

Audit Assurance for Solvency II Internal Models

1 Introduction

Institutions submitting an application under Article 112, 230 or 231 of the Solvency II Directive (Directive 2009/139/EC) are required to demonstrate that they comply with the internal model requirements. The requirements for the application are contained in the various sections of the 'Contents of Application' issued by DNB on 11 August 2011, and published on Open Book.

It is the responsibility of the institution's management to assess if the application meets the requirements of the Solvency II Directive (Section 116). The management of the institution will derive its conclusion that the application complies with this Directive from the reports and findings of the functions and departments set up for this purpose within the institution and from the activities and findings of its Internal Audit Department (IAD). DNB therefore expects the application package for the Internal Model (the template and corresponding documents) to be accompanied by a statement and a relevant memorandum of findings by the IAD. Both documents are discussed below.

First, the scope of the IAD activities to be expected is set out (Chapter 2), followed by a discussion of the preconditions for these activities (Chapter 3). Chapter 4 deals with the communication between the IAD and DNB as well as the review by DNB, and Chapter 5 focuses on the report by the IAD.

This document is based on the current regulations and levels 1, 2 and 3 as presently known, and is expected to be adjusted to future amendments.

2 Purpose and scope of the activities of the IAD

The activities of the IAD are designed to assure the management of the institution that the application meets the Solvency II Directive requirements as laid down by DNB in the Contents of Application document. They do not serve to establish whether the institution's internal model meets the Solvency II requirements for internal models, but whether the information in the application package is complete and reflects the actual situation at the institution¹.

To this end, the IAD assesses the design, existence and operation of the processes and procedures related to the internal model. This implies that the IAD assesses whether the elements named in the Contents of Application document are correctly reflected and, on the basis of this assessment, gives an overall opinion of the adequacy of the application package submitted, by way of a statement.

The scope of the internal model is described in section H1 of the Contents of Application document.

¹ There may be cases in which the IAD (besides assessing the application package submitted) is involved in a substantive assessment of some of the application package elements for compliance with the Solvency II requirements. This may be the case if the IAD is involved in compiling or verifying the requirement analysis (part G of the Contents of Application document), in checking the model validation policy or in validating the Use Test. While, self-evidently, the IAD may in such cases base its assessment of the application package on its own findings, such activities fall beyond the scope of the activities to be expected within the scope of this document.

3 Guidelines for the activities to be performed

The activities needed to attain the requisite level of assurance are independently determined by IAD. Within this scope, the IAD is required to observe guidelines regarding the following aspects:

- a) Relying on other parties (internal or external)
- b) Making use of past activities and/or activities serving other purposes
- c) Standards and rating methodology
- d) Substantiation of choices

These aspects are discussed below.

a) Relying on other parties

In its activities, the IAD is free to enlist the services of other parties, both external (e.g. an independent review of the requirement analysis by an external party) and internal (e.g. model validation or an other 2nd-line function). Before relying on an in- and/or external party, the IAD must first make sure that party is sufficiently independent and competent². Furthermore, the scope of the assignment and the approach, as well as the process of forming the conclusion are subjected to a high-level review. In addition, an IAD may decide to execute (risk-based) substantive depth reviews to assess the quality of the activities performed. This also depends on the extent, nature and importance of the activity to be outsourced. Any lack of in-depth reviews or sporadic use thereof will need to be convincingly underpinned.

b) Making use of past activities and/or activities serving other purposes

The IAD may decide to rely on activities performed in previous years and/or for other purposes (e.g. SOx), provided that it has been sufficiently and demonstrably established that the conclusions are still valid and/or sufficiently meet the specific requirements for Solvency II³.

c) Standards and rating methodology

The activities of the IAD are designed to assure the management. It is therefore up to the management in the first place to indicate what level of assurance is desired. Another consideration for DNB not to issue guidelines regarding this point is that the majority of considerations within the scope of the decision-making process will be of a qualitative rather than quantitative nature. This calls for careful recording of the choices made and of the underlying considerations.

Furthermore, IAD is required to use the method it employs to classify and weigh findings and draw conclusions (ratings) also for assessing the application package. DNB expects the IAD to afford DNB insight into its rating methodology, which DNB will compare with other institutions in the application process. The outcomes of this benchmark or the use of the rating method in practice might induce DNB to discuss possible alterations of the methodology with the IAD.

