Insurance sector risks & priorities for 2023

A guide for carriers and intermediaries

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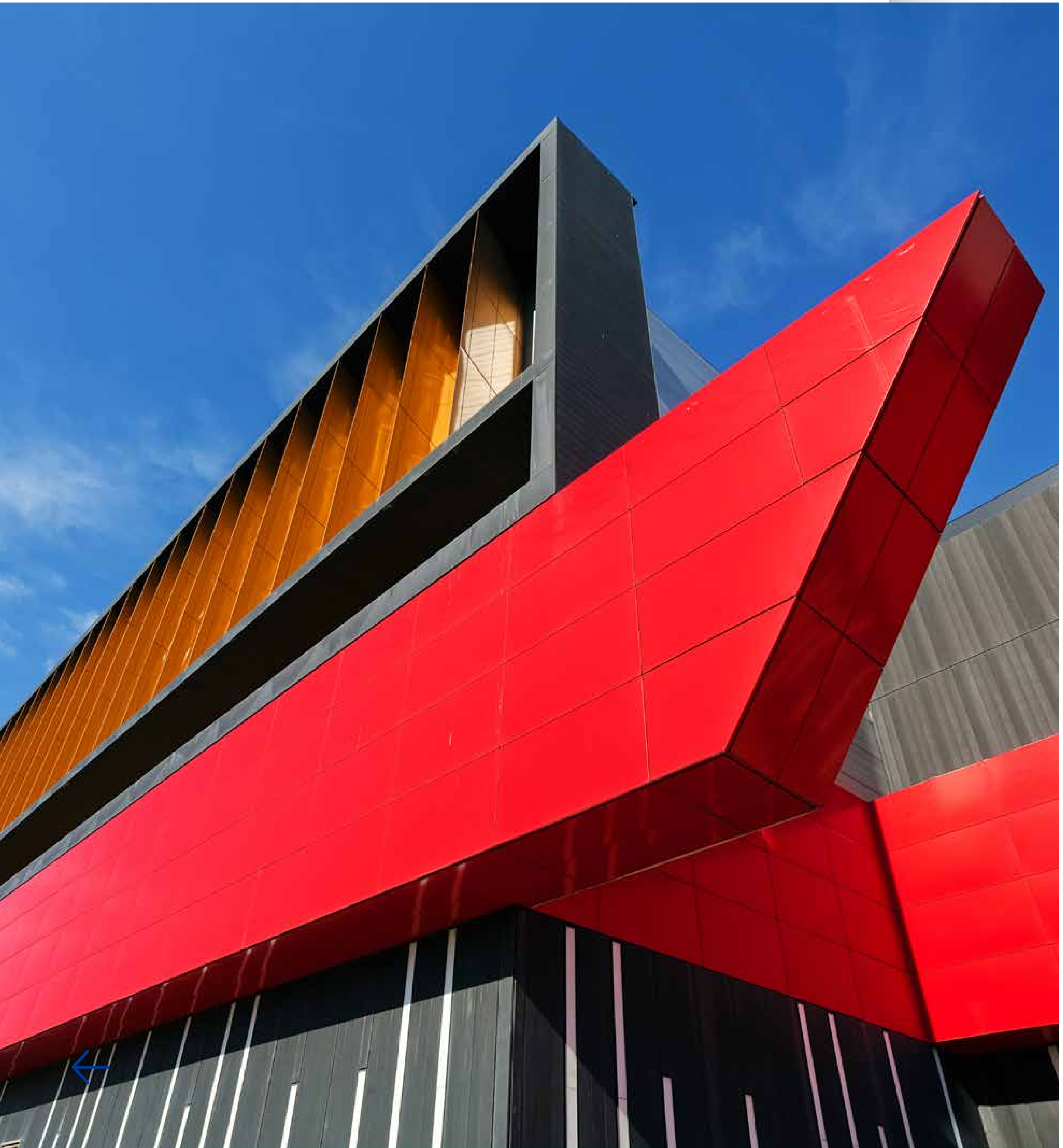

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Insurance sector risks & priorities for 2023

In January, we published our views on the issues facing insurance sector firms and their internal audit functions during 2022. We highlighted that recent years have seen considerable challenge and change, primarily as a result of the Covid-19 pandemic. It is fair to say that challenge and change has continued as a theme into 2022, but for different (and often connected) reasons.

The beginning of the year was marked with the Russian invasion of Ukraine which, in addition to the tragic human cost, has had widespread economic and political impacts across the globe. In the UK, we have seen economic challenges and political uncertainty with the rising costs of living, an energy crisis and appointment of a new Prime Minister.

Firms in the financial services sector have had to navigate this macro environment at the same time as facing increased regulatory pressure. There has been a raft of regulatory change including the implementation of operational resilience requirements, and final rules for a new appointed representative regime and a new Consumer Duty. Meanwhile, HMT's Review of Solvency II earmarks future changes to the regulatory framework that firms will need to navigate.

