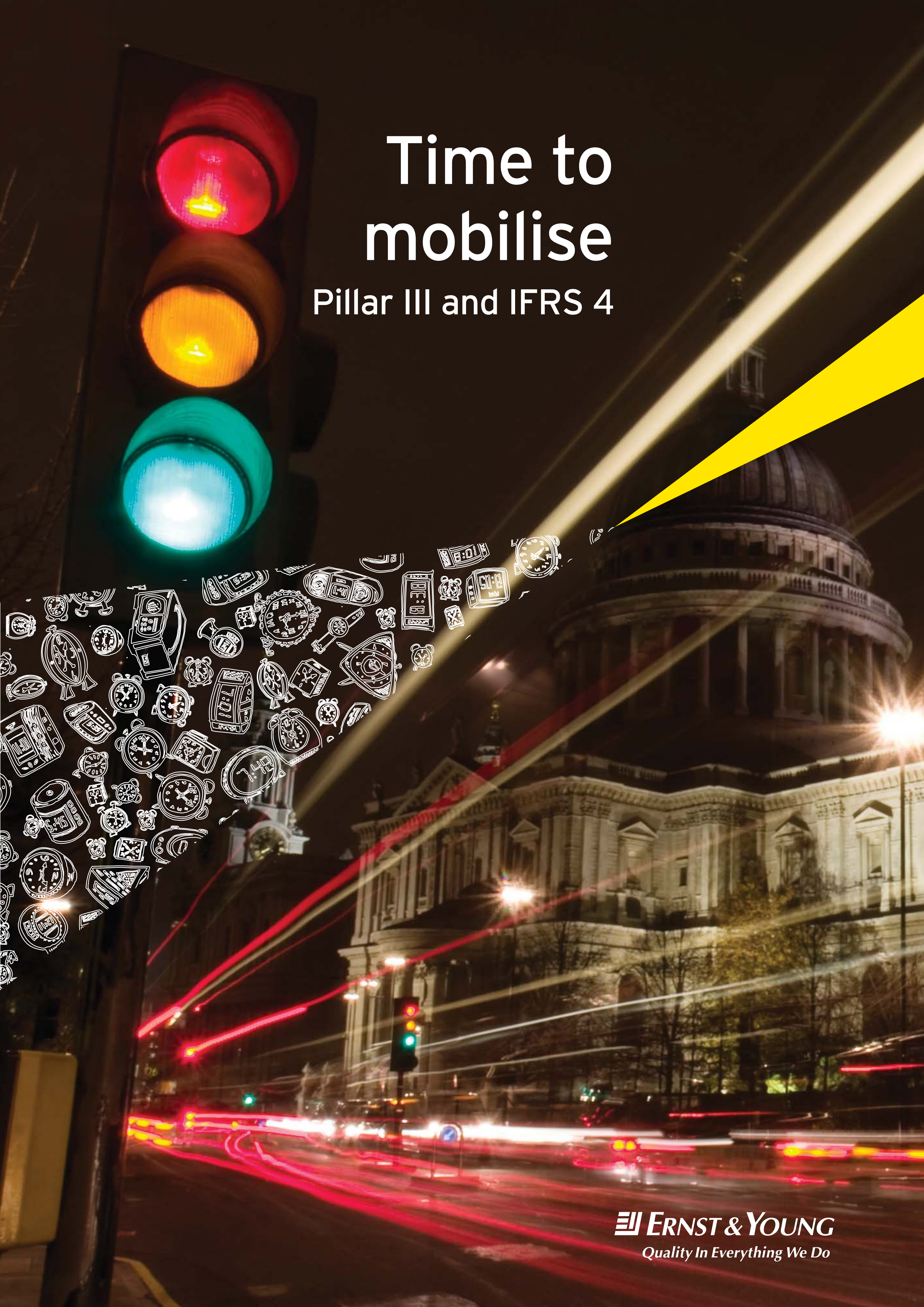

Time to mobilise

Pillar III and IFRS 4

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Executive summary

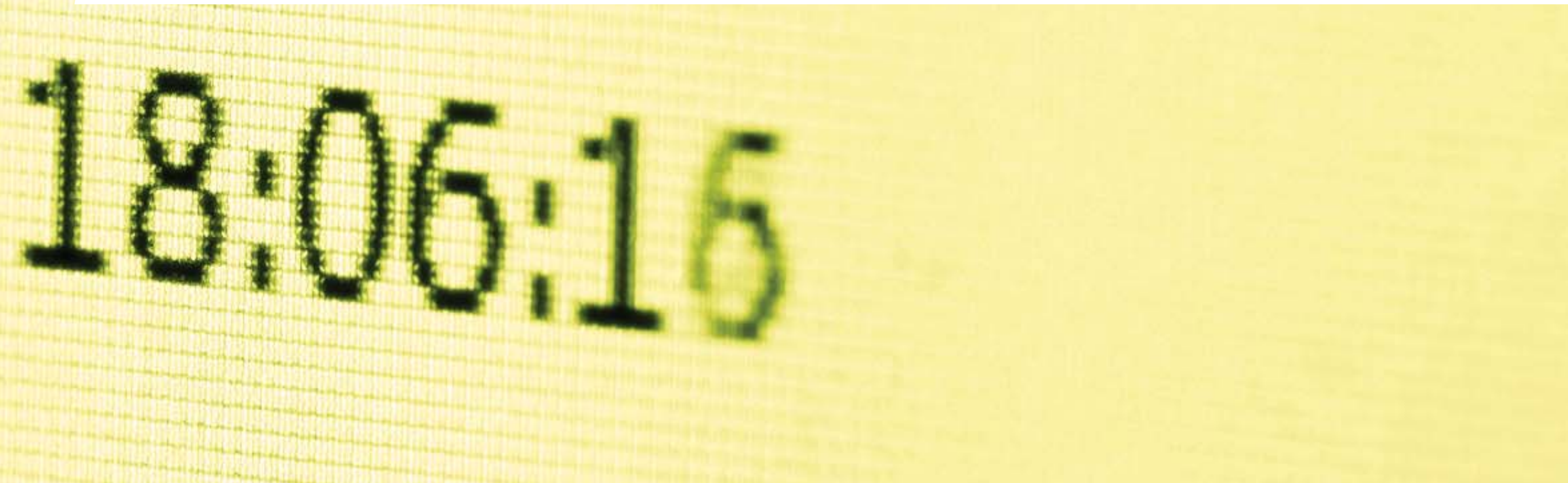
As the new European regulatory framework under Solvency II marches closer, attention is increasingly focused on the public and regulatory reporting that will be required under Pillar III.

Under the Solvency II framework, Pillar III will be the public and private reporting face of the technical provisions and capital requirements required under Pillar I and will provide the evidence of the own risk and solvency assessment (ORSA) and the insurers' risk governance framework under Pillar II.

This gives rise to a number of new and additional challenges around data, systems changes and the need to 'upgrade' and speed up reporting processes to meet the requirements. Given these challenges, insurers should undertake a methodical approach in preparing to meet the Pillar III requirements, as well as design their overall Solvency II reporting cycle to include model runs and the ORSA. To develop a well thought-out implementation plan, further consideration needs to be given to the expected requirements and associated impacts of the long anticipated IFRS 4 Phase II. With the time lag between the implementation of Solvency II and the delayed adoption date of IFRS 4 Phase II (yet to be confirmed), insurers should also address the strategic versus tactical nature of solutions to optimise project investments.

A number of organisations are now quite advanced in their assessment of the impacts of the expected Pillar III reporting requirements. As these impacts and the changes to existing reporting processes become better understood, a significant challenge remains. Businesses must design solutions to integrate into other 'business as usual' processes in the expected time frame.

In this paper, we will provide an overview of the key issues under Pillar III, an implementation framework to address Pillar III and the critical success factors when addressing IFRS 4 Phase II alongside Solvency II.



Overview

Following the publication of the Level 1 directive in 2009, the European Commission issued Omnibus II in early 2011 which proposed transitional measures regarding Solvency II requirements, and also deferred the implementation date of Solvency II to 1 January 2013. However, the recent updates to Omnibus II draft proposals, as drafted by the European Council Presidency, propose a further change in the commencement date for Solvency II to 1 January 2014; although this is still pending agreement and will ultimately require approval from the European Parliament. Alternative approaches to implementation and transitional measures are possible, although there is general recognition that the readiness of some firms and supervisors makes the original implementation date very challenging.

