



SPAIN

FINANCIAL SECTOR ASSESSMENT PROGRAM

TECHNICAL NOTE—INSURANCE SECTOR SUPERVISION AND REGULATION

November 2017

This Technical Note on Insurance Sector Supervision and Regulation for Spain was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in October 2017.

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October 31, 2017

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Prepared By
**Monetary and
Capital
Markets
Department**

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Spain. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Please also see the Financial System Stability Assessment at <http://www.imf.org/~media/Files/Publications/CR/2017/cr17321.ashx> Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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Glossary

AGROSEGURO	Spanish Association of Insurers for Combined Crop Insurance
A&H	Accident & Health
ALM	Asset Liability Management
AML	Anti-Money Laundering
ASSAL	Association of Latin American Insurance Supervisors
BdE	Bank of Spain (<i>Banco de España</i>)
CCS	Insurance Compensation Consortium (<i>Consortio de Compensación de Seguros</i>)
CDD	Customer due diligence
CESFI	Financial Stability Committee (<i>Comité de Estabilidad Financiera</i>)
CFT	Combating the Financing of Terror
CMG	Crisis Management Group
CNMV	Securities Market National Commission (<i>Comisión Nacional del Mercado de Valores</i>)
DGSFP	Directorate General of Insurance and Pension Funds (<i>Dirección General de Seguros y Fondos de Pensiones</i>)
DH	Double Hit (Scenario from 2016 EIOPA stress testing)
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
ESRB	European Systemic Risk Board
FSAP	Financial Sector Assessment Program
GAAP	Generally Accepted Accounting Principles
G-SIIs	Global Systemically Important Insurers
HLA	Higher Loss Absorbency capacity
IAE	Spanish Institute of Actuaries (<i>Instituto de Actuarios Españoles</i>)
IAIG	Internationally Active Insurance Group (IAIS definition)
IAIS	International Association of Insurance Supervisors
ICEA	Institute of Insurance Entities Cooperation and Research
ICPs	Insurance Core Principles
IGS	Insurance guarantee scheme
LTG	Long-Term Guarantees
LY	Low Yield (Scenario from 2016 EIOPA stress testing)
MA	Matching Adjustment as used in Solvency II
MCR	Minimum Capital Requirement
MdE	Ministry of Economy, Industry, and Competitiveness (<i>Ministerio de Economía, Industria y Competitividad</i>)
MMoU	Multilateral Memorandum of Understanding on Cooperation and Information Exchange
MoU	Memorandum of Understanding
OECD	Organisation for Economic Co-operation and Development
ORSA	Own Risk and Solvency Assessment
P&C	Property and Casualty

SCR	Solvency Capital Requirement
SEPLBLAC	Spain's Financial Intelligence Unit (FIU) and AML/CFT Supervisory Authority (<i>Servicio Ejecutivo de la Comisión de Prevención del Blanqueo de Capitales e Infracciones Monetarias</i>)
VA	Volatility Adjustment as used in Solvency II

EXECUTIVE SUMMARY¹

This Technical Note (TN) provides an update on the Spanish insurance sector and an analysis of certain key aspects of the regulatory and supervisory regime.

This FSAP is most supportive of the government's announcement that the DGSFP (Directorate General of Insurance and Pension Funds) will become an independent insurance supervisory authority. This aligns with the recommendations of the IMF during its FSAP's in both 2006 and 2012. As an agency of the Ministry of Economy, Industry, and Competitiveness (*Ministerio de Economía, Industria, y Competitividad*) (Mde) currently, DGSFP is subject to overall government budget constraints which directly affect the ability of the DGSFP to carry out its mandate. As an independent authority, it should have the authority to fund its programs on its own via fees levied on the industry, yet be accountable for those costs, to the stakeholders.

Looking ahead to the independent functioning of the DGSFP as the insurance and pensions supervisor in Spain, it should have a duty to contribute to the work of Spain's other financial sector supervisors on topics such as macroprudential surveillance and systemic risk. This would be in addition to its normal duties in the supervision of insurers and pension plans. Finally, in cooperation and collaboration with other financial sector supervisors in Spain, the DGSFP should participate in relevant cross-sectoral group and financial conglomerate supervision.

Even though this TN contains a number of recommendations, the DGSFP is an effective insurance and pensions supervisor. DGSFP staff have demonstrated their capabilities during the current FSAP discussions with various stakeholders (insurers, other country supervisors, auditors, actuaries, etc.) have helped to confirm this view.

While the Spanish insurance market is the sixth largest in Europe, its rate of growth and penetration (as measured by premiums per capita) remain modest. Combined with the small size of Spain's private pension plan market, the rate of saving in Spain in these two instruments is lower than for many other EU countries. The DGSFP and relevant government authorities should consider the potential benefits for Spain of encouraging an increased rate of private savings directed toward the insurance and pension sectors.

Six of the top 10 insurers in the country are domestic and are owned by Spain's banks. The top five insurers by assets comprise 53 percent of the assets of all insurers. Bank-owned life insurers in Spain receive 70 percent of their new business in the form of bancassurance, primarily sourced from parent bank customers. The DGSFP should routinely examine its inter-sector exposures, ask its five largest insurers to develop recovery and resolution plans and finally, to jointly engage with banking

¹ The author of this note is Stuart Wason (IMF Expert), part of the Spain FSAP 2017 team led by Udaibir Das. The analysis has benefitted from discussions with the staff of the Spanish Treasury and the DFSFP, the Bank of Spain, the Spain FSAP team, and reviewers at the IMF.

supervisors in discussions of cross-sectoral issues during supervisory colleges for bank owned life insurers in Spain.

The Spanish insurance market is complex due to the presence of large numbers of insurance groups. The DGSFP is a member of supervisory colleges for 29 EU insurance groups. For three of them, the DGSFP is the group-wide supervisor. One of these is an IAIG (Internationally Active Insurance Group). DGSFP also supervises 43 insurance groups which operate only in Spain. Many of the largest of these are owned by the banks. Four of these are classed as financial conglomerates by the three EU supervisory authorities². While the DGSFP has demonstrated its leadership in the identification and organization of supervisory colleges, it should further develop its skills in supervising at the group level, as well as at the level of the insurance legal entity.

Spanish insurers invest conservatively, largely in fixed income securities, mostly government bonds. Many life insurers pay considerable attention to the matching of their asset and liability cash flows. In the 2016 European Insurance and Occupational Pensions Authority (EIOPA) stress testing, Spain's life insurers demonstrated their resilience to a continued low interest rate environment compared to other EU countries. However, the stress test results also revealed the need for better matching of assets and liabilities by all insurers, even among those insurers applying for the Matching Adjustment (MA) under Solvency II. The DGSFP should direct all insurers to improve their matching of assets and liability cash flows regardless of their use of the Solvency II MA.

Staff views that the supervisory culture in the DGSFP appears to be reactive or compliance focused. This can be a natural initial outcome from the complexity of introducing all the new Solvency II laws, regulations and procedures, especially when implementation must be consistent across the EU. However, Solvency II does embody substantive change in the form of market consistent valuation and the use of various judgement based assumptions and methods, which require much keener review than previously as well as greater engagement with insurer management and technical experts. Supervisory focus should shift towards qualitative as well as quantitative review of the key methods and assumptions used by the insurer including the proportionate verification of technical provisions and capital requirements. It is recommended that DGSFP also develop its skills in areas now quite relevant in the Solvency II framework such as governance and risk management.

² The coordinator of these four financial conglomerates is the ECB and the DGSFP is designated as a relevant competent authority.

Table 1. Main Recommendations	
Recommendation	Priority
Assess risk profile of insurer	
Matching: More supervisory focus on insurers to improve their asset/liability cash flow matching regardless of their use of the Solvency II “matching Adjustment.”	High
Bank-owned insurers: Monitor linkages/ cross investments; greater contact with bank supervisors.	Medium
Groups: More supervisory focus on the head of group monitoring interlinkages, related parties’ investments and risk management at group level;	Medium
Review adequacy of insurance supervision	
Culture: More proactive less reactive; more principles based; more forceful and directive.	Medium
Skills: Shift supervisory focus towards qualitative as well as quantitative review of the key methods and assumptions used by the insurer including the proportionate verification of technical provisions and capital requirements. The DGSFP should also develop its skills in areas now quite relevant in the Solvency II framework such as governance and risk management.	High
Engagement: With insurers on their plans for risk and capital management and forward looking capital requirements (ORSA) under Solvency II.	High
Recovery and resolution plans: Establish these with top 5 insurers.	Medium
Assess the effectiveness of the DGSFP	
Independence: Plans should include legal foundation, mandate and budget funding.	High
Macroprudential role: Contribute to cross-sector development and monitoring.	Medium
Systemic risks: Contribute to cross-sector identification and monitoring.	Medium
Cooperation: Increase cross-sector supervisory cooperation and collaboration in Spain.	High

INTRODUCTION AND BACKGROUND

A. Scope and Approach of this Note

1. This technical note (TN) provides an update on the Spanish insurance sector and an analysis of certain key aspects of the regulatory and supervisory regime prepared as part of the 2017 Financial Sector Assessment Program (FSAP). It has been prepared by Stuart Wason (an external expert engaged by the IMF) and Apostolos Apostolou (IMF), drawing on discussions in Spain from March 3 to 17, 2017. The technical note refers to the Insurance Core Principles (ICPs) issued by the International Association of Insurance Supervisors (IAIS) in October 2011, as revised in October 2013. This technical note also refers to the results of the 2016 EIOPA stress testing carried out on the insurance sector.

2. This TN includes an analysis of Spanish practice in relation to selected ICPs in the context of a wider discussion of key issues in regulation and supervision. The note does not include a detailed assessment of observance of the ICPs. The most recent assessment, conducted on the basis of the 2011 version of the ICPs, was carried out in 2012. The main focus of this TN is on recent developments in the sector and key vulnerabilities, including, for life insurance, those associated with the continuing low interest rate environment; the preparations of the authorities and industry for the implementation of the Solvency II requirements (which took effect in full on January 1, 2016); and the supervisory oversight architecture in Spain, of which the DGSFP is an important member.

3. This TN refers to laws, regulations and other supervisory requirements and practices in place at the time of the discussions in Spain. This TN takes account of the major changes in regulations which took effect with Solvency II implementation as well as the development of supervisory practices. In respect to the 2012 detailed assessment against the ICPs, the authorities provided a full self-assessment, supported by anonymized examples of actual supervisory practices and assessments.

