



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Regulatory Landscape – The View from Europe

Address by Matthew Elderfield, Deputy Governor

to the

European Insurance Forum

23 May 2011

Good afternoon ladies and gentlemen. It is a pleasure to be back at this year's conference and to have an opportunity to talk about the regulatory agenda facing insurance companies. My thanks to Sarah Goddard and her colleagues at DIMA for helping organize this event again. DIMA is an important stakeholder to the Central Bank and Sarah plays an important role in supporting the international insurance sector in Ireland. So, it is my pleasure to be able to take part in this event again.

I thought I would use my time today to give an overview of the regulatory agenda for insurance from three perspectives:

- a domestic Irish one, in terms of the changes taking place at the Central Bank of Ireland;
- a European one, focusing on the advent of EIOPA, the new EU insurance regulatory authority, and on the implementation of Solvency II; and finally,

- a global one, discussing two particularly important areas of work being led by the IAIS, the International Association of Insurance Supervisors, namely the development of international solvency standards and the debate on systemically risky insurers.

First, a little context about the insurance sector in Ireland.

Insurance is an important and thriving part of the international financial services sector in Ireland and has been one of the clear financial success stories here in spite of the crisis. There were 308 licensed insurance and reinsurance companies in Ireland writing some €58bn gross written premium in 2009. The overall number of companies has stayed stable since 2007, as has the volume of gross written premium in the direct life and reinsurance sectors, while gross written premium in direct non-life has grown significantly.

That is a sizeable sector and the level of activity needs to be seen in the context of the condition of the global insurance market. As you know, the international market is continuing to experience soft pricing conditions due to excess capacity. This inhibits growth in gross written premium as the needed correction in pricing is delayed due to the soft market conditions. Also, firms generally have faced difficult trading conditions in light of the macroeconomic environment and have faced pressure on their investment returns due to the financial crisis. So, the relative stability of the Irish-based sector in such a difficult environment is notable and reflects positively on the attractions of Ireland as a financial center.

The industry itself is heterogeneous. There is a substantial captive market, a domestic life and non-life market and also a substantial international sector. The international sector covers a range of product types, with significant concentrations in reinsurance and variable annuity expertise, and Dublin also provides the hub for pan European activities. Based in the EU, with the

advantage of the improved cross-border passport under Solvency II, a well educated English speaking workforce, a stable and competitive corporate tax regime, and strong infrastructure in terms of professional services firms and legal system, the Irish insurance sector is developing a network effect. It is well positioned to continue to expand as a market and provide a platform for increased activity when the insurance cycle eventually does turn.

The success of the insurance sector is in spite of the problems in Ireland's banking sector and sovereign financial position, but, when you think about it, this is less remarkable than it first appears. The financial strength of an insurance company individually – or of a sector collectively – is based on the quality of its balance sheet and its business operating environment, not where its headquarters is located. A handful of insurance companies may have a predominantly domestic Irish business model, but these are by far a small minority in an international sector that operates on a European scale with a highly diversified asset base.

What about the risk that banking regulation – in Ireland or indeed elsewhere – will influence insurance regulation disproportionately. This is an issue I'm sensitive to, both in domestic policy debates and European and international ones. But it's a debate prone to exaggeration and distortion. Of course, insurance companies are not banks, so the rule book for banks shouldn't be Xeroxed wholesale onto insurance. But, also of course, there are lessons from the financial crisis about the way supervision and regulation works generally, so we need to think seriously about what that means for the insurance sector. So, we need to take a granular approach and think matters through issue by issue.

What does all this mean then for the domestic regulatory agenda for insurance? The Irish financial crisis – a banking crisis – does present a lot of lessons to be learned about the way regulation and supervision generally didn't work effectively in Ireland. The various reports on the crisis, and also my own observation, highlight not only banking-specific problems but also

some fundamental gaps in the basic regulatory infrastructure that applies across all sectors. These include an absence of effective standards for corporate governance and fitness and probity and also weaknesses in how the Central Bank is resourced and organized for front line supervision. Our approach in making these changes has been to take a risk-based and proportionate approach involving consultation with industry. Our corporate governance standards are designed to fill a gaping hole in the Irish regulatory framework and to raise standards, encouraging more focus on governance and broadening the gene pool of Irish corporate life by bringing more diversity and experience onto boards. It does require substantial changes for some companies. We think this is right and appropriate and that the starting point of a stronger regulatory system is stronger governance standards, starting at the board level and, later this year, looking at internal governance standards.

