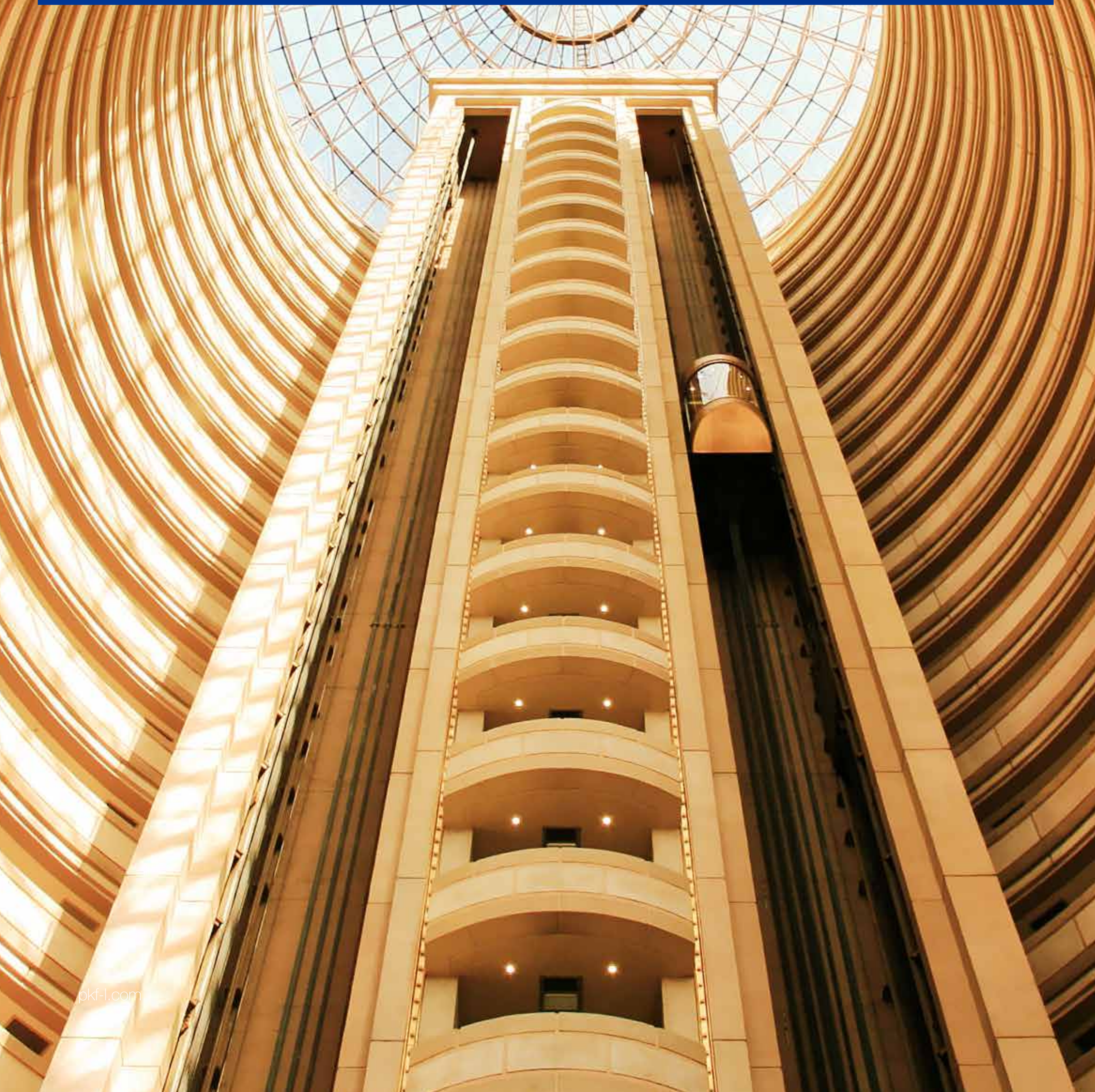
A publication for insurance carriers

June 2023

PKF

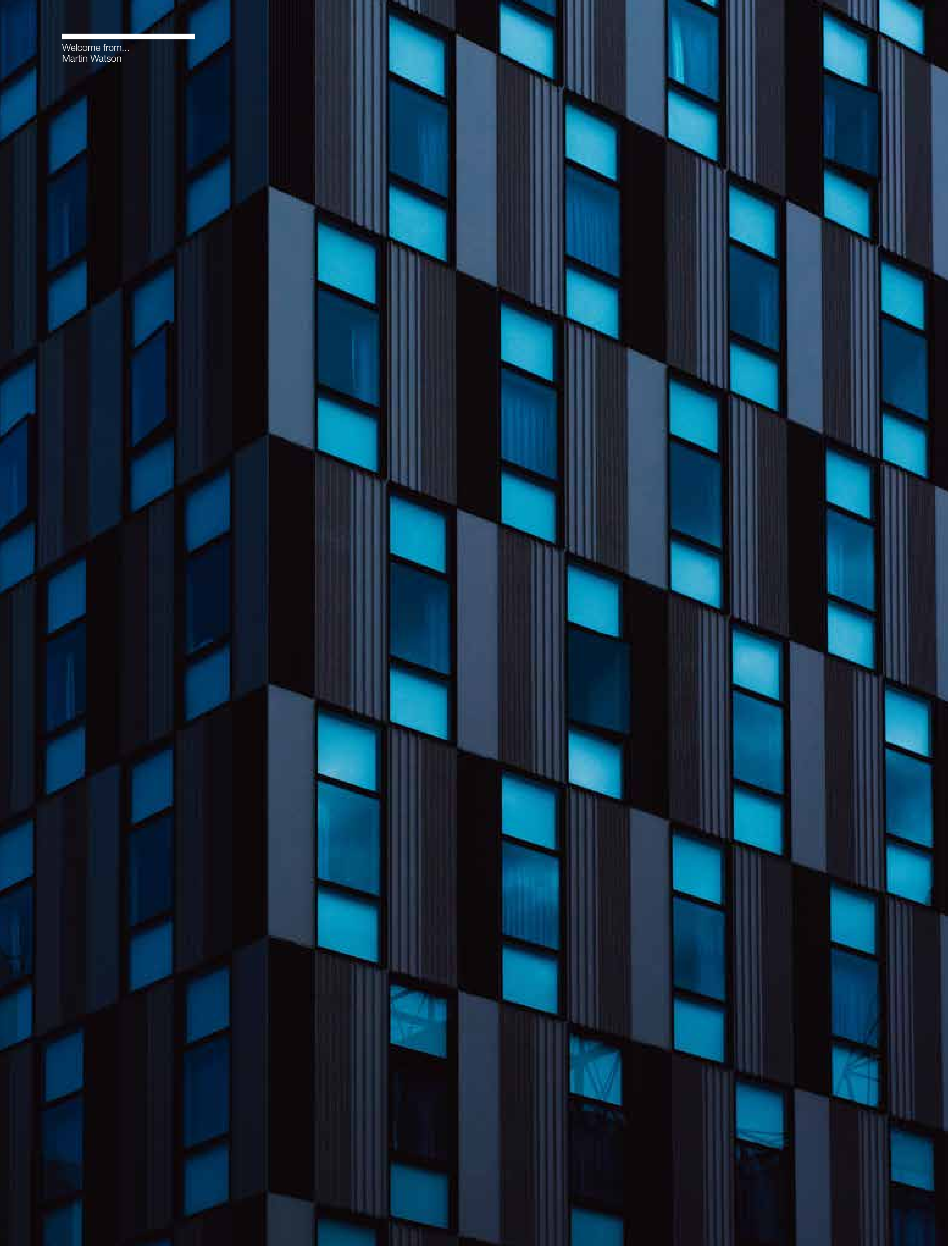
Insurer Update

In this issue



Contents

Insurer Update
In this issue...