4. The ICP self-assessment was reviewed and informal scoring of the level of observance was conducted. ICPs selected for review are broadly those in the 2012 Detailed Assessment of Observance described as being most in need of improvement. They include the ICPs on the governance, solvency requirements (valuation, investment and capital adequacy), supervisory approach (including supervisory authority, supervisory review, preventive and corrective measures) and cross-border cooperation. The focus of the work is on the requirements that took effect in January 2016 and the progress made by the authorities since the 2012 Detailed Assessment of Observance. No scoring of the level of observance of the selected ICPs is given in this note.

5. The authors are grateful to the authorities and private sector participants for their excellent cooperation. The authors benefitted greatly from the inputs and views expressed in meetings with insurance regulators, supervisors, insurance companies and industry and professional organizations.

B. Overview—Institutional and Market Setting

Institutional framework and arrangements

6. Spanish financial markets are supervised by three separate sectoral supervisors:

banking by the Banco de España (BdE), securities by the Comisión Nacional del Mercado de Valores (CNMV), and insurance and pensions by the Dirección General de Seguros y Fondos de Pensiones (DGSFP). As a member of EIOPA, the DGSFP conforms to relevant EU level legislation and regulation (e.g., Solvency II).

7. The key insurance legislation in Spain includes:

- Ley 20/2015, de 14 de julio, de ordenación, supervisión y solvencia de las entidades aseguradoras y reaseguradoras (LOSSEAR) and the Royal Decree developing this law, Real Decreto 1060/2015, de 20 de noviembre, de ordenación, supervisión y solvencia de las entidades aseguradoras y reaseguradoras (RDOSEAR). These two texts transpose the European Union Solvency II Directive, repealing most of the articles of the previous private insurance organization and supervision law and regulation.
- LOSSEAR and RDOSEAR only cover a part of Solvency II, the level one Directive which needs to be transposed by every EU Member State (Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast) (Text with EEA relevance), as amended by Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 (the so-called “Omnibus II Directive”).
- The rest of the Solvency II regulation issued by the European Union is applied in Spain and includes a number of legal texts, notably Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), amended by Commission Delegated Regulation (EU) 2016/467 of 30 September 2015 amending Commission Delegated Regulation (EU) 2015/35 concerning the calculation of regulatory capital requirements for several categories of assets held by insurance and reinsurance undertakings (Text with EEA relevance) and a number of Implementing Technical Standards and Regulatory Technical Standards which are also directly applicable. In addition to this, the DGSFP has issued Resolutions declaring that it will be complying the different sets of EIOPA Guidelines.
- Private Insurance Intermediation Law (Ley 26/2006, de 17 de julio, de mediación de seguros y reaseguros privados LMSP).
- Insurance Contract Law, Ley 50/1980, de 8 de octubre, de Contrato de Seguro.

Insurers must comply with other ministerial orders, resolutions, circulars, guidelines, acts, issued by the federal government or DGSFP.

8. The Ministry of Economy, Industry and Competitiveness (Mde) is the agency

empowered by the LOSSEAR to supervise insurance activities in Spain, with the exception of mutual insurers that operate solely within an Autonomous Community³ where the Autonomous Community has agreed to assume their supervision. By regulation, MdE has delegated the insurance supervisory responsibility to DGSFP, a department within the MdE.

9. DGSFP supervises only private insurance. Social insurance plans are not subject to DGSFP supervision. Social insurance is an integral part of the Spanish social security system, providing financial protection for disability, work injury, illness, maternity, unemployment, and old age (state pension).

10. There are several levels of insurance legislation. Insurance laws are a transposition of European enacted by approval of the Government and the Parliament. Royal consents give effect to new laws. MdE, being the responsible ministry for insurance, has the power to issue insurance regulations, pursuant to power conferred by the primary insurance laws. MdE also has the power to issue administrative orders pursuant to power conferred by laws and regulations. Finally, DGSFP may issue rulings (*resolution*) which are binding on licensed institutions or individuals.

11. DGSFP is a department within the MdE funded by the State budget. This implies that it is organically dependent on the MdE. As such, it does not have autonomy in setting its budget. The organic dependency on the MdE entails additional drawbacks, affecting its organizational and operational autonomy, including the ability to hire the human resources needed to duly perform its tasks. In 2016, as part of government wide cost reductions, the DGSFP was required to reduce its 2017 operating budget by €1 million from its 2016 level of €15.6 million. This cut significantly affects the DGSFP's ability to perform its supervisory mandate. The DGSFP does not levy any fees on industry participants, except a one-time registration fee on intermediaries. Fees as well as administrative fines collected are passed over to the Treasury. In 2015, registration fees of €6 million were collected.

12. Some of the largest insurers operating in Spain are insurance groups or belong to financial conglomerates. To enhance collaboration among supervisory authorities, both domestically and internationally, DGSFP has signed Memorandum of Understanding (MoU) with BdE, CNMV, and SEPBLAC. SEPBLAC is Spain's Financial Intelligence Unit (FIU) and AML/CFT Supervisory Authority (*Servicio Ejecutivo de la Comisión de Prevención del Blanqueo de Capitales e Infracciones Monetarias*). There is a specific MoU among BdE, CNMV, and DGSFP regarding financial education. Since 2012, DGSFP has also signed with other supervisory entities the following MoUs:

- Bermuda (2016).
- ASSAL, Association of Latin American Insurance Supervisors (2016), the countries which have signed the ASSAL MoU are: Colombia, México, Costa Rica, Puerto Rico, Guatemala, El Salvador, Chile, Uruguay and Spain.

³ By law, these Autonomous Communities should consult DGSFP before granting a license. However, it is not always done in practice. As at the end of 2015, there were 123 such entities in 7 Autonomous Communities with gross written premium of €0.1 billion, or 0.2 percent of total Spanish insurance market in 2015. About half of these entities are in the Autonomous Community of the Basque Country, although if measured by premium volume, this Autonomous Community is not the largest.

Nevertheless, before 2012, Spain signed an MoU with Uruguay (2010), El Salvador (2008), México (2006) and Switzerland (2006).

13. The 2012 FSAP reported a high degree of compliance with 16 of the 2011 version of the IAIS ICPs while 10 others demonstrated the need for improvement. Amongst other points, it identified some areas for improvement that are relevant to the scope of this technical note:

- Despite the lack of independence in the regulatory structure, there is no evidence to suggest that DGSFP is not independent in carrying out its duties. However, the budgetary dependency appears to have limited DGSFP's ability to expand its resources to match its expanded responsibility, particularly in the area of group-wide supervision;
- DGSFP is solely dependent on the State budget;
- Without additional budgetary resources, the DGSFP should review the scope of its work;
- Supervision is hampered by the lack of resources especially for on-site supervision;
- Requirements on insurer disclosures should be strengthened;
- Shortcomings in suitability of persons, corporate governance, risk management and internal control will be addressed when Solvency II is implemented.

14. Significant progress has been made on these recommendations since 2012. Solvency II implementation has required DGSFP to address these issues and many of the FSAP recommendations are reflected in the current supervisory approach.

15. There are no statutory insurance guarantee schemes (IGS) for life or non-life insurance in Spain. The benefits of IGS on policyholder protection and more generally for jurisdictional financial stability have been noted by both the European Commission⁴ EIOPA⁵ and the OECD.⁶ While the EIOPA Discussion Paper included a useful survey of IGS practices among EU member states, to date no further initiative has been taken. With this background, the DGSFP and relevant authorities should consider whether policyholders, especially life insurance policyholders should be afforded specific coverage guarantees in the event of insolvency.

⁴ European Commission (2010) White Paper "On Insurance Guarantee Schemes," http://ec.europa.eu/finance/consultations/2010/whitepaper-on-igs/docs/whitepaper_en.pdf.

⁵ EIOPA -CP-16/009, "Potential Harmonization of Recovery and Resolution Frameworks for Insurers."

⁶ OECD (2013), "Policyholder Protection Schemes: Selected Considerations", *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 31, OECD Publishing, Paris. <http://dx.doi.org/10.1787/5k46l8sz94g0-en>.

16. The Insurance Compensation Consortium (*Consortio de Compensación de Seguros CCS*)⁷ plays an important role in insurer insolvencies insurers. All policyholders, beneficiaries and affected third parties are protected by a form of policyholder protection scheme (PPS). According to this scheme, special treatment is provided to insurance contract creditors, whose balances can be acquired by CCS at the request of the creditors at their option without waiting for the results of the relevant Creditors' Meeting, at a percentage higher than they would likely obtain in the ordinary (but perhaps lengthy) liquidation process. In so doing, the CCS takes over the legal position of the insurance creditors that have been acquired within the Winding up Plan. Once the CCS has been entrusted to liquidate an insolvent insurance company, the CCS has nine months to hold the CCS Board meeting to decide about the purchase of insurance contract credits and to determinate the level of protection of policyholders (the percentage). The CCS then sends the offers to the policyholders and it keeps the offers till the creditors meeting. After the creditors meeting, the insurance creditors who didn't sell their credits to the CCS and the CCS, who took over the legal position of the insurance creditors whose credits were acquired, will be paid according to the Winding up Plan. The winding up activities of the CCS are funded by:

- Ex-ante and compulsory tax levied on non-life policyholders (except Export Credits Policies) of 1.5 per thousands of premiums;
- Return on investments;
- Recoveries from the Winding-Up Plan (The CCS, after the acquisition of insurance credits, has the rights of the original owners who were covered by the PPS).

C. Market Structure, Insurance Products and Industry Performance

17. The insurance sector in Spain is well developed and mature. It is the sixth largest in Europe, with gross premium income of €55.3 billion (US\$61.3 billion) in 2015, a 3 percent increase from 2014 (see Table 2). There is room for market development as evidenced by an insurance density (premium per capita) of US\$1,322 and an insurance penetration rate (premium as percentage of GDP) of 5.6 percent, as compared to the average of US\$1,634 and 6.9 percent, respectively, for the whole of Europe.⁸

⁷ CCS is a public institution but not part of the government. It has its own legal status and full capacity to act. It is not supervised by the DGSFP, although it must comply with the requirements in insurance laws and regulations. It is funded through mandatory surcharges on each insurance policy issued. At the end of 2015, it has a reserve fund of €9.5 billion (of which €1.9 is for winding up activities). It has a staff strength of 312. The CCS senior management is entrusted to its Board of Directors, which is presided over by whoever holds the position of Director General of the DGSFP. The Board is made up of 14 members, with equal representation of the Private Insurance Market and the Central Administration. CCS has three main functions: (i) permanent insurance functions—providing coverage for (a) extraordinary risks for natural (floods, storms, earthquakes and tsunamis, volcanic eruptions and falling of meteorites) and social-political (terrorism, rebellion, insurrection, riots and civil commotion, and actions of armed forces in peacetime) perils; (b) compulsory motor insurance for unaccepted or uninsured private vehicles and all official vehicles of government and public agencies; and (c) multi-peril crop insurance, working through Spanish Association of Insurers for Combined Crop Insurance AGROSEGURO; (ii) other insurance functions—as and when required by public interest and market circumstances. A two-thirds majority of board approval is needed for CCS to take on additional insurance functions; (iii) non-insurance functions—winding-up of insurers.

