Progress Report on the Follow-up to the Peer Reviews on Pre-application of Internal Models

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Executive Summary

In Q1-Q3 2014 EIOPA concluded the follow-up to the two peer reviews on pre-application of Internal Models, which were completed in mid-2013[1]. The follow-up exercise aimed at analysing the progress made by National Competent Authorities (NCAs) and EIOPA with respect to the recommendations made as a result of the peer reviews.

The current assessment is based on information acquired through the above mentioned peer reviews, as well as through the NCAs' progress reports submitted for this Follow-up exercise, in the beginning of 2014.

The analysis has applied the principle of proportionality with respect to the implementation of the recommendations and best practices. Such proportionality approach implies higher expectations towards NCAs with more experience in pre-application processes (e.g. number of processes initiated by national groups/undertakings as well as number of processes in which the NCA is involved).

With reference to the NCA specific recommendations this follow-up to the peer reviews has established that the vast majority of the NCA specific recommendations have been already followed-up and those remaining are planned to be implemented by 2015 in order to better structure processes, tools, resources used in pre-application/application of internal models, keeping in mind the respective circumstances at national level.

With respect to the general recommendations, on the basis of the adopted proportionality approach, the focus was put more strongly on NCAs that have more experience with pre-application processes.

Regarding the best practices identified in the initial peer review, the NCAs with more pre-application processes in place have undertaken major actions, taking into account the proportionality principle (based on respective organisation, capabilities and resources available) to improve their processes and knowledge.

1. Methodology

The present progress report is developed based on the analysis of the follow-up actions taken by NCAs and EIOPA from the peer review on pre-application of Internal Models.

According to articles 84 and 87 of the EIOPA Methodology[2] for conducting peer reviews the implementation of actions agreed in the final report from the peer

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[1]https://eiopa.europa.eu/Publications/Reports/EIOPA-RP-13-096a_Peer_Review_IntMod_Final_Report_web.pdf#search=report%20peer%20review See Report EIOPA-RP-13-096a: İn 2012, EIOPA conducted two Peer Reviews on the application of specific provisions of the CEIOPS *Guidance on Solvency II: "Pre-application process for Internal Models", formerly known as CP801* ('Pre-application Guidance'). The two peer reviews focused on the supervisory practices of National Competent Authorities (NCAs) and colleges.

review is expected to be monitored and reported to the BoS in the following manner:

- Following the completion of a peer review, individual annual progress reports are requested of the competent authorities that have been the subject of the peer review.

- The frequency of the progress reports may vary, taking into account the significance of the deficiencies identified during the review. The reports will be requested from competent authorities as long as deficiencies identified during the relevant review remain to be addressed.

- Based on the individual progress reports, a collective progress report will be presented to the EIOPA Board of Supervisors on an annual basis.

- Other forms of follow-up action may, where appropriate, be pursued in respect of the competent authorities. For example, bilateral discussions between the competent authority on the one hand and the Chairs of the Review Panel and EIOPA on the other hand, may take place (e.g. in cases of serious deficiencies or in circumstances, where there is an ongoing failure to take appropriate measures to rectify identified deficiencies). The Review Panel will be advised of the outcome.

1.1 Proportionality

In the course of the analysis the following criteria for proportionality have been considered: number of pre-application processes and size of the market/insurance sector involved in the pre-application process.
The proportionality criteria have been taken into account to understand how NCAs have responded to the general recommendations, as well as how NCAs have considered the best practices identified.

1.2 Information used for the follow-up peer review

The Review Panel has taken into account the following information in the course of the follow-up to the peer reviews:
- the detailed information from the initial peer review (2012), based on a larger number of data;
- progress reports provided by each NCA during the follow-up phase (in the beginning of 2014);
- additional clarification requested, in some cases, to better understand the actions put in place by each NCA.