As we look ahead to what 2023 has in store, there are a number of important topics that should be "front of mind" for firms and their internal audit functions. We have categorised these into five areas and further details can be found on the following pages:

Please get in touch if you'd like to discuss any of these topics with us and help you to understand and assess how they impact your firm.

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Protecting the consumer

Consumer Duty

The FCA has released its final rules and guidance on Consumer Duty (CP21/36). The rules introduce a new Consumer Principle that requires firms to act to deliver good outcomes for retail customers and cross-cutting rules providing greater clarity on the FCA's expectations.

The FCA is looking at the market to move quickly and adopt the new Consumer Duty. The implementation timetable for affected firms includes:

- By the end of October 2022, firms should have agreed and formalised their implementation plans and be able to evidence effective scrutiny and challenge.
- Product manufacturers should aim to complete existing product reviews by April 2023.
- Output from product reviews should be shared with product distributors by the end of April 2023 to allow time to meet their obligations.
- Implement any remedies to existing open products by the end of July 2023.

What does this mean for you?

- Have you developed and formalised your implementation plans and have you retained sufficient evidence of challenge within your governance arrangements?
- Have you identified and recorded existing open and closed products in scope for Consumer Duty requirements?
- Have you prioritised reviews in-line with the potential risk posed by the products to customers?
- Have you identified and communicated with distributors to align review and remediation activities for open products?

Product development and reporting

In May 2021, the FCA published its feedback and final rules (PS21/5) on General Insurance (GI) pricing practices, setting out new governance, review and reporting requirements for product manufacturers and distributors in the GI market.

The rules include specific reporting requirements and timeframes for firms to report products to the FCA and ensure that effective and timely review of products is conducted to mitigate the risk of consumer harm.

What does this mean for you?

- Have you allocated the product oversight and attestation role to a suitable Senior Managers & Certification Regime (SM&CR) role holder? Do they have the skills and experience to attest on the value provided by products to the GI market?
- Have you defined and embedded relevant data capture across the key features of GI products?
- Do you have effective systems and processes to ensure data is captured and reported effectively and in line with regulatory timeframes (commenced 30 September 2022)?
- Have you adopted the changes to PROD 4 relevant to your product governance and fair value review activities?

Financial management

Financial resilience

Financial resilience is the ability of firms to withstand events that affect their capital structure, liquidity, revenue and assets. Uncertainty in financial risks can influence financial performance, affecting the value that stakeholders place on firms.

Both the FCA and PRA are continuing to focus on the importance of financial resilience and the need to have the resources and flexibility to respond to a range of different shocks. In light of the current financial climate, this continued focus is unlikely to abate.

For insurers, the PRA set out its concerns around financial resilience in a changing economic and claims environment at the beginning of the year. These challenges remain and it is important that insurers regularly monitor their liquidity and solvency positions.

For intermediaries, the FCA has been closely monitoring firms through its financial resilience survey. It has highlighted the importance of a prudent approach to financial management, the need for adequate protection of client money and maintenance of suitable wind-down plans.

What does this mean for you?

- Financial resilience must be a top priority for firms and subject to regular review and testing for a range of stresses and scenarios.
- Key assumptions underlying financial forecasts, including inflation, should be carefully considered by the business and subject to governance oversight.
- Comprehensive wind-down plans should be established in accordance with the FCA's latest "Wind-down Planning Guide".
- Adopt a forward-thinking approach to demands on liquidity and impact on capital levels.

Financial controls / UK SOX

The UK Government's Department for Business, Energy and Industrial Strategy (BEIS) published its response to reforming corporate governance and audit on 31 May 2022. This confirmed that proposals to introduce UK SOX have been dropped. Whilst many may have breathed a sigh of relief, the prospect of tighter control framework requirements is not off the table.

The FRC (soon to be ARGA) has taken up the mandate from BEIS to put more emphasis on control environment attestation for corporate entities in the UK. New FRC Chair, Sir Jan du Plessis, pledged in June 2022 that the FRC will hold directors to account with a version of UK SOX – "It won't be Sarbanes-Oxley, but it is the same idea."

At PKF, we are seeing a number of firms looking to better formalise their financial control frameworks. This is often driven by a desire to aid external auditors to move to a controls-based audit but there are wider benefits to improving financial controls.

What does this mean for you?

- All firms should consider if there are any steps that need to be taken to enhance control culture and documentation of key financial controls.
- Are financial controls sufficiently formalised and robust to support complete, accurate and timely financial reporting?
- How does your Audit Committee gain assurance and is it satisfied with the robustness of financial controls? Is greater assurance needed in this area?
- Is the Internal Audit (IA) function within your firm adequately set up to help the business by providing assessments of framework and control maturity?
- What are external stakeholder expectations in this area and are they being met?

Increasing cost of living/inflation

No-one is immune to rising inflation and the increasing costs of living. The Bank of England has said it now sees UK inflation peaking at 11% in October and remaining above 10% for a few months before starting to come down.

In order to combat inflation and bring it back to its 2% target, the Bank of England has been raising interest rates since December 2021 and further rate increases are expected in the coming months.