⁸ Swiss Re: World Insurance in 2015, Sigma No. 3/2016.

Table 2. Market Size in Absolute Terms and Relative to Economy					
	2011	2012	2013	2014	2015
Gross Written Premium (GWP-€Mill)	64,049	60,822	59,862	59,603	61,110
GDP (€Mill)	1,073,413	1,039,758	1,025,634	1,037,025	1,075,639
GWP / GDP (in %)	5.98	5.85	5.84	5.75	5.68
Premium / Population	1,368	1,301	1,287	1,283	1,316
GWP— life (€Mill)	30,229	27,173	26,385	25,859	26,409
GWP—life / GDP (in %)	2.82	2.61	2.57	2.49	2.46
GWP—life / Population	645	581	567	557	569
GWP—non-life (€Mill)	33,820	33,649	33,476	33,744	34,700
GWP—non-life / GDP (in %)	3.16	3.24	3.26	3.25	3.23
GWP—non-life / Population	723	720	720	726	748

Source: DGSFP

18. There are a significant number of players in the Spanish insurance market, with representation by most of the major international groups. The number of life insurers has been slowly decreasing, from 97 in 2012 to 86 in 2015. At the same time, there has been some consolidation in the non-life sector, with the total number of nonlife insurers decreasing from 171 in 2012 to 150 in 2015 (see Table 3). In addition, there were 719 companies authorized to write business in Spain in 2015 (increased from 640 in 2014) under the EU freedom of services arrangements. There are 79 foreign branches operating in Spain. The number of branches has been fairly stable over the years. The bulk of the branches are from insurers based in the United Kingdom (33), France (16), Germany (7), and Ireland (7).

Table 3. Number of Licensed Insurers				
As at end of:	2012	2013	2014	2015
Domestic insurers				
Life insurance	97	95	91	86 ¹
Non-life insurance	171	167	159	150
Reinsurance	2	2	3	3 ²
	270	264	253	239
Foreign branches in Spain	81	77	75	79

Source: DGSFP

¹ At the end of 2015 this number includes 59 composite insurers. DGSFP stopped issuing composite licences in 1984.

² The three Spanish entity non-life reinsurers are: GCO Reaseguros; MAPFRE RE; Nacional de Reaseguros

19. The Spanish insurance market is characterized by the presence of a few large insurers dominating the market as well as a large number of small insurers. In 2015, the top five life

insurers commanded 59 percent of the life market (by assets), the top five nonlife insurers 24 percent (by premium) of the non-life market, and the top five composite (insurers licensed to write both life and non-life business) insurers 52 percent (by assets) of the composite market. With the exception of the life insurer category, Spanish insurers dominate the top five rankings.

20. The Spanish insurance market is complex due to the presence of large numbers of insurance groups. DGSFP is member of supervisory colleges for 29 EU insurance groups. For three of them the DGSFP is the group-wide supervisor (MAPFRE, Catalana, Liberty). MAPFRE is also identified as an IAIG. DGSFP also supervises 43 insurance groups which operate only in Spain. Many of the largest of these are owned by the banks. Four of these are classed as financial conglomerates by the Joint Committee of the European Supervisory Authorities⁹ (i.e., BBVA, Banco Santander, Ibercaja, Criteria). Directive 2002/87/EC requires (subject to some size criteria)¹⁰ the application of supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. This Directive is commonly known as FICOD.

	31/12/2011	31/12/2012	31/12/2013	31/12/2014	31/12/2015
TOTAL	86,999	88,296	86,294	87,851	83,781
Tied agent	86,757	88,038	86,042	87,605	83,506
Multi tied agent	163	186	199	205	223
Bancassurance	79	72	53	41	52
Brokers	3,023	3,014	3,038	3,078	3,152
Source: DGSFP					

21. There is a diverse network of insurance distribution channels making use of virtually all established forms of insurance sales. There is significant stability regarding the distribution insurance market. Bancassurance is the main distribution channel of life insurance products with a market share of 70 percent of new business premium (or 66 percent of total premium) in 2015. In recent years, agents and brokers have been slowly increasing their portion of sales at the expense of bancassurance. On the other hand, non-life insurance policies were mainly (66 percent by new business premium) sold through agents and brokers. In recent years, it has been observed that the bancassurance channel is gaining market share in non-life insurance distribution (see Tables 5 and 6).

⁹ European Securities and Markets Authority, European Banking Authority and European Insurance and Occupational Pensions Authority.

¹⁰ Art. 2(14)(e), Supplementary Supervision Directive.

Table 5. Distribution of New Business Premium by Channel in 2015

Channels	Life	Non-Life
Agents	15.97%	31.13%
Brokers	7.24%	35.30%
Bancassurance	69.97%	18.97%
Direct Sales	6.87%	7.13%
Internet	0.02%	2.52%
Others	0.22%	4.96%

