



# Positioning the internal audit function within the Solvency II framework

## Key challenges

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Throughout its fundamental review of the capital adequacy regime of the European (re)insurance industry –*Directive 2009/138/EC on the taking-up and pursuit of the business of insurance and reinsurance as amended ('Solvency II' or 'the Directive')*, entering into force on 1 January 2016—will introduce revised risk management and governance standards.

These revised standards will cause the system of governance of (re)insurance organisations to evolve with the implementation of mandatory key functions, adequate articulation of which is crucial to provide for sound and prudent management of the business.

Of the key functions enforced by Solvency II, the internal audit function intends to remain entirely responsible for the examination and evaluation of the adequate functioning and effectiveness of internal control systems and all other elements of the system

of governance, along with the evaluation of whether such internal control system remains sufficient and appropriate for the organisation's business.

While it is expected that the role and objectives of the internal audit function will not deviate from its primary focus in the Solvency II framework (an assurance activity for those charged with governance of the organisation, designed to add value and improve operations), some key principles are to be properly followed during the implementation.

## Major challenges for the internal audit function under the Solvency II regime

### Key features of the internal audit function

The internal audit function is defined as an independent, objective assurance and consulting activity whose role is to add value, improve an organisation's operations and ensure the respect of regulatory obligations. It helps an undertaking to accomplish its objectives by providing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, the actuarial function, the compliance function and internal governance processes.

The internal audit function can also be seen as a tool for improving an undertaking's operations and related controls by providing insight and recommendations. It provides value to governing bodies and senior management as an objective source of independent advice.

However, beyond this generic definition of the internal audit function, key features have to be respected in order to ensure an appropriate working of the function within the framework of Solvency II and in compliance with Institute of Internal Auditing (IIA) standards.

### These key features are the following:

#### 1. Independence and objectivity

In order to comply with Solvency II and IIA standards, the internal audit function will have at all times to be independent of the activities it audits. Such independence will allow the internal audit function to perform its work freely and objectively. It will also allow the function to render impartial and unbiased judgments essential to the proper conduct of its activities objectively.

**Indeed, the independence of the internal audit function is incompatible with the situation in which:**

- The staff of the internal audit function is in charge of tasks it is called upon to check or tasks which are not related to its area of control
- The internal audit function is, from an organisational point of view, included within the business units it controls or reports hierarchically to them

The authority that the internal audit function must have also requires that it should be able to exercise its responsibilities, on its own initiative, express itself freely and access all external and internal data and information (in all business units of the institution it checks) deemed necessary to fulfil its role.

The authority of the internal audit function must be objective in carrying out its work.

Even if, in many situations, this can be challenging, the internal audit function must exercise independent thought and judgement. The head of the function should not make his/her own judgment conditional upon that of other persons including, in particular, those checked.

Objectivity also requires that conflicts of interest are avoided. To achieve this, the internal audit function must remain free from interference by any element in the organisation, including in matters of audit selection, scope, procedures, frequency, timing or report content, to enable the maintenance of the necessary independent and objective mental attitude. Internal auditors should also have no direct operational responsibility or authority over any of the activities audited.

Accordingly, they will not implement internal checks, develop procedures, implement systems, prepare records or engage in any other activity that might impair their judgement. In order not to challenge their independence of judgement, the persons responsible for internal audit cannot be in charge of the preparation or establishment of elements of the administrative organisation and internal governance. However, this fundamental principle does not prevent them from taking part in the implementation of a sound internal control mechanism through observations and recommendations that they provide in this respect.

In all cases, internal auditors must exhibit the highest level of professional objectivity in gathering, evaluating and communicating information about the activity or process being examined. They must make a balanced assessment of all relevant circumstances and not be unduly influenced by their own interests or by others in forming judgments.

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## The co-operation of the internal audit function with other governance functions is also expected to increase through improved exchange of information

### 2. Proficiency and due professional care

In parallel, all internal audit engagements must be performed with proficiency and due professional care. This means that internal auditors must have or must acquire, where necessary, the knowledge, skills and any other competences needed to perform their individual responsibilities.

