



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP11/20

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

July 2020



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Responses are requested by Friday 30 October 2020.

In light of current measures to help prevent the spread of Covid-19, please address any comments or enquiries by email to CP11_20@bankofengland.co.uk.

Alternatively, please address any comments or enquiries to:

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1 Overview

1.1 This consultation paper (CP) sets out the Prudential Regulation Authority's (PRA) proposed expectations and guidance relating to auditors' work on the matching adjustment (MA). It includes clarifications in relation to the existing position. The PRA also proposes several new expectations that relate to the communication by auditors on the subject of the MA.

1.2 The proposals in this CP would result in changes to Supervisory Statement (SS) 11/16 'Solvency II: external audit of, and responsibilities of the governing body in relation to, the public disclosure requirement' (Appendix 1).

1.3 This CP is relevant to UK Solvency II firms (including mutuals) that have approval to make use of the MA, especially those that are subject to an audit requirement in respect of their Solvency and Financial Condition Report (SFCR).¹ The CP is also relevant for the auditors of such organisations and the users of these SFCRs.

1.4 The purpose of these proposals is to clarify the current expectations for auditors in relation to the MA and increase transparency on the respective roles of auditors and the PRA. The proposals would set out the PRA's expectations regarding the way that auditors should consider the MA as part of their audit work. The proposals would also clarify the scope of the PRA's approval of the MA.

Background

1.5 The PRA has carried out a significant amount of work on the MA in recent years. A large amount of this work has focussed on clarifying and updating expectations in relation to the MA approval and the PRA's approach to reviewing the amount of MA claimed by firms (eg through the Effective Value Test – EVT).² The PRA aims to clarify the requirements and expectations for auditors that form a view on the MA as part of their audit of the SFCR.

1.6 The MA allows firms to adjust the relevant risk free interest rate term structure for use in calculating certain technical provisions. The MA represents an increase in the discount rate used by insurers to value these insurance liabilities (known as 'technical provisions'). The higher the discount rate, the lower the value of technical provisions. The amount of MA claimed and its impact on technical provisions are subject to external audit as part of the PRA's existing requirements for firms meeting the applicable criteria.

1.7 The PRA wishes to clarify the position regarding aspects of the scope of its assessment of a firm's MA application, as distinct from what it approves in granting a firm the right to apply the MA to technical provisions. Rule 6.1 in the Technical Provisions Part of the PRA Rulebook specifies that the use of the MA is subject to PRA approval. The conditions for MA eligibility are set out in Regulation 42 of the Solvency 2 Regulations 2015 (the 'S2 Regulations').³ As part of its assessment

¹ The external audit requirement for 'relevant Solvency and Financial Condition Reports' are set out in the External Audit Part of the PRA Rulebook.

² The Effective Value Test is a diagnostic tool that is used by the PRA as appropriate. Further details are available from paragraph 3.20, PRA Supervisory Statement 3/17 'Solvency II: Illiquid unrated assets' April 2020: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss>.

³ The FSMA Solvency 2 Regulations 2015: <https://www.legislation.gov.uk/uksi/2015/575/contents>.

of an MA application, the PRA takes into account a range of factors, including aspects of the calculation of the MA⁴ as relevant and appropriate in each case.

1.8 Although requirements relating to the calculation of the MA are not part of the eligibility conditions, the PRA considers the size of the MA benefit claimed by the firm (on an ongoing basis) in its role as supervisor. In addition, this impact of the MA on technical provisions (referred to in this document as the 'scale' of the MA) is a 'relevant element'⁵ in scope of the opinion that auditors of the SFCR are required to provide by The External Audit Part of the PRA Rulebook.⁶ The PRA therefore considers it important to be clear about the interaction of necessary work that it and the auditors may carry out.

1.9 As noted in the original consultation paper that resulted in the audit requirement being introduced (CP43/15),⁷ the benefits of external audit can include greater discipline to the disclosure preparation process and the audit can underpin trust in the information reported. It can also provide confidence that the information has been prepared on a consistent basis and been verified, aiding users' decision making and assisting in the efficient operation of the market. An effective audit can reduce the likelihood that material information relevant to the firm's financial position goes undetected.

