Insurance sector risks and priorities for 2024

pkf-l.com

In this publication...

Introduction

We're delighted to share our views on the risks and issues facing insurance sector firms and their internal audit functions in 2024.

At the macroeconomic level, 2023 has been a year of ongoing challenge with continued rising costs and interest rates affecting both firms and households. The insurance sector has had to manage the impact of this on their customers, suppliers and investment portfolios, and their own cost base. Continuing geopolitical instability with the ongoing war in Ukraine as well as increasing tensions with China are impacting global trade and prices. Finally, as I write this, the emergence of a new Covid variant looks set to put the UK healthcare system and society under additional pressure once again.

So, what does 2024 have in store? Maybe not many 'new' issues hitting the headlines, but certainly a continuation and perhaps a re-emphasis on what has come before. IT and cyber risk continues to be at the forefront of every risk survey I've seen published in recent weeks, and the risks relating to rising costs and the need for firms to be financially resilient remain strong. In other areas, the emphasis has changed from last year. Rather than implementing, 2024 will be the year that firms will be embedding Consumer Duty.

We also expect to see progress in Environmental, Social and Governance (ESG), not only because of the wave of extreme weather events in recent months that will impact the insurance sector, including wildfires in Canada and Europe, but also because of increasing regulation and stakeholder expectation in this area.

Internal audit functions play an important role and have a unique position in helping their firms to implement the right governance, risk management and internal controls to manage the risks they face. This publication aims to inform and prioritise those risks for 2024 which we have categorised into five areas:

1. Financial management
2. Governance & culture
3. Operational & IT risk
4. Regulation
5. Environmental, Social & Governance.

As always, PKF is here to help you understand and assess how these risks impact your firm, and how you can reflect them in your internal audit strategies and plans.

Jessica Wills
Partner and Head of Governance, Risk & Control Assurance
+44 (0)20 7516 2229
jwills@pkf-l.com

Financial management

Firms must navigate the complex financial challenges they face from IFRS 17, regulatory demands to remain financially resilience, inflationary pressures and an increasingly complex tax landscape.

Key contacts

Satya Beekarry
Partner
+44 (0)20 7516 2200
sbeekarry@pkf-l.com

Pauline Khong
Actuarial Director
+44 (0)20 7113 3559
pkhong@pkf-l.com

Mimi Chan
Tax Director
+44 (0)20 7516 2264
mchan@pkf-l.com

Samiha Shaikh
Governance, Risk & Control Assurance Director
+44 (0)20 7516 2345
sshaikh@pkf-l.com

IFRS 17

IFRS 17 establishes the principles for the recognition, measurement, presentation and disclosure of insurance contracts and was effective from 1 January 2023. Its objective is to ensure that firms provide relevant information that faithfully represents those insurance contracts and enables users of financial statements to assess the effect that insurance contracts have on a firm's financial position, financial performance and cash flows.

Larger firms are well advanced with their implementation of IFRS 17. Many have carried out IFRS 17 transformation projects to overhaul their financial reporting infrastructure and process. The effects of and risks associated with these changes should be thoroughly assessed, including the impact on the completeness and accuracy of reporting and any knock-on effects on BAU activities within finance functions.

Smaller firms are still in the construction phase of their IFRS 17 projects and are creating back-up plans as pressure builds to deliver opening balance comparatives. The key priority for these firms should be to ensure adequate resourcing, good data management and robust pre- and post-implementation plans.

What does this mean for you?

The implementation of IFRS 17 has a number of financial and operational impacts including changes to the presentation of financial statements and financial performance/profit which will in turn have a knock-on effect on remuneration. Firms and their internal audit functions will need to consider:

- Has a suitable and sustainable operating model for financial reporting been adopted? Ultimately, firms should consider how they can further refresh and refine their finance functions, including streamlining and automating processes as much as possible
- Is the actuarial function effective in supporting IFRS 17 compliance and driving continued improvements? Are the actuarial and finance teams working together effectively to achieve this?
- What assurance is needed from the internal audit function over continued improvements post-implementation?
- Does management and the board have a good understanding of the new MI/reporting and KPIs that are being produced under IFRS 17? These will look different, and firms need to think about how they will monitor financial performance going forward. Similarly, investor reporting under IFRS 17 is likely to need careful consideration to ensure key messages are clear
- Does the firm have sufficient resources and training to cope with the continuing demands of IFRS 17?
- How can the internal audit function better engage with external auditors to identify where assurance over IFRS 17 systems and controls is needed?

Financial resilience

In its Dear CEO letter - Insurance supervision: 2023 priorities in January, the PRA highlighted the impact of the difficult economic outlook on the insurance sector. It emphasised the effect of credit and concentration risks on life insurers and the imporance of conducting stress testing for adverse credit scenarios. Claims inflation is a challenge for general insurers and the effects on pricing, reserving, business planning and capital modelling need to be robustly considered and subject to strong governance, something that was further highlighted in the PRA's recent Dear Chief Actuaries letter – Insights from PRA thematic review of general insurance and capital modelling.

The PRA has continued to monitor financial resilience through its supervisory activities. In January, the PRA published feedback on insurance stress testing and concluded that, whilst firms are resilient to specified stress scenarios, mitigating measures need to be adopted. In the same month, the UK Government consulted on introducing an Insurer Resolution Regime which will give the Bank of England powers to take action to stabilise and manage the failure of an insurer.

For intermediaries, the FCA continues to focus on the importance of a prudent approach to financial management, the need for adequate protection of client money and maintenance of suitable wind-down plans. During 2023, the FCA has consulted on a new financial resilience regulatory return (FIN073) for solo-regulated firms from January 2024. This will allow access to up-to-date financial resilience data so that the FCA can readily assess financial resilience risks and intervene where needed to reduce harm to consumers.

What does this mean for you?

- Financial resilience should continue to be a top priority for all firms and subject to regular review and testing for a range of stresses and scenarios. Firms should adopt a forward-thinking approach to demands on liquidity and impact on capital levels
- Insurers should review the results of the PRA insurance stress testing and thematic review, perform a gap analysis and ensure relevant findings are addressed
- Key assumptions underlying financial forecasts, including inflation, should be regularly considered and subject to governance oversight
- Comprehensive wind-down plans should be established in accordance with the FCA's latest Wind-down Planning Guide. All wind downs and failures should be done without causing harm to consumers and other market participants
- Solo-regulated firms should ensure they can readily produce and submit the data required for FIN073 and have suitable controls in place to ensure the completeness and accuracy of this.

Financial crime and fraud

The FCA has made a clear commitment to proactively identifying financial crime activities to prevent harm to firms and implications for consumers. It continues to invest in technology and join up with partner agencies with a clear response.

Key weaknesses and risks seen in financial crime prevention processes and controls include:

- Lack of clear ownership and blurring of roles and responsibilities, especially between second and third lines
- Limited risk and control assessments – firms failing to identify high risks with little mitigation in place
- Weakness in due diligence, screening systems and onboarding activities resulting in sanction exposures
- Lack of management reporting including exception-based reporting and actions
- Emerging financial crime risks not being assessed with strategic, operational and technological changes
- Non-compliance with new regulatory expectations such as proliferation financing.

