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24 February 2011

Re: Consultation Paper CP49 – Impact Metrics & Impact Based Levies

Dear Sirs,

Introduction

We welcome the publication of the *Consultation Paper* on impact metrics and impact based levies which you published last December and we are grateful to have the opportunity to comment on its content. This submission is made on behalf of both our general insurance and also our life assurance businesses in Ireland.

At Zurich we welcome initiatives which are directed at enhancing the regulatory framework and optimising the Central Bank of Ireland's ("CBI") supervisory approach. We are of the view that risk-based supervision is appropriate and that making a distinction between high and lower impact firms represents a sound approach.

However, we are very strongly of the view that mixing prudential impact and systemic impact, as occurs in CP49, is not a good approach. We believe that it is imperative that CBI avoids mixing systemic risk considerations with risk based supervision.

It is for this reason that we are concerned that classification of a firm as "high-impact" may create a perception – both with national and international regulators and the market in general - of this firm as posing a systemic risk. Such a perception could have far-reaching and unintended consequences for the firms concerned. Meanwhile, the assessment of systemic risk posed by individual financial institutions is a highly complex task, and work in this area by international policymakers (e.g. the Financial Stability Board and the International Association of Insurance Supervisors) is still ongoing.

Insurers and Banks

In our previous submissions to CBI in the context of previous consultation processes, we have suggested that CBI consultation papers ought to more explicitly differentiate between banks and insurers to the point that where necessary, separate consultation papers and separate resultant policy papers, codes and rules are published in respect of insurers. This distinction ought not to be disregarded in the mistaken belief that there are no major differences or on the basis of administrative convenience.

We are very strongly of the view that adequate recognition must be afforded to the different operations and types of business by banks as against that of insurers. The importance of making such a distinction is ever more pressing in the context of the assessment of risk.

In particular, we are concerned by the proposal to directly compare the impact score between banks and insurers by applying a divisor. Such a divisor will necessarily involve a considerable degree of arbitrariness and may

therefore create distorted perceptions of the risk posed by different financial institutions.

Level of Impact and Systemic Risk

There are a number of reasons for asserting that insurers should be treated differently from banks and for the purpose of this submission, the principal differences are outlined in the Annex. One principal reason is that, in contrast with banks, the traditional insurance business model does not pose a systemic risk.

Internationally, consensus is building on the view that core insurance activities do not pose a systemic risk. For example, the Geneva Association has reached the view that core insurance activities are not a source of threat to the financial and economic system. A further example is the LePetit Report produced by the French Ministry of Finance, which asserts that:

> "In the insurance industry, size allows for a greater diversification of risks and therefore a better overall risk profile … The nature of insurance activities is such that they cannot be described as systemic,"[1]

The Swiss Federal Council Expert Commission have concluded that:

> "There is currently no de-facto need to rescue an insurance company…In contrast with banks, insurers have more possibilities of coping with the effects of a crisis."[2]

Added to that is the view of Lord Turner, Chairman FSA who finds that:

> "Failures of one insurance company don't tend to produce knock-on failures among others,"[3]

[1] LePetit Report, April 2010.
[2] Swiss Federal Council Expert Commission, September 2010.
[3] Lord Turner, Chairman FSA, October 2010.

At page 7 of CP49, CBI states:

> "It is possible that the failure of some of the largest financial firms in other sectors might have a severe impact on the Irish economy which falls short of a systemic impact."

We note and welcome CBI's recognition to the effect that insurers do not warrant categorisation as posing a systemic risk. As noted at section 4.5 of CP49, this perspective is consistent with the growing international consensus on this issue.

However, we would caution that the term high impact should not be equated with systemic risk. It is for this reason that we ask CBI to exercise a considerable degree of care when assigning any type of classification to an insurer, so as to ensure that where a firm is adjudged to be high impact, that impact rating must in no way be equated, by CBI or others, with any perceived level of systemic risk posed.

On that basis, and having regard to the need to differentiate between banks and insurers, we would suggest that CBI gives some consideration to the approach to the assignment of entirely different categorisation labels to banks as against those of insurers.

This is an area of particular concern to us and we would welcome the opportunity to discuss this matter in greater detail at a meeting with you.

Specific Comments and Queries

We now set out some comments and queries which we have in relation to the Consultation Paper by reference to the numbering system which is utilised in CP49.

2.1 – Probability Metrics

We are firmly of the view that in the context of the probability metrics, adequate consideration must be taken of the differences between stand-alone companies as against group companies.

We assert that where a regulated entity is part of a wider, strong and well diversified group, this fact should be taken into consideration so as to reduce the probability measures. We believe that it is important that this consideration is adequately reflected in the context of probability considerations.

