ICAEW
REPRESENTATION 2/24

REVIEW OF SOLVENCY II: REFORM OF THE MATCHING ADJUSTMENT

Issued 2 January 2024

ICAEW welcomes the opportunity to comment on the Prudential Regulation Authority's consultation on reforming the matching adjustment, published on 28 September 2023, a copy of which is available from this link: CP19/23 – Review of Solvency II: Reform of the Matching Adjustment.

Should you have any questions relating to this ICAEW response, please contact the ICAEW Financial Services Faculty, using the following email address: fsf@icaew.com.

ICAEW welcomes the Prudential Regulation Authority's (PRA) consultation (CP 19/23) on reforming the matching adjustment (MA).

Generally, we feel there are a number of areas where further clarification would be helpful. Our main comments are:

- We believe the timeframe for implementation is too tight and may pose significant challenges to firms and auditors. Any flexibility to agree a feasible timeline to deliver the first attestation report would be welcome (see Q1).
- Further clarification is needed around the PRA's expectations for the provision of assurance on internal credit assessments, including its interaction with the audit procedures covering the Matching Adjustment (MA) within the SFCR (See Q12).
- Further clarification is also needed on the PRA's expectations for the interaction of the attestation report, voluntary additions to the Fundamental Spread (FS) and the scope of the audit of the SFCR; and whether an update to the supervisory statement 11/16 is required, given the anticipated significant level of additional audit work that may be required if the additions to the FS are in scope of the audit (see Q15).

We explain these points in more detail in the main body of our response.

ICAEW
Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK
T +44 (0)1908 248 250 F +44 (0)20 7920 0547   icaew.com

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 166,000 chartered accountant members in over 146 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

This response was prepared by the 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, 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.

DETAILED COMMENTS

1. We set out below our detailed comments. We have answered the questions in the consultation paper that are of most relevance to our members.

CHAPTER 1 - OVERVIEW

Question 1. The PRA invites feedback on the proposals set out in this consultation, including:

The implementation timeline

2. Paragraph 1.20 envisages that the PRA will publish its final policy and rules on the MA during Q2 2024 with an effective date of 30 June 2024. We note that firms that use the MA will be able to take advantage of the MA reforms in advance of 31 December 2024. Paragraph 6.33 foresees the MA attestation be provided no later than 14 weeks after the firm's financial year end. Paragraph 8.9 proposes that the first submission of the on-cycle annual Matching Adjustment Asset and Liability Information Return (MALIR) is due by 23 June 2025 (for most firms whose financial year ends on 31 December) based on the 2024 position.
3. We are sensitive to the short timeframes envisaged by the proposals. Affected firms will need to design and implement governance, systems, processes, and controls changes to meet the first annual attestation requirement by the beginning of April 2025 without full clarity on the final rules until mid-2024. We anticipate that the current implementation timeline will create short term resource pressures on actuarial, investment and financial reporting teams and might not be sufficient for firms to close gaps, perform 'dry-runs' of their processes, and develop appropriate risk monitoring processes ahead of the first attestation deadline. Further, while we acknowledge that firms have more time to produce and report the MALIR to the regulator, in practice the Senior Management Function (SMF) making the attestation will want to have reviewed this same data as part of their attestation.
4. We would therefore believe the PRA should consider permitting firms to agree bilaterally with their PRA supervisory team a feasible timeline to deliver their first attestation report. This would give firms more time to design, build, review, refine and embed the effective governance, systems, processes, and controls required to make an MA attestation.
5. In addition to the timeframe being a challenge for insurers, we also are concerned about the effect on audits. The auditor will be undertaking their audit procedures over the MA while insurers might be grappling with implementing the new rules and there is lack of clarity of the need for MA changes as a result of the reform. The challenges are described in the 'MA application documentation' section below and in our answer to question 15.

MA application documentation

6. There are broader points where the implementation is somewhat unclear. For example, as part of the audit of the calculation of the MA, the auditor is required to consider whether the assets and liabilities included within the MA calculation fall within the scope of the PRA approved MA application, but paragraph 4.2E of SS11/16 clarifies that "In forming the opinion required by Rules 2.1 and 4.1 of the External Audit Part of the PRA Rulebook, auditors are not required to assess whether a firm meets the eligibility criteria for the use of the MA".
7. The proposed changes will introduce certain new requirements. It would be helpful for the PRA to be clear where these requirements essentially 'override' the documentation or MA approval that the firm already has. As an example, the auditor will identify the assets for which the firm has approval to include in the MA calculation by reference to the PRA approved MA application and supporting documentation. CP19/23 brings a new category of assets with "highly predictable" cashflows into scope of the MA. We understand that some firms believe that existing assets in the MA portfolio may be considered "highly predictable" under the new rules. We would appreciate the PRA clarifying the approach which the auditor

is expected to take to assets of this sort or other areas where the current approved application appears out of line with the new rules.

8. Another example where clarity would be welcomed, concerns the mechanics of notching to calculate the Fundamental Spread. Para 9.2 of CP 19/23 states the PRA will require firms to derive a more granular FS by rating notch by linearly interpolating the technical information published by the PRA for each relevant CQS. Does the PRA plan to publish the interpolation by notch as part of the published technical information to avoid the potential issue of different insurance firms arriving at slightly different ways of producing such interpolation?

