24 July 2012

Dear Firm

Solvency II update for IMAP firms

When I wrote to you in May I set out our commitments to keep under review our approach to implementing the Solvency II Directive and to give feedback at an individual and thematic level. In June, I shared our thinking on how we would monitor the ongoing appropriateness of internal models after approval. In this letter, I want to take the opportunity to provide an overall update on Solvency II and to give further feedback for firms in IMAP. While I am addressing my letter to you as the Chief Executive Officer of your firm, it may be useful for you to pass it to your Solvency II lead, technical specialists and others as appropriate.

Policy update and our implementation assumptions

The Solvency II Directive, while adopted, is subject to ongoing uncertainty both on the timing of implementation and the detail of some of the requirements. A short amending directive, adopted on 3 July 2012, changed the original implementation date of 1 November 2012 in the Solvency II Directive with a new timetable requiring transposition by Member States on 30 June 2013 and implementation by firms from 1 January 2014. The timetable continues to be extremely tight, particularly in the context of a legislative process that has already been far from straightforward. We await a key vote in the European Parliament on the Omnibus II Directive in October and the related Level 2 implementing measures to provide clarity on policy.

We acknowledge that the longer it takes to agree text in Europe, the greater the chance that the timetable may slip even further. Were this to happen we would review our implementation schedule, but for the time being we feel we have no other option than to use an implementation date of 1 January 2014. We remain sensitive to the implications of delays to firms and reiterate our commitment to identify ways in which firms may be able to use their Solvency II work to meet the requirements of the current ICAS requirements.

We continue to give you early sight of our proposals for the new regime and on 11 July we published the second in a series of consultation papers to transpose the Solvency II Directive into our Handbook. Responses are invited by 11 October. CP12/13 ‘Transposition of Solvency II – Part 2’ and further information is available on the CP page of our website.

I also refer you to EIOPA’s publications of the outcomes of the consultations on the Own Risk and Solvency Assessment and reporting to inform your preparations for Pillars 2 and 3 of the new regime. We have published links to these documents at

1 See http://www.fsa.gov.uk/about/what/international/solvency/policy/cp
Domestically, we are holding meetings with the industry through our expert groups to set out what these consultations mean in the run up to implementation. We will keep our website updated with links to the consultations and further information.

Making progress in IMAP

I am pleased to say that we have started to receive submissions from firms in pre-application. We are seeing some good quality work that is allowing us to progress our review work so that we should be able to form a preliminary view within six months. Our ability to do this relies heavily on firms adhering to the submission schedule and supplying us with the agreed information at the required level of quality.

Looking ahead, where our preliminary view is either that the requirements are met or more work is needed (see Our approach to assessments and decisions before the start of the Solvency II) we expect to continue working with firms – either individually or on a thematic basis – in the period up to their formal application to use an internal model. This will vary by firm based on its individual submission slot and overall timetable. For example, our activity with the firm between our preliminary view and its formal application may be determined by the stage of development of the model and any changes that may arise. Ideally, we would like to see models that are either final or in an advanced stage of development, but we recognise that some changes will be required. We will expect firms to apply a formal change process to their model from the point of making a submission to us.

We will provide more detail on the timing and steps for the internal model application process in Q4 2012. We will also set out our approach to assessing the impact of any policy updates on our processes or materials and our communication with the industry. Our need to be able to apply the new regime from January 2014 is the reason why it is vitally important that you stick to the submission slots we have already agreed with you, as there is very little scope in our timetable for any form of slippage.

It may also be worth reminding firms that the FSA and other Member States are part of the continual peer review process run by EIOPA. We expect to have our next review of our internal model approval process in September. While we can not give feedback from this process, we will let you know of any findings issued by EIOPA.

Feedback from our IMAP work to date – July 2012

I was encouraged to hear from firms that they are getting feedback from their supervisory team and that the themes in my letter of 14 May 2012 were useful in firms’ assessment of their own progress. We have identified two areas for additional feedback from our IMAP work: i) expert judgement; and ii) data risk. I have included the detail at Annex A, and ask you to pass this to the relevant people in your firm. I would like to remind you that this thematic feedback does not supersede individual feedback from your usual supervisory contact.

What’s going on and what’s coming up?

You will have seen that, as referred to in my speech in February, we have now published our two-stage approach to the review of technical provisions as part of our work with IMAP firms. Your supervisor will discuss what you need to do to complete the first stage in the coming months, and we will provide further information on the

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2 Available at http://www.fsa.gov.uk/static/pubs/international/sol-ii-our-approach-assessments-decisions.pdf
second stage of the review in Q4 2012 so that it can be completed in the first half of 2013. By way of reminder, you will not be required to complete the external review by your submission slot.

We are also planning data collection exercises to inform our assessment of firms’ internal model calibrations. In developing our requests, we have been mindful of the work that we need to do with firms in the run-up to implementation and the competing demands on firms on other Solvency II-related work, e.g. the EIOPA stress test due in the autumn. We plan to issue requests to IMAP firms in two tranches:

i. life insurance and general insurance firms will receive a request for data on their capital outputs later this month. We will also be requesting information about the firm’s reliance on the standard formula in its partial model where applicable. In addition, life insurance firms will receive a request for internal model risk calibrations on a standardised basis; and

ii. general insurance firms will receive our general insurance stress testing (GIST) exercise in September.

