SolvencyIIReview@hmtreasury.gov.uk

AFM Response to Review of Solvency 2: call for evidence

19 February 2021

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

   - Provide our views on how the review of Solvency 2 regime can support greater innovation and competitiveness in the UK insurance market; and
   - Explore changes in the regime that deliver proportionality and relevance for small UK based insurers, including AFM members.

About AFM and its members

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £19.6 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2] and to take account of corporate diversity[3].

[1] ICMIF, https://www.icmif.org/publications/market-insights/market-insights-uk-2016
[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted
[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

Introductory comments

4. We welcome the Call for Evidence, as an integral part of a review of Solvency 2 and its application to the UK market. Whilst the original Directive benefitted from significant influence from UK regulators, by necessity it was developed to suit the different insurance markets in all EU states and, as a result, involved many compromises.

5. With the UK's departure from the European Union, the strong likelihood is that the EU Directive will continue to evolve, without the benefit of input from the UK. Inevitably, the Directive is likely to become more onerous to implement, less of an effective fit with the needs of the UK market and, most importantly, less likely to afford the right protections for UK consumers. Where the UK seeks to develop a newly competitive and innovative role for financial services post-Brexit, it is vital that the nature of all regulation, including Solvency 2, is designed to fit that vision- and to enable the UK insurance sector to play a meaningful role in future economic and social policy in the UK.

6. We regard the review of Solvency 2 as an opportunity therefore to revitalise the UK insurance market, and to ensure it remains one of the most significant insurance markets in the world. But for organisations that only offer products to UK-based consumers, it is at least as vital that the UK market remains competitive, and that consumers (including SMEs) have a broad choice, and can safely and confidently match their financial needs with products that are cost-effective and relevant.

Purpose of the review

7. We agree with the Government that the purpose of the review should go beyond a solution for transposing the EU Directive into the UK rulebook, and that it is right to consider the regime in relation to the broader role of insurance in supporting the needs of society.

8. That said, AFM members, alongside all UK insurers, have invested significantly in meeting the expectations of Solvency 2. The hard work committed to complying with the Directive has led firms to gain a much better understanding of their business, and the risks it is exposed to. The skills and knowledge of management, and the quality of internal capital management decisions, have been enhanced.

9. However, implementation costs have been higher than expected, and have offered only limited proportionality for smaller insurers[4]. We do not wish to see wholesale dismantling of the standards in Solvency 2 therefore, but greater relevance and calibration of its principles to the future needs of the UK market, and a more proportionate approach to compliance.

10. We recognise that broad equivalence (of the UK regime with that in the EU) is valuable- just as it is to international standards more broadly. We consider this will be achieved effectively by a commitment to aligning outcomes (such as policyholder protection and a capital regime that accommodates 1 in 200 year events), rather than retaining the current EU regime, and the changes that are in planning by EIOPA. In general terms, the EU focus remains on achieving consistency, and in raising standards in all countries to a common level, whereas consumer protection and capital management techniques are more consistently high in the UK, and would lend themselves to a more principles-based and outcomes-led approach.

11. There are some common differences in mutual insurers in the UK compared to listed companies:

    a. Mutuals are owned by UK consumers and taxpayers, and not by wealthy institutional or overseas investors. Governance arrangements are focused on securing the best long-term interests of policyholders, who are also owners of the business. Hence, insurer strategies relating to dividend policy or rating agency sentiment do not apply, and changes to Solvency 2 should have the capacity to level the playing field between different business models, not exacerbate existing disadvantages.
    b. Mutuals tend to be smaller businesses, due in part to the limitation that their main access to capital is via preserved profits, which means their capacity to grow is limited. As a result, most mutuals take a conservative approach to capital management, holding higher reserves in many cases, and this imposes constraints on their capacity to divert further capital inefficiently.
    c. Mutuals tend to be simple businesses, with a limited product range, which reduces their capacity to shift focus in different economic environments, or to where regulatory conditions are more benign or favourable (including offshoring).
    d. Mutuals continue to use UK GAAP accounting standards and would therefore be severely damaged by any shift towards international benchmarks, such as iFRS or international capital

[4] For example, one AFM member with annual premium income of under £10 million estimated the cost of implementing Solvency 2 was £1 million.

standards. Any changes should therefore preserve UK GAAP on the same terms, and as a viable alternative for UK-only focused businesses.

