groupe considers whether a limited scope to check of additions and processes or whether a full scope will serve the aim of the external audit. The Groupe would like to emphasize the role of expert judgment in determining technical provisions in both of the processes of setting up the balance sheet, the reinsurance assets and determining the MCR & SCR by stressing the balance sheet. Expert judgment is used by the firm's actuarial function and assumed by the AMSB who is responsible for both technical provision and solvency requirement. Assessing the internal expert judgment should be part of the scope of the external audit.

ACTORS IN THE EXTERNAL AUDIT

The Groupe introduces in its comments the full necessity that the audit is conducted with the right expertise. Especially, article 48 (2) of the Solvency II Directive sets necessary competencies for the actuarial function which the Groupe think should also apply for the external auditor.

Assessing the internal expert judgment needs an actuarial expertise. Hence, an external actuary's opinion should be required to perform any external audit/review in order to assure the public (and not only the supervisor who has a direct link with the undertaking) that the expert judgment applied in the process is appropriate.

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If the accountant which conducts the external audit has not enough actuarial expertise, he should explicitly rely on an external actuary to fulfill his audit.

As a piece of giving independent confidence to the public, the Groupe is convinced that it would be better that the opinion of the real person whose expertise represents 90% of the real work, the external actuary, is disclosed.

The Groupe can clearly anticipate that taking into account the specific history of each country more specifically about the role of experts like actuaries concerning the review of specific elements like the technical provision, each country will propose an organisation of this advice based on each market. The Groupe is of the view that due to the inherent complexity of the technical provisions and due to the fact that these are falling under the domain of the Actuarial Function, to be organised by the AMSB of the undertaking, it would be desirable to have the provisions reviewed by an external and independent actuary conforming to professional and ethical standards as required for that function.

As a consequence the external auditor should meet the criteria set out in Article 48.2 of the Directive. The interface between validation and audit of technical provisions should be clear, so as to avoid unnecessary cost and duplication.

Risk profile as element of external audit

The Groupe is keen to draw the attention to the additional need created by the Solvency II environment to give comfort to the stakeholders of a (re)insurance undertaking. Statements on the actual risk profile of the company (Article 51.1.b) should also be subject to review. Guidelines should be specified for this specific review. As sensitivities and stress testing are part of the SFCR (article 289 of the draft IM regulation), the Groupe proposes to help drafting guidelines to specify the review on that subject. This review will rely on the forward looking view on the individual company risk profile, supported by the quantitative assessment and results of the ORSA process, not to disclose them but to check if the summary presented in Article 51.1.b correctly presents the risk profile of the undertaking. Such opinion can be expressed by a qualified actuary. It is important for the public to be assured of the risk profile of the undertaking which will underwrite insurance.

Raising the bar

The Groupe would welcome attempts to establish common EU approaches to external scrutiny and audit however the Groupe find it difficult to accept that member states will accept such guidelines as the basis for external review when current practice might involve a wider scope to their regime of scrutiny and audit.

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The Groupe notes that the Solvency II Directive does not require external validation/assurance on Technical Provisions. This is despite the fact that Technical Provisions will often be the most significant item on an insurer's balance sheet that requires expert judgment. If external assurance is to serve its stated purpose it needs to encompass comprehensive reassurance on the value of Technical Provisions in particular. Current practice in some member states requires either external or professional review of the Technical Provisions booked by insurers. These member states are unlikely to want to dilute the level of policyholder protection afforded by their current regime, so harmonisation of assurance on Technical Provisions would seem to point to an extension of external or professional review to all member states.

The Groupe supports an enlargement of the scope of the audit to the SFCR and not only to components. When an external audit would become compulsory, the Groupe will continue to support this enlargement.

However, there is still a danger that if the scope of the audit is restricted to some elements of the SFCR whereas entities will disclose their SFCR to the public as having been audited, then the public could believe that all or at least all quantitative information in the SFCR has been subject to external audit.

Thus either the external audit should address all information in the SFCR or a robust and transparent mechanism needs to be applied in the SFCR so that the public is properly informed about the scope of the external audit.