What does this mean for you?

- Firms must have clear and dedicated risk assessments for financial crime, with detailed testing and interrogation of the design of controls especially around customer and counterparty onboarding
- Clearly defined and evidenced roles and responsibilities for financial crime and fraud risk management must be established across the three lines model
- The internal audit function should consider financial crime risks in its plans and ensure alignment and adherence to relevant requirements. This includes sanction testing controls, sanction lists used for screening purposes and methodology for conducting proliferation financing risk assessments. Ad hoc or targeted reviews of key risk areas may be beneficial.

Cost of living

There is some good news regarding UK inflation with the Consumer Price Index falling to 7.9% in June 2023 driven by lower energy costs. The Bank of England expects inflation to fall to around 5% by the end of the year, however it is unlikely to return to the 2% target until 2025.

The FCA has focussed on how customers are treated in financially challenging times. Firms must treat customers well throughout the customer journey, and particularly through the claims settlement process.

The FCA's guidance on supporting customers in financial difficulty came into effect on 31 July 2023 and followed the Dear CEO letter released in September 2022. The guide considers how rising costs can ultimately make it harder for consumers to access affordable insurance cover (due to high premiums) and for firms to remain competitive and continue to underwrite certain lines of business.

Furthermore, in July 2023, the FCA released its findings from the review of how home and motor insurers are meeting its expectations over customers and rising costs. Good practices were observed but the following poor practices were seen:

- Delays in settling / handing claims, with root causes being reliance on third parties, claim complexity and supply chain challenges
- Weaknesses in data flow and information sharing between distributors and manufacturers
- Increases in claim complaints resulting from rising claim costs, supply chain limitations and poor communication
- Weak processes and controls to identify vulnerable customers.

What does this mean for you?

- Firms must ensure they understand and can articulate how a customer may experience financial difficulty and have proactive steps and early engagement procedures in place
- Board and senior management should regularly review vulnerable customer policies to include specific characteristics of customers who are vulnerable to financial difficulty
- Firms need to be prepared for increased levels of customer contact and ensure they can support this operationally
- Sales and underwriting procedures should involve reassessing the risk profile of a customer and proactively identifying any vulnerabilities due to financial difficulty. The most suitable and appropriate products should be sold in the customer's best interest
- Firms should design processes to help avoid cancellations by those customers with essential cover e.g. motor insurance that is legally required and other cover that is categorised as recommended
- Firms need to ensure distributors and manufacturers are working in harmony to deliver best customer outcomes and also to ensure the customer is a priority.

Tax

As tax becomes increasingly complex and greater emphasis placed on tax transparency, there are a number of tax developments to consider for the year ahead and areas of tax that HMRC is focusing on. Key changes are:

- Corporation tax increased from 19% to 25% on 1 April 2023. The interest rate on late payment of corporation tax rose to 7.75% in August 2023, which marks a 5% increase since January 2022
- From 1 April 2023 there were some changes to the capital allowances legislation and the Annual Investment Allowance (AIA) cap of £1m became permanent
- HMRC has made significant changes to the R&D schemes
- UK Pillar 2 minimum tax legislation (which sets a global minimum effective tax rate of 15%) applies to companies/groups with annual consolidated turnover exceeding €750m for accounting periods that begin on or after 31 December 2023
- Country by Country Reporting (CbCR) applies to cross border groups with €750m consolidated turnover. In the context of ESG reporting and steps towards greater tax transparency, a new EU directive mandates public CbCR for financial years starting or after June 2024 and requires groups that are EU parented or groups with EU subsidiaries or branches of a certain size to report
- The UK has legislated that groups with a CbCR requirement are obliged to maintain an OECD Master File and Local File (prescribed and standard formats of transfer pricing documentation) for accounting periods beginning on or after 1 April 2023. Groups also need to be aware of other country requirements for the jurisdictions that they operate in. Applicable thresholds, filing and transfer pricing documentation requirements can differ
- HMRC continues to focus on the use of contractors and whether in fact these individuals are really employees. The responsibility lies with the employer to determine the employee/contractor status. If a contractor is in fact and employee, the firm has the obligation to add them to its payroll and deduct tax and Class 1 NI
- Hybrid working continues to feature for firms keen to attract and retain talent; however, there are some tax implications where other countries are involved
- UK resident Directors, UK non-resident Directors and non-executive Directors of UK firms are of particular interest to HMRC and expect them to appear on the UK payroll
- Following the UK's withdrawal from the EU, many UK-based insurance groups have set up companies and/or branches in EU member states to continue writing EU insurance business. There are specific partial exemption provisions that exclude supplies made from overseas establishments from the UK partial exemption calculations
- HMRC has recently been targeting insurers with a sectorised partial exemption special method (PESM) to check if they are correctly applying their PESMs.

What does this mean for you?

It is increasingly important for firms to ensure that they have sound tax advice and support, especially large or complex groups. Internal audit functions typically focus less on tax due to firm's having external tax advice and support, however they should consider tax risk and controls within their audit universe and plans.

Firms under the Senior Accounting Officers (SAO) regime must take extra care when providing SAO certification to HMRC that tax governance, procedures and controls to manage tax risks are maintained. Internal audit functions can play a role in providing assurance over the effectiveness of these controls.

In response to recent tax developments, firms should ensure they have adequate tax systems and controls, including:

- Processes and controls to ensure that payment deadlines are met and, with the higher tax rates, that payments on account can be estimated with greater accuracy. An 'overpayment' of estimated tax should be made in order to minimise exposure to interest
- Procedures to ensure accurate treatment of any potential capital allowance claims and any CIS and VAT considerations
- Processes to ensure any R&D tax relief claims are being made accurately
- Assessment of potential exposure to UK Pillar 2 minimum tax legislation
- Monitoring to ensure compliance with the transfer pricing responsibilities including additional compliance requirements that may come if the Summary Audit Trail and the International Dealings Schedule are introduced
- Seeking advice where firms have staff working overseas as they may be creating a taxable presence both for themselves and the firm in a second country. Procedures should be reviewed to ensure that there is no inadvertent creation of overseas permanent establishments and that changes such as the recent consultation reviewing the definition of a permanent establishment are considered
- Controls around the regular review of Directors' pay structure to ensure compliance with UK tax and social security rules
- Periodic review of partial exemptions methods and calculations.

Governance & culture

Effective governance and strong culture remain critical for firms from both a commercial and regulatory perspective.

