A publication for insurance carriers

December 2023

PKF

Insurer Update

In this issue

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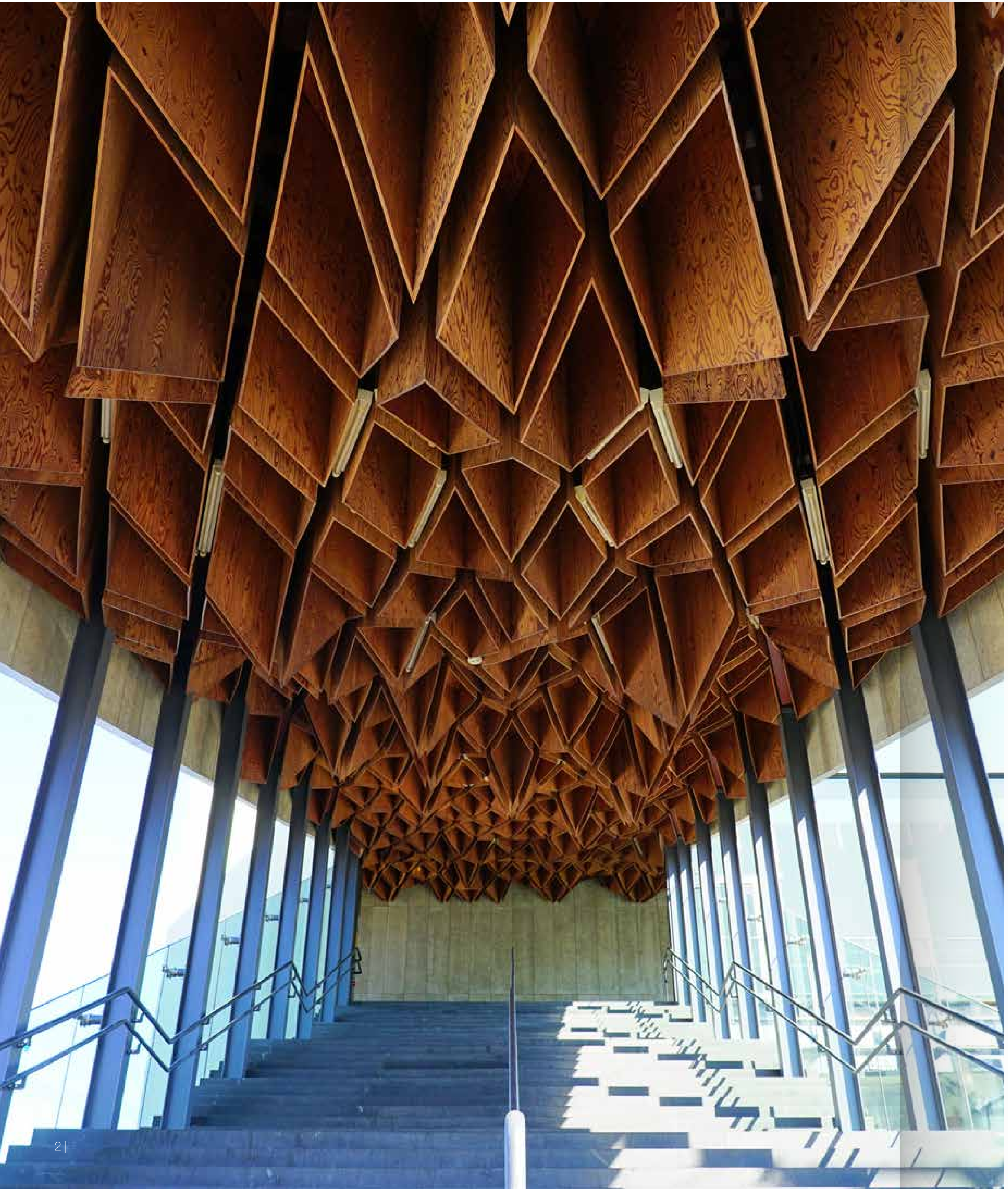


Insurer Update
In this issue...

Welcome to our publication for insurance carriers

Welcome to our latest edition of Insurer Update. This publication aims to help carriers across the insurance market understand and digest some of the more pertinent financial reporting and tax developments, and their implications for medium sized and smaller insurers.

In our June edition, we outlined the main objectives of the Solvency II reform in the UK. But what's the latest? We take a look back and forward at this year's consultation papers and recent legislative changes.

The latest regulatory pronouncements are always of interest. The FCA and PRA published their respective consultation papers in September on the proposal to introduce a new regulatory framework on diversity and inclusion (D&I) in the financial sector. We look at what this could mean for your business as new regulations come into force.

It's been a little over 12 months since our insurance audit team provided an update on ESG reporting and a lot has happened over this period. In this edition, we provide a brief summary of key developments in the past year.

And finally, as we look towards a New Year, we review some of the key tax areas to consider in the next 12 months, from Transfer Pricing to Human Capital.

We hope you find this edition useful and thought provoking. As always, please contact any of the team to discuss how we can support your business and let us know your thoughts on future topics.

Martin Watson
Partner

+44 (0)113 524 6220
mwatson@pkf-l.com

Tax in 2024: what is coming your way?

As we look towards a New Year, we review some of the key tax areas to consider in the next 12 months.

Corporation tax and international tax matters

HMRC opened a consultation over the summer (ending in August) on **transfer pricing, permanent establishments and diverted profits tax.** There is, so far, no timeline for future actions.

But here are some key points to monitor and consider with your tax advisor:

- Possible simplification of UK-UK transfer pricing and alignment of reporting requirements to those of CbCR and Pillar 2 information needs
- Certain businesses with UK activities may fall within the broader definition of ‘dependent agent permanent establishment’ and inadvertently give rise to a UK taxable presence
- As diverted profits tax (DPT) is brought into Corporation Tax, the applicable higher tax rates are expected to remain. But you may be able to access double tax relief for tax paid under the mutual agreement procedure, which is not currently the case for DPT.

Groups with consolidated turnover above €750m

OECD Base Erosion Pillar 2. UK Pillar 2 minimum tax legislation applies (global minimum effective tax rate is 15%) to companies or groups with annual consolidated turnover exceeding €750m, for accounting periods that begin on or after 31 December 2023.

Both IAS 12 and FRS 102 provide a temporary exception to the requirements for deferred tax assets and liabilities related to Pillar 2 taxes. You must, however, disclose the application of the exception, as well as the qualitative and quantitative information regarding the company’s exposure to Pillar Two taxes in the financial statements as at 31 December 2023.

What does this mean for you?

- Consult with your tax advisor to agree disclosures for inclusion in the 2023 financial statements
- Although the first reporting date is 30 June 2026 (for a 31 December 2024 year end), the first provisions may need to be considered as early as Q1 2024, see our article
- Continue monitoring UK and global Pillar 2 developments.

Transfer pricing documentation

The UK has legislated that groups with a country-by-country reporting requirement are obliged to maintain an OECD Master File and Local File (prescribed standard formats of transfer pricing documentation) for accounting periods beginning on or after 1 April 2023.