Welcome to our publication for insurance carriers

Welcome to our latest edition of Insurer Update. This publication aims to help carriers across the insurance market understand and digest some of the more pertinent financial reporting and tax developments, and highlights the implications for medium sized and smaller insurers.

With ongoing confusion over the reporting of claims information, in this edition, we look at the Civil Liability Act and explain the reporting requirements for certain motor insurers.

FREDs are the Financial Reporting Council's mechanism for consulting on proposed changes to financial reporting standards in the UK and Republic of Ireland. With the comment period for Financial Reporting Exposure Draft (FRED) 82 having ended in April, we take a look at its significance and potential impacts for insurance carriers.

Following last year's Government consultation on Solvency II, we provide an overview of the main proposals and how 'Solvency UK' in shaping up post-Brexit.

Also in this edition, with Consumer Duty remaining high on the regulatory radar, our Governance, Risk and Control Assurance team explains the best way to design and operate effective governance controls ahead of the July deadline. They also look at the risks and priorities for insurance sector firms and their internal audit functions in 2023.

And finally, our VAT experts explain why insurers should consider how their investments impact their partial exemption calculations before HMRC beats them to it.

We hope you find this edition useful and thought provoking. As always, please contact any of the team to discuss how we can support your business and let us know your thoughts on future topics.

Martin Watson
Partner

+44 (0)113 524 6220
mwatson@pkf-l.com

The Civil Liability Act: one-off reporting requirements for certain motor insurers

There is still confusion over the reporting of claims information, making compiling data a considerable challenge for affected insurers. We look at the key barriers to progress.

The Civil Liability Act in 2018 introduced amended legislation for handling motor claims such as whiplash in the courts in England and Wales. Within the Act were requirements for reporting of certain claims information. This was to help HM Treasury (HMT) and the FCA to determine the effect of the new legislation and whether policyholders had received the benefit of any cost savings.

Two years later, the Civil Liability (Information Requirements) and Risk Transformation (Amendment) Regulations 2020 introduced details to implement additional one-off reporting to the FCA. This applies to insurers who issued more than 100,000 private motor policies in England and Wales in any of the years beginning 1 April 2020, 2021 or 2022. It requires them to complete a return covering each of those years. The return for all three years must be submitted by 1 October 2023.

Two sets of data are required. The first set is factual information that needs to be audited. The second is counterfactual information, where an auditor must provide assurance that specific requirements have been followed in calculating that information.

What are the problems?

Unfortunately, neither the Act nor the subsequent Regulations are sufficiently clear on how to compile the information. And there are some apparent inconsistencies between the Act and the Regulations. What's more, the information to be reported is not in a format in which most insurers maintain their records, so this increases the challenge for insurers extracting the information and auditors auditing and/or reviewing it. It is unclear how this data will provide relevant evidence on which HMT could assess the impact of the new legislation.

The quality and reliability of the data is also affected by the fact that many of the required reporting periods have distorted motor claims incidence. This is mainly because of Covid restrictions, which reduced the mileage driven during the various lockdown periods and the subsequent rebounds.

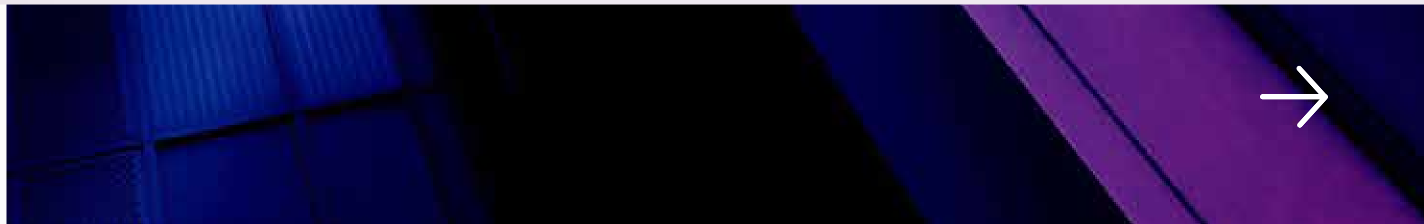
To help clarify the requirements, there are ongoing discussions between HMT, the FCA, the ABI and auditors. Their aim is to seek a workable solution for insurers to comply with the requirements of the Act and the Regulations. Discussions to date have been largely positive but are still ongoing, however, there is a clear willingness from all parties involved to find pragmatic solutions to the challenges outlined below.

The challenges of gathering data

The FCA has developed reporting templates and guidance with the ABI. But these continue to be refined, particularly to ensure consistency of the information to be reported.

Various challenges remain with compiling the necessary data. Significant assumptions may be required including:

1. Most insurers' current annual reporting periods are not to 31 March, so they will have to recompile the data to the periods specified.
2. Claims must be allocated to the period when they are 'finally settled', which might be open to interpretation. The claims information is only in relation to the third party personal injury claims element of motor claims and the related portion of legal costs. This may require a basis of allocating such costs from the total motor claims to the third personal party injury element only.
3. For Payment Protection Orders (PPOs), which might be settled as one-off lump sums and/or annuities, it's unclear what amounts should be reported, and in which periods, due to different interpretations of the terms 'settled' and 'paid'.
4. Premium information is required for those policies that relate to third party personal injury coverage. But insurers do not usually issue policies for only that element of coverage. This means they don't normally set their pricing in a way that might enable a straight-forward allocation. So this absence of clear guidance may lead to an arbitrary estimation.
5. The counterfactual information, which includes estimating how premiums and claims would have differed had the Act not been passed, causes even more uncertainty.



The format of the auditor's report is yet to be finalised. There are major challenges with the auditability of most of the required information. And the level of assurance an auditor can provide might be limited by the nature of the information required by the Act and the Regulations.

More clarity and support needed

Auditors will seek to align their audit and/or review procedures with the legislation, but this should be proportionate in time and expense. What's needed is a clear, acceptable basis of preparation for each section of the required reporting. These bases and the required level of materiality to be applied by the auditors in providing assurance might need input from the FCA. If there's a change of auditors during the relevant periods, there will be added challenges from the amount of work required to analyse the period(s) before the current auditors were appointed.

All things considered, we hope the ongoing discussions on the exact templates and guidance to help insurers prepare the returns will soon bear fruit. Also needed is clarity on the audit scope, including the level of assurance that can be provided for each section of the required reporting and the respective materiality level.

With only four months to the due date for returns submission, there's still much to resolve for insurers and their auditors. Clarity and simplicity will be important so that the cost and effort of producing this information is proportionate to its benefit. This is especially important as insurers who report under IFRS and their auditors gear up to their first period of reporting under IFRS 17.

Affected insurers must prepare for this reporting and identify obstacles in their data collation processes. They should keep up to date with the FCA's guidance and liaise with their auditors on how they are expecting to address data issues and provide the necessary audit evidence.

If you would like further guidance on any of the issues raised in this article, please contact Neil Coulson.

Neil Coulson
Partner

+44 (0)20 7516 2270
ncoulson@pkf-l.com

FRED 82: is the shakeup bigger than expected?

The comment period for Financial Reporting Exposure Draft (FRED) 82 ended in April. Satya Beekarry, Partner in our Insurance team, takes a look at its significance and likely impact for insurance carriers. Should you begin planning now?

FREDs are a way for the Financial Reporting Council (FRC) to seek feedback on proposed changes to financial reporting standards in the UK and Republic of Ireland. The FRC issues FREDs regularly, and at least every five years.

For each FRED the FRC typically holds a consultation period, during which interested parties can send comments. The Council then considers the comments before finalising the proposed changes. FRED 82 was issued in December 2022 following only the second periodic review of FRS 102. It proposes several changes to FRS 102 to broadly align it with IFRS. This means some consequential changes to FRS 103 and its implementation guide (IG). The changes are likely to be effective from 1 January 2025.

Is IFRS 17 coming to UK GAAP?