² This goes beyond the establishment as such that an external party is a renowned external office, but extends to aspects like dependence on other assignments, the possible concurrence of assignments and the general expertise of the staff involved. One specific element is the question whether the external party is sufficient familiar with the institution.

³ This especially applies to data, because data characteristics that are validated under SOx may be quite different from the ones that are relevant for the internal model. Therefore, compliance with these requirements needs to be established at this level. Since the data used sometimes have a long history and/or a sensitive to errors, it is assumed that a comprehensive process-oriented approach does not suffice for assessing the quality of the data.

d) Substantiation of choices

The IAD will be allowed much freedom in organising and executing its activities. As said above several times over: it is emphasized once more that the way how choices and conclusions are arrived at must be transparent to a third party. This applies, for example, to the manners in which specific in-depth assessments are chosen and spot checks are selected.

4 Contacts with and assessment by DNB

As appears from the foregoing, DNB does not provide for all contingencies in this document as it wanted to leave the IAD some leeway, as the regulations are still under construction and as it is simply impossible to anticipate every situation. Instead, there will be periodical consultations to discuss the approach and any interpretation differences and unexpected situations. The positions that DNB will take during these contacts may alter, depending on changes in situations or new information. If an institution should seek a formal position from DNB regarding important aspects, it will need to follow the formal procedure to request such position.

DNB intends to base its assessment of the application package partly on the activities of the IAD, but not after it has subjected these activities to a risk-based assessment and review. In consultation with the IAD, DNB will seek to perform the reviews as much as possible during the pre-application phase, and not postpone them to the application phase. The IAD will place its files at DNB's disposal to this end.

DNB will furthermore base itself on other information about the institution's internal model becoming available during the various interviews, on on-site reviews and on results from benchmarking exercises.

5 Reports

The IAD reports about its activities by means of a statement, for which a model text is included in Annex 1. In addition, the IAD will lay down its findings in a memorandum. Annex 2 contains a suggestion for a table of contents for this memorandum, which the IAD is free to extend.

The memorandum enables the IAD also to clarify – besides to its findings – the considerations underlying the weighing of these findings. In addition, the IAD is requested to rate every sub-component of the application package individually, using its own rating methodology⁴.

The memorandum could also contain:

- An overview of the reviews performed and of the outcomes (ratings)
- A description of the (business) units not or partly covered by the assessment
- Main open issues with expected dates of resolution and/or interim mitigating measures

Where and if applicable, the IAD may refer to the findings and conclusions of third parties, provided that the report concerned is part of the application package or attached to the memorandum.

⁴ E.g. sub-components J1 and J2 separately.

Annex 1: Statement by Audit Assurance regarding Internal Model Application

To: Management Board

We have assessed the application package of the Solvency II internal model application, to be submitted to De Nederlandsche Bank NV by insurer, for compliance with the Contents of Application document of DNB. The outcome of our assessment is reflected by the conclusion stated below. Our findings are included in the attached memorandum.

Our assessment was performed in accordance with the guidelines adopted by De Nederlandsche Bank NV and with the relevant Dutch auditing standards.

Conclusion:

On the basis of our assessment we have established that the application package sufficiently/insufficiently complies with DNB’s Contents of Application document. The application is complete, is an accurate reflection of the internal model and no material facts have been omitted.

Specification of findings (optional)

Limitations of the activities

Uncertainties

Inaccuracies that must be addressed

Other findings relevant for DNB, if applicable, with references to specific passages in the attached memorandum

Note: the above must not imply an erosion of the conclusion

Limitation of use and scope

We bring to your notice that this statement is intended for the management and the supervisory board of insurer and not suitable for other purposes. This statement, or parts thereof, may therefore not be made available to others without our prior permission. We do not object to this statement being communicated to De Nederlandsche Bank NV and any foreign supervisors involved in the assessment of the Internal Model of insurer

Place.....

Date.....

On behalf of the internal auditing department of insurer

Name.....

Position.....

Signature.....

Annex: Memorandum of findings

Annex 2: Suggestion for Memorandum content

1. Executive summary
2. Explanatory notes to the assignment and the scope of the activities
3. Explanatory notes to the methodology employed (incl. an overview of the most important parties involved)
4. Findings and conclusion per relevant (sub-)component of the application package (including a substantiation of choices and conclusions)