The UK Prime Minister has also now announced measures to tackle the rising costs of living, but these come at a cost, which will have wider and more long term effects on the economy as a whole.

For firms in the insurance sector, rising inflation has multiple effects on customers, claims costs and reserving and operational expenses.

What does this mean for you?

- Firms need to be aware and address enhanced FCA expectation that the financial sector serves and supports its customers at this time. In particular, additional consideration of increased customer vulnerability, e.g. due to financial difficulties, is needed where applicable.
- Firms should implement close monitoring of risks around general economic and social inflation and its impact on the cost of claims. We expect these risks to be reflected in risk management frameworks / registers and subject to regular review and discussion at relevant governance committees.
- Rising inflation needs to be factored into pricing models, reserving assumptions and business plans. Management needs to satisfy itself that appropriate allowance for inflation has been made across these areas and assumptions are reasonable.
- Greater cost control is likely to be necessary in respect of operational costs, particularly staff costs as a result of increasing wage inflation.

CASS 5

The insurance intermediary sector has seen a number of Dear CEO letters and other FCA pronouncements in recent years relating to client money and this continues to be an important priority. The FCA recently stated that “a number of firms have inadequate CASS arrangement and insufficient oversight and control of their client money arrangements.”

In PKF’s experience of conducting CASS and internal audits in this area, a number of common pitfalls and weaknesses prevail in the systems and controls supporting CASS compliance.

Furthermore, where firms are pursuing acquisition and integration strategies, there are significant risks and challenges to ensuring there is suitable protection and oversight of client money arrangements within the new environment.

What does this mean for you?

- Firms must be proactive in this area and regularly review their client money arrangements to ensure they remain fit for purpose. This might involve re-visiting the Dear CEO letter of July 2021 to ensure all areas of FCA concern have been properly addressed and there is effective monitoring and oversight to ensure ongoing compliance.
- Consider the adequacy of CASS systems and controls and ensure there is regular testing across first, second and third lines.
- Where acquisition and integration is a key strategy for your firm, ensure:
- CASS risks and controls are thoroughly investigated as part of due diligence activity.
- There is a clearly defined approach and plan for integrating CASS processes and systems. Where they are not being centralised / integrated, there must be suitable controls and oversight of CASS compliance across all parts of the organisation.
- Boards and the Senior Manager Function holder (SMF) responsible for client money must be able to demonstrate effective governance in this area and ensure it is consistently on the agenda.

Governance, culture & people

Senior Managers & Certification Regime ('SM&CR')

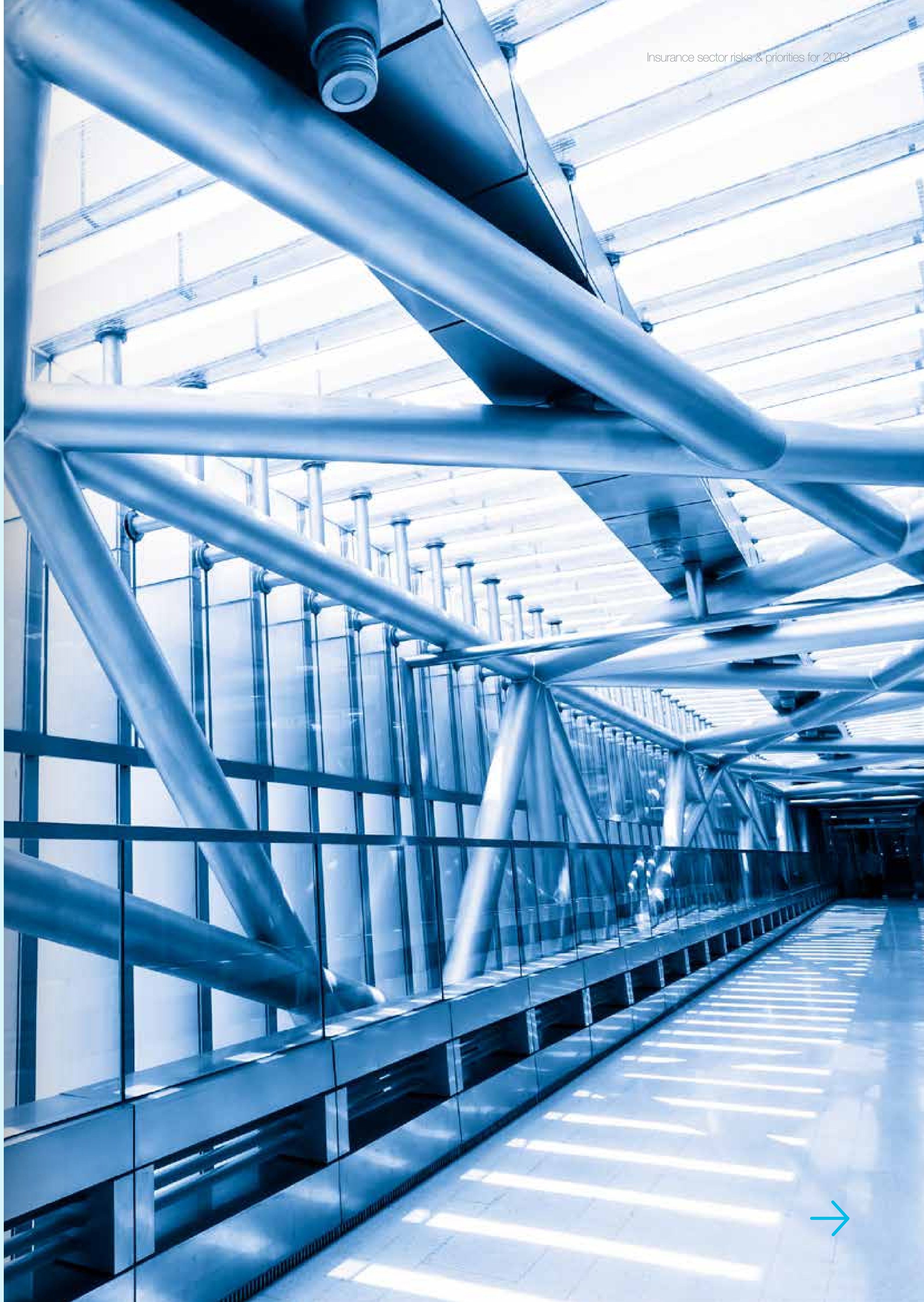
The SM&CR came into force for insurers and intermediaries on 10 December 2018 and 10 December 2019 respectively. The overall aim was to improve accountability and culture within the financial services sector.

