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June 2016

FINANCIAL SECTOR ASSESSMENT PROGRAM

INSURANCE SECTOR SUPERVISION—TECHNICAL NOTE

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INSURANCE SECTOR SUPERVISION

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared in the context of an IMF Financial Sector Assessment Program (FSAP) mission in Germany during November 2015 led by Ms. Michaela Erbenova. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

ALM	Asset Liability Management
BaFin	Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht)
BMF	Federal Ministry of Finance
CMG	Crisis Management Group
DeckRV	Mathematical provisions ordinance (Deckungsrückstellungsverordnung)
G-SIIs	Global Systemically Important Insurers
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
FSAP	Financial Sector Assessment Program
FSC	Financial Stability Committee
GAAP	Generally Accepted Accounting Principles
HLA	Higher Loss Absorbency capacity
IAIS	International Association of Insurance Supervisors
ICPs	Insurance Core Principles
IHK	Chambers of Industry and Commerce
LTG	Long-Term Guarantees
MCR	Minimum Capital Requirement
MMoU	Multilateral Memorandum of Understanding on Cooperation and Information Exchange
MoU	Memorandum of Understanding
ORSA	Own Risk and Solvency Assessment
P&C	Property and Casualty
QRT	Quantitative Reporting Template
SCR	Solvency Capital Requirement
VAG	Insurance Supervision Act (Versicherungsaufsichtsgesetz)
VVG	Insurance Contracts Act (Versicherungsvertragsgesetz)
XBRL	eXtensible Business Reporting Language
ZZR	Additional Interest Provisions (Zinszusatzreserve)

EXECUTIVE SUMMARY

German insurers face challenges from the low interest rate environment. In life insurance in particular, prolonged low interest rates are eroding insurers' ability to provide expected returns, and potentially also to meet guarantee commitments, over the medium term. Health, property and casualty and reinsurance companies are also affected by the low rate environment, though to a more limited extent, reflecting lower dependence on investment returns. Other risks, from the underwriting cycle for example, and from downward pressure on reinsurance rates, are being managed through changes in the business mix and active repricing.

Solvency II is requiring German insurers to address negative pressures occurring in the future in a forward looking manner. While many life insurers have developed considerable financial strength over years and performance remains sound, the implementation of Solvency II is requiring those insurers subject to its requirements (most insurers) to recognize more of the cost of their commitments in the current valuation of their balance sheets. Even under Solvency I requirements, life insurers have been required since 2011 to build greatly increased reserves for future commitments (the Additional Interest Provisions—Zinszusatzreserve or ZZR). Policyholders have been experiencing reduced bonus allocations. Financial strain at individual companies is possible, if low rates persist, particularly those with business concentrated in traditional lines of life insurance.

The authorities have been taking a macroprudential approach to managing the pressures on life insurers. The ZZR requirement was introduced in order to improve the protection of policyholders through increased reserves calculated on a more market consistent basis than previously provided for by the historic cost based national GAAP used for Solvency I. Steered in part by the Financial Stability Committee (Ausschuss für Finanzstabilität—AFS) established in 2013, the authorities made legislative changes (in the 2014 Life Insurance Reform Act) to give life insurers relief from requirements to distribute a disproportionate share of unrealized investment gains to departing policyholders. In implementing Solvency II, adjustment measures for long-term guarantee business and transitional measures (phasing in the new requirements over 16 years) have been offered in full, subject to the approval of BaFin, the federal insurance supervisory authority. These measures will defer the full impact of the new market consistent valuation basis on past business.

Life insurers subject to potential strain on either the Solvency II or national GAAP measure have been identified by BaFin and are subject to close oversight. Surveys have been conducted on the impact of Solvency II, and BaFin is monitoring companies' positions with and without the effect of transitional measures. Nonetheless, there remains uncertainty over market reactions to the new requirements, while the proliferation of measures of financial strength may hamper interpretation and understanding of the numbers. Solvency II numbers will be reported with and without adjustments and transitional measures, while financial statements will continue to be based on national GAAP which has not been aligned with Solvency II. The continuing importance of national GAAP in relation to policyholder participation provisions, a central feature of German life insurance, makes Solvency II implementation particularly complex in Germany.

It is recommended that BaFin continue to monitor the impact of the new requirements and require action plans where companies face difficulties in meeting them. Where companies are relying on transitional measures to do so, BaFin should ensure that they have robust and credible plans for meeting the full requirements by the end of the 16-year transitional period and earlier, where possible. It should take action to restrict business or withdraw approval of transitional measures, where necessary. Given the multiplicity and high transparency of solvency numbers that will be available (from 2016 for supervisory reporting and from 2017 for public disclosure), planning should be undertaken to ensure a high degree of public understanding of the different measures.