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[2] EIOPA Methodology for Conducting Peer Reviews: https://eiopa.europa.eu/Publications/Administrative/eiopa-rp-11-017-peer_review_methodology_final_cl_01.pdf#search=peer%20review

2. Follow-up action on NCA Specific Recommendations

On the basis of the answers to the questionnaire, which described the individual actions undertaken or planned, the Review Panel has taken into account the progress made with respect to each individual recommendation.

The NCA specific recommendations deal with the following issues:
- consistency of processes/reviews; this aspect also included the need for sharing procedures, findings and experiences within the NCA and, in particular, between the several pre-application processes already in place;
- resources, in particular in the sense of appropriate expertise of resources involved in pre-application processes;
- sharing of outcomes within the College, especially in the sense of involvement of NCAs (home and host) on specific issues. This also includes exchange of information in the Colleges to ensure informed decision making;
- support from other NCAs and EIOPA to support the improvement of necessary expertise and the framework for pre-application processes.

In general, taking into account the proportionality principle, all of the NCAs that received individual recommendations during the original peer reviews have undertaken or planned follow-up actions to better structure processes, tools and resources used in the pre-application/application of internal models, accepting the specific recommendations from the Review Panel, in accordance with the respective national circumstances.

NCAs that have no or only few pre-application processes initiated by national undertakings or groups, have considered it premature to undertake initiatives, reserving the decision to take action when required.

3. Follow-up Action on General Recommendations

The general recommendations from the original peer reviews on pre-application for internal models were addressed either to all NCAs, or to EIOPA. 4 of the general recommendations were addressed to NCAs, and 21 recommendations were addressed to EIOPA.

3.1. Follow-up Actions by NCAs

The Review Panel is cognisant of the need for the general recommendations set out below to be applied proportionately.

General Recommendation
6.3.3 Colleges should have clear and timely college minutes, where disagreements are included under decision points and actions to address them are noted. This can be encouraged through EIOPA.

There is no evidence from answers to the progress report template that any NCA was not aligned with this recommendation.

The following examples are to highlight best practices:

- Implementation of specific Guidance circulated to all supervisors concerned. In this Guidance the expectations of supervisors when completing college minutes are detailed, including the need to ensure that any disagreements and follow up actions should be documented.
- Finalising the minutes not later than a month after the college meets.
- Distribution of the minutes through a secure website.

According to Guideline 10 in the Final Report on the Public Consultation for the Guidelines on the operational functioning of colleges[3] to record minutes of the meeting and to formalise and follow up the action points are main tasks of the group supervisor.

General Recommendation
6.3.5 Colleges should ensure that plans concerning the involvement of the Group Supervisor in local reviews are agreed upon early within the college.

There is no evidence that any NCA was not aligned with this recommendation.

The following examples are to highlight best practices:

- Provision in the collaboration arrangement foreseeing the possibility for the group supervisor to participate in a local review. Some group supervisors state that the work plans of their colleges comprise joint on-site examinations and that these work plans are agreed in the colleges.

- A specific section in the Guidance to supervisors on the co-ordination of inspection plans between group and host supervisors.

Guidelines 21 and 22 of the Guidelines on the operational functioning of colleges lay down procedures for carrying out joint on-site examinations which are more detailed and more generally applicable than this general recommendation.

General Recommendation
6.4.1 NCAs, especially those who have well developed and tested training programmes, could invite NCAs who have less developed training programmes to participate in their training. NCAs should be encouraged to advertise their training programmes / schedules and NCAs could be allocated certain topics to develop and share training with other NCAs. Helping other NCAs to plan training could also be useful.

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[3] Final Report on the Public Consultation No. 14/010, see
https://eiopa.europa.eu/Publications/Consultations/EIOPA-BoS-14-146_Final-Report-on-CP-14-010-GL_Op_Funct_Coll.pdf#search=14%2F10

This general recommendation is mainly applicable to those NCAs that have well developed and tested training programmes. Although these NCAs have been encouraged to open training courses to other NCAs and share training material with other NCAs with less developed training programmes and less experience, it is not feasible for most of the NCAs to offer these training programmes to other NCAs particularly due to language issues, budget constraints or limited resources or experience. For the time being, only two authorities have shared their training programmes with other NCAs.

