**ICAEW**
REPRESENTATION 96/20

# SOLVENCY II: THE PRA’S EXPECTATIONS FOR THE WORK OF EXTERNAL AUDITORS ON THE MATCHING ADJUSTMENT
CP 11/20

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ICAEW welcomes the opportunity to comment on the *Solvency II: The PRA’s expectations for the work of external auditors on the matching adjustment* published by the Prudential Regulation Authority on 30 July 2020, a copy of which is available from this link.

We support and welcome the clarification of the regulator’s expectation of external auditors of regulated firms and the enhanced transparency that these proposals provide to all stakeholders.

We however, recommend that the PRA delay the application of these expectations until 31 December 2021, so that external auditors can determine their audit approach and discuss this with the audit committees of regulated firms. Given that regulated firms and external auditors will already face significant challenges relating to the Covid-19 for this year end, we consider that such additional work on the part of the regulated firms could create challenges and delays to the issuance of an unqualified audit opinion.

This response of 30 October 2020 has been prepared by the ICAEW Financial Services Faculty. As a leading centre for thought leadership on financial services, the faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk management, auditing and reporting issues facing the financial services sector. The faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services.

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## KEY POINTS

1. ICAEW is pleased to respond to the Prudential Regulation Authority's consultation paper (CP) 11/20 that sets out the PRA's proposed expectations and guidance relating to auditors' work on the matching adjustment (MA).

2. We understand that the PRA's proposals fall into two categories: (1) clarifications and enhanced transparency regarding the external audit of the MA; and (2) new expectations that relate to the communication by auditors on the subject of the MA.

3. We appreciate that the PRA has carried out a large amount of work on the MA in recent years. While this has mainly related to clarifying the regulator's expectations of regulated firms, it is helpful now to ensure that it is clear for all stakeholders what is expected of external auditors. We therefore support and welcome the enhanced transparency that these proposals provide to all stakeholders.

4. We do have however, a few observations on the contents of the proposals as set out in the consultation paper.

5. For the reasons set out in (1) and (2) below, we recommend the PRA to delay the application of these expectations until 31 December 2021, so that external auditors can determine their audit approach and discuss this with the audit committees of regulated firms. Given that regulated firms and external auditors will already face significant challenges relating to the Covid-19 for this year end, we consider that such additional work on the part of the regulated firms could create challenges and delays to the issuance of an unqualified audit opinion.

### (1) Clarifications and enhanced transparency regarding the external audit of the MA

6. We would note that while the PRA does not regard these proposed clarifications as new expectations, it does recognise that the clarifications could potentially cause auditors to reconsider the scope of work that they currently carry out in relation to the SFCR. As a consequence of these proposed clarifications, the information contained within a regulated firm's MA application previously considered as the framework against which an external auditor should conduct their work would instead become the subject matter of an external auditor's opinion. In some situations, this may lead to increased burden and cost for both regulated firms and their auditors. In this regard, we consider that it is important that regulated firms and their external auditors have sufficient time to discuss what alternative or additional procedures and appropriate documentation (if any) may be required as a result of these clarifications such that the external auditor can obtain sufficient, adequate audit evidence to support their overall opinion.

7. The PRA is not prescriptive about the audit work necessary to support an auditors' opinion on the SFCR. We agree that such prescription would not be appropriate. However, given the complex structures that regulated firms have used to restructure their portfolios of unrated, illiquid assets in order to produce MA-eligible notes with fixed cash flows and the potential for external audit firms to interpret the proposals differently, we consider that further guidance and/or detail is required to ensure some consistency of external auditors' approaches.

8. The audit of some of methodologies and judgements involved in the matching adjustment – particularly relating to a regulated firm's approach to internal credit ratings of MA portfolio

assets and mapping these to credit quality steps – is highly complex and require specialist skills. While specialists are already extensively involved we do consider that it would be beneficial that the PRA further clarified the framework against which the external auditor should assess a regulated firm's approach and whether this will be grounded in the Solvency II regulations, or in an individual regulated firm's agreement with the PRA. In particular, the current audit requirement has been that auditors need to test the application of the insurer's methodology for assessing credit ratings rather than perform an assessment of the appropriateness of that methodology and the resultant credit ratings. The PRA has required some insurers to obtain independent assessments of their credit rating methodologies in the recent past. Requiring auditors to re-examine the credit rating methodology might not achieve the PRA's objectives due to materiality considerations and may create an expectation gap between PRA and auditors in this complex area. As noted below, a number of further expectations are currently set out in supervisory statements (such as SS3/17) rather than PRA rules. Further, in our collective experience an external auditor must properly consider correspondence between the regulated firm and their supervisor in respect of a firm's MA calculation methodology to understand how its calculations have evolved since the original MA was approved.

### (2) New expectations that relate to the communications by auditors on the subject of the MA

9. We note the expectations of the external auditor where they become aware through the course of their work that the regulated firm may not be compliant with MA requirements. The PRA supervisory statement 3/17 set outs a number of expectations in respect of regulated firms investing in illiquid, unrated assets within their MA portfolios. These expectations do not set absolute requirements and therefore, it would be helpful if the PRA could clarify that the term 'MA requirements' referred to in 4.2J does not extend to expectations set out in SS3/17. We note further that an external auditor currently plans and performs their audit work to produce an opinion confirming that the relevant elements of the SFCR are prepared in all material respects with the PRA rules and Solvency II Regulations on which it is based. The external auditor is not required to confirm that the firm complies with supervisory statements.

10. Further, it would be helpful if the PRA could clarify what the external auditor should do if the regulated firm does not meet with one of the expectations set out in a supervisory statement. For example, there may indeed be circumstances in which a regulated firm has calculated its MA in accordance with the PRA rules and Solvency II Regulations but does not meet the effective value test ('EVT'). This could then lead to a situation where an external auditor has issued an unqualified ('clean') audit opinion over the scale of the matching adjustment that is subsequently challenged by the PRA. We believe that such an outcome could be confusing and would not adequately represent the firm's position to users of the SFCR.

11. 4.2J makes no reference to an external auditor's existing statutory duty to report to the regulator where they reasonably believe that there is or has been or may be or may have been a contravention of any relevant requirement that applies to the regulated firm and that failure may be of material significance to the regulator in determining whether to take action. As a result, this could lead to inconsistent approaches taken by different external auditors.

12. While we agree that the insights auditors obtain in undertaking an external audit of the relevant elements of the SFCR may contribute to an effective auditor-supervisor dialogue further details as to how the PRA envisages this relationship would be helpful. Clarifying the

contents, timings and format of the dialogue would enhance the transparency of the process not only for auditors and supervisors but insurers too.

13. Finally, we note that the matching adjustment is part of HM Treasury's review into Solvency II for which Call for evidence has been issued. We would like to take this opportunity to offer ICAEW's participation in the Government's review of certain features of Solvency II. We would recommend a full review and simplification of the rules that apply to the UK insurers following Brexit.