BaFin's regulatory and supervisory regime for insurance has been strengthened by Solvency II implementation. A more risk-based approach to evaluating risks and allocating resources is being taken. There is an increased focus on groups, in the regulatory and particularly the reporting requirements, and in the allocation and organization of BaFin's resources. The process for assessing and approving internal models for solvency purposes, though fewer groups have applied than in some other EU countries, has built technical expertise and greater experience of working in a coordinated international framework through colleges of supervisors. After a large increase in recent years, BaFin's insurance supervisory resources appear appropriate for the new demands.

The transition to Solvency II has also required extensive retraining of supervisors and rethinking of the supervisory approach, processes which need to continue. Aspects of the new framework, such as governance and risk management, are principles-based, as are the new investment rules. There is considerable scope for insurers to use own assumptions in solvency calculations. More judgment will be demanded of supervisors. Aspects of BaFin's approach remain relatively compliance-based and there is scope to focus more on qualitative requirements, particularly in the context of peer group review. It is also recommended that BaFin communicate in writing to insurers, particularly larger companies, its key concerns and supervisory priorities, for example by sharing more of the main findings from the risk classification system. BaFin should also strengthen its intervention framework by introducing target minimum solvency requirements to be communicated to insurers based on the ORSA review; and a policy framework for the imposition of capital add-ons, making use of its powers in the insurance supervisory legislation.

BaFin has also been implementing the IAIS framework for the Global Systemically Important Insurers (G-SIIs) for which it has responsibilities. Its approach will need to be developed as the international work progresses, for example, to implement the additional loss-absorbing capacity requirement proposed by the IAIS, although there is no single EU framework for this at present, as Germany would prefer. There is scope to apply BaFin's requirements on the one German domestic G-SII to those other large insurance groups that include reinsurance operations with global reach. Notwithstanding the different supervisory objectives applicable to reinsurance in Germany and the outstanding issues being considered by the IAIS on the systemic significance of reinsurance, BaFin could consider the application to reinsurers of macroprudential tools used in the case of primary insurers, including regular stress tests and recovery and resolution planning.

Table 1. Main Recommendations	
Recommendation	**Priority**
BaFin should continue to maintain a watchlist and continue to use its powers to ensure that companies produce and comply with appropriate action plans where they face difficulties in meeting the new solvency requirements or maintaining a surplus under national GAAP.	High
BaFin should ensure that companies using the transitional measures under Solvency II have a robust and credible plan for meeting their SCR requirements by the end of the 16 years period and, where possible, earlier. This process should include stress testing to ensure that such insurers would meet the SCR even after a plausible shock.	High
The calibration of ZZR requirement should be kept under review within a framework of close attention by the authorities to the national GAAP framework as it applies to insurers given its continuing importance in relation to insurance regulatory objectives, including fair treatment of policyholders.	Medium
Supervisory priorities following full implementation of Solvency II should shift from internal models to the assumptions used by insurers using the standardized approach and on investments.	Medium
Supervisory and specialist resources should be maintained at their current high level to manage the continuing challenge of Solvency II implementation and the resulting risks that will arise during the early period after the new requirements come fully into effect.	Medium
Given the multiplicity and high transparency of Solvency II numbers that will be available (particularly from 2017 when the public disclosure requirements take effect), planning should be undertaken to ensure a high degree of public understanding of the different measures.	High
BaFin should consider whether it could better communicate to insurers, particularly larger companies, its key concerns and supervisory priorities, for example by disclosing more of the main findings from the risk classification system.	Medium
BaFin should consider a more formal approach to intervention in case of a deterioration in the financial position of an insurer as measured under the national GAAP framework.	High
BaFin should also consider a more systematic approach to communicate supervisory expectations based on the ORSA review; and it is encouraged to make full use of the provisions in the supervisory legislation to require capital add-ons of insurance companies in the circumstances envisaged in Solvency II.	Medium
BaFin could consider the application to all the larger groups of macroprudential tools used in the case of the one German G-SII, including regular stress tests and recovery and resolution planning.	Medium
BaFin should be empowered to place additional regulatory requirements on G-SIIs, including the requirements for additional loss-absorbing capacity being developed by the IAIS.	Medium

INTRODUCTION[1]

A. Scope and Approach of this Note

1. **This technical note provides an update on the German insurance sector and an analysis of certain key aspects of the regulatory and supervisory regime.** The note has been prepared as part of the 2015 Financial Sector Assessment Program (FSAP). It has been drawn on discussions in Germany from November 3 to 18, 2015. 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. A separate technical note records the results of stress testing carried out on the insurance sector.