Source: DGSFP

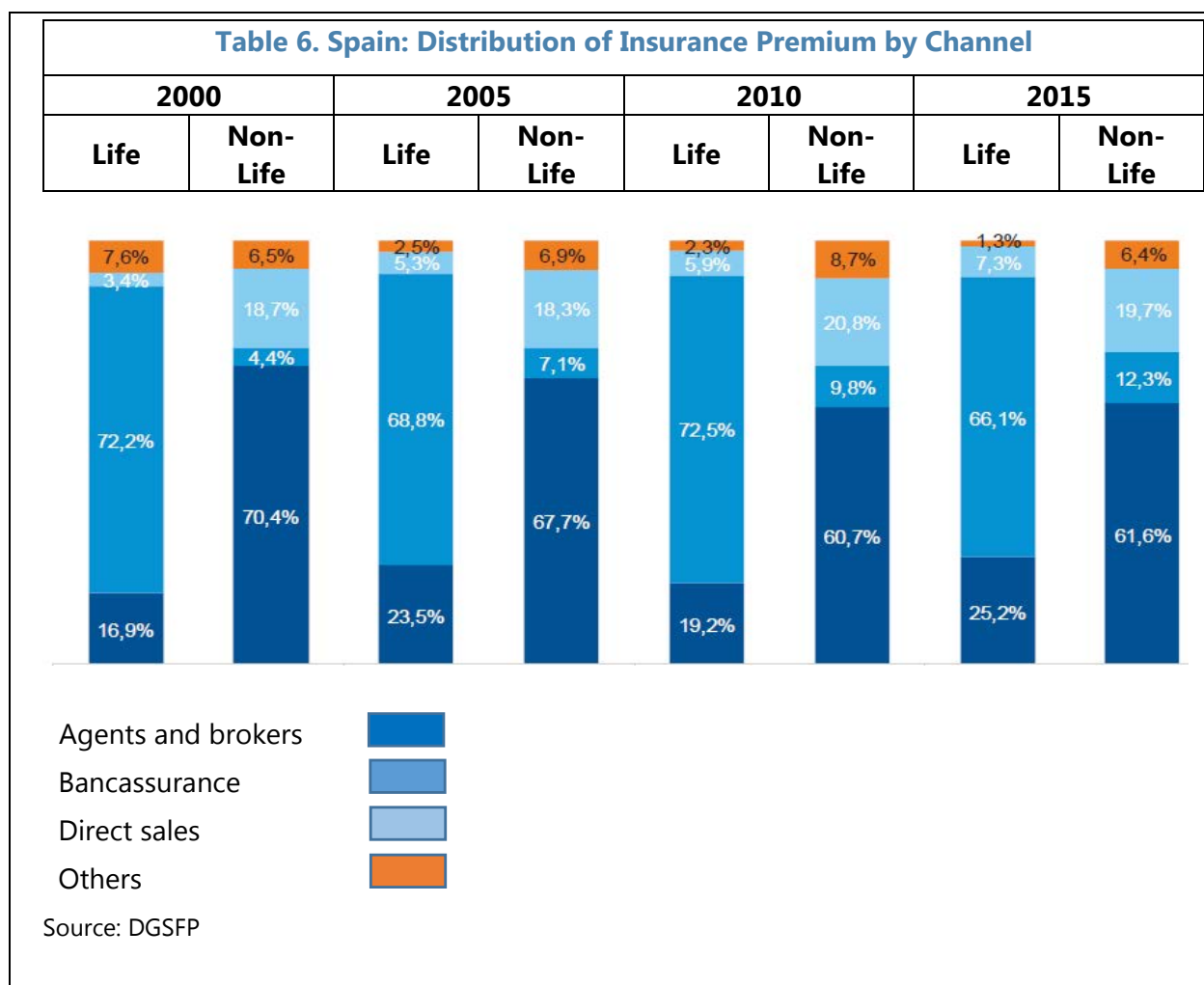


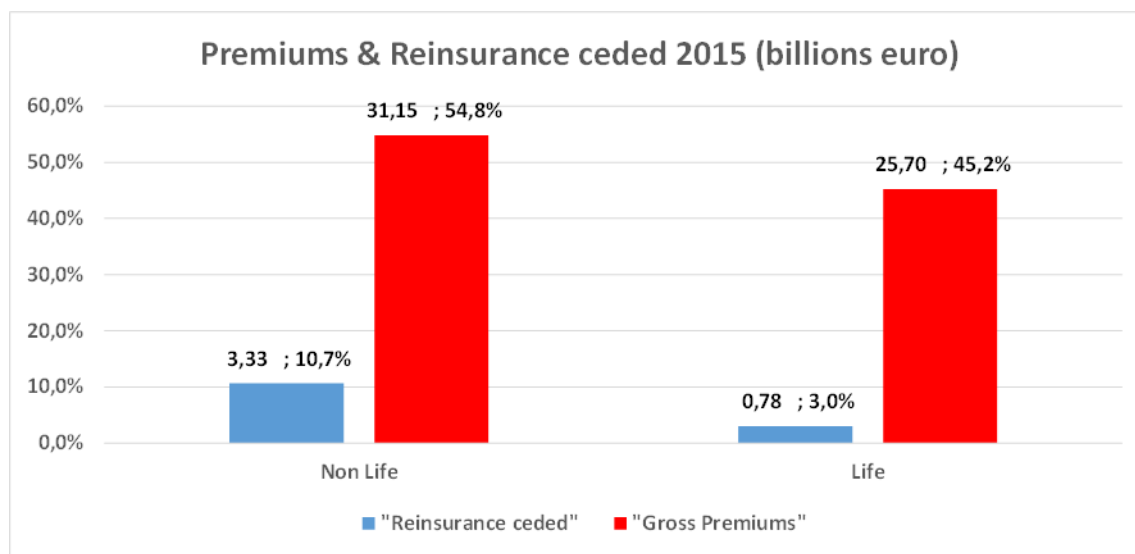
Table 7. Distribution of Gross New Premium Written ^{/1} (in € millions)							
Life Insurance				Non-Life Insurance			
Line of Business	2013	2014	2015	Line of Business	2013	2014	2015
Domestic Risks:							
Participating	6,910	7,459	5,603	Motor	9,610	9,445	9,695
Non-Particip.	4,208	4,691	7,283	Property	11,614	11,525	11,968
Term	3,196	3,355	3,486	Liabilities	1,073	1,009	1,011
Annuities	7,946	6,406	5,881	A&H	7,884	8,225	8,448
Unit-Linked	3,062	2,816	2,721	Others	1,942	2,076	2,138
Foreign Risks	551	600	751		1,354	1,464	1,442
	<u>25,873</u>	<u>25,237</u>	<u>25,725</u>		<u>33,476</u>	<u>33,743</u>	<u>34,700</u>
Source: DGSFP							
^{/1} Data in Table 7 does not include business pursued in Spain from other European economic Area (EEA) countries through branches or Freedom to Provide Services (FPS) since this information is not available to Spain. However, business pursued in other EEA countries from Spain through branches or FPS it is included in Table 6.							

22. Insurance premium written has been relatively stable over the past three years. A mature and saturated market coupled with recent economic difficulties are key challenges for industry growth. There is a wide variety of life insurance products, distributed fairly evenly across participating, non-participating (including term), investment-linked and annuities. In 2015, premiums for non-participating life products increased noticeably while other categories such as participating and annuities decreased. The major non-life products are motor (28 percent) and property (34 percent) and A&H (24 percent) (see Table 7).

23. The reinsurance market in Spain is relatively modest in size. There are three reinsurers operating in Spain as companies (all three are Spanish). In addition, one EU reinsurer operates in Spain on a branch basis. As seen in Figure 1, relatively modest volumes of insurance are ceded to reinsurer, likely due to the low volumes of insurance per capita and also by the participation of the CCS in catastrophic insurance. A unique feature of the Spanish market is the protection offered by the CCS on catastrophic risks, funded by compulsory premium surcharges on every non-life policy issued. On an ongoing basis, the CCS provides capacity to the multi-peril crop insurance sector through a reinsurance arrangement with the Spanish Association for Combined Insurers for Crop Insurance (AGROSEGURO).¹¹

¹¹ AGROSEGURO manages the Multi-Peril Crop Insurance (SAC) under a co-insurance arrangement by private insurers in which CCS has a 10 percent participation.

Figure 1. Reinsurance Ceded



24. Assets held by insurers as at end of 2015 totaled €303.9 billion, or 28.2 percent of GDP.

Assets related to life insurance business accounted for 80 of total industry assets. Equally, the 59 composite insurers also accounted for 80 percent of total industry assets (Table 8). The top 10 insurers in asset size (all composites) accounted for 55 percent of total industry assets.

Table 8. Assets Held by Insurers

(in € billions)	2011	2012	2013	2014	2015	% Share of Total
Life insurers	29.0	27.3	27.9	29.3	29.1	9.6
Non-life insurers	24.9	25.4	25.8	26.6	25.7	8.5
Composite insurers (*)	196.1	205.2	221.2	246.0	242.8	79.9
Reinsurers	5.2	5.4	5.4	6.0	6.3	2.0
Total	255.2	263.4	280.3	307.8	303.9	100.0
% of nominal GDP	23.8	25.3	27.3	29.7	28.2	--

Source: DGSFP

*** Composite insurer split**

(in € billions)	2011	2012	2013	2014	2015
Life	169.4	179.1	194.8	219.1	214.6
Non-life	26.7	26.1	26.4	26.9	28.2
	196.1	205.2	221.2	246.0	242.8

25. The investment of insurance assets is predominantly in fixed income instruments, while direct exposure to real estate is low. Holdings in government securities (largely Spanish) are around 44 percent of invested assets (up from 23 percent in 2010), while corporate securities are around 21 percent of invested assets (down from 32 percent in 2010). Forty-six percent of the corporate securities held by composite insurers were issued by banks. The same comparable ratio for life and non-life insurers was about 30 percent. Most of the growth in insurer assets between 2010 and 2015 has occurred in the composite insurers (i.e., from €129 billion to €242.8 billion). In the same period, insurers selling with only a life license have seen their assets decline significantly (i.e., from €85.5 billion to €29.1 billion). This investment strategy is aligned with the required matching of the long-term liabilities that insurers, life and composite, have in their books. Credit risk is therefore concentrated around sovereign debt and corporate debt (Table 9).

26. Related party investments and cross sectoral linkages may also be an important source of risk to the life industry, particularly the composite insurers. While for capital requirements double counting and intra-group transactions are disallowed, the total intra-group and related company receivables are around five percent of the investments supporting the technical provisions. Furthermore, some insurers use deposits placed with their parent banks to provide the capital guarantee under the unit-linked business. Thus, intra-group exposure may be even higher than Table 9 indicates. Cross-sectoral linkages exist from insurance companies' bank deposits and holdings of bonds issued by banks. Solvency II, has affected these linkages since risk concentration against one counterparty leads to higher capital requirements.

Table 9. Investments of Insurance Assets

As at end of 2015	Life		Non-Life		Composite	
	€ bn	% Total	€ bn	% Total	€ bn	% Total
Intangible assets	0.22	0.8	1.62	6.3	1.69	0.7
Investments:						
Government securities	13.03	44.9	4.69	18.3	113.60	46.8
Corporate securities	6.78	23.3	3.44	13.4	51.69	21.3
Equities	1.35	4.6	4.36	17.0	17.90	7.4
Real estate and related	0.17	0.6	0.55	2.1	3.82	1.6
Investments supporting unit-linked	3.01	10.4	-	-	11.37	4.7
Receivables	0.28	1.0	2.31	9.0	5.04	2.1
Intra-group/related company receivables	0.09	0.3	0.63	2.5	5.77	2.4
Reinsurance recoverables	0.18	0.6	3.26	12.7	2.78	1.1
Cash	0.94	3.2	1.79	7.0	20.03	8.2
Other assets	3.00	10.3	3.02	11.8	9.11	3.7
Total assets	29.05	100.0	25.67	100.0	242.80	100.0

Source: DGSFP

27. Despite the stagnation of premium income, insurers remain profitable. For the non-life business, catastrophic risks are covered by the CCS resulting in high retention of premium. For the life business, about 80 percent of life insurance (by new premium) is guaranteed return investment products with little mortality or longevity risks. Life insurers typically use asset/liability matching to

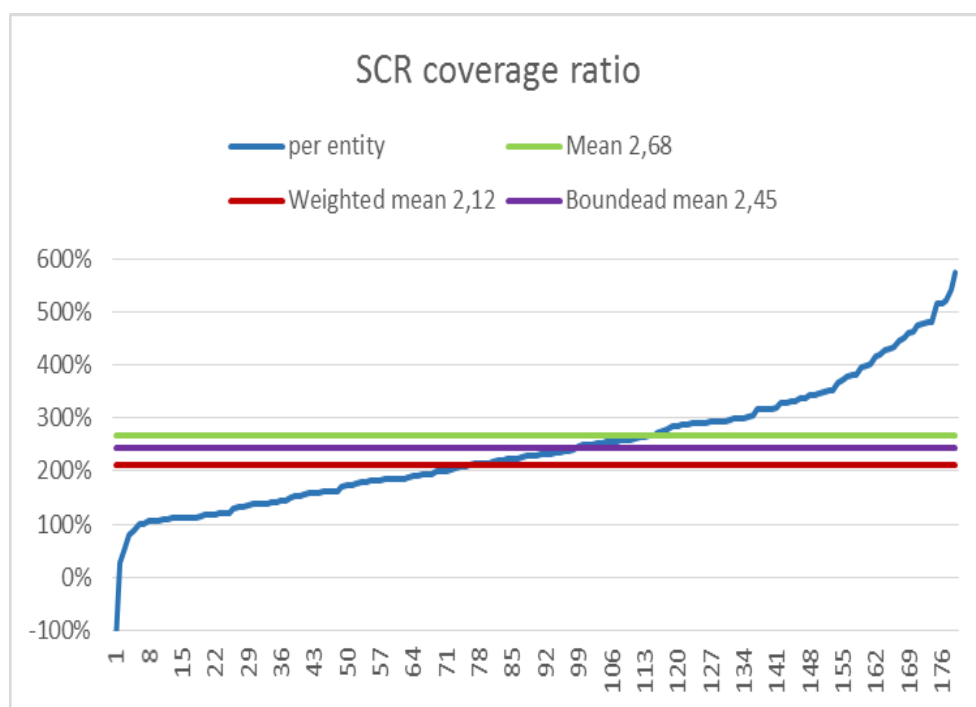
manage interest rate risk. Nonetheless, the portfolio is subject to continued low interest rates and an increase in credit spreads. The Institute of Insurance Entities Cooperation and Research (ICEA) data as well as that gathered by the DGSFP confirms that industry profitability as measured by return on equity (ROE) was favorable in 2015 (Table 10).

(in € billions)	Composite	Life Only	Non-Life Only	Total
Gross premium	38.2	3.7	15.0	56.9
Net premium	36.2	3.6	12.9	52.6
Assets	242.8	29.1	25.7	297.5
Liabilities	213.9	26.0	16.9	256.8
Excess of assets over liabilities	28.9	3.0	8.7	40.7
P&L	2.33	0.27	0.89	3.49
ROE (in %)	9.63	11.72	11.29	10.16
Source: DGSFP				

28. Based on EU solvency requirements, both life and non-life industries appear to be adequately capitalized. Under Solvency I the industry show on average a sound solvency margin of around 200 percent above the required capital in the life sector and 350 percent in the non-life sector (Table 11). Figure 2 shows solvency ratios according to Quantitative Impact Study (QIS) 5 (carried out before the introduction of SII for better calibrating the standard capital requirement (SCR) formula and assess its impact on the European insurers)—updated to use end of 2015 data. As of the end of 2015, only one small insurer in the process of liquidation has an SCR ratio below 100 percent.

