

**Comments Template on
Consultation Paper on Proposal for Guidelines on Pre-application for Internal
Models**

**Deadline
19 June 2013
12:00 CET**

Name of Company: ASSOCIATION OF FINANCIAL MUTUALS

Disclosure of comments: of Please indicate if your comments should be treated as confidential: Public

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- ⇒ Do not change the numbering in the column "reference"; if you change numbering, your comment cannot be processed by our IT tool
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Reference	Comment	Resolution
General Comment	<p>The Association of Financial Mutuals represent financial mutual insurers within the UK, with 53 member companies and assets approach £100 billion. We welcome the chance to comment on this consultation paper.</p> <p>We believe the Guidelines are useful and provide practical guidance for national competent authorities (NCAs) to start reviewing undertakings readiness according to the Guidelines from 1 January 2014.</p> <p>Considering this it should be stressed the importance of not basing any supervisory enforcement actions, including add-ons, on the outcome of the Guidelines. We would welcome a statement making this recommendation clear.</p> <p>It should be recognised that undertakings plan a phased progress towards compliance up to formal application date.</p>	

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	<p>Some of the requirements, especially on documentation, extend somewhat beyond what was originally intended by creating an unnecessary and disproportionate level of detail.</p> <p>This envisaged level of detail seem not to bring any added value on assessing the quality of the models and contains the risk of turning the NCA assessment into a compliance exercise requiring more resources for both undertakings and regulators, instead of creating a constructive dialogue.</p>	
Introduction. General Comment	EIOPA should consider how to integrate these Guidelines with the already issued pre-application Guidelines (former CP 80).	
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Section I. General Comments		
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1.20.	Suggest that EIOPA will disclose cases where the current binding national legal framework hinders compliance to specific Guidelines.	
Section II. General Comments		
Chapter 1. General Comments		
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1.22.	<p>It is critical that the undertakings get feedback in a timely manner and not at the end of the process. As such, we propose rewording. “National competent authorities should provide continuous feedback to the undertaking on the reviews they carry out on the internal model for the purposes of pre-application.”</p> <p>The feedback should be specific so that the undertakings can take appropriate action and develop towards a binding commitment of the NCAs for the purpose of a “provisional approval” of mature and stable model components. The feedback of NCAs should indicate if the internal model is compliant with the requirements of the Directive. We therefore would add: “National competent authorities should indicate in their feedback if the internal model, or parts thereof, are compliant with the requirement set out in Directive 2009/138/EC, in particular Articles 112, 113, 115, 116, 120 to 126, 230 and 231.”</p>	
1.23.		
1.24.	<p>A notification should not be required for any change. This requirement is too extensive. Further guidance on the relevance criteria would be helpful to assure a consistent and convergent approach.</p> <p>Also, often model changes result from feedback provided by the NCA. We would propose that EIOPA includes in the Guideline that in these cases the undertakings should refer to this feedback in their notification of changes.</p>	