Under the Omnibus II draft proposals, the European Insurance and Occupational Pensions Authority (EIOPA), is required to draft implementing technical standards (previously known as 'binding technical standards') which will cover the detailed requirements for Pillar III.

As discussed further below, these are yet to be finalized and ultimately require approval from the European Council and European Parliament. Nevertheless, regulators have been privately discussing the proposed measures with the industry, providing an opportunity for insurers to prioritise their key challenges. But to complicate matters, insurers must also maintain flexibility in addressing future reporting requirements under IFRS, particularly the new proposed insurance contracts standard, IFRS 4 Phase II. In most cases, the prescribed reporting timelines for Solvency II will accelerate existing financial statement and regulatory close processes, impacting resourcing and sequencing in insurance finance departments, as well as the design of the close processes and the supporting IT infrastructure. To that end, it is important that insurers consider scheduling dry runs to test their ability to produce the new and revised reporting within the required time frame in a controlled environment.

Organisations should also consider the broader process and control challenges of implementing Pillar III relative to moving qualitative and quantitative requirements. As discussed later in this article, insurers will operate between now and the pending approval of the 2014 implementation date within an undefined or partially defined environment.

On a positive note, a considerable level of technical alignment exists between IFRS 4 Phase II and the principles for calculating the technical provisions for the market consistent balance sheet under Solvency II. However, the two regimes have different purposes and, as such, they are unlikely to be identical. Insurers need to design reporting systems that maximise input and output flexibility if they are to grasp the opportunity to align financial and regulatory reporting processes. System development life cycles and IT change processes and protocols in each insurance

group will dictate the pace of change. These processes and protocols will also determine when significant gap analysis work needs to begin in order to understand differences between the two sets of requirements.

Timeline

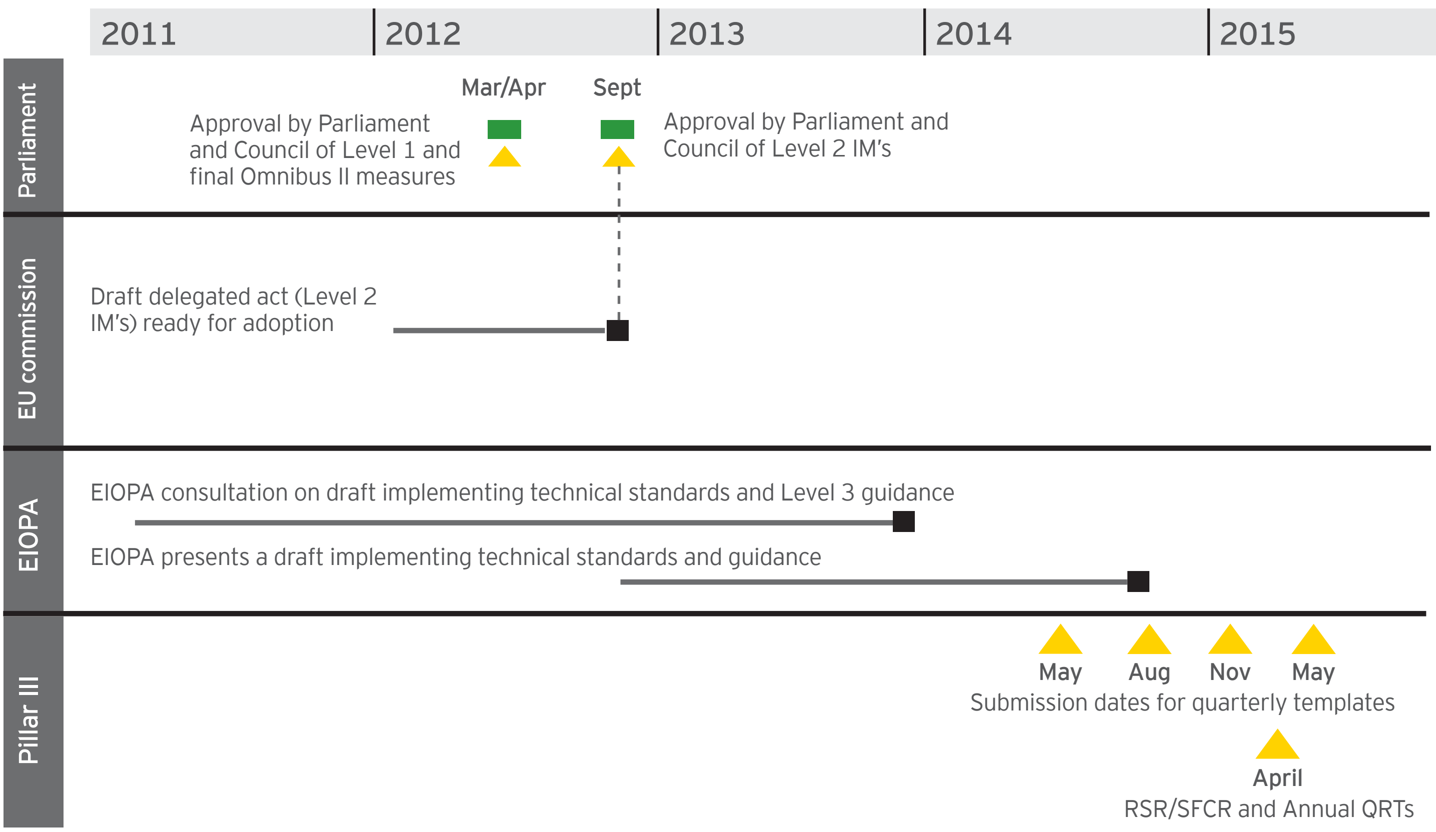
The timeline on page 3 illustrates that the Solvency II regime and reporting under Pillar III would begin for insurers, pending approval by the European Parliament, by 2014. Since Pillar III reports will communicate the outcome of entity and group regulatory positions and assessments, there is significant interaction between Pillar III and the other pillars of the Solvency II regime. We expect to see further details of the implementing technical standards and Level 3 guidance after September 2012 – once the 'Delegated Acts' (formerly known as Level 2 implementing measures) have been finalised by the European Commission and approved by the European Council and European Parliament. EIOPA, in consultations with the local regulators, have started drafting the implementing technical standards and constructing the proposed Level 3 requirements. Private consultations with certain European insurers and local trade bodies on proposals for detailed reporting templates are taking place before their draft standards are submitted to the European Commission – which is not expected to issue the final implementing technical standards for ultimate approval by the European Council and European Parliament before the end of 2012.