Links with Solvency II directive or with the draft implementing measures (IM) regulation (Valuation for solvency purpose, Capital management)
The guideline doesn't refer to article 51 of directive 2009/38/EC or to the draft IM. For better clarity of the purpose, a clear reference would be better. If a direct reference is not preferred, using the same list of elements could be used.

Role of the actuary

Best practices should include explicitly actuaries in external audit :

IAIS observes in its Guidance paper 7 "The use of an actuary as part of a supervisory model" that "In auditing the financial statements of an insurer, the external auditor must address the technical provisions established by the insurer. It is important to have reliable data as the basis for calculating technical provisions. The external auditor plays an important role in ensuring the reliability of the data. The calculation of these provisions generally requires special expertise, methods and techniques, which are provided by an actuary. In some cases, actuaries are employed within auditing firms. The external auditor, if not possessing this expertise, may engage an actuary to review the methods, techniques and calculations

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underlying the insurer's provisions; in some jurisdictions such a review is required. This independent actuarial advice enables the auditor to reach an informed conclusion regarding the appropriateness of the insurer's provisions. While external auditors and actuaries may be subject to different legal frameworks across jurisdictions, the work of an external auditor and an actuary are closely linked.

In particular, the relationship between actuaries and external auditors is enhanced by:

1. Clear definition of roles of the actuary and the external auditor;
2. Arrangements for formal communication between the actuary and the external auditor.

The relationship between the actuary and the external auditor might be set out in law, regulations or professional guidance."

IAIS recognizes the necessity of the presence of the external actuary whether the actuary is or is not employed by the auditing firm.

The Groupe recommends to follow IAIS guidance paper as the European Union should adopt high quality standards of supervision. The Groupe believes that an auditor opinion should be based on a specific expertise of an Actuary who should also be independent from the assessed (re)insurance undertaking and is acting with full responsibility. For clarity, the Groupe recommends that the signature of this actuary is required and public.

To our view several elements which need to be reported under the Solvency II legislation contain expert judgment and forward looking elements that are typically the expertise of the actuarial profession. To our view therefore the external audit of elements such as the technical provisions, reinsurance assets, SCR and MCR should be externally audited under the responsibility of a qualified actuary.

And more specific: Undertakings should ensure that the Solvency II external audit is performed by statutory auditors as defined by the Directive 2006/43/EC. That statutory auditor should rely on actuarial expertise to review the appropriateness of data, methods, assumptions and the calculation process underlying technical provisions and SCR and MCR, and should rely on the opinion of an external actuary, independent from the assessed insurance or reinsurance undertaking.

The Groupe considers that it would be a good practice that the name of the external actuary and the opinion the actuary has provided should be disclosed and should not stay anonymous as this expertise is of primary importance for the global external audit. The Groupe advocates transparency for this expertise.

Alternatively, the person who signs the public audit opinion could be allowed to rely on a signed opinion from an external actuary (who meets the criteria of article 48(2) of the

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Directive) regarding the adequacy of the technical provisions even though this opinion might not be public. And should also incorporate the SCR and MCR.

The actuarial profession, as the accounting profession, is also governed by high quality standards of qualification, practice, code of conduct and discipline even if they are not covered by a European directive.

INFORMATION PRINCIPLE

According to combined article 51 and 35 of the Solvency Directive the information "must reflect the nature, scale and complexity of the business of the undertaking concerned, and in particular the risks inherent in that business; (b) it must be accessible, complete in all material respects, comparable and consistent over time; and (c) it must be relevant, reliable and comprehensible."

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Points of attention

OTHER ADDITIONAL VOLUNTARY DISCLOSURES

The external audit report should be clear if the additional voluntary disclosed information are subject to review. As stated by article 289 of draft IM regulation, "Where insurance and reinsurance undertakings disclose publicly, in accordance with Article 54(2) of Directive 2009/138/EC, any information or explanation related to their solvency and financial condition whose public disclosure is not required by the laws, regulations and administrative provisions adopted pursuant to that Directive, these undertakings shall ensure that, where relevant, such additional information is consistent with any information provided to the supervisory authorities pursuant to Article 35 of Directive 2009/138/EC. "

FORM OF THE OPINION

The form of the external audit opinion should be set by the regulation and should be clear for the public according to the extent of the audit. Following A8 of ISA 805, the form of the opinion could be: The external auditor gives to the public, an unmodified opinion when the auditor concludes that the financial statements (here the prudential balance sheet and the MCR / SCR) give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework (ic. Solvency II).