1.10 For the PRA, external audit enhances the reliability of the information disclosed and can be an effective and efficient complement to the PRA's direct supervision. The insights that auditors obtain in undertaking an external audit of the relevant elements of the SFCR may also contribute to an effective auditor-supervisor dialogue.⁸ If auditors did not form their own views on the relevant elements of the SFCR, this would limit the assurance available from the audit process for the PRA and other users. The PRA therefore considers it is useful for there to be clarity as to the role of the PRA and auditors in relation to the MA.

1.11 The Chancellor made a written statement⁹ on Tuesday 23 June 2020 that the Government plans to bring forward a review of certain features of Solvency II, to ensure that it is tailored to take account of the structural features of the UK insurance sector. The review will consider areas that have been the subject of long-standing discussion while the UK was a Member State. These will include, but are not limited to: (i) the risk margin; (ii) the matching adjustment; (iii) the operation of internal models; and (iv) reporting requirements for insurers. The Government expects to publish a 'call for evidence' in autumn 2020. This CP is published based on existing requirements and does not pre-judge any changes that could result from such a review.

Implementation

1.12 The PRA proposes that the draft changes to SS11/16 would be effective for SFCR audits carried out in respect of periods ending on or after Thursday 31 December 2020.

⁴ Chapter 7 of the Technical Provisions Part of the PRA Rulebook.

⁵ The 'relevant elements' of the SFCR that must be covered by an auditor's opinion are set out in The External Audit Part of the PRA Rulebook – External Audit 2.2.

⁶ Chapter 4 of the External Audit Part of the PRA Rulebook – Duties on the External Auditor. Although the impact of the MA on Technical Provisions is part of the 'relevant elements' that is within scope for audit, the scope of external audit would not include the impact of the MA on the SCR where this is based on an internal model (External Audit 2.2(3)).

⁷ This is summarised from paragraph 3.12 and 3.13 PRA Consultation Paper 43/15 'Solvency II: External audit of the public disclosure requirement', November 2015: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-external-audit-of-the-public-disclosure-requirement>.

⁸ PRA Supervisory Statement 7/13 'The relationship between the external auditor and the supervisor: a code of practice', April 2013: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-relationship-between-the-external-auditor-and-the-supervisor-a-code-of-practice-ss>.

⁹ Financial Services Update: Written statement - HCWS309: <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2020-06-23/HCWS309/>.

Responses and next steps

1.13 This consultation closes on Friday 30 October 2020. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP11_20@bankofengland.co.uk.

1.14 The proposals set out in this CP have been designed in the context of the current UK and European Union (EU) regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising once any new arrangements with the EU take effect.

1.15 The PRA has assessed that the proposals would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018'¹⁰ for further details.

1.16 The draft SS attached to this CP should be read in conjunction with SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'.¹¹

¹⁰ April 2019: <https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018>.

¹¹ April 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss>.

2 Proposals

2.1 The proposals set out in this chapter would be expected to bring increased clarity and transparency to how the MA should be considered as part of the external audit of the SFCR. The proposals are intended to ensure clarity both for SFCR users about the extent to which auditors have taken account of the MA in their audit opinions and also for the auditor as to how it should incorporate information about the MA into its overall SFCR opinion.

2.2 The PRA's proposals therefore fall into two groups:

- clarifications and enhanced transparency on the existing position regarding the external audit of the MA; and
- new expectations of auditors in relation to the MA.

