THE SOCIETY OF ACTUARIES IN IRELAND

Submission on the Central Bank of Ireland's Consultation on Impact Metrics for the Risk Based Supervision of Financial Firms by the Central Bank and on Impact Based Levies

February 2011

1 Introduction

The Society of Actuaries in Ireland is the professional body representing the actuarial profession in Ireland. Many of our members hold responsible roles within or as advisers to financial services firms. They act as Board members, Appointed Actuaries (with statutory responsibilities), Signing Actuaries (also with statutory responsibilities), and senior managers carrying a range of responsibilities including financial and risk management.

In addition, the Society is an active member of the Groupe Consultatif Actuariel Europeen and is fully engaged in the Groupe's ongoing work on governance systems and prudential regulatory standards, especially in relation to the development of Solvency II.

The Society welcomes the opportunity to participate in this Central Bank of Ireland ("Central Bank") "Consultation on Impact Metrics for the Risk Based Supervision of Financial Firms by the Central Bank and on Impact Based Levies".

We support the Central Bank's aim to optimise the allocation of its finite resources by determining supervisory prioritisation via the consideration of both impact and probability of business/compliance failure. That said, we caution that care must be taken to ensure that the approach adopted does not create the risk that serious potential problems deriving from an entity's non-core business could be overlooked.

We provide general comments in Section 2 followed, in Section 3, by answers to specific questions posed in the consultation paper.

2 General Comments

Probability of Failure

The paper consults on impact metrics and their use as a determinant of levies. However, it does not go into detail on the proposed approach to determining probability of failure. We consider that metrics on the probability of failure are as important as impact metrics.. We consider it would be beneficial to consult on the complete framework when a proposal is available and we would welcome the opportunity to contribute to this consultation.

Clarification

We would welcome clarification on how the combination of impact metric, divisor and probability rating will be applied in determining the supervisory prioritisation and levies. As above, we would be pleased to contribute to further consultation when proposals on the various elements of the overall framework, and how they will be integrated, are available.

We would welcome elaboration on the differences between ongoing and immediate supervisory attention and what each entails. We note the comments that consideration of impact *"is important in order to calibrate the right level of ongoing supervisory attention"* and consideration of probability *"is important in order to identify the firms most in need of immediate supervisory intervention"*. We consider that the probability of failure should be an important factor in determining ongoing as well as immediate supervisory attention.

Systemic Risks

We welcome the Central Bank's recognition of systemic risk in assessing the impact rating under the enhanced risk-based supervisory model. One of the key reasons for regulation of financial markets is to avert the dangers of problems in one area spreading to other parts of the system, and the damage that would be done by a systemic financial collapse. We recognise that identifying systemic risk is a not a trivial task but agree that it should be a key aspect of the model. We would welcome the opportunity for further consultation as this model is developed and enhanced over time.

"No failure" Regime

The paper states in section 4.2.4 that it is not intended to create a "no failure" regime for the smaller regulated firms. This statement could be taken to imply that it is intended to create a "no failure" regime for larger firms. We consider it would be dangerous to create this impression as it is not possible or realistic to create such a regime. Moreover, we believe that it is not an appropriate target. To prevent systemic collapse or loss of confidence in the financial system, it is not necessary to guarantee the solvency of every financial institution but merely to ensure that the failure of one participant does not threaten the whole system. Aiming for a "no failure" regime would result in uneconomic levels of capital requirements and would prevent companies from taking certain business risks that create wider societal benefit. The Solvency II regime for insurance companies aims to reduce the risk of failure to a 1 in 200 probability. We believe that it would be appropriate for the Central Bank's regulatory processes to be based on a similar target, rather than a "no failure" target.

Risks of formula-based supervision

We have concerns that, if the allocation of supervisory resources becomes very automated and formula-driven, some key risks will be missed. Consider, for example, the issues that arose at AIG, which derived from non-core business. It is questionable whether the metrics proposed would aid in spotting comparable future problems.

3 Response to Questions

In this section, we respond to most of the specific questions posed in the Central Bank's consultation paper. The question numbers below correspond to those in the paper.

1. Of the different approaches to the calculation of impact scores [average of scores from individual metrics, weighted average or largest individual score] do you have a view as to which method is preferable and why?

We feel that it would be reasonable to determine a firm's overall impact score as an average of its individual scores, rather than use the largest individual score.

It is proposed that the individual scores will be determined by applying divisors to certain metrics.

A simple average of the individual scores is essentially a weighted average with equal weight being applied to each score. This may be appropriate if the divisors are determined and used in such a way that all of the metrics are translated onto a consistent scale.