Before we get to the key proposed changes from FRED 82, let's dispense with the elephant in the room. It is not proposing to bring IFRS 17 (Insurance Contracts) into UK GAAP, at least not yet. This is a welcome relief for insurance carriers that report under FRS 102/103 or have transferred to it from IFRS.

But FRS 101 as a choice is effectively dead for Schedule 3 insurers. So any insurers that previously reported under FRS 101 would have moved over to either FRS 102/103 or full IFRS, with effect from 1 January 2023. For such insurers, either option could present significant changes depending on their individual circumstances.

Given its complexity, the IASB's post-implementation review of IFRS 17 is unlikely to be completed by 2026. What's more, the FRC's consultation timetable means IFRS 17 in any form is unlikely to be incorporated earlier than 2030, if ever. At least this provides some welcome certainty for the industry in the medium term. Indeed, it will have taken IFRS 15 and IFRS 16 seven years to become effective in some form under UK GAAP.

What are the key changes proposed by FRED 82?

- Revenue recognition (Section 23 of FRS 102). The new model for revenue recognition will be broadly aligned with IFRS 15, but with some simplifications. Insurance contracts under the scope of FRS 103 are outside the scope of Section 23 and are not directly affected by these changes (see more below). The five steps of IFRS 15 are:

  1. Identify the contracts with a customer.
  2. Identify the performance obligations in the contract.
  3. Determine the transaction price.
  4. Allocate the transaction price to the performance obligations.
  5. Recognise revenue when each performance obligation is satisfied.

- Lease accounting (Section 20 of FRS 102). The new lease accounting model will be broadly aligned with IFRS 16, but with some simplifications. It will require almost all leases to be brought onto the balance sheet from the lessee's perspective.

- Insurance contracts (FRS 103 and IG). Consequential amendments to FRS 103, including to the IG, are proposed in connection with the amendments to Section 23. They seem to seek alignment between revenue recognition for insurance contracts and the proposed amendments in Section 23.
- Other changes. FRED 82 also proposes other changes, mostly seeking alignment with IFRS. These include the adoption of the IFRS 13 definition of fair value, guidance on factors to consider when accounting for uncertain income tax positions, share-based payments and business combinations.

What is the potential impact of FRED 82?

Given the challenges IFRS preparers faced with IFRS 15 (Revenue) and IFRS 16, FRED 82 is likely to affect you. For some in a big way and for others less so. The commercial impact of these changes could be wide reaching for the insurance industry.

The good news is there is no change to the accounting for insurance contracts which is currently set out in FRS103. It is however important to review all your other major customer contracts in detail to understand this potential impact. The new revenue standard has requirements for identifying distinct performance obligations. Insurance groups that, in addition to underwriting or assuming insurance risks, earn revenue from other sources in the scope of Section 23 of FRS 102 (such as brokerage income, auto repairs, claims management) need to consider the various services they provide.

They must then make an allocation to performance obligations based on the relative standalone selling prices, and analyse potential patterns of revenue recognition.

Entities may need to judge what constitutes a 'distinct' performance obligation and the period/pattern over which a customer receives the benefits of these distinct services.

The timing of revenue recognition for your business might be affected. Arrangements in the scope of Section 23 of FRS 102 that feature contingencies and trail commissions need particular consideration. This is because the new revenue standard will require entities to recognise revenue when a performance obligation is satisfied, even if the amount of revenue is uncertain.

The consequential amendments to FRS 103's IG could change the gross written premiums (GWPs) of insurers. This is a concern as it is a key metric for most general insurers. What's more, as the proposed substantial changes are to the IG, which is non-authoritative in nature, this could lead to unnecessary diversity in practice in an industry that needs more consistency.

What about leases?

The new lease accounting model means most leases must be brought onto the balance sheet. This could have a significant impact on your financial statements and key ratios. It will increase your lease liabilities and right of use assets on the balance sheet. It will also add to finance expenses and depreciation of the right of use assets while decreasing the operating lease rentals in the income statement.

The IFRS 16 definition of what constitutes a lease might also mean that new contracts are identified as leases that would not have been previously. For example, in group scenarios, consideration of which entity has the right of use of an asset could mean new leases and sub-leases are identified, all leading to more complexity.

All these changes could affect your profit margins, reward schemes, and ability to meet financial covenants and pay dividends. So it's important to understand the changes that are proposed and to start planning for the transition now.

What are commenters saying?

Most commenters have been broadly supportive of the proposed changes. This is partly because the FRC, to its credit, began the review process early in March 2021 and considered the views of stakeholders in drafting FRED 82. It's likely most of the amendments will be finalised as proposed, including those relating to Sections 20 (leases) and 23 (revenue).

But not everyone is happy with certain aspects of the proposals. In the insurance industry, most respondents disagree with the proposals to amend the IG to FRS 103 as they may result in changes to current practice.

Insurance contracts are specifically excluded from the scope of Section 23, the IG is not mandated, and the FRC has not yet considered how to align FRS 103 with IFRS 17, if at all.

Some of the proposed changes to the IG appear misguided, as they seem to consider GWPs as revenue in Section 23. In fact, it is gross earned premiums or net earned premiums that would be more closely aligned with the concept of revenue. I share these views and certainly hope the FRC will consider these comments in finalising the amendments.

Several commenters have also expressed concerns that the proposed effective date of 1 January 2025 provides a very short lead time in which to prepare. By comparison, the effective date of IFRS 15, initially issued in 2014, had to be deferred to 1 January 2018 to allow sufficient time for transition.

What other amendments is the FRC working on?

The most recent is FRED 83, which the FRC issued in April, which proposed changes to FRS 102 and FRS 101. These would introduce a temporary exception to the accounting for deferred taxes arising from the implementation of the Pillar Two model rules, together with targeted disclosure requirements.

As my colleague Chris Riley discussed in an earlier edition, the OECD's Pillar Two model rules introduce a global system of interlocking top-up taxes that aim to ensure that large multinational groups pay a minimum amount of income tax. The FRED 83 proposed amendments are like those issued by the IASB for IFRS reporters in May. We expect FRED 83 to be uncontroversial in the UK. It is broadly supported, as shown by the rapid finalisation of the corresponding IAS 12 (IFRS) amendment by the IASB. The comment period for FRED 83 was much shorter, ending in May, and we expect the FRC to finalise the amendments this summer.

How can we help?

Our experienced accounting advisory team can help you with impact assessment, implementation, and transition to the amended FRS 102 standards. We have previously worked on IFRS 15, IFRS 16 and IFRS 17 transitions and understand the challenges these accounting changes pose. Please do not hesitate to contact us to discuss further.

Satya Beekarry
Partner

+44 (0)20 7516 2200
sbeekarry@pkf-l.com

Post-Brexit Solvency II reforms: what is changing?

Following last year's Government consultation on Solvency II, here's an overview of the main proposals and decisions made as a result.

Solvency II is the regime for (re)insurance undertakings within the European Union. Aiming to reduce the risk of insolvency, the directive and supporting regulation introduced harmonisation across the EU. Before Brexit, entities in the UK had to comply with this regime.

In April 2022, the UK Government released a consultation to review Solvency II so that it could adapt to the UK's position outside the EU. This consultation was underpinned by three objectives:

- to spur a vibrant, innovative, and internationally competitive insurance sector
- to protect policyholders and ensure the safety and soundness of firms
- to support insurance firms to provide long-term capital to support growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets, as well as investment consistent with the Government's climate change objectives.