2.3 These proposals build on the existing SFCR audit requirements that are set out in the External Audit Part. They also complement guidance that already exists in relation to the MA and audit of the SFCR.¹²

Clarifications and enhanced transparency on the existing position regarding the external audit of the MA

2.4 The main MA requirements can broadly be divided into those that affect the scale of the benefit calculated, those that affect eligibility, and those that affect the way that the MA is applied. The first of these, the impact of the MA on technical provisions, falls within the 'relevant elements' that are taken into account as part of the external audit of the SFCR. For example, the quantification of the impact of a change to zero of the MA on that undertaking's financial position is specified as a relevant element of the SFCR.¹³ In addition, the MA has a direct impact on technical provisions which are part of the relevant elements subject to audit.¹⁴

2.5 The PRA's proposals are set out below.

Auditor assessment of eligibility conditions

2.6 Auditors are not required to assess whether a firm has met or continues to meet the MA eligibility conditions as part of its audit of the SFCR. The eligibility conditions for the MA are assessed by the PRA at the point of granting an MA approval and remain under review as appropriate. As noted in paragraph 3.4 of SS11/16, auditors are not expected to express an opinion on the validity of an approval, waiver or other supervisory determination.

¹² PRA Supervisory Statement 11/16 'Solvency II: External audit of, and responsibilities of the governing body in relation to, the public disclosure requirement', October 2018: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-external-audit-of-the-public-disclosure-requirement>, PRA Supervisory Statement 7/18, 'Solvency II: Matching Adjustment', July 2018: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-matching-adjustment-ss>, and April 2020: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss>.

¹³ A quantification of the impact of the MA being set to zero is required by Article 296(d) of the Commission Delegated Regulation (EU) 2015/35. This quantification is required as part of templates S.22.01.21 and S.22.01.22 which are defined in Commission Implementing Regulation (EU) No. 2015/2452 and referred to as relevant elements of the SFCR in External Audit 2.2(2).

¹⁴ For example, the MA would affect the templates S.22.01.21 and S.22.01.22 (the impact of long term guarantees and transitional measures) and S.02.01.02 (the balance sheet) as specified in the SFCR Implementing Technical Standard. Commission Implementing Regulation (EU) No. 2015/2452: https://eur-lex.europa.eu/eli/reg_impl/2015/2452/oj.

Auditor assessment of the scale of the MA

2.7 As part of the audit opinion provided in relation to the SFCR, auditors would be expected to consider the scale of the MA. This reflects that the scale of the MA is part of the 'relevant elements' (External Audit 2.2) and so within the scope of the audit requirements.

2.8 The PRA is not prescriptive about the audit work necessary to support the auditor's opinion, or the approach that it should take in forming its view. This is consistent with the PRA's practice in relation to other aspects of the audit of the SFCR. However, the PRA has specified expectations for firms in relation to the MA which may also be relevant for auditors to consider.

2.9 It is the overall impact of the MA on technical provisions that would be relevant to contributing to an auditor's opinion. However, for illustrative purposes only, the process which determines the MA benefit could potentially be thought of as including the following components from an audit perspective:¹⁵

- scope of the MA approval¹⁶ (eg whether the assets and liabilities that are included in the matching adjustment calculation fall within scope of the matching adjustment approval that has been given);
- data accuracy (eg details associated with the assets or liabilities in the MA portfolio including external credit ratings where applicable);
- methodologies, judgements and processes (eg internal ratings for the matching adjustment portfolio and their mapping to Credit Quality Steps. Also, the classification of asset exposures as to central governments, financial institutions or other to ensure that the MA for assets with sub-investment grade credit quality does not exceed that for investment grade assets of the same duration and asset class); and
- 'mechanical' calculation and other factors (eg the detailed calculation of the MA based on the Solvency II requirements).

2.10 The above has no bearing on how the MA calculation would be carried out, which is specified by legislation. In addition, the PRA is not expressing a preference as how auditors choose to take the MA calculation into account which may vary from case to case.

PRA review of the MA

2.11 As explained in SS7/18¹⁷ firms should ensure that their existing approved MA portfolios satisfy the MA conditions on an ongoing basis and pursuant to Rule 6.3 in the Technical Provisions Part of the PRA Rulebook, they must also notify the PRA if they cease to comply with those conditions.¹⁸ The PRA expects a firm's risk governance to include a robust process to assess their

¹⁵ This is shown for illustrative purposes only. Other ways to consider components of the MA calculation would also be possible.