This opinion should be based on the opinion of an external actuary. The Groupe is ready to provide proposals at another stage of the process.

FORWARD LOOKING VIEW ON EMERGING RISKS AND ON POTENTIAL CHANGES IN RISK

The external audit opinion should assure that results are free from material mistakes and prepared, in all material aspects, in accordance with the Solvency II regulatory framework. The external audit needs to foresee in an external expert opinion on elements such as emerging risks or market trends which might not sufficiently be captured in the underlying models and processes. The Groupe thinks it is most important that such a forward looking view of an external expert should be included. The Solvency II external audit report should not be only addressed to the AMSB but also to the other key functions.

TIMELINES

As the publication of the external audit may add two weeks to the processes, timelines of the SFCR publication should be adapted to the new request of an external audit.

WEBSITE

The external auditor report and the accompanying external actuary report should be disclosed in the website of the undertaking in the same way as the SFCR is published (see article 292 of draft IM regulation).

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SFCR OTHER THAN THE REGULAR ANNUAL ONE

Article 54 of the Solvency Directive states that "In the event of any major development affecting significantly the relevance of the information disclosed in accordance with Articles 51 and 53, insurance and reinsurance undertakings shall disclose appropriate information on the nature and effects of that major development." A statement from the external audit should be published alongside this additional SFCR.

The side letter should also be addressed to the 4 key functions (and not only to the AMSB and to the supervisor).

LINKS BETWEEN THE EXTERNAL AUDIT AND THE STATUTORY AUDIT

The external auditor should also be allowed to rely on any other external audit established on statutory account or consolidated account according to directive 2006/43/EC. It would enable the auditor to avoid duplicating any audit that is already covered by traditional statutory audit. Especially the audit of the assets and the liabilities (other than linked to technical provisions or reinsurance assets) may be directly driven by the statutory audit.

EXPERT JUDGMENT

The external auditor should be allowed to rely on the work of an external actuary to review technical provisions. cash-flows, taking account of the time value of money (expected present value of future cash-flows), using the relevant risk-free interest rate term structure" and that "the calculation of the best estimate shall be based upon up-to-date and credible information and realistic assumptions and be performed using adequate, applicable and relevant actuarial and statistical methods", the actuarial function, in determining the technical provisions and reinsurance assets, will have to apply appropriate expert judgment in a large number of cases. These expert judgments demand training, knowledge, experience and exercise of professional and other Insofar as "the best estimate shall correspond to the probability-weighted average of future standards (as required by Article 48(2) of the Solvency II Directive). The external auditor should rely on an actuary who has a similar level of training, knowledge, experience and exercise of professional and other standards so that a reliable opinion can be formed on such expert judgments.

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Emerging risks and changes in risk

The information on which the external auditor can rely upon are components of the *overall process* in the assessment of the market consistent balance sheet. However, a key component missing in the information is an expert view on elements such as emerging risks or market trends (or other potential changes in risk in the future) that might threaten the companies solvency position in the near or longer future. These emerging risks and market trends are parts of Article 521.1.b of the SFCR and are parts of the check of the Technical Provision calculations.

The Groupe believes that a substantive review of Technical Provisions will be required and that it will not be sufficient to rely solely on the internal controls and internal validation processes of the undertaking.

In some member states existing regulations require separate validation or review of the calculation and methodologies used in determining the Technical Provisions. This provides extra comfort to auditors in placing reliance of the Technical Provisions numbers.

It is difficult to see those existing supervisors where validation is regulated moving to a system where no such verification is a requirement.