Strong corporate governance is not a sector specific requirement, but should apply generally: Ireland's reputation as a financial centre would take a very serious blow if the problems in the banking sector were to manifest themselves elsewhere, and stronger governance standards are designed in part to ensure this does not happen. And problems in the insurance sector are not impossible. We have witnessed serious solvency problems at a major domestic insurance company, which will require a substantial call on compensation arrangements, and the finite insurance problems of the past touched the international insurance sector in Ireland.

However, our approach has been proportionate and risk-based. Of the about 308 licensed insurance companies, we have carved around 110 captives out of the main corporate governance code and they will have their own bespoke code which we have developed with the assistance of DIMA to reflect the unique business model of captives. Of the remainder, in fact only some 11 insurance companies are deemed "major institutions" which have the full weight of the code applied to them. These are the companies with very large

operations, domestically or cross border, which would pose significant policyholder detriment if problems occurred – and reputational damage to Ireland's growth as an insurance sector.

I think it is perfectly reasonable that tougher corporate governance standards apply to this subset of firms: for example, that more time is set aside for more board meetings to facilitate more challenge of management, analysis of risks and reviews of strategy. We have indicated directly to firms and representative bodies that we are pragmatic about how participation in such meetings can take place and we will be publishing a Frequently Asked Questions (FAQ) document on the new standards.

The corporate governance standards were improved due to the input of industry comments: we didn't agree with everything but we did find the consultation exercise helpful in calibrating our standards concerning international groups, for example. We are currently engaged in a consultation exercise concerning fitness and probity standards and I would encourage firms and their representative bodies to pay close attention to the proposals and let us know their views. This is another exercise in closing a glaring gap in the regulatory framework in Ireland that applies across all sectors: the absence of a statutory framework for assessing the fitness and probity of individuals working in the financial services sector. The framework will be familiar to those of you operating in other jurisdictions, for example the Approved Persons regime in the UK.

We have set out proposals to tailor the scope of the pre-approved controlled functions to the sorts of roles that are relevant for the insurance industry, but we would welcome your thoughts. There are also some important issues about how the scope of the broader controlled functions category works. We do not require preapproval for all categories but do have the power to ban individuals operating in these functions and firms are required to keep track of individuals in this group and to conduct appropriate due diligence

regarding their appointments. The statutory definition of this group is broadly defined and we have some important consultation questions as to the practicalities of conducting due diligence for this broader group. I suspect this will have limited impact on most international insurance companies, but please tell us if you disagree. However, domestic firms with substantial retail sales forces will want to think carefully about the proposals.

If fitness and probity and corporate governance are the two immediate changes to the common regulatory framework in Ireland, we are also making changes as to how we do front line supervision. I was surprised to find how under resourced the supervisory functions were at the Financial Regulator and, also, by a lack of an adequate risk assessment framework. We are working to address both of these weaknesses.

The overall size of the regulatory staff at the Central Bank will approximately double from when I arrived to the end of next year. The number of insurance staff will increase from 42 at the end of 2009 to a target of 113 staff at the end of 2011. We are also expanding our actuarial capacity – from 4 qualified actuaries and three trainees at the end of 2009, we now have 7 qualified actuaries and 4 trainees, and by the end of the year we plan to have 8 qualified actuaries and 7 trainees. We have set up a specialist team for supervision of variable annuity firms, created a dedicated team for supervising a large “hub and spokes” group (of which more in a moment) and also now have a dedicated insurance prudential policy team to lead our implementation work on Solvency II. This addition of resources will give the Central Bank the capacity to do supervision more effectively, with specialist knowledge of the firms that we supervise and to allow a distinctly insurance – not banking! – emphasis in our approach. I am also creating a dedicated post of Director of Insurance Supervision that will report directly to me. Recruitment for this position is well advanced. The post will ensure that the important insurance sector has a dedicated senior supervisor at the Central Bank. I also retain a close personal interest in insurance regulatory issues

from my time in Bermuda and reflected in my participation on the EIOPA Management Board and the IAIS Executive Committee.