12. As a result of the above, we strongly agree with the sentiment expressed in the statement in paragraph 1.8 of the Call for Evidence, that it is 'particularly important to ensure an appropriate regulatory system that meets the needs of small and medium- sized insurance firms, including new entrants to the market, thereby boosting competition'. The insurance regulatory regime, along with legislative changes, in the UK over the last 25 years has increased concentration. In 1995 around half the UK insurance sector was mutual; today that has fallen to under 10%, whilst in our main competitors, such as the US, Japan, France and Germany, the mutual portion of the insurance sector remains resilient, at 30% plus.

The role of insurance in society

13. We consider that changes to the UK capital regime should actively take account of the role of insurance more broadly, as well as how some of those wider social components are regulated. Currently Treasury plays a relatively passive role in assessing how effectively insurance delivers good outcomes for society at large: we believe there is more scope for engagement, particularly to resolve issues that would require legislative changes, or where existing co-ordination between regulators is inconsistent or ambiguous.

14. Insurance for example is less recognised in its capacity to support key societal initiatives than deposit-takers. Yet with assets of £1.9 trillion, the capacity of the sector to support major infrastructure plans, or to support Covid-recovery, is immense. Yet current capital requirements force a more defensive approach to investments.

15. In a similar vein, harnessing insurers in support of the Government's climate change agenda is critical, both in the role of the sector, as major investors, to promotin change to a carbon-neutral economy, but also in understanding and mitigating the physical risks of climate change. Some insurance, as we know it today, will become increasingly unavailable and unaffordable without the kind of actions explored in the Green Finance Strategy.

16. Equally, AFM members have a strong focus on 'serving the underserved': providing financial products to parts of our community that may otherwise find access difficult. This includes developing protection products for the self-employed, making savings plans available to all via

low minimum investments, and providing health care products that are affordable and help families with limited resources manage their money more effectively.

17. Amongst the outcomes the review of Solvency 2 can achieve is to ensure regulation is proportionate, and that it enables successful small insurers, including mutuals, to thrive and better support the needs of the community.

Risk margin

18. The Cost of Capital Risk Margin seeks to mirror the risk premium that would be required for another insurer to take on the risk of providing the benefit to the policyholder.

19. For products like Holloway Income Protection, the effect is significant: for example, for one of our members, the risk margin is almost 40% of the BEL, whilst for another, the risk margin amounts to half of own funds and 80% of the SCR. As smaller companies, with simpler operations, they are less likely to have sought regulatory approval to use the TMTP (Transitional Measures on Technical Provisions, that are allowed for the first 16 years of the Solvency 2 regime), which other insurers have used to mitigate the presence of the Risk Margin. Nor have they been able to take advantage of reinsurance, or interest rate hedging, to manage the volatility of the risk margin to interest rates. This means that insurers effectively end up holding more capital than is necessary to meet the 1-in-200 requirement, and for Holloway income protection providers that disadvantage may be greater than for larger, proprietary income protection companies.

20. In these circumstances, and given EIOPA's own acceptance that the cost of capital is too high, we would like to see a substantive and early reduction. Whilst reducing the cost of capital is the simplest and most effective solution, we also make the following observations:

    a. Any changes to the risk margin need careful examination, to understand the implications, and to avoid negative consequences for smaller, mutual insurers.
    b. It is possible that the underlying methodology could be reviewed and changed - there are various approaches that could be adopted and the current cost of capital approach is only one (the Australian model has been cited as a potential alternative). However, the potential advantages need to be weighed up against the cost and time of changing; and any other method for

assessing the market value of the liabilities would have its own limitations.

c. We strongly suggest that any move to, say, an 85% confidence interval on the risk profile, as envisaged in the International Capital Standards, should be tested first. We would suggest the PRA should first look at elements of the standard formula on the life insurance SCR, to examine whether a more thoroughly researched standard formula component could be used.
d. Any changes in current assumptions should also test the volatility of any changes. For example, the volatility of longevity risk might increase now with the pandemic, but this would require a detailed and costly series of Quantitative Impact Studies.

21. Whilst most smaller mutuals do not currently make use of reinsurance, a more relevant approach to calculating the risk margin may make it more worthwhile for small mutuals to establish reinsurance arrangements, and as a result those businesses may become more competitive and find growth options easier to take up.

<u>Matching adjustments</u>

22. The matching adjustment is not largely used by AFM members, due to the costs and bureaucratic complexity of the approach. The same is true of the transitional provisions.

23. This adjustment is too difficult for any smaller insurer to apply for. The costs associated with doing the actuarial and investment work, as well as the application to the PRA effectively means that it is only available for very large insurers. This has a consequent impact on the ability of smaller insurers to offer annuities and other products, where the illiquidity margin of return on some assets becomes an essential element of the consumer offer.

