

Comments Template on CEIOPS-CP 56 Consultation Paper on the Draft L2 Advice on Tests and Standards for Internal Model Approval		Deadline 11.09.2009 4 p.m. CET
Name of Company:	PricewaterhouseCoopers LLP	
Disclosure of comments:	CEIOPS will make all comments available on its website, except where respondents specifically request that their comments remain confidential. Please indicate if your comments should be treated as confidential:	No
<p>Please follow the following instructions for filling in the template:</p> <ul style="list-style-type: none"> ⇒ <u>Do not change the numbering</u> in the column "reference". ⇒ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a paragraph, keep the row <u>empty</u>. ⇒ Our IT tool does not allow processing of comments which do not refer to the specific paragraph numbers below. <ul style="list-style-type: none"> ○ If your comment refers to multiple paragraphs, please insert your comment at the first relevant paragraph and mention in your comment to which other paragraphs this also applies. ○ If your comment refers to sub bullets/subparagraphs, please indicate this in the comment itself. <p>Please send the completed template, <u>in Word Format</u>, to secretariat@ceiops.eu. Our IT tool does not allow processing of any other formats.</p> <p>The numbering of the paragraphs refers to Consultation Paper No. 56 (CEIOPS-CP-56/09).</p>		
Reference	Comment	
General Comment	Overview This consultation paper is an excellent step forward in defining the standards for granting approval for internal models, and in giving the insurance industry a good base for their work with internal models.	

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3.100.	The proposed principles based approach is very sensible as any prescriptive, list-based, approach would fail to capture the reality of usage in the wide range of insurers across the EU. The exposition of the areas where usage might be expected is however extremely helpful. We note that in 3.59 CEIOPS suggest further Level 3 text. Depending on the eventual status of CEIOPS level 3 text thus could yet become a requirement and care should be taken not to reverse the Level 2 advice to go for a principles based approach.	
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3.106.	The requirement to produce results split by material lines of business is not necessarily onerous of itself. However, depending on how diversification and possibly risks such as operational risk are apportioned, the result could differ from one insurer to another. It should not be part of the Use Test that such allocation is part of Use - as this may legitimately be not applicable (applies to point g).	
3.107.		
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3.110.	The term "allocating diversification" implies, by virtue of 3.76, a detailed capital allocation that uses each level of diversification – diversification within market risk say and across to insurance risk say. While such evidence of capital allocation may be commonplace in the largest undertakings we do not believe it should be an effective requirement for all undertakings.	
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3.114.	We did not understand why the internal model would always be able to assess the expected profit from potential decisions. We could see the internal model would be able to provide the capital and risk management impact of a potential decision against which any assessed profit could be viewed.	
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4.47.	There is to be further Level 3 guidance on the responsibilities of among others, the risk management function. We are concerned as to how the risks management function can properly be responsible for the "design and implementation of the internal model" as well as "testing and validation of the internal	

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	model” and “analysing the performance of the internal model”. We feel there needs to be more clarity over how the typical lines of defence are expected to perform in this governance structure.	
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4.51.	See comments on paragraph 4.47	
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5.48.	<p>The paragraph sets out a desire for as full as possible a distribution of required capital by percentile – as full as the distribution of underlying risks. The reasoning for the necessity of such detailed output is quite briefly described. In practical terms the production of a full distribution of capital will be impeded by a) the underlying risk distributions being limited to a few single point estimates, b) the complexity that diversification parameters and non-linearity effects vary by percentile, c) partial model situations having only one estimate of capital – that at the standard calibration.</p> <p>We believe this requirement may lead to false accuracy being imputed to the model, to the detriment of the understanding by senior management of the model. We suggest a more balanced requirement would be to look for three estimates from the model, at the risk appetite of the firm, at the calibration of the standard formula, and at the level of typical business planning risk stresses, perhaps 1 in 20.</p>	
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5.104.	<p>Consistency at a broad level between the calculation kernel and the valuation of the technical provisions is very sensible. However, in practical terms there would be a high price to pay, in complexity of technical provision valuation, if this was to be construed as a requirement for use of the same factors so the 99.5% scenario out of the TPs should equal the capital. In practical terms the technical provisions a) may not be on a stochastic basis where this is not called for, b) will often be subject to Monte Carlo simulation with varying accuracy and variability depending on the number of runs, c) will often be programmed with risk models that are fitted mainly to the body of future plausible events to gain the most accuracy – rather than contain complex modelling of varying diversification assumptions by extremity of stress which, in TP terms, would add little to the result of averaging the large number of scenarios projected.</p>	
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5.107.	We support the sensible comment that an assessment of consistency between technical provisions and capital model should be subject to being both possible and proportionate.	
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5.111.	The collection of data, other than data altering with the frequency of model usage, is required to be "with a frequency in line with that of the model validation process". As this later process is to be annual that imposes an annual update to parameters and assumptions used elsewhere in the model. This requirement needs to be proportionate as some data gathering exercises are expensive and stable – such as purchasing long run averages of actual credit default data – , so repeated purchase is wasteful and uninformative.	
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5.174.	The scope of data quality is very broad, covering "all data used in the internal model....irrespective of whether it is internal or external". We see the logic of this but interpret this as meaning the data quality standards apply to such areas as correlations – which elsewhere CEIOPS recognise as an area of intrinsically low confidence data. This requirement needs to be made explicitly subject to the application of 5.183 (Data and expert judgement).	
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5.184.	A requirement for expert judgement to be subject to robust challenge has been recognised elsewhere.	