(in € million)	2014 SI	2015 SI	2015 SII
Available capital resources over minimum capital requirement:¹			
Life	632	634	530.8
Non-life	1075	1060	552.2
Available capital resources over prescribed capital requirement:²			
Life	223.8	221.3	203.3
Non-life	402.3	403.3	223.6
Source: DGSFP			
¹ Minimum capital requirement or MCR is defined in the Solvency II glossary as “The capital level representing the final threshold that triggers ultimate supervisory measures in the event that it is breached.”			
² Prescribed capital requirement or Solvency Capital Requirement (SCR under Solvency II legislation) is defined as “The amount of capital to be held by an insurer to meet the Pillar I requirements under the Solvency II regime.”			

Figure 2. Solvency II SCR Coverage Ratios at end of 2015



Source: DGSFP

29. Banks and insurers are closely connected but insurers do not represent a systemic risk to the banks themselves. The top three insurers by asset size are directly owned by the biggest banks in Spain. Indeed, 6 of the top 10 insurers by asset size are owned by Spanish banks or savings institutions. The dominant business for these bank-connected insurers is traditional life insurance with 70 percent of it being sold through bancassurance. While these insurers are obviously dependent on their parent banks for new business, such business does not represent a growing or systemic risk to the banks themselves. As noted earlier, the asset purchases of these insurers (and the entire industry) are quite conservative and are not heavily weighted towards investments in banks, real estate or real estate protected covered bonds.

30. The role and size of private pension funds is smaller in Spain than in some other jurisdictions and smaller than those held by insurers. All private pension plans in Spain are supervised by the DGSFP. As the majority of the plans are Defined Contribution plans, there is no risk of plan insolvency due to benefit guarantees. It is the individual plan members who bear the risk that the funds accumulated on their behalf will be sufficient to provide for their retirement income expectations as well as their future longevity (to the extent that guaranteed payout annuities do not provide complete longevity protection (i.e., their small size provides an insufficient income replacement ratio by themselves at retirement). Both banks and insurers are active in managing the funds in the pension sector.

Type	Number of plans	Assets (in € billions)
Defined Benefit	12	.5
Defined Contribution	2,390	77.1
HYBRID	455	26.4
TOTAL	2,857	104.0
Source: DGSFP		

31. Debt and other fixed income securities are the main asset classes in which pension funds invest. In particular, pension funds invest 57.4 percent in debt securities, of which 27 percent is Spanish sovereign debt.

Distribution of main assets classes of pension funds (%)	3T	4T	1T	2T	3T	4T	1T	2T	3T	4T	1T	2T	3T
	2013	2013	2014	2014	2014	2014	2015	2015	2015	2015	2016	2016	2016
Equity securities	10,13	10,28	10,50	10,65	10,50	9,88	10,69	10,17	9,78	10,52	10,07	10,96	11,40
Venture capital	0,70	0,65	0,65	0,65	0,65	0,63	0,65	0,66	0,69	0,68	0,73	0,73	0,72
Ucits	11,72	11,58	11,98	12,56	13,32	13,27	15,48	15,72	15,41	15,90	15,86	17,05	17,80
Debt securities	62,49	62,61	63,91	63,40	61,69	59,31	59,98	58,17	60,04	57,47	58,16	58,39	57,41
· of which Spanish sovereign	36,28	38,18	39,59	39,04	37,73	35,50	35,54	33,42	31,76	29,45	29,14	28,27	27,02
· of which other sovereign	7,03	6,60	6,40	7,20	8,16	9,38	9,73	9,53	11,98	11,98	11,90	11,62	11,71
· of which private	19,18	17,84	17,91	17,16	15,79	14,44	14,72	15,22	16,30	16,04	17,11	18,50	18,68
Deposits	14,96	14,87	12,97	12,75	13,84	16,90	13,20	15,28	14,08	15,44	15,18	12,87	12,67
TOTAL	100	100	100	100	100	100	100	100	100	100	100	100	100

MAIN FINDINGS

A. Insurer Key Risks and Vulnerabilities

Interest Rate Risk and Matching

32. The main risk to Spanish insurers, especially for life insurers is due to interest rates.

Spanish life insurance products contain various interest rate guarantees in many of their traditional life and annuity products. Spanish insurers invest the premiums received to provide for the policyholder benefits in the future. If an insurer selects assets such that their cash flows match the liability cash flows, then the value of the assets and liabilities becomes insensitive to interest movements. Asset/liability cash flow matching is desired to avoid balance sheet volatility, losses, swings in own funds and capital ratios such as Solvency II's SCR. Matching can be a complex matter for insurers with a complex portfolio of assets and liabilities. Many EU countries face similar issues to Spain but the important aspects in Spain will be highlighted in the text that follows.

33. The 2016 EIOPA stress tests provide much useful information showing the vulnerability of EU jurisdictions to interest rate risk.

Seventeen Spanish insurance undertakings representing 82 percent market share participated in the stress tests. EIOPA tested two stress scenarios—low for long interest rates (LY) and a double hit (DH) scenario which also factored in increased credit spreads and asset shocks. Across the EU, both scenarios had a significant impact on the excess of assets over liabilities although the DH scenario was more severe. The use of various buffering adjustments, allowed in the transition to Solvency II, significantly buffers not only the current baseline solvency position of EU insurers but also the adverse impact of the DH (and to a lesser extent the LY) scenario. The baseline SCR for Spain in the report is 192 percent with buffering (as currently permitted under Solvency II) and 110 percent without. This shows the impact of the Long-Term Guarantee (LTG) measures (i.e., transitional measure, matching and volatility adjustments, respectively denominated as MA and VA) permitted under Solvency II (see box below for a description of this terms).

34. Spanish results appear to follow the EU average results in many respects. The duration of Spanish liabilities is relatively long (i.e., Macaulay duration of 10.1) when compared with that of the assets thus contributing to the adverse impact from both the LY and DH scenarios. Overall, the AoL (assets over liabilities) ratio for Spain fell from 111 percent in the baseline by just over 2 percent in DH scenario, and by less than 1 percent in LY scenario. However, excluding the impact of buffering, the AoL ratio significantly worsened in the DH scenario to about 90 percent.

35. Upon review with DGSFP of the EIOPA stress test results for the involved insurers, it is the staff's assessment that DGSFP has a sound view of the test results and that appropriate supervisory responses have been taken. The staff is supportive of the DGSFP view that the stress test results must be reviewed with LTG measures included. In particular, the staff supports the use of the MA and VA measures as representing an appropriate supervisory perspective for the DGSFP. The staff prefers examination of the results without transitional measures but this was not a material

factor in the analysis. While the EIOPA stress test aggregate results for Spain showed little movement in the SCR results according to the LY scenario, the individual insurer results were much more interesting. While some insurers demonstrated muted SCR volatility, most insurers, including those using the MA demonstrated SCR volatility (both up and down). Conclusions from this review suggest that,

- Insurers who have better asset/liability cash flow matching are less sensitive to interest rate risk,
- Insurers using the MA only do so for a portion of their business, in part due to restrictive Solvency II rules for their use,
- The direction of SCR volatility under the stress test is directly related to the nature of the mismatch position (i.e., assets are longer or shorter than the liabilities), and
- Most insurers would benefit from improved asset/liability cash flow matching.

Finally, as expected the DH scenario is very significant for insurers. Although SCR ratios may be weaker than normally desired, supervisory actions such as ORSA follow-up, regular engagement with insurer management about risk and capital management, advance preparation of recovery plans, etc... will position the DGSFP to proactively respond with affected insurers to these scenarios.

Box 1. Solvency II Long Term Guarantee Measures

In accordance with Solvency II, the calculation of the SCR and MCR can be subject to various adjustments collectively known as Long Term Guarantee measures or simply LTG. All of Spain's 17 EIOPA stress test participants use one or more forms of the LTG measures. The measures are:

- Transitional measure—Upon application to the supervisor, the insurer can spread the increase in capital (S II over S I) over 16 years. Some of Spain's insurers have applied to use the transitional measure.
- Matching adjustment (MA)—Upon application to the supervisor and subject to strict conditions and monitoring, the insurer can make a yield adjustment for the portion of their asset and liability portfolio they demonstrate as being matched. Essentially the yield adjustment allows the discounting of the technical provisions using the underlying asset yield of the matching assets held (net of defaults). Fifteen Spanish life insurers use the MA. The only other EU country to use the MA is the UK.
- Volatility adjustment (VA)—This spread adjustment can be used by any insurer without supervisory approval for any blocks of business not already subject to the MA (i.e., cannot have both on a block of business). The volatility being referred to is that of Own Funds due to the technical provisions normally being discounted using risk free rates while the assets move at their market values. This spread is defined in Solvency II. It is widely held (but not universally) in IFRS and supervisory debate that some sort of spread above risk free is appropriate for technical provisions. The VA and MA are Solvency II's way of partial acknowledgment that the discount assumption should be higher than risk free.

36. The DGSFP should apply more supervisory focus on insurers to improve their asset/liability cash flow matching regardless of their use of the Solvency II “Matching Adjustment.” The detailed analysis of individual insurer results (even those using the MA) indicated noticeable sensitivity to the low for long EIOPA stress test. Insurers should be asked to review their Board approved policies dealing with asset/liability matching. Management of an insurer’s exposure to interest rate movements of all kinds through asset/liability cash flow matching is a fundamental insurance risk management principle to be applied by all insurers to the extent practical.

Bank Owned Insurers

37. There are very close ties between Spain’s banks and its largest insurers. Six of the largest 10 insurers are owned by the banks. Indeed, the top three insurers are owned by the banks. Seventy of the new business for these insurers is sourced through bancassurance at these banks. In some cases, the bank is involved in the insurer’s asset management.

38. Despite their close ties, other types of financial inter-connectedness between the banks and the largest insurers are limited.¹² This review indicates that the holding of bank sourced assets (especially parent bank) appears to be limited. The following figures indicate the split of the insurer assets that have been sourced by the banks. At the end of 4Q2016 these assets amounted to €86,186 million or about 30 percent of all insurer assets.