24. We would suggest a complete overhaul of the matching adjustment with simple rules that can be followed by any insurer for a minimal amount of extra work (say under 10 man days for their actuarial and investment teams). A standard pack that can be used would be useful. Automatic acceptance, as long as the pack is adhered to, would make the regulators' and the insurers' work simpler.

<u>Calculating on the SCR</u>

25. The application of effective and proportionate capital requirements is critical to the success of the insurance sector. It is notable that the

number of insurance failures in the UK have been very low in the last 20 years, and the few there have been are generally of insurers passporting into the UK. Even during 2008/09, where the government had to intervene to prop up banks that were too big to fail, the solvency positions of the UK insurance sector remained solid.

26. We agree that there is scope to simplify the calculations in the Solvency Capital Requirement, SCR. Whilst this might make it easier for some firms to adopt an internal model (or partial internal model), the standard formula has to remain the default option for the majority of UK insurers. Otherwise, any attempts to simplify the regime will have failed.

27. In recent years, the reliance on providing for '1 in 200 year events' has become less apparent, given the frequency with which events previously considered unlikely have occurred. This suggests recalibration of the standard formula, and wider capacity of PRA and firms to agree adjustment to it, will help reduce the need for internal models, and allow capital to be used more efficiently. To illustrate, one general insurance member of AFM, with Member Funds of less than £25 million, considers they are carrying around £2 million more for insurance risk in their SCR than is necessary, because they are unable to fully reflect the benefit of their reinsurance arrangements in the standard formula. They have not applied for a USP because the cost and time required to apply is disproportionate.

28. With regard to specific changes, we would suggest:

   a. Recalibration of the standard formula risks on morbidity based on industry experience – probably by using the CMI's data on morbidity.
   b. A recalibration of some of the components of the life and health standard formula SCR might be appropriate. The mass lapse risk was chosen arbitrarily by EIOPA and a more considered view of mass lapse might be appropriate, with differing factors by differing product/ plan types. The health risk morbidity risk factors are based on quite flimsy evidence and cause a much larger morbidity risk than is probably justified by experience.
   c. The interest rate risk is unsuited to a time of negative interest rates, as mentioned by EIOPA in their review, and as inferred recently by the Bank of England.
   d. The standard formula operational risk component may need recalibration and should be subject to diversification within the BSCR.
   e. We suggest some real world simplifications on look-through. Some insurers have a large proportion of their investment portfolio held in collectives, and find it expensive and difficult to

manage the market risk component, to allow for the actions required on credit risk, and to give proper allowance for the impact of swaps and derivatives within collectives. The calculation of market risk on an insurer's collective investments is often at the limit of internal expertise. Investment managers would be better placed to perform the calculation, and this would better enable insurers to broaden the choice of investments, such as to explore climate change and other ESG options.

f. The costs will be one-off system changes, though we have not quantified them. The benefits will be a more sensitive and better calibrated SCR for the PRA to use.

29. For income protection insurers, the SCR on morbidity in the standard formula appears large and has limited justification in Solvency 2 literature. This could be examined first before changing the risk margin, given that this has a large impact on the risk margin of IP providers (see paragraph 19 above). Similarly, there is limited justification behind the mass lapse standard formula SCR assumption, which has a major impact on the risk margin for unit-linked policies. Again, work here on arriving at a more thought-through SCR could be more profitable than examining the risk margin approach. Both of these forms of capital requirement cannot be hedged and have a direct impact on risk margins.

30. In cases where the standard formula is deemed inappropriate, and where there is insufficient justification for a full or partial internal model, the insurer normally makes the best of the standard formula. Greater granularity of the standard formula can help, as can the Forward Looking Assessment of Solvency (FLAS) and Own Risk and Solvency Assessment (ORSA).

31. We recognise and support the Government's desire to explore how changes to the SCR can remove some of the barriers to insurers providing long-term support to growth in the economy, and to promoting capitalisation of climate change-related risks. In our experience:

a. infrastructure funds and long-term bonds on infrastructure are difficult to invest in, as a result of the authorisation requirements from the PRA. Long-term equity is also hard to model within a mark to market single one-year stress model.
b. It is too early to give a view on climate change risks: the industry is just considering these risks for ORSAs and for FLAS work. Within the next two years, there may be some simple parameters that can be used.