Internal auditors must apply the care and skill expected of a reasonably prudent and competent internal auditor. However, due professional care does not imply infallibility and, in some cases, the internal audit function should legitimately consider the support of an external expert in the subject, in order to ensure an adequate level of expertise on specific areas to be covered according to the internal audit plan.

In order to achieve reasonable proficiency and due professional care, it is thus important that internal auditors enhance their knowledge, skills and any other competences whenever possible through continuing professional development.

### 3. Professional ethics

In order to comply with professional ethics, the internal audit function must adhere to the IIA's mandatory guidance including the IIA's Definition of Internal Auditing, Code of Ethics and its Standards. This mandatory guidance constitutes the principles of the fundamental requirements for the professional practice of internal auditing and for evaluating the effectiveness of the internal audit function's performance.

Of course, the internal audit function must also adhere to relevant policies and procedures of the company covering the professional behaviour and ethics of the undertaking's employees.

### 4. The internal audit charter

All these key features will have to be described in the internal audit charter which is the cornerstone defining the purpose, authority and responsibilities of the internal audit function. This document must in all cases be consistent with the the IIA's Definition of Internal Auditing, Code of Ethics and its Standards.

The internal audit charter, which is drawn up by the internal audit function, will have to be approved by both the executive board and the board of directors of the company. Its content is to be brought to the attention of all staff members of the company, including those who may work in branches and subsidiaries.



### How the internal audit function will contribute to an effective system of governance

In addition to the set-up of an internal audit function, the Solvency II framework Directive requires insurance undertakings to have an effective system of internal governance in place. Its objective will be to provide *'a sound and prudent management of business'*, in which the position of the internal audit function has been emphasised.

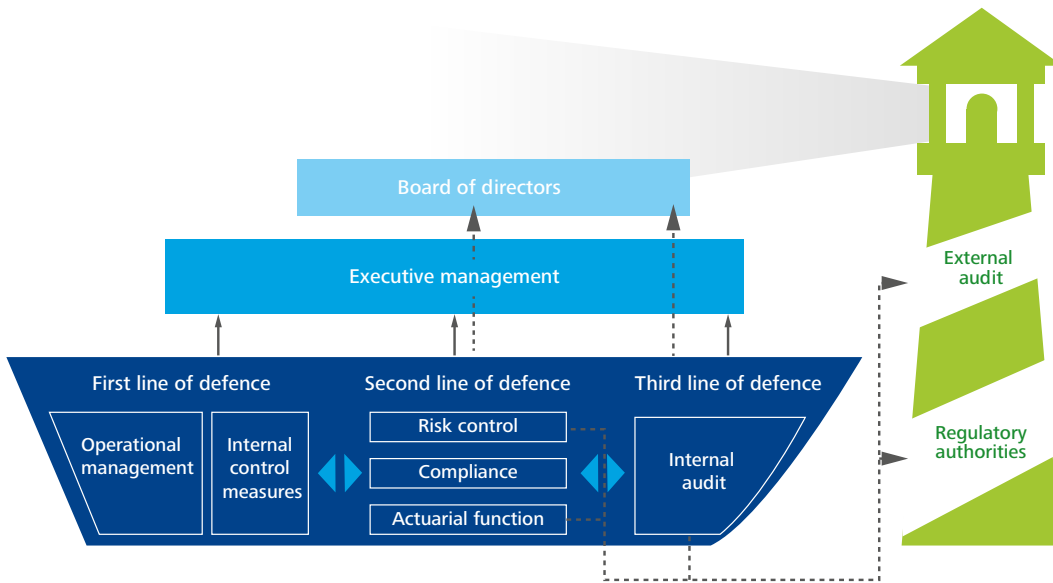
Indeed, the governance system of Solvency II implies four key functions, namely the risk management, the compliance, the actuarial and the internal audit functions.