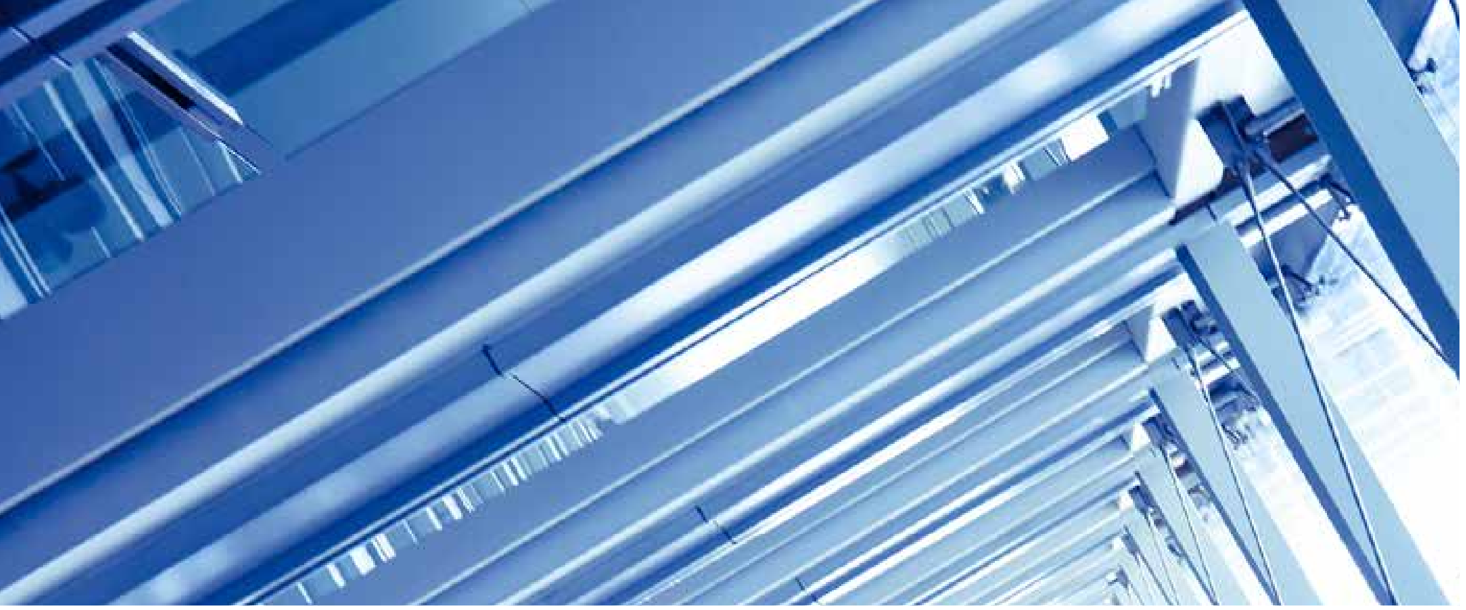
Most firms successfully implemented the new regime but it is clear from FCA and PRA communications that accountability remains a strong focus, underpinning their interactions with firms, and that they will take action where Senior Management Function holders fail to take reasonable steps to govern, manage and control their respective areas of responsibility.

In addition, we are starting to see the FCA require attestations (e.g. for compliance with GI pricing practices, product suitability and Consumer Duty) from Senior Managers being used as a supervisory tool.

What does this mean for you?