Key contacts

Jessica Wills
Partner and Head of Governance,
Risk & Control Assurance
+44 (0)20 7516 2229
jwills@pkf-l.com

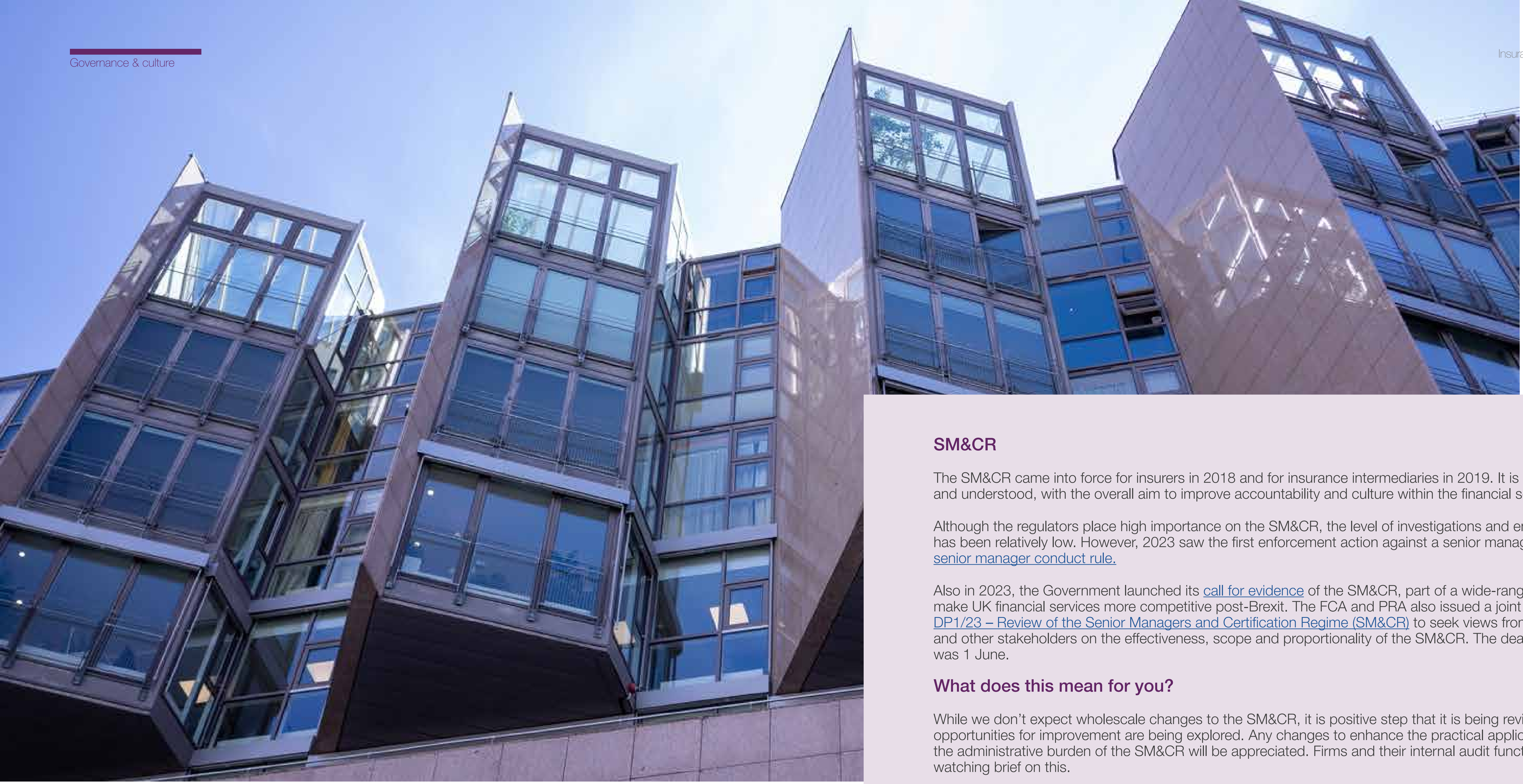
UK Corporate Governance Code

In May, the FRC launched a consultation document on changes to the UK Corporate Governance Code which address the policy issues raised the the UK Government in its white paper on Restoring Trust in Audit and Corporate Governance. They focus on the areas of internal control, assurance and resilience and will apply to accounting years that start on or after 1 January 2025.

What does this mean for you?

A summary of the proposed changes and potential implications for firms has been recently published on PKF's website. Internal audit functions should specifically consider:

- When reviewing governance arrangements, whether the firm is adequately considering governance outcomes as well as the governance structure / process
- In response to the new Code, whether the board requires greater assurance from the internal audit function in areas such as ESG strategy, embedding culture, the adequacy of succession planning, and the effectiveness of the firm's diversity and inclusion policy
- How the internal audit function will contribute to the development of the Audit and Assurance Policy (for PIEs)
- What additional or specific outputs will internal audit need to deliver to support the board's declaration on internal controls
- What additional engagement is needed with the audit committee to support its enhanced remit under the Code.



SM&CR

The SM&CR came into force for insurers in 2018 and for insurance intermediaries in 2019. It is now well established and understood, with the overall aim to improve accountability and culture within the financial services sector.

Although the regulators place high importance on the SM&CR, the level of investigations and enforcement action has been relatively low. However, 2023 saw the first enforcement action against a senior manager for a breach of a senior manager conduct rule.

Also in 2023, the Government launched its call for evidence of the SM&CR, part of a wide-ranging shake-up to make UK financial services more competitive post-Brexit. The FCA and PRA also issued a joint discussion paper DP1/23 – Review of the Senior Managers and Certification Regime (SM&CR) to seek views from firms, consumers and other stakeholders on the effectiveness, scope and proportionality of the SM&CR. The deadline for responses was 1 June.

What does this mean for you?

While we don't expect wholescale changes to the SM&CR, it is positive step that it is being reviewed and opportunities for improvement are being explored. Any changes to enhance the practical application and reduce the administrative burden of the SM&CR will be appreciated. Firms and their internal audit functions should keep a watching brief on this.

In the meantime, and given the time that has passed since the SM&CR was introduced, firms and their internal audit functions should be asking:

- Do the SM&CR arrangements put in place when the SM&CR came into force remain appropriate?
- Do senior managers remain aware of their roles, responsibilities and what they are accountable for? Is this correctly reflected in statements of responsibility or do they need updating e.g. where roles and responsibilities have evolved over time?
- How well is SM&CR embedded in the culture and operations of the firm?
- Is accountability demonstrated from the top of the organisation?
- How is the firm ensuring that conduct rules are understood and embedded across the staff population?

Operational & IT risks

As the IT risk landscape rapidly evolves, firms and their internal audit functions need to stay ahead of the curve and anticipate the emerging risks and opportunities.

Key contacts

Phil Broadbery
Technology Partner
+44 (0)20 7516 2235
pbroadbery@pkf-l.com

Harjit Sembi
IT Assurance Director
+44 (0)20 7189 1399
hsembi@pkf-l.com

Cyber security

A recent study on Covid-19 and cyber risk in the financial sector revealed that the financial sector has experienced the largest number of Covid-19- related cyber events after the health sector, with payment institutions, insurers and credit unions the most affected. Insurers in some jurisdictions are reporting an increasing number of malware and other cyber attempts. Insurance supervisors consider cyber security risks to be the main trigger of other risks.