I want to turn to EIOPA and IAIS matters very shortly, but let me mention one issue that has been the subject of scrutiny at a domestic level by the Central Bank, namely the variable annuity sector. Ireland has developed as a centre for variable annuity business, with a total of 12 companies now transacting variable annuity business from here. Variable annuities are an important product that assists consumers in planning for a secure retirement, by providing savings instruments with certain guarantees on the performance of investments. The attraction and potential growth of this product line is clear.

However, it is also clear that providers of these products face significant risks, which must be managed carefully. The Geneva Association acknowledges that "VA providers saw their capital positions erode rapidly when markets came under substantial pressure in 2008 and early 2009. This reflected inadequate hedging strategies and substantial tail risk." My staff has provided me with a list of twelve insurance companies worldwide that have suffered significant VA losses over the past few years, which have required collectively many billions of Euros of recapitalization. A sense of tact inhibits me from reading out the list of companies, but they are very prominent ones and are firms which on the face of it would for the most part otherwise be considered well managed.

While the Geneva Association and indeed individual firms argue that lessons have been learned and that "the sophistication of hedging programmes has improved" it is understandable that regulators wish to cast a close and challenging eye on the risks posed by these businesses and that the Central Bank should be one of the regulators at the forefront of that process given the concentration of business in Ireland. We have set up a specialist VA supervisory team and are looking to conduct joint inspections with other

leading EU regulators. We have taken part in the EIOPA task force on VA business, which is producing useful standards. And we have also taken some own initiative work on VA risks. In particular I have asked that we scrutinize closely the effectiveness of hedging programmes at the firms that we supervise and only allow capital recognition of hedging where it is well founded. I am also keen to ensure that capital levels generally are robust for this business. We have implemented more rigorous capital requirements for newly written VA business this year. We did debate waiting for Solvency II before taking action, but the projected premium growth of this business was significant and we felt it would be imprudent to defer action. However, Solvency II will indeed be the key regulatory framework for VA business in the future. We will require all VA writers to apply for use of internal models to ensure that solvency standards are appropriately calibrated to the unique risks of VA business. We will ensure rigorous scrutiny of these models and will look closely at hedging effectiveness in stress conditions as part of that assessment. Having a robust regulatory framework, operated by supervisors with specialist knowledge, should be welcomed by VA carriers as a way of demonstrating to stakeholders that their pan-European business is founded on strong foundations.

Let me now turn to the European scene directly. The two very big developments are the creation of EIOPA – the European Insurance and Occupational Pension Authority – and the introduction of Solvency II. The formation of EIOPA is potentially a “game changer” for European insurance regulation and shouldn’t be considered an incremental step up from its predecessor body, CEIOPS, but a significant new regulatory authority with its own identity. There are a number of reasons for this, but let me highlight two. EIOPA will have much stronger standard setting powers which will be directly binding on all EU, including Irish-based, insurers and indeed on the Central Bank of Ireland. The scope for national differentiation in insurance regulation in Europe will become much more limited. But EIOPA is not just about standard setting: it is also about convergence in supervisory practices,

developing a more common EU supervisory culture as we work together on more direct front line supervision at an EIOPA level on matters such as financial stability stress tests and supervisory colleges.

We are lucky to have two very capable and dedicated individuals leading EIOPA in Gabriel Bernardino and Carlos Montalvo and it is my pleasure to be able to work with them at close quarters on the Management Board of EIOPA. They are supported by a very impressive and hard working team. It is important that EIOPA has the necessary resources – in terms of staffing and budget – in order to tackle its numerous responsibilities. The Central Bank has sought to do its part by making one of our most experienced and able members of staff available for secondment to EIOPA.

EIOPA's biggest immediate challenge – like that of the entire insurance industry – is the implementation of Solvency II. An important and welcome innovation in international insurance solvency standards, Solvency II will provide a more risk-based and market consistent approach to assessing the solvency requirements of insurance companies. The Central Bank is focused on working closely with our European partners and with Irish industry to making implementation a success. We have invested in building up our staffing levels, EIOPA participation, project management capability and communications outreach to make the project a success.