- Given the time that has passed since SM&CR came into force and the dynamic nature of the sector and firms within it, firms should review and gain assurance that their SM&CR arrangements remain appropriate.
- It may be necessary to reinforce responsibilities to Senior Managers and provide training, particularly in areas where regulatory expectations have / are changing or increasing, such as operational resilience, Consumer Duty, appointed representatives or Environmental and Social Governance ('ESG').
- Where firms and their Senior Managers are making attestations to the regulators, there must be strong governance and controls around the data and information supporting the attestation.





Talent management & retention

Workforce pressure has been most recently felt through the “Great Resignation”, the ongoing trend in which employees have voluntarily resigned from their jobs en masse, mainly in the wake of Covid-19. Additional pressures on the UK labour market include:

- Brexit limiting the number of European migrants working in the UK;
- Wage inflation encouraging staff to move jobs and gain higher salary; and
- Trend of younger generations becoming less loyal to their employers.

Talent management and retention is continuing to rise up as a key risk and focus for discussion in Board and Audit Committees. In some cases, staff turnover is causing significant operational challenges and disruption with consequential impacts on the stability and effectiveness of the control environment. From a financial perspective, wage inflation and recruitment costs are incredibly high so retention of staff is considered critical, with regular pay reviews, wellbeing initiatives etc being deployed to help manage this.

What does this mean for you?

Firms should:

- Be pro-active in identifying any resource gaps and ensuring they are being adequately and appropriately filled.
- Assess if retention measures are necessary to ensure they keep hold of their top talent for as long as possible.
- Develop succession plans to ensure that unforeseen loss or unavailability of staff can be suitably managed.
- Conduct regular staff listening activities / surveys to ensure that organisational culture and talent management practices are effective and meeting the expectations of employees.

Diversity & inclusion (‘D&I’)

D&I is an important aspect of organisational culture. Firms with high awareness of, and provision for, D&I tend to have a good overall culture. Staff at every level of an organisation are responsible for making it welcoming to all and representative of the community it serves.

Not all organisations put adequate emphasis on D&I and various pressures exist for these firms to act now:

Talent pressures
New entrants to the job market are more diverse and socially conscious, with many already making decisions about their careers based on their values. This trend is set to continue, so firms need to be proactive if they want to attract and retain strong talent.

Supply chain pressures
Firms are increasingly expanding their due diligence activities on their suppliers and commercial partners to include value measures such as D&I.

Legislation and regulatory pressures
Gender pay gap reporting has been mandatory for large employers in the UK for a few years. Ethnicity pay gap reporting is rumoured to follow in due course.

The FCA has issued a policy statement regarding diversity and inclusion on company boards and executive management for UK listed entities. For the wider financial services sector, a consultation paper on improving diversity is expected imminently.

For those operating within Lloyd’s, the new Principles for Doing Business include a culture element, which states that Managing Agents should be inclusive, creating a diverse high-performance culture. Recent appointments of Chief People Officer and Head of Culture at Lloyd’s, look set to increase the focus on culture within the market.

What does this mean for you?

- Where on your D&I journey is your firm?
- Is your organisation adequately positioned to retain and attract top talent?
- Are you a market leader, follower or have no profile in this space?
- Is your firm and executive management representative of the customers you serve and the area you operate in?
- Does your organisation have a strategy to ensure D&I objectives are met? Are there any known road blocks in achieving your strategy?
- Are your D&I initiatives well supported by the Board?
- Are you well positioned and ready to carry out discovery or data gathering exercises to determine the diversity within your firm?
- Are the public statements you make on diversity and inclusion well supported?

Operational & IT risks

Operational resilience

Operational resilience has been a key topic in recent years and continues to be so. In-scope firms implemented their operational resilience frameworks in accordance with the first policy milestone of 31 March 2022.

However, it is important that firms do not "rest on their laurels" and think that operational resilience is done. There is now a transition period to 31 March 2025 in which firms are expected to perform scenario testing, refine their frameworks and make necessary changes and investment to ensure they can operate within the impact tolerances they have set.

On 25 May 2022, the PRA made a speech which highlighted that "operational resilience cannot be achieved through compliance alone" and indicated that mapping should rapidly become more sophisticated and scenario testing evolve.

It is important that firms continue to focus on operational resilience during 2023 and achieve the progress the regulators are expecting to see.

What does this mean for you?

- Boards and senior management must continue to focus on their firm's operational resilience as the wider financial sector becomes more dynamic, complex, and reliant on technology and third parties. While outsourcing cloud computing to providers in different countries can improve firms' resilience, it also gives rise to new risks to operations which the regulators expect firms to manage effectively.
- Ensure that your firm can identify and explain its important business services and ensure that impact tolerances can be tested for all important business services identified.
- Firms should regularly review their operational resilience arrangements, particularly where firms are acquiring and changing their business model / structure and systems.
- If they haven't already, internal audit functions should assess whether operational resilience has been correctly implemented within their firms. There should be regular check points across the transition period to ensure that lessons are learned from scenario testing and frameworks are becoming more sophisticated.