General Recommendation
6.4.3 Besides risk experts, line supervisors should be involved in the reviews of internal models for undertakings that are in the pre-application process, in order to provide first-hand information on qualitative aspects on the review and the undertaking.

Almost all NCAs have brought their practices in line with this general recommendation. In most cases line supervisors, in close cooperation with risk experts, are involved in the reviews of internal models for undertakings that are in the pre-application process, providing qualitative and quantitative information on the review and the undertaking.

3.2. Follow-up Actions by EIOPA

The final report on the Peer Reviews on Pre-application of Internal Models approved at the June 2013 BoS meeting, recommended that a formal follow-up of the majority of the general recommendations should be undertaken specifically by EIOPA.

Various follow-up actions have been undertaken by EIOPA's Centre of Expertise in Internal Models (CoEIM), the Internal Models Committee (IMC) and its Informal Supervisory Meeting (ISM), as well as the EIOPA Colleges Team in the twelve months following the publication of the report.

The CoEIM created various actions from the recommendations in the report.

- Some of the recommendations – notably those related to colleges – were overtaken by the development of the Solvency II Preparatory Guidelines[4]. Filling gaps in the Colleges Guidelines will be obviated by text in the chapter "Functioning of colleges during the pre-application process for internal models for groups" in the Internal Models Guidelines.

- The CoEIM, in collaboration with the Colleges Team, IMC and ISM, will continue to implement the outstanding actions.

Overall EIOPA has taken actions already on all the general recommendations addressed to it and good progress has been made. On the basis of the analysis

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[4] https://eiopa.europa.eu/Pages/Standards/Standards-Guidelines-and-Recommendations.aspx

undertaken, the Review Panel has suggested certain areas where further follow-up is needed, among which to:

- encourage the use of consistent communication, on-going exchange of best practices, continuous sharing of experience on quality assurance and technical papers;

- encourage the use of a consistent approach for group and local reviews.

4. Adoption of Best Practices

This section is intended to outline how NCAs have considered the best practices identified in the original peer review, and also highlights, where possible, the reasons for which the NCAs decided whether to take certain initiatives.

The analysis was conducted taking into consideration that 'best practices' constitute non-binding and non-exhaustive examples of positive practices; they do not disqualify other practices and may not be suitable for all NCAs, taking into account national specificities and scale of operations. For this reason, NCAs are invited to consider best practices, including whether the practices could be usefully adopted by them, but do not have any obligation to adopt them.

In the follow-up exercise feedback was invited from all NCAs about whether the respective best practice has been generally considered and which actions have been taken or planned to apply it.

The proportionality criteria have been applied also when considering the NCAs' responses with respect to best practices.

The follow-up showed that NCAs with more experience have undertaken major actions, based on respective organizational structures, capabilities and resources available to improve their processes and knowledge, in particular in the sections dealing with Communication, Reviews, Colleges, pre-application and Planning.

With respect to the best practices identified in the area of "Training", also NCAs with less experience have undertaken training initiatives, most of which were based on the EIOPA training program.

A detailed overview of each section of the best practices follows below.

4.1. Communication

Generally, since most of the NCAs are in the process of reviewing one or more pre-applications for internal models, they have also started implementing other procedures, for instance the communication with the market or other parties. Those NCAs that have not received any pre-applications have obviously not reached the same level of implementing such a communication process.

- o Regarding setting up a communication plan, most of the NCAs have already taken actions, focusing on dialogue with undertakings. The NCAs confirm having regular dialogues with the undertakings. The smaller have not

implemented a communication plan, for the likely reason that those NCAs have not been involved in or leading any pre-application processes.