2.2 – Meaning of "Impact"

In section. 2.2, the meaning of "impact" is outlined as being "in essence, size or ability to cause prudential harm or customer loss." We would welcome a much more clear definition of the effect and scope of what is envisaged by the term "impact". We find the current bold text wording in section 2.2 to be vague, ambiguous and its true meaning to be open to debate.

The meaning of impact is also expanded upon in the following terms: "We are talking about how large a firm is in the context of the Irish and in some cases global economy." In relation to that particular sentence, we recognise that whilst size may be a significant determinant in determining impact, we are firmly of the view that other factors must also be considered.

Adequate consideration must also be given to the existence or absence of reinsurance arrangements/contracts as this will again be a significant determinant of impact.

On page 6 of CP49, CBI states:

> "It is expected that most if not all of the impact metrics used in deciding on a firm's impact rating will be quantitative once the right impact metrics have been chosen".

Whilst we agree with this statement in general, it is possible to observe that one of the flaws that have led to the recent global financial crisis was this belief in models / quantitative metrics. In our view, quality of management, risk management processes and other qualitative metrics are also key and must therefore be afforded sufficient recognition in the context of metrics.

2.3 – Geographic Scope of Assessment of Impact

From a reading of section 2, and section 2.3 in particular, it is not clear whether CBI's interpretation of impact will be limited to an assessment of factors which occur in Ireland, or the EU or the global economy. Therefore, we ask that you provide us with more information about the basis upon which such decisions will be made.

2.4 - Materiality

By mentioning the issue of materiality of a compliance or business failure, it raises the question of interpretation. It is not exactly clear as to what CBI would regard as constituting a "material compliance or business failure". We would ask that you provide more certainty and clarity around CBI's proposed approach on this issue.

2.5 – Overall Approach

In our view, the combination of a fairly static impact criteria ("footprint" - as in size) and an individualised probability assessment (quality of processes and governance) as set out in 2.5 is a basically sound approach.

3. – Divisors, Impact Scores & Impact Ratings

As a general point, we question the concept of comparability across sectors and would seriously question the worth of making such a comparison. In the insurance sector, we have Solvency II, and for banks, Basel III. The concepts expressed in those requirements are much more detailed and we would suggest that CBI should seek to work within those existing requirements rather than seeking to reinvent the wheel.

As acknowledged at Para 3.1, divisors are "a less exact science" and this is a cause of some concern for us. We query whether the experiences regarding the use of divisors in a limited number of other jurisdictions constitutes a sound and trusted basis for the implementation of such an approach in this jurisdiction.

Also, to arrive at these divisors, a significant amount of historical data is necessary to guarantee statistical relevance. The derivation of the divisors is of particular importance. We now ask that you provide us with more detailed information as to how you propose to set appropriate divisors. For example, does CBI have the necessary statistics for Ireland, and if not, we question whether it is appropriate to assume that divisors from other countries can be fairly applied to the Irish economy.

4 – Supervisory Engagement Model

The supervisory engagement model needs to be relatively easy so that everybody understands where their respective company sits with respect to probability and impact (see section 4.4). We recognise that CBI then needs some discretion in defining the level of scrutiny / regulatory oversight to some degree regardless where the company sits in the matrix.

4.2.1 – High Impact

We are aware of the arguments to the effect that Zurich Insurance plc (ZIP), for example, ought to be categorised as being a high impact firm for the purpose of supervisory engagement. However, we disagree with the suggestion in 4.2.1 that there should be any correlation between firms which are regarded as high impact for the purpose of supervisory engagement and firms which are categorised as being major institutions in the context of the corporate governance requirements.

4.2.4 – Frequency of Inspection Visits

In respect of Medium Low Impact Firms, section 4.2.3 indicates the likely frequency of inspection visits as being "periodic inspection visits". However, in respect of High Impact Firms and Medium High Impact Firms there is no indication as to the likely frequency of inspection visits. Therefore we would welcome some additional information in relation to what the CBI's plans are in this regard.

4.3 – Role of the Impact Rating

There is a very clear statement at section 4.3 which states:

> "The impact rating will therefore drive the Central Bank's engagement model for any given firm"

We are somewhat concerned by this statement as it suggests that to the exclusion of all other considerations, the impact rating will be the primary driver of CBI's engagement model.

We are of the view that both the probability rating and the impact rating should be the primary driver of CBI's engagement model.

5 – Impact Derived Levies

We are of the view that the basis upon which funding requirements are imposed on the insurance industry should mirror the assessment by CBI of the risk in each segment and the level of effort involved in supervising each segment. We are opposed to any arrangement which would give rise to cross-funding of supervision costs between segments.