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1.25.	The NCA should assess whether the model change alters the degree of compliance of the undertaking to the relevant requirements and should communicate its assessment to the undertaking. We therefore add: "The national competent authority should assess whether the model change requires the update of any feedback given to the undertaking."	
Chapter 2. General Comments	<p>Time-critical model changes that are proven necessary in the context of regular model updates, (e.g. the introduction of new products or legislative amendments) call for the implementation of a fast track model change approach.</p> <p>Example:</p> <ol style="list-style-type: none"> 1. A change in the legal environment comes into force on 1st of December. 2. The impact of the change is classified as major according to the Model change policy. 3. The undertaking is prepared. The procedures are in place and the application for model change including calculations and documentation is sent to the NCA. 4. NCA takes 6 months for approval plus 1 month for a final decision by EIOPA. 5. This means that on the key date 31 December there are two models in place and for the "Solvency Balance sheet" and "SCR" two sets of numbers are available. <p>First approach: The undertaking considers the numbers of the approved model. However these numbers are not adequate.</p> <p>Second approach: The undertaking considers the numbers of the changed model. The numbers are considered adequate, but the model is not approved. A pragmatic solution must be found for such cases.</p>	
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1.31.	The requirement to evaluate should be restricted to changes that are connected.	
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Chapter 3. General Comments		
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1.37.	The requirement to improve the model will be difficult to demonstrate in the initial phases of model use.	
1.38.	<p>The model needs to fit the business. However this does not mean that all of the aspects listed under a) to f) need to be fulfilled for the internal model to fit the business. The risk model certainly needs to play a role in the key business decisions; however certain business decision will also require the use of additional models and/or considerations.</p> <p>We also suggest deleting “(f) other relevant ones”, as this doesn’t provide guidance.</p>	
1.39.	Regular discussions of models in the risk committees should also serve the purpose. Formal trainings should not be required. This also seems too extensive, so “and staff” should be deleted.	
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1.42.	Decisions are made by people taking into account a variety of sources and tools, the results of the internal model being one of them. There is a danger of reducing decisions within undertaking to a pure mechanical exercise which is neither desirable nor sensible in our view. There is a need to have the freedom to use other methods for risk assessment than the ones of the approved internal model (see 1.43).	
1.43.	We do not understand what the requirement to identify inconsistencies and consider them to improve the internal model would mean in practice. Different frameworks exist with different objectives, assumptions, models. They are known by the undertakings and the management. The internal model cannot be a “reconciliation” tool.	
1.44.	Business decisions cannot be based only on internal model outputs, neither justification or retrospective verification of such decisions according solely to what internal model outputs are saying are relevant. Retrospective verification of decision-making may not be possible at that granular level of a certain decision. The P&L attribution is more appropriate. We therefore suggest deleting this part of guideline 14.	
1.45.	Business decisions are not only based on internal model outputs and sometimes other indicators may be more	

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	material in the decision. We would amend "... and how the output is aligned with the decision" to "...and whether the decision is considering the output of the internal model"	
1.46.	We would amend "where the output [...] with the decision" to "where the decision is not consistent with the output of the internal model" A significant amount of effort would be required if an undertaking should have to formalize and document every decision making process in the business and produce and update the documentation on a regular basis.	
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Chapter 4. General Comments	We agree it is important to document and validate formally key material assumptions but Guidelines 22 and 23 are too demanding and would distract knowledgeable resources from ensuring quality and adequacy of assumptions to an administrative documentation exercise.	
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1.57.	It is important to note that an internal model could have several hundred model assumptions. We propose to amend the text to focus on material assumptions setting and not all assumptions setting. We would delete "and the use of expert judgment in particular" and replace it with "follows a validated and documented process that would include requiring expert judgment to be justified".	

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1.58.		
1.59.	Assumptions should be subjected to an appropriate senior management validation. In order to focus on what is to be achieved and not on how to achieve it, we propose to delete the text " <u>up to and including the administrative, management or supervisory body.</u> "	
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1.72.	<p>Requiring undertakings to monitor circumstances under which assumptions are false is paramount to requiring undertakings to monitor circumstances under which a decision would be considered a bad decision instead of a good one. This would suppose that all possible outcomes have been considered and those outcomes are seldom finite.</p> <p>Practical clarification would be requested as to what criteria exactly would be used to define this kind of a process other than those already required by internal model validation in which assumptions are challenged by being tested and justified.</p>	
Chapter 5. General	This discusses the requirement of consistency of methods used in the risk model and the calculation of technical	