What does this mean for you?

- Companies must comply with their transfer pricing responsibilities. These include monitoring the additional requirements that may come if the summary audit trail and the international dealings schedule are introduced
- Groups must also be aware of other country requirements for the jurisdictions in which they operate. Applicable thresholds, filing and transfer pricing documentation requirements can vary from country to country.

Tax transparency and disclosure

Country by country reporting (CbCR) applies to cross border groups with €750m consolidated turnover. In the context of ESG reporting and initial steps towards more tax transparency, there is a new EU directive that mandates public CbCR reporting for financial years starting on or after June 2024. It applies to groups that are EU parented or have EU subsidiaries or branches of a certain size.

What does this mean for you?

- Focus on efficiency in gathering data as you work towards a 2025 publishing date.
  - In this context, consider that CbCR data will feed into the Pillar 2 safe harbour considerations. This will be the first time that CbCR data directly impacts tax calculations.
  - Be aware of other ESG initiatives. If the group plans to make voluntary disclosures, say under the Global Reporting Initiative 207, then it will help to gather data for the various reporting requirements holistically.

Human capital considerations

HMRC continues to focus on the use of contractors and whether they count as employees. There are several key indicators for being classed as an employee. The responsibility lies with the employer to determine the employee/contractor status. If a contractor is an employee, based on HMRC's criteria, the company must add the person to their payroll and deduct tax and Class 1 National Insurance.

Hybrid working continues in companies keen to attract and retain talent. But when more than one country is involved, it's important to seek advice as there may be tax implications for the corporate as well as the individual.

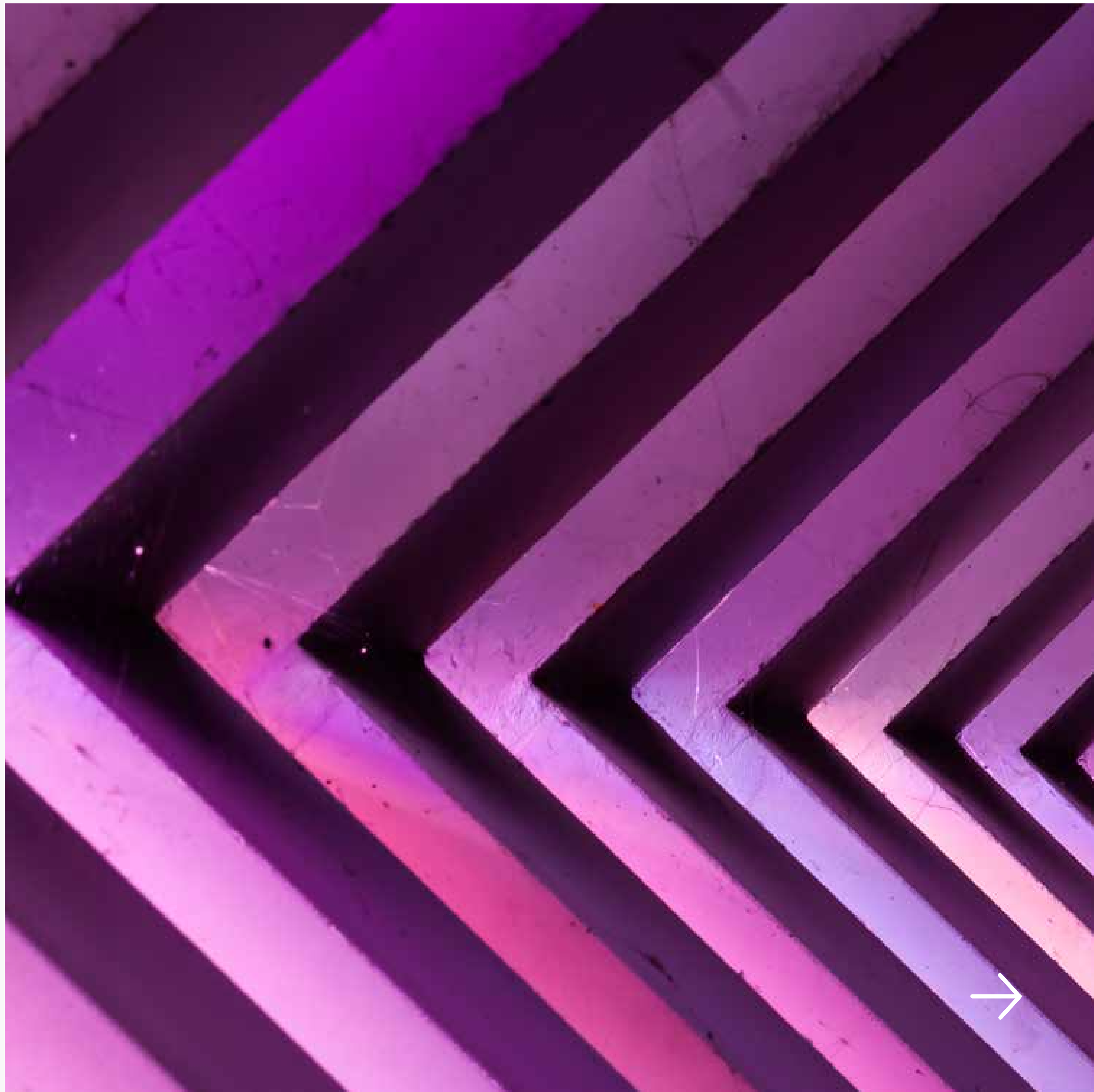
UK resident directors, UK non-resident directors and non-executive directors of UK companies are of particular interest to HMRC. Directors and statutory board members of a UK company are taxed under specific legislation and HMRC expects them to appear on the UK payroll. Specific social security (National Insurance) rules for non-resident directors of a UK company must be observed.

What does this mean for you?

- Where more than one country is involved, contact your tax advisor. The individual may be creating a taxable presence both for themselves and the company in a second country.
- We recommend a regular review of the pay structure for directors. This will ensure compliance with UK tax and social security rules – which can be complex.

Indirect taxes

Since Brexit, many UK-based insurer groups and insurance intermediaries have set up companies and/or branches in EU member states so they can continue writing EU insurance business. Specific provisions exclude supplies made from overseas establishments from the UK partial exemption calculations that are used to determine the recoverable amount of residual input VAT.



HMRC has recently been targeting insurers with a sectorised partial exemption special method (PESM), focusing on divisions with investment sectors. Its key focus is to check whether they are correctly applying their PESMs. The issue with these sectors can be twofold:

- Often, little thought is given to how recoverable input VAT will be calculated (for example, boilerplate formulas are used)
- Some insurers are not using their sectors at all. Instead, they are applying the standard values-based method for input VAT recovery when they have a PESM agreed with HMRC that they are required to follow.

What does this mean for you?

- We recommend insurance businesses with overseas establishments check that their UK VAT returns treat the activity of such branches in a way that complies with the partial exemption provisions.
- We recommend insurers speak with their tax advisors to review how their investments impact their VAT partial exemption calculations. See our article.