The communication regarding the preparedness of the formal application is different from the communication on the pre-application process. The best practices suggest colour coding, scores or ratings; most NCAs apply such an approach already or are in the process of implementing it.

o The question about what language should be used in the written communication has been already clarified by most of the NCAs during the pre-application phase and is likely to be solved in the formal application.

o The communication and co-operation of external consultancies varies among the NCAs, as some use co-operations while some use other external experts. However, no referrals are made to co-operations with other NCAs regarding for instance lack of data. Some NCAs have not faced these difficulties yet and therefore have not been able to present how they would have solved any issues.

o It is not currently harmonised how the feedback will be presented to the undertaking. Some NCAs have not considered the feed-back yet or did not provide detailed information on how some best practices identified have been considered.

4.2. Reviews

Best practices concerning Reviews have been taken into consideration by many NCAs, taking into account the proportionality principle.

Some supervisors already had specific tools/procedures for the review of internal model pre-application process, other supervisors have planned to adopt measures in line with the best practices identified.

o Solutions dealing with the development of methodologies to list the requirements from the Solvency II Directive, including provisions from Levels 2 and 3, have already been developed for more than one third of the NCAs concerned (big and middle size). For instance some NCAs have already developed a specific tool, (template or handbook) that supports reviews on IM pre-application or application processes.

Other similar initiatives taken by NCAs:
- check list or tool for reviewing internal models that reflects the legal requirements of Levels 1, 2 and 3;
- handbook for the internal model application processes that defines the supervisory expectations and decision points stemming from the regulations and guidelines in connection with internal models, containing the supervisory methods and questionnaires based on the Guidelines on Pre-Application of Internal Models and previous on-site experiences;
- template solutions required from the undertaking in order to foster the preparation for Solvency II, in line with the EIOPA guidelines on pre-

application process for internal models. These templates contain requirements pertinent to an internal models pre-application process and short explanations on how these requirements are being met or what remains to be done on the requirements relevant to a particular review.

One third of the NCAs have planned to develop or to finalise procedures or tools based on Solvency II requirements.

NCAs that adopt or have planned to adopt specific tools that support IM reviews have chosen user friendly IT solutions (mainly based on excel).

The following examples of sophisticated system adopted, by NCAs, consider best practices:
- SQAT (Scenario Quantitative Analysis Tool) is a new tool to assess the calibration of the stochastic internal models used by many life assurance undertakings.
- The Standardised Risk Information (SRI) tool is used by the general insurance actuaries to assess the output from undertakings' internal models in respect of premium and reserving risk, at varying percentiles, at both an aggregate level and broken down by lines of business;
- Models in R. Basing developed internally;
- Matlab programs to perform calculations using the undertaking's data in order to verify the results of the undertaking's internal model.

o Best practices related to the purpose of sharing experiences and knowledge with the banking sector are more easily adopted by NCAs where insurance supervision is closer to bank supervision (in particular in the case in which a National Central Bank includes insurance supervision or in case of integrated supervisory authorities). Nevertheless, NCAs not structured in a single supervisory authority have also organised meeting or committees that assure exchange of experiences from the insurance and banking sectors.

o The principle indicated in the best practice concerning "the level of assessment based on the readiness of the undertaking" is applied – taking into account the proportionality principle – by a large number of NCAs. They tend to devote resources mainly in the more complex pre-application processes. Most NCAs do not have many ongoing IM pre-application processes.

o The risk-based approach in the reviews is mainly expressed when NCAs define their work plan (reviews plan, inspections plan), taking into consideration the materiality of what must be reviewed. The NCAs that still do not use risk-based criteria, due to the small number of pre-application processes, have planned to use them when necessary.

o Best practices concerning templates used to plan and record the findings of reviews have been adopted by NCAs to varying degrees for instance via a report, tool, template, meeting or excel file. It can be considered a best practice, for instance, to provide a *Model Overview Work Plan (MOWP)* – considered a key deliverable of the internal model process. It is a working document aiming to present in a structured manner the information collected

in a walkthrough. It includes the individual work plan shared and agreed with the undertaking, listing the tasks that need to be performed and relevant timeframe.