There are a huge number of issues to talk about on Solvency II but I want to briefly touch on five: implementation timelines, calibration, model approval, equivalence and, perhaps less obviously, hub and spoke structures.

On implementation timelines, my observation is simply one of concern about the increasingly compressed amount of time we all have – regulators and industry – to land some important outstanding issues and to implement important technical changes to systems which have big implications for risk management and solvency levels. This is not the fault of anyone – all the

European bodies are working flat out to make this work – but it is clear that the timeline for Omnibus II had added a complication to an already difficult project timeline. The determination at EIOPA and, I understand, at the Commission, is to progress as much of the non Omnibus II impacted work as possible, as quickly as possible, so that firms have an early sighting of what is required.

I think a couple of conclusions flow from this timelines issue. We need to give consideration to the phasing of particular obligations on supervisors and insurance firms to ensure that there is adequate time to implement different aspects of the directive and to recognise the implications of the Omnibus II timeline. But it is also important that we maintain momentum with the implementation project in terms of completing policy deliberations and providing certainty on the specific of requirements that will be applied.

My second conclusion is that we must take care that the entire regulatory community and insurance industry isn't diverted into the Solvency II project, with the best and brightest of our people distracted with preparations, so that we don't collectively take our eye off the day job and any emerging risks. With hindsight, I think this was one of the lessons of the Basel II implementation process, where firms and supervisors alike had their most qualified prudential risk management staff committed to Basel implementation at the time the credit bubble was growing. So, at the Central Bank we need to make sure that we continue to ramp up our risk assessment work and ensure that effective risk mitigation plans are put in place for our most important firms.

One of the complications of the implementation timeline is that a considerable amount of work remains to be done on calibration. We have a good foundation for this work, with the successful Quantitative Impact Survey 5 (QIS5) exercise. I'm grateful for the hard work that so many Irish firms put in to the process. We had 220 full quantitative submissions,

representing 81% of the companies impacted by the directive, some three times the number of participants in QIS4. Thank you all for your efforts.

There are a lot of issues from QIS5 that require further work and the letter from EIOPA's Chairman to the European Commission, available on the EIOPA website, gives a good indication of what is on the "to do " list of issues to be worked through. In addition to the detailed list of issues to consider, there is also the question of the aggregate or cumulative impact of the Solvency II framework, where the representative bodies for the insurance sector have made strong representations about their concerns. I'm not convinced that the overall QIS5 results justify a fundamental lurch in the recalibration towards weaker solvency standards. However, I do agree that there are some important issues to be resolved which, taken collectively, will impact the overall solvency picture and the costs of implementation.

For example, it is clear that complexity remains a big challenge for the industry and, frankly, for supervisors. For example, the counterparty default risk methodology and the risk margin element of calculating technical provisions clearly require a fresh look with an eye to simplification.

The calibration of non-life underwriting risk is also an area that is a priority for EIOPA, to assess whether current calibrations are consistent with a 99.5% confidence level. There is a lot of detail in this exercise, varying by particular risk class, but I think that, certainly for catastrophe risks, it looks like we haven't got it right yet. We seem to be in the worst of both worlds: some firms view the methodology as too complex for EU exposures and others as too blunt and simplistic for non-EU exposures.

Even with some recalibration for non-life business, I think the overall direction of change compared to Solvency I is clear and that the trend will be towards more rigorous solvency requirements.

As an aside, I wonder what that will mean for the inflection point of the insurance cycle. A thoughtful observer of the insurance scene, Brian Duperreault, has wondered whether an accumulation of developments over time might presage a change in pricing dynamics by affecting the market's psyche. A relative strengthening of non-life solvency standards should be added into that mix. In the meantime the continuing soft market requires vigilance by supervisors to ensure that underwriting discipline is maintained and that reserve releases are not used to flatter profitability at the cost of balance sheet strength.

Perhaps the most difficult area that needs to be considered concerns the treatment of Expected Profits in Future Premiums, along with the related question of contract boundaries. QIS5 assumed that all EPIFP could count towards tier 1 capital, much to the consternation of some supervisors who view a tier 3 treatment as appropriate. For our part, the Central Bank would favor a middle course which allows some recognition in tier 1 subject to prudent limits.

