

Comments on Consultation 37-09 Draft advice on the procedure to be followed for the approval of an internal model

Name of company: PricewaterhouseCoopers

Please insert your comments in the table below, and send it to secretariat@ceiops.eu in word format. In order to facilitate processing of your comments, we would appreciate if you could refer to the relevant section and/or paragraph in the Consultation Paper 37-09.

Reference	Comment
General comment	<p>Overview</p> <p>This consultation paper is an excellent step forward in defining the process for granting approval for internal models, and in giving the insurance industry a good base for their work with internal models. We welcome the principle-based approach, which should help in avoiding the systemic risk inherent in a market that is pushed in a single direction by a more prescriptive regime. It is necessary to continue to achieve the right balance between prescription and principle going forward.</p> <p>We understand that further supervisory issues for model approval in a group context will be covered in another consultation paper released in June. June will also see the consultation paper that addresses the standards expected from a model to gain approval for use. For many (re)insurers these June consultation papers will be critical.</p>
General comment	<p>System of Governance</p> <p>The emphasis that the internal model includes not just the calculation kernel that provides the capital assessment, but also the wider risk management system, is to be applauded. This ensures that the approval process should engage properly with all management processes that reflect the Use Test. However, CEIOPS should consider providing more detail around exactly what should be included in the context of the wider system of governance (including the risk management function).</p> <p>Additionally, (re)insurers will need to consider, and discuss with the industry and supervisors, what depth of detail is necessary around their governance systems to avoid immaterial changes having to be processed as a "change" to the application (albeit possibly a minor one).</p>

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<p>General comment</p>	<p>Scope of application</p> <p>There could be more partial models submitted than anticipated, for example due to product changes or new products falling outside the existing approved model while re-approval is sought, or from immaterial lines of business being left on the standard formula as they do not form part of a (re)insurer’s calculation kernel.</p> <p>(Re)insurers need to be realistic as to what parts of their business are currently outside their economic capital modelling, or are included on an approximate basis. CEIOPS should explain this more widely to outside commentators, and the industry, so that approval of a partial model is not somehow seen as a poor or unsatisfactory result.</p>
<p>General comment</p>	<p>Content of calculation kernel</p> <p>The breadth of the numerical calculation involved in coming to a capital assessment could mean an application that incorporates nearly all of a (re)insurer’s asset and liability models rather than just one or more calculation kernels. This would not aid the approval process and many of the elements would themselves be subject to audit.</p> <p>CEIOPS may wish to clarify that the calculation kernel is those parts of the mathematical models that are being used beyond the calculation of the SCR on the standard formula.</p>
<p>Paras 3.11 – 3.14</p>	<p>The pre-application process is a sensible suggestion, and should be actively encouraged both by supervisors and by other interested parties such as industry bodies. The earlier the engagement, the more likely that the approval process will be relatively smooth. The current debate around QIS4 shows the need for further discussions around model capability between the industry and supervisors in each jurisdiction.</p> <p>The pre-application process is not only important for large (re)insurers, but also for medium and small sized entities. Therefore CEIOPS should advise supervisors to structure the pre-application process so as to enable medium and small-sized (re)insurers to engage their limited resources.</p>

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CEIOPS should give consideration as to how the pre-application phase will work on an ongoing basis, i.e. after the implementation stage of Solvency II will it be mandatory for model approval in the future.

It must be recognised that an insurance group may well see each of its EU subsidiaries engaged in a national pre-approval process, as well as being engaged in a discussion with its lead supervisor on its group model under the Pillar II process. During the pre-approval process, CEIOPS should encourage national supervisors to engage with each other through their regulatory colleges to make these discussions the most fruitful and least repetitive.

Para 3.26 The Use Test naturally interconnects with the model development of the calculation kernel. Given the widespread review and development of models across the industry at the present time it is necessary that supervisors strike a balance between looking for a long period of demonstrable use of a particular calculation kernel and accepting that methodologies are being improved across the industry.

This need is heightened as the approval process starts long before the formal submission. While the definition of "reasonable period" in 3.22 might be taken to mean at least a full business cycle of 12 - 18 months (i.e. from business plan to completion of the next business year) CEIOPS and national supervisors should not provide a disincentive to firms improving their models during this "reasonable period". CEIOPS should clarify their expectations in this regard.

Para 3.28 Supervisors should confirm to the (re)insurer when the submission is complete.

Para 3.29 We understand that national supervisors will be able to impose more detailed standards than those recommended by CEIOPS. This will complicate the application process for insurers seeking approval from multiple supervisors for model use. We suggest that if the detailed standards differ, the lead supervisor should be able to explore with the (re) insurer and the national supervisors whether one set of standards could be applicable for the group as a whole.

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Para 3.30

The demands of the approval process will largely depend on the detail required. Since the requirements outlined in 3.30 are intended to be a minimum, CEIOPS and local supervisors should ensure that more detail, such as that contained in 3.22, is released to the industry. Further, CEIOPS should note that the timing of any unexpected requirements near to the implementation date of the Directive could be disruptive to the whole process.

Similarly, the proportionality principle needs to be properly articulated by CEIOPS in its advice to avoid the implementation measures becoming needlessly onerous for small/medium-sized (re)insurers. For example, it would be beneficial to include examples around the Use Test requirements.

Additionally, insurers in many jurisdictions will have had little experience of Use Tests or similar concepts. It is vital that CEIOPS explains the requirements in 3.30 in relation to the Use Test.

