Global Insurance Internal Audit

Current insights and emerging trends

May 2013
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Internal audit functions in insurance are positioned to play a significant role in further improving risk management practices and helping to deliver sustainable change; but this will require ongoing specialist capabilities and enhancements to learning & development frameworks.

Global insurers wishing to achieve a sustainable competitive advantage in this climate of macroeconomic and regulatory pressure are continuously looking to their products and services – and their competitors – to seek improvements. Amid this there will be a focus on managing risks to capital and investments, as well as driving continued operational efficiencies (for example, through technology).

Against that backdrop, Ernst & Young surveyed heads of internal audit from 18 prominent insurance organizations across the UK, Western Europe, the US and Australia, to gauge the challenges facing internal audit functions in the sector.

Through the survey, respondents shared their views on areas such as governance and risk management, risk and control convergence, training and development, the change agenda, Solvency II and social media. This report reflects what they told us.

We found:

► Risk management features prominently on internal audit’s agenda. Internal audit is demonstrating a breadth of coverage on risk as a second line of defense function but more is expected on assessing both its capability and impact on driving risk culture in the first line of defense.

► Although internal audit is firmly placed to be involved in risk and control convergence initiatives, the exact nature of that involvement is affected by which function in the organization is primarily responsible.

► The majority of internal audit functions have their direct reporting line to the Audit Committee, but a number are reporting to the Chief Executive Officer or Chief Financial Officer.

► The demand for specialist skills remains significant, with actuarial, information technology and risk featuring prominently on recruitment needs.

► Training needs are not solely focused on technical subject matter. The increasing trend for new hires coming from the first and second lines of defense shows that learning & development agendas need to align more tightly with capability needs.
Matters of risk and governance

Internal audit is focused firmly on risk management matters, and further evolution to reporting lines is expected.

Independent assessment of risk

All heads of internal audit plan to focus on risk management during 2013. While the proposed coverage appears broad, the three most prominent areas of focus are:

► Risk identification and assessment (100%)
► Roles and responsibilities (89%)
► Reporting and management information (MI) (89%)

What areas do you plan to cover in your next review of risk in the second line of defense?

By contrast, the areas with the least proposed coverage relate to the people agenda – capabilities within the second line of defense, and risk culture in the first line of defense. This may be symptomatic of internal audit needing to bide its time, as many of the investments made in risk due to Solvency II start to take effect.

Encouragingly, this picture echoes the CIIA Consultation Paper, which impresses the need for internal audit to assess the adequacy and effectiveness of risk management.

This ongoing focus by internal audit may need continued evolution, as the enhanced standards also cite that the third line of defense should consider the establishment and embedding of risk appetite, the risk and control culture in an organization, and how capital and liquidity risks are managed. Furthermore, with recovery and resolution planning on the horizon for the insurance industry, increased focus may be warranted on stress and scenario testing in the longer term.

Reporting lines

A predominant pattern emerged from the respondents, with 68% having a direct reporting line to the Audit Committee. For the remainder, their reporting line was varied being to the Chief Executive Officer, the Chief Financial Officer and the Board.

To whom is internal audit reporting?

Direct reporting lines

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This snapshot on the current state does differ from the recommendations in the CIIA Consultation Paper, where internal audit’s primary reporting line is recommended to be to the Chairman of the Board (who, in turn, may wish to delegate responsibility to the Audit Committee Chair). The inference, if the recommendations are embraced, is that approximately 30% of respondents may need to reconsider and change their current reporting lines.
Risk and control convergence

Recent years have seen a continued investment and development in risk management within the insurance sector. A part of this is the rise of risk and control convergence, whereby organizations seek to better harmonize responsibilities, activities and reporting across the three lines of defense.

While this rise has been borne partly due to increasing pressure on costs – and the desire to remove inefficiencies and duplicate risk and control activities – capital markets and rating agencies are pushing for better evidence of integrated risk management. One aspect has not changed, which is the need for risk management to balance its focus on mitigation with one of enabling value creation.

Such developments are building on a position of risk management in the second line of defense being deemed ‘Solvency II-compliant’ (at least by design effectiveness). 73% of respondents see their organization looking to make improvements in this area.