The strength of feeling on calibration of the standardised approach to solvency is perhaps, surprisingly, felt equally by those larger firms that expect to use internal models. It is useful to tease out the reasons why as we turn to discuss models. There is clearly a fear that supervisors will use the simplified calculation results as a floor for considering model approval, rejecting models that have too steep a benefit compared to the standardized approach. I want to disabuse you of that impression. The reality should be somewhat different. We should instead reasonably be using the standardized results of modeling firms to act as a common yardstick to allow peer group comparisons. Where a firm has a significantly more favorable position versus its peers as a result of the use of a model, then that is a useful prompt for a challenging supervisory dialogue.

This does, of course, beg the question as to whether the entire peer group is receiving a prudent level of solvency benefit from using an internal model. This is an area that worries me, but where a floor based on the standardized formulae is not the answer. The fact is that insurers can receive significant reductions in their solvency requirements from the use of internal models. The mathematical basis for such reductions is usually derived from aggregation calculations to take account of diversification, relying on correlation matrices or copulas that include a significant degree of subjective judgment. Given the big impact that such calculations can have on the overall solvency picture, it's sometimes tempting to wonder whether supervisors (and industry) are agonizing too much over the fine calibration of specific risk buckets when the marginal impact of these changes are dwarfed by the impact of judgment calls on correlation or dependency.

It is of course important to recognize such diversification effects – that is the foundation of prudent insurance – and therefore to recognize the dependencies that are integral to the internal model. But we know that, as in capital markets, relationships can behave in unexpected ways in extreme tail events, causing apparent diversification benefits to become overstated.

Supervisors that are approving models need to take a prudent approach on this issue and to make sure we don't get distracted by the minutiae of the model and miss the big picture question – what level of overall solvency requirement is being generated and are we comfortable with that? We need to be prepared to make a supervisory judgment call on that – which will be extremely difficult and will involve close dialogue with firms – and not just focus on the technical pass/fail questions. This needs to influence our approach to the process of model approval, to ensure we take a risk-based approach and are aware that the law of marginal diminishing returns certainly applies to some areas of temptingly extensive scrutiny. Even with a focused and risk-based approach, however, this will involve considerable resources and additional costs, so we are planning to introduce a special levy

for internal models. We will be consulting with representative bodies about this shortly.

A quick word about equivalence – that is the process by which non-EU jurisdictions are assessed to see if their regulatory standards are broadly equivalent to Solvency II and therefore whether firms from that jurisdiction should enjoy the benefits of the directive. Equivalence is very important for Ireland because we have a lot of international, non-EU companies with bases in Ireland, especially from Bermuda and Switzerland, which are both in the first round of the equivalence assessment process. I won't prejudge or speak for the EIOPA assessments, but my personal view is that both jurisdictions are serious and committed to making the necessary preparations to achieve regulatory equivalence under Solvency II. I am impressed by the good progress my successor at the Bermuda Monetary Authority, Jeremy Cox, and his team have been making on the equivalence project, including the introduction of a framework for group supervision which is starting to be introduced. I would encourage the Bermuda market and government to continue to support the BMA so it has the resources that it needs to see the introduction of group supervision all the way through, with sufficiently sized and skilled teams to do front line consolidated supervision for some very substantial groups.

A mention of group supervision leads naturally to my final topic on Solvency II: the possible rise of the hub and spokes operating model. This model involves a single legal entity as the operating company but providing services on a cross border basis via branches, rather than via subsidiaries. It is a natural option for pan-European carriers that wish to optimize their capital and achieve operating efficiencies. At one point Solvency II contemplated a so-called group support arrangement that would have allowed optimisation of capital with subsidiaries, but that didn't make the final cut of the directive, so the hub and spokes model may be an attractive option as firms consider their

ideal structure to take advantage of the business opportunities afforded by the directive.

