Internal audit in insurance: market issues and trends
Contents

3 Legal risk
The need for clarity

5 Solvency II – Pillar 3
A complex process

7 Strategic risk
Be prepared

9 How EY can help
Introduction

Welcome
to the first in a series of regular briefings on
topics of interest in insurance internal audit.

EY is the market leader in providing internal audit services to the
financial services (FS) sector and to the insurance sector in particular.
As a result, we are able to gain unique insights into the challenges facing
the insurance industry and the ways in which internal audit can help
businesses meet these challenges.

Through discussions across the insurance industry, looking at internal
audit practices across multiple sectors and our own interactions with
regulators, we have identified three hot topics that are important
for internal audit to focus on: legal risk, strategic risk and Solvency II –
Pillar 3.

Each of these areas brings its own challenges. Failure to identify and
address legal risks can lead to expensive fines. Failure to manage
strategic risk can also be costly, in terms of reduced competitiveness
and, ultimately, profitability. The demands of Pillar 3 reporting may
require a concerted effort to improve data quality and the processes
involved in collating that data.

This briefing document aims to help you to guide your future internal
audit activity, inform the scope of items reviewed, increase the value
internal audit brings to key stakeholders and aid understanding of the
common challenges across the industry.

If you have any questions about any of the articles or suggestions
for topics you’d like to see covered in future issues, please contact a
member of the team.

---

1 The EY global research team in 2015 determined EY work with 72% of the Fortune 100 internal
audit functions (including 37% as a sole provider). This is more than any other professional
services firm.
Legal risk
The need for clarity

Legal risk is a multibillion dollar problem in financial services, but it is still not widely understood. So, how can internal audit teams help their organisations to manage it effectively?

The concept of ‘legal risk’ is ill-defined and, generally, poorly understood. Meanwhile, legal losses continue to make headlines in the FS sector and sanctions imposed by regulators have risen to a level that is now driving behavioural change.

Such change is overdue, with legal risk costing the FS industry upwards of £100bn per year. It has been a focus of FS regulators since 2012, when the FSA called a meeting of General Counsels to highlight their role as a second line of defence. Then, in 2015, the European Banking Authority (EBA) expanded the scope of legal risk to include ethical conduct and challenged in-house legal teams to reconsider their role within conduct risk management. The EBA also outlined how legal risk should be incorporated into operational risk capital calculations, requiring legal risk taxonomies to be reviewed.

To add to that pressure, in 2016, the FCA announced that it would consult on the role of the General Counsel, to clarify their position within the Senior Insurance Managers Regime (SIMR).

Take control
The lack of clarity about what constitutes legal risk has resulted in a wide range of approaches to managing it. There are several steps that FS firms need to take. The advent of the SIMR and the need to prove that you are in control of legal risk will require new investment in integration of working practices, alignment of risk data sets, and greater influence and oversight over business decisions for the legal function.

To manage legal risk consistently across a complex organisation, the legal team should adopt a second line of defence role and proactively assess potential exposure by advising the business at a macro level on how to reduce exposure. This is in addition to their first-line responsibilities and it means that in-house legal teams need to acquire new skill sets.

To help firms design and implement effective legal risk management frameworks, EY has published a high-level definition of legal risk. You can use this as a foundation for a review of your legal risk management processes, policies, governance, data and management information (MI).

EY definition of legal risk
Legal risk is the risk of financial or reputational loss that can result from lack of awareness or misunderstanding of, ambiguity in, or reckless indifference to, the way law and regulation apply to your business, its relationships, processes, products and services.

Working practices
Our 2016 legal risk industry survey explored current working practices around legal risk management and reached three broad conclusions:

1. Legal risk is owned by the General Counsel and in-house legal department.
Lawyers’ subject matter expertise makes them the natural owners for legal risk. However, the breadth of the legal risk area means that there is a need to create a structured set of supervisory controls in order to meet risk management responsibilities.

2. Legal risk is not well integrated into operational risk frameworks.
Legal risk overlaps with other risk areas. Organisations in FS are usually complex, so legal risk must be integrate with operational risk frameworks in order to be managed effectively. This can be achieved by developing dashboards, predictive legal risk models and near-real-time key risk indicators from current operational risk data sets.

3. There is broad agreement on legal risk priorities and challenges.
Legislative and regulatory compliance remains a key priority for most respondents, but duty-of-care or ‘conduct’-related risks are also a top priority for a significant number of those surveyed.

2 The definition was published in Legal risk 2.0: Show you’re in control
The right skills

In light of these findings, it is important to review how your organisation manages legal risk, including the work of various legal teams across the entire organisation.

You will also need to review the adequacy and effectiveness of processes to manage and oversee legal risk in line with the latest regulations. This will require access to appropriate legal skill sets and a good working knowledge of legal risk management.