However, insurers cannot afford to wait for the end of 2012 and the final requirements to begin implementation activities. Pillar III introduces stringent reporting deadlines and significant information requirements. In addition, finance departments will have other conflicting projects and demands (such as finance change programmes and current business as usual, quarterly and year-end financial reporting), which will require them to prioritise scarce resources to meet Solvency II reporting.

We expect insurers to continue their implementation activities based on the existing guidance in the final advice on Supervisory Reporting and Public Disclosure Requirements (formerly Consultation Paper CP 58) issued in October 2009. Additional guidance can be obtained from information contained in the EIOPA's consultations and pre-consultations of draft Level 2 implementing measures, Level 3 guidance and binding technical standards.

Given the number of tasks that need to be accomplished for reporting to commence by the proposed 2014 live date (pending approval), the time to mobilise, plan and determine deliverables for Pillar III reporting is now.

Solvency II timeline



Pillar III reporting requirements

The table on page 5 illustrates the current view of proposed Pillar III reporting, covering the three main reporting requirements: Regular Supervisory Report, Solvency and Financial Condition Report and Quantitative Reporting Templates. It also addresses frequency, submission date and accepted format, highlighting the requirement for internal approval by an administrative or management body.

The proposed Pillar III reporting requirements are subject to change as the EIOPA and the European Commission work to finalise the details. The current requirements include:

- Regular Supervisory Report (RSR) is the private report submitted to the supervisor for groups and individual statutory entities. The current view is that a full report will be submitted every three years, with an annual supplement (significantly lighter in content) provided in the intervening years in the cycle.
- Solvency and Financial Condition Report (SFCR) is the public report to be published annually by groups and individual statutory entities.
- Quantitative Reporting Templates (QRTs) are templates for quantitative analysis that will form part of the RSR; some templates will also be part of the SFCR. Some templates will be required on an annual basis, while a smaller subset will be required quarterly. The templates are likely to cover the market consistent balance sheet, with a comparison to the current statutory balances, as well as an analysis of available capital (own funds). Other templates will cover details about premiums, claims and expenses, changes in technical provisions, reinsurance and available capital, analysis of change in basic own funds or source of earnings analysis and investments and special purpose vehicles, as well as analysis of the capital requirements for the Solvency Capital Requirement (SCR) and Minimum Capital Requirement (MCR). Group-specific QRTs are likely to give details about the composition of the group, as well as information about intra-group transactions.