39. Possible types of risk for bank-owned insurers and their supervisors as a result of their parent include:

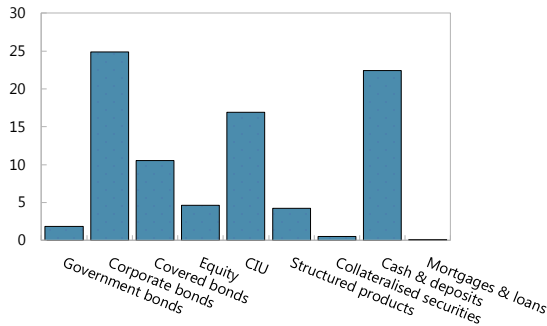
- High counterparty risk charges in the SCR due to the rating of their parent—other ownership structures might alter this charge.
- Reliance on bancassurance as the primary source of new business—recovery and resolution planning may be more challenging for these insurers due to their parent bank.
- Cross-sector spillover of risks to insurers from the banks—Regular collaborative supervision within and between the financial sectors is key to avoiding this spillover. At present these risks appear moderate but cross-sectoral supervisory collaboration is currently limited to information exchanges between the cross-sectoral supervisors.

¹² See the technical note on “Interconnectedness and Spillover Analysis” for more analysis.

Figure 3. Banks and Insurance Companies' Exposures Using Regulatory Data

Insurance companies have substantial exposures to banks...

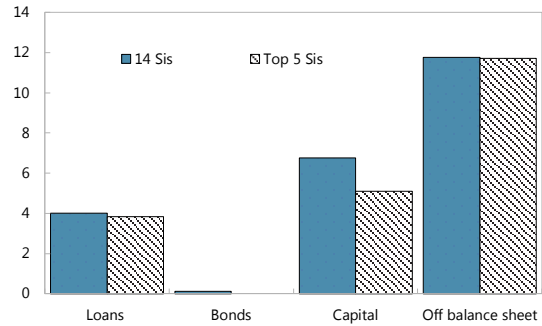
Insurance companies exposures to banks (2016)
(euro billions)



Sources: DGSFP

But banks have limited exposures to insurance companies.

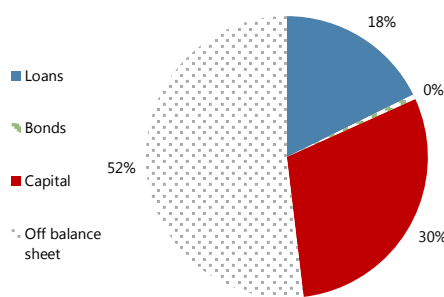
Exposures of banks to insurance companies (2016Q2)
(euro billions)



Sources: BdE

Larger banks exposures to the insurance sector is off balance sheet...

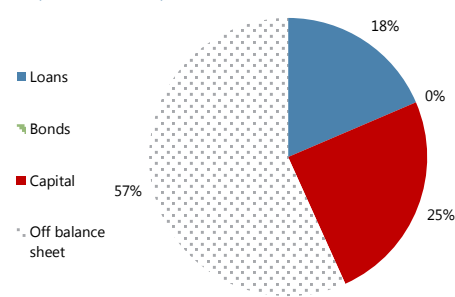
Sis exposure to insurance sector (2016Q2)
(percent of total exposure)



Sources: BdE

And the largest banks hold a substantial portion of insurance companies' capital...

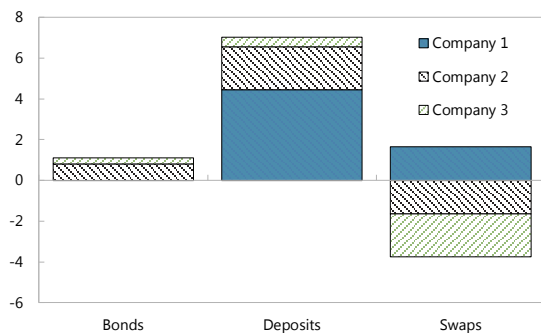
Top 5 Sis exposure to insurance sector (2016Q2)
(percent of total exposure)



Sources: BdE

Insurance companies deposits with parent banks is relatively small compared to overall bank liabilities....

Insurance company exposure to parent bank
(euro billion)

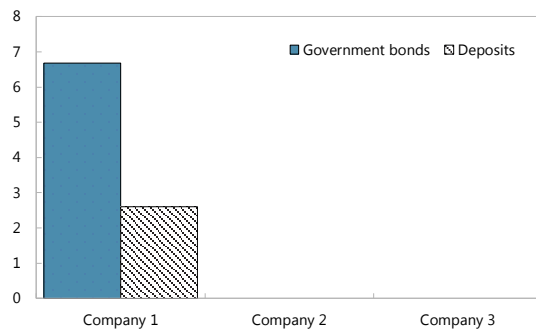


Sources: DGSFP (2016)

Sources: BdE, DGFSP, and IMF staff calculations.

And repo transaction between banks and insurance companies appear to be limited....

Insurance assets pledged as collateral in repo agreements
(euro billion)



Sources: DGSFP (2016)

Groups

40. As previously noted in this TN, DGSFP supervisors are involved directly or indirectly in the supervision of a large number of insurance groups and four financial conglomerates. By their very nature groups entail extra complexity for the supervisor in understanding and mitigating the risks arising from groups. Group risks can take many forms.¹³ They can arise from the many types of linkages or inter-connections within the entities of the group, including the different roles played by entities within the group structure. Group risk also arises due to the need for all involved supervisors to be effective in supervising not just the individual entities for whom they may be the home/host supervisor in their sector but also to continue to be effective even if the group operates across sectors.

41. DGSFP has demonstrated its ability to lead supervisory colleges. During this FSAP DGSFP supervisors demonstrated their ability to lead and contribute to supervisory colleges. They have shown their supervisory skills in organizing the colleges, their meetings, agendas, participants, meeting material, making supervisory judgements etc. Their ability to disseminate college materials electronically via a secure web portal is most effective. This appears to have entailed considerable extra effort by some DGSFP staff. Independent feedback was also received from relevant insurers and supervisory college members confirming the abilities of the DGSFP with respect to colleges.

42. Notwithstanding the DGSFP accomplishments in organizing supervisory colleges, the large numbers of groups and their complexity requires effective supervision at both the entity and head of group level. Effectiveness in supervising at the group level frequently requires understanding interlinkages across groups/financial conglomerates, taking the proper action and in some cases requiring add-on capital and/or enhanced supervision. Leading supervisory practices with respect to groups should be investigated and integrated into DGSFP practices in a proportionate manner.

Systemic Risk

43. There is currently little evidence to suggest that insurers are currently subject to or are themselves a source of systemic risk in Spain. Some possible sources of systemic risk were reviewed including bank generated assets purchased by insurers; bank ownership of insurers; EIOPA stresses (low-for-long and double hit) and concludes that these are not of systemic concern at this time.

44. Despite a prolonged period of low interest rates, insurers continue to invest considerably and conservatively in government bonds. There is little evidence of a search for yield in lesser credit quality assets or in alternative asset classes. There is also little evidence of the development of alternative forms of life insurance products that might encourage the purchase of such assets. This raises the question of whether there is an underlying cause(s) for such conservative behavior in the life insurance industry. The DGSFP should gain a better understanding of the reasons

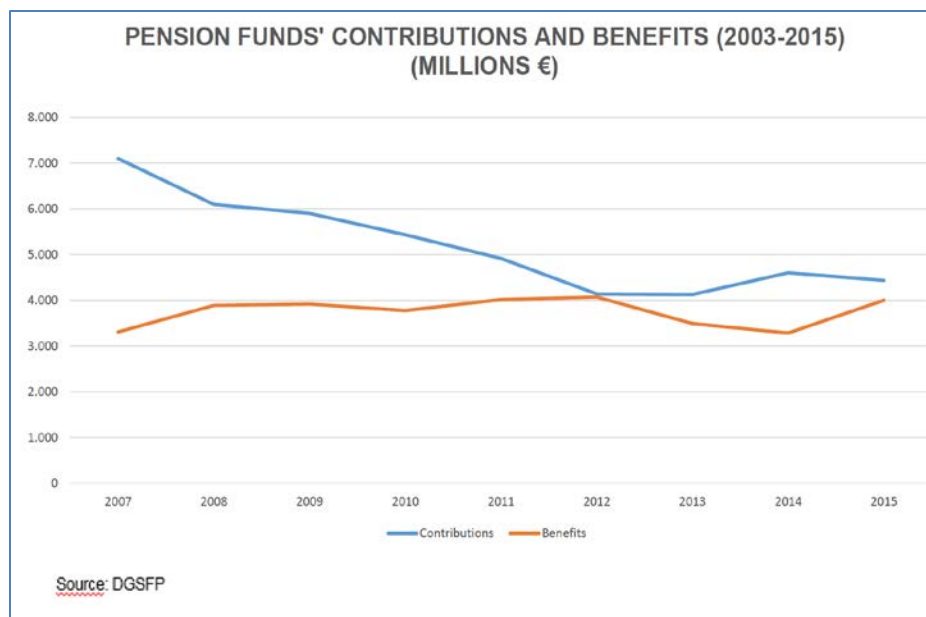
¹³ IAA Risk Book (2016) [Addressing the consequences of insurance groups](#)—by Alan Joynes, Ralph Blanchard and Stuart Wason.

behind such behavior from industry leaders. It is possible that some of capital requirements of Solvency II have dis-incented the purchase of non-government securities and perhaps the restrictive conditions on the use of the MA have also contributed. Any significant shift in insurer appetite for assets, especially long term assets, may have an impact on the overall market.

Pensions

45. The most important challenges facing the DGSFP with respect to pensions are as follows:

- (i) *Low interest rates.* Firstly, low interest rates could give rise in the case of defined benefit pension schemes to the need of the application of sponsor support and secondly,



defined contribution pension schemes with an insufficient total amount for the retirement.

- (ii) *New investments.* The need for pension funds to have access to new investments suitable to ensure a long-term guarantee, security, liquidity and diversification.
- (iii) *Longevity.* The need for pension benefits to adequately provide for continued improvements in longevity.
- (iv) *Technological.* The need to respond to new technologies in the financial markets.

As most pension funds and plans are defined contribution rather than defined benefit plans the exposure of the DGSFP to plan insolvency is quite low (i.e., plan insolvency is restricted to those few remaining defined benefit plans). In recent years, the contribution rates to private and corporate pensions have slowed.

46. The important linkages between pension plans and other segments of the financial system in Spain are as follows:

- Most pure management entities (without being life insurance companies) are owned by credit entities, insurance companies and management entities of UCITS or investment entities. This ownership achieves more than 50 percent of the capital of each pure management entity.