Third party risk management

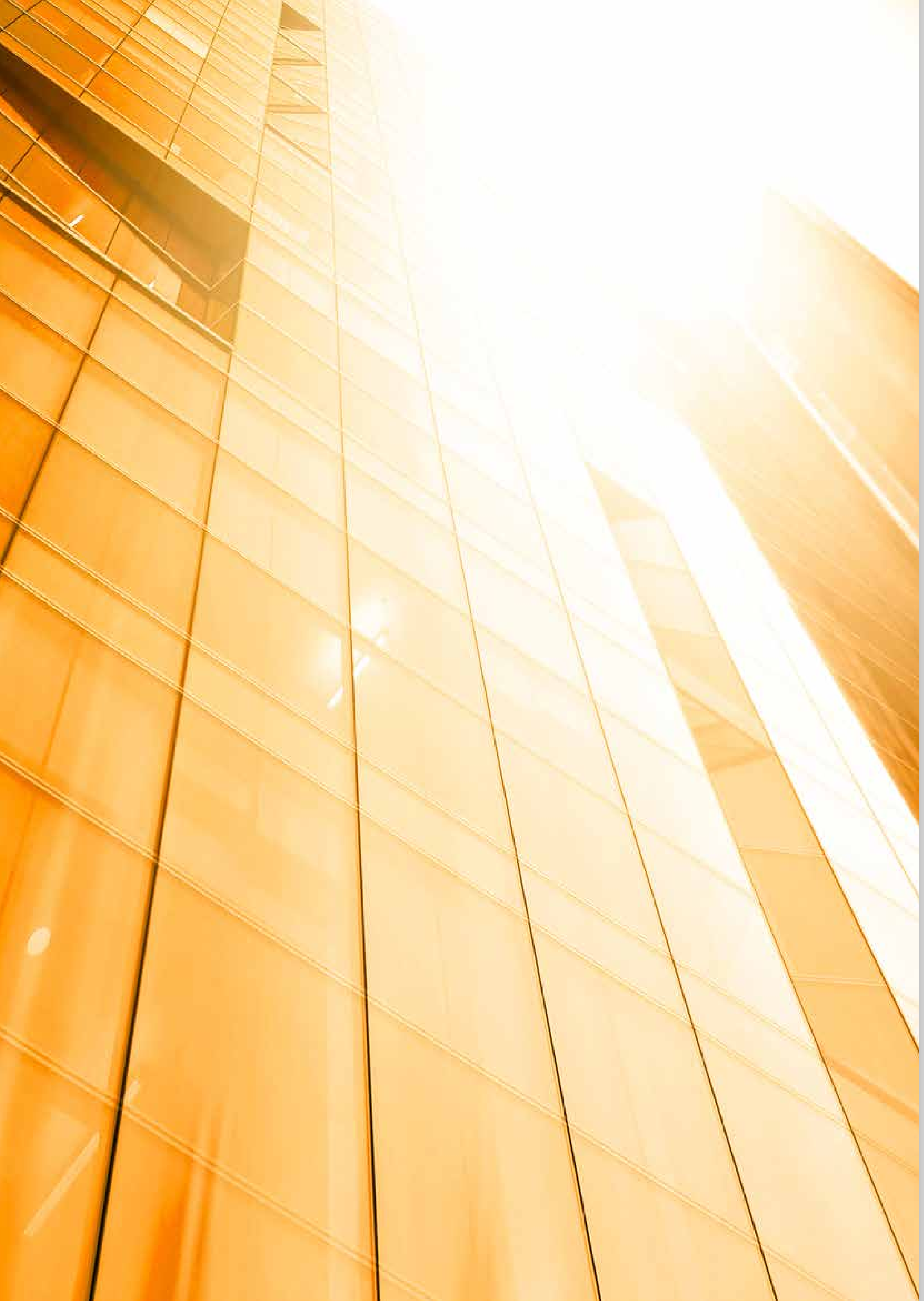
The Discussion Paper 3/22 – Operational resilience: Critical Third Parties (CTP) to the UK financial sector, issued jointly by the PRA, FCA and the Bank of England, discusses how to manage the systemic risks to the financial stability, market integrity and consumer protection of the UK financial services sector posed by certain third parties.

This paper addresses the important role that third parties play in an ever increasing global, complex and technology driven business environment. Third parties help firms deliver products and services to their customers by providing value, knowledge, expertise, competitive advantage, efficiencies and savings. Examples of third parties include (but are not limited to) suppliers, intermediaries and logistics providers.

Managing third-party risk is an ongoing process, rather than just assessing risks at the time of on-boarding. The Discussion Paper proposes the following set of minimum resilience standards that CTPs should have in place: Identification; Mapping; Risk Management; Testing; Post-incident Communication; Learning and Evolving.

What does this mean for you?

- Ensure that an appropriate level of due diligence is undertaken before a decision is taken whether to enter into an agreement with a potential third party.
- Ensure that a risk-based approach is used to help you design, implement and test third party risk and compliance programmes.
- Define the critical security, privacy, and business continuity controls third parties should have in place before they are permitted to work with your firm.
- Ensure policies, procedures and controls are in place to monitor third parties on an ongoing basis.
- Ensure that a system is in place to identify and record issues and incidents arising from your firm's interactions with third parties and how they were resolved.