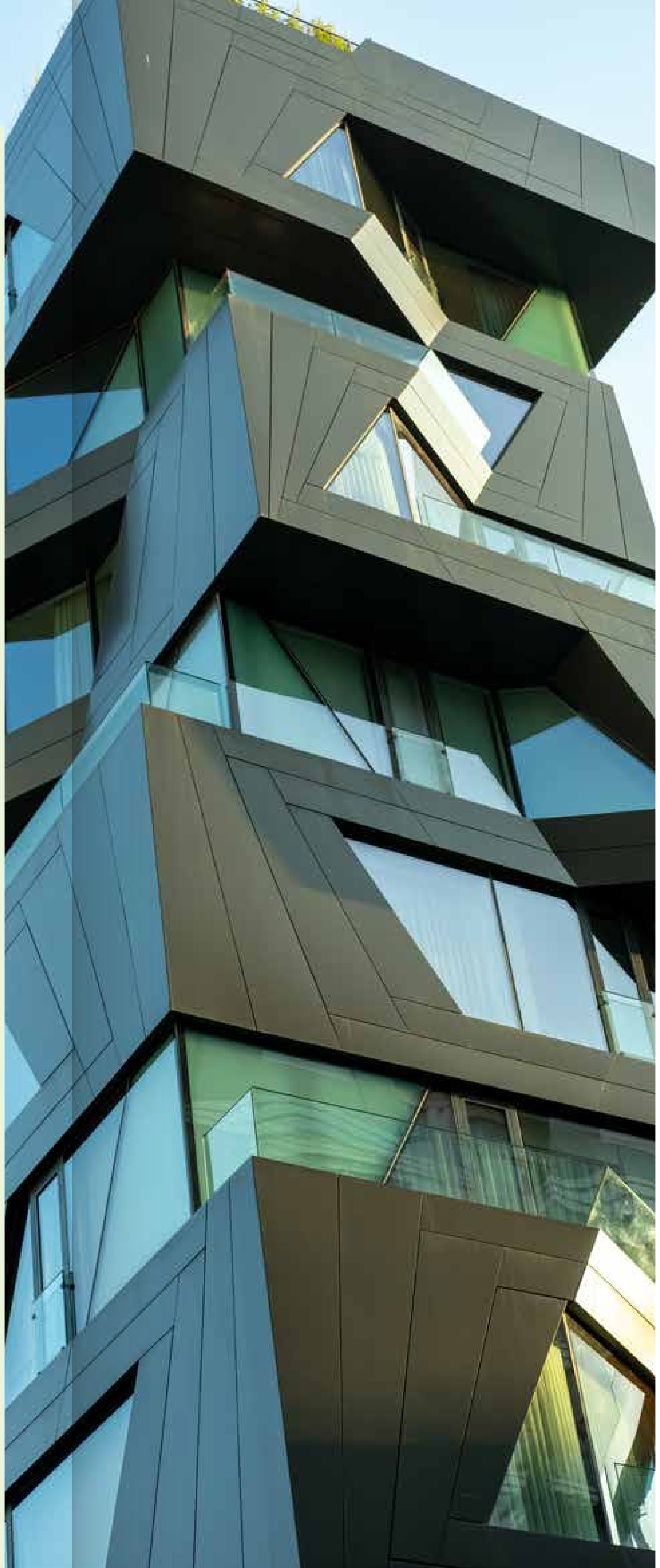
The consultation received 67 responses from insurance market stakeholders including insurers, consultancies, industry groups and individuals.

The full consultation documents can be found here.

Matching adjustment - fundamental spread

The consultation paper proposed a review of the 'fundamental spread'. This is used by firms as part of their matching adjustment calculation (which is mainly utilised by larger life insurers). It represents the expected cost of default and downgrade of assets which back providers' annuity business, and to which firms are therefore exposed.

This review responded to several indicators suggesting that the fundamental spread may not be capturing retained risks properly. Miscalibration of the fundamental spread would mean that credit risk may not be appropriately captured in insurers' balance sheets. This, in turn, could weaken protection for policyholders.



Respondents recognised the risks to the current calibration but considered the current methodology to be prudently calibrated. The consensus was that incorporating a credit risk premium would increase the best estimate liability, reduce own funds and hence increase capital buffers.

What's more, there would be an increase in balance sheet volatility which would then require further capital buffers. The impact on the market would be a disincentive to the provision of annuities and investment in illiquid assets such as infrastructure. The cost of these disincentives would be passed on to consumers.

Following this feedback and its own independent analysis, the Government decided not to make any updates to the current design and calibration of the fundamental spread. However, it has introduced further controls to ensure that risk management by insurers is aligned with the Prudential Regulation Authority (PRA)'s risk tolerance. These include:

- Regular stress testing exercises as prescribed by the PRA (which will be allowed to publish individual firm results).
- Senior managers holding formal regulatory responsibilities being required to formally attest whether there is sufficient fundamental spread on their firm's assets to reflect all retained risks.
- Permission for insurers to apply a higher fundamental spread through an add-on if they believe that the standard allowance is insufficient.
- An update to the matching adjustment rules (see below).

The Government will revisit the calibration of the fundamental spread in five years' time to ensure that the approach remains appropriate.

Matching adjustment – increasing investment flexibility

The consultation also made the following proposals for the matching adjustment:

- The current Solvency II regime only allows cash flows generated by assets which are fixed in timing and amount to be used for matching adjustment portfolios. The proposal was to allow a broader range of assets to be eligible.
- Extending the range of eligible liabilities for the matching adjustment to include morbidity risk products, such as income protection products.
- Assets which have a credit rating below BBB will no longer be as disproportionately treated in matching adjustment portfolios. The objective was a more credit risk sensitive fundamental spread.
- Faster decisions by the PRA on matching adjustment eligibility applications for less complex assets. This will be achieved through the separation from the review of asset valuation, credit rating and capital modelling. This will enable insurers to deploy capital into new asset classes.
- Currently, a breach to the matching adjustment rules lasting more than two months would lead to the entity losing the full matching adjustment benefit. A more proportionate approach to such breaches is proposed, which will help insurers to plan better on the basis of a more stable matching adjustment benefit. It would also lower costs associated with asset portfolio restructuring.

The above proposals will be implemented. Following market feedback, the Government also decided to replace the requirement for 'fixed cash flows' to be reworded as 'highly predictable cash flows', further supporting flexibility.

Risk margin

The consultation paper proposed that the risk margin calculation be reviewed to achieve a 60-70% cut for long-term life insurers. The Solvency II regime uses a cost of capital approach and is sensitive to the duration of the liabilities, the risk-free yield curve at the time of the calculation, the lines of business and the resulting risk profile of the entity.

The Government proposed a modified cost of capital approach that would retain the sensitivity to the differences in risk profile and duration. What's more, the disruption would be minimal as the approach is similar to that being proposed in the EU. The 60% reduction would mean that insurers reduce the sub-optimal allocation of capital resources. A lower risk margin would also lead to a reduction in the volatility in insurers' balance sheets introduced by the change in interest rates from one reporting period to the next.

Another incentive to reduce the risk margin was the current loss of life reinsurance business to jurisdictions outside the UK, where a lower risk margin is required. Market respondents agreed with the concept of having a risk margin to transfer a book of insurance business. However, most believed that under the Solvency II regime, the margin is higher than necessary and that the proposed cuts are useful. They agreed with a modified cost of capital method, as it is theoretically sound and in alignment with the current approach.

The final reform is that the risk margin will be reduced by 65% for long-term life insurance business, including PPOs. Since general insurers typically have a lower risk margin which is less volatile, mainly as a result of the shorter tail on average, they would be less impacted by a reduction in the risk margin. A 30% cut for general insurers was deemed appropriate.