- Life insurance companies can be management entities of pension funds. On December 31, 2015, of a total of 82 authorized management entities, 47 were life insurance companies (57.3 percent) that manage 33 percent of the total assets of pension funds.
- Marketing of individual pension schemes can be made by credit entities, life insurance companies and management entities of UCITS, investment serviced enterprises and insurance intermediaries.
- Depository entities have to adopt the form of credit entities with a registered office or branch in Spain.
- Analysis and selection of investments are usually made by specialized entities that take part in bank or insurance, management entities of UCITS and investment services groups.

B. Effectiveness of Insurance Supervision

47. The DGSFP has made very good progress in addressing the 2012 recommendations. Of course, the news that the government intends on creating an independent insurance supervisor is welcomed—more on this in the next section.

48. Important in the progress made since 2012 has been the introduction of Solvency II which is now law. There are many features of Solvency II and related laws and regulations that have fundamentally modernized insurance supervision across the EU. In its pre-FSAP self-assessment of ICP compliance, it is clear that Spain's performance under several ICP's automatically improved as the laws took effect. During the 2012 FSAP, 9 ICP's were scored as being Partly Observed (PO) and 1 ICP was rated as Not Observed (NO). While the 2017 FSAP was not focused on the detailed observance of the ICP's, it is obvious through the DGSFP self-assessment and all the presentations made to the IMF team, that considerable progress has been made. An informal review by the IMF team of the DGSFP's self-assessment suggests that the ICP ratings on many ICP's have indeed improved noticeably. A fundamental reason for the improvement has been the legal adoption of the Solvency II framework of laws and regulations in Spain, as well as for the rest of the EU, with effect from January 1, 2016. The introduction of Solvency II by itself has improved the assessments of compliance for a large number of ICP's due to the broad nature of Solvency II reform (e.g., governance, control functions, risk management, valuation, ORSA, capital adequacy, etc.). Of course, the enactment of new laws is a necessary but not sufficient condition for improved ICP performance as the DGSFP must also be fully ready with systems, staffing and training to fully implement the changes to their laws and regulations related to Solvency II. As noted throughout this TN, the DGSFP is well prepared for Solvency II. However, this TN does note specific areas in which ICP ratings could continue to be improved as experience with Solvency II is gained.

49. Not all insurance entities are subject to Solvency II. Three types of entities according to article 101 of LOSSEAR and transitory disposition 4 of LOSSEAR (collectively called the Special

Solvency Regime or RES) are permitted to remain subject to the simpler pre-Solvency II regime. Currently there are 48 of these fairly small¹⁴ entities remaining.

50. The supervisory process begins “off-site” with a scanning of the financial data filed by insurers with the DGSFP. The database consists of the regularly filed data by insurers such as financial statements (both accounting and Solvency II) including balance sheet items, profit and loss, investments, technical provisions, SCR, Own funds and DGSFP’s supervisory Risk Assessment Framework (RAF). The Inspections Department then screens the database for all insurers to identify indicators of risk. This is referred to as off-site inspection. This screening of the database of insurer financial data is a most useful (and leading practice) tool and is readily applied to all insurers. Some of the presentation material on this database appeared to suggest that the tool be used to identify “breaches.” While these are important to identify, DGSFP is encouraged to further develop their database tool to explore new and novel queries to identify risks and risk trends (e.g., drop in SCR, drop in profits, change in asset mix etc.). One of the advantages of this database tool to the supervisor is its ability to readily compare the results of an insurer against its peers.

51. The next step in the supervisory process is to prepare a risk map of all the insurers to identify those insurers needing the most attention. The DGSFP supervisory risk mapping tool allows supervisors to rate each entity according to two equally weighted dimensions—impact (using premiums, technical provisions and assets) and risk (examined through solvency and results). This is a good starting point for all insurers, notably modest sized insurers. As the DGSFP gains experience this first year with Solvency II, it is advised that the simple two-dimensional risk map approach evolve into a more sophisticated scoring mechanism which would allow additional database elements and trends to be reflected in a score (i.e., score to include different types of asset risk, technical provision risk, trends in profits and SCR, etc.). Presumably the risk mapping tool can then be used as a composite leading indicator of which small to medium sized insurers require further detailed review. With respect to large insurers, their complexity requires detailed on-site inspection and scoring. For these insurers, data screening is only the beginning of the supervisory (“inspection”) process.

52. Insurers subject to more intensive supervision include those in colleges and those already identified by off-site supervision as having problems. More intensive supervision includes on-site supervision to investigate issues more thoroughly. Such on-site work uses well defined and transparent protocols for ordering an on-site, conducting the inspection, preparation of reports, insurer feedback and finally communication of actions to be taken. The DGSFP maintains a Corrective Measures Department to ensure that ordered actions are taken by the insurer. This department maintains a close check on insurers subject to monitoring procedures, control measures and disciplinary procedures. Having reached a peak in the years 2013–2014, the number of insurers subject to review by Corrective Measures has now declined to moderate levels. In the event that an

¹⁴ Criteria include gross earned premiums \leq €5 million.

insurer nears dissolution, the DGSFP has established communication protocols with the CCS to ensure that policyholders remain protected to the greatest extent possible.

53. As noted earlier in this report, group supervision is a significant aspect of the work of the DGSFP. The Inspection and International Relations areas of the DGSFP have demonstrated their ability to supervise groups and to assumed leadership as the group-wide supervisor as appropriate. Some of the more complex groups supervised by the DGSFP were reviewed in some depth via case study presentations to staff. DGSFP group supervision expertise was affirmed by other country supervisors interviewed during the FSAP.

54. The introduction of Solvency II has required that the DGSFP develop software tools in support of insurance supervision. These tools include the DGSFP Excel based database of financial data from insurers, a data warehouse of various supervisory guides and tools, web portals for supervisory colleges and the risk mapping tool to help guide supervisory workplan. Some of the tools allowed immediate comparison on data from an insurer to a chosen peer group of companies. This is very helpful to supervisors in providing them with relevant points of comparison. The tools that have been developed appear useful and effective in support of risk-based supervision.

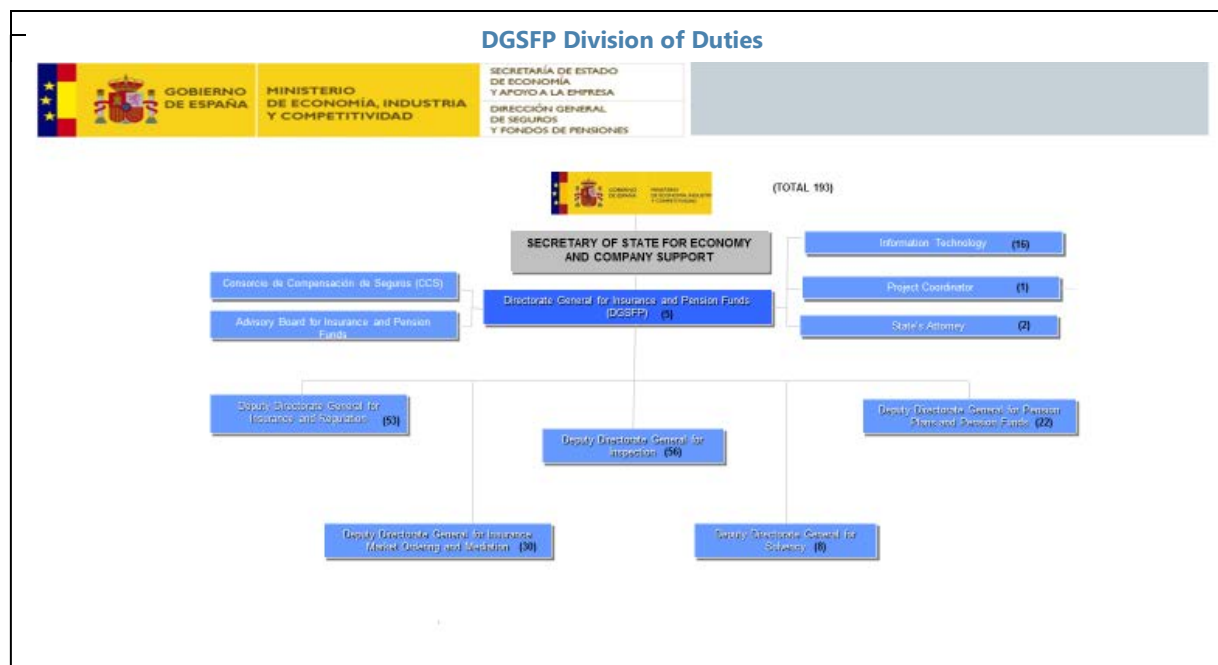
55. The DGSFP, in accordance with the law,¹⁵ maintains an Advisory Board for Insurance and Pension Funds. Chaired by the Director General, the Advisory Board includes a broad cross-section of insurance and pensions stakeholders who provide advice on issues pertinent to the work of the DGSFP. The DGSFP may wish to consider ways in which performance feedback can be provided confidentially from stakeholders. One such means is to contract with a firm to conduct directed confidential interviews of all key stakeholders.

56. As pension plans were not a primary area of investigation for this FSAP, no view is taken of pension plan supervision within the DGSFP. No performance related feedback was received regarding pension plan supervision during the course of the FSAP.

57. Market conduct activities occur partly within the Deputy Directorate for Regulatory Policy and partly within the Deputy Directorate for Insurance Market Ordering. Within the former is the Complaints Department consisting of 22 staff. This department handled 10,396 complaints in 2015, down from 11,026 in 2014, and 12,457 in 2013. While the complaints can be due to a variety of consumer complaints against insurers and pension plans, the large majority are due to insurers. The responsibility for supervising insurance intermediaries and also for the market conduct of insurers, reinsurers and intermediaries, rests with 2 departments totaling about 17 staff within the Insurance Market Ordering Deputy Directorate. The DGSFP should consider the benefits of combining all the activities for market conduct into one Directorate.

¹⁵ Art. 18 Ley 20/2015; Art. 3 Real Decreto 1060/2015; Ley 40/2015 de Régimen Jurídico del Sector Público.

58. At the time of the FSAP, DGSFP staff totaled 193 persons. The main division of duties can be seen in the following chart.