Cyber security

In light of Russia's invasion of Ukraine, the National Cyber Security Centre (NCSC) has called for all organisations, especially financial services firms, to increase their cyber security vigilance.

It is not uncommon for the threats faced by firms to vary over time, and there is a need to strike a balance between the current threat, the measures needed to defend against it, the implications and cost of those defences and the overall risk this presents.

In PKF's experience, firms are unlikely to make widespread system changes quickly in response to a change in threat, but they should make every effort to strengthen their cyber security defences on an ongoing basis.

What does this mean for you?

- The most important thing for firms of all sizes is to make sure that fundamentals of cyber security are in place to protect their devices, networks and systems.
- Ensure all devices, third party software such as browsers, office productivity suites and internet facing services are updated and patched for known security vulnerabilities.
- Ensure access (normal or privileged) to the network and applications is only granted to authorised users (whether internal or external), the use of robust passwords is enforced and that access no longer required is revoked in a timely manner.
- Ensure that robust cyber security controls are in place to detect and protect against threats arising from malware e.g. ransomware, phishing emails, Denial of Service, password attacks, and social engineering; and that recovery plans are in place should your network become compromised.
- Confirm backups are running correctly by performing test restores.

Regulatory change

Environmental, Social & Governance ('ESG') reporting

Through 2022 we have seen an increasing interest from investors, regulators, clients and other stakeholders on firms' Environmental and Social Governance (ESG) disclosure and activities. The UK intends to make TCFD-aligned disclosures mandatory across the economy by 2025, with a significant portion of mandatory requirements in place by 2023.

What does this mean for you?

- Have you adapted existing governance arrangement to demonstrate consideration and focus on ESG elements?
- Have you conducted an analysis on your current ESG credentials?
- Have you considered your ESG strategy and commitments?
- Have you established processes and systems to record, analyse and report TCFD-aligned disclosures within a formal governance framework?
- Have you considered limited or reasonable assurance over qualitative and quantitative disclosures?

Appointed representatives ('ARs')

The FCA has finalised its rules and guidance for principals on improving the AR regime. Principals must ensure they continue to meet these enhanced requirements and provide information on, and analysis of, AR business models, complaints and revenue information within the expected timeframes.

What does this mean for you?

- Do you act as principal for one or more ARs and do you have a strong understanding of the activities that your ARs perform?
- Have you established processes to assess and report on AR business models and credentials?
- Do you and your ARs have effective systems and processes to define, record and report complaints and revenue information within 60 days of your account reference dates?

Back branching

31 December 2022 sees the end of the Temporary Permission Regime (TPR) for UK branches of EEA domicile intermediaries. Most firms have received 'landing slots' and have completed relevant applications for FCA licencing.

The transition from the TPR to full FCA oversight brings with it increased regulatory scrutiny and expectations, including oversight and financial resilience.

The FCA has confirmed that client money held at UK branches of EEA domiciled intermediaries will not fall under the FCA jurisdiction, but will fall under the relevant home state regulator.

What does this mean for you?

- Have you established effective oversight, including roles and responsibilities and SM&CR requirements?
- Have you identified and tested financial resilience scenarios?
- Have you reviewed and considered commercial / contractual agreements between regulated or services companies?
- Have you established and maintained the correct client asset permissions under home state regulator?

Solvency II review

HM Treasury published its consultation on the Review of Solvency II in April 2022. The review aims to "ensure that the UK's prudential regulatory regime is better tailored to reflect the particular structures, products and business models of the UK insurance sector and the wider UK regulatory approach." The consultation closed in July 2022 and the responses will inform the final package of reforms.

The proposed reforms include a reduction in risk margin, changes to the calculation of the matching adjustment, increased flexibility to allow more investment in long term assets and reduction in EU-derived regulations which contribute to reporting and administrative burdens.

What does this mean for you?

- At this stage, firms should have a watching brief on the proposed reforms and their potential impact, such as:
- Firms using internal models will need to re-evaluate / design their models to reflect the changes.
- Decrease in the capital requirements and better capital allocation due to reduction in the risk margin.
- Potential changes to investment strategies to include a wider range of assets as a result of greater flexibility.
- Reduced documentation standards and other requirements relating to internal models.
- Reduced burden on finance teams as a result of reporting reforms.
- Significant benefits to smaller insurers due to the increase in Solvency II thresholds.
- Reduced barriers to entry for new insurers due to the new mobilisation regime.
- The reforms will require changes to legislation and PRA rules and supervisory expectations and will take some time to finalise and be implemented.

About PKF
Simplifying complexity for our clients

PKF is one of the UK's largest and most successful accountancy brands.

With over 150 years' experience in the insurance market, PKF has built up a solid and comprehensive reputation as one of a small number of UK accounting firms with in-depth expertise in supporting businesses, their owners and investors across the insurance industry.

