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Insurance Sector: Regulatory and Internal Audit Priorities for 2022

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The last 24 months have seen a lot of challenges and changes that could not have been predicted. The impact of Covid-19 is ongoing and its impact on business still to be fully understood. It has already changed not only the way businesses operate and the way people work; it has also required the reinvention of basic selling methods, interactions with customers and a reliance on digitisation to remain commercially successful. All of this impacts the assurance needs of businesses and their stakeholders which internal audit functions must address.

The regulators have recognised that change and challenge is the new norm. This has resulted in a focus on firms being resilient both operationally and financially. To be able to face significant and unpredictable events, such as Covid-19, it will be crucial for firms to ensure they are resilient and customer interests are protected.

The impact of Brexit, the BEIS focus on governance and internal controls, the increasing complexity of business models and strategies, and continued regulatory scrutiny are just some of the other challenges for firms to navigate. This means greater reliance on suitable compliance, and more pressure from management on the Internal Audit functions.

All these issues are reflected in the FCA and PRA 2021/22 Business Plans and our views on the hot topics and priorities that should feature on internal audit plans for insurance sector firms are set out below.

Regulatory plans and priorities

1. PRA focus

The PRA has published its insurance supervision priorities for 2022[1] covering:

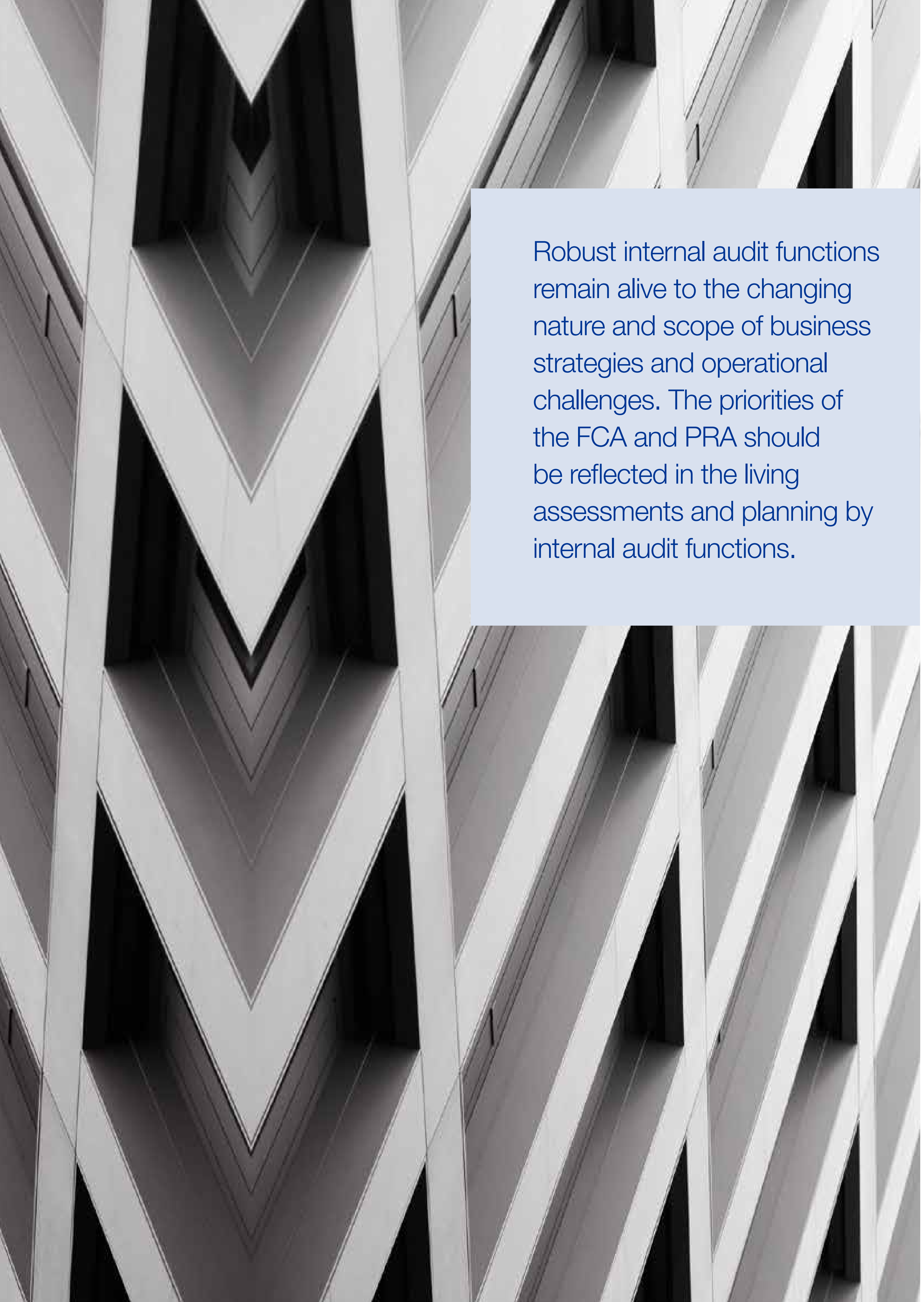
- Financial resilience
- Operational risk and resilience
- Financial risks arising from climate change
- Regulatory change
- Third country branches seeking authorisation
- Diversity and Inclusion ("D&I").