This model requires responsibility to be differentiated and distributed at three different levels named lines of defence:

- 1 The first line of defence consists of the business units that take or assume risks within a pre-defined policy and limits and carry out checks.  
The types of checks performed consist of:

  - Daily operational checks
  - Critical on-going checks: persons in charge of validation
  - Checks performed by the authorised management on matters for which they are directly responsible
- 2 The second line of defence contributes to the independent risk control. The challenge of the second line of defence functions is to ensure compliance with and execution of risk, actuarial and compliance strategies, approaches, and related management information.
- 3 The third line of defence is composed of the internal audit function. It provides an independent, objective and critical review of the first two lines of defence. As already detailed above, the objective of the internal audit function will be to provide an independent, objective and critical assessment of the design and effectiveness of the overall system of internal control.

Figure 1: The three lines of defence model



This model illustrated in the above figure puts in evidence where the separate functions operate within the governance structure of the insurance undertaking even though interactions/channels of communications must exist in order to avoid each line of defence operating within its own 'silo'.

Such a governance model, reflecting the regulatory expectation detailed in the *'Consultation Paper on the proposal for Guidelines on system of governance and own risks and solvency assessment'* (publication EIOPA-CP-14/017) points out the most critical challenges that the internal audit function of an insurance undertaking will have to achieve:

1. To impose itself in organisations where, until now, an internal audit function was not a regulatory obligation for (re)insurance undertakings in all EU countries. This objective will be achieved by clear communication of the role and responsibilities of the function within the organisation (i.e. an internal audit charter) as well as its operating procedure (i.e. internal audit plan, assignments, reporting and follow-up of recommendations).
2. To develop co-operation with other lines of defence while remaining independent and objective when performing internal audit assignments.
3. To have an extensive level of proficiency in order to be in a position, on the one hand, to issue recommendations relevant for the improvement of operations but also, on the other hand, to be considered within the organisation as being in a position to provide advice upon request from executive management or other governance bodies.

In this way, the internal audit function will appear a key part of this governance system and contribute to the soundness and prudence of an insurance undertaking. In this context, the internal audit function will have to extend its scope of intervention in covering this new governance framework more specifically.



**Extensive role of the internal audit function within the Solvency II framework**

Article 47 of the Directive requires (re)insurance organisations to provide for an effective internal audit function. The internal audit function must include an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance.

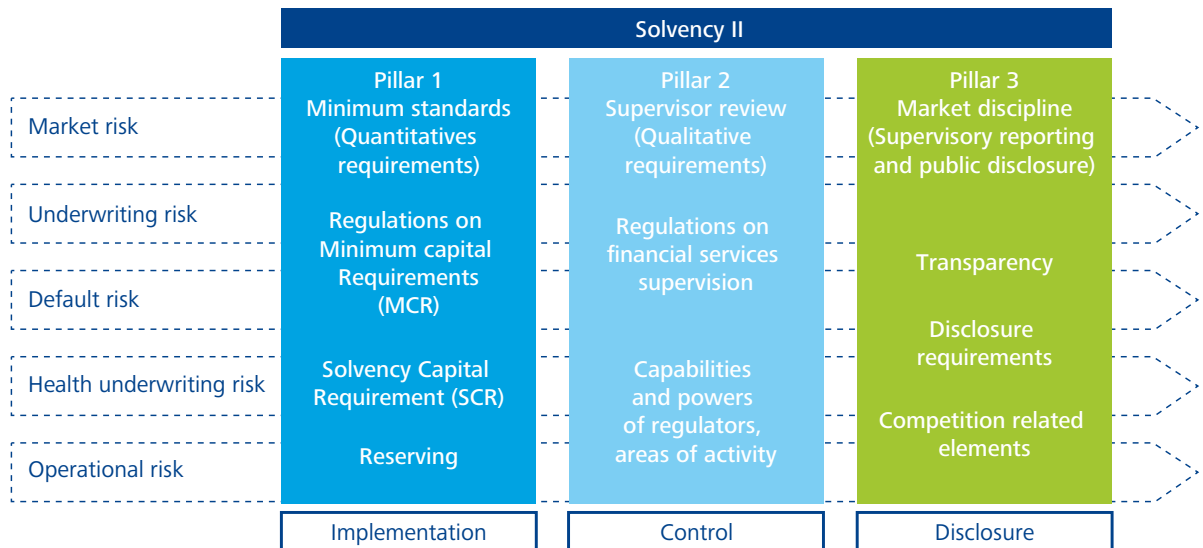
While the Directive states that the system of governance should be proportionate to the nature, scale and complexity of the operations of the organisation, it assumes, however, that the internal audit function must be in place and operate effectively, primarily in the reporting of any findings and recommendations to those charged with governance of the organisation.