As risk and control convergence initiatives are primarily seeking to provide a more joined-up approach, they are not removing the need for internal audit to exercise judgment on when to place reliance on the work of the second line of defense – a point re-enforced in the CIIA Consultation Paper.

How would you characterize the anticipated impact of risk and control convergence developments?

There are differing views on who should take the lead responsibility for making risk and control convergence happen, with risk in the second line of defense and internal audit in the third line of defense being equally cited (44% each).

Which line of defense do you think should take primary responsibility for coordinating the planning and reporting of converged risk and control?

Our observations in the wider financial services market see the risk function (in the second line of defense) typically taking primary ownership for leading risk and control convergence initiatives – a role which extends to maintaining it when in business-as-usual mode.

For those embarking on such initiatives, the relative impact on the organization varies. While there is a relatively even spread from respondents, the internal audit functions in the larger organizations see it as having the more significant impact on current practices across the three lines of defense.

Ernst & Young insights

- Our experience shows that, once a risk and control convergence initiative embeds, internal audit includes independent testing of the integrated risk and control assessments (maintained by the first line of defense) as part of its overall assurance plan.
Demand for specialist skills remains high, with increasing alignment to the learning & development agenda on the horizon.

Training needs
It is clear that today’s internal audit functions in insurance require training to cover a broad range of subject matters. Respondents informed us that their anticipated needs were as follows:

- Technical skills (39%)
- Soft skills (29%)
- Auditing skills (23%)

The focus was not biased solely toward technical needs. This may be influenced by an increasing trend of internal audit new hires coming from roles in the first and second lines of defense, bringing technical skills with them, but not the necessary experiences of how to plan, deliver and report an audit.

Approximately a quarter of respondents have their learning & development plans highly aligned to their competency frameworks.

Even though nearly two-thirds have their learning & development frameworks somewhat aligned, this indicates there is further work to be done - in terms of being clear that training is appropriately targeted and driving as much benefit as possible.

How training is delivered
Approximately half of respondents receive primarily generic training from external providers. By contrast, 95% feel that bespoke training delivers greater value in terms of both impact and relevancy - this can be bespoke for either internal audit or the organization.

This infers that a significant proportion of internal audit functions are not currently having their training expectations and needs fully met.

Respondents indicated that an average of 4% of internal audit’s budget is currently set aside for training. Delivering against the recommendations in the CIIA Consultation Paper will undoubtedly require internal audit functions to re-appraise their current capabilities and may well drive increased (relative) levels of investment in training as a result.
Recruitment of specialist skills

Actuarial, Information Technology and risk accounted for nearly half the identified recruitment needs over the next 12 months.

What are the three most sought after skills that your function needs more of?

This pattern has not changed significantly in recent years within the insurance industry, due to the impact of Solvency II. The increased transparency that Solvency II brings to risk and capital means internal audit’s heightened focus in these areas will become a permanent change. That said, the means by which assurance is provided will continue to evolve and become more sophisticated.

The recruitment of specialist skills is not dominated by one particular source, with a relatively even split across the different sources.

What is the strategy for securing the most sought after skills?

It is interesting to note that the preferred source differs for the three most needed skills:

► Actuarial – from within the business
► Information Technology – from the external market
► Risk – from a third party

Value of external perspectives

The use of third parties continues to be important for in-house internal audit functions. They are drawn upon for a wide variety of subjects, such as risk appetite, model risk, underwriting governance and pricing.

A shift in emphasis is being observed from 'delivery support' to 'experience transfer,' whereby the third party provides advice through any stage of the audit, from reviewing the audit scope to providing insight into appropriate recommendations.

Heads of internal audit currently articulate the value of third party co-sourcing largely through the ability to deliver audits that were not previously possible and, invariably, this is linked to bringing certain technical expertise to bear (that does not reside within the function). These are relatively 'inputs-based' measures, and there is more for internal audit to do for measuring and communicating the value from third party co-sourcing to its stakeholders.