2. FCA focus:

The FCA Business Plan[2] notes that the way in which people access and use financial services, along with the structure of global wholesale markets, has significantly changed. In July 2021, the FCA released its long-awaited Business Plan for the next 12 months focussing on consumer, wholesale market and cross sector priorities.

The collection and use of data to more proactively identify and intervene on any threats of harm or misconduct are going to underpin the FCA's approach (with a big investment in this for the next 3 years). The FCA is intending to use its powers and its connections with other bodies to enforce and take actions required - a more aggressive approach than previously seen.

1 - PRA insurance supervision priorities for 2022 - https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2022/january/insurance-supervision-2022-priorities.pdf?la=en&hash=0AFDCE727B64DADB0AC857398B4FC1208471EFE9
2 - FCA Business plan 2021/2022 - https://www.fca.org.uk/publication/business-plans/business-plan-2021-22.pdf



Robust internal audit functions remain alive to the changing nature and scope of business strategies and operational challenges. The priorities of the FCA and PRA should be reflected in the living assessments and planning by internal audit functions.

As a new and emerging risk, we have considered recent regulatory and reporting changes published regarding Environment, Social & Governance (ESG) risks and have outlined our view of what senior management should be doing in 2022 and also the assurance and value that internal audit can provide.

ESG – climate-related financial risks & net zero

A key topic of focus featured in the FCA Business Plan. The FCA will support the UK government's net-zero commitment by adapting the regulatory framework to enable a market-based transition to net-zero.

Insurance carriers are subject to the PRA's SS3/19 and July 2020 'Dear CEO' letter which builds on the TCFD requirements - this should have been implemented and embedded by the end of 2021.

This particular topic is driven by regulation, investor and social pressures and government/net zero commitments.

Firms need to integrate ESG into all aspects, including strategy, governance, culture, MI, monitoring and reporting.

New disclosures will need to be made to ensure transparency and the right outcomes can be achieved.

Firms should consider climate change a permanent/recurring risk and act to mitigate by:

- Ensuring climate change and sustainability is central to the organisation's values, mission, and strategic goals
- Investing in projects that will future proof products and services
- Planning for any climate-related physical and political risks which may jeopardise an organisation's future
- Whilst not a current requirement, firms should think about their longer-term net zero strategy
- Reducing organisational greenhouse emissions and moving away from harmful or unsustainable activities
- Large insurance firms have started taking decisive actions i.e. introducing policies over coal, gas and oil to reduce green house gas emissions.

Internal audit should:

- Assess application and implementation of requirements as set out in PRA's SS3/19 and July 2020 'Dear CEO' letter
- Ensure governance and clear responsibilities around climate change policy, compliance, risk management, monitoring and reporting
- Assess the extent to which the relevant 1st and 2nd line teams have identified and assessed how climate risk impacts the firm and its entities/divisions
- Assess skills and resources of the firm to champion and commit to managing climate risks including how ESG is embedded in the firm's strategy
- Establish how climate risk is considered operationally and how investment decisions are made
- Where relevant, determine how TCFD or TCFD-aligned disclosures have been embedded and the quality and completeness of these
- Evaluate the adequacy of scenarios considered by firms
- Consider how the actuarial team input and consider climate risk scenarios and determine if appropriate
- Review the approach firms have taken to net zero and ensure accountability and suitable governance
- Assess business strategy against public statements to ensure achievable
- Assess whether the Firm has the adequate technical skills and knowledge to work towards net zero
- Assess the impact and monitoring of net zero across the organisation.

Other internal audit topics to consider:

There are several other areas that should be considered in Internal Audit plans that reflect FCA and PRA priorities. For example, the Dear CEO letter issued in September 2021: FCA Supervision Strategy for Lloyd's & London Market Insurers and Others.