In response to this level of increased attack, the European Council and the European Parliament introduced The Digital Operational Resilience Act (DORA) (Regulation (EU) 2022/2554). Under DORA, firms must follow rules for the protection, detection, containment, recovery and repair capabilities against information and communication technologies (ICT) related incidents. DORA acknowledges that ICT incidents and a lack of operational resilience have the potential to jeopardise the soundness of the entire financial system.

DORA will apply from 17 January 2025 and being a regulation, rather than a directive, will be binding in its entirety and directly applicable in all EU Member States. Insurance and reinsurance undertakings and intermediaries are in scope of DORA. Although it is EU regulation, many UK entities will fall into scope.

What does this mean for you?

DORA explicitly refers to ICT risk and sets out rules on ICT risk management and governance, incident reporting, digital operational resilience testing, ICT third-party risk monitoring and information sharing. It creates a regulatory framework for digital operational resilience, whereby all firms need to make sure they can withstand, respond to, and recover from all types of ICT related disruptions and threats. To achieve a high level of digital operational resilience, it is important for firms to demonstrate they have:

- Documented ICT risk management procedures, including management of ICT third party risk
- A process to report major ICT related incidents and notify, on a voluntary basis, significant cyber threats
- Performed adequate and robust digital operational resilience testing
- Processes in place to share information and intelligence in relation to cyber threats and vulnerabilities.

To achieve this, firms will need to identify if they are in scope and if so, prepare a high-level DORA readiness strategy and implementation plan. Internal audit functions can provide challenge and assurance whether all requirements of the regulation have been identified and addressed. Going forward, internal audit functions should review the ongoing effectiveness of ICT risk management, incident reporting, resilience testing and third party risk management.

Digital transformation

Many firms across the insurance sector are looking to better automate, digitise and transform their operations and processes to deliver efficiencies, support better internal controls and/or improve customer experience.

Lloyd's of London, as an example of this, Lloyd's has embraced digital technology which is now at the core of how it wants to do business. In November 2022, Lloyd's launched a new digital portal to provide members, third-party capital providers and members' agents quick and easy access to their Funds at Lloyd's data. The portal includes a dashboard showing Funds at Lloyd's holdings and valuations, with the ability to customise screens and reports so that users can extract data / information for further analysis. It also provides a secure messaging and document exchange facility between stakeholders and the member services team at Lloyd's, ensuring that personal data is always protected.

In addition, Lloyd's published Blueprint Two, a compelling two-year programme that brings to life the ambitions published in Blueprint One in September 2019, with solutions that will shift the market to a digital ecosystem, powered by data and technology – aimed at ultimately delivering better value at a lower price for customers.

The comprehensive programme and priorities detailed in Blueprint Two are intended to deliver revolutionary change for the market, ensuring it is digital from start to finish, with data at its core.

It builds on the goals set out in Blueprint One, detailing the digital-led change and execution plan to build the solutions over the next two years, transforming the way in which the market operates, to make it simpler and more efficient for market participants to trade. Blueprint Two deliverables include:

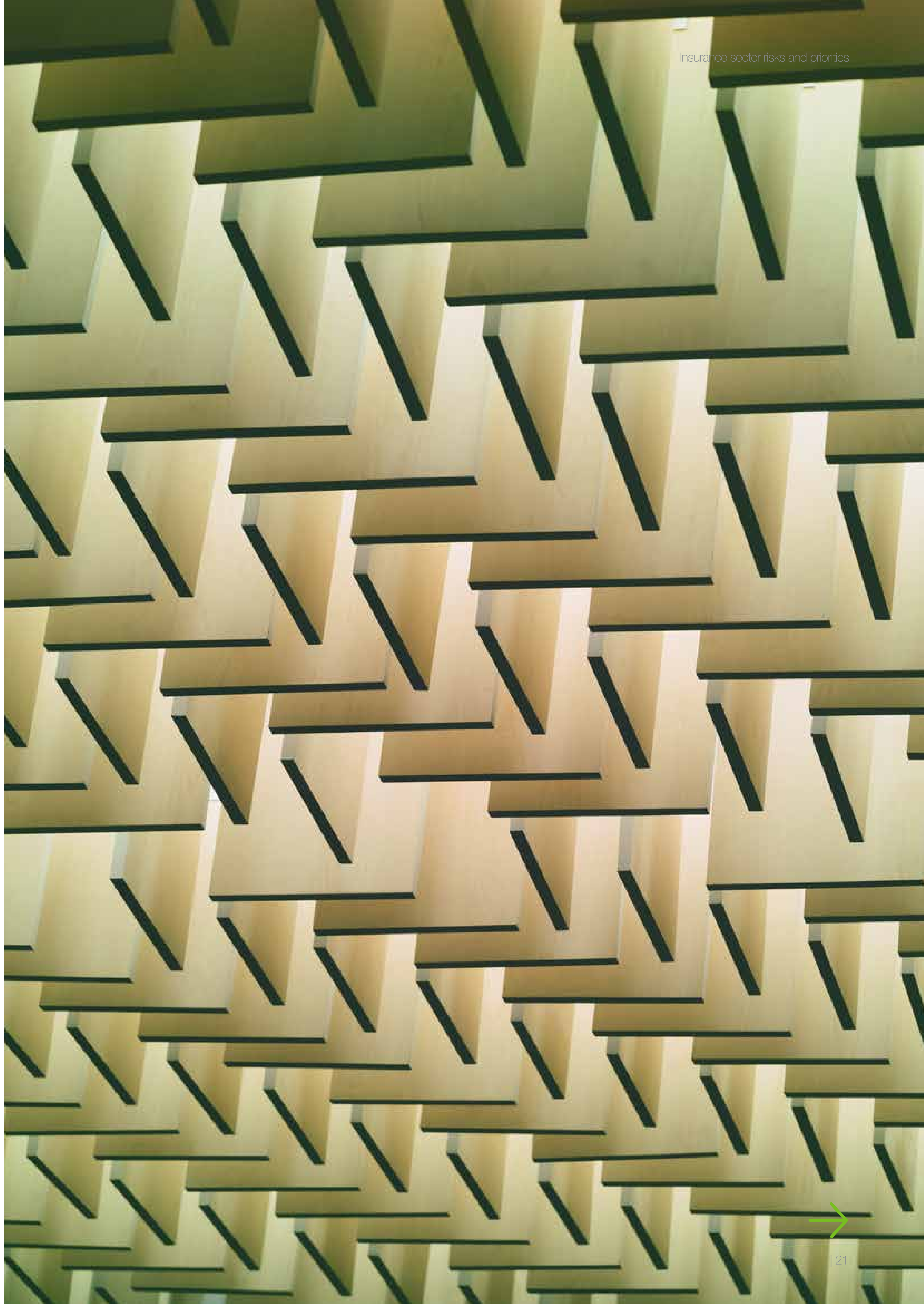
- Approved and clear data standards that will support the next generation of placement platforms and solutions at Lloyd's
- A new Lloyd's marketplace gateway and processing capability that will allow cover to be evidenced and issued in minutes and simultaneously create technical accounting records
- Automated claims recognition, routing and orchestration that will facilitate faster claims payments.