Our Governance Risk & Control Assurance team delivers a range of second- and third-line assurance services across the Lloyd's and London market for insurance carrier and intermediary firms.

We provide a dynamic approach to independent assurance, built around a mutual understanding of what works best for our clients. We offer fully outsourced internal audit functions tailored to the size and complexity of firms, and co-source services using our market and subject matter specialisms to support in-house teams.

How we can help

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- Governance, risk and control assurance →
- Tax →
- Transaction advisory →
- Restucturing →
- Business outsourcing →

PKF UK in numbers

9th
Largest audit practice in the UK in the latest Accountancy Daily rankings

17
Offices across the UK

2,035+
Employees and 167 partners

£182.5m
Fee income and growing rapidly

Insurance industry in numbers

1st
Largest auditor of insurance intermediaries

7th
Largest auditor to general insurers

150+
Insurance industry clients

100+
Insurance specialist staff and partners

PKF International in numbers

Part of the 14th
Largest global accounting network

480
Offices in 150 countries

$1bn+
In aggregate fee income

20,000
Employees

Our expert team can help you

To find out more please contact us.

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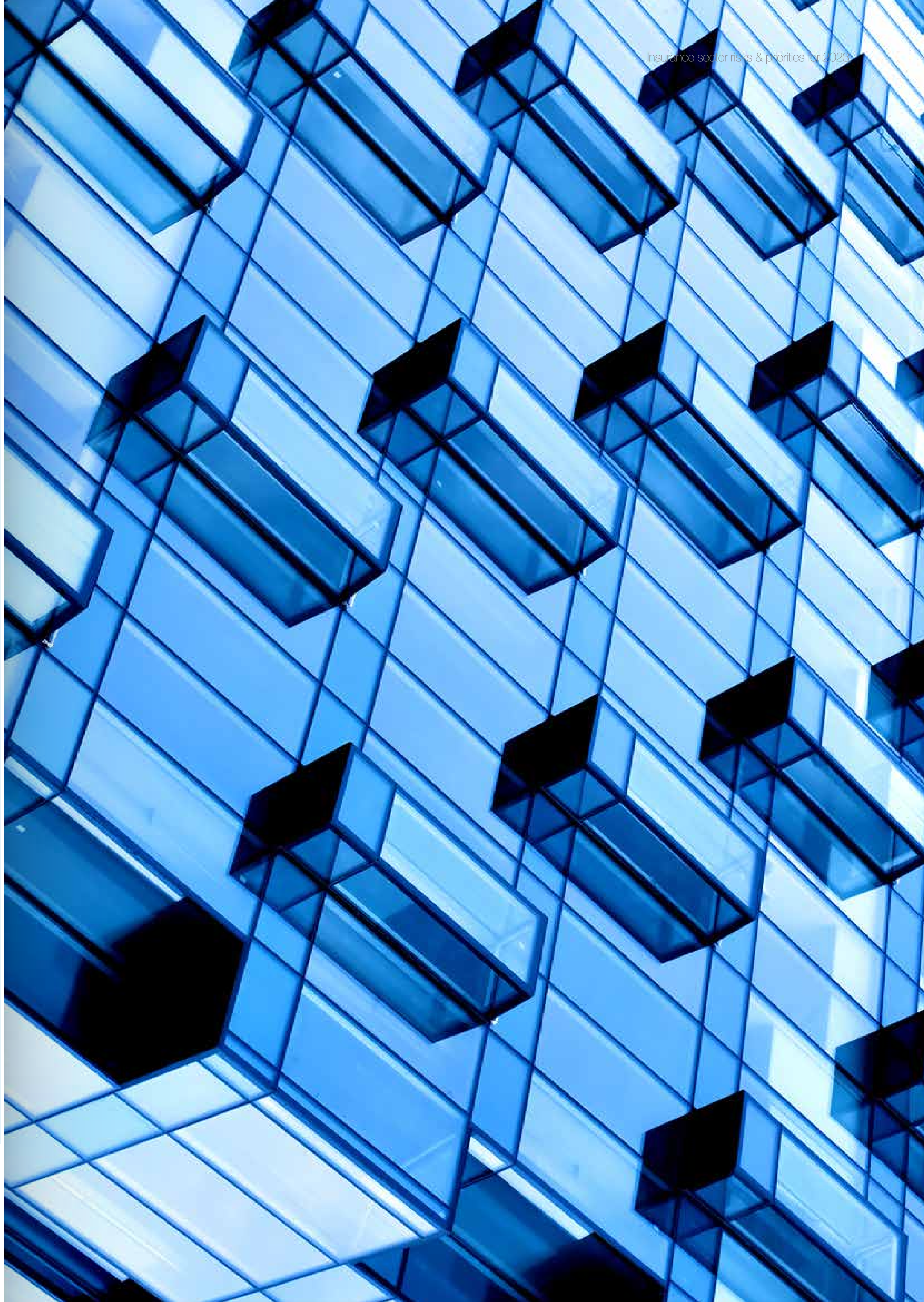

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