¹⁶ Whether assets and liabilities that are included within the MA portfolio fall inside or outside of the scope of the MA approval can have implications for the calculation of the MA. For example, if assets or liabilities are included in the MA portfolio that not within the scope of the approval then the MA would be miscalculated. The PRA would expect that auditors form their own view about whether assets and liabilities are in scope of the MA approval that is provided.

¹⁷ July 2018: Paragraph 8.1 <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-matching-adjustment-ss>.

¹⁸ PRA Technical Provisions Rule 6.3.

ongoing compliance.¹⁹ Similarly, as demonstrated by SS7/18 chapter 5 and by SS3/17,²⁰ the PRA expects firms to be able to provide robust justification for the basis of their MA calculations.

2.12 The PRA's supervisory activities in relation to the MA are risk-based and may include, where relevant, an assessment of how the MA is applied and calculated by firms'.²¹ They may also include the use of diagnostic tools to consider the scale of the MA as well as the monitoring of industry issues and other metrics connected to the MA. Such monitoring activities recently contributed to a PRA statement on the application of the matching adjustment during Covid-19.²² The PRA may apply closer scrutiny and, where appropriate, would consider use of its relevant supervisory powers under Section 55M FSMA²³ where the PRA has concerns about the compliance of a firm's MA calculation with Technical Provisions Chapter 7.

2.13 So, as part of its supervisory work, the PRA may review compliance with the MA requirements including the eligibility conditions and the calculation of the MA for one or more firms. However, since the calculation methodology is not part of the approval criteria under Regulation 42 of the Solvency II Regulations, the PRA does not approve the firm's calculation of the MA when approving use of the MA.²⁴ Therefore, auditors should not treat these as being part of the framework that they audit against. Instead, auditors would be expected to form their own view as to whether the calculation of the MA is correctly calculated in the context of the overall opinion provided.²⁵

New expectations of auditors in relation to the MA

2.14 In addition to the above clarifications, the PRA also proposes that:

- if an auditor becomes aware, through the course of its work, that a firm may not be compliant with MA requirements then the PRA would expect the auditor to inform the firm in the first instance. Auditors may also choose to remind the firm of the requirement in Technical Provisions 6.3 for the firm to inform the PRA if it is not able to comply with the conditions specified and to take the necessary measures to restore compliance as soon as possible. Sharing such information with the PRA may help to make best use of information known by auditors to further supervisory objectives; and
- if a firm materially changes its approach to calculating the MA then the PRA would usually expect this to be discussed by the firm with the supervisory team. However, if the auditor is aware that the PRA has not been informed of such a change then it would be expected to pass this information to the PRA. This sharing of information would allow the PRA to consider

¹⁹ July 2018: Paragraph 8.1 <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-matching-adjustment-ss>.

²⁰ <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss>.

²¹ These may be either at firm level or cross-firm.

²² July 2020: PRA Statement to insurers on the application of the matching adjustment during Covid-19: <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-covid-19-prudential-insurers>. Other examples of the PRA's monitoring of the MA are shown in the speech 'An Annuity is a very serious business' by David Rule, Executive Director of Insurance Supervision (26 April 2018): <https://www.bankofengland.co.uk/speech/2018/david-rule-2018-conference-on-bulk-annuities-and-longevity-risk-transfer>.

²³ Section 55M of the Financial Services and Markets Act 2000: <https://www.legislation.gov.uk/ukpga/2000/8/section/55M>. (Imposition of requirements by the PRA)

²⁴ This includes the methodologies, processes or judgements that are used to determine the scale of the MA.

²⁵ Examples of methodologies, processes and judgements relevant for calculating the MA include the approach used by a firm to estimate internal credit ratings and the mapping of these ratings to credit quality steps. Other relevant methodologies may include the firm's approach to aggregating data, judgements and processes to calculate the matching adjustment in line with Solvency II requirements.

whether it wishes to review the new calculation methodology or the scale of the MA. This may also help the PRA to consider whether the firm continues to meet the requirements and any expectations that are set out in its supervisory statements.