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Comments	<p>provisions.</p> <p>While a certain method will be adequate to calculate technical provisions another one might be better to capture the aspects of risk measurement. Consistency in this cases means differences are not material if these methods are used for the same purpose e.g. to calculate the best estimate.</p> <p>The method chosen should be adequate for the task. Risk measurement and calculation of the best estimate might very well force the usage of different but consistent methods. Therefore, the discussion of consistency should be handled carefully.</p>	
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1.77.	<p>A quantitative assessment of consistency is often difficult. Sometimes it will be even impossible, for example because there don't exist any consistent actuarial methods. Therefore an assessment has to be based mostly on expert judgement.</p>	
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Chapter 6. General Comments		
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1.88.	We don't understand the aim of this requirement as the internal model is supposed to represent the risk profile of the entity with its own characteristics, so not necessarily in line with market practices. This is inconsistent with the aim of the internal model. The assumptions should be verified depending on undertakings profile.	
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Chapter 7. General Comments	All models are only approximations of reality. Therefore the guidelines on calibration should be applied to the mathematical risk measure only (and the related time horizons). Other approximations used in internal models, e.g. certain limited number of risk factors should not be treated by the guidelines of chapter 7. This should be clarified.	
1.91.	This aspect should only be applied to the mathematical risk measure, as all models are approximations of reality.	
1.92.	We would oppose any interpretation that requires undertakings to quantify the impact of the approximation (because if it is possible to quantify, it should also be possible to avoid it). We understand point a) as the possibility for the undertaking to evaluate with a qualitative statement the error introduced by the approximation, without having to necessarily measure it. We would also delete points b) and c) as we perceive them as far too detailed and containing a high risk of being interpreted by NCAs in quantitative terms.	
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Chapter 8. General Comments	The level at which the P&L Attribution is performed should follow its uses, i.e. risk and business steering, and not the legal structures. Major business units should follow their managed structure rather than legal structures, i.e. not every legal entity forms a major business unit	
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1.105.	It is important to note that this predominantly applies to insurance risks where there is not, in many cases, market data but only undertaking specific data available to calibrate the internal model. For market risks it appears more important that the calibration of the internal model is tested against market data rather than the concrete profit and loss attribution of the undertaking, as this may be skewed due to trading activities throughout the one year risk horizon.	
1.106.	The P&L Attribution should explain the causes and sources of profits and losses using a certain categorisation of risks. This categorisation should be consistent with the categorisation of risks as applied in the internal model in order to allow for a validation of e.g. the completeness of the risks modelled. A drill down to a more granular level should only be performed in cases where the more aggregated P&L attribution exhibits unexpected behaviour of risks. Only consistency but not identity of risk drivers with the internal model should therefore be required in the context of the P&L attribution.	
1.107.	It appears overly burdensome to document on an annual basis how the results of the profit and loss attribution are used in risk management and decision-making. The profit and loss attribution provides a retrospective view on the performance of the business. The decision-making contains a forward-looking element. Therefore it should not be requested that decisions need to take into account the outcome of the profit and loss attribution in each and every case.	
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Chapter 9. General Comments		
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1.120.	This appears overly burdensome. Should only be asked that the validation (carried out by the risk management function) is regularly reviewed by the internal audit.	
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1.129.	The validation policy should only specify how the allocation of tasks is governed.	

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1.137.	Independence is not a quality of the validation tool. It should therefore be deleted in this context. Guideline 47 already deals with independence.	
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1.140.	We fear that this results in very onerous documentation requirements. Guideline 51 should rather be assessed during on-site visits throughout the pre-application phase rather than by requirements to document all of those aspects listed from a) to d).	
1.141.	This could result in very extensive calculations. Its application should therefore be limited to very few selected cases.	
Chapter 10. General Comments		
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1.146.	The history of the development of the methodology is part of the documentation of model changes.	

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	A documentation of all methodologies which were considered but not subsequently used is excessive and virtually impossible in the long run. We would delete this section.	
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1.149.	We strongly oppose any interpretation that requires undertakings to document differently according to the different levels of stakeholders under all circumstances as we would find this requirement unreasonable and an extension of the original text. Further clarification of this point would be welcome.	
1.150.	We would amend “a user manual” to “user manuals or process descriptions”	
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1.152.	We would delete “hardware systems”.	
1.153.	We would delete “hardware systems”.	
Chapter 11. General Comments		
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1.159.	It should be made clear that this does not mean that insurance undertakings cannot choose one single provider.	
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Chapter 12. General Comments		
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Compliance and Reporting Rules		
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2.73.	We consider the costs/ benefits to consumers as rather indirect and would state: "No direct costs / benefits [...]"	
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2.78.	We consider the costs/ benefits to consumers as rather indirect and propose to change the paragraph accordingly.	
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