Reducing reporting and administrative burden

The consultation made these additional proposals to reduce the burden on entities:

- Reforms to the internal model framework. This will include reduced requirements for documentation, statistical quality standards, the 'use test' and profit and loss attribution. The aim is to enable simpler approaches when they are sufficient. Any remaining limitations would be mitigated through safeguards, which could be capital add-ons, exposure limits and approval conditions.
- Branches of foreign insurers will not be required to calculate local capital or to hold assets to cover them. This was estimated to impact around 160 branches at the time of writing.
- Increase thresholds of premium and technical provisions before Solvency II becomes applicable.
- Make reporting more proportional by simplifying complex templates and deleting others. Also reduce reporting frequency of some templates and amend others so they are applicable to the UK market.
- Introduction of a mobilisation regime for new insurers, with an optional phase for new insurers to enter the market. This will include modified entry requirements, such as a lower capital floor and lower expectations for key personnel and governance structures. There may also be reporting requirement exemptions. To protect policyholders, proportionate restrictions will accompany these reduced regulatory standards.
- Allow groups to temporarily use multiple group internal models following an acquisition or merger. Further, acquired firms will not be required to hold temporary additional capital post-acquisition.
- Reduce the administrative burden of legacy system maintenance. A simplification of the calculation of Solvency II transitional measures was also

proposed.

- Many market respondents welcomed the reduced burden proposed. Some were concerned that reduced reporting may lead to an increase in ad-hoc reporting requests. Others worried that any significance divergence from European templates would increase costs for entities required to report under both regimes. However, the market did support the proposals to remove branch capital requirements and introduce a mobilisation scheme.

The Government decided to proceed with the proposals and to increase the threshold to £15m in annual gross written premiums, which is triple the previous threshold. It will also increase the threshold to £50m in gross technical provisions, which is double the previous threshold. Entities which have a lower threshold may still opt into Solvency II (as adopted in the UK) if they wish.

Implementation of the Reforms

In February 2023, Sam Woods (CEO of the PRA) gave a speech at the ABI dinner about the next steps for Solvency II reforms. He said, "Discussions with colleagues in the Treasury about precise timings are ongoing, but at this point our broad expectation is that we will publish a first consultation on some of the topics above in June, followed by a second consultation, on those areas that will benefit from more time for industry engagement to make sure we can get the details right, in September. "

In June 2023, the UK Government has released draft regulations to give effect to the consultation's reforms. These confirm a drop in the cost of capital used to calculate the risk margin from 6% to 4%, cutting risk margins for general insurers by circa 30%.

The drafts regulations are subject to change, but have been released to aim for early engagement and implementation. The Government expects the reforms to the risk margin to be implemented by year end 2023 and the reforms to the matching adjustment by June 2024. The other outstanding reforms are expected to be in place by year end 2024.

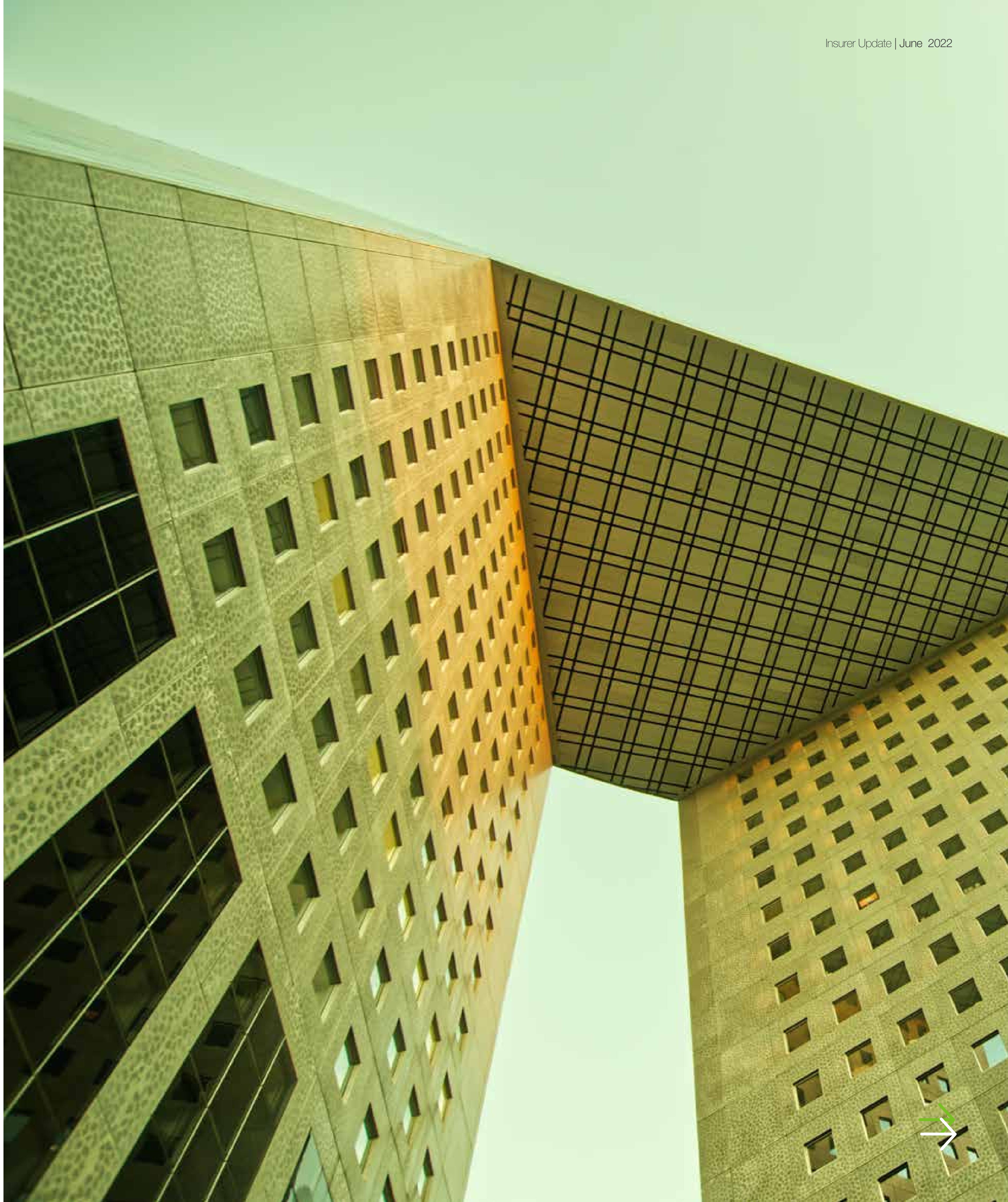
The draft Regulation can be found here.

Given the desire to implement some of the package of changes for upcoming December 2023 year ends, government and industry will need to move at pace to make this a reality.

For more information on any issues raised in this article, please contact Michaela Buttigieg.

Michaela Buttigieg
Actuarial Senior Analyst

+44 (0)20 7516 2200
mbuttigieg@pkf-l.com



Embedding Consumer Duty – how is your firm doing?

Consumer Duty remains high on the regulatory agenda. Here's our guide to the best way to design and operate effective governance controls.

Richard Willshire
Director - Governance, Risk & Control Assurance

+44 (0)20 3650 3676
rwillshire@pkf-l.com

The FCA's latest business plan identifies specific provisions that consider the way firms approach positive consumer outcomes in the context of their authorisation and supervision.

The implementation date for new and existing open products is 31 July. With this in mind we have reviewed the FCA's updated guidance and provide our insight on the important focus areas for firms.