Para 3.30(l)

The independent review/validation report must be renewed regularly according to the Directive requirement for regular validation. The expansion in 3.22(l) requires internal or external independence. We believe this is a sound requirement but it does have some consequences.

We suggest that the risk management function, given its role as owner of the model, needs to acknowledge the limited level of validation it can provide. A typical third line of defence function such as internal audit is unlikely to contain the necessary skill set. We believe that firms will often need external help to either support an internal function such as internal audit, or to directly provide the external assurance the (re)insurer wishes to obtain. The external auditor should be one of the parties considered by the (re)insurer and/or the supervisory authority to provide the independent review (assuming it is not excluded by accounting independence considerations).

Additionally, we suggest that CEIOPS should provide more clarification around what level of reliance supervisors will place on these independent review/validation reports. Guidance/standards detailing what needs to be included in the reports would also be useful.

The Directive also requires that all the Article Tests are applied by (re)insurers to any external software that may be incorporated in the internal model. The providers of such external software would normally be precluded from providing the

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independent review/validation report, but could reasonably release information to the public domain (such as technical standards, data detailing calibrations to the market etc). This information could be leveraged by (re)insurers, thereby avoiding unnecessary duplication of effort in demonstrating adherence with the Articles from first principles.

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Paras 3.61 –
3.78

- The provision for minor and major changes in the approval application is welcome and represents a sensible approach to what is an important issue. While 3.72/3.75 on the reporting of minor and major changes is sensible, CEIOPS needs to clarify the definitions of minor and major changes. Whilst the(re)insurer is responsible for creating the policy for changing the internal model, supervisory authorities should encourage common standards by providing guidance and examples around the distinction between minor and major changes. This distinction is a new concept, and consultation with industry bodies is essential in order to understand its meaning fully and ensure sensible change policies are submitted as part of the approval process.
- It would be useful to see more principle based wording in 3.61- 3.78 to allow flexibility in how supervisors deal with major changes that are in fact non material or widely accepted across the industry as necessary to update industry's approach to models. In particular, any significant delay in the reappraisal after a major change to a long established model itself works against the requirement for the use test to be met for an existing model. (It is quite possible that a major change could lead to initially little or no change to the calculated SCR, but this could itself alter as time progresses. However some changes, perhaps to the system of governance, may result in no change to the SCR).
- Inadvertent failures to notify of changes could arise from misunderstanding of the minor / major distinction; particularly in the areas of risk management and model governance. We believe supervisors should be encouraged to debate the proposed change policy to assist firms in avoiding potential non-material traps of this kind.
- The requirement to report minor changes quarterly, or more frequently, is appropriate for general (re)insurers' calculation kernels, but, in our experience, most life (re)insurers implement changes to models half yearly, in line with their external reporting. Therefore, there could be some excessive reporting and this could be made more discretionary for supervisors as to the regularity, or the detail to be given, in reporting minor changes.
- Guidance is needed on the time period taken by the supervisory authority to approve or reject a revision to the change policy. A phased approach, whereby changes to the internal model change policy are approved by the supervisor prior to changes to the model being made, may reduce (re)insurers' ability to react sufficiently quickly to changing external and internal circumstances.

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- It would be very useful to have further clarification on what 'well in advance of intended implementation' (para 3.72) and on 'exceptional circumstances' (para 3.74) are intended to represent.

Para 3.97 The preceding text (paragraph 3.85) indicates that the data itself is assessed by the supervisor rather than data related procedures. The scope of the assessment should surely concentrate on the robustness of the procedures and control of these data procedures rather than testing data directly, else the review might be considerably expanded.

Para 3.95 This assessment opens the possibility that supervisors require changes that are out of line with general industry/management views and that different requirements are specified by different supervisors, something that could be a problem for multinational groups.

The June consultation paper on standards will be very important in this regard, as will CEIOPS activities to engender common standards among supervisors.

Para 3.98 All aspects of the assessment need to be documented properly by the supervisory authority, particularly in terms of on-site inspections and telephone conversations, in order to avoid later misunderstandings that could lead to inadvertent rejection.

Para 3.174 The option of rejection of full model approval and simultaneous acceptance of a partial model is sensible. For example, in the current state of development, operational risk modelling may not meet the approval criteria nor certain areas with poor statistical data quality.

However, the supervisor should be careful not in any way to cherry pick the areas where the internal model increases the capital requirements (by higher stresses or stressing risks not captured in the standard formula SCR) even where the underlying methods warrant rejection.

Section 3.5 There appears to be no mechanism for (re)insurers to appeal against a decision to reject or provide limited approval. We believe CEIOPS should consider this further either through its own role or other suggestions such as an advisory committee that might include a range of members such as supervisors, insurance undertakings, actuarial and risk societies and technical standard setters.

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Para 3.172	Further clarification of the 'waiting period' would be helpful, how this ties into the proportionality principle, and how it works with cases where terms and conditions are applied.
Para 3.174 – 3.176	Further clarification of whether the 'waiting period' will be applied to those parts of the full model that are rejected would be helpful.
Para 3.179	<p>The publication of a decision on a (re)insurer's application should include only successful applications and not rejections. We believe this is the intention here, but the wording is unclear.</p> <p>Information on rejections could be released in the form of anonymous case studies or reports which would help both supervisors and industry better understand the process.</p>

Following consultation with members of the PricewaterhouseCoopers network of firms in the European Union, this response summarises the views of member firms who commented on this consultation paper. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.