2. **The note includes an analysis of German 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.[2] (The most recent such assessment, conducted on the basis of the 2003 version of the ICPs, was carried out in 2011.) The main focus of the note 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 approach to large insurance groups, including those that have been identified by the IAIS as Global Systemically Important Insurers (G-SIIs).

3. **The note refers to laws, regulations and other supervisory requirements and practices in place at the time of the discussions in Germany, as well as the position under Solvency II.** The note 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 12 ICPs analyzed in the note, the authorities provided a full self-assessment, supported by anonymized examples of actual supervisory practices and assessments. The institutional arrangements for financial sector regulation and supervision are outlined in Section B of this note.

4. **The selected ICPs are analyzed but without scoring the level of observance.** ICPs selected for review are broadly those with macrofinancial relevance and with material regulatory changes. They include the ICPs on solvency requirements (valuation, investment and capital adequacy), supervisory approach (including supervisory authority, supervisory review, preventive and corrective measures) and cross-border co-operation. The focus of the work is on both current insurance regulation and the requirements that took effect in January 2016, reflecting the timing of the FSAP work in late 2015. To avoid a departure from the IAIS ICP assessment methodology, under which regulation and supervision are normally evaluated as at the time of assessment, no scoring of

[1] This Technical Note was prepared by Nobuyasu Sugimoto, Monetary and Capital Markets Department, IMF and Ian Tower, IMF external expert.

[2] The IAIS ICPs apply to all insurers, whether private or government-controlled. Specific principles apply to the supervision of intermediaries.

the level of observance of the selected ICPs is given in this note. The detailed ICP analysis, including comments, is set out in the Annex to the 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. **BaFin is the principal insurance supervisor.** BaFin (the Federal Financial Supervisory Authority - Bundesanstalt für Finanzdienstleistungsaufsicht) is part of the executive branch of the German federal government and is responsible to the Federal Parliament via the Federal Ministry of Finance (BMF). Its status is that of a federal institution with legal personality governed by public law and part of the portfolio of the BMF. The BMF exercises supervision over BaFin, with a focus, defined in regulation, on the legality and fitness for purpose of BaFin's administrative actions. It chairs BaFin's Administrative Council, the body responsible for oversight of the management of BaFin.

7. **The supervision of insurance companies in Germany is based on the Insurance Supervision Act (VAG).** Insurers have to comply with other acts, codes, ordinances and circulars issued by the federal government or BaFin. The BMF leads at federal government level on laws, regulation and public policy related to financial supervision, while other ministries, including the Ministry of Justice, have responsibility for aspects of the overall framework.

8. **Federal State authorities and Chambers of Industry and Commerce also have a supervisory role.** Authorities at the Federal State (Bundesland) level are responsible for supervising publicly-owned insurers whose activities are limited to the relevant federal state, as well as private insurers of lesser economic significance, representing in total only 0.1 percent of the total premium income of the market. Insurance intermediaries are subject to licensing and supervision by the Chambers of Industry and Commerce (IHK). However, BaFin exercises an indirect form of supervision over agents affiliated with licensed insurers by placing requirements on the insurer's relationship with the agent.

9. **The 2011 FSAP highlighted a high degree of compliance with (the previous version of) the IAIS ICPs.** Amongst other points, it identified some areas for improvement that are relevant to the scope of this Technical Note:

- Further development of a risk-based supervisory approach, including the expansion of group-wide supervision and supervision of insurers' investments; progress in this area is addressed in the analysis of ICPs 9 and 15;
- Development of stress-testing capacity and analysis of longer-term effects: ICPs 9 and 24;

- Increase in the frequency and number of on-site inspections: ICP 9;
- Increase in the number of staff with actuarial expertise and related quantitative skills: ICPs 2 and 9; and
- Enhancement of reporting requirements for insurers as well as the shortening the time lags in the publication of aggregate insurance data: ICP 9.

10. Most of these recommendations have been addressed since 2011. Solvency II implementation has required BaFin to address these issues and many of the FSAP recommendations are reflected in the new supervisory approach.

Insurance guarantee schemes

11. Since the end of 2004, there have been statutory guarantee schemes for life insurance and substitutive health insurance. The guarantee funds are supervised by BaFin. There are two schemes, for life insurers and health insurers. The schemes have not so far been called upon to support a failing insurer, although the life insurance scheme originated in a private sector mechanism that was used to support the failing life insurance company Mannheimer Life in 2003.