Ernst & Young insights

► Internal audit functions are increasingly undertaking training needs assessments, and using these as a basis for developing comprehensive learning & development curriculums.
► An emerging leading practice is for in-house internal audit functions to blend their need for increasingly-senior subject matter resource (from their co-source providers) with targeted learning and development geared to both individual and functional needs. Such an integrated approach allows the scheduling of targeted training prior to audits being performed.
Supporting organizational change

Change initiatives feature prominently on audit plans, with an increasing opportunity to comment on benefits realization.

**Degree of change**

Internal audit continues to have a healthy focus on the change agenda within their organizations. The majority of functions are devoting between 11% and 20% of their audit plan to such matters in 2013.

What percentage of your 2013 plan do you envisage will relate to ‘change’?

![Percentage distribution](chart)

The importance of internal audit’s role in organizational change is echoed by the CIIA Consultation Paper, which proposes that the function’s remit includes involvement in key ‘corporate events’. This may mean that involvement on a more real-time basis increases for many internal audit functions, prompting a refresh of related audit response strategies.

**Focus areas**

Respondents cited a broad spectrum of change they anticipated providing assurance activity over, with the most prominent being:

- Organizational (25%)
- Information Technology (IT) (25%)
- Strategic (17%)
- Regulatory (13%)

This is consistent with the market experiences we observe, with internal audit being involved in a variety of change initiatives, ranging from the embedding of Solvency II, replacement of actuarial models, implementation of new systems (e.g., claims) and data warehouses, through to specific business process changes to accommodate new regulatory requirements (e.g., Retail Distribution Review in the UK).

**Proving value**

Internal audit functions are not only commenting on whether change is being managed and delivered appropriately, but increasingly on whether the change is bringing the desired benefits. Almost half of respondents confirmed they are required by stakeholders to assess this.

Respondents cited two main ways of determining benefits realization:

- Comparison to business case
- Delivery against agreed change methodology

A fundamental aspect of the former is the active consideration of whether the benefits being proposed are the right benefits in the first place (i.e., are they clearly aligned with business strategy?).

**Ernst & Young insights**

- Leading internal audit functions are assessing whether the information being used by executive management in key decision-making around change initiatives is sufficiently balanced and free from bias (in terms of articulating benefits, risks and costs).
- More progressive internal audit functions are providing assurance on benefits realization; they are considering whether the benefits are being sustained, remain measurable, and whether the outcomes are built into the right people’s targets.
Focus on risk and capital

There is a notable shift toward the embedding of processes and controls as programs move into business-as-usual.

Greatest challenge to date
Before the recent changes to the proposed effective date (to 1 January 2016), internal audit functions have devoted significant time and effort in recent years to supporting its organization’s Solvency II Program. 60% of EU respondents cited the ever-changing deadlines as being the greatest challenge Solvency II has posed to their ability to provide appropriate assurance to their stakeholders. Furthermore, such continued uncertainty has placed a strain on audit planning and resourcing.

The focus on Pillars 1 and 2
Despite the delayed implementation date, many insurers are now actively moving much of the Pillar 1 and 2 activity (and associated processes and controls) from the program into business-as-usual. Primarily this is to reduce the ongoing overhead burden associated with maintaining an initiative in formal ‘project status,’ and, more importantly, to start experiencing genuine business benefits from the significant investments made.

EIOPA’s¹ current proposals for the Solvency II interim measures cover elements of Pillars 1 and 2. With respect to pre-application of internal models, many firms have only been able to provide evidence that was ‘directional’; the emphasis will likely change toward actively demonstrating the embedding of the model use into critical business processes (e.g., strategic planning, risk appetite, performance target-setting and monitoring).

In terms of Pillar 2, the focus is more toward the systems of governance (including the effectiveness of the risk management framework) and a forward-looking assessment of the entity’s own risks (based on the ORSA² principles). These are areas where internal audit functions will play an important role in providing independent assurance.

Views on Pillar 3
Market experience shows that Pillar 3 is generally the least developed aspect of Solvency II for many organizations. The delay to the effective date has resulted in many insurers pausing for thought.