For further guidance on any issues raised in this article, please contact Mimi Chan.

Mimi Chan
Partner

+44 (0)20 7516 2264
mchan@pkf-l.com

Diversity and inclusion: new regulations

The regulators are consulting on proposals for wide-ranging changes to how firms tackle diversity and inclusion (D&I) and their reporting. What will this mean for you?

The FCA and PRA published their respective consultation papers (FCA CP23/20 and PRA CP18/23) in September on the proposal to introduce a new regulatory framework on D&I in the financial sector. Comments on the consultation papers must be in by 18 December. The final regulatory requirements will be set out in a joint policy statement in 2024. In-scope firms, which include insurers, will be subject to the new rules 12 months later. The proposals apply differently to firms depending on the number of employees and their SM&CR categorisation. Firms with less than 251 employees will be exempt from many of the requirements, but must meet the minimum standards.

What are the key proposals?

- Integration of non-financial misconduct considerations into staff fitness and propriety assessments, conduct rules and the suitability criteria for firms to operate in the financial sector
- Reporting annually on average number of employees and data collection.
- Reporting and disclosure of certain D&I data
- Requirement to establish, implement and maintain a D&I strategy
- Determining and setting appropriate diversity targets
- Recognition that a lack of D&I is a non-financial risk.

Non-financial misconduct

The FCA is proposing to explicitly include non-financial misconduct within:

- Conduct rules
- Fit and proper assessments
- Suitability guidance on the Threshold Conditions.

Conduct rules

The scope of conduct rules will be expanded to take account of serious instances of bullying, harassment and similar behaviour towards fellow employees, and employees of group companies and contractors. Guidance will also be provided on:

- Types of behaviour that would fall within the expanded scope of conduct rules, and that may breach conduct rules; and
- Conduct that is out of scope because it relates to an employee's personal or private life.

Fit and proper assessments

The FCA proposes to explain in more detail how non-financial misconduct forms part of the Fit and Proper test for Employees and Senior Personnel (FIT) section of the FCA Handbook. Particularly, it will emphasise that bullying and similar misconduct in the workplace is relevant to fitness and propriety, as is equally serious behaviour in a person's personal or private life. This will be supported by examples of non-financial misconduct, such as sexual or racially motivated offences.

Suitability guidance on the Threshold Conditions

To maintain integrity and conduct in UK markets, the guidance on the Suitability Threshold Condition will be extended. It will include offences relating to a person or group's demographic characteristics (such as sexual or racially motivated offences). And it will also encompass tribunal or court findings showing that the firm, or someone connected with the firm (such as a director), has engaged in discriminatory practices.

What firms should consider doing

- Perform a gap analysis between their current processes that support conduct rules and fit and proper assessments, to determine if they need updating to meet the FCA requirements on non-financial misconduct
- Update policy documents, procedures, codes of conduct and handbooks to reflect the new requirements
- Develop training materials and deliver training to employees.

D&I strategies

In-scope firms will be required to develop an evidence-based D&I strategy that takes account of their current progress on D&I. This strategy must contain the following, as a minimum:

- D&I objectives and goals
- Plans for meeting those objectives and goals and measuring progress
- A summary of arrangements made to identify and manage any obstacles to meeting the objectives and goals
- Ways to ensure adequate knowledge of the D&I strategy among staff.

Firms will be required to make the D&I strategy easily accessible and free to obtain (for example, through their website). This will facilitate stakeholder engagement and scrutiny on their approach, and progress against stated commitments.

D&I strategies may be reviewed by the FCA as part of its supervisory assessment of how firms are identifying, monitoring and taking steps to address D&I issues.

What firms should consider doing

- Review existing D&I strategies to assess any gaps against the minimum requirements
- Identify resources needed to develop a D&I strategy and activities and plans for achieving this. It may be worth seeking external advice or support
- Consider how the firm will make the D&I strategy easily accessible
- Determine how the D&I strategy will be incorporated into current processes and systems.

Setting targets

Firms must set specific, time-bound diversity targets to address under-representation at both board and firm-wide level. They will be expected to set at least one target for demographic characteristics of the board, the senior leadership, and the employee population as a whole.

Whilst the FCA has provided guidance on compulsory and voluntary demographic characteristics, it will not specify which characteristics the targets must cover nor what those targets should be. Firms must consider the context in which they operate by taking into account available data on the diversity profiles of the UK population and the geographical area in which they carry out regulated activities.

Those based in other countries that carry out operations in the UK would be in-scope. If they do not have a board or senior leadership in the UK, they would not have to set a target for the parts of the business based overseas.

Firms may choose to set inclusion targets voluntarily, in addition to their diversity targets.

They must provide information on:

- Demographic characteristics for which they have set targets, and their inclusion targets (if any)
- The percentage at which each target has been set
- The year each target was originally set, and the year the firm is aiming to meet it
- The current level of representation against each target (%)
- The rationale for the targets set
- Any further details the firm would like the FCA to consider about targets they have set.

What firms should consider doing

- Agree which demographic characteristic target they would like to report on
- Agree whether to report on inclusion targets and, if so, which one(s)
- Allow sufficient resources and time to implement systems to capture the required data
- Identify potential difficulties in encouraging employees to provide data, and mitigating factors
- Make changes to their data collection processes and policies.

Data reporting

Employee numbers must be reported annually by firms of any size, but the proposed data reporting requirements would only apply to firms with more than 250 employees. They will need to:

- Collect and report annually to the regulators in numerical figures, data across a range of demographic characteristics, inclusion metrics and targets, via a regulatory return
- During the first year, report such data as is practicable and explain the reasons for any gaps and how they will be closed
- Report data to the FCA and PRA using a single data return.

Data should be reported to the FCA in three categories: board, senior leadership and all employees (including the board and senior leadership).

Limited Scope SM&CR firms are out-of-scope for data reporting requirements.

What firms should consider doing

- Map out the data reporting process - consider whether this will be integrated as part of an existing process or form part of a separate one
- Allocate ownership for the D&I data reporting process
- Update HR or other systems if appropriate
- Clarify responsibilities for reviewing and approving the data to be reported, including the related governance process.