We summarise other key topics below, that have previously featured on the regulator's horizon, and will mirror the regulatory business plans and continue to be areas in focus:

Governance, culture and embedding SM&CR

A number of additional requirements and changes have been made since SM&CR was implemented for insurers. For solo regulated firms, the first set of certified assessments fell due in March 2021 and new rules on consumer duty are being developed. Generally, governance and accountability remain key priorities for the regulators.

Internal audit functions should:

- Assess their Board and governance effectiveness
- Continue to review governance and management structures for adequacy, including the use of example issues and incidents/events as case studies to validate this
- Ensure the SM&CR framework is fully operational and that requirements are being adhered to as expected e.g. fitness and propriety checks for certified staff, training/ reporting over conduct rules and reasonable steps framework.

Diversity and Inclusion ('D&I')

This is an emerging hot topic and a key area of focus in the FCA Business Plan and PRA priorities. The FCA wants firms to have more diverse representation at all levels, inclusive cultures and design/deliver products that reflects the diverse needs of consumers. The FCA expect to see better data collection by firms but it is unclear how they will measure progress.

The FCA plans to publish its own diversity indicators and intends to develop mechanisms to measure firms' progress against diversity outcomes.

Board members should ensure they are familiar with their own firms' statistics and have a strategy to make improvements where necessary.

Firms should ensure:

- Boards are charged with and committed to promote and monitor D&I
- Clear accountability to link SM&CR, culture and D&I
- D&I is operating in the firm – succession planning, remuneration, HR/recruitment including adequate policies and procedures
- Public reporting of diversity data and D&I policies. Firms have experienced challenges in collating adequate and accurate data. Whilst there is no requirement for any reporting currently, it is expected that there will be new regulatory requirements as indicated in the July 2021 discussion paper published by the three financial services regulators "DP21/2 Diversity and inclusion in the financial sector- working together to drive change".

Conduct and vulnerable customers

The FCA will finalise/introduce any new Consumer Duty rules before 31 July 2022. In addition, as a result of Covid-19 and the economic environment, the population of vulnerable customers is increasing. The FCA finalised guidance on the fair treatment of vulnerable customers and this is a key focus point in their 2022 Business Plan.

Firms should:

- Ensure policies and procedures reflect fair treatment to customers throughout the whole customer journey and retain good evidence of its application in practice
- Refresh training and communications to ensure policies and procedures are practiced and that staff are aware of the drivers of vulnerability
- Ensure the business model and culture reflects fair treatment of customers
- Be able to demonstrate actions from the FG21/1 guidance using the firm's own judgement on the fair treatment of vulnerable customers
- Demonstrate in their processes/control that they have assessed and incorporated the FCA key areas.

Internal audit should:

- Review how firms have actioned and implemented the Consumer Duty rules within their policies, procedures, any training/ communication materials and business models
- How the first and second lines monitor/ review application and embedding of treatment of consumers and take suitable remedial actions
- Assess whether firms have considered and implemented appropriate actions from all relevant regulatory guidance/policies.

Furthermore, it is recommended that internal audit functions review the various guidance documentation and ensure that firms are adhering to the FCA's published policy statement PS21/5 with its final rules on GI pricing practices in May 2021 and PS21/11 General insurance pricing practices – Amendments in August 2021.

The system, controls and product governance rules came into force on 1 October 2021 and rules in relation to premium finance disclosure, pricing and auto-renewal remedies, reporting requirements, and related glossary and administrative changes came into force on 1 January 2022.

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Priority for 2021 should have been design of controls, systems and preparing a method to implement and report on this basis. In 2022, firms should focus on implementation and readiness.

Internal audit should consider the following:

- Governance and approval of technical decisions
- The quality of controls over the financial reporting process before it goes live in 2022/23 including documentation for external audit reliance
- The transitions to BAU processes and controls
- Management of critical resources and skilled staff to ensure technical accuracy.

Regulatory and Internal Audit priorities for 2022

Financial crime and fraud management

Emerging risks such as increased cybercrime during the pandemic, increased use of crypto currency and and the sanctions regime post Brexit, are creating opportunities for fraud and finance crime. The 5th EU Money Laundering Directive came into force in January 2020.

The FCA aims to reduce fraud. It supports the Investment Fraud Online Safety Bill, and is being lobbied to extend this to online marketing too.

The risk is relatively low in the insurance sector. The main relevance is whistleblowing in relation to financial crime/fraud.