2.15 The above approaches are consistent with principles 1 and 3 of the existing code of practice between auditors and supervisors (LSS) 7/13).²⁶

3 The PRA's approach to consultation

3.1 The PRA has a statutory duty to consult when introducing new rules and where, as here, it is not making rules, has a public law duty to consult widely where it would be fair to do so. When doing so, the PRA typically provides the following in relation to the proposed policy:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective, insurance objective (if applicable), and secondary competition objective;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with its duty to have regard to the regulatory principles; and
- a statement as to whether the impact of the proposed policy will be significantly different to mutuals than to other persons.

3.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.²⁷

3.3 The PRA is also required by the Equality Act 2010²⁸ to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services, and functions.

Cost benefit analysis

3.4 The PRA does not regard the proposed clarifications and the enhanced transparency as new expectations. However, the PRA recognises that the clarifications could potentially cause some auditors to reconsider the scope of the work that they currently carry out in relation to the SFCR. The implications of this may vary by regulated firm and by auditor. The PRA does not anticipate that the costs of audit would increase significantly. In addition, to the extent that the work performed by auditors needs to increase to better support their overall opinion on the audit of the SFCR, the costs would be in line with those captured at the time that the audit of the SFCR requirements was established.

3.5 The proposed clarifications and the enhanced transparency could help users of the SFCR to understand the assurance available from the work of auditors. This, in turn, could aid users' decision-making and enhance market discipline. In addition, these proposals could also help ensure

²⁶ April 2013: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-relationship-between-the-external-auditor-and-the-supervisor-a-code-of-practice-ss>.

²⁷ Section 30B of the Bank of England Act 1998.

²⁸ Section 149.

that any calculation issues are identified at an early stage which, in turn, helps ensure that insurers hold an appropriate level of financial resources.

3.6 The PRA's proposals for certain MA information to be shared with the PRA are not expected to add significantly to costs for auditors (or firms) as these new expectations do not require additional work or procedures to be carried out. The expectations apply to auditors only to the extent that they become aware of specific issues in the course of their existing work. The PRA notes that the code of practice between auditors and supervisors²⁹ already establishes principles of regular dialogue between these parties and an open, co-operative, and constructive relationship. In addition, firms are required to deal with their regulators in an open and cooperative way and must disclose to the PRA anything relating to the firm of which the PRA would reasonably expect notice.³⁰

3.7 These new expectations could help identify eligibility issues and enhance supervisory effectiveness, which could help ensure that the MA claimed by firms is appropriate. For example, if contact with auditors enables the PRA to identify issues relating to the eligibility of the MA earlier, it may be able to better target its resources to higher risk areas.

Compatibility with the PRA's objectives

3.8 The proposals are intended to promote clarity, transparency, and consistency in relation to existing audit requirements. This is expected to give users of the SFCR, including investors, policyholders, and the PRA greater confidence in firms' reporting. The additional clarity may also contribute to ensuring that auditors provide suitable assurance in relation to the MA.

3.9 The PRA considers that the proposals will contribute to market discipline, and the PRA's objectives of promoting the safety and soundness of firms and securing an appropriate degree of protection for policyholders.

3.10 The PRA has assessed whether the proposals in this CP facilitate effective competition. The proposals will improve transparency and help ensure that firms derive appropriate MA benefit, thereby helping to facilitate effective competition.

Regulatory principles

3.11 In developing these proposals, the PRA has had regard to the regulatory principles. Three of the principles are of particular relevance:

- the principle that a burden or restriction which is imposed on a person should be proportionate to the benefits which are expected to result from the imposition of that burden: the PRA has not sought to introduce new requirements through this CP, or to extend its expectations in a way that would be burdensome for auditors or firms. It does propose to clarify what it approves as part of MA approval and the implications of this for the work of auditors. This is consistent with taking a proportionate approach;
- the need to use the PRA's resources in the most efficient and economic way: the proposals could help identify any concerns with the MA calculation at an earlier stage which could allow the PRA to use its resources more effectively and efficiently. For example, by identifying issues

²⁹ April 2013: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-relationship-between-the-external-auditor-and-the-supervisor-a-code-of-practice-ss>.