Pillar III reporting overview

	RSR	SFCR (separate from RSR)	QRTs
Frequency	Full report for first year reporting and thereafter in full on a triennial basis Inter-triennial reports will only reflect material changes from the prior year submission Undertakings shall submit for the first time in relation to financial years ending on or after 31 December 2014 (pending approval)	Full report on annual basis Undertakings shall submit for the first time in relation to financial years ending on or after 31 December 2014 (pending approval)	Quarterly and annual Undertakings with Dec year ends shall submit for the first time in relation for quarter ending 31 March 2014 for quarterly reporting Undertakings with Dec year ends shall submit for the first time in relation for year ending 31 Dec 2014 (pending approval) for annual reporting
Submission date (NB – transition arrangements will extend submission deadlines for groups and solo entities in the first two years)	Solo: within 14 weeks of year end Group: up to additional six weeks Some to be potentially subject to external audit by regulators	Solo: within 14 weeks of year end Group: up to an additional six weeks if separate group SFCR produced Some to be potentially subject to external audit by regulators	Solo: within 5 weeks for quarterly templates after the quarter end Solo: within 14 weeks for full year end templates Groups: up to additional 6 weeks for annual solo and group QRT templates Some to be potentially subject to external audit by regulators
Format	Electronically – common structure as developed by EIOPA	Electronically – common structure as developed by EIOPA	Common standardised template format as developed by EIOPA Electronically - common structure as developed by EIOPA
Internal approval by administrative or management body	Yes	Yes	Yes

The table on page 7 provides more detail about proposed RSR and SFCR content, and highlights the QRTs that relate to the relevant sections of those reports. It also indicates areas that overlap with existing public reporting by insurers.

There is an open question about how a report on the ORSA prepared as part of Pillar II activities will interact with the requirements for Pillar III. It is likely that ORSA reporting to supervisors and management will be captured separately. However, Pillar III reporting might make reference to the results of the ORSA and the structure around it that has been embedded into the risk and reporting framework of an insurance entity.

It might also be expected that, as part of the transition, the regulators will require an opening Solvency II balance sheet with the SCR calculation within the first few months of the first reporting period.

Proposed RSR and SFCR contents

	Business and performance	System of governance	Risk profile	Valuation for solvency purposes	Capital management
Qualitative information	‣ Business and external environment ‣ Objectives, strategies and prospects – including projections (RSR only) ‣ Performance underwriting activities by material lines of business ‣ Performance from investment activities ‣ Operating/other expenses	‣ General governance arrangements ‣ Fit and proper ‣ Risk management system ‣ ORSA ‣ Internal control ‣ Internal audit function ‣ Outsourcing ‣ Other material information ‣ Reporting at group level	‣ Qualitative and quantitative information ‣ Underwriting risk ‣ Market risk ‣ Credit risk ‣ Liquidity risk ‣ Operational risk ‣ Other risks ‣ Material risk concentration ‣ Risk mitigation techniques ‣ Stress and scenario testing-internal model/ SCR	‣ Description of the bases and methods used for the valuation of: ‣ Assets ‣ Technical provisions ‣ Other assets and liabilities ‣ Explanation of any major differences for the valuation in financial statements	‣ Own funds ‣ MCR and SCR ‣ Option set out in Article 304 used for the calculation of its SCR ‣ Differences between the standard formula and internal models used ‣ Internal model ‣ Non-compliance with MCR and SCR
QRTs	‣ Premium expertise and technical results templates ‣ Variance analysis templates	‣ N/A	‣ Reserve analysis and risk exposure ‣ Reinsurance templates	‣ Balance sheet, investments and technical provisions templates	‣ Own funds, SCR and MCR templates ‣ Variation analysis templates
Current disclosures	‣ Front section of annual financial statements	‣ Internal governance and compliance documents	‣ IFRS 7/ IFRS 4	‣ IAS 1	‣ IAS 1

Challenges for Pillar III reporting

The Pillar III reporting challenges facing insurance companies fall primarily into eight categories. These categories capture the breadth and depth of data required, business and legal entity issues, the introduction of more frequent reporting and systems solutions to be considered within a new reporting framework. We look at them in more detail in the following paragraphs.

