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countdown



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Model approval: Preparing a convincing case

With the internal model approval process (IMAP) likely to be a learning curve for both supervisors and applicants, what practical steps can companies take to make a convincing case?

‘Essentially, all models are wrong, but some are useful.’¹ Just how useful to the solvency and sound management of the business is the crux of whether supervisors are likely to approve an internal capital model under Solvency II. In particular, rather than coming up with reams of extraneous technical detail about the operation of the model, applicants first need to be able to prove that the model analysis is actually understood, trusted and used in the running of the business.

The IMAP timetable of the UK Financial Services Authority (FSA) sets out the key preparatory steps leading up to application (see Figure 1). For those seeking approval ready for Solvency II implementation in 2012, this breaks down into work across three business cycles:

- the first cycle up to October 2010 will be characterised by generic feedback from the FSA such as thematic reviews;
- The second cycle, up to October 2011, covers specific dry runs; and
- the third cycle encompasses submission and review, and, in most cases, this will extend beyond 2012.

There is growing acceptance that most model approval is initially likely to be partial as many firms seek more time to overcome difficulties that may preclude a full model IMAP. A key first step is therefore to judge what risks or product lines may need to be excluded and which to concentrate on in the first round. It is equally important to ensure that these priority areas are not pursued in isolation from the rest of the business

¹ Attributed to statistical model pioneer, Professor George E.P. Box

as applicants will be expected to show supervisors how a partial model will fit into the overall governance, solvency assessment and decision-making of the business, as well as develop a longer term plan to either remain on a partial basis or extend the model and its governance. In looking at the timings, it is also important to bear in mind that the IMAP process is likely to stretch the resources of the FSA and other EU supervisors, so those that allow their preparations to slip could find themselves at the back of a lengthening queue for initial acceptance, review and approval. Smaller firms could be at particular risk of losing out as supervisors may begin to prioritise larger and more complex entities as their in-trays fill up.

Early engagement

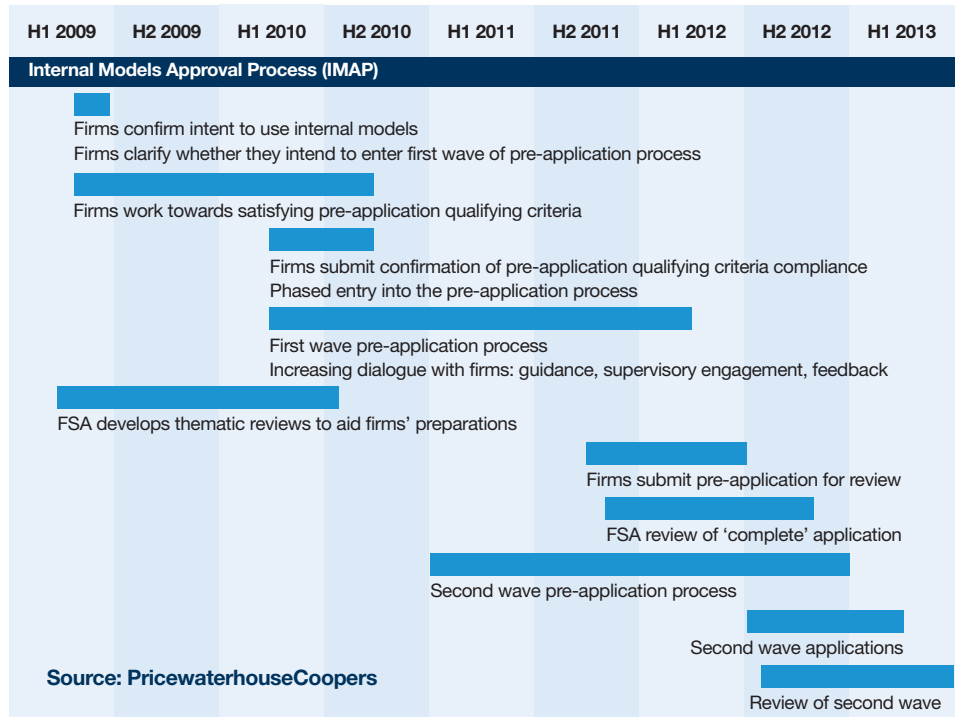
Figure 2 outlines the key tests for internal model approval. Many of these criteria will be familiar to companies that have experience of the UK’s

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Internal Capital Adequacy (ICA) regime. What the move to the ICA underlined was the importance of early interaction with supervisors to find out what they expect. Experience of the ICA also highlights the need for early engagement with the board.

The acid test is whether boards and business teams are ready to make decisions based on a clear understanding of the underlying assumptions, potential limitations and susceptibility to change in the model analysis they receive. A final lesson is the need for effective resource planning as competition for key staff

Figure 1 | IMAP timetable



is likely to intensify in the lead up to implementation. Shortages and associated poaching of personnel could be particularly acute among actuarial, risk management and internal audit professionals.

Test of embedding

Solvency II is set to take the ICA ‘use test’ a step further and document it through media such as the Own Risk and Solvency Assessment (ORSA). The ORSA will be the engine of organisational embedding by providing a clear and regularly updated test of how far the model actually influences management action. Ensuring the ORSA process is up and running by 2010 and followed up thereafter is therefore likely to be a crucial prerequisite for approval. While the necessary assessment and substantiation is likely to be demanding, the ORSA report could offer a useful basis to communicate the strength and embedding of risk management to rating agencies and other key stakeholders.

Bridging the gaps

While most companies seeking model approval will already have carried their gap analysis, our work with clients suggests that many are finding it difficult to turn this analysis into concrete plans. Building on the contacts with supervisors mentioned earlier, a good starting point is to put yourself in the supervisors’ shoes and judge what they are likely to find useful. The ORSA can in turn help firms to judge what more work will be required to satisfy the use test and help to align model approval with other key aspects

“Early engagement with supervisors will help to discern what they expect and enable firms to focus plans and resources on how to develop ‘intelligent’ documentation.”

Figure 2 | Overview - Tests for Internal Model Approval



of Solvency II implementation such as the development of a data quality policy and systematic risk management framework. Validation policy is likely to be an especially important focus for supervisors and Boards. It should therefore sit alongside data and change policies within the overall planning process and be built into applicants' self-assessments. Key considerations include management's input into the design of the validation policy, whether the tools used are appropriate and applied frequently enough and how the validation policy is likely to affect risk management.

Making preparations count

The IMAP will be a significant challenge for applicants and regulators alike,

especially as a quite a lot of the details for preparation, submission and approval have yet to be finalised. However, it is possible to make working assumptions that are needed to plan ahead, and develop firm foundations for the approval process. Applicants must prove that the model has the statistical foundations, understanding within the organisation and underlying governance and control to drive decisions. Early engagement with business teams will help to bring users on board. Early engagement with supervisors will help to discern what they expect and enable firms to focus plans and resources on how to develop 'intelligent' documentation.

Giving you the edge

PricewaterhouseCoopers is helping a range of insurers to get to grips with the practicalities of Solvency II implementation. If you would like to know more about how to develop an effective plan for internal model approval, please contact:



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