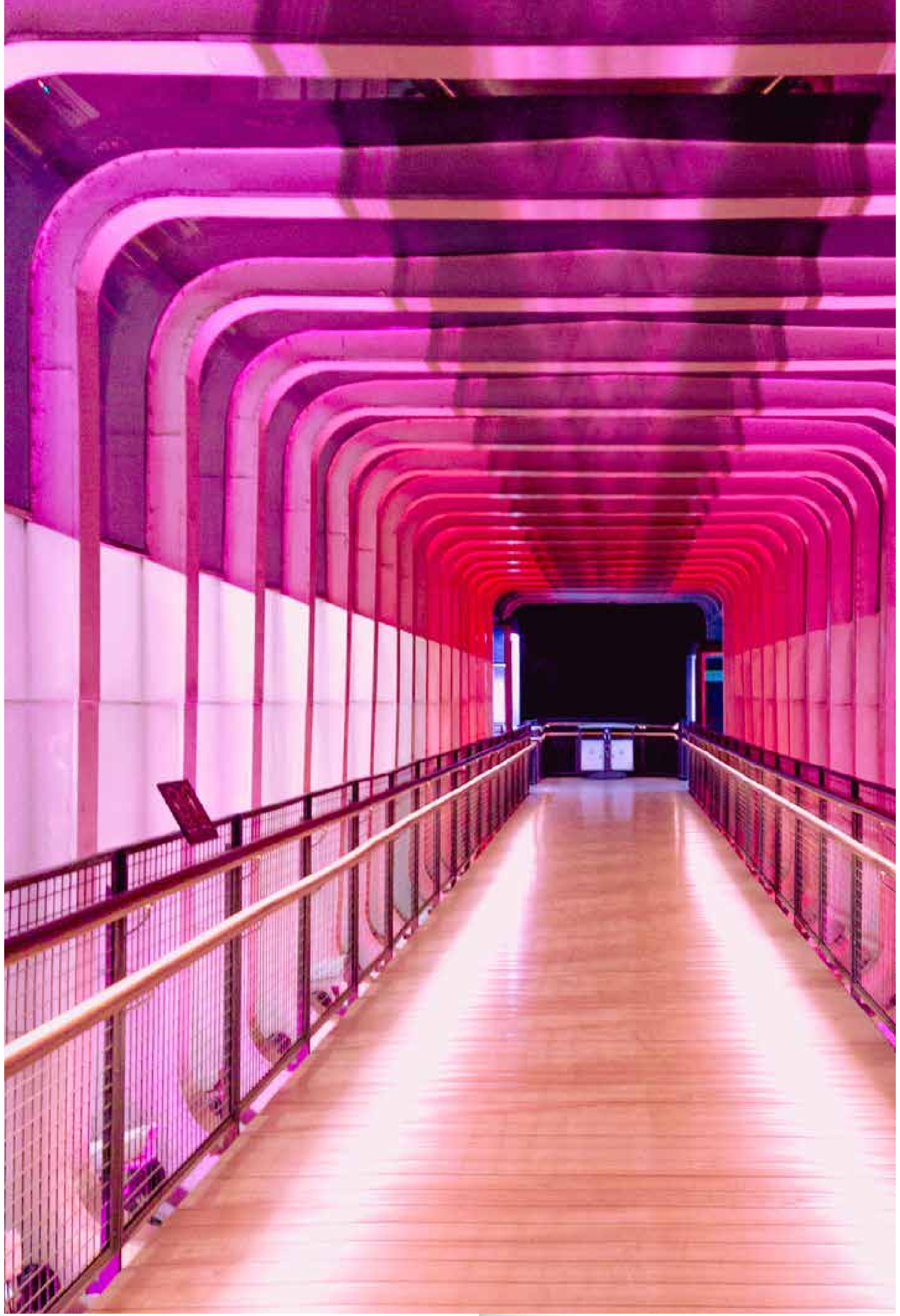
Data disclosure

Firms will need to make public disclosures on D&I data to increase transparency and scrutiny and to facilitate comparisons between firms on D&I performance. This should be done either when they publish annual reports and accounts or, for firms that do not do so, within six months of the end of their financial year.

The rules on disclosure will come into force 12 months after the final rules are published. In the first year they are in force, firms can make their disclosures on a voluntary basis. From the following year onwards, disclosures are mandatory for in-scope firms.

What firms should consider doing

- Allocate ownership of the process for data disclosure (e.g. whether it will be the responsibility of HR or finance)
- Update, if necessary, annual reports and accounts or the financial year end process for incorporating D&I disclosures
- Clarify the responsibilities for reviewing and approving the data disclosure, including the related governance process. Consider a potential role for the internal audit function to provide assurance over disclosures.



Risk & governance

New guidance will be introduced for large firms to make clear that matters relating to D&I must be considered as a non-financial risk and treated appropriately within the firm's governance structures.

The following responsibilities will remain with the firm's board:

- D&I strategies: Although the FCA will not insist on the frequency of reviews, boards will need to review the D&I strategy regularly enough to ensure it remains appropriate, effective and fit for purpose
- Setting targets: The board would oversee the targets set and would be expected to explain the rationale for the targets chosen, if need be.

Firms need to consider how a range of relevant functions can contribute to progress on D&I. Risk functions, as well as internal audit functions, will play an important role in managing risk and giving assurance to boards.

What firms should consider doing

- Agree how the board will oversee D&I strategy and targets, including timing and frequency
- Update board terms of reference to reflect enhanced responsibilities for D&I
- Consider independent assurance over D&I strategy, data reporting and disclosure.

If you'd like to discuss the FCA and PRA consultation papers and potential impacts on your firm, please contact Jessica Wills or Prianca Hanoomanjee in our Governance, Risk & Control Assurance team.

Jessica Wills
Partner

+44 (0)20 7516 2229
jwills@pkf-l.com

Prianca Hanoomanjee
Senior Manager

+44 (0)20 7516 2460
phanoomanjee@pkf-l.com

Parametric insurance: a game-changer or a threat to traditional insurance?

In an era of climate change and the unexpected events it can cause, it makes sense that a different approach to insurance is gaining traction.

As the world grapples with the intensifying effects of climate change, the insurance industry faces unprecedented challenges arising from physical, transition and litigation risks.

Big and unexpected losses are nothing new in the insurance world. But they are also why the demand for insurance is unlikely to fade any time soon. The frequency of natural disasters is surging, and so is their severity, leaving a trail of destruction and financial hardship in their wake. And increasingly they're happening in new locations that don't have a history of such events.

Traditional indemnity insurance, the cornerstone of risk mitigation for centuries, is struggling to keep pace with these escalating threats. Parametric insurance is re-emerging as a serious alternative in a world where big data and artificial intelligence (AI) now have a more prominent role.

My first foray into parametric insurance was over 17 years ago as auditor and verification agent for an entity providing coverage for hurricanes and earthquakes. It was at a time when traditional players were either hesitant to underwrite the risks or price them at a very prohibitive level following some large losses in the region. This company later expanded into providing parametric rainfall coverage, and other programmes have replicated the base concept around the world.

The importance of advances in data

Parametric insurance has presented itself as a transformative approach that promises to revolutionise risk management in the face of climate change. So far it has made limited progress into the traditional market. But are things about to change as a result of big data and AI?

Unlike traditional insurance, which reimburses the insured for actual losses, parametric insurance triggers pre-determined payouts based on objective parameters, such as wind speed, rainfall, or earthquake intensity. This innovative approach eliminates the need for lengthy and costly claims assessments. And that means accelerating the delivery of critical financial support to those in need.