Internal audit should focus on the quality of:

- Fraud risk assessment procedures across the firm/teams
- The identification and assessment of the controls in place
- The firm's governance framework
- Policies and procedures
- Awareness and education.

Financial resilience

The FCA believes that firms with weak financial resilience are more likely to fail.

Therefore, the FCA will focus on leveraging data to monitor the financial resilience of solo regulated firms and will target interventions at those firms with weak financial resilience. The FCA will also review elements of the compensation framework to ensure it remains appropriate and proportionate.

It is recommended that firms have:

- Appropriate capital, liquidity and reserves and achieve orderly wind down
- Proportionate level of financial resources

Increased monitoring and supervision in this area should be expected.

Firms should:

- Assess and regularly monitor the strength of their financial position and assess and quantify threats to financial resilience via stress and scenario testing
- Develop a long-term strategy and ensure there are appropriate capital, liquidity and reserves, including appropriate/relevant stress testing
- Have effective governance and oversight including an appropriate risk appetite statement and metrics

- Ensure any client monies held are adequately protected
- Develop appropriate and robust wind-down plans.

Internal audit should review the firms liquidity risk management framework, risk assessment, stress testing, risk appetite setting, liquidity buffer setting, risk monitoring, and contingency planning.

UK controls framework

The Department of Business, Energy & Industrial Strategy (BEIS) has revealed options for firms in overseeing the strength of internal controls; Directors to attest to the strength of internal controls; external audit reports to cover work performed on internal controls without forming an opinion; and formal opinion on the strength of internal controls by the external auditor. The preferred option is a Director's statement about the effectiveness of controls. This will be a considerable task for many smaller firms.

Whilst there is no clear indication of when the approach will be finalised, internal audit functions should consider completing a readiness assessment in the future, most likely in 2022/23, and when further guidance is released. Firms should start considering their Financial Controls Framework/readiness and consider any additional guidance released in 2022.

Reserving and exposure management

The PRA issued a 'Dear CRO' letter to insurance firms in November 2020 focussing on reserving & exposure management. Firms should have reviewed this and addressed the outcomes from this letter, specifically:

- Reserving challenges due to longer tail lines
- Weak reserving assumptions/reserve estimates - due to limited claims history in the large claims ultimate loss ratio assumption used in both the business plan as well as other assumptions in reserving methods can cause an area of judgement that is subjective and difficult to assess. Expert judgment tends to be optimistic rather than based on measuring the potential exposure from the written or target risk profile and then mitigating with the use of reinsurance
- Risk appetites and exposure management controls
- Additional complexities and uncertainty in estimating losses due to Covid-19
- Risk and capital management frameworks and stress testing capabilities to consider contract uncertainty risk.

In addition, the PRA has recently highlighted the impact of current inflation levels on the cost of claims. Internal audit should consider these risk areas in exposure management and reserving audits.

Operational resilience

Final Policy Statements were issued by the regulators in March 2021 and requirements need to be implemented by March 2022. Firms should be able to adhere to impact tolerances by March 2025.

In scope firms are required to establish their operational resilience frameworks by 31 March 2022. By this time, they need to have identified their important business services; set impact tolerances; performed a mapping of people, processes, technology, facilities and information; and performed scenario testing to a sufficient level. Firms have a further three years to demonstrate they can remain within the impact tolerances they have set.