What does this mean for you?

In order to compete in a fast pace, digital business world, it is important to ensure the integration of digital technologies into all aspects of business operations by:

- Identifying how to use technologies to deliver new products and services
- Improving existing products and services
- Streamlining processes
- Having a continuous improvement strategy which helps to ensure that the firm's IT infrastructure remains fit for purpose.

Internal audit functions need to familiarise themselves with the digital transformation strategies and projects within their firms and identify what assurance is needed. This may take different forms such as project assurance and involvement in relevant project steering committees or post-implementation reviews to assess the effectiveness of new processes and controls within the digital environment. As firms move towards greater automation and digitisation, internal audit functions may need to radically change their approach to monitoring and testing controls.



Regulation

Insurance sector firms have faced a raft of regulatory change in recent years and this looks set to continue - firms and there internal audit function must be abreast of changes on the horizon.

Key contacts

Jessica Wills
Partner and Head of Governance, Risk & Control Assurance
+44 (0)20 7516 2229
jwills@pkf-l.com

Paul Goldwin
CASS 5 Partner
+44 (0)20 7516 2251
pgoldwin@pkf-l.com

Pauline Khong
Actuarial Director
+44 (0)20 7113 3559
pkhong@pkf-l.com

Consumer Duty

Consumer Duty came into force on 31 July 2023 for new and existing products and services. Whilst firms, particularly their compliance teams, will be breathing a sigh of relief to have met the implementation date, it doesn't end there. The focus for 2024 will be:

- Embedding current Consumer Duty requirements into firm culture and BAU operations
- Ongoing monitoring of customer outcomes; and
- Developing and delivering implementation plans for closed products and services (rules come into force on 31 July 2024).

Consumer Duty has brought a significant shift in FCA expectations and had a wide impact on firms across product and service design; identification of target market, including any vulnerability; distribution strategy; price and value; and customer communication / understanding and support.

Throughout 2024, firms will need to assess, test, understand and evidence customer outcomes to evaluate if they are meeting Consumer Duty requirements. This will require good quality data and MI, strong governance, and decisive action to ensure that any signs of poor customer outcomes are suitably addressed.

What does this mean for you?

As a new piece of regulation, firms and their internal audit functions will continue to pay close attention to Consumer Duty throughout 2024 and beyond. Key considerations might include:

- Are there any gaps or overdue actions from Consumer Duty implementation plans and how are these being tracked, managed and overseen through to completion?
- As Consumer Duty moves from a 'project' to 'BAU' state, how is it being governed and is this effective and readily demonstrable?
- Is data and MI adequate for ongoing monitoring of customer outcomes? Is it complete, accurate and sufficiently granular (e.g. by product/service, different customer groups) to inform effective decision-making? Where data and MI indicate poor customer outcomes, how is this escalated and addressed?
- How is Consumer Duty being embedded into the firm's culture and operations – how well do staff understand what is required of them in delivering Consumer Duty?
- Is Consumer Duty integrated into the risk management framework?
- How is the internal audit function adopting and demonstrating a customer outcome focus?
- Have suitable implementation plans been developed for closed products and services?

Solvency II reform

In June, the PRA published CP12/23 – Review of Solvency II: Adapting to the UK insurance market which sets out proposals to deliver significant reforms for Solvency II. It supports the UK Government's response to its Solvency II consultation review with three objectives; a competitive insurance sector; investment to support growth; and policyholder protection.

The proposed reforms to Solvency II include:

- Reduction to the risk margin used to calculate technical provisions
- Changes to the matching adjustment for life insurers
- Streamlined rules for internal models
- Greater flexibility for insurance groups in calculating group solvency requirements
- Removal of certain requirements for UK branches of international insurers
- New mobilisation regime for new insurers
- Simplified reporting templates
- Increase to thresholds for the Solvency II regime.

The proposed reforms will be implemented in phases, with the reduction to the risk margin taking effect by 31 December 2023, reforms to the matching adjustment taking place by the end of June 2024 and all other reforms taking effect on 31 December 2024.

What does this mean for you?

Firms need to review the proposed reforms, assess their specific impact and perform a gap analysis. As part of this, firms should consider what they must change to meet the proposed reforms, what might be beneficial to change (e.g. to take advantage of the flexibility and simplifications that the Solvency II reforms offer) and the knock-on risks and opportunities.

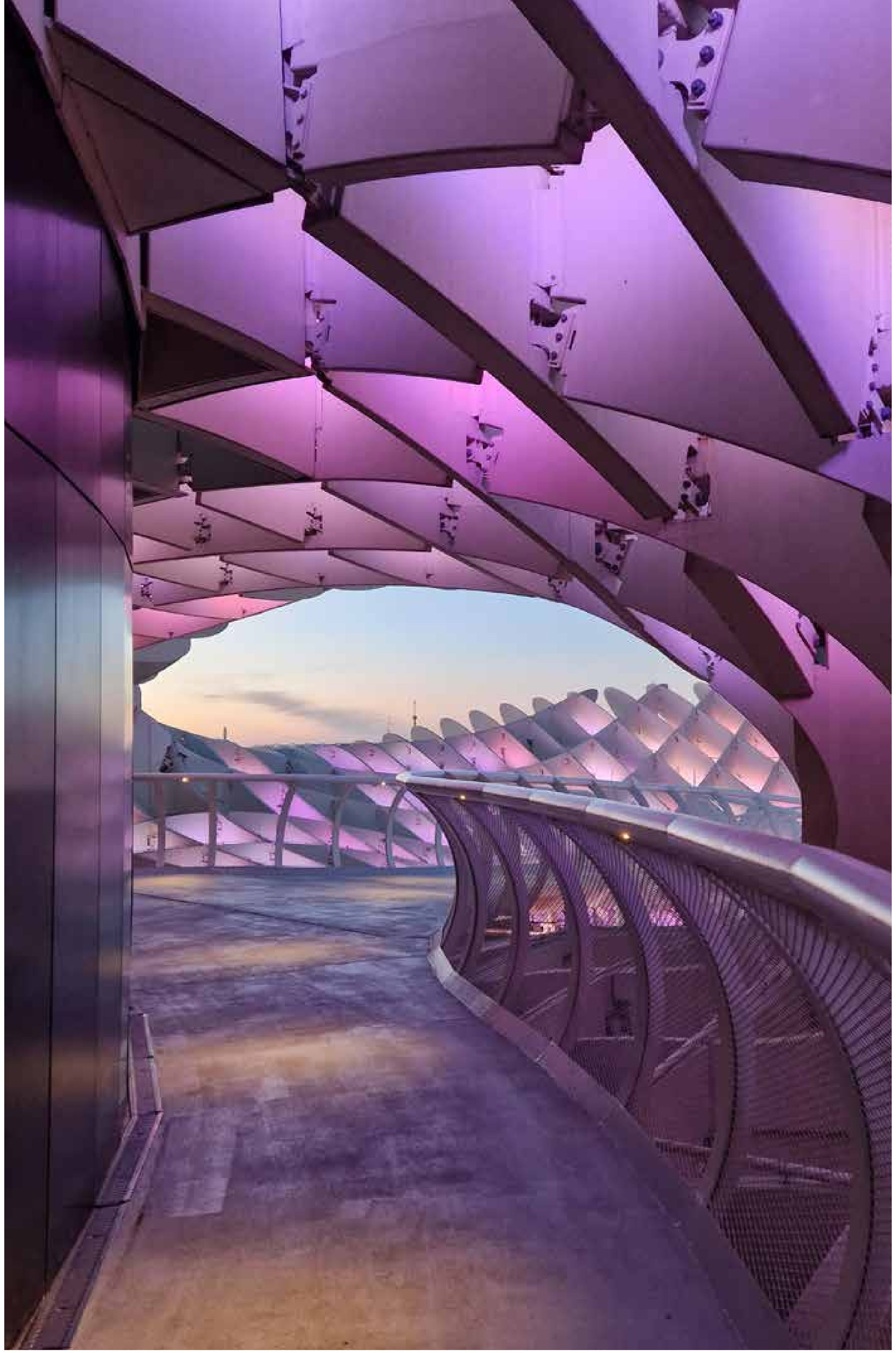
At an operational level, firms will need to:

- Update technical provision calculations / models to adopt the revised risk margin
- Consider changes to financial reporting processes and systems to align to new reporting templates
- Assess the impact of reforms to the internal model framework on model documentation, use and validation. Firms not currently using an internal model may wish to consider the benefits of implementing one under the simplified framework
- For life insurers, changes to the matching adjustment will offer increased investment flexibility and opportunities to reconsider their investment strategy
- Consider what internal audit assurance is needed to ensure that Solvency II reforms are appropriately identified and implemented.

CASS 5

Client money remains a priority for the FCA, particularly in the context of the current economic environment and the need for firms to be financially resilient and ensure adequate protection of client money. Current areas of FCA concern and interest include:

- Credit write backs - The FCA takes a strong view and will only allow a credit write back where there has been express consent to write off. In such circumstances, the FCA expects the firm to pay away the monies to charity rather than keep them for their own account. In line with this, the FCA has recently consulted in CP23/12 on the expansion of the Dormant Assets Scheme to include dormant client money
- Group restructuring – Where firms are undertaking group restructuring, revoking client money permissions, de-authorising and closing down regulated entities, it is important that this is handled correctly. In such situations, and where business is transferred to another group entity, it is sometimes difficult to clear client balances and the transferor is left with client money which it cannot easily pay away. So long as there is a novation clause in place and the firm has properly communicated with its clients considered acceptable to move its residual client money to another group entity, this is considered acceptable considered acceptable
- Unknown receipts – There has been some debate as to whether unknown receipts should be moved out immediately to prevent pollution or whether it is appropriate to leave in the client bank account whilst the firm investigates. These should be left in the client bank account whilst the firm investigates in order to protect the possible client money



- Use of properly designated high interest client bank accounts – This has become attractive due to rising interest rates. The use of such accounts is not an issue, so long as all consumer duty obligations are met. The firm must give due consideration to the length of time it ties up the deposit in the 'term' accounts and is mindful of the need to satisfy insurer payment requirements under credit terms etc. Firms should take caution over 'investment' products that have begun to appear to invest client money as there could be a breach in permissions if the firm moves into the territory of a 'discretionary money manager' for which they do not have the relevant permissions.

What does this mean for you?

- Firms and their internal audit functions should regularly consider the adequacy of their CASS 5 arrangements, systems and controls and related governance and oversight
- Firms should have a clear and comprehensive CASS 5 risk and controls mapping or matrix which sets out the applicable rules, risks and mitigating controls. This should be subject to regular review and testing, including by internal audit
- Firms undertaking legacy projects / reviews should pay close attention to any credit write backs and make sure these are only processed following comprehensive investigation, receipt of legal advice and express consent. Firms should have clear policies, procedures and approvals / sign offs for credit write backs, along with effective oversight from a governance committee
- Firms undertaking group restructures must ensure the adequate protection of any remaining client money that is transferred
- Where firms are considering the use of properly designated high interest client bank accounts, they should undertake suitable due diligence to ensure that the accounts are appropriate and do not lead to a breach of permissions.

Environmental, Social and Governance

ESG is hugely important for the insurance sector - with increasing and complex ESG laws and regulation, ongoing stakeholder interest and exposure to climate change - it is a key topic for 2024 and beyond.

Key contacts

Justine Sacarello
General Counsel
+44 (0)20 7113 3562
jsacarello@pkf-l.com

The acronym ESG was first used by the UN Global Compact in their 2004 Whitepaper titled "Who Cares Wins" and has since led to international law and regulation requiring firms to incorporate ESG factors into their operations and supply chains.

Climate change

ESG is hugely important for the insurance sector. Not only does the industry provide insurance cover against natural catastrophes and extreme weather events, it is also a significant asset owner, long-term contributor, and custodian of many of the assets that ESG engages with and has an impact on.

Insurers have a leading role to play in the global transition to ESG in a range of ways, from providing a mechanism for transferring risk from one party to another, to controlling significant pools of assets. There is value at risk for insurers who ignore the financial risks of climate change or delay starting their transition to ESG compliant business models.

The insurance sector is acutely aware of the impact of climate change with increased frequency, severity and volatility of extreme weather events impacting property and casualty insurers. These insurers need to carefully consider their appetite for underwriting these risks and ensure they are correctly priced to reflect the increased exposure. Parts of the USA have become uninsurable because of the impacts of climate change - some insurers have stopped offering new coverage in California because of catastrophe exposure, as well as regulatory scrutiny and loss of competitive advantage.

Helpfully, regulators have published their expectations as to how insurers should manage the financial risks of climate change, including the PRA's SS3/19 Enhancing banks' and insurers' approaches to managing the financial risks from climate change.

What does this mean for you?

- Where firms are assessing their climate change exposures and revising their underwriting strategies (e.g. withdrawing lines certain lines of business or geographies), this will be of significant interest to the market and wider stakeholders
- Insurers are well placed to provide an early warning system for policymakers and the market, by looking at risks and the challenges in pricing those risks because of ESG-related factors like natural catastrophes. This will allow the market to adjust and find price mitigation solutions so the insurance sector can continue to offer affordable cover
- In pricing ESG-related coverage, insurers analyse historical trends and data to predict a range of outcomes and assign probabilities to those that allow insurers to earn a reasonable rate of return, build a surplus that will protect their financial position and be sustainable so they can meet future claims. This market intelligence enables insurers to identify risk mitigants. If risks are no longer profitable to underwrite and insurers withdraw, governments will have to take action to make insurable assets more robust and resilient from ESG physical risks
- Internal audit functions should assess how their firms have implemented PRA requirements and expectations for managing the financial risks from climate change. Other work by internal audit functions might include assessing the governance and controls to ensure that revised underwriting strategies to manage climate change exposures are being followed or challenging their firms on how lessons learnt from recent extreme weather events and related claims are informing the future underwriting strategy, including pricing.