³⁰ Rule 2.7 of the Fundamental Rules Part of the PRA Rulebook.

sooner, the PRA may be in a position to focus its resources more effectively on higher risk issues; and

- the principle that the PRA should exercise its functions as transparently as possible: the proposed amendments to SS11/16 would clarify what the PRA approves as part of the MA approval, and the implications of this for the work of auditors. The PRA anticipates this would aid users of the SFCR in understanding the scope and depth of the audit opinion provided.

Impact on mutuals

3.12 The PRA considers that the impact on mutuals of the proposed amendments to the Supervisory Statement is expected to be no different from the impact on other firms. Additionally, only a small number of mutual firms make use of an MA approval and are within scope of the SFCR external audit requirements.

HM Treasury recommendation letter

3.13 HM Treasury has made recommendations to the PRC about aspects of the government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.³¹

3.14 The aspects of the government's economic policy most relevant to the proposals in this CP are:

- achieving a better outcome for consumers through promoting safety and soundness and securing suitable protection for policyholders. The draft supervisory statement is expected to lead to greater clarity as to the assurance that auditors provide. This may serve to enhance market discipline and also result in greater assurance being provided through the work of auditors;
- the principle that a burden or restriction which is imposed on a person should be proportionate to the benefits which are expected to result from the imposition of that burden;
- the need to use the resources of each regulator in the most efficient and economic way; and
- the need to exercise the functions of the PRA as transparently as possible.

3.15 The last three bullet points above have been considered in the compatibility with the PRA's objectives, and regulatory principles sections above.

Equality and diversity

3.16 The PRA considers that the proposals do not give rise to equality and diversity implications.

³¹ Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at <https://www.bankofengland.co.uk/about/people/prudential-regulation-committee>.

Appendix 1: Draft amendments to SS11/16 'Solvency II: External audit of, and responsibilities of the governing body in relation to, the public disclosure requirement'.

In this appendix, new text is underlined and deleted text is struck through.

...

4 Audit guidance

...

Audit of the Matching Adjustment (MA)

4.2A The scale of the matching adjustment (ie. the extent to which the MA impacts on technical provisions) is within scope of audit where the PRA's external audit rules apply.³² This reflects the fact that the impact of the MA falls within the 'relevant elements' that external auditors of the SFCR are required to form a view on.³³

4.2B However, the interaction of the SFCR external audit rules and those relating to firms' use of the matching adjustment (MA) may be complex. This reflects the nature of the MA, the role of the PRA in supervising its use, and the interaction of these with audit requirements.

Framework for considering the MA requirements in the context of the External Audit Rules

4.2C In the context of the External Audit Part, the main requirements relating to the MA can usefully be separated between the related but distinct conditions of eligibility (as specified by the FSMA Solvency 2 Regulations 2015 – Regulation 42),³⁴ the calculation of the MA (specified by Chapter 7 of the Technical Provisions Part of the PRA Rulebook) and the way that the MA is applied (specified by Chapter 6 of the Technical Provisions Part of the PRA Rulebook).³⁵

4.2D The PRA takes into account the firm's description of its process to calculate the MA during the MA application process. It does not approve the firm's calculation methodology as part of that process. The PRA supervises firms' use of the MA and the scale of MA benefit claimed on an ongoing basis, in a way that is consistent with the PRA's published approach to insurance supervision. As part of supervisory work, the PRA may decide to review a firm's MA calculation in order to ensure that this is done to an appropriate standard and complies with relevant requirements. The PRA may apply closer scrutiny and, where appropriate, would consider use of its relevant supervisory powers under S.55M FSMA³⁶ where it has concerns about the compliance of a firm's MA calculation with the legislative requirements (eg Technical Provisions Chapter 7).

Auditor assessment of the MA

4.2E 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 conditions

³² The external audit requirement for 'relevant Solvency and Financial Condition Reports' are set out in the External Audit Part of the PRA Rulebook.

³³ For example, the quantification of the impact of a change to zero of the MA on that undertaking's financial position is specified as a relevant element of the SFCR (External Audit 2.2(1) and Article 296(2)d of the Commission Delegated Regulation (EU) 2015/35). In addition, the MA has a direct effect on Life Technical Provisions which are within scope of the External Audit rule.