59. It is the overall finding of this FSAP that the DGSFP is an effective insurance supervisor. The DGSFP has made many improvements to its supervisory framework, processes, people and systems since the 2012 FSAP. Despite overall resource constraints the staff have ably demonstrated their skills as they implement Solvency II. Nevertheless, Solvency II represents fundamental change in the fabric of financial reporting and solvency assessment. The move to market consistent measures creates significant Own Funds volatility, volatility which needs to be understood in advance through proactive not reactive supervision (e.g., note previous comments regarding screening of financial data for breaches and two-dimensional risk map scoring as two examples). In addition, the move to best estimate assumptions in the technical provisions requires much keener review of assumptions and hence engagement with the actuarial function than ever before. Consequently, this TN contains several recommendations necessary for the DGSFP to remain effective as it gains experience in a Solvency II environment.

C. DGSFP Effectiveness

60. This FSAP is most supportive of the government's announcement that the DGSFP will become an independent insurance supervisory authority. This aligns with the recommendations of the IMF during its FSAP's in both 2006 and 2012. As an agency of the Mde currently, the DGSFP is subject to overall government budget constraints which directly affect the ability of the DGSFP to carry out its mandate. As an independent authority, it should have the authority to fund its programs on its own via fees levied on the industry it oversees, yet be accountable for those costs, both to the government and to the industry it serves. As previously mentioned in this TN, one mechanism for receiving feedback on DGSFP performance may be through the use of an independent firm to conduct confidential targeted interviews with members

of the insurance and pensions sector regarding DGSFP performance. The anonymized report would be made available to the interviewees on a confidential basis as well as the DGSFP.

61. Looking ahead to the independent functioning of the DGSFP as the insurance and pensions supervisor in Spain, it should have a duty to contribute to the work of Spain's other financial sector supervisors on topics such as macroprudential surveillance and systemic risk.

This would be in addition to its normal duties in the supervision of insurers and pension plans. The insurance and pensions sectors in Spain, or any country, are important pillars in the social safety net of a nation. Each pillar has an important role to play and the development and success of Spain's macroprudential policies for its citizens and will therefore require contributions from the DGSFP due to its important role as insurance and pensions supervisor. Ultimately, overall macroprudential policy will need to be coordinated by a designated authority at the choosing of the government. Systemic risks can be a source of unexpected shocks to a country and it is a duty of all its supervisors to work together to try to identify sources of systemic risk before they build and do harm. In this modern age, systemic risks do not restrict themselves to specific financial sectors. Indeed, systemic risks can be difficult to detect as they build-up and infiltrate multiple sectors. Once again, the DGSFP has an important role to play as many insurers have close connections with the banks in Spain.

62. Finally, in cooperation and collaboration with other financial sector supervisors in Spain, the DGSFP should participate in relevant cross-sectoral group and financial conglomerate supervision.

During this FSAP, it was noted that there is very considerable supervisory cooperation and collaboration among insurance supervisors within the EU and globally due to the international presence of insurers. This is very important for insurance supervision but it is also necessary that cross-sectoral cooperation and collaboration should work equally well within Spain due to the dominant presence of bank-owned life and composite insurers, some of which are recognized as financial conglomerates. Ultimately, supervision of such entities requires strong coordination among all involved supervisors. While appropriate protocols have been established between the relevant cross-sectoral supervisors in Spain, sustained levels of collaboration on supervised entities is not apparent and needs to be improved.

63. The DGSFP and relevant government authorities should consider the potential benefits for Spain of encouraging an increased rate of private savings directed toward the insurance and pension sectors.

An observation of this FSAP, both from the research data for this Mission and candid views we received from members of the insurance and pension community, is that the rate of saving in Spain through insurance and private pension is lower when compared to other EU countries. A strong insurance and private pensions market is an important element of Spain's social safety net. Study of the potential benefits of an increased rate of savings may be a useful next step for the people of Spain.

64. Policyholder protection is indirectly provided to insurer policyholders through a variety of programs managed by the CCS.

CCS has long played an important and successful role in the winding-up insolvent insurers and in so doing, realizing the best possible recovery percentage for policyholders. During the FSAP, it was noted that as DGSFP supervisory intensity increases in the event of a troubled insurer, appropriate confidential discussions with senior executives of the CCS

begin. With this background, and given the substantial ties between Spain's largest banks and largest life insurers, it may be appropriate to consider whether policyholders, especially life insurance policyholders should be afforded specific coverage guarantees in the event of insolvency. Such guarantees would be provided by an entity separate from the DGSFP and be funded from the industry. Such a guarantee scheme could be designed to be similar in size to those offered by the banks to depositors. The presence of insurance policyholder protection guarantees can serve to increase the public's confidence in insurers and thereby promote sales. The operations of a policyholder protection guarantee scheme could be set up independent of CCS or perhaps included in its mandate. Finally, as noted earlier in this TN, the CCS plays an important "back-stop" role for the non-life industry with respect to several important catastrophic risks. The ex-ante accumulation of fees from the non-life insurance industry has enabled the CCS to build a buffer against these catastrophic risks. Since the size and frequency of the catastrophic risks covered by the CCS can be difficult to assess, the CCS, non-life insurers and relevant authorities should study, with the assistance of relevant experts, the optimal size of the catastrophic risk buffer including possible corridor limits for its growth.

65. The on-going effectiveness of the DGSFP is dependent on its ability to attract and retain sufficient resources to accomplish its mandate. Such resources need a combination of supervisory skills as well as insurance industry experience. During the course of the FSAP, it was apparent that the DGSFP is currently understaffed, has suffered turnover and has found it difficult to hire additional staff either due to budget restrictions or competitive terms offered in the private markets. The current staff of the DGSFP have demonstrated their skills, teamwork and adequacy in insurance and pension supervision. It will be an important requirement for the effectiveness of the DGSFP going forward that these resources be retained and enhanced. Departments needing additional staff will be those involved in the supervision of groups, the review of judgement based technical material (ORSA, technical provisions, control function adequacy, etc.) and the important need for Spain to participate actively in various IAIS and EIOPA committees.

RECOMMENDATIONS

A. Key Recommendations

- **Matching:** There should be more supervisory focus on insurers to improve their asset/liability cash flow matching regardless of their use of the Solvency II "Matching Adjustment". The detailed analysis of individual insurer results (even those using the MA) indicated noticeable sensitivity to the low for long EIOPA stress test. Insurers should be asked to review their Board approved policies dealing with asset/liability matching.
- **Bank-owned insurers:** While appropriate protocols have been established between the relevant cross-sectoral supervisors in Spain, sustained levels of collaboration on supervised entities is not apparent and needs to be improved. In addition, the DGSFP should monitor insurer cross-sector linkages and exposures individually and in aggregate on a routine basis.

Inter-connectedness with the banks is important due to significant bank ownership of the largest insurers.

- **Groups:** While the DGSFP has demonstrated its leadership in the identification and organization of supervisory colleges, it should further develop its skills in supervising at the group level as well as at the level of the insurance legal entity. Group supervision frequently involves dealing with complex international structures requiring the ability to ask tough questions of management at the group level.
- **Culture:** The DGSFP should aim to be a more proactive and less reactive supervisor; more principles based than following a checklist; and to be more forceful and directive in its supervision. During this FSAP, it was noted that DGSFP staff tend to focus on risk as measured by an SCR or MCR not by the underlying risks and strategies and their development in the insurer (e.g., distribution, product design, investments, matching, risk management). This seemed to be reflected as well in the risk map tool which should be enhanced as a risk indicator to capture more of an insurer's key risks (e.g., credit, market, insurance, product, risk mitigators, etc.).
- **Skills:** With Solvency II now implemented, there should be a shift in supervisory focus towards qualitative as well as quantitative review of the key methods and assumptions used by the insurer including the proportionate verification of technical provisions and capital requirements. The DGSFP should also develop its skills in areas now quite relevant in the Solvency II framework such as governance and risk management.
- **Engagement:** Supervisors should seek greater engagement with insurer boards, senior management and other key staff to better understand their businesses and to enable them in turn to better understand supervisory priorities. This engagement is important at all levels within an insurer and an insurance group (i.e., with CEO, CFO, CRO, actuarial function etc.). Greater engagement is especially important with the increased use of expert judgement in technical provisions, risk management, matching and governance overall. Such engagement enables the supervisor to be "out front" or proactive with emerging risks and risk exposures and ultimately should help to reduce the frequency and severity of supervisory work required to be reactive to insurer compliance matters.
- **Recovery and resolution plans:** DGSFP should make use of its powers to require significant insurers (say top five) and those subject to higher levels of risk, to develop recovery and resolution plans in case of a crisis. The process of preparing such plans is of value both to the insurer and to the supervisor as a common understanding of key business strategies is clarified.
- **Independence:** Plans for an independent DGSFP should be developed including topics such as legal foundation, governance, mandate, ability to determine its work plan, set its budget, hire staff and fund its operations from industry fees.

- **Resources:** To ensure the on-going effectiveness of the DGSFP as an independent authority a plan must be developed to enable the DGSFP to retain and attract sufficient resources to accomplish its mandate. Such resources need a combination of supervisory skills as well as insurance industry experience.
- **Macroprudential role:** The DGSFP should have a duty to contribute to the work of Spain's other financial sector supervisors on macroprudential surveillance. The insurance and pensions sectors in Spain, or any country, are important pillars in providing financial security to persons and corporations. Ultimately, overall macroprudential policy will need to be coordinated by a designated authority at the choosing of the government.
- **Systemic risks:** The DGSFP should have a duty to contribute to the work of Spain's other financial sector supervisors on systemic risk. Systemic risks can be a source of unexpected shocks to a country and it is a duty of all its supervisors to work together to try to identify sources of systemic risk before they build and do harm.
- **Cooperation:** The DGSFP should have sustained levels of cooperation and collaboration with the relevant cross-sectoral supervisors in Spain. While appropriate protocols are in place with these supervisors, sustained levels of cooperation and collaboration with respect to supervised entities are not apparent.

B. Other Recommendations

- **Rate of savings:** The DGSFP and relevant government authorities should consider the potential benefits for Spain of encouraging an increased rate of private savings directed toward the insurance and pension sectors.
- **Policyholder protection:** The DGSFP and relevant authorities should consider whether policyholders, especially life insurance policyholders should be afforded specific coverage guarantees in the event of insolvency. Additionally, the CCS, non-life insurers and relevant authorities should study the optimal size of the catastrophic risk buffer including possible corridor limits for its growth.
- **Impact of low interest rates:** The DGSFP should investigate the possible connection between persistently low interest rates, the heavy investment by insurers in government bonds and various regulatory requirements related to the SCR and MA (for example). The investigation should determine if these practices are of net benefit to policyholders and to Spain's economy generally.
- **Market conduct:** The DGSFP should consider the benefits of combining all the activities for market conduct into one Directorate.