<u>Reporting requirements</u>

32. Solvency 2 contains many layers of regulatory reporting, and some effort has been made in recent years to attempt to rationalise and simplify these for smaller insurers. But we consider there is greater scope to reduce the burden of reporting: this burden is felt by the PRA just as much as by firms, as supervisors admit that they are unable to spend time reviewing much of the non-numerical data that is sent to them.

33. The risks of the current approach therefore are both that firms divert time and attention to reporting, that regulators miss emerging risks, and that excessive reporting stifles innovation. To illustrate, PRA regularly asks small insurers to send in their ORSA; the document sets out some of the strategic ambitions of the firm, and plans therefore may be diluted, either to fit regulatory expectations, or for fear of the leakage of plans to competitors. In Denmark, where insurers recognised the high use of consultants in the regulator, and the high turnover of regulatory staff to those consultancies, small mutuals successfully argued that their ORSA should not be sent to the regulator.

34. We consider PRA should take advantage of the opportunity to view reporting requirements in the round: previously, with requirements to generate reports for cross-EU review as well as for national purposes, there has been a significant amount of added complexity and duplication. A single set of reporting requirements should streamline these needs.

35. AFM members value the waivers that PRA has provided on quarterly reporting for smaller insurers. However, these have only been granted on a temporary, renewable basis, and we would like to see the exemptions made permanent.

36. We have previously sent to PRA suggestions for simplifying the asset reporting templates: this involved looking at each line of current reporting, and suggesting whether it was critical/ nice to have/ of no value, in relation to small (PRA Category 5) firms. Even were such changes adopted (PRA has not responded on the detail), the reporting requirements would remain onerous for small firms, and we consider that restricting the asset data to just the information in the balance sheet may be sufficient.

37. We also consider the Regular Supervisory Report (RSR) should be significantly simplified, and removed altogether for small, Cat 5 firms, as it contains information that largely duplicates what is available in the SFCR (Solvency and Financial Condition Report) and the ORSA. Indeed, during 2020, PRA cancelled the reporting requirement for year-

end 2019, reinforcing its limited usefulness to them. One solution, for larger firms, is to make the RSR a small additional report that holds commercially sensitive information not included in the SFCR.

Thresholds for regulation

38. AFM has a significant number of members who are below the current threshold, or just above. We are a member of the European Mutuals trade body, AMICE, and contributed to their response to the recent EIOPA consultation: including on thresholds for the Directive, and proportionality within it. We are aware therefore that EIOPA is recommending a significant increase in the threshold for inclusion in the regime, of up to €25 million gross written premium income, albeit with flexibility for national supervisors to adopt a level appropriate to the needs and maturity of the insurance sector in each country.

39. For smaller insurers, the capital and compliance requirements of Solvency 2 may put them at a significant competitive disadvantage, compared to large insurers, and we believe this is a bad outcome for consumer competition and prices. We suggest that the Government directs PRA to adopt a new threshold, at a level that properly reflects the scale and maturity of the UK insurance sector. Due to the high level of concentration of the UK insurance sector, we believe that a meaningful threshold can be set, which ensures the vast majority of insurance company assets (e.g. 80%, or 90% of assets) continue to be managed within the Solvency 2 regime, whilst delivering a more proportionate approach for smaller insurers. Insurers trading in the EU, for whom equivalence with the EU regime is important, would be expected to seek to retain full Solvency 2 compliance, as may some others, for example, those near the new threshold.

40. This target for inclusion of 80% of the market has been adopted by PRA already, in its supervision of Solvency 2. To enhance proportionality, PRA has offered a waiver to quarterly reporting for smaller (category 4 and 5) insurers, whilst its exemption for external audit of the SFCR was extended on a points-based system. Either of these approaches could be carried over into the Solvency 2 threshold more generally. Alternatively, a simple monetary threshold could be adopted to approximate a target for inclusion/ exclusion (e.g. 80% or 90% of assets in Solvency 2): we have not quantified this, but would expect this to create a threshold of at least £50 million gross premium, or £200 million technical liabilities.

41. Insurers that currently sit between the current Solvency 2 threshold and the revised higher amount would not seek to lose the value of the

significant investment they have made in complying with Solvency 2, nor would they wish to align to the Solvency 1 regime maintained by current non-Directives. Instead we would wish to see a 'Solvency 2 lite' regime in place, with a simplified approach.