CHAPTER 4 – CREDIT RATINGS UNDER THE MA

Question 12. Do you have any comments on the PRA's proposals in respect of internal credit assessments?

9. Paragraph 4.19 of the consultation paper states "*The PRA expects that the MA regulations will introduce a requirement for internal credit assessments, in the relevant portfolio of assets, to be comparable to those arising from an external credit rating*". And in paragraph 4.22 the PRA proposes "*the internal credit assessments must be subject to proportionate independent external assurance to ensure that the internal credit assessment outcomes lie within a plausible range of issue ratings that could have resulted from a CRA*".

10. Our members are not Credit Rating Agencies (CRAs) but have in the past undertaken work over ratings assessments as part of their audit procedures covering the MA in line with PRA's expectations set out in chapter 4 of SS11/16. We are, however, unclear on the PRA's expectations for the proposed new assurance of the credit assessment and what it might entail, and so whether this work would be something that our members might undertake. We also think that firms might be unclear how they should approach obtaining assurance. We would, therefore, appreciate further clarification and guidance on the PRA's proposals and expectations, including in the following areas.
    - Does the PRA expect the proposed assurance to assess whether the credit assessment for a particular asset is within a plausible range, as opposed to whether the firm has an appropriate methodology designed to deliver that assessment outcome?
    - Whether the PRA has any expectation who would be eligible or would be appropriate to provide the external assurance? We ask this question because, for example, does the PRA consider that only a CRA can form the judgement whether the assessment is likely to deliver an outcome "within the plausible range of issue ratings that could have resulted from a CRA".
    - What are the PRA's expectations for "independence" of the assurance provider? We ask because the auditor of the SFCR may in limited certain circumstances, be able to undertake other work on behalf of the firm.
    - What level of assurance does the PRA expect to be provided, and is the same level of assurance required in all cases? Reasonable assurance provides a higher degree of confidence than limited assurance but carries a higher cost for firms. Letting firms choose as appropriate to their risk, would align with a proportionate approach to be taken to obtaining assurance.

11. As noted above, as part of the audit procedures covering the MA, in line with the expectations set out in SS11/16, our audit firm members are required to obtain audit comfort on the internal credit assessments made by the audited entity to the extent these are used in MA calculation. Under the PRA proposals, if the firm is required to obtain independent assurance on its internal credit assessments used in the MA calculation, we are unclear what the implications might be for the audit work procedures on the MA. In particular, we would appreciate clarification whether the internal credit assessment remains in scope of the external audit, and it is for the auditor to determine what reliance (if any) to place on the separate assurance obtained by a firm? If so, the approach may result in some duplication of work, and a potential issue if the external auditor forms a different view on an internal credit

assessment compared to the firm performing the independent assurance on the internal credit assessment.

CHAPTER 6 – MATCHING ADJUSTMENT ATTESTATION

Question 15. Do you have any comments on the suggested list of factors that firms should consider in attesting to the FS covering all retained risks?

12. In paragraph 6.30, the PRA proposes that neither the attestation report nor the underlying evidence would be within the scope of external audit as the purpose of the attestation is for the firm to give the PRA assurance on the FS and the MA. This clarification is welcome as we note from paragraph 6.31 that firms would be required to disclose within their SFCR whether or not an attestation has been made. It would also be useful if the PRA could indicate that the disclosure relating to the MA attestation should be made in an unaudited section of the SFCR, such as B System of Governance or as part of the directors' responsibility statement which accompanies the SFCR. This would ensure consistency in terms of where firms make the attestation disclosure in the SFCR, as well as ensuring that the disclosure is not made in an audited section of the SFCR, which may pose an issue for the audit opinion.
13. In paragraphs 6.11 and 6.12, the PRA recognises that, where firms judge the FS to be insufficient or the derived MA inconsistent with the attestation, the attestation requirement may in some cases result in voluntary additions being made by firms to the FS. Notwithstanding paragraph 6.30 does not require external audit of the attestation, it is not clear whether any voluntary additions to the FS may become subject to external audit. Unless there is a clarification made to the contrary, it appears that the external auditor would need to audit the voluntary additions to the FS and, given this is an area of judgement and uncertainty, it would require a significant amount of incremental work to the approach our members currently take to the prescribed FS. As per paragraph 4.2F of SS11/16, in order to provide the audit opinion required in relation to the SFCR, the external auditor is expected to consider the scale of the MA benefit claimed by the firm and therefore, implicitly, the scale of the FS to the extent that it is part of the MA calculation. It would be useful if the PRA could clarify their expectations in terms of the external audit of any voluntary additions to the prescribed FS, and whether an update to the supervisory statement is required given the anticipated significant level of additional work should the additions to the FS be included in the scope of the audit.
14. We also note that the references made to the Technical Provisions part of the Rulebook in chapter 4 of SS11/16 in relation to the Matching Adjustment need to be updated to reflect the proposal to move these rules into a new Matching Adjustment part of the Rulebook. While amendments and updates to other supervisory statements have been included in the appendices to CP19/23, the required amendments to SS11/16 appear to have been omitted.