Level of data

The largest challenge in producing the information needed concerns the breadth and depth of data required, particularly for the technical provisions and asset portfolios. Organisations are likely to incur significant problems in sourcing the required data – ranging from incomplete data sources to sensitivity over public disclosure of previously confidential information. Since a large proportion of the QRT data will be sourced from Pillar I and Pillar II work, it will be imperative to feed those requirements back to the areas responsible for producing the relevant output. This will require financial, actuarial and risk reporting teams to engage with one another regularly to ensure the requirements are met and to avoid working in silos.

Business unit versus legal entity

Reporting requirements for Solvency II apply at the legal entity level, while current reporting is typically by business unit. The challenge will be how to produce these different views and reconcile them. This is particularly relevant for internal reporting, which may be used to produce the requirements for the SFCR and RSR.

Identification of data gaps

Typically, at least five types of data gaps will be identified:

- Current information is sufficient, but processes are not timely enough.
- Current information already exists in a similar format, but needs to be adapted.
- Current information already exists, but is outside the financially controlled environment
- New information is required which is Solvency II specific and produced by other Solvency II workstreams.
- New information is required which is Solvency II specific, but is not produced by other Solvency II workstreams.

The challenge will be to classify gaps by type and to design a tailored approach to address each gap to ensure the solution is implemented in an efficient manner alongside other Solvency II workstreams.

Uncertainty around requirements and changes

The final version of Pillar III requirements is still being developed. The best approach for an organisation appears to be continuous involvement and discussions with regulators. Insurers should focus initial efforts on the latest updated information templates and develop an accelerated response time to the changing information requirements.

Availability of resources

Getting the right resources to provide the right input at the right time will remain a challenge for many insurers. Securing dedicated resources to steer the path of Pillar III from an early stage is critical to ensuring successful project delivery over the next two and a half years. Insurers may consider using a balance of external consultants with their internal resources to assist in the design and implementation of their Pillar III reporting. Additionally, they may wish to introduce incentives to retain existing project teams.

External audit requirements

The external audit requirements specifically for Pillar III reporting are yet to be finalised, but organisations, particularly IFRS reporters, are expected to use their Solvency II technical provisions to drive their financial and risk reporting in their statutory statements. Insurers should engage with their auditors as part of their preparation to move to Solvency II.

Frequency of reporting

The introduction of quarterly regulatory reporting and the level of qualitative and quantitative disclosures required for the RSR and the SFCR will be new to many insurers. Furthermore, ensuring that organisations are able to meet tighter and faster reporting cycles will require a significant investment in people, processes and technology. With approximately two and a half years until the reporting regimes begin, organisations will need to test their risk, actuarial and finance function abilities robustly to meet those challenges.

Pillar III outputs will ultimately be delivered in an electronic format, requiring organisations to bridge their outputs into the prescribed format once determined by EIOPA. It is expected that QRTs will be required either in XBRL or XML format, whereas RSR and SFCR may be required in a structured PDF document, iXBRL or iXML format.

System solutions

To address the challenges described above, organisations should consider whether current reporting systems are adequate or fit to meet the requirements. If insurers use outsourced IT services, particular challenges may exist around the auditability of that data in order to demonstrate data validation and integrity to the regulators.

Consideration also needs to be given to IFRS 4 Phase II, and where there are likely to be impacts on the same systems and processes as Solvency II, so that more informed decisions can be taken on solution options and determine when to invest in strategic versus tactical solutions.