5 – Basis for Levies

At present, the levy which is payable to CBI is calculated by reference to the prudential aspect and also by reference to customer base. This is in spite of the fact that, with regard to ZIP for example, CBI is not responsible for its worldwide conduct of business supervision. We are of the view that the only

conduct of business supervision which should be chargeable to Zurich is in respect of the conduct of business supervision of the Irish business units.

It is in that context that we welcome a proposal to recalibrate the basis upon which levies are calculated.

However, in the levy calculations it will also be important to make a distinction between Irish premium and cross-border premium. The first basis for levying should be the Irish premia, the cross-border premia should also count, but it is important to bear in mind the fact that cross-border premia do not increase the extra effort necessary from CBI to the same extent as more Irish business would. In our view, a different qualifier or possibly a cap should apply.

Regarding the levy calculation, we would welcome greater detail on the target level of funding which CBI is seeking to raise by means of levies.

5 - Levies Paid in Other Countries

We are of the view that the proposed approach to the calculation of levies ought to take account of levies paid in other countries for conduct of business supervision.

5 – Preparedness for Solvency II

In view of the significance of Solvency II, with regard to impact derived levies we are of the view that CBI should have regard to an insurer's preparedness for Solvency II as a mitigating factor.

5 - Branches

It is not entirely clear from the terms of CP49 as to how CBI views branches of overseas companies selling in Ireland, in particular, whether they will bear a levy for the conduct of business element. This gives rise to questions as to whether the metrics should be worldwide or Irish domestic market only.

6 – Metrics & Levy Obligations

It seems that future levy obligations will be based on impact metrics. In our view, this seems inappropriate as impact metrics alone do not take into account probability impact.

6 – Impact Metrics - Recognising Risk Mitigating Factors

In assessing risk and the associated levy obligations, risk mitigating factors ought to be taken into account. For example, if other countries provide an insurance guarantee scheme which, in the case of our general insurance business, covers ZIP or Zurich Life Assurance plc (ZLAP) in their marketplace, this should be recognised as reducing the risk which ZIP or ZLAP poses in an Irish context.

6.2 – Impact Metrics

We are unconvinced that it is possible to allocate an appropriate divisor to all metrics and therefore would welcome greater clarity form the CBI on this issue.

6.4 – Useful Metrics

In respect of the metrics we view as being most useful, in respect of our non-life business, we view the following metrics as being of importance:

- Capital requirements
- Share of Irish market as a whole

And we regard the following as being useful net metrics:

- Gross/net technical provisions
- Gross/net written premium.

With regard to the metrics we view as being most useful, in respect of our life business, our view is that Solvency II capital requirement is the appropriate impact metric for the life insurance industry. This gives a risk based

assessment of the business. To assess the relative impact across industries a risk based assessment (Solvency II) should be used calculated on the same probability of ruin parameters (e.g. 1 in 200 over 1 year)

6. Category B.4, p.19 – Suitability of Metrics

Some of the metrics identified in relation to Category B4 in column 2 (page 19) are very subjective and difficult to have a consistent view on. For example with respect to "Number of staff" - an insurer might have service companies which have no employees. With respect to "Number of customers" – in the context of our general insurance business, is someone with a two cars and a house insured by Zurich, to be regarded as being one customer or 3. With regard to the "Number of customers" it would be necessary to differentiate between commercial lines and private lines. Also, are corporate clients to be regarded as being one customer or are counted on the basis of the number of the contracts that they have. In addition, in our view, the "Average contract size by premium" is not a good or appropriate indicator.

These observations suggest that hard, factual financial information would serve as a sound, verifiable basis for impact metrics.

6. Category B.4, p.19 – GWP as a Measure of Risk

Whilst we recognise that GWP is often used as a measure of risk, to simply note GWP without further analysis is, in our view, to fail to have regard to the real level of risk ultimately retained within the company, as a substantial portion or even all of the GWP might be reinsured.

The same argument can be made in respect of the "Gross liabilities" metric as again there might be a substantial degree of reinsurance in place. Therefore a simplistic view of a "Gross liabilities" figure will not reveal the real level of risk.

On that basis, we are anxious to learn more about how, in the context of the proposed impact metrics, CBI proposes to gain a better understanding of the level of risk retained by an insurer.

Question 1– Calculation of Overall Impact Score

In the calculation of the overall impact score, we favour a weighted average of the impact scores. We favour this approach as it appears to factor in diversity amongst other things.

However, it is not clear from the terms of CP49 as to how the weighting would be arrived at. In this regard, we would like capital requirement to be highly weighted.

Question 2

In our commentary on section 3 of CP49 (above) we have already expressed concern regarding the concept of comparability across sectors.