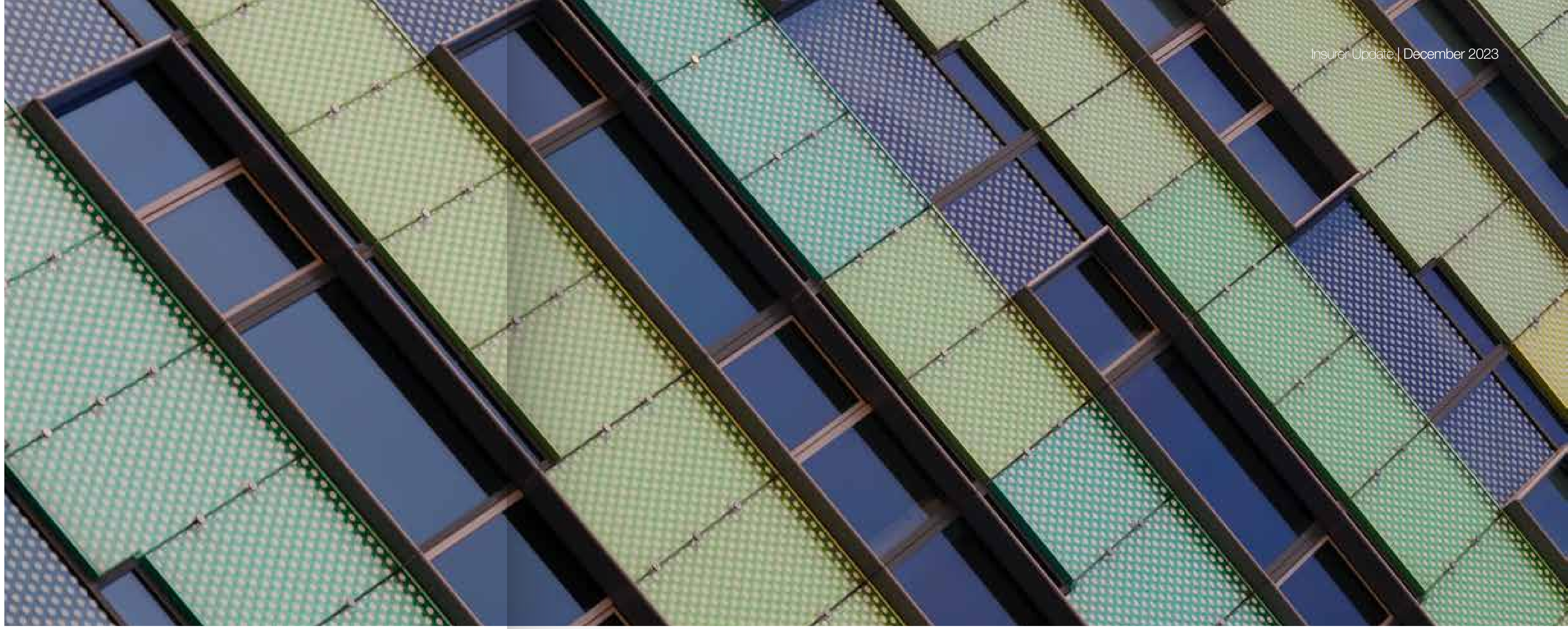
Paradoxically, the future success of parametric insurance largely depends on how accurately and consistently it can model the actual losses that would arise from traditional insurance. Given the benefits of parametric insurance, if policyholders' confidence grows in the parametric models to mimic actual losses, a paradigm shift is not just likely but might be for the greater good.

The benefits of parametric insurance

Parametric insurance offers a compelling list of benefits, particularly for covering hard-to-insure risks like natural catastrophes. Its advantages over traditional insurance include:

- **Rapid payouts.** By eliminating the claims assessment process, parametric insurance speeds up the disbursement of funds, enabling affected communities to recover more quickly. Providing rapid relief after major loss events is a huge advantage when liquidity challenges could mean that businesses and governments fail. Even if traditional insurance could eventually pay out for the same losses, it might be too late

- **Reduced moral hazard.** The objective nature of parametric triggers lessens the risk of moral hazard, where insured parties take advantage of the insurance for their own benefit



- Dynamic pricing. Parametric insurance premiums are tailored to reflect the actual probability and severity of the insured event, providing fairer and more equitable pricing
- Data-driven insights. Parametric insurance uses advancements in data and AI to enhance product design, underwriting, and claims processing. This leads to more precise and effective risk management strategies.

What are the challenges?

Despite its transformative potential, parametric insurance faces challenges that need to be addressed before it is adopted more widely:

- Basis risk. The potential mismatch between the parametric payout and the actual loss, known as basis risk, can leave insured parties exposed to financial gaps or windfalls. This is a critical success factor for parametric insurance. Advancements in data and AI are likely to reduce this risk over time, building more trust in these products
- Regulatory uncertainty. The regulatory landscape for parametric insurance is still evolving, creating uncertainty for both insurers and insureds
- Traditional insurance resistance. Traditional insurers may see parametric insurance as a threat to their market share, hindering its broader adoption
- Accounting and actuarial complexity. Parametric contracts will generally not meet the definition of 'insurance' contracts for accounting purposes and have to be marked to market as 'derivative instruments'. This can add complexity to accounting and actuarial systems where finance and actuarial teams are not familiar with the accounting and modelling for derivatives
- Lack of understanding. This is, in my opinion, the biggest obstacle to large scale adoption of parametric products and it will take time for stakeholders to gain a better understanding of how this kind of insurance works.

Overcoming these challenges will need collaboration between insurers, regulators, and policymakers to set clear guidelines, improve transparency and foster trust in parametric insurance. Only by addressing these concerns will parametric insurance fully realise its potential as a game-changer in the insurance industry.

How might parametric insurance work in agriculture?

To illustrate how parametric insurance works, let's look at an example of crop insurance. Suppose you are a farmer who grows avocados in a region that is prone to drought. You want to protect your income from the risk of crop failure due to lack of rainfall.

So you buy a parametric insurance policy that pays you a fixed amount of money for every millimetre of rainfall below a certain threshold during the growing season. The threshold is based on the historical average rainfall for your region, and the payout is based on the expected yield and price of your crop. The premium is calculated based on the probability and severity of the drought, derived from the historical and forecast data that consider different climate change scenarios.

The rainfall is measured by a network of weather stations that are verified by a third party. If the rainfall is below the threshold, you receive the payout automatically and quickly. If the rainfall is above the threshold, you do not receive any payout, but you still have a good harvest and hence are protected against adverse events.

This example shows how parametric insurance can provide a simple and effective solution for covering the risk of drought, which is one of the most common and devastating natural hazards for agriculture.

But it also shows how parametric insurance can entail some basis risk, as the payout may not match the actual loss. For instance, if the rainfall is below the threshold but your crop is still healthy, you will receive a windfall. If the rainfall is above the threshold but your crop is damaged by other factors, such as pests or diseases, you will suffer a gap.

So parametric insurance may not be suitable for all types of risk, or for all types of farmer. It may need to be combined with other forms of insurance, or other risk management strategies, to provide comprehensive and tailored protection.

From the insurer's perspective, providing coverage across a broad range of geographies and risks will reduce its exposure to any single risk (such as drought in California). The principle of diversification for the insurer applies to both traditional and parametric insurance.

A paradigm shift in risk management?

I don't believe parametric insurance is a mere substitute for traditional insurance. In my view, it's a complementary or supplementary tool that adds to the risk management toolkit. It does this by boosting the resilience and sustainability of the insurance industry, and of society more broadly.