If the divisors are not used in this manner, then a weighted average would be preferable to a simple average as a large but less material metric would not unduly influence the result. However, appropriate weights would have to be determined, which would be complex.

2. The Central Bank will clearly have to make judgements when deciding what divisors to apply to each impact metric in order to devise a set of impact scores which are correctly calibrated. Do you wish to suggest mathematical processes which the Central Bank should apply to ensure that it calibrated impact scores across sectors appropriately?

We agree that allocating divisors to metrics is a judgement-based process. We consider this process should be approached on a sector by sector basis. That is, the divisors chosen should reflect the key qualitative differences between sectors that affect their risk profile. For example, insurers are funded in advance through up-front premiums while banks are funded in arrears through debt repayments and interest payments. Other examples of qualitative differences are liquidity risk and use of leverage.

We consider it is difficult to mathematically assess a qualitative measure. It has not been feasible for us to allocate resources to formulating proposals in this regard at the present time. However, we would welcome the opportunity to consult on the Central Bank's proposed divisors for the chosen metrics within each sector, when these become available.

3. *Do you regard the Central Bank's plan to use impact metrics as a major determinant of the levies firms pay as fair? If not, why not?*

We consider that impact should be a contributing factor in determining the levy payable.

The consultation paper notes that *"it has been an important principle of the funding process that cross subsidisation between industry categories should be avoided to the extent reasonably possible"*. We acknowledge that "*a move to using impact scores to set fees is likely to enhance the linkage between the amount of the levy payable and the amount of regulatory resource consumed*". However, we note that an approach based purely on impact scores would result in cross-subsidies between firms with different risk profiles.

Alternatively, a levy determined by the supervisory resources allocated to a firm would be based on both impact and probability of failure. The advantage of such an approach is that the levy is aligned with the supervisory resource consumed and, in turn, rewards entities managing risk with lower levies. However, we recognise the practical difficulties of this approach. There is a significant subjective element in determining probability of failure and the use of impact metrics alone results in a more objective calculation. Using an objective measure also provides greater predictability to firms in projecting levies.

3.1 *Would you favour phasing in the changes in the weight of the net annual funding requirement attaching to different industry categories, should the introduction of levy setting by impact score alter the current balance of the net annual funding requirement between different industry categories?*

We consider that phasing in changes is a reasonable approach where substantial modifications are being made to the levy setting policy.

4. *Do you think the impact metrics set out above are the appropriate impact metrics for each type of firm? Which two or three would you attach the greatest importance to in each firm category?*

With respect to life and non-life, insurance and reinsurance categories, we consider that "Solvency II Capital requirements" would be an appropriate metric but it will not be available until 2013. This metric would reflect to some extent both the probability and impact of a failure - an aspect that may need to be taken into account when deciding on other elements of the framework. We consider that the current Solvency I capital requirements would not be an appropriate metric, given the crude nature of the calculation.

For life undertakings (direct/reinsurance), we also consider "Total liabilities"(i.e. gross) to be important. However, we note that "Average contract size by premium" may be misleading due to the mix of regular and single premium income. For non-life (direct/reinsurance) undertakings, we consider "Gross liabilities" and "Gross/net written premium" to be important also.

We consider that "Number of staff" would reflect impact on staff as stakeholders of an entity rather than (necessarily) impact in the wider context of customer loss or prudential harm to the economy.

5. What other impact metrics should the Central Bank consider using for different types of firm?

For life (direct and reinsurance) undertakings, we suggest that consideration be given to using “annual premium equivalent” (i.e. annual premiums plus a proportion of single premiums – typically, a proportion of 10% is used for new business statistics).

6. Should the Central Bank attach equal importance to the alternative impact metrics for different firm types you discuss in your responses to questions 4 & 5 above or should it attach more weight to one or another metric? If so, which ones?

We have not formed a firm view on this question, but intuitively it seems probable that different metrics will not be equally important and that the relative importance of any one metric may be different for different types of firms.

7. Should wholesale firms have different impact metrics from retail firms focused on consumers?

Depending on the metrics that are ultimately selected, it might be appropriate for wholesale firms to have different impact metrics than retail firms.

7.1 If so why?

Certain metrics, such as number of customers, may be appropriate in assessing the impact of a retail firm but not of a wholesale firm. A retail firm will have a smaller number of customers and customers of a different type. The impact of the failure of a wholesale firm is very different to that of a retail firm.

10. In terms of category of firm, should the Central Bank consider sub-dividing some of the firm types above and applying different divisors to different types of firm?

For some firms, such as life and non-life insurance firms, it would be possible to subdivide by class of business. Arguably this would result in more homogeneous categories of firm. However, greater subdivision of this nature would result in a more complex and less practical approach.

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