As far as legal risk is concerned, an internal audit scope should include the following:

**Reporting**

► Regular and ad hoc reporting of legal risk to the Executive and Board Risk Committee

**Governance and MI**

► The indicators used for monitoring legal risk management exposures and loss reporting methodology
► The roles and responsibilities of the legal function
► The role of the legal function in the ‘three lines of defence’ model

**Policies and standards**

► The legal risk framework
► The communication and training approach to embed legal risk policies
Solvency II – Pillar 3
A complex process

As firms implement the full reporting requirements of Pillar 3, this is increasingly becoming an area that internal audit needs to focus on.

Pillar 3 reporting is one of the key outputs of the Solvency II regime and, in the case of the publicly reported Solvency and Financial Condition Report (SFCR), will be an important source of information for external stakeholders. The effective delivery of these reports will be critical to the regulatory scrutiny that a firm receives over the coming years.

The new requirements are leading firms to seek efficient approaches to reporting that meet the regulatory requirements whilst minimising disruption and cost. Firms that can achieve this will have an advantage over their peers that cannot.

Reporting requirements
Solvency II as an European Economic Area (EEA) wide capital regime includes enhanced disclosure requirements and risk management standards for the European insurance industry. It came into force on 1 January 2016; affected firms will have already submitted their day one reporting and, where relevant, will be submitting ongoing quarterly Quantitative Reporting Template (QRT) reporting to the regulator. Firms with 31 December year-ends were required to submit their first annual solo reporting by 19 May 2017 and their first annual group reporting by 30 June 2017.

Pillar 3 annual reporting requirements are a lot more extensive than the quarterly reporting requirements. As a result, many firms and groups are still busy addressing the data gaps, and improving data quality and processes in order to be able to deliver by the reporting deadlines.

Pillar 3 reporting consists of:
► Annual public narrative SFCR, including publicly reported QRTs
► Triannual narrative Regular Supervisory Report (RSR), or details of material changes in years when a full RSR is not required
► Quarterly and annual supervisory QRTs (national regulators may grant quarterly exemptions in some cases)
► Annual supervisory National Specific Templates (solo only)

Once the first annual Pillar 3 reporting is completed, many firms and groups will still have a lot of work to do to move from the tactical solutions they have developed to meet the reporting requirements to a repeatable, ‘business-as-usual’ process.

Many will need to have an ongoing programme to improve the underlying processes and data quality to facilitate the effective delivery of Pillar 3 reporting – particularly as the annual reporting deadlines reduce by two weeks each year, until they reach 14 weeks for solo and 20 weeks for group for 2019 year-ends onwards.

Complex challenges
Firms face a number of challenges in meeting the Pillar 3 reporting requirements:
1. Whilst these requirements have been finalised, the industry continues to try to interpret the details in some areas.
2. Providing effective ‘three lines of defence’ coverage of all elements of Pillar 3 reporting is complex. Pillar 3 reporting processes will cover many areas, including data, systems and accounting policies. Many of these may have been reviewed, at least in part, in the course of other audit or validation activities, so understanding the gaps is critical.
3. Managing the evolution of the process as it moves to a ‘business-as-usual’ solution will require robust controls and ongoing monitoring of those controls as the risks evolve.
4. There is likely to be a need for parallel reporting (both manual and automated) during the transition to business as usual. This will require monitoring of two solutions and an effective governance process to move to the automated solution in a controlled manner.
5. Once the end-state solution is implemented, the firm should look for ways of improving the process over time, to minimise disruption to business activities.
You should consider the following areas as part of a review of Pillar 3 reporting:

**Production process**
- The end-to-end production process and controls for in-scope areas, including reconciliations between each statutory accounts balance sheet and the Solvency II balance sheet
- The design effectiveness of controls over the production of the Pillar 3 SFCR, RSR and QRTs

**Methodology**
- How the relevant Solvency II requirements have been complied with, including any completeness checks
- Any aspects of methodology where the approach is not in line with established practice or the intent of the Solvency II regulation and guidelines
- Areas of subjectivity, ambiguity or lack of clarity where management has exercised judgement

**Chart of accounts**
- The creation of new accounts only applicable to Solvency II, and the removal of accounts only applicable to IFRS or local GAAP
- Adjustments made to other accounts applicable to both IFRS and Solvency II, but where the underlying recognition and valuation principles are different, including the treatment of tax-related balances
- Accounts where no adjustments are needed

**Data**
- Key sources of data and how that data flows across the end-to-end Solvency II production process
- The design effectiveness of the relevant controls over data quality and data flows

**Systems**
- The firm’s Solvency II systems landscape and their design effectiveness in supporting the production process
- The management of the relationship with any software provider

**Roles and responsibilities — governance**
- The Solvency II reporting and disclosure policy
- The ownership of relevant Solvency II activities and ‘hand-offs’ between actuarial, risk and finance (treasury, investments) functions
- Review the responsibilities for the output produced, including involvement from and approval by those charged with governance
Strategic risk
Be prepared

To remain competitive and maintain profitability, insurers need to have an appropriate strategic risk management framework and must be prepared to react to new risks.