Steps towards Pillar III implementation

	Mobilise and plan	Focused gap and heat map analysis	Solution design	Roadmap	Delivery
Key activities	‣ Mobilise the team and project kick-off ‣ Confirm project terms of reference (TOR) and scope ‣ Put governance structures in place ‣ Identify target operating model ‣ Develop project plan and delivery schedule	‣ Map reporting schedule and identify critical path ‣ Validate process and controls for qualitative disclosures ‣ Identify key Pillar I, II and III dependencies ‣ Walk through and validate findings with key stakeholders	‣ Document top-level process and controls ‣ Develop integrated management, financial, statutory and regulatory reporting dataset ‣ Develop new critical path, schedule and service levels ‣ Identify potential application solutions, taking into account leading practices ‣ Validate internal solution set with stakeholders	‣ Develop high-level action plans for initial solution set with indicative costs and resources ‣ Initiate roadmap sequencing in terms of priority, resources, high-level milestones and quick wins ‣ Develop overall business case and transition to implementation	‣ Develop detailed delivery plans ‣ Implement solutions, including quick wins, and transition to the new close process
Deliverables	‣ Project TOR ‣ Project plan ‣ Project governance	‣ Data dictionary (leveraging Pillar I requirements) ‣ As-is project analysis (including critical path) ‣ Prioritised heat map	‣ Key design decisions ‣ To-be process and controls blueprint ‣ To-be data flow diagram ‣ Target application architecture ‣ Determine approach and design ‣ Principles for dealing with IFRS Phase II	‣ Prioritised programme of work ‣ Business case and implementation roadmap showing how benefits are delivered over time	‣ Quick wins ‣ Phased programme of process improvements over time

Implementation approach for Pillar III

The chart above illustrates a typical implementation approach to defining and designing Pillar III reporting solutions. While the activities are flexible to meet each organisation's individual needs, the steps ensure a systematic and integrated approach across all areas of the insurer's Solvency II project.

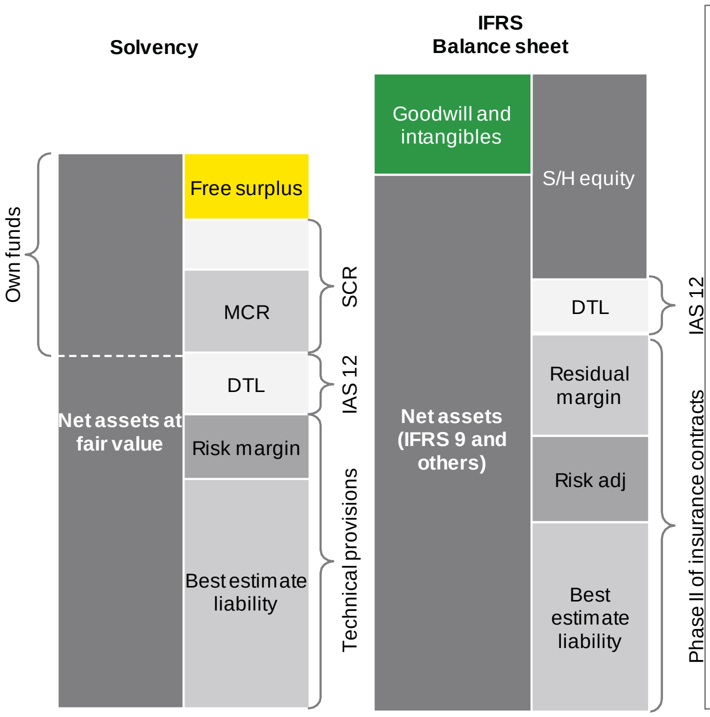
A key deliverable is to ensure that the implementation plan incorporates a dry run (ahead of the latest proposed live date of 2014, pending approval by the European Parliament) to test the robustness and the degree of embedding of the solution(s). The approach helps focus on those key tasks and deliverables which need to be undertaken to recognise the impact on processes and systems and deliver implementation success.

Impact of IFRS

Our recent publication, *Presentation and disclosures*, illustrated the main presentation requirements based on the IFRS 4 Phase II exposure draft proposals released in July 2010. The IASB is currently debating the final requirements of Phase II, with a decision to be expected in Q4 2011 of whether to re-expose or move to a review draft of the standard at that time. Thereafter, the target date for the final standard is expected to occur during H1 of 2012. As this deadline approaches, organisations will need to determine their implementation strategy alongside their Solvency II implementation plans. Options include:

- 'Wait and see' and accept that solution design and spend may ultimately prove to be more costly and inefficient
- Build in flexibility where possible, based on the anticipated IFRS 4 Phase II requirements
- Adopt more tactical Solvency II solutions in the short term and defer strategic solutions and spend until such time as IFRS 4 Phase II requirements are known (i.e., after the final standard is issued)