Responses will be requested within two months of the data request to firms.

**Monitoring the ongoing appropriateness of internal models**

In my letter of 18 June, I shared our early thinking on the indicators that we are developing to monitor the ongoing appropriateness of internal models after approval. We are at the start of the development process and I would like to reiterate our invitation for suggestions of other indicators that we may be able to use. To give us time to prepare the template and instructions for September, please send your suggestions to Solvency2@fsa.gov.uk by cob Friday 17 August 2012.

**Next steps**

We remain committed to updating you of developments in our approach to implementing the Solvency II Directive, sharing early developments in our thinking and giving feedback from our work with IMAP firms. We are looking to hold the next FSA Solvency II conference later this year, and will provide further information in September. I have set out a timetable at Annex B that I hope you will find useful. Please note that it is based on information available at the time of writing.

Please continue to raise issues and questions with your usual supervisory contact or at one of our FSA Solvency II forums so that we can consider them in the planning of future communications.

Yours sincerely

Julian Adams

Director, Insurance
Additional feedback from our IMAP work to date – July 2012

1) Expert judgement

We recognise that expert judgement is important and necessary in many aspects of internal models and should be viewed as a process. It is important to bear in mind that the Directive’s requirements also apply to expert judgements that are used in the model. In this regard, we have found instances of expert judgement being used without the corresponding governance around it. Examples include:

- The inability of some firms to articulate the materiality of the assumptions derived from expert judgements, particularly where a model is not yet sufficiently developed to produce the required results.

- The reasons for coming to a decision not being clearly documented. We believe this is essential so that knowledge generated in the assumption-setting process is not lost and the conclusion can be shown using evidence and challenged. This is particularly relevant where there is a wider range of plausible answers and/or the decision made has material implications for the firm’s internal model.

- Evidence that experts have made decisions without the benefit of relevant information from elsewhere in the firm, thereby calling into question the validity of the decision made. For example, data analysis has been conducted relating to a risk without a detailed understanding of the actual exposures or how the underwriting or claims management practice has evolved over time.

- A lack of evidence of effective challenge that might address biases in expert judgement such as the anchoring of assumptions. This part of governance is particularly important as, by its very nature, expert judgement is difficult to validate, and benchmarking is often the only validation tool considered by firms. In several cases we have not been able to find evidence that alternatives were considered, or assessed objectively.

- No explicit links to the validation of the internal model, e.g. identifying triggers that would result in additional validation. More generally, validation has focused on statistical tests and has not provided evidence to support the qualitative expert judgements made.

- Some firms have attempted to set up a framework to govern the exercise of expert judgement, but are not following it during model development. This poses problems for validators and supervisory review. It also stores problems for the future maintenance of the model as there is a danger of incorrectly anchoring in assumptions.

We remind firms that while proportionality does apply for the application and validation of expert judgement and its governance, it does not mean that requirements do not need to be met.

2) Data risk

In July 2011, we published a scoping tool to help us assess whether a firm’s data management complies with the standards set out in the Solvency II Directive and the draft Level 2 implementing measures for internal model approval. We have been conducting reviews as part of our work with IMAP firms to assess the quality of data used in the internal model. While this review work is not complete, we intend to issue interim feedback to firms later this year based on our findings to date.
## Timetable as at 24 July 2012

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<tr>
<th>Date</th>
<th>Description</th>
<th>For action and/or information</th>
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<tr>
<td>July</td>
<td>Industry meetings on the ORSA and Reporting, information available on our website (see <a href="http://www.fsa.gov.uk/Solvency2">www.fsa.gov.uk/Solvency2</a>)</td>
<td>For action</td>
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<td>Early August</td>
<td>First tranche of data request to life and general insurance IMAP firms, for response by end-September</td>
<td>For action</td>
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<td>17 August</td>
<td>Responses with suggestions for early warning indicators due</td>
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<td>September</td>
<td>Responses to first stage of the review of technical provisions due</td>
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<td>September</td>
<td>Second tranche of data request to general insurance IMAP firms for response by the end of November</td>
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<tr>
<td>September</td>
<td>Templates and instructions issued to all IMAP firms to collect data for the calibration of early warning indicators</td>
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<tr>
<td>September</td>
<td>Data response from life and general insurance IMAP firms due for first tranche request</td>
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<tr>
<td>11 October</td>
<td>Consultation closes for CP12/13</td>
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<td>22 October</td>
<td>Plenary vote scheduled in the European Parliament for the Omnibus II Directive</td>
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<td>November</td>
<td>Data response from general insurance IMAP firms due for second tranche request</td>
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<td>Q4 2012</td>
<td>Updates on the:</td>
<td>For information and action</td>
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<td>• internal model application process;</td>
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<td>• interim findings from our review of firms’ data management;</td>
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<td>• approach to reviewing and communicating changes to our materials and process as a result of policy updates; and</td>
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<td>• second stage of our review of technical provisions.</td>
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<td>Further information on the next FSA Solvency II industry conference</td>
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