Because of the UK’s decision to leave the EU, along with a host of additional industry challenges in areas, such as digital, cybercrime and analytics, effective risk management has been plunged into the spotlight. Insurers’ success increasingly depends on their ability to adapt quickly to evolving market change and grapple with strategic uncertainty.

Integrating strategic risk analysis into their overall business strategy and planning processes will be key in promoting the sustainability of their business model, minimising the impact of uncertainty on their profit and ensuring they have a competitive advantage.

A business imperative
Strategic risk is the risk associated with making wrong business decisions, implementing decisions poorly or being unable to adapt to changes in the operating environment. These risks can either affect business strategy decisions or are created by them.

As the strategic risks facing insurers in Europe evolve, sometimes rapidly, managing these risks continues to be high on their agenda. After all, a lack of responsiveness to key industry challenges such as the rise of digital, Brexit and insurtechs could leave insurance companies with falling market share if they don’t adapt appropriately. The low interest rate environment is constraining investment yields; in an already challenging market, poor investment decisions could be extremely costly. Moreover, most insurers have a cost base that is too high and margins that are too low, and they must look to change their operational capabilities to ensure a lower-cost business in the future.

With insurers’ innate desire to remain profitable and competitive, they must be appropriately managing and mitigating strategic risks.

Understanding strategy, and the opportunities and risks presented in the business environment, will enhance the ability to manage uncertainty and emerging risks. The strategy and risk life cycle outlined in the diagram below shows a high-level way of doing this.

The strategy and risk life cycle

1. Business risk analysis
   Identify uncertainty and categorise upside and downside risks.

2. SWOT analysis
   Prepare for uncertainty to optimise upside potential and protect downside value.

3. Strategic planning
   Position and execute to maximise opportunities and minimise losses.

4. Strategy implementation
   Monitor and adapt to change.
Risk assessment
Firms should use stress and scenario testing to inform their strategic risk management. This testing needs to provide real insight into how the strategic risks could affect their business and should be used appropriately to drive strategic decisions. Insurers must be ready to respond to the risks that changes their earnings, capital and liquidity projections present.

In internal audit, you need to ensure you understand the strategic risks across the organisation and consider them appropriately in risk assessments. You should consider the following areas as part of a review of strategic development:

Governance
► The allocated roles and responsibilities across the first and second lines of defence
► The strategic risk management framework
► The responsibility for strategic risk management at executive management, board and committee level
► The quality of challenge and debate on strategic risks at board level (and that it is evidenced sufficiently)

► The manner in which strategic risks are identified, assessed and managed within the firm's risk appetite
► The degree to which the organisation engages external bodies for perspectives and ideas to avoid 'groupthink'

Process
► The monitoring of strategic risks
► The quality of MI prepared for strategic risk management
► The process for the strategic management of the business, including forecasting, planning and budgeting processes
► The process for cash flow management, focusing on how strategic risks are considered
► The reliability and appropriateness of underlying models used in strategic risk management
► Stress and scenario testing to feed into the strategic risk management process, including appropriate use of the insight
How EY can help

EY has an integrated perspective on all aspects of organisational risk. We are the market leaders in internal audit and financial risk and controls, and we continue to expand our capabilities in other areas of risk, including governance, risk and compliance as well as enterprise risk management.

As the leading provider of internal audit services, we work closely with our clients of all sizes and across all sectors and bring our knowledge and experience to every engagement. We invest heavily in our people, methodology and technology in support of our commitment to quality. We innovate by utilising tools and enablers such as embedded data analytics and controls optimisation in our work to provide the most efficient and cost effective internal audits.

Contact
To find out more about EY can help with internal audit challenges, please contact a member of the team

David Parkinson
Insurance Internal Audit Leader
EY UK LLP
Email: dparkinson@uk.ey.com

James (Jim) Gusich
Partner
EY UK LLP
Email: jgusich@uk.ey.com

Alan Crawford
Director
EY UK LLP
Email: acrawford1@uk.ey.com

David Sooby
Senior Manager
EY UK LLP
Email: dsooby@uk.ey.com

Manav Soni
Senior Manager
EY UK LLP
Email: msoni@uk.ey.com
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

EY is a leader in serving the financial services industry
We understand the importance of asking great questions. It’s how you innovate, transform and achieve a better working world. One that benefits our clients, our people and our communities. Finance fuels our lives. No other sector can touch so many people or shape so many futures. That’s why globally we employ 26,000 people who focus on financial services and nothing else. Our connected financial services teams are dedicated to providing assurance, tax, transaction and advisory services to the banking and capital markets, insurance, and wealth and asset management sectors. It’s our global connectivity and local knowledge that ensures we deliver the insights and quality services to help build trust and confidence in the capital markets and in economies the world over. By connecting people with the right mix of knowledge and insight, we are able to ask great questions. The better the question. The better the answer. The better the world works.

© 2017 EYGM Limited.
All Rights Reserved.

EYG no. 05245-174Gbl.
EY-000041550.indd (UK) 09/17. Artwork by Creative Services Group
London.
ED None

In line with EY's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.

ey.com