o Benchmarking of internal models to support reviews is still being developed by NCAs observed, but a number of NCAs are starting to use it to support some of the more technical aspects of the reviews.

o Best practice regarding undertakings' internal audit function has been adopted by about half of the NCAs.

o Almost all NCAs organize meetings with undertakings in order to understand the actual level of preparedness of the undertaking/group itself to IM pre-application process. The best practice is strongly taken into consideration and the solutions adopted by NCAs should be highlighted, in particular those that provide:
  • the kick-off meeting for the pre-application process with a large number of NCAs' staff to obtain basic knowledge of specific aspects of the internal model and to set expectations;

  • the analysis of each specific module of the internal model, mostly starting with the organisation of a workshop where a large number of the relevant NCA's staff is invited (in addition to representatives of the undertaking);

  • that the meetings take place on a regular basis with a number of knowledgeable supervisory staff, included senior management; no meetings have been planned for NCAs that do not have local pre-application processes.

o All NCAs that provided responses on this topic, use a pre-application team composed of people with different background, except for those that still do not have a local pre-application process.

4.3. Colleges

Best practices concerning colleges are mainly relevant to group supervisor NCAs. Most of the answers in the progress reports of host supervisor NCAs have been only used to check and confirm the group supervisors' answers.

o To facilitate the communication of colleges, establishing a secure web-based platform is a practice which has been observed by a large majority of the group supervisors. Other supervisors use encrypted e-mails.

The best practice to align the local pre-application process with that of the group supervisor should be observed by host supervisors. The majority of the NCAs state to have their pre-application processes in line with those of the group supervisors.

Difficulties in aligning the pre-application processes of group and host supervisors appeared only in the very early phase of pre-application where host supervisors started their processes earlier than group supervisors.

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o All group supervisors state that they grant full participation in reviews to host supervisors. A few host supervisors mention that lack of resources is an obstacle to fully participate in all group reviews. A group supervisor mentions that the level of involvement of the host supervisors varies considerably. Different supervisors say that these reviews are a valuable tool to learn about the internal model and to be able to concentrate on the local implementation later. However, it is evident that it makes sense to choose a level of involvement that corresponds to the materiality of the internal model and the undertaking itself for the host supervisor.

o Nearly all group supervisors state that they have informed in a clear and timely manner the other NCAs about their approach to pre-application and the work plans. Few NCAs admit delays in the communication due to resource restrictions. The usual means of communication are e-mails, conference calls, college meetings or separate sessions, via the authority's website or in the IMC/ISM-meetings.

o There does not seem to exist a common understanding as to the meaning of "pre-visits". It is understood either as a preparatory meeting to plan an on-site-visit, as an opportunity for NCAs to learn the basics of the internal model before an on-site-visit or as a synonym for an on-site visit. Despite this different understanding all group supervisors affirm that they have pre-visits. Apart from "on-site-pre-visits" on-site visits can be prepared in college meetings or by conference calls.

o All group supervisors claim to have frequent college meetings to focus on review topics in these meetings. The meeting frequency varies from once a year to four times a year and depends on the size and tasks of the college and the specificities of the group. Usually these college meetings are supplemented by other activities, such as workshops, conference calls and on-site visits. Frequently, technical and organisational issues are on the agenda and this agenda is agreed between the college members in advance. Sometimes college meetings are organised back-to-back with other (on-site) activities, the likely reason for this being to keep travel expenses low.

4.4. Planning

The application of the best practices with respect to planning deal with a range of aspects relating to the planning of pre-application reviews including: the tools used to develop plans; responsibility for coordinating the process; governance of planning; transparency on the planning process; and resourcing tools.

The best practices have been considered in the actual practices by the majority of NCAs, in some cases building on the practices that were in place at the time of the original peer reviews.