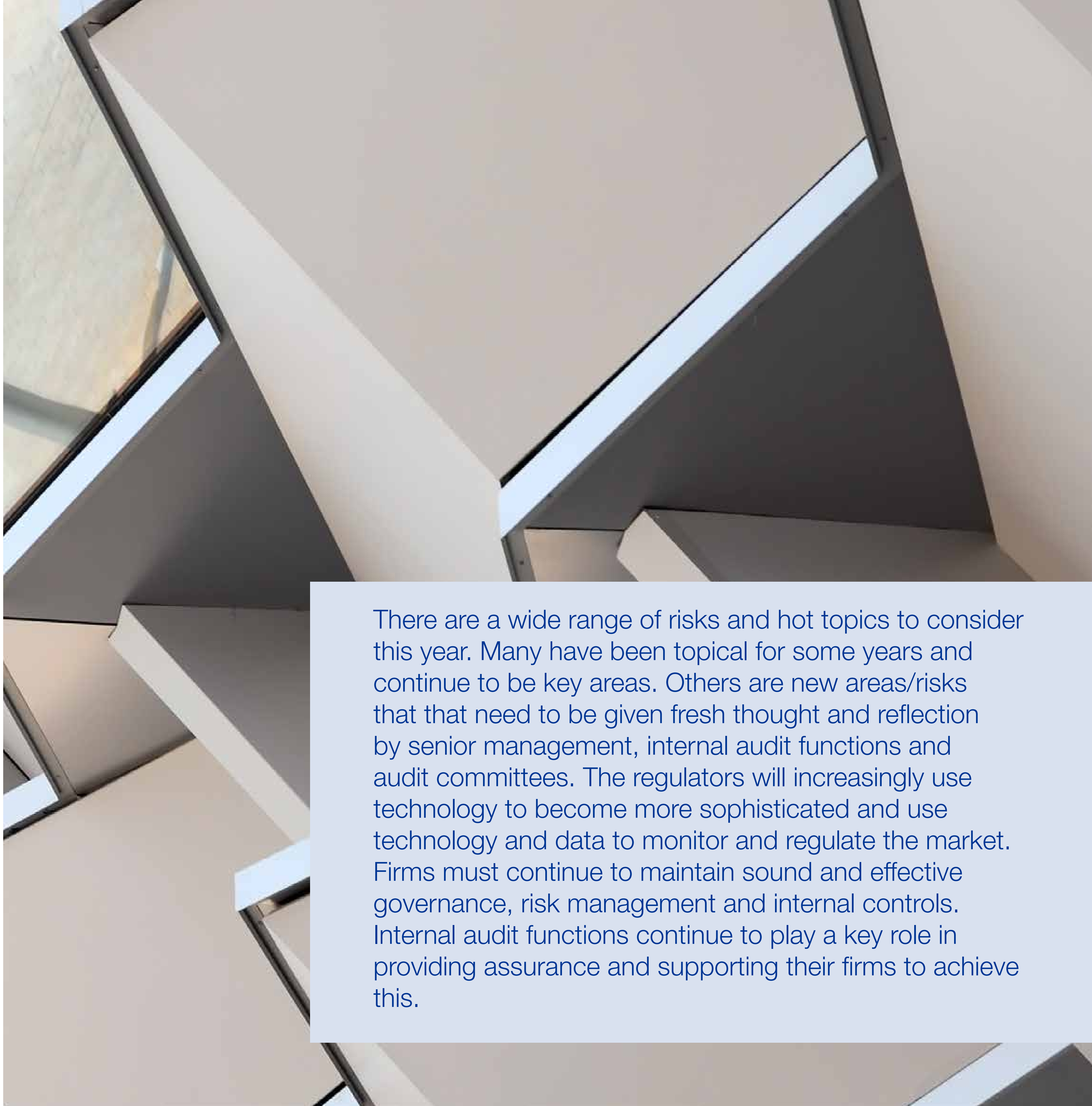
Internal audit functions should ensure they have the right expertise and experience to perform operational resilience audits. Their initial focus should be on the firm's application of the regulatory requirements and the adequacy of the various components and overall framework that has been established, including governance oversight and documentation. Given the important, holistic view that internal audit functions have over their firms, they are likely to have valuable insights around key operational risks, dependencies and vulnerabilities.

IT related hot topics

Firms should also consider the following:

- Cyber governance and security
- Cyber security
- Data governance
- IT strategy and governance
- Legacy systems
- IT change and transformation.

Overall, the major risk is still cyber security, protecting systems and data from unauthorised or inappropriate access. Although it is likely that there is already a focus on cyber security generally, there are certain areas arising from the ever-changing IT risk landscape that merit closer attention than previously. In particular, the reliance on Cloud-based infrastructure and applications brings its own challenges which are often not well understood or mitigated as they require different skill sets to traditional computing environments. Linked to this is the increasing use of specialist third-parties to provide services and software and the need for appropriate ongoing due diligence and to ensure that the respective roles and responsibilities are appropriate and clearly understood. Finally, given the increasing levels of ransomware attacks, firms should have a detailed plan of action to protect against and respond to a ransomware attack.



There are a wide range of risks and hot topics to consider this year. Many have been topical for some years and continue to be key areas. Others are new areas/risks that that need to be given fresh thought and reflection by senior management, internal audit functions and audit committees. The regulators will increasingly use technology to become more sophisticated and use technology and data to monitor and regulate the market. Firms must continue to maintain sound and effective governance, risk management and internal controls. Internal audit functions continue to play a key role in providing assurance and supporting their firms to achieve this.

Our expert team can help you

To find out more please contact us.

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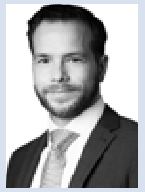

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