Focus areas	What should firms do	Assurance activities
Implementation	Ensure implementation projects are nearing completion, having identified and prioritised the riskiest products or most vulnerable consumers. Document and prioritise a record of products and associated value measures reflecting the risk and consumer vulnerability. Complete consumer journey mapping and consider the overall culture, training and processes needed to support the delivery of outcomes. Map distribution chains and third party engagements to understand how consumers interact with products and firms.	Review the governance, oversight and monitoring of implementation activities, schedules, risk assessments and prioritisation to make sure management is focused on the most vulnerable consumers and products. Review implementation project delivery and outcomes to check that objectives have been met and Consumer Duty has been embedded across the firm. Review first and second line training, metrics and reporting to ensure that existing and new metrics have been developed and are being used when considering products, services and consumer engagement. Review the assessment of product distributors across consumer channels. Ensure the assessment reflects the role of parties throughout the consumer and product life cycle.
Governance and oversight	Establish clear roles and responsibilities for Consumer Duty across SM&CR / governance structures and allocate a Consumer Champion. Oversee and monitor plans to implement and embed Consumer Duty in firm operations. Embed consumer outcomes in decision-making, commercial and operational forums, monitoring and metrics. Identify and align product / types of product ownership, building on pricing product governance work completed previously. Engage firm, insurer and distribution chain stakeholders to ensure a consistent and co-ordinated approach across product delivery and service.	Review new or enhanced roles / responsibilities across SM&CR positions to ensure that Consumer Duty remains a high priority for governance processes. Review the governance structure and reporting channels to ensure effective oversight of Consumer Duty, sufficient airtime within relevant committees and incorporation into risk, culture and strategic discussions. Review the oversight, engagement and challenge of counterparties across the distribution chain to ensure that the Consumer Duty is embedding. Review the pricing and product attestations and assessments completed by relevant forums / committees to ensure appropriate ownership and oversight of products.
Management and operations	Review and assess current firm culture and seek to embed good consumer outcomes as part of the firm's culture. Map and understand the specific consumer touchpoints within product distribution / consumer journeys across the life cycle of each product. Assess the impact of continuing or discontinuing provision of products or services to vulnerable consumers. Review and align reward and/or remuneration structures to reflect consumer impacts and the objectives of the Consumer Duty. Consider the financial and non-financial benefits and costs associated with each product / type of product. Consider the variation between absolute and relative value provided by products.	Review the approach, focus and metrics used to measure individual, divisional and firm performance to ensure they reflect consumer interests and measure outcomes. Review the mapping and analysis of consumer journeys and how these support a consumer-focused approach, in line with the nature of the product / service. Review the remuneration and reward objectives to ensure they promote a consumer-focused culture and operating environment. Review the value metrics created for products and assess the balance between financial and non-financial benefits and costs considered through value assessments and the impact on absolute or relative value.

Focus areas	What should firms do	Assurance activities
Processes, systems and controls	When mapping consumer journeys, review and update processes, systems and controls to align with consumer requirements. Review and assess current systems, product and performance metrics to ensure they are configured to capture new / amended data logged against consumer outcomes. Review existing underwriting, claims and complaints processes and decide whether enhancements or changes are needed to implement new authorisations or reviews through product life cycles. Review system change management projects and enhancements for conflicting or complimentary request and prioritise coordination of consumer focuses enhancements. Review and update existing procedures and processes to capture instances of poor consumer outcomes.	Review the design and operating effectiveness of new or amended controls within placement, support and claims processes. Provide assurance that firms have defined and enabled appropriate data fields to capture relevant and timely consumer focused data. Review change management programmes for system updates to ensure appropriate consumer impact assessment and analysis. Review the retention of personal consumers to ensure this is done in compliance with established internal processes and that relevant GDPR controls are working effectively. Review formal process documentation to ensure this reflects processes accurately and is up to date.
Third parties	Identify all key third parties included in consumer mapping documentation, with clear roles, responsibilities and accountabilities agreed and formalised. Establish new, or enhance existing, governance and oversight in third party SLAs to ensure consistent and effective adherence to Consumer Duty requirements. Develop systems and processes so that third parties are clear on the reportable data and metrics needed to demonstrate adherence to the Consumer Duty. Consider the impact on consumers in the event of loss of a third party, across the product life cycle.	Review and confirm the identification of third parties within consumer journeys, provide assurance that the third parties are correctly identified and categorised, and that clear roles and responsibilities have been agreed. Review third party SLAs and other commercial agreements so that these are consistent, where possible, and reflect requirements to meet Consumer Duty obligations. Provide assurance that respective roles and liabilities are clearly established. Review the data and reporting requirements set by the firm to ensure these remain clear, consistent and that they meet Consumer Duty requirements across all consumer touchpoints undertaken by third parties. Review third party reliance and impact assessments to ensure that sufficient processes are in place to meet consumer requirements in the loss of a critical third party. Placement, processing, claims and remediation are key focuses.

Focus areas	What should firms do	Assurance activities
Data strategies	Assess current data capture and reporting to identify known gaps in your current suite, or aim to centralise and standardise potentially disparate reporting. Develop new, or enhance existing, data capture fields and reporting requirements reflecting Consumer Duty expectations. Ensure that data is captured consistently across groups of products, customers and distribution channels to enable analysis and comparison. Consider how you will monitor outcomes across different groups of customers, including vulnerable customers.	Benchmark specific data and reporting metrics against industry-observed practices so that they are consistent and reflect the Consumer Duty requirements. Review existing systems and processes to ensure that data is captured, recorded, analysed and reported consistently and reflects a consumer focus. Review the development of new or additional data fields or reporting that provide insight on consumer journeys, including analysis of time taken, click / tap journeys and third party handoffs.

Many aspects of Consumer Duty are not new for the insurance industry and build on previous initiatives. But firms should still put in considerable effort to fully embed Consumer Duty and deliver the cultural change the FCA is looking for.

After the 2023 deadline, firms are likely to receive data and oversight requests from the FCA. This is part of the regulator's process to validate efforts across the sector and identify poor performing firms, potential consumer detriment or other areas of concern.

For further insight, advice or specialist assurance support with your consumer portfolio, please contact Richard Willshire in our Governance, Risk & Control Assurance team.

Insurance sector risks & priorities for 2023: mid-year update

Last September we shared our views on what should be front of mind for insurance sector firms and their internal audit functions. Now we revisit those topics and how they have evolved.

Protecting the consumer

As predicted, Consumer Duty has been a significant focus for firms during 2023. The new Consumer Duty is an important piece of regulatory change: the FCA is looking for a cultural shift. It requires significant effort to implement and has widespread impacts on firms.

As firms put their energies into that implementation, the FCA has provided further guidance and released updates to the market earlier this year. These included both Dear CEO / portfolio letters and the results from their multi-firm review. The FCA is keen that firms have a structured and robust approach to implementing and embedding the Consumer Duty rules into their processes, systems and cultures. And it has highlighted several key considerations for firms ahead of the nearing July 2023 deadline for open products. You can read more in our article about Consumer Duty in this issue.

Internal audit functions are developing their approaches and plans, focusing first on whether implementation plans are progressing and whether the key Consumer Duty requirements due by 31 July 2023 have been completed. These Consumer Duty-related assurance needs will likely continue to ensure that the FCA's intended outcomes are achieved and that Consumer Duty is sufficiently embedded in firms' culture and operations.

Financial management

Financial resilience remains a key priority for the regulators. In its Dear CEO letter Insurance supervision: 2023 priorities in January, the PRA highlighted the effects of the difficult economic outlook on the insurance sector. In particular, credit and concentration risks are a challenge for life insurers, and claims inflation is a challenge for general insurers.

The effects of inflation on pricing, reserving, business planning and capital planning/modelling need to be carefully considered. The PRA will continue to monitor this through its supervisory activities.

In January this year the UK Government consulted on introducing an Insurer Resolution Regime which will give the Bank of England powers to take action to stabilise and manage the failure of an insurer. Again, it shows a desire to minimise the impact of financial failure.

For internal audit functions, there can be a tendency to rely on external auditors to cover the financial risks and controls of a firm. In the current economic environment, internal audit functions should challenge themselves over whether this approach remains appropriate. Is there enough consideration and coverage of financial risks within the audit universe and plan?

Governance, culture & people

The SM&CR came into force for insurers on 10 December 2018 and is now well established and understood, with its overall aim to improve accountability and culture in the financial services sector.

In March this year, the Government launched its call for evidence of the SM&CR, part of a wide-ranging shake-up to make UK financial services more competitive post-Brexit.