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	<p>“Good practice does not exclude the use of expert opinion in internal models, but rather ensures that there is a proper process behind its usage” Actuarial Aspects of Internal Models for Solvency II, paper presented to the UK actuarial profession February 2009.</p> <p>Expert opinion is often used precisely where data is unreliable or, due to its heterogeneity, needs particularly careful interpretation. This is explicitly recognised in 5.255. It is therefore difficult to see that such expert judgement could always be “falsifiable, refutable and testable” given the lack of data through which to do this. A similar comment arises with error rate. If the judgement is essentially over the interpretation of the few, and often contradictory, data points for extreme or quite extreme events, then the expert choice of data that underpins a 1 in 200 year event is of necessity hardly capable of a “known or potential error rate”.</p> <p>We believe the requirement for validation and documentation, added to by sensitivity analysis of the validation requirements, are a sound basis. The more exacting tests of 5.184 (a) and (c) should apply only where data exists to support such tests.</p>	
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5.252.	For diversification this paragraph requires the undertaking "fully justifies the assumptions underlying the modelling of dependencies". Given the requirements of 5.174 and 5.184 is that wording implying further justification is required than that provided by the two paragraphs cited?	
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5.256.	While we recognise that uncertainty may sometimes require additional measures such as an increased capital assessment there is a danger that too high an implied level of compliance may either mean few	

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	<p>models could be approved for use, or supervisors press for additional capital margins of prudence in many of the models. This would seem inconsistent compared to the standard formula calibration and also inconsistent with the necessarily uncertain business of insurance. If risks were well defined and determinable insurance would have less relevant.</p> <p>We feel this paragraph needs rewording to make clear it does not authorise a form of widespread capital add-on.</p>	
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5.298.	<p>We can see the attraction of requiring a report back to the supervisor where the undertaking does not apply the management actions it modelled within the capital model. However, we believe that in the level 3 text it would be appropriate to highlight that</p> <ul style="list-style-type: none"> - as management actions depend heavily on the path of events that lead up to the action - and more than one action may be capable of use at that time - and the model "rules" for actions will necessarily be simplified from what is a vast range of events and actions - then the supervisory response should have regard to whether the capital assessment has been materially altered by the undertaking taking an alternative management action (or no action) rather than whether the undertaking took the modelled action. 	
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6.52.	CEIOPS expresses a view that the undertaking should using its own calculation methodology in running its business, and thus meeting the Use Test. It should not be attempting, and is not being asked, to use in its business the end result of its analysis of how its calculation methodology is equivalence to a one year 99.5% VaR standard. We very much support this. We did feel the drafting should be looked at in case the "consistent" in the paragraph is interpreted as meaning the opposite to the above.	
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7.21.	<p>CEIOPS expresses a preference for profit and losses to be recognised on the basis of "internal definitions" consistent with "the variable underlying the probability density forecast (Article 119)". We take this to be the internal model assessment of capital, possibly calculated over a different time period than one year as allowed under the Calibration Article.</p> <p>We support CEIOPS preference if our interpretation is correct. We do have difficulty seeing the relevance of the Profit and Loss attribution as an exercise separate from Validation. We believe it is very important as part of Validation.</p>	

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8.126.	We agree responsibility remains with the board of the undertaking for validation. However, as we note in our response on 4.47, we remain unclear how CEIOPS sees the risk management function being responsible for both the design and build of the model as well as the validation and improvement of the model (4.30). A more natural division would be for the actuarial function to be responsible normally for model build and design, allowing risk management to perform its second line of defence role of oversight and challenge.	
8.127.		
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8.130.	We support leaving validation frequency as determined in a proportionate manner, but note that an up to date independent validation report is required as part of the approval submission in CP 37. The submission demands on "major change" to the model, which could be quite frequent given the pace of change in the industry, could of themselves effective drive a more explicit frequency of validation. Too frequent validation has the danger of making the process repetitive and less challenging.	
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8.141.	We agree that undertakings should have a formal policy on independent validation. We also agree that this policy should also consider how independence is maintained over time. However, the discussion in the preceding white text (8.51) implies a harsh test that "taints" the reviewer if a prior review has recommended change. This would seem to make the use of an internal audit function impossible, and cause the undertaking to move from one external reviewer to the next. This seems both costly and disruptive for a questionable benefit given that all these reviewers may have other consultancy interactions with the undertaking. We believe independence should focus on ensuring the proper relationships more broadly and not focus on whether a prior change has been recommended or not (comment applies to point g).	
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8.163.	We recognise the usefulness of what is termed "reverse stress testing" where the undertaking investigates stresses that are less than the 99.5% one year standards but are of a scale to put in question the viability of the business model of the undertaking. However, such tests would seem to fall into the ambit of the ORSA. We could not see what purpose they performed in a validation test of a model being approved for use to replace the standard formula SCR.	
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