The Groupe thinks that the design of the standard formula or the Undertaking (or Group) Specific Parameters approval are not the scope of the external audit. However the Groupe wonders how an external auditor could give a reasonable assurance for a SFCR if the standard formula doesn't correctly reflect the specific risk profile of the undertaking or if an internal model or a capital add-on would be necessary.

The external auditor should receive information confirming that the standard formula correctly reflect the specific risk profile of the undertaking or that an internal model or a capital add-on is not necessary.

It is important that the auditor concludes that the financial statements (here presented in the SFCR) give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework (here solvency 2) without restriction, the external auditor should also check (in links with the Actuarial and the Risk Management functions) that the risk profile has not evolved in a way that the standard formula no longer reflects the specific risks of the undertaking ort that should lead to a necessary ineternal model or a capital add-on.
To our view the appropriate reflection of the evolution of the risk profile within the standard formula calculations as at year end should be part of an external opinion.
A qualified actuary would be appropriately positioned to pick up this role and provide an external opinion taking a more holistic forward looking role.

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EXPERT JUDGMENT

The external actuary may be useful for the external auditor to review the loss absorbing capacity of technical provisions and deferred taxes which is subject to an expert judgment: "The adjustment referred to in Article 103(c) for the loss-absorbing capacity of technical provisions and deferred taxes shall reflect potential compensation of unexpected losses through a simultaneous decrease in technical provisions or deferred taxes or a combination of the two. That adjustment shall take account of the risk mitigating effect provided by future discretionary benefits of insurance contracts, to the extent insurance and reinsurance undertakings can establish that a reduction in such benefits may be used to cover unexpected losses when they arise. The risk mitigating effect provided by future discretionary benefits shall be no higher than the sum of technical provisions and deferred taxes relating to those future discretionary benefits."

RECOVERY PLAN

The SFCR may contain elements regarding days of non compliance of the SCR. Especially a recovery plan may be disclosed with forecast data. The Groupe considers that actuaries are best placed to review the disclosure according this task.

The Groupe is ready to offer its help to draw further guidelines or standards to set a clear way to split between the supervisor role and the external auditor role.

INTERNAL MODEL

The Groupe thinks that the internal model approval is not the scope of the external audit. This internal model approval is the subject of a formalized process between the undertaking and the supervisor. It may include external auditors and actuaries through the process of validation but it has nothing to do with the external audit of the SFCR. The external audit should not include an assessment of the appropriateness of the design surrounding the Internal Model as this is evaluated and approved by the supervisory authority.

However the Groupe wonders how an external auditor could give a reasonable assurance for a SFCR if the insurance undertaking has ceased to comply with the requirements set out in Articles 120 to 125 during the year.

The external auditor therefore should receive information confirming that the internal model is still valid. If this is not the case the Groupe considers that it would diminish the interest of the external audit for the public.

When the auditor concludes that the financial statements (here presented in the SFCR) give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework (here solvency 2) without restriction, the external auditor should also check (in links with the Actuarial and the Risk Management functions) that the risk profile has not evolved in a way that the insurance undertaking has ceased to

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comply with the requirements set out in Articles 120 to 125 during the year. To our view the appropriate reflection of the evolution of the risk profile within the internal model calculations as at year end should be part of an external opinion. A qualified actuary would be appropriately positioned to pick up this role and provide an external opinion taking a more holistic forward looking role.

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References

- Solvency II Directive 2009/138/EC **to be completed**
- Implementing Measures **to be completed**
-

Groupe Consultatif Publications

- Raising the bar on Insurance Technical Expertise (December 2012)
  - A position paper on the Role of the Actuary under Solvency II
- Use of an expert
  - **To be completed**

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Groupe Consultatif Actuariel Européen

The Groupe was established in 1978 to bring together the actuarial associations in the European Union to represent the actuarial profession in discussion with the European Union institutions on existing and proposed EU legislation which has an impact on the profession.

The Groupe also now provides a forum for discussion amongst all actuarial associations throughout Europe.

The Groupe currently has thirty-seven member associations in thirty-five European countries, representing about 20,000 actuaries.

Advice and comments provided by the Groupe on behalf of the European actuarial profession are totally independent of industry interests.

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