Internal audit functions have had to react accordingly; 87% of EU respondents are delaying planned Pillar 3 assurance activity. Despite such activity being moved back, 87% of respondents intend to cover Pillar 3 in some form in 2013. Of the 87% covering Pillar 3 in 2013, the most common aspects are:

► Data quality management (93%)
► System requirements and developments (69%)

What aspects of Pillar 3 do you expect to cover?

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<td>Data quality management</td>
<td>93%</td>
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<tr>
<td>System requirements and developments</td>
<td>69%</td>
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<tr>
<td>Governance over reporting processes</td>
<td>53%</td>
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<tr>
<td>Integration with existing financial model</td>
<td>43%</td>
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<tr>
<td>Reporting content production</td>
<td>39%</td>
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<tr>
<td>Reporting management framework</td>
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This internal audit focus appears justifiable, due to the significant increased demand for additional information, which organizations may need to report in 2015 (based on 2014 data).

Many insurers are using 2013 as the year to finalize high-level design architecture and make decisions associated to data or systems build (or vendor selection if not wanting to build in-house).

Ernst & Young insights
► Internal audit teams are planning to provide assurances that processes and controls are embedding across Pillars 1 and 2, especially around capital model, the ORSA and risk management.
► The focus includes assessing risk mitigation techniques being applied across the model life cycle, and looking into risk culture and whether risk management is helping to instil the right attitudes and behaviour toward risk taking.

¹ EIOPA - European Insurance and Occupational Pensions Authority
² ORSA - Own Risk and Solvency Assessment
Emerging thoughts on digital

Internal audit is in the early stages of covering the risks being posed by digital developments.

**Insurers are embracing digital**

Our 2012 Global Insurance Consumer Survey revealed that customers' use of online sources of information is set to increase dramatically. Consequently, insurers are stepping up their investment in digital strategies, with many already active in developing digital tools across several areas of the value chain.

Digital tools have been developed for end customers and intermediaries, and focus mainly on the provision of information, modeling personal requirements and generating quotes. In general insurance, they are also used to support the claims process.

The business case for investment in social media is not yet fully robust, something that applies to both financial and non-financial services sectors. Activity to date is based on a fundamental belief that social media will play a key part in future business models, rather than a measurable return on investment.

Our experiences show that insurers are using digital in a variety of ways, such as their corporate website, Facebook, apps (tablet and smartphones) and mobile sites.

**Emergence on internal audit plans**

Audit plans in 2013 are starting to reflect the rise of social media and its increasing influence on business. 42% of respondents plan to conduct a review related to social media in 2013, noting that 11% did similar in the previous year.

Coverage in 2012 and into 2013 has been varied, with the most common areas tackled being equally:
- Social media governance (73%)
- Security and privacy (73%)

**Which aspects of social media do you plan on covering?**

- Social media governance
- Security and privacy
- Changes in customer experience
- Changes in recruitment
- Changes in marketing and PR
- Changes in internal corporate collaboration
- Other

By contrast, relatively little of the focus is targeted toward marketing and PR processes and activities; areas where the potentially greatest risks lie around reputational management.

**Looking ahead**

Social media represents both a great challenge and opportunity for the insurance industry. Two notable early challenges that are emerging include:

- Lack of integration: digital tools being a complementary, but not alternative, way of interacting with suppliers and customers. Therefore, digital technology will risk complicating the process and frustrating customers if it is not joined-up seamlessly with other existing channels.
- Lack of governance: identifying the stakeholders within the business, establishing an appropriate governance structure, and managing the risks of digital tools is key. The governance structure and processes put in place must be appropriate to the fast-paced nature of this technology, in order to avoid hampering innovation.

It is encouraging that internal audit functions are already positioning themselves to tackle the latter challenge.

**Ernst & Young insights**

- Internal audit functions are undertaking a 'top-down' analysis of where digital developments pose notable risk in their organization's value chain, and incorporating this into their existing risk assessment processes.
- Innovative audit activities include assessing the effectiveness of process and controls in response to an adverse event, in principle, similar to business continuity planning (e.g., how would the organization respond if it were trending negatively on Twitter?)
### Key contacts

Should you wish to discuss any of the points raised in this publication, please get in touch with your usual Ernst & Young contact, or these individuals:

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