The cases where best practices have not been adopted are typically limited to NCAs which have very few (or no) undertakings in pre-application.

Below follow examples of NCAs' actions taken on the basis of the identified best practices:

- Development of a risk map/list of the characteristics of the internal model which allows better planning of resources and which is used to identify key issues arising in respect of the internal models at an early stage;

- Co-ordination of the pre-application process resides with technical staff and project managers;

- Simple, pragmatic plans for pre-application;

- The organisation of the governance for the pre-application process is streamlined to allow quick decision making;

- The process is clearly documented and guidance is provided on the approaches that should be adopted;

- Many decisions are taken at working level;

- Strong audit trails are embedded in the pre-application process;

- Processes to manage key person risks;

- Resource/planning tools that allow better follow-up of the pre-application process.

4.5. Pre-application

NCAs which have received requests for pre-application have prepared a pre-application package in the way considered most appropriate and practical for the specific national situation (taking into consideration the proportionality principle).

- The solution to use an "Application template" should be highlighted. Some NCAs consider the opportunity to use the EIOPA Application Template as a basis for the package for the "application phase" and, for some NCAs, even for the preliminary phase of pre-application process.

- Some NCAs (with a low number of pre-application processes in place) have taken into account the best practices and are undertaking initiatives to implement an application/pre-application package, to be aligned with the preparatory guidelines.

- The NCAs that have only received one request for pre-application of an internal model have not considered it necessary, for the moment, to adopt a specific package. They prefer to acquire information also through meetings.

- The same NCAs that have adopted an IM pre-application package have also taken into account international requirements.

- The best practice which deals with Internal Audit (statements or measurements of findings by Internal Audit) has been taken into consideration by many NCAs for a possible implementation of the respective IM application processes.

o Almost all NCAs have considered the best practice concerning governance of the pre-application process. At least 30% of the NCAs have already considered this aspect (including governance analysis in the IM process), others are implementing their IM processes in order to consider governance analysis.

4.6. Training

In the area of training activities, actions by NCAs have been undertaken focusing on the preparedness of NCAs' employees in order to familiarise themselves with the new Solvency II regulatory framework, setting up several tools such as basic training programmes on Solvency II aspects for all employees, tailor-made programmes on specific topics and risks of internal models for experienced staff and manuals or materials for reviews under the Solvency II regime.

Moreover, most of the NCAs participate in external training activities offered by EIOPA or other external providers.

As to training on change management, most of the NCAs have not included such course in their training plan. However, some have reinforced their internal training programme with this specific training in order to ensure that Solvency II is better embedded in their organisation.

There are certain solutions adopted by NCAs that provide for the establishment of a specific cross-sector team for Solvency II, created in order to enhance the decision-making process for developing the NCAs' positions on Solvency II issues (for the purpose of international as well as national fora) and to provide for the use of expertise from different organisational units in this process. The cross-sector team's tasks also include the steering of preparation of the NCA (staff and management) and the supervised entities towards Solvency II.

5. Impact on Common Supervisory Culture

Based on the analysis of the follow-up actions taken by NCAs, it can be concluded that the approaches of different supervisors with respect to pre-application are converging following the original peer reviews.

With reference to the NCA specific recommendations this follow-up exercise has established that the vast majority of the NCA specific recommendations have been already followed-up and those remaining are planned to be implemented by 2015 in order to better structure processes, tools, resources used in pre-application/application of internal models, keeping in mind the respective circumstances at national level.

The risk of supervisory arbitrage with respect to pre-application processes has diminished over the last two years.

6. Follow-up measures

As stated in the EIOPA Methodology for conducting peer reviews, the implementation of actions taken by NCAs could be assessed by a further follow-up.

With respect to actions which certain NCAs have committed to take in 2014-2015, as well as the suggested actions for EIOPA, the respective NCAs as well as EIOPA are expected to inform the Review Panel about the actions taken by mid-2015.