



FINANCIAL REGULATOR  
*Rialtóir Airgeadais*

**EUROPEAN INSURANCE FORUM**  
**SOLVENCY II – CHALLENGES FOR REGULATORS**  
**Address by Head of Financial Regulation, Matthew Elderfield**  
**to the European Insurance Forum 2010**  
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Good afternoon. My thanks to DIMA for this invitation to take part in this year's European Insurance Forum.

I would like to offer my own thoughts on the challenges to regulators posed by Solvency II in the context of taking a risk-based approach to regulation and supervision.

In Ireland we have started a process of overhauling our approach to financial regulation. Rather than making the artificial distinction between rules-based or principles-based regulation, it's clear we need to have a mixture of both and take an approach rooted in a clear understanding of risk.

This will involve developing a regulatory model that allows for the intensity of our regulatory framework and level of supervisory engagement to be calibrated to the inherent risk and impact of a particular firm or sector.

This is consistent with the underlying intent of Solvency II and its application to the captive insurance sector provides a case in point. It's clear, as a general proposition, that the inherent risk profile of most captive insurers is significantly different from other insurers. Captive insurance is at its core inherently an exercise in self-insurance by a

corporation. It's important that the implementation of Solvency II reflects that different risk profile.

As a result, we have been a strong advocate of taking the concept of proportionality that exists within Solvency II and applying it to the captive sector. European guidance on proportionality is still being developed and by necessity will be relatively high-level. The devil will be in the detail of the application of Solvency II at the firm-specific level.

But we recognize that the uncertainty facing captives can be unsettling. We appreciate in particular that the Pillar II provisions of Solvency II may look daunting to a captive in terms of the obligation to prepare an Own Risk and Solvency Assessment. So let me say a few things to the DIMA membership on this particular issue.

To start, I would note that the inventory of topics that is covered by the ORSA is pretty fixed and covers matters such as a firm's overall solvency needs, its internal risk tolerance limits and compliance with solvency and technical provisions. However, the format of the ORSA is not prescribed and can be interpreted in light of the proportionality principle. In this respect we are committed to taking a common sense approach. Captives will be permitted to develop ORSA material that covers the requisite ground in a fit for purpose manner.

As a result, captives that take the time to put together a sensible assessment of the various Pillar II risks will receive a fair hearing from my staff. And frankly, if the first effort isn't great, we are prepared to be pragmatic and work with firms in an iterative process to see the ORSA is improved over time. In this spirit, we are prepared to work with DIMA to assess a handful of captive ORSAs on a pilot basis and use this for broader industry feedback. This way DIMA's members will have a clearer picture of what we view as good practice and where we think more work is needed.

What about the other end of the risk spectrum? Let me highlight an area where I think it is particularly important to ensure that we can provide

robust challenge in a risk-based manner, namely the use of internal models. I am cautious about over-learning the lessons of the banking crisis for the insurance industry. Insurance companies are inherently different from banks and, while there have been some notable exceptions, many insurance companies have weathered the financial crisis in relatively better position than their banking counterparts.

However, one lesson that does apply to insurers is the need to take a sceptical and challenging view of a firm's internal risk management practices, including the use of internal models. As you know, Solvency II provides an option, subject to regulatory approval, for insurers to calculate their solvency requirements by employing such internal models. In this respect the Solvency II provisions are in fact more liberal than those in the banking regime: Basel II prescribes the maximum level of diversification that may be recognized in a model. In contrast, Solvency II does not set similar restrictions and it is a matter for agreement between insurer and their supervisor as to the degree of diversification that may be permitted.

This is an important point, because recognition of diversification effects can lead to a significant reduction in solvency requirements. A key area of debate between regulator and firm will therefore be how an insurer approaches its analysis of correlation and therefore the level of diversification that is permitted. The banking crisis has show how in times of intense stress, correlations can shift towards 1 and apparent diversification can disappear. A similar effect can manifest itself in insurance, as tail events can demonstrate unexpected correlations between different lines of insurance, as was evidenced during 911 or Hurricane Katrina.

More generally, I suspect that many insurers still have some way to go to refine their models to make the grade for regulatory approval. Modelling catastrophic events is challenging, for example, and reinsurance companies can be dependent on poor data quality from underlying cedants.

All this points to the need for rigorous scrutiny of insurers' internal models. Under our new risk-based regulatory approach, I am asking the staff to be more challenging and assertive where this is required. In cases of high impact insurance companies that are proposing to rely on the use of internal models, I will be encouraging such a challenging approach, particularly if significant reductions in solvency requirements are at stake. We are prepared to hand out pass marks, but only if insurers have done their homework properly.

One additional matter that deserves a whole presentation just to itself is systemic risk. Solvency regimes can cause convergence of methods and calibrations which poses its own danger. It is for this reason that Pillars 2 and 3 are most important and will receive an increasing share of our attention as the project evolves.

There is also a healthy debate starting around the question of whether some types of insurance company pose systemic risk and therefore require enhanced regulation perhaps on a par with systemic banks. As noted above, I am cautious about too readily reading across banking standards without taking account of the particular characteristics of insurance balance sheets. But this is an issue that merits further discussion on another occasion.

Let me finally say a few words about our state of readiness for Solvency II more generally. We recognize that this is a key project for the Financial Regulator, as well as the industry, over the coming few years. As a result, we have been gearing up the level of resources that are committed to Solvency II implementation. This has involved adding to our existing complement of actuaries. We will also be setting up a dedicated policy team dealing with prudential insurance matters. We are already very heavily committed to the work of CEIOPS and this will continue and be enhanced over time, as CEIOPS transforms itself into one of the new European Supervisory Authorities.

In addition to these strictly Solvency II-driven changes, we are also adding to our supervisory staff to provide better coverage for our highest impact firms, so that we are better resourced for the supervisory tasks that will arise from the Directive.

All this means that Ireland is on track for Solvency II implementation. We recognize that insurance companies around the world, both within the EU and outside, are measuring up their options as to their optimal structure to be ready for the Directive. Solvency II provides important passporting benefits for insurance companies from whatever base they chose in the EU and it is already clear that firms are re-organizing their corporate structures to take advantage of these privileges.

In addition to the policy work that I have discussed here, we are also taking the opportunity to look at our authorization processes so that we can be prepared to more efficiently handle applications from firms from within the EU or from third country jurisdictions. We have transferred insurance authorization activity into the insurance supervision department to ensure that applications can be handled by expert staff from day one. Processing of applications will receive high priority, the demands of Solvency 2 notwithstanding, and resources will be made available as required. If insurance companies decide to re-domicile to Ireland or to re-organize their EU operations to use Ireland as the hub of their activities, we will have an efficient process that can ensure high prudential standards are maintained when firms seek to act swiftly on the commercial choices thrown up by the Directive.

Our challenge as a regulator, then, is not only to ensure that we tackle the implementation of Solvency II in a risk-based way. It is also to ensure that we have the resources, market understanding and improved processes to respond efficiently to the commercial changes that are just around the corner.

Thank you.