ESG governance and strategy

ESG is wide-ranging with inherent conflicts between the E, S and G. This is further exacerbated in firms that operate internationally as jurisdictions have different - and sometimes conflicting - approaches. To navigate these, it is important for firms to establish and implement an ESG strategy, detailing plans and proposed actions on each step of the ESG journey towards an ESG compliant business model. It also requires strong governance and oversight to ensure that ESG risks and opportunities are well managed within the firm's overall business strategy and risk appetite.

As part of their ESG strategy, it is encouraging that insurers are reviewing their underwriting footprint and making public commitments about the stances they will take. The insurance sector is also engaging in a significant period of product innovation to embed ESG into their products such as net zero linked products and carbon offset products in motor insurance. Firms are also embedding ESG into their own infrastructure and operations.

What does this mean for you?

- Firms should consider the guidelines within the Task Force on Climate-related Financial Disclosures (TCFD) on disclosing the transition risk inherent in ESG journeys. TCFD provides useful guidance to help firms make good disclosures and manage transition risks. It will also help guide thinking and oversight of third-party risk, business portfolios, and supply and value chains
- Firms recognise that ESG is important, but often struggle to source the right people to drive their ESG strategy, actions and initiatives. ESG needs to be embedded throughout every division of an organisation and we are seeing a shift away from a single individual being responsible for ESG. Whilst boards have overall responsibility for creating and implementing the ESG strategy, firms should carefully consider their structure and how ESG can be owned and embedded across the organisation
- Firms need to socialise their ESG strategy across the organisation, including the commitments to products and solutions that will be developed to ensure transition.
- Firms need an approach to engaging with all stakeholders
- Internal audit functions can help their firms to assess whether there is a coherent ESG strategy and whether progress in delivering the strategy is in line with expectation. From a governance perspective, internal audit functions can assess the structure and process for ESG governance and decision-making, as well as clarity of ESG roles and responsibilities across the firm.

Regulatory challenges

ESG presents commercial, regulatory and strategic challenges for the insurance sector. To date, ESG has been largely led by civil society but now a significant volume of law and regulation exists or is in the pipeline e.g. to manage the financial risks from climate change and increase ESG transparency through reporting and disclosures.

A fundamental and global challenge relates to current and planned regulation regarding ESG especially the EU Taxonomy which will impact the insurance sector, of course, impact the insurance sector. The EU Taxonomy Regulation poses numerous challenges not least because there is a lack of global harmonisation regarding what is, and what is not, considered to be 'Green'. Other prominent regulation includes the Corporate Sustainability Reporting Directive (CSRD) and the Corporate Sustainability Due Diligence Directive (CSDDD).

The CSRD is intended to align with the global standards of the International Sustainability Standards Board (ISSB) and will involve a step change in the way in-scope firms report on sustainability issues. It expands the scope of European-wide mandatory ESG reporting and imposes detailed standards. The CSDDD imposes due diligence requirements to identify, prevent, mitigate, cease and account for certain adverse human rights and environmental impacts in firms' own operations, their subsidiaries and value chains.

What does this mean for you?

- Firms should be paying close attention to ESG laws (including 'soft laws') and regulations that are on the horizon
- Where impacted by laws or regulation (or where adopting voluntarily), firms need to integrate ESG into their operations and supply chains. Firms may also use their leverage as investors and insurers to steer partners towards more sustainable choices to adopt ESG complaint business models or pursue ESG-compliant investment strategies

- ESG-related law and regulation is complex, meaning it is not easy for the insurance sector to implement, despite willingness to do so. Firms must ensure they have the resource and skills to deal with this
- Firms must give themselves time to consider if they are in-scope of new law and regulation and prepare for the detailed, and potentially burdensome, reporting requirements that may impact them e.g. from the CSRD and CSDDD
- Firms must establish a functional database, start collecting relevant data and make sure that data is correct as greenwashing (and other similar) claims are anticipated to increase as ESG reporting increases
- Internal audit functions should be aware of the current and emerging ESG regulation that impacts their firm. As new ESG regulation comes into play, there is a role for internal audit functions to provide assurance over readiness and any change / implementation projects. Furthermore, there may be specific assurance needs over ESG data and reporting.

Liability risks

The PRA's SS3/19 Enhancing banks' and insurers' approaches to managing the financial risks from climate change highlighted liability risks arising from parties who suffer loss or damage from the physical or transition risks arising from climate change and who seek to recover losses from those they hold responsible.

Where companies misrepresent products, fail to take action to reduce their environmental impact or produce misleading or inaccurate ESG reporting, they are exposed to liability risks from a range of stakeholders. NGOs and civil society are using greenwashing and creative legal techniques as strategic tools to incentivise companies to start, or expedite, their transition to ESG-compliant business models.

ESG-related litigation and greenwashing claims have increased exponentially over recent years and this, together with the anticipated uptick in regulatory actions against firms and their directors, will impact insurers writing D&O and PI insurance.

What does this mean for you?

- Firms writing D&O and PI insurance, should closely monitor trends in ESG-related litigation and greenwashing claims as part of emerging risk monitoring. Underwriting strategies, practices and pricing for these classes of business will need to respond accordingly. Internal audit functions may be able to challenge the effectiveness of emerging risk monitoring and approaches to managing exposure to liability risks
- To manage their own liability risks, firms should review their investment portfolios to ensure they align with the firm's ESG strategy / values. Any 'green' investments should be verified as genuine to avoid the risk of perceived or actual greenwashing.

Social and Governance

Firms need to give equal priority to 'S' and 'G' alongside the 'E' to avoid financial losses, reputational risk and potential legal action.

The 'S' considers firm's contribution to the communities in which they operate and includes diversity, equity and inclusion. Whilst the insurance sector has made progress in this area, there is more to do to ensure that gender, ethnicity and other protected characteristics are represented at senior management and board level.

There are also challenges where staff in underwriting and claims roles are nearing retirement age, risking a loss of essential technical knowledge and expertise. The need for increased diversity and inclusion in the financial sector was reinforced in September 2023 through joint consultation by the PRA and FCA.

The 'G' represents firms' licence to operate and addresses matters including executive pay, board structure and independence, AML, anti-bribery and corruption issues and conflicts of interest. It also considers responsible tax strategy and stakeholder engagement. The insurance sector generally has well-established and mature governance arrangements that align to regulatory requirements, including the SM&CR, which provides the framework for good governance. Well-governed firms should also benefit from a higher ESG rating, which in turn allows them to demonstrate their value to their customers and wider stakeholders.