At the Central Bank we are developing an enhanced supervisory model for hub and spoke structures. We have not finalised our thinking – and are starting to consult our European partners and affected firms – but some key principles are being settled. For companies which plan to operate on a hub and spoke basis, we want to make sure that the hub is substantial and has sufficient critical mass to exercise effective control over its branch operations. We would also expect to have a sizeable supervisory team dedicated to each hub and spoke operation, a principle which has been accepted readily by the firms involved. A key part of the supervisory model is the approach to the oversight of branch operations. Unlike with subsidiaries, as hub supervisor we must be prepared to exercise effective direct oversight over branch operations. This involves assessing the quality of hub control functions, but also commissioning specialist branch level review from skilled third parties with local market knowledge as well as having our own programme of on-site work at the branch level. We also believe it will be important to ensure an enhanced level of supervisory co-operation with the supervisors of the host countries in which the branch operates. We propose to offer host supervisors a level of cooperation and interaction comparable to that for a subsidiary host supervisor, such as an open offer to take part in any branch inspections with us. As this framework develops it provides insurance companies contemplating the hub and spoke model with a clear understanding of the enhanced supervisory regime that would apply and provides comfort to host supervisors as to the rigor of the approach we are adopting.

I want to conclude my remarks today by talking about two developments at the international level, in terms of work being spearheaded by the International Association of Insurance Supervisors or IAIS. The IAIS has long played an important role as an international standard setter but, similar

to EIOPA, it is transforming itself to adapt to the new post-crisis global regulatory agenda under the able leadership of Peter Braumuller as Chairman and Yoshi Kwai as Secretary General.

The key longer term project underway at the IAIS is the so-called ComFrame initiative, where Monica Maechler from FINMA deserves a lot of credit for making important progress in the past year or so. As I say, the IAIS is an international standard setter, but the nature of those standards can be rather high level in some areas. Bluntly speaking, this has meant that Solvency II has effectively become the de facto binding international standard on solvency. This is certainly the case of European firms but also, through the equivalence mechanism, effectively for non-EU jurisdictions as well. This to my mind has highlighted the need to reassess the adequacy of IAIS standards in some areas. The other driver is the need to ensure effective group supervision of insurance companies. The financial crisis exposed some notable gaps in the framework that applied to big international groups and therefore the need to consider an appropriate regulatory response.

The IAIS has therefore launched the ComFrame initiative to develop common international standards for internationally active insurance groups, including solvency standards. ComFrame consists of 5 modules: Scope of Application, Group Structure, Quantitative & Qualitative Requirements, Supervisory Cooperation and Jurisdictional Matters. Each of these modules will address a specific group of elements. The elements will be grouped into different Priorities and are being developed over a three year period. We will have an important early milestone in the process in July this year with the launch of a consultation process for IAIS Members and Observers.

ComFrame is an important initiative which has the support of the Central Bank, as it provides an opportunity for more consistency in international solvency and group supervision standards. We clearly have a long way to go and I don't really see ComFrame cutting across Solvency II any time soon but rather helping shape the next evolution of the European solvency

framework in due course. But to deliver on its potential ComFrame will need to move pretty swiftly from high level principles and not be afraid to tackle key quantitative standards, so that it provides a robust framework which supervisors could rely upon as an alternative to regional standards such as Solvency II.

If ComFrame is a multiyear project for IAIS, a focus of considerable immediate discussion is the question of systemically important financial institutions and how to apply the Financial Stability Board's SIFI framework to insurance companies. As I'm commenting on a systemic risk issue I'm obliged to note that my comments are personal and do not reflect the position of the European Systemic Risk Board, of which I am a member, or indeed of the IAIS Executive Committee which is still deliberating on this issue.

In speaking at this event last year, I expressed a note of caution over applying the banking SIFI framework directly to insurance companies, due to the inherently different nature of insurers and insurance failures. Encouragingly, the international debate has recognized that fundamental difference and from most quarters it is now accepted that traditional insurance activities do not create the same systemic risks as posed by banking. However, that is not the end of the story, and work is continuing within the IAIS and in cooperation with the FSB on whether certain insurers should nevertheless be categorized as systemically important due to their interconnectedness, lack of substitutability, non-traditional activities and, possibly, size.