The FCA and PRA also issued a joint discussion paper (DP1/23 – Review of the Senior Managers and Certification Regime (SM&CR)) to seek views from firms, consumers, and other stakeholders on the effectiveness, scope and proportionality of the SM&CR. The deadline for responses was 1 June.

Whilst we don't expect wholescale changes to the SM&CR, it's good news that it is under review and that possible improvements are being explored. Certainly, any changes to reduce the administrative burden of the SM&CR on firms will be appreciated.

In more recent news, the FRC launched a consultation document on the UK Corporate Governance Code in May. The consultation focuses on internal control, assurance and resilience. The main changes relate to:

- ESG – proposed changes that require boards to report on climate ambitions and transition planning in the context of firm strategy, and expand the remit of audit committees to oversee ESG disclosures, controls, processes and assurance.
- Director commitments – in response to investor concerns over the number of board positions held by directors and their time commitment, proposals address this issue and suggest increasing transparency and reporting on director appointments.
- Diversity and inclusion – proposed revisions to strengthen the Code in this area, including consideration of diversity beyond gender and ethnicity and increased reporting on succession planning.
- Audit, risk and internal control – significant changes to Section 4 of the Code reflecting the need for a more robust framework of risk management and internal control. This includes requirements for an audit and assurance policy and to follow the FRC's minimum standard for audit committees.

The proposed changes to the Code will apply to accounting years starting on or after 1 January 2025. Although the Code only applies to premium listed companies, the proposed changes will interest all firms as an example of best practice which could, in time, cascade down to non-listed and smaller firms.

For internal audit functions, it's important to monitor proposed changes to the SM&CR and Code for their potential impact on firms. Where changes need to be implemented, internal audit functions should be giving assurance on their effective implementation and embedding.

Operational & IT risks

Operational resilience and IT risks, particularly cyber risk, remain top priorities for firms and the regulators. The threats are continually evolving and there are increased cyber incidents, including ransomware attacks.

Both the FCA and PRA business plans for 2022/23 highlight the ongoing importance of operational resilience and indicate further oversight and supervision in this area. Firms have until March 2025 to test and refine their operational resilience frameworks. In particular, the regulators will be looking at consistency in approach and dependency of third parties. Joint consultation papers on the oversight of third parties and the reporting of operational incidents are expected later this year.

For internal audit functions, operational and IT risks should remain a key component of internal audit plans and subject to regular reassessment given the evolving risks.

Most importantly, internal audit functions should make sure their firms continue to test and refine operational resilience frameworks before the March 2025 deadline.

Regulatory change

In September we identified ESG, appointed representatives, back-branching and the Solvency II review as key areas of regulatory change. Of these topics, ESG and the Solvency II review will have the most prominent and wide reaching impact. You can read more in our article about the Solvency II review in this issue.

ESG initiatives and reporting remain high on firms' agendas, reflecting increased pressures from a wide range of stakeholders: regulators, investors, customers, employees and wider society. The UK intends to make TCFD-aligned disclosures mandatory throughout the economy by 2025, with a significant number of requirements in place this year.

There is also growing demand from investors for firms to provide ESG data and reporting.

The regulators are particularly focused on climate-related financial risks including physical risks, transition risks and liability risks. In its business plan for 2023/24, the PRA says that insurers have taken "concrete and positive steps" to implement their expectations in this area, but the level of embedding varies and more progress is needed in all firms.

ESG should now feature in some way in internal audit universes and plans. For example, this might mean a high-level review of implementation and embedding of the PRA's expectations for managing climate-related financial risks, a targeted review of compliance with any ESG underwriting or investment guidelines, or ESG disclosures and public commitments /statements. Undoubtedly, internal audit functions need to develop their skills and understanding of this topic. Future work in this area is only likely to increase, with greater demands for ESG assurance from a variety of stakeholders.

If you would like further support on any of the issues raised in this article, please contact PKF's Governance, Risk & Control Assurance team.

Jessica Wills
Partner – Goverance, Risk & Control Assurance

+44 (0)20 7516 2229
jwills@pkf-l.com

PESMs: are you applying yours correctly?

Insurers should consider how their investments impact their VAT partial exemption calculations before HMRC beats them to it.

Insurers that incur third party investment management fees may be in danger. They could be open to scrutiny by HMRC. Those who have not given sufficient thought to how their investments impact their partial exemption calculations may face significant costs by way of assessments of VAT, penalties and interest.

On the other hand, there are also opportunities to increase input VAT recovery by carefully considering all possible approaches.

HMRC appears to be aware that a number of Lloyd's syndicates are not correctly applying their partial exemption special method (PESM) for VAT. These should be reviewed regularly. But we understand that HMRC has seen PESM agreements that are dated many years in the past and has assessed syndicates that may have forgotten the rationale behind the agreements.

At the moment HMRC is looking specifically at syndicates with sectorised PESMs, but the issue applies to any insurer that pays third party investment management fees.

The Lloyd's VAT arrangements

HMRC is mostly targeting agreements that are based on the Lloyd's VAT arrangements (LVA) that have been in place for many years. Although the LVA do provide a basic PESM template that may be appropriate for many syndicates and other Lloyd's participants, they don't necessarily reflect the way the insurer calculates its recoverable VAT. So they may not provide a sufficiently clear direction as to how to calculate recoverable input VAT.

We are currently helping several Lloyd's syndicates to recalculate their recoverable VAT for previous years. HMRC asked them to do the recalculation because they hadn't correctly applied the method set out in the PESM - agreed between the syndicate and HMRC many years ago.

HMRC understandably believes there may be more syndicates that have made mistakes in their VAT returns for the same reason. HMRC has sent out questionnaires designed to bring to light similar errors.

Sectorised methods with an investment sector

From our observations, HMRC seems most interested in cases with two-sector PESMs, where sector one is based on underwriting income and sector two on investment income. These PESMs are often identical (or almost identical) to the template PESM provided in the LVA.

It is particularly in the investment sector that insurers and syndicates appear to have difficulties.

In many instances, HMRC is finding that the input VAT relating to the investment sector is being recovered using the recovery rate of the underwriting sector. While this may lead to an 'under recovery' of input VAT, HMRC has made it clear that the agreed PESM must be applied.

In other instances, HMRC disagrees that (or fails to understand how) the method used by the syndicate in its investment sector relates to the method as set out in the agreed PESM. If the PESM is based on the standard LVA wording, it may not be possible to apply the method precisely as agreed.

There are other cases where HMRC and the syndicate may both have lost critical parts of the PESM (some PESMs are over 20 years old). This may lead to a strange situation where HMRC is reminding the syndicate that it must follow the PESM, but neither party is certain precisely what was agreed.

Issues and opportunities

If an agreed PESM is incorrectly applied, or not applied at all, HMRC may consider clawing back overclaimed input VAT (plus interest) going back four years. HMRC may also levy careless error penalties of up to 30% of the VAT assessed.

Conversely, some syndicates may be leaving input VAT on the table and may be able to increase their input VAT recovery (retrospectively going back up to four years). There are two ways to do this: either by strictly following the approach set out in their agreed PESM or, if they don't already have one, setting up a PESM which takes investments into account.

Wider application

The above is not only relevant to syndicates with sectorised PESMs. It also applies to insurers that sell securities as part of the regular management of their investment portfolio and pay third party investment management fees. This is true whether or not a syndicate (or other insurer) has agreed a PESM with HMRC.

This is because input VAT related to the sale of securities is a special case in partial exemption. The input VAT incurred on such activities must be ringfenced and apportioned according to use.

'Use' is not defined and there are, therefore, many different 'use' methodologies that are arguably 'fair and reasonable'.

A keen HMRC VAT officer could, for example, impose significant financial costs and administrative burdens on a syndicate (or other insurer) that had not already thought about how its investments might affect its input VAT recovery calculations. On the other hand, more forward planning for the correct approach may significantly increase input VAT recovery levels.