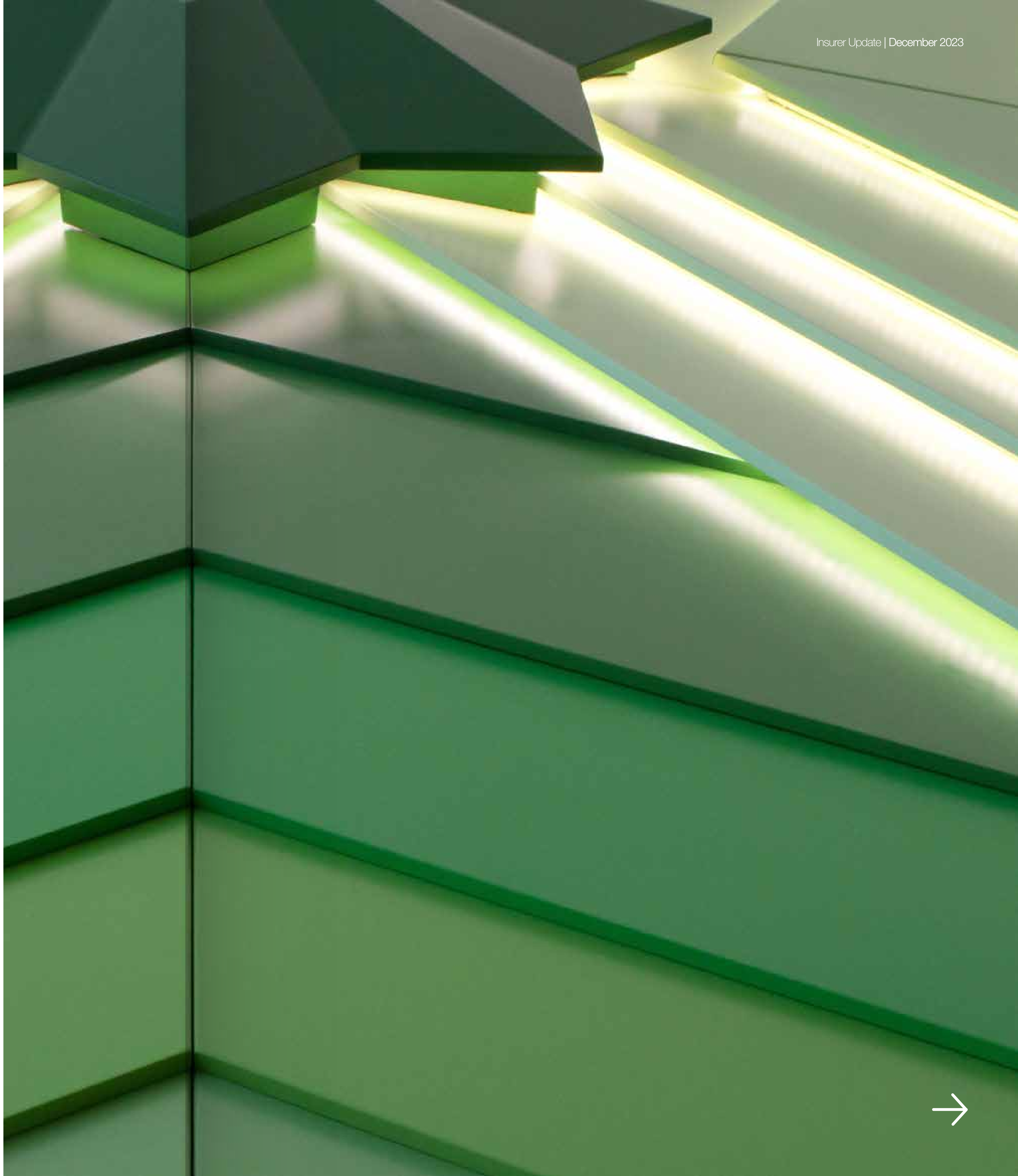
By harnessing the power of data, technology, and objective parameters, parametric insurance offers a more robust and responsive approach to risk mitigation in the face of climate change risk. As the world adapts to the escalating threats posed by climate change, it will play a pivotal role in safeguarding communities and economies against the devastating impacts of natural disasters.

Some insurers might perceive parametric insurance as a threat to their business model. But others see it as an opportunity to innovate and grow their market share. In a world full of uncertainties and possibilities, I believe that those who innovate and embed the technological advances into their business, whether traditional or parametric insurance, will prevail.

If you would like advice or further information on parametric insurance, please contact Satya Beekarry.

Satya Beekarry
Partner

+44 (0)20 7516 2425
sbeekarry@pkf-l.com



Solvency II: what's the latest?

We take a look back and forward at this year's consultation papers and recent legislative changes.

In our June article Post-Brexit Solvency II reforms: what is changing? we outlined the main objectives of the Solvency II reform in the UK, triggered by Brexit:

- to encourage a vibrant, innovative, and internationally competitive insurance sector
- to protect policyholders and ensure the safety and soundness of firms
- to support firms in providing long-term capital to foster growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets, as well as investment consistent with the Government's climate change objectives.

Following HMT's consultation paper on Solvency II reform in the UK, two key consultation papers have been released by the PRA thus far in 2023.

Review of Solvency II: Adapting to the UK insurance market (CP12/23)

On 29 June, the Government published the first of its two consultation papers, CP 12/23. The Prudential Regulation Authority (PRA)'s proposals and the key benefits covered by this consultation are:

- Simplifications and process improvements to the transitional measure on technical provisions (TMTP) calculation so as to reduce costs and complexity for firms. Also to make sure firms plan effectively for the end of these transitional measures in 2032.

  Who benefits? The 24 life insurance firms that currently have TMTP approval and any firm that is granted TMTP permission in the future after accepting business that already benefits from TMTP.

- A new, streamlined set of rules for internal models (IM) where these are used by insurers to calculate their capital requirements.

  Who benefits? All insurers that already have IM approval from the PRA, and those that may consider applying for permission in future.

- Greater flexibility for insurance groups in calculating group solvency requirements. This in turn would provide more flexibility in the development of group IMs and allow a better reflection of underlying risks.

  Who benefits? Any UK insurer for which the PRA is group supervisor.

- The removal of certain requirements for branches of international insurers operating in the UK, to facilitate entry or expansion and the international competitiveness of the UK insurance sector.

  Who benefits? The 130+ branches of international insurers that currently operate in the UK across a range of business models. This includes general insurance firms that operate in the wholesale London insurance market and reinsurance firms.

- The streamlining and removal of reporting requirements that the PRA considers unnecessary for the UK insurance sector, to increase proportionality and reduce complexity.

  Who benefits? All insurers, to varying extents.

- A new 'mobilisation' regime, to facilitate entry and expansion for new insurers and encourage the international competitiveness and growth of the UK insurance sector.

  Who benefits? Firms that are thinking of applying for authorisation as an insurer in the UK, now or in the future.