42. Taking firms below a significantly raised threshold for Solvency 2, as opposed to simplifying within the regime, would have a number of benefits:

    a. Insurers that are currently close to the threshold will have greater operational certainty: in the past we have seen some insurers decide to transfer parts of their book, or to reduce the supply of products, in order to remain below the threshold, and we do not consider that this cost and compliance approach will always be in the best interest of policyholders;
    b. UK legislation has determined that all UK insurers are classified as Public Interest Entities (even though the assumption often made in Government is that all PIEs are listed firms- or equivalent in size to them). For the purposes of the Audit Regulation and Directive, the Financial Reporting Council has defined an insurer as only those businesses within the scope of Solvency 2. Hence, by raising the threshold and removing firms from Solvency 2, they will not be audited as a Public Interest Entity. We have attached a paper recently sent to BEIS on the impact of current arrangements, which add a significant audit cost to AFM members.
    c. Actuarial assessment is vital to life insurers, and should be retained under Solvency 2 lite, albeit in a simplified manner; the requirement for an actuary for non-life insurers- only recently introduced- should not be a requirement for Solvency 2 lite.
    d. New insurers currently face the full force of Solvency 2, making it very difficult to establish a new insurance business in the UK, particularly as a mutual business model.
    e. We consider that the existing non-Directive insurers should continue to maintain their Solvency 1 arrangements, albeit with incentives to move to the Solvency 2 lite regime if they approach the current threshold.

43. A Solvency 2 lite regime may consist of simplified versions of many of the tools that feature in Solvency 2:

    a. The ORSA in particular is a valuable strategic tool, though it can be simplified for smaller insurers.
    b. The assessment of capital requirements, via the SCR and MCR are relevant, though show contradictory results for some smaller

insurers and might therefore be simplified. We set out some suggestions above in the section on SCRs.

c. Simplified regulatory reporting will provide the PRA with annual returns. By contrast, we consider that quarterly reporting and the SFCR offer little or no value to the PRA, and none at all to policyholders. A simple excel spreadsheet could be produced by PRA to close any data gaps.

We would be happy to work with Treasury and PRA on the detail of these proposals.

Mobilisation of new insurance firms

44. The creation of the PRA/ FCA start up unit is a positive step forward, but has resulted in only two new authorisations in 2019/20[5]. PRA's plan for a 'mobilisation' phase are welcome, though there has been no engagement with mutuals on this.

45. We consider that the regime for new insurers should seek to remove some of the barriers to entry we currently see; amongst deposit-takers for example there is an introductory regime for new credit unions. For new insurers, anticipating full Solvency 2 compliance from onset is the most significant barrier, and we consider the basis for Solvency 2 lite, as set out above, would resolve this.

46. Forming a new mutual insurer would be an attractive option for many people considering creating a new insurance business: the origins of insurance- in self-helping and the sharing of problems- are very mutual. We receive regular enquiries from people who would like to establish a friendly society, but are put off by the complexity and cost, as well as the 'capital conundrum' (that generally, you can't create membership without capital, and you can't create capital without members).

47. As a result, many people exploring niche mutual insurance solutions, focused often on supporting people in areas badly served by their current insurance options, go underserved. This puts greater onus on the welfare state. In some cases, the managers of a prospective mutual have decided that a more practical solution is to establish as a discretionary mutual. This greater control of the business and removes some of the regulatory barriers to entry[6].

[5] See p48 on PRA annual report 2019/20: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/pra-annual-report-2019-20.pdf?la=en&hash=28BDCB5F125FCCEF008A0A7BB880E8BB10E69B23

[6] AFM has produced a short guide to discretionary mutuals: https://financialmutuals.org/wp-content/uploads/2018/04/Discretionary-mutuals-v0120.pdf

48. In recent times, a growing number of large businesses have begun to explore the option of developing a mutual to manage their internal insurance needs. Traditionally, if they felt they were getting a bad deal from high street insurers, they may look at establishing a captive/ offshore insurer. Supporting ways to onshore business back to the UK would inevitably be good for the UK economy.

Other areas for review

49. The Treasury paper considers how the insurance industry can make a more substantive role in society, and where changes to Solvency 2 might facilitate this. We suggest it would be worth considering:

   a. The Financial Services Compensation Scheme is seeking to raise a levy of over £1 billion for 2021/22, and this includes a very significant increase in costs for insurers. However, as we explore above, the UK Solvency 2 regime has avoided significant failures amongst UK insurers. Most of the compensation paid by FSCS in its insurance pool relates to foreign insurers. UK insurers and their policyholders are therefore paying twice: to maintain an effective capital regime for UK firms, and to remedy the lack of that in overseas firms. We consider current passporting arrangements make it too easy for poorly capitalised firms to enter the UK market, and that this is bad for the economy and for UK policyholders, who bear the cost of failures.