All in all, we recommend that syndicates and other insurers consider this matter proactively before they are prompted to do so by HMRC.

To discuss any of the issues raised in this article, please contact Mark Ellis.

Mark Ellis
Partner, VAT

+44 (0)20 7072 1102
mellis@pkf-l.com

About PKF
Simplifying complexity for our clients

PKF is one of the UK's largest and most successful accountancy brands.

We have been a trusted adviser to the UK insurance industry for over 150 years and have one of the largest and most experienced teams of insurance experts within the accountancy profession.

Established initially as a Lloyd's practice, our clients now span the entire insurance market – from Lloyd's syndicates to life, general and health insurers, brokers and MGAs.

Our expert Insurance team are specialists in dealing with clients who operate across borders and that team extends to include colleagues in Insurance hubs including, Gibraltar, Malta, Guernsey, the US and Ireland.

How we can help

- Audit →
- Governance, risk and control assurance →
- Tax →
- Transaction advisory →
- Restucturing →
- Business outsourcing →
- Actuarial services →
- Technical accounting advice and support →

PKF UK in numbers

9th
Largest audit practice in the UK in the latest Accountancy Daily rankings

24
Offices across the UK

1,450+
Employees and 129 partners

£153m
Fee income and growing rapidly

Insurance practice in numbers

140+
Insurance industry clients

7th
Largest auditor to insurance industry

110+
Insurance specialist staff & partners

30%
Advisor to one third of the UK's Top 50 Brokers

PKF Global in numbers

Part of the 14th
Largest global accounting network

480
Offices in 150 countries

$1bn+
In aggregate fee income

20,000
Employees

Get in touch today to see how we can help...

Martin Watson
Partner – Audit & Assurance
+44 (0)113 524 6220
mwatson@pkf-l.com

Neil Coulson
Partner - Audit & Assurance
+44 (0)20 7516 2270
ncoulson@pkf-l.com

Carmine Papa
Partner - Audit & Assurance
+44 (0)20 7516 2271
cpapa@pkf-l.com

Thomas Seaman
Partner - Audit & Assurance
+44 (0)20 7516 2450
tseaman@pkf-l.com

James Wilkinson
Partner - Audit & Assurance
+44 (0)161 552 4220
jwilkinson@pkf-l.com

Satya Beekarry
Partner – Audit & Assurance
+44 (0)20 7516 2425
sbeekarry@pkf-l.com

Jessica Wills
Partner – Goverance, Risk & Control Assurance
+44 (0)20 7516 2229
jwills@pkf-l.com

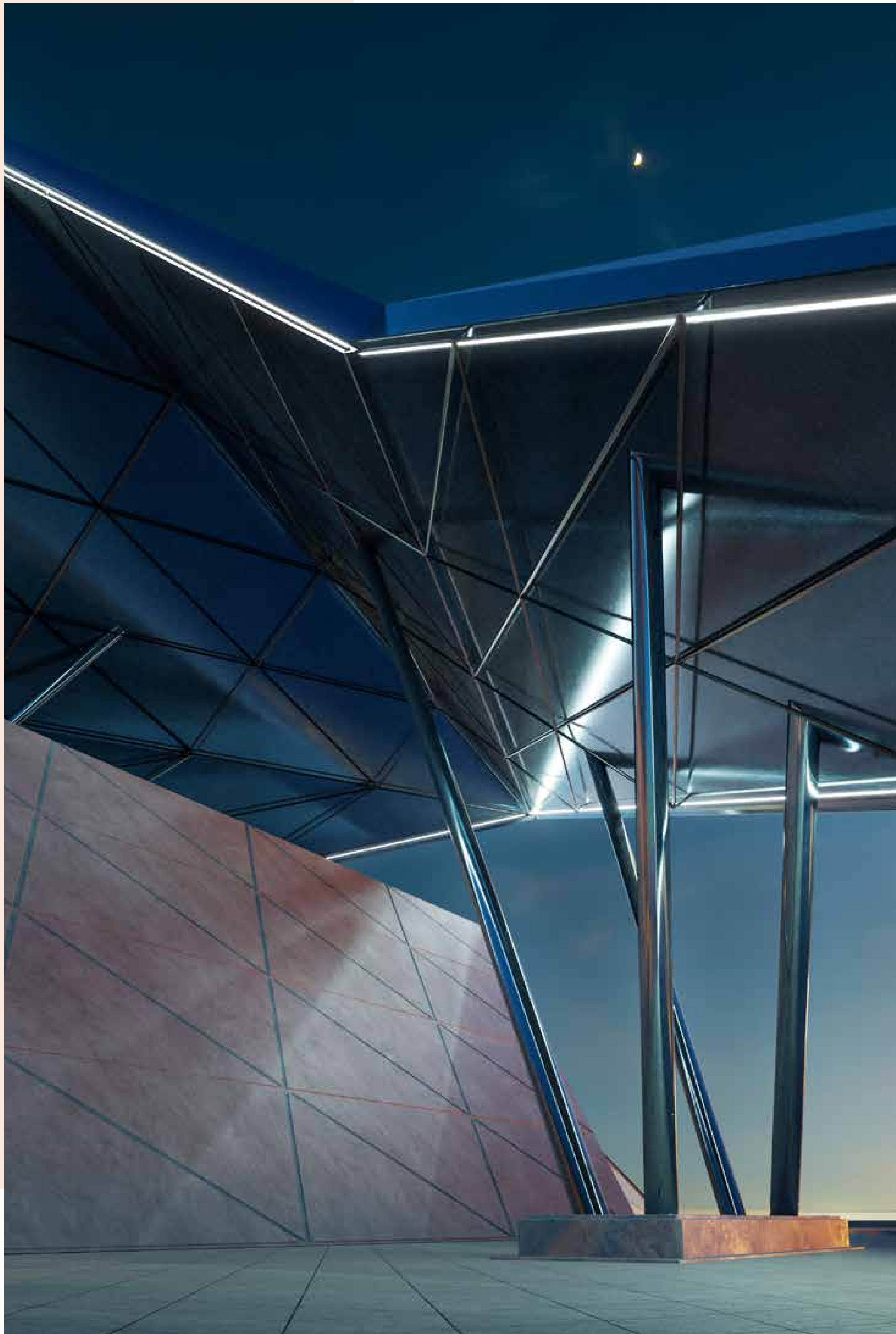
Chris Riley
Partner – Corporate Tax
+44 (0)20 7516 2427
criley@pkf-l.com

Mark Ellis
Partner - VAT
+44 (0)20 7072 1102
mellis@pkf-l.com

Richard Willshire
Director - Goverance, Risk & Control Assurance
+44 (0)20 7516 2200
rwillshire@pkf-l.com

James Randall
Director - Audit & Assurance
+44 (0)113 526 7960
jrandall@pkf-l.com

Pauline Khong
Director - Actuarial
+44 (0)20 7113 3559
pkhong@pkf-l.com



PKF Littlejohn LLP

www.pkf-l.com

London

15 Westferry Circus
Canary Wharf
London, E14 4HD
Tel: +44 (0)20 7516 2200

Leeds

3rd Floor
One Park Row
Leeds, LS1 5HN

Tel: +44 (0)113 244 5141

Manchester

11 York Street
Manchester
M2 2AW

Tel: +44 (0)161 552 4220

This document is prepared as a general guide. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication can be accepted by the author or publisher.

PKF Littlejohn LLP, Chartered Accountants. A list of members' names is available at the above address. PKF Littlejohn LLP is a limited liability partnership registered in England and Wales No. 0C342572.

Registered office as above.

PKF Littlejohn LLP is a member firm of the PKF International Limited family of legally independent firms and does not accept any responsibility or liability for the actions or inactions of any individual member or correspondent firm or firms.

PKF International Limited administers a network of legally independent firms which carry on separate business under the PKF Name.

PKF International Limited is not responsible for the acts or omissions of individual member firms of the network.