Whatever process is chosen it should be calibrated to the empirical evidence of the impact of failures in the different sectors. Also, the impact rating should take into account the fact that banks are inherently more risky than insurance companies.

It is also important that the approach which CBI adopts is clear, easily understandable and is transparent.

Question 3

In our view, impact metrics would represent a correct approach on the basis that an in-depth assessment would be conducted by the CBI for that purpose – and that it would include, amongst other things, a proper assessment of corporate governance standards. Companies should be charged based on where they sit in the matrix (i.e., the higher the probability, the higher the fees, the higher the impact, the higher the fees). The matrix should hold the whole model together and make it consistent.

The levy that a firm pays should be based on level the supervisory oversight required. Use of impact metrics is fair to the extent that they reflect the supervisory effort required.

We do not favour phasing in the changes in the weight of the net annual funding requirement.

We are of the view that the introduction of levy setting by impact score should alter the current balance of the net annual funding requirement, provided it will be truly risk based across the industry.

As already stated, we are opposed to any arrangement which would give rise to cross-funding of supervision costs between segments.

Question 4

Our response to this question is addressed above in reference to section 6.4.

Question 5

The proposed approach, which is based on metrics only, is not truly risk-based as it fails differentiate between well controlled organisations and poorly controlled organisations. There is a lot of information on how the impact metric will be calculated. However, in our view, what is missing are the soft factors such as: governance, reserving, risk management, quality of management, activity of host regulators etc.

We understand that these considerations may be the radar screen when CBI evaluates "probability" but we are of the view that these considerations should be expressly reflected in the context of impact metrics.

Question 6

We favour the attaching of weightings so as to enable CBI to tailor its approach dependent upon the type of firm. We would favour CBI affording a substantial weighting to the capital requirement.

Question 7

Some time ago, CBI decided to categorise ZIP and also ZLAP as being "wholesale firm". Whilst there are several factors which would suggest that these should instead be categorised as a retail firms, we currently do not take issue with this categorisation.

However, in the context of impact metrics, we would have difficulty with ZIP and ZLAP receiving an unfavourable treatment as a direct consequence of being categorised as a wholesale firm.

Question 8

We expect that ZIP would fall within Category B4 – non-life insurance undertaking with a head office in Ireland. However, we note that B4 does not make any reference to the existence of overseas FOE branches. We expect that ZLAP would fall within Category B1.

Question 9

We are of the view that GWP would not be appropriate in this context.

Question 10

Yes, we would favour sub division to reflect host state regulatory activities and are of the view that there should be further divisors and account taken for host country levies.

Concluding Remarks

We would like to re-affirm our commitment to supporting a strong supervisory regime and in this context we welcome proposals which will result in the efficient use of limited supervisory resources. We are of the view that a

move towards risk-based supervision is an appropriate approach. We agree that a straightforward but transparent classification of supervised entities makes sense. However, we are firmly of the view that in doing this, clear distinction between nature of entities is needed for several reasons, including the fact that the business models are different, the risk profiles (eg. inherent systemic risk in banks) are different, the underlying regulation is different, and the supervisory tools and actions are also different. These differences must therefore be reflected in the levies which are imposed.

Meeting Request

At a number of points throughout this submission we have sought clarification on specific issues. We would very much welcome the opportunity to meet with you for the purpose of discussing those issues as well as discussing aspects of our submission in greater detail.

In the interim, if you have any queries or require additional information, please do not hesitate to contact us.

Yours sincerely,

Dr. Brian Hunt
Head of Government & Industry Affairs, Zurich

Annex

Factors which Distinguish Insurers from Banks

There are significant differences inherent in the business models of insurers as against those of banks:

- Traditional insurance activities have an inverted cycle of production (pre-funding of liabilities) and therefore do not rely on short-term debt to a significant degree
- Asset liability management is a key characteristic for insurers, whereby the maturity of assets is calibrated to match expected claims payments
- Since insurers primarily hold securities, their assets are typically more liquid than those of banks whose assets mainly consist of loans
- Banks are traditionally involved in maturity transformation, while insurers typically do not take such risks

It can also be said that the insurance sector has a stabilising effect because of its shock-absorbing capacity and its long-term investment horizon. Furthermore, insurance companies have a proven and sound resolution mechanism that enables an orderly wind down over time.

These and other factors which distinguish insurers from banks and demonstrate very clearly that insurers do not pose systemic risk in the way that banks do, are explored more fully in the Zurich White Paper entitled *Insurance and Stability – the Reform of Insurance Regulation*[4].

[4] Available at: http://www.zurich.com/main/insight/downloadlibrary/introduction.htm

Finally, as regards the distinctions which can be made between banks and insurers in the context of risk, it is important to not lose sight of the fact that no core insurance activity has ever triggered a systemic financial crisis.