Solvency II reporting thresholds

The final benefit, and perhaps of most interest to those at the lower end of the UK insurance market, relates to thresholds for Solvency II reporting. The Government has recently withdrawn several proposed audit and corporate governance reforms. CP 12/23 also raises the size thresholds at which small insurers – including many mutuals – are required to enter the Solvency II regime. So it's welcome news that the PRA still seems committed to the principle that smaller insurers are not burdened with onerous and disproportionate compliance costs.

Solvency II thresholds would be permanently switched from euros to pounds sterling. Those relating to gross written premiums would increase from €5m to £15m, whilst thresholds relating to an insurer's gross technical provisions would increase from €25m to £50m.

These changes would likely affect nine firms currently within the Solvency II reporting regime, whilst also giving smaller insurers room to grow without fear of being caught by the rules. These nine firms would, in the future, have the option to operate under the non-directive firm (NDF) sector rules.

Interestingly, if the GWP or technical provisions thresholds were increased further to £20m and £75m respectively, eight more firms would likely have the option to operate under NDF rules. The PRA is keen to emphasise its aim for balance and proportionality throughout. This is why the new £15m and £50m thresholds were chosen.

Whilst all insurance firms will always have the option to report under Solvency II rules, the PRA considers that the proposals would mean a more proportionate approach to the regulation of small firms, supporting their ability to grow and compete in UK insurance markets.

Reform of the matching adjustment (CP19/23)

The PRA launched the second consultation paper in September, CP 19/23, which specifically covers reforms to the matching adjustment (MA).

These proposals have three broad objectives: to improve business flexibility; to be more responsive to the level of risk; and to increase firms' responsibility for risk management.

Improving business flexibility

This aims to give firms more latitude for their investment portfolios. One example is widening the range of investments which qualify for MA (which might include assets with 'highly predictable' cash flows, rather than just fixed cash flows). Another is expanding the types of insurance business which may claim MA, and allowing more MA to be claimed from sub-investment grade (SIG) assets.

Being more responsive to the level of risk

The PRA aims to establish a streamlined MA application process for a range of suitable assets. This would vary according to risk, and would make the regulatory treatment of breaches of MA conditions more proportionate, so providing for more flexible and appropriate consequences. This reform aims to remove the 'cliff-edge' effect of losing the MA completely. Finally, the granularity of the fundamental spread would be increased, improving its risk sensitivity when used to calculate technical provisions.

Enhancing firms' responsibility for risk management

Firms would be allowed more flexibility in various measures, while the PRA would be more responsive to the level of risk. That means more onus on firms to stay on top of risk management. This would take the form of an MA benefit attestation process, clarifying risk expectations for management of SIG assets, formalising data submissions on MA assets and liabilities, formalising requirements for internal credit assessments, and ensuring MA eligible firms demonstrate compliance with the Prudent Person Principle.

Legislative changes already passed

By way of an early christmas present, HMT has recently passed legislation bringing in to law some of the key changes proposed in HMT's initial consultation. Most notably, the proposed reforms to the risk margin calculation have been passed, as has removal of the requirement to produce the Regular Supervisory Report ('RSR'). Both of these are effective for the 31 December 2023 year end.

The Insurance and Reinsurance Undertakings (Prudential Requirements) (Risk Margin) Regulations 2023.

The PRA has stated that a number of QRTs/NSTs do not need to be completed for the 2023 year-end.

Solvency II Review – considerations for year-end 2023.

Next steps

The consultation comment periods are now closed. So the proposals contained in CP 12/23 and CP 19/23 are likely to be implemented for 31 December 2024 year ends. Although affected firms may incur some initial costs, the PRA expects the long-term reduction in compliance costs to substantially outweigh these.

If you would like advice on any of the issues raised in this article, please contact James Randall.

James Randall
Director

+44 (0)113 526 7960
jrandall@pkf-l.com

ESG reporting – a fast-moving landscape

New standards and frameworks for ESG reporting continue to emerge. We provide a brief summary of key developments in the past year. Find out if they apply to you and how you will need to prepare.

It's over 12 months since our insurance audit team last gave an update on environmental, social and governance (ESG) reporting, and a lot has happened since then. Reporting on climate change is becoming more and more embedded, with regularly-produced analysis as to 'what good looks like'. The Financial Reporting Council's recent CRR Thematic review of climate-related metrics and targets is an example.

ISSB landmark standards

The launch of the International Sustainability Standards Board (ISSB)'s first sustainability disclosure standards is widely viewed as a game changer for sustainability reporting across the globe.

The inaugural standards are comprised of S1 and S2. IFRS S1 aims to facilitate disclosures from entities about sustainability risks and opportunities as part of their general purpose financial reports. IFRS S2 encourages companies to disclose information about how they manage the potential negative effects of climate change, including physical risks such as extreme weather events and transition risks like government policy changes.

The ISSB recognises that sustainability reporting is at very different stages of maturity in different jurisdictions. Its approach is therefore proportionate and flexible. For example, to help identify relevant matters for disclosure, companies should use reasonable and verifiable information that is available without undue cost or effort. The emphasis is on 'decision-useful' information, rather than a prescriptive set of disclosure requirements.

The key question for most preparers is 'who will need to apply these standards?'. ISSB standards are designed to be 'GAAP agnostic'. This means the scope of companies that may need to adopt them is not dependent on whether they use IFRS or UK GAAP.

In its Green Finance Strategy in March, the UK Government reconfirmed its commitment to assess, and decide whether to endorse, the standards. The Business and Trade Secretary will be responsible for making the decision to create the first two UK Sustainability Disclosure Standards (UK SDS) and the department aims to do this by July 2024.

Climate transition plans

The Transition Plan Taskforce (TPT) Disclosure Framework gives UK companies comprehensive guidance for producing climate transition plans. Its aim is to support companies in developing and implementing plans to achieve their net zero ambitions.

In October the TPT published its finalised Disclosure Framework and supporting guidance. Consistent with its November 2022 consultation, the framework is based around five key pillars:

1. Foundations
2. Implementation strategy
3. Engagement strategy
4. Metrics & targets
5. Governance

We believe climate transition plans will become mandatory for UK-listed issuers. The Government has also made it clear that it expects transition plan requirements to be embedded across the financial services sector.

The FCA has already said it will consult on proposals for mandatory sustainability disclosure requirements, based on the ISSB's Sustainability Disclosure Standards once they are endorsed for use in the UK. These may include climate transition plan disclosures based on the TPT's framework. The new requirements are likely to be in force for accounting periods beginning on or after 1 January 2025 and reporting should begin in 2026.

CSRD raises the bar

The Corporate Sustainability Reporting Directive (CSRD) is new EU legislation that requires all large companies and listed SMEs to publish regular reports on their environmental and social impact activities. The directive was effective from 5 January 2023 and builds on previous corporate sustainability reporting under the 2014 Non-Financial Reporting Directive (NFRD).