12. The role of guarantee schemes is to provide continuity of insurance policies. They do so by transferring the portfolio of a troubled insurer to the scheme. BaFin can order such a transfer without consent from the insurer, the guarantee scheme or policyholders. However, the schemes do not compensate any loss caused by an insurance company's failure. In principle, claims are secured, but BaFin must reduce contractual benefits by up to five percent if the resources of the scheme are insufficient and the scheme itself may amend the insurance terms and tariffs of the transferred portfolio, if reasonable. BaFin can take measures to prevent a large number of contract cancellations.

13. All life and private health insurers must be members of the guarantee schemes and the scheme for life insurers has ex ante financing arrangements. The life insurance scheme is funded up to 1 per mill of the net technical provisions of all members. Currently the fund for life insurance has around EUR 900 million in assets. Should these be inadequate to support a transferred portfolio, special contributions of another 1 per mill of the net technical provisions can be levied from members. In addition, life insurers have committed, under private arrangements, to raising a total of 1 percent of net technical provisions (around EUR 9.0 billion). The health insurance scheme is funded on an ex-post basis and there is no contribution until a call is made on the guarantee. There is no guarantee fund for P&C (Property and Casualty) insurers other than for motor vehicle third party liability insurance.

C. Market Structure, Insurance Products and Industry Performance

14. There are 413 insurance companies supervised by BaFin.[3] Many are small mutual companies (139 in total). The total investments of insurers in 2014 were EUR 1,569 billion, composed of life insurers (EUR 911 billion), health (EUR 232 billion), P&C (EUR 154 billion) and reinsurers (EUR 272 billion).[4] The number of insurers has been declining since 2008, from 460 to 413. While most of the decline occurred through mergers or takeovers, a few firms failed or were suspended by BaFin every year.

15. The insurance industry remains profitable with high solvency ratios, although careful analysis is needed of these numbers, especially in the case of life insurers. Average ROEs in the last three years are 6.6 percent for life, 4.0 percent for P&C and 8.3 percent for reinsurers. The average solvency ratios at the end of 2014 were 163 percent for life insurers, 312 percent for P&C and 885 percent for reinsurers. In the past few years, life insurers have been required to generate profits to address additional reserving requirements in place since 2011 (ZZR—see Main Findings, section A below), and the majority of them appear to have been made by recognizing unrealized gains on fixed income securities. The underlying performance of life insurers could therefore be much lower than the published figures. P&C insurers are also facing growing pressures on profitability from competition and, in motor insurance, a pronounced underwriting cycle.

16. German life insurers invest conservatively. The largest shares of life insurers' investments are allocated to government securities (25 percent) and mortgage bonds (21 percent), which are ultimately financed by the originating banks, followed by bonds of financial institutions (11 percent).[5] Exposures to equity and other risky assets are limited (equity 6 percent of the total, alternative investments 1 percent). Loans and real estate also account for small shares (mortgage loans 6 percent, other loans 6 percent and real estate 4 percent). Investment allocation of non-life insurers (P&C and reinsurers) is similarly conservative.

17. Products with guarantees still dominate the life insurance market and non-life insurance comprises mostly traditional lines of business. Unlike insurance markets in other advanced economies, products with minimum guarantees (including participating policies) dominate the German insurance markets. Unit-linked and related products account for less than 10 percent of the total liabilities of life insurers. Data on premiums from new sales of unit-linked products (which account for about 15 percent of total premium income in the last five years) suggest that the share of such products will increase in the future but only gradually. Non-life insurance is also dominated by traditional lines of business (such as motor, property and liability).

[3] In addition, there are approximately 1,000 insurers which are not supervised by BaFin but by Federal State (Bundesland) level authorities.

[4] Total assets of the banks are EUR 8,315 billion.

[5] All the ratios in this paragraph are against total asset unless mentioned specifically.

The share of less traditional business lines, such as credit and surety insurance is small (less than 1 percent of total premium income). Therefore, the potential risk is limited.

18. Distribution channels are mostly traditional, with the majority of sales being transacted through single-tied agents. The share of single-tied agents is more than 40 percent in life and P&C and 50 percent in health insurance. While the bancassurance channel is growing, it still accounts for less than 20 percent of the market, even in life sales. Tied agents are supported by relatively high levels of commission, although there is some expectation that this will start to fall as a result of recent regulatory changes (the Life Insurance Reform Act—see below).

19. Bank—insurance linkages and interconnectedness with other parts of the financial sector are limited, compared with neighboring countries. While complete details on ownership structures are not publicly available, there is only a small number of significant insurers which are part of a group