³⁴ FSMA Solvency 2 Regulations 2015: <https://www.legislation.gov.uk/uksi/2015/575/contents> (SI 2015 575) - Transposing the Solvency II Directive – Article 77b when taken together with the Technical Provisions Chapter 6.

³⁵ Technical Provisions Chapter 7 - Transposing the Solvency II Directive – Article 77c and 77e(3).

³⁶ Section 55M of the Financial Services and Markets Act 2000: <https://www.legislation.gov.uk/ukpga/2000/8/section/55M>. (Imposition of requirements by the PRA)

for use of the MA. As noted in paragraph 3.4, auditors are not expected to express an opinion on the validity of an approval, waiver or other supervisory determination.

4.2F However, to provide the audit opinion required in relation to the SFCR, auditors are expected to consider the scale of the MA claimed by the firm. This reflects the fact that the impact of the MA on technical provisions falls within the relevant elements that are within the required scope of audit as set out by Rule 2.2 in the External Audit Part of the PRA Rulebook. The MA calculation depends in part on the application of the MA calculation requirements (Technical Provisions Chapter 7). However, the scale of the MA could also be affected if the assets and liabilities used to calculate the MA were not within scope of an MA approval.

4.2G The PRA is not prescriptive about the audit work necessary to support the auditor's opinion on the SFCR, or the approach that it should take in forming its view. The PRA notes that the audit approach taken is likely to vary based on circumstances, materiality, risk and other factors.

PRA review of the MA

4.2H The MA calculation does not form part of the eligibility conditions under which the PRA would be obliged (if the conditions were met) to provide approval under Regulation 42(2) and (4) of the FSMA Solvency 2 Regulations 2015. As the calculation methodology is not part of the approval conditions, the PRA's approval does not cover the firm's calculation of the MA.³⁷ Therefore, auditors should not treat these factors as being part of the framework that they audit against. Instead, auditors are expected to form their own view on the calculation of the MA, as part of their work to give an opinion as to whether the relevant elements of the SFCR are prepared in all material respects in accordance with the PRA rules and Solvency II Regulations on which it is based.³⁸

4.2I Where the PRA has carried out work to review the MA calculation (including the methodologies, processes or judgements that contribute to the MA), an auditor of the SFCR would still be expected to incorporate its own views on this calculation into its audit opinion. Similarly, the PRA does not expect auditors to assume that an absence of PRA challenge (eg in relation to the MA calculated) overrides a need for auditors to form their own views in the SFCR audit opinion.

Expectations for auditor communication

4.2J If through the course of its work, an auditor becomes aware that the firm may not be compliant with MA requirements, then the PRA would expect the auditor to inform the firm in the first instance. Auditors may also choose to remind the firm of the requirement in Technical Provisions 6.3 to inform the PRA if it is not able to comply with the conditions specified and to take the necessary measures to restore compliance as soon as possible.

4.2K If a firm materially changes its approach to calculating the MA, then the PRA would usually expect this to be discussed by the firm with the supervisory team.³⁹ However,

³⁷ This includes the calculation methodologies, processes and judgements that are used to determine the scale of the MA.

³⁸ For example, the PRA would expect that auditors form their own view about whether assets and liabilities are in scope of the MA approval that is provided. If assets or liabilities were included in the MA calculation then the MA benefit would be miscalculated.

³⁹ At a minimum this would include changes that would be expected to have a material impact on the calculation of the MA at the time of change or in the future. The Solvency II regulation (Commission Delegated Regulation (EU) 2015/35 - article 291) states that information shall be considered as material if its omission or misstatement could influence the decision-making or the judgement of the users of that document, including the supervisory authorities.

consistent with LSS7/13,⁴⁰ if the auditor is aware that the PRA has not been informed of such a change then the auditor would be expected to pass this information on to the PRA.

⁴⁰ PRA Legacy Supervisory Statement 7/13: 'The relationship between the external auditor and the supervisor: a code of practice', April 2013: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-relationship-between-the-external-auditor-and-the-supervisor-a-code-of-practice-ss>.