The CSRD will impact more companies than any other piece of sustainability regulation to date, raising the bar on disclosures across the 'E', 'S' and 'G'. All companies that fulfil two of the three criteria below must comply with the directive:

- Net turnover over €40 million
- Balance sheet assets over €20 million
- More than 250 employees

Approximately 50,000 companies worldwide will be required to disclose, track and measure their sustainability performance. CSRD will apply to all:

- companies listed on regulated markets in the EU (apart from listed micro-enterprises), and large companies (as defined by the criteria above). These companies will also have to take into account information at subsidiary level.
- listed SMEs, although there will be a transitional period when they can opt out until 2028. There are big benefits for SMEs that comply with the reporting.
- non-EU companies with a net turnover of €150 million in the EU, and with at least one subsidiary or branch in the Union.

Companies subject to the CSRD will have to report according to European Sustainability Reporting Standards (ESRS). The standards were developed by EFRAG, previously known as the European Financial Reporting Advisory Group, an independent body bringing together different stakeholders. The standards will be tailored to EU policies, while building on and contributing to international standardisation initiatives.

For those companies in scope, the requirements are onerous. Firstly, they must collate over 1,000 data points, including metrics and qualitative data. This can be phased in over three years, but organisations must report not only on topics that are material to them, but also on data gathered from their value chain. In addition, there is 'limited assurance' required in the first year of reporting, followed by 'reasonable assurance' in subsequent years.

So sustainability reporting standards are increasing in their scope and in the context of external reporting. Although many UK entities are still unsure as to how these new requirements will apply to them, it's inevitable that reporting will only become more onerous.

All this means that staying abreast of the requirements is vital. But what is paramount is making sure that ESG considerations form part of your organisation's governance and decision making. Only then can you be ready to tell your story when new regulations come into force.

For more information about the issues raised in this article, please contact Martin Watson.

Martin Watson
Partner
+44 (0)113 524 6220
mwatson@pkf-l.com

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Martin Watson
Partner – Audit & Assurance
+44 (0)113 524 6220
mwatson@pkf-l.com

Cheryl Mason
Partner - Audit & Assurance
+44 (0)20 7074 9946
cmason@pkf-l.com

Carmine Papa
Partner - Audit & Assurance
+44 (0)20 7516 2271
cpapa@pkf-l.com

Thomas Seaman
Partner - Audit & Assurance
+44 (0)20 7516 2450
tseaman@pkf-l.com

James Wilkinson
Partner - Audit & Assurance
+44 (0)161 552 4220
jwilkinson@pkf-l.com

Satya Beekarry
Partner – Audit & Assurance
+44 (0)20 7516 2425
sbeekarry@pkf-l.com

Jessica Wills
Partner – Goverance, Risk & Control Assurance
+44 (0)20 7516 2229
jwills@pkf-l.com

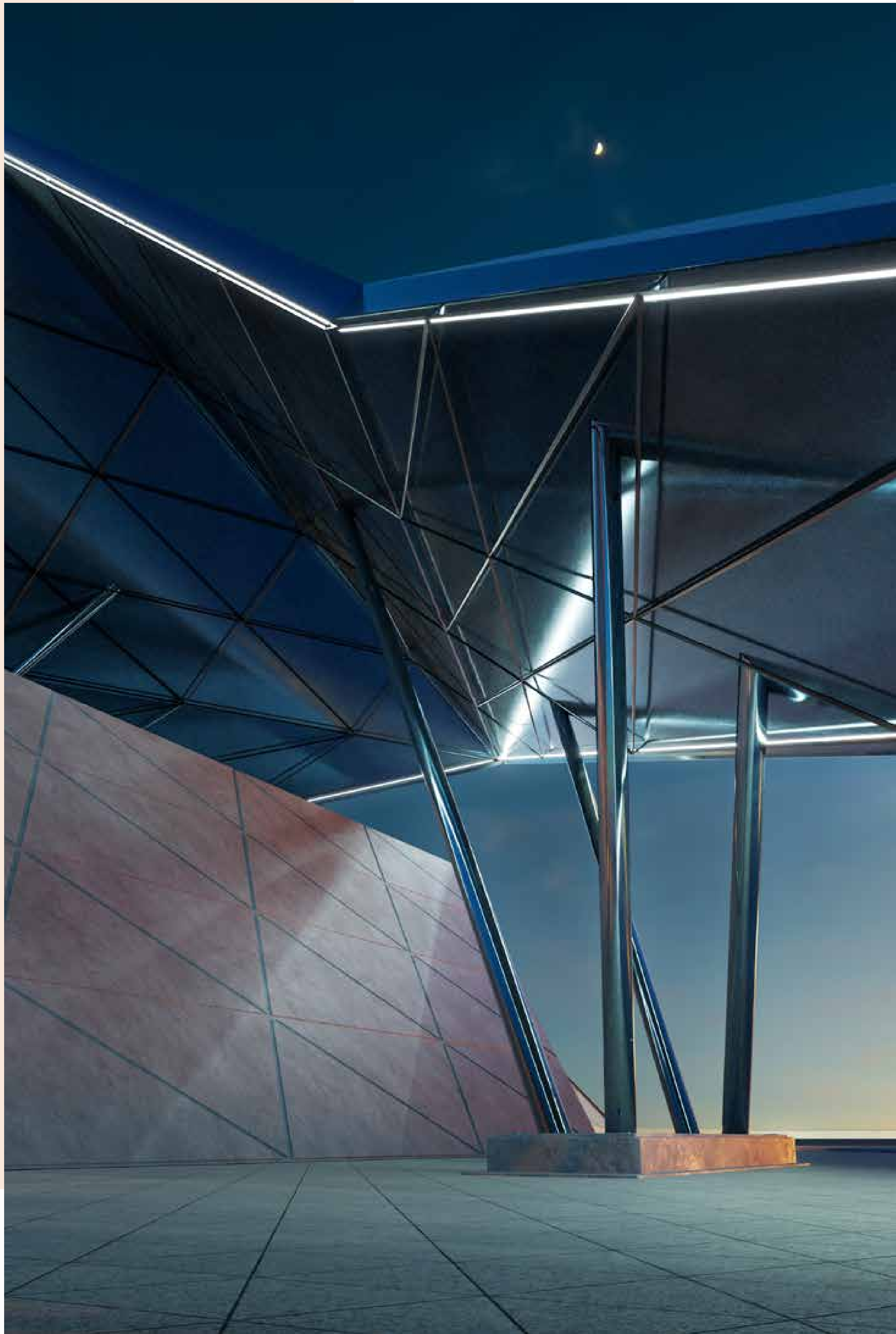
Chris Riley
Partner – Head of Tax
+44 (0)20 7516 2427
criley@pkf-l.com

Mark Ellis
Partner - VAT
+44 (0)20 7072 1102
mellis@pkf-l.com

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

James Randall
Director - Audit & Assurance
+44 (0)113 526 7960
jrandall@pkf-l.com

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



PKF Littlejohn LLP

www.pkf-l.com

London

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

Leeds

3rd Floor
One Park Row
Leeds, LS1 5HN

Tel: +44 (0)113 244 5141

Manchester

11 York Street
Manchester
M2 2AW

Tel: +44 (0)161 552 4220