Key measurement differences in Solvency II and IFRS



Solvency II

- Value all non-insurance assets and liabilities consistently with IFRS where fair value is permitted.
- No goodwill or intangibles which are not traded in active market in Solvency II balance sheet.
- Contingent liabilities recognised if ‘material’.
- Employee benefits and termination benefits – EIOPA eliminated the corridor option.
- Open issue for deferred tax on assets and liabilities not included in Solvency II balance sheet

Key differences in insurance liabilities

- IFRS distinction between insurance and investment contracts and unbundling
- Discount rate and allowance for liquidity
- Residual margin
- Risk margin
- ED mandates use of premium allocation for pre-claim liability for short-duration contracts
- Contract boundaries potentially more restrictive under Solvency II

The chart above illustrates the key measurement differences between IFRS 4 Phase II and Solvency II balance sheets. Insurers will ultimately need to design a reporting process that can identify the key valuation differences between regimes, as well as the impact on their business and operations. They must also determine the key critical success factors to facilitate the implementation.

The areas of the insurers’ operations and businesses that will determine their success for implementation of Phase II and Solvency II can be identified as illustrated on the chart on page 11.

By addressing these particular areas, insurers can start to consider the incremental challenge that IFRS 4 Phase II will drive from a Solvency II starting point.

Developing a concise and detailed roadmap for IFRS 4 Phase II will also inform the impacted business functions of the detailed activities to be undertaken; and where they have the ability to flex solutions between the two regimes and cost or changes required to achieve that flexibility.

Requirement	Deliverables for Phase II and Solvency II success
1. Actuarial modelling	Actuarial models with functionality and flexibility to allow adjustments for the production of best estimate cash flows, discounting and risk adjustments under Phase II and Solvency II
2. Scheduling	Reporting timelines of financial reporting will dictate when balance sheet and income statement information will have to be produced – this may accelerate Solvency II reporting timetables to facilitate Phase II reporting timelines
3. General ledger	Flexible general ledger to enable production of a Phase II income statement (margin approach), as well as reconciliation (roll forward) disclosure of insurance assets and liabilities – Solvency II profit and loss attribution to be designed so that it can be used for financial reporting disclosures
4. Reconciliation	Functionality to reconcile between IFRS values and Solvency II market consistent balance sheet amounts by line item – financial reporting system needs to facilitate this reconciliation, particularly for insurance liabilities
5. Audit	Financial reporting information produced under Phase II to meet audit and SOX requirements – data validation and controls over information used in Solvency II models need to meet the same requirements, as the same processes will produce information for financial reporting
6. Performance	Internal and external KPIs and management information redesigned to reflect Phase II metrics – as management information is redesigned for Solvency II purposes, the Phase II requirements should be considered
7. Forecasting and budgeting	Forecasting and budgeting tools with Phase II capability – if remuneration of management will, in the future, be based on Phase II forecasting, this is likely to receive greater emphasis (Solvency II-based forecasts and projections should also become more robust as the financial reporting-focused forecasts are developed.)
8. Systems	Systems to measure and amortise the residual margin by cohort and coverage period based on historical transactions – for short-duration contracts, systems to calculate and amortise unearned premium balance; this requirement is in addition to Solvency II requirements and should be added to models and GL/ reporting systems
9. Data	Large differences of data between Solvency II and IFRS 4 Phase II for similar components of an insurance contract, i.e., contract inception date, contract boundary principles, etc. – addressing overlap of data requirements will ensure objectives are met for both standards
10. Disclosures	Detailed disclosure requirements about insurance and financial risk need to be updated for IFRS 4 Phase II– Solvency II Pillar III also requires similar disclosures for RSR and SFCR; reporting process and systems should be designed to deliver risk disclosures that can be used for both purposes

Conclusion

Organisations have many issues to consider in implementing Pillar III and meeting the proposed reporting requirements for both Solvency II and IFRS 4 Phase II. Focusing on key activities and deliverables, as well as measurement differences, will be critical for insurers if they are to facilitate implementation and design robust solutions within the designated time frame.

At Ernst & Young, we have been closely monitoring the development of Pillar III reporting and IFRS 4 Phase II, and are working with many organisations to help develop their reporting capability under both regimes.

In our opinion, given the scale of challenges ahead, preparations for Pillar III reporting need to start now to ensure a smooth transition. Assessing the impacts of IFRS 4 Phase II will also help to minimise the costs of implementation that might otherwise be incurred through unnecessary re-working of solutions, and ensure that both reporting requirements are on track to be met.

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