



## CP11/20 Solvency II: The PRA's expectations for the work of external auditors on the matching adjustment

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### Key points

The PRA's Consultation Paper CP11/20 provides useful clarifications of the PRA's expectations in relation to current practice, and is generally helpful in setting expectations in relation to revised practice.

However, we believe that it would be helpful to provide more guidance on the general information sharing/ reporting process between the auditor and the firm's senior management, and then the PRA. It would be good practice for auditors to discuss matters with the firm's senior management prior to contacting the PRA if appropriate. We think this is especially important given the complexities of the Matching Adjustment (MA).

Our interpretation of the CP11/20 proposals is that internal credit ratings are being brought explicitly into the scope of the audit. Our understanding had been that previously, the auditor confirmed the application of the PRA-approved rating methodology. Use of internally-rated assets within MA portfolios has received significant PRA scrutiny and/or external validation. Therefore, any audit work in this area should be proportionate, taking into account both materiality and prior reviews conducted by third parties (including by the PRA).

The proposed implementation timescale of year end 2020 may be challenging for firms and their auditors to prepare in relation to some aspects of the new requirements of CP11/20.

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1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's Consultation Paper (CP11/20) on its expectations for the work of external auditors on the Solvency II Matching Adjustment (MA). In developing our response, we have drawn upon input from members working for insurers or insurance auditors/ advisors.
2. It is important to note that, as for any IFoA response, we have considered the PRA's proposals from the perspective of what is in the public interest.
3. The CP provides useful clarifications of the PRA's expectations in relation to current practice, and is generally helpful in setting expectations in relation to revised practice. However, below we flag a number of areas where further guidance may be useful.
4. The CP includes clarification that the auditor is not required to assess whether the insurer meets MA-eligibility conditions. However, paragraph 4.2J (Appendix 1) explains that action is required *if the auditor becomes aware* that the MA is not complied with. It may be difficult for an auditor to evidence subsequently that they were not aware of any such non-compliance. As such, this appears to place an implicit obligation on the auditor to seek evidence that the MA is being complied with, despite this not forming part of the audit.
5. Paragraph 4.2J also requires the auditor to remind the firm to contact the PRA. However, it is silent on:
  - whether the auditor is required to obtain evidence of that contact having taken place. We presume however that the auditor would require such evidence; or
  - what action should be taken if that evidence is not provided, although it may be reasonable to assume that the auditor would be expected to contact the PRA in that situation.
6. Paragraph 4.2K refers to a material change to the MA calculation, and the requirement for the auditor to act (in this case to contact the PRA) *if the auditor is aware* that the firm has not contacted the PRA. Similarly to the MA-compliance point above, it may be difficult to evidence subsequently what the auditor was aware of. As such, this appears to place an obligation on the auditor to seek evidence that the firm has contacted the PRA, and to act if it were unable to obtain that evidence.
7. In relation to these points, we believe that it would be helpful to provide more guidance on the general information sharing/ reporting process between the auditor and the firm's senior management, and then the PRA. Clearly it would be good practice for auditors to discuss matters with the firm's senior management prior to contacting the PRA if appropriate: to confirm that they have correctly understood the situation, and to minimise the risk of inaccurate findings being reported, for example. We think this is especially important given the complexities of the MA.
8. Our interpretation of the CP proposals is that internal credit ratings are being brought explicitly into the scope of the audit; our understanding had been that previously, the auditor confirmed the application of the PRA-approved rating methodology (as it formed part of the approval of the MA). Use of internally-rated assets within MA portfolios has received significant PRA scrutiny and/or external validation. Therefore, any audit work in this area should be proportionate, taking into account both materiality and prior reviews conducted by the firm's internal audit function and by third parties (including by the PRA). Otherwise, any duplication of external audit and PRA validation activity could lead to additional cost, which may not be in the public interest.
9. A further issue to consider is the scenario where an audit firm reaches a different view in relation to an asset's internal credit rating; this gives rise to the risk that the audit firm ends up de-facto rating

that asset. There are also potential difficulties with the scenario where the PRA and audit firms reach different conclusions in relation to a credit rating.

10. The proposed implementation timescale of year end 2020 may be challenging for firms and their auditors to prepare in relation to some aspects of the requirements of the CP (such as points raised above). Ideally, changes to audit processes should be agreed and implemented well ahead of the year-end process commencing.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager ([steven.graham@actuaries.org.uk](mailto:steven.graham@actuaries.org.uk)) in the first instance.

Yours Sincerely,

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**President, Institute and Faculty of Actuaries**