      The EIOPA review of Solvency 2 considered insurance guarantee schemes, and recovery and resolution, and we consider the UK Government should consider whether the FSCS continues to fulfill an effective role in insurance. In addition, in Belgium, the regulator has established that the capital constraints on mutuals are taken into account in a future recovery and resolution regime.

   b. A recent European Commission paper considered directors' duties and sustainable corporate governance in the EU [7]. Amongst its finding was that the proportion of revenues paid to shareholders had increased from 1% in 1992, to 4% in 2018. This fourfold increase in value extracted from the business reduces the potential of the business to be sustainable for the long-term, or to create value for society at large. Maintaining a viable and active mutual sector is one way of ensuring businesses remain sustainable (in every sense) for the long-term. UK legislators and regulators have in the past 25 years overseen

[7] https://op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en

the mutual sector shrink enormously, and the review of Solvency 2 offers an opportunity to consider again how all business models thrive in a post-Brexit UK.

50. We would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

Martin Shaw
Chief Executive
Association of Financial Mutuals

External audit for smaller mutual insurers: a failing market?

In recent times, AFM members have reported significant problems in the supply of external audit. To illustrate we've included two case studies (anonymised), reflecting reported problems in the last few months.

The problems emanate from two recent changes to audit regulation. First, the UK's definition of Public Interest Entity has been extended to all insurance companies. Second, given mounting concern about the effectiveness of audit following some notable business failures, audit standards have, quite properly, been raised. However, some of the regulatory changes have exacerbated problems in supply, such as requirements on non-audit services and re-tendering requirements.

The combined effect of these changes is that there has been a significant contraction in the supply of external audit. Previous audit suppliers have exited, indicating that the PIE rules are overly onerous and make the work unviable. There are now only a handful of firms willing to provide audit services to our members, and these firms are becoming more selective about which work they will take on.

Prices of audit have increased significantly. This is blamed on external forces, such as new audit oversight requirements; however, auditors appear to have imposed very high minimum fee levels, so for small organisations there is increasingly less correlation between the work being undertaken and the price paid.

Insurance companies in the UK are highly regulated, and with the help of their actuaries they manage their businesses cautiously. Business failures are therefore very rare, and large parts of the audit role are devoted to verifying the work of other professionals. The purpose of the current PIE definition does not sit accurately with AFM members, who are small insurers and represent no systemic risk to the economy or their policyholders; equally, the nature of audit reform seeks to tackle problems which are not prevalent in the sector, and which did not take account of its impact on unlisted/ mutually owned insurers.

In summary, **the supply and price of audit now represents a significant threat to our sector, and as a result we consider the market for external audit is not working effectively.** Some of the possible solutions that should be considered are:

- To revise the definition of PIE in the UK, to exclude unlisted insurance companies below a threshold of, say, £500 million annual premium income (BEIS);
- To revise the threshold for inclusion of Solvency 2, to take more small insurers out of the regime which currently adopts inclusion in the Directive as the definition of insurer (HM Treasury and PRA);
- To investigate the supply of external audit to small insurers (CMA/ FCA);

- To review audit reforms, to consider whether they are having the desired outcomes, both in terms of maintaining effective audit standards, and retaining an approach which is proportionate to the risk and scale of the business (FRC).

AFM member case studies

Case study 1

The incumbent audit firm indicated during 2020 that they would not seek to renew audit services beyond the year-end 2020 report and accounts. The insurer has begun to tender for a new audit provider, and found that prices quoted are typically three or four times the current price. The insurer has premium income below £5 million and in 2020 has had to reduce headcount from 7 to 5, and considers that within the next 3 to 5 years, the cost of audit will be so significant that it will be unable to justify the expenditure to its members. Put another way, audit fees from one of the Big 4 audit firms are projected to be around 50% of the wages and salary bill for this organisation; by comparison, Aviva, the UK's largest insurer paid less than 0.1%.

Case study 2

To meet rules on re-tendering, this insurer approach ten audit firms to quote for audit of the 2020 year-end accounts. Only one of the ten were willing to undertake the work- the incumbent auditor- and only then at a significantly increased price. The insurer is exploring how it might undertake a more successful retendering exercise in 2021, as audit rules expect the audit committee to make a recommendation of the successful candidate to the Board, and to identify both its first and second choice candidates and the reasons for its selection.