Here too there is a lot to talk about but I want to be careful to respect the confidentiality of the IAIS and FSB deliberations that are taking place on the detail of the classification regime. However, I would like to take an opportunity to make a few general comments about the approach that could emerge in this area.

First, I would like to question whether size in and of itself has great value in determining the degree of systemic risk of a traditional insurance company: if it is accepted that traditional insurance does not pose systemic risk, then it is not clear that conducting such business in large size has a transformative effect on the nature of the risk. I do accept that perhaps size could help define the universe of firms that could be assessed against any systemic risk criteria, as a pragmatic way of conducting the exercise over a manageable population. But I think those that wish to apply size as a significant inherent determinant of systemic risk for traditional insurance need to set out their case more convincingly. (I do think that there is an issue around size and the structure of insurance compensation schemes, but that is another topic for another day.)

Conversely, it needs to be accepted that non-traditional activities at insurance companies can indeed pose profound systemic risks and need to have a heavy weighting in any classification methodology. I think these especially need to include OTC derivatives activities (properly measured, where there are some important nuances to be tackled) and financial guarantee activities.

To my mind, it is perhaps interconnectedness that is the most difficult issue to tackle. There is certainly interconnectedness between the insurance sector and the banking industry through, for example, investment in bank debt and equity by insurers. In this case, the trajectory of contagion is from a bank failure into the insurance industry and, obviously, not the other way around. Prudent investment diversification requirements (versus individual bank holdings but also at a sectoral level) would seem the best mitigant, and to be required generally, rather than for a discrete set of insurers that are on a SIFI list based on the size of their investment portfolio. Indeed, Solvency II seeks to address both individual and sectoral concentration risk. Any large exposure to an individual risk carries a punitive capital charge in the calculation of the SCR and any large sectoral exposure can be addressed

under the prudent person principle in Pillar II. This principle already exists in the regulation of reinsurers, another area where interconnectedness is an issue.

Another debate on interconnectedness centres on reinsurance: should large reinsurers be deemed systemically important due to the fact that they are connected to cedant insurers. I would suggest that this is another area for caution and for thinking carefully about which way around to look at the problem. There is certainly a valid question regarding the extent to which one or more large reinsurers could pose a systemic risk by, through their failure, transmitting financial problems to cedant insurers who might suddenly face the loss of reinsurance cover and have a weakened balance sheet. The Geneva Association and, before it, the Group of Thirty has done some good work in this area which argues that the contagion impact would be limited. However, this might be made more rigorous by simulating the impact of a significant catastrophic event on the balance sheet of a set of hypothetical insurers, to take account of the direct financial shock on the cedants, while also simultaneously assuming the loss of reinsurance cover from more than one large provider of cover, to assess a scenario where more than one large reinsurer faces difficulty in such an event.

The conclusion of this analysis may, nevertheless, say something more about cedant counterparty diversification standards than necessarily argue for designating reinsurers as systemically important with higher solvency requirements that might restrict capacity. Ensuring all cedant insurers have prudent limits on concentration to reinsurers would, on the face of it, seem to be a more straightforward policy response. Perhaps that is a final general comment about this debate. It may well be that there are aspects of the interconnectedness issue for insurance that are not best tackled by a SIFI listing and the application of additional capital requirements, but rather by looking to alternative policy responses, such as reviewing the adequacy and

international consistency of investment and reinsurance concentration standards.

I fear I may have exhausted your patience, but I hope I have been able to demonstrate – in case you didn't already know it -- that there is a very busy regulatory agenda for the insurance industry. There are some important initiatives at the domestic Irish level, the global level and especially the European level. There is perhaps a common theme in that busy agenda: the need to ensure a careful balance between, on the one hand, learning the lessons of the financial crisis that are relevant for insurance regulation and, on the other hand, avoiding an automatic application of banking standards to the insurance industry. While that may be the common theme, as ever the devil is in the detail, requiring a careful regulatory judgment, informed by constructive dialogue with industry, on each individual issue based on the merits of the case at hand. I hope I have given you an appreciation of some of the particular topics where the debate is taking place and I encourage those with an interest in the Irish insurance sector to take an active role in that debate with the IAIS, EIOPA and the Central Bank of Ireland.

Thank you for your attention.