What does this mean for you?

- Firms must recognise their stakeholder's demands to behave with greater accountability, and the individuals within the firm, and in an ethical manner – even if this goes beyond the legally required thresholds
- Firms must also recognise that diversity and inclusion is needed and that purpose-led organisations are more likely to attract and retain talent
- Firms should consider succession planning and how to provide training and development opportunities to the next generation to retain and attract diverse talent into the sector to fill the roles which are becoming available
- Firms and internal audit functions should regularly review the oversight and controls relevant to their governance framework to avoid incidents of poor behaviour, inaccurate financial reporting / disclosures, or other incidents that could give rise to reputational damage
- As ESG evolves, firms and their internal audit functions should regularly review how ESG risks are embedding into the existing risk management framework and process
- With greater regulator and stakeholder focus on 'S' and 'G', internal audit functions may need to expand their activities into new areas e.g. reviewing diversity and inclusion strategies, initiatives and reporting.

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

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

PKF UK in numbers	Insurance intermediaries in numbers	PKF Global in numbers
12th Largest audit practice in the UK in the latest Accountancy Daily rankings	**1st** Largest auditor of insurance intermediaries	**Part of the 14th** Largest global accounting network
17 Offices across the UK	**90+** Insurance intermediary clients	**480** Offices in 150 countries
1,450+ Employees and 180 partners	**30%** Advisor to one third of the UK's Top 50 Brokers	**$1.4bn+** In aggregate fee income
£153m Fee income and growing rapidly	**15** PE backed insurance intermediary clients	**21,000** Employees

Key contacts

To find out more please contact us

Jessica Wills
Partner and Head of Governance, Risk & Control Assurance
+44 (0)20 7516 2229
jwills@pkf-l.com

Satya Beekarry
Partner
+44 (0)20 7516 2200
sbeekarry@pkf-l.com

Paul Goldwin
CASS 5 Partner
+44 (0)20 7516 2251
pgoldwin@pkf-l.com

Phil Broadbery
Technology Partner
+44 (0)20 7516 2235
pbroadbery@pkf-l.com

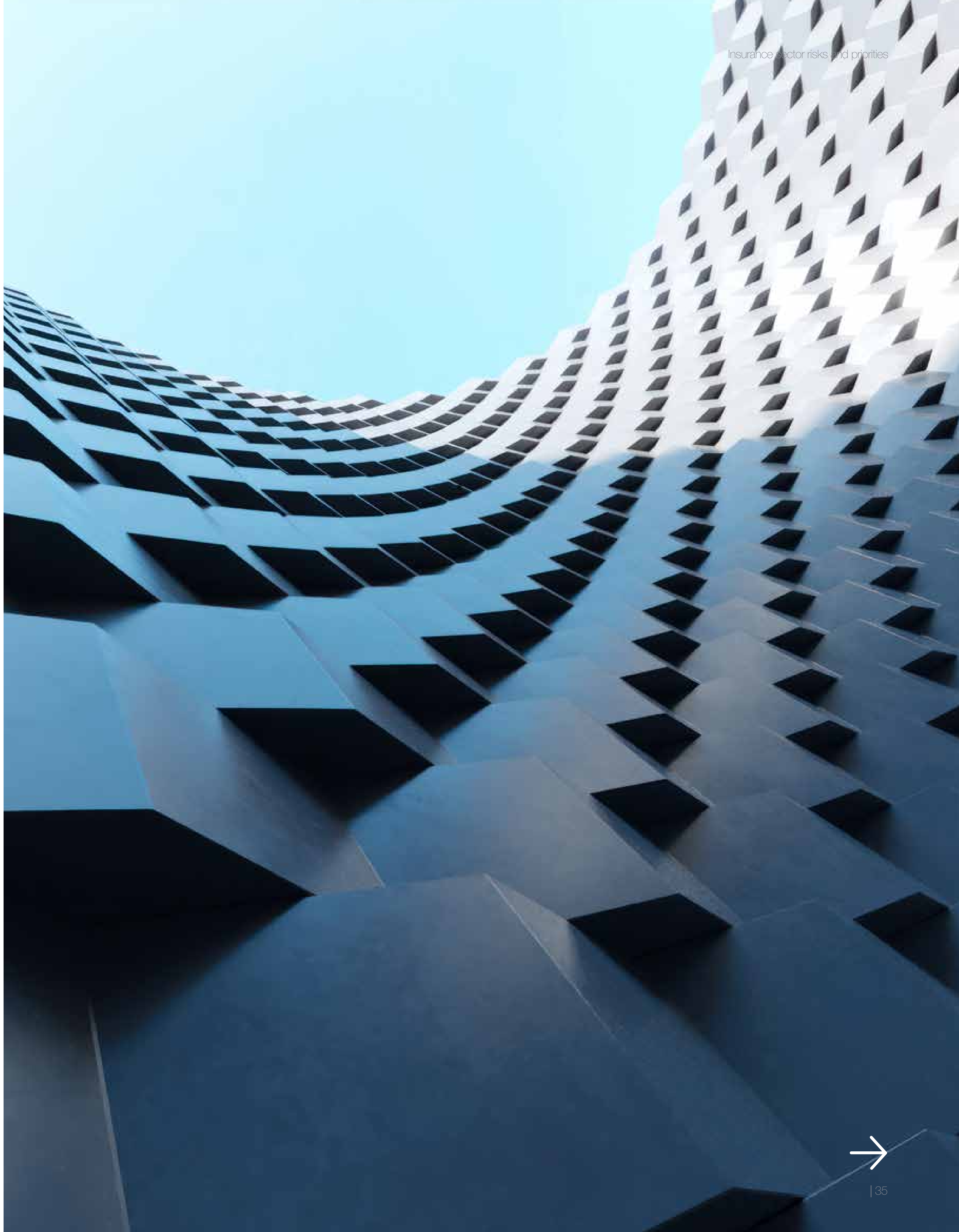
Justine Sacarello
General Counsel
+44 (0)20 7113 3562
jsacarello@pkf-l.com

Pauline Khong
Actuarial Director
+44 (0)20 7113 3559
pkhong@pkf-l.com

Samiha Shaikh
Governance, Risk & Control Assurance Director
+44 (0)20 7516 2345
sshaikh@pkf-l.com

Mimi Chan
Tax Director
+44 (0)20 7516 2264
mchan@pkf-l.com

Harjit Sembi
IT Assurance Director
+44 (0)20 7189 1399
hsembi@pkf-l.com



PKF Littlejohn LLP

London
15 Westferry Circus
Canary Wharf
London E14 4HD
+44 (0)20 7516 2200

Leeds
3rd Floor, One Park Row,
Leeds, Yorkshire,
LS1 5HN
+44 (0)113 244 5141

Manchester
11 York Street,
Manchester,
M2 2AW
+44 (0)161 552 4220

www.pkf-l.com