Assuming the internal audit function operates effectively means that the internal audit function is expected to design and implement an audit plan that encompasses the whole internal audit scope (activities, components and functions) as amended by the Solvency II framework.

**A comprehensive audit approach that should consider the whole spectrum of the regulatory requirements with the deployment of an integrated audit plan**

The internal audit function has to consider all the requirements of the Solvency II framework, leading to an enlargement of the scope of internal audit and an impact on the audit approach and working programmes, since Solvency II compliance items are expected to be included in the carrying out of each internal audit assignment.

Figure 2:



As part of the extension of internal audit tasks prescribed by Solvency II, the review of the Own Risk and Solvency Assessment (ORSA) and Pillar 3 communication processes and outcomes can be highlighted:

1. Defined as *'the entirety of the processes and procedures employed to identify, assess, monitor, manage, and report the short and long term risks a (re)insurance undertaking faces or may face and to determine the own funds necessary to ensure that the undertaking's overall solvency needs are met at all times'*, the ORSA sheds light on the impact of strategic decisions on the organisation's overall solvency and its outcome. A yearly report submitted to the regulatory authority is subject to an independent review from the internal audit.

This review will be carried out to ensure that the ORSA process and outcome are appropriately designed and implemented, considering the following objectives as part of the internal audit approach: effectiveness of the ORSA governance and process, compliance with Solvency II requirements and timeliness of reporting, appropriateness of the risk models applied and consistency with the overall risk profile of the organisation and reliability and traceability of information supporting risk assessment.

2. Pillar 3 reporting and disclosures will also widen the scope of internal audit with the review of the processes in place supporting the preparation of both quantitative and qualitative information contained in the Solvency and Financial Condition Report (SFCR) and the Regulatory Supervisory Report (RSR). This review will aim at ensuring that this information is relevant, reliable, accessible and complete in all material aspects, consistent with the Solvency II requirements.

In the meantime, this expansion of the internal audit scope may also give rise to further collaboration between the internal audit function and the external auditor of the organisation. Indeed, it is expected that these reporting requirements will be subject to external audit, and, in some instances, the external auditor may decide to rely on the work performed by the internal audit function.

Within the organisation, the co-operation of the internal audit function with other governance functions is also expected to increase through improved exchange of information.





**A fundamental role in the assessment of the internal control and governance systems**

Within the three lines of defence model, the internal audit function provides assurance on the design and effectiveness of the overall system of internal control, including risk management and compliance functions.

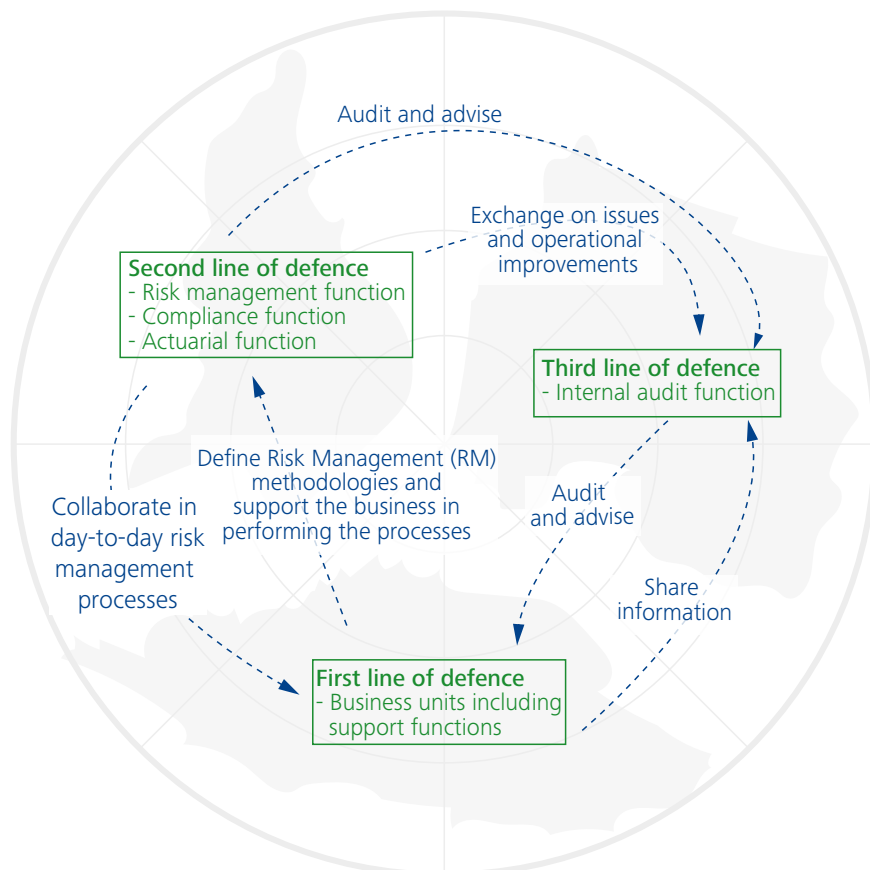
Despite having adopted the 'three lines of defence' risk governance model, some organisations still struggle to articulate how oversight is assigned among the governance functions and other support functions.

Transparent and fair apportionment of responsibilities for supervision is crucial to achieving an adequate organisational structure along with an appropriate segregation of responsibilities.

**As the third line of defence, the internal audit function is uniquely positioned:**

- To provide an independent assessment of the governance system
- To enhance the communication process between the different functions
- To foster the use of a common language throughout risk identification, categorisation and reporting processes

Figure 3:



Independent assessment of the governance system by the internal audit function relates in particular to assessing risk management and compliance functions.

- The monitoring of compliance with laws and regulations, including how the compliance function fulfils its responsibilities

**Assuming that the internal audit function has the appropriate capability regarding matters of risk and regulatory interest, the audit scope should be focused respectively on:**

- The effectiveness and efficiency of risk management systems in the context of both current and potential future risks
- In this context, risk management systems set out the necessity to review the adequacy of processes for identifying, measuring, assessing and reporting on all the risks resulting from the organisation's activities as well as the integrity and robustness of the risk management information systems, including the reliability and completeness of the data used

Along with a broader scope of internal audit, the internal audit function is dealing with more diversified areas of expertise such as actuarial, regulatory and information technology matters.

Consequently, internal auditors will have to broaden their technical skills continuously to ensure suitable competencies are available to achieve an independent and timely review of the internal control and governance systems.

## Conclusion

The new governance system defined by Solvency II enforces the deployment of key functions and foresees that the internal audit function will play a fundamental role in the recurrent maintenance and assessment of internal control, risk management and governance systems and processes. This strengthened role becomes even more evident when the magnitude of the scope of audit is considered.

Beyond the existing guidelines and professional standards that are to be followed by the internal audit function, some major challenges appear when it comes to an effective implementation of the function: adequate professional knowledge and industry expertise are pre-requisites that entail investment in human capital and dedicated training in most organisations.

In that respect, the organisation could address this governance requirement by:

- The development of an internal audit department within the organisation, under the responsibility of a Chief Internal Auditor with strong knowledge of the industry and of internal audit standards and market practices
- Or the outsourcing of the internal audit function, with the use of external expertise that should be assimilated by the organisation, which will ultimately retain the overall responsibility for maintaining an effective internal control function