Internal audit in insurance – current market issues and trends

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Introduction

EY continually gathers valuable insights into the challenges facing the industry, and in these briefings we explain the role internal audit can play in helping organisations to respond to these challenges.

Regulatory change can be hugely disruptive for everyone working in financial services. In this issue we focus on two changes that will have a major impact on insurers; the EU’s General Data Protection Regulation, which comes into effect in May, and IFRS 17, which sets out a new approach for accounting for insurance contracts and will apply to annual reporting periods beginning on or after 1 January 2021. Both will require organisations to make significant changes to their processes, and internal audit has a key role to play in ensuring these changes are implemented correctly, as well as in ongoing assurance once they are in place.

Continued financial market instability will put stress on insurers’ investment and capital positions. This will make decisions about investment allocation all the more important, as we examine the elements that go towards designing a successful investment strategy and how internal audit can provide the necessary oversight.

Finally, we look at the increasingly central role the Corporate Development Officer is playing in many organisations and the ways in which internal audit functions may need to adapt in order to keep pace with this change.

If you have any questions about any of the articles in this issue, or suggestions for topics you’d like to see us cover in the future, please contact a member of the team. You can find our contact details on page 16.
General Data Protection Regulation (GDPR)

The volume of change required to meet the May 2018 deadline should not be underestimated.

Understanding its impact

GDPR was published by the European Commission in May 2016 and will come into effect in May 2018. It replaces the 1995 General Data Protection Directive and applies directly in each of the 28 EU Member States. The volume of change required to meet the May 2018 deadline has been great, with many Insurers expecting the need to continue remediation efforts beyond this date.

Given the regulatory deadline on 25 May 2018, internal audit teams should continue to play an important role in ensuring that every aspect of a company's activities is GDPR compliant.

Key areas of GDPR impact include:

► **Fines**
  Fines of up to 4% of annual worldwide turnover can be levied for data protection breaches, which may trigger changes to risk appetite.

► **Wider scope**
  GDPR applies to all data controllers and processors established in the EU and organisations that target EU citizens.

► **Accountability**
  Organisations must prove they are accountable and demonstrate compliance.

► **Mandatory breach notification**
  Organisations must notify the supervisory authority of data breaches 'without undue delay' or within 72 hours.

► **Privacy Impact Assessments**
  Organisations must undertake Privacy Impact Assessments when conducting risky or large-scale processing of personal data.

► **Consent**
  Consumer consent to process data must be a freely given statement of affirmative action, for specific purposes. Customers must be informed of their right to withdraw their consent.

► **New rights**
  Including a right to be forgotten, a right to portability and a right to object to profiling, are being introduced.

Areas with significant impact for insurers includes the need to:

► Lawfully process sensitive data in line with GDPR requirements.

► Justify the collection, storage and retention of data. Provide access to that data, held in a variety of means, in multiple locations. Including data held or provided by third parties.

► Implement restructured process designs.
Why is it important?

**Commercial incentives** – The general public are becoming increasingly aware of their privacy rights and have higher expectations of organisations that process their data. This is a trend that is set to continue with the transition to GDPR. The new regulation will help to ensure that firms proactively prevent loss of customers and market share as a result of data breaches. In addition, adherence to GDPR could help to build trusting relationships with stakeholders, to drive loyalty and retention. Addressing increasing public awareness of, and concern about, data privacy.

**Compliance** – ultimately, firms need to comply with GDPR, particularly with the increasing pressure from regulators, not to mention rising fines and penalties. Ensuring adherence will also assist in the prevention of reputational damage, along with the significant costs associated with recovery from breaches, potential lawsuits from those affected and the inherent loss of trust.

What challenges does this involve?

Organisations face a number of challenges in meeting the requirements of GDPR, including:

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<tr>
<th>Privacy governance</th>
<th>Firms need the ability to establish a comprehensive model to lead privacy transformation.</th>
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<tr>
<td>Data flow mapping</td>
<td>There must be an understanding with regard to data flows in the organisation combined with ambitious data flow mapping initiatives which are detailed and resource-intensive.</td>
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<tr>
<td>Right to be forgotten</td>
<td>Applications require features on the key changes brought by GDPR around the right to be forgotten, data portability and data retention.</td>
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<tr>
<td>Big data analytics</td>
<td>Firms need to balance leveraging the strategic value of the data while ensuring privacy.</td>
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What would an internal audit scope include?

Internal audit functions should consider the following areas within the scope of a post-implementation review of GDPR:

**Accountability and Governance**
- Review and assess the governance structure and privacy accountabilities in place.
- Review key roles and responsibilities in relation to GDPR requirements, including the role of the Data Protection Officer.
- Assess the culture of data protection within the organisation.

**Translation of the ‘GDPR Programme’ into ‘business as usual’**
- Review and assess the completeness of the scope of the GDPR programme that has been implemented, to ensure it effectively incorporates all relevant aspects of GDPR.
- Review and assess whether the GDPR programme has been successfully implemented and whether there are any outstanding requirements.
- Assess the transition from ‘GDPR programme’ to ‘business as usual’.
- Review the process for addressing outstanding actions including methodology for prioritising non-compliant areas.

**Policies and procedures**
- Review policies and procedures in place including how they are embedded within the organisation.
- Review the Privacy Impact Assessment processes and supporting templates.
- Review processes in place to ensure that individual rights, including the right of access to, rectification and erasure of personal data, can be managed in line with GDPR requirements.
- Review documentation and application of data security measures to ensure systems and applications are secure by design.
- Review processes and contracts in place with third parties that process data on the organisation’s behalf.

**Awareness and additional safeguards**
- Review training in place and business awareness of the requirements of GDPR and its impact.
- Safeguards, to ensure data being transferred outside of the European Economic Area (EEA) has the benefit of adequate protection.
**IFRS 17**

This represents a significant change for insurance finance functions and will require system changes, process changes and training.

**A major accounting change**

The implementation of IFRS 17 will require that insurers embark on a major change programme in which internal audit should play an integral role.

IFRS 17 details a new approach to accounting for insurance contracts. It was issued by the International Accounting Standards Board in May 2017 and replaces IFRS 4. IFRS 17 applies to annual reporting periods beginning on or after 1 January 2021. The objective is to improve financial reporting by providing more transparent and comparable information across insurers.

The key changes in IFRS 17 are:

- Insurance contract revenue will be lower, as it will now be presented on an earned basis and will exclude amounts that are considered to be receipts of investment components.
- Revenue and expenses are recognised as earned or incurred.
- Insurance finance expense is excluded from insurance service results and is presented either (i) fully in Profit/Loss or (ii) in Profit/Loss on a cost basis, with the difference between the cost rate and the current market interest rate being shown in Other Comprehensive Income, depending on accounting policy.
- Written premiums will be disclosed in the notes to the financial statements, along with significant detail about how insurance liabilities have moved during the period.
The Standard uses three different measurement approaches:

► **The General Model, also known as the Building Block Approach (BBA)** — for long-term contracts. Insurance contracts will be valued using fulfilment cash flows\(^1\) plus the Contractual Service Margin\(^2\).

► **The Premium Allocation Approach (PAA)** — a simplified approach which can be used for contracts with a duration of one year or less (or where using it gives a materially similar liability to the General Model). An insurance contract is valued as a pre-claims coverage liability (based on the premium received) and an incurred claims liability.

► **The Variable Fee Approach (VFA)** — for direct participating contracts. Insurance contract liability is based on the obligation for the entity to pay the policyholder an amount equal to the value of the underlying items, net of a variable consideration charged for the contract.

IFRS 17 requires insurers to apply its requirements at a level of aggregation which it calls a ‘group’. These groups comprise insurance contracts that share various characteristics:

► Groups may not contain contracts issued more than one year apart.

► Groups should contain contracts that are subject to similar risks and managed together.

► Contracts should be divided, based on the expected level of profitability, into: those that are expected at inception to be onerous (or loss-making); those where there is no significant risk that they will become onerous in the future; and the rest.

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\(^1\) Current estimate of amounts that the insurer expects to collect from premiums and payout of claims, including the adjustment for the timing and risk of those cash flows (risk adjustment).

\(^2\) The expected profit for providing future insurance coverage (e.g., unearned profit).
Why is it important?

IFRS 17 will provide better information about the current and future profitability of insurance contracts. This will improve the transparency of reporting for insurance contracts and provide additional and standardised information for investors and other users of financial statements to use in their decision-making.

This represents a significant change for insurance finance functions and will require system changes, process changes and training. Insurers have no option but to comply with the new standard, and getting this right will be critical.

What challenges does this involve?

Insurers should already have started assessing the impact of IFRS 17, given the anticipated scale of the changes and the complexity of the implementation. The first stages of the assessment should include conducting a gap analysis to understand key differences compared with current accounting, actuarial and reporting practices.

Some of the key challenges insurers anticipate during IFRS 17 implementation include:

- **Scale of change** — The need to bring additional systems and data within financial reporting control could involve a significant amount of changes to the existing framework, documentation, reporting process, management information (MI) and KPIs.

- **Increased volatility** — By using current market discount rates, IFRS 17 will bring greater volatility in financial results and equity. Economic mismatches between assets and liabilities will become more visible, and insurers may need to revisit the design of their products and their investment allocation.

- **Resource constraints** — There will be a need to train staff to meet IFRS 17 requirements. This will have an impact on business as usual, with the potential need to recruit additional workforce and develop new skills.

- **New data requirements** — There will be a need for new data and updated systems and processes. This will be challenging, given the long time horizon over which many insurers operate and the legacy systems that many still use. Entities will also have to develop controls around any system and process changes, and to develop or upgrade existing controls for business as usual after transition.
What should an internal audit scope include?

IFRS 17 will represent a major change programme and will extend beyond finance and actuarial teams, affecting insurers’ processes, people and technology. The expected effects will need to be communicated to a broad range of internal and external stakeholders. Therefore, internal audit should be an integral partner throughout implementation.

Pre-project assurance

Internal audit should conduct pre-project and in-flight project assurance audits to ascertain whether the project will meet its commitments to stakeholders. This can include:

► The review and development of capabilities to deliver the IFRS 17 transformation programme, including reviews of governance, MI and project tracking tools.

► Reviews of the implementation plans to ensure they are adequate to deliver the required system changes and will meet IFRS 17 requirements within the deadlines and budget.

Real-time in-flight project assurance

Internal audit should provide continuous assurance as to whether the IFRS 17 transformation programme delivers the required capabilities and statutory requirements, within the budget and deadlines.

Areas of interest will include:

► Testing the robustness of controls driving new process quality, and ensuring they are integrated into existing or new control frameworks.

► Reviewing process and controls documentation, operating procedures, and accounting policies and practice manuals.

► Working with the external auditor to build auditable reporting figures.

► Reviewing new or revised internal reporting templates (e.g., forecasts and other management reports).

► Reviewing new disclosure processes and procedures for each reporting period.

► Reviewing account mappings based on the new Chart of Accounts.
Internal audit in insurance market issues and trends

Post-project assurance

Internal audit should also conduct post-implementation audits to provide assurance that new policies, processes and controls, and systems are appropriately embedded and comply with the standard. This can include:

- Analysing new closing and reporting processes, including timelines and responsibilities
- Reviewing the new Balance Sheet and Profit and Loss formats to ensure they meet new presentation requirements
**Investment strategy**

A carefully planned investment strategy can help to maintain the direction and discipline required to achieve investment goals, and to mitigate the external influences.

**Important decisions**

Planning a suitable investment strategy is central to maintaining profitability, and requires careful oversight.

Continued financial market instability will put stress on insurers’ investment and capital positions. These stresses compound the most critical macroeconomic challenge for the insurance sector – low interest rates. Long-term rates across Europe are expected to stay low, weighing on capital positions and earnings.

General insurers’ ability to respond through repricing, efficiency savings and investment strategies will stay under pressure in 2018. Life insurers are even more vulnerable, given the proportion of guaranteed products in their legacy portfolios and levels of interest rate sensitivity in their business mix. Investment strategies should be geared to a continuation of low interest rates – and, as they are a key driver for absolute return on investment, they will need to be tailored to adapt to these challenging market conditions.

In addition, as noted in the article on page 5, IFRS 17 requires the use of current market discount rates and links the accounting for insurance liabilities to the assets held and the contractual relationship between the two. This may result in greater volatility in financial results and equity and economic mismatches between assets and liabilities may become more visible. As a result, oversight over the investment allocation and its processes and controls is key.

**Why is it important?**

An investment strategy that reflects an insurer’s wider business objectives will empower management to make investment decisions that are in the best interests of the whole business. They must also be sensitive to the various risk measures and constraints identified. Insurers are generally in a situation where they are trying to manage multiple balance sheets and metrics that are often conflicting. A carefully planned investment strategy can help to maintain the direction and discipline required to achieve investment goals, and to mitigate the external influences (such as political, economic and regulatory change) that prohibit the effective execution and management of that strategy.

To do this, firms will need to:

- Develop resilient investment strategies with clear exit and mitigation plans:
  - Gauge the impact of changing market dynamics and lower valuations on non-traditional asset portfolios (e.g., real estate allocations in the event the market falls or the investor mix changes significantly).
- Develop stress test portfolios to assess resilience against a scenario of ongoing low rates and asset price declines, or a rise in interest rates.
- Determine the effects of Solvency II on capital requirements and assess where asset allocation optimisation or reinsurance may help drive this down.
- Prioritise investment strategies that bolster profits without substantially raising the firm’s risk profile, and move away from underperforming products that have no clear upside in sight.
- Focus more heavily on socially responsible investing to meet the rising expectations of shareholders and policy-makers.
What challenges does this involve?

There are a number of challenges to building and executing an effective investment strategy. Questions insurers need to answer include:

What is the best way to choose between investments?

An investment needs to be selected subject to investment limits/restrictions, its fit with liabilities, its value given the risk appetite it consumes, operational constraints and secondary constraints (e.g., solvency, liquidity). Due to the nature of the approvals and conversations that must take place, investments in new asset classes can be a long process. However, this can also be a way to open up beneficial new sources of investment return without over-exposure to risk, and can effectively maximise return for a given risk allocation.

How do we ensure the asset allocation is providing the best return on risk?

A number of considerations need to be made to ensure this is the case:

► Has a full asset universe been determined?
► Are there appropriate constraints over the choice of assets and could some be relaxed or removed?
► Are the current constraints aligned to the wider business objectives and strategy?
► Do the investment constraints capture the most important risk metrics?
► Have you assessed the use of commercial optimisation techniques that could make assets work harder, resulting in an improved risk-adjusted return?

What is the best way to execute and monitor the investment strategy?

Historically, insurers have tended to make investment decisions without the use of a sub-committee. More recently, firms have been moving to a delegated authority model, which can enable firms to make faster investment decisions. However, in this model, boards need to ensure they remain accountable and still maintain appropriate control over investment decisions.
What should an internal audit scope include?

Internal audit should consider the following areas within the scope of a review of an investment strategy:

<table>
<thead>
<tr>
<th>Investment strategy</th>
<th>Selection of investments</th>
<th>Execution of investment strategy</th>
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<tr>
<td>► Defined investment strategy, including components for different products, asset pools, hypothecated/segregated pools, funds and asset allocation levels.</td>
<td>► Process for the setting of investment limits.</td>
<td>► Governance structure of approving investments, including the roles and responsibilities of the governing bodies.</td>
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<tr>
<td>► ‘House’ investment beliefs in terms of definition and alignment to strategy – e.g., active versus passive management, value investing.</td>
<td>► Assessment of the appropriateness of an asset class to support relevant liabilities.</td>
<td>► Agility with which investment decisions can be made.</td>
</tr>
<tr>
<td>► Processes to ensure alignment to business objectives and constraints, including how the investment strategy is integrated with the business risk appetite.</td>
<td>► Process for defining and applying long-term economic assumptions.</td>
<td>► Extent of delegation of authority for investment decisions, and mechanisms in place to ensure that decisions are taken within the defined authority and that appropriate escalations are made.</td>
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<table>
<thead>
<tr>
<th>Asset allocation</th>
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<tr>
<td>► Processes for determining the asset universe.</td>
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<td>► Processes to identify and remove asset constraints.</td>
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<tr>
<td>► Approaches for asset optimisation.</td>
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<tr>
<td>► Approach to rebalancing a portfolio’s asset allocation targets and weights.</td>
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<td>► Approach to asset/liability matching.</td>
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Corporate development functions

Many firms are creating or strengthening the role of the Corporate Development Officer (CDO).

A new challenge

Corporate Development Officers are playing an increasingly vital role in strategy at both the corporate and business-unit levels, and internal audit teams may need to take a closer look at their activities than they have done in the past.

The insurance industry

In the insurance sector, the increasing focus on digital amongst major insurers is leading to yet another reassessment of the strategic direction and fit of legacy businesses. Firms are also working hard to protect their ratings and their capital position under Solvency II, increasing the pressure to divest non-core businesses and de-risk balance sheets.

Many firms are also looking at corporate development as a way of responding to disruption. Developing joint ventures and innovative partnerships, often with non-traditional businesses (e.g., start-ups), is increasingly becoming the norm. The processes for valuing and leveraging learnings from such set-ups will need reviewing to meet these specific needs.

Seizing opportunities, whilst remaining focused on optimising capital and portfolios, is high on the corporate agenda. These strategic growth objectives are translating into a wider remit for CDOs due to rapid market changes, the blurring of sector lines and disruptive forces such as enhanced geopolitical concerns and shareholder activism.

Many firms are creating or strengthening the role of the Corporate Development Officer (CDO) and they are becoming even more involved in portfolio optimisation and commercial assessment. Whilst this increases the profile and importance of the role, it also brings broader responsibilities and a need to develop new skills.

The benefits of getting this right include the ability of the CDO to act effectively in the deal market, to assist in the delivery of strategy and to drive technological enhancements across the business. Firms that fail to deliver these improvements will find themselves left behind.
The skills a CDO requires

In 2015, EY conducted a survey of corporate development functions (CDFs) entitled Corporate development today: driving strategy, accelerating growth. This study found that most CDFs have a finance/accounting/treasury professional (96%) and/or strategic planning professional (80%) on staff. They also maintain strong relationships with the finance, legal and strategic planning groups. The survey found that:

► CDOs spend 60% of their time on transaction execution and 40% on strategy.
► The key areas where the CDO influences corporate strategy are in grounding M&A decisions in sound financial data, developing transaction strategy and supporting strategic planning.
► The CDO most often leads and performs planning and structuring transactions, negotiation, opportunity identification and valuation.

Whilst the primary focus of the CDF is inherently on investing capital, it also plays a vital role in optimising corporate capital deployment.

Over the past five years, the CDF has developed more formalised processes to evaluate deals. It is conducting regular portfolio reviews of the business and understands the growing need to perform cultural fit assessments as globalisation broadens the pipeline of potential targets. With a wider remit, the CDF now also needs a stronger grasp of such megatrends as digital transformation and big data analytics, as well as an understanding of the latest regulatory and tax implications of deals.

Complex challenges

Firms face a number of challenges in implementing and maintaining an effective CDF:

1. Commercial assessment is one of the two leading causes of deal failure (the other being strategy). There is a strong case for the importance of a robust strategy and a formal M&A process. The impact of the acquisition on Solvency II will be a key consideration.

2. Operational assessment (business plan, technology, supply chain, human resources) is another area in which corporate development is becoming more deeply involved. There is a need to develop a greater understanding of when to leverage skills from other business units.

3. Big data has huge potential to transform the effectiveness of CDOs and the teams they lead. However, it is present in a huge variety of structured and unstructured forms, and can sometimes lack accuracy.

4. Measuring the performance of the function remains a challenge. Although it is difficult to apply quantitative metrics to every aspect of the function, reliable measures are a component in determining the effectiveness of both the CDO and the CDF.

The continued importance of M&A to insurance firms and increasing scrutiny of deals, combined with the wider remit for CDOs, means that internal audit functions have to take a closer look at the CDF to at least ensure the existence of processes for appropriate use of capital.

This can be a particular challenge in fast-growing, acquisitive businesses that are involved in transactions. There is also a need to independently review the extent to which deals are made in line with the strategy set out by the board.
Corporate development functions

Internal audit functions should consider the following in their audit plans:

**Post-deal reviews**
- The effectiveness of the execution of the deal
- The reporting on the deal to management, including the accuracy, completeness and appropriateness of the reporting
- The application of lessons learned from previous deals
- The governance implemented over the new structures
- The use and development of different processes for managing 'non-traditional' activity, such as joint ventures or partnerships
- The realisation of revenue and cost synergies

**Governance of the CDO**
- The reporting lines for deal execution and the CDF’s reporting
- The ability for approvals for deals to be efficiently obtained
- The governance over approval limits
- The alignment of the deal pipeline with the business strategy
- The strategic decision-making process that was followed to determine whether to use external corporate development advisers versus in-house functions, including the cost-benefit analysis

New demands require new skills

Top three reasons for deal failure:
1. Commercial assessment process
2. Strategic process
3. Integration process

Additional skills wanted
- Risk management
- Investor relations
- Regulatory
- Treasury
- Sales and marketing
- Market research
- Human resources
- Project management
- Tax

Top three transaction objectives
1. Enter new geographic markets
2. Strengthen core business
3. Acquire new technology

- Legal
- Integration
- Corporate governance
- Big data analytics
- Business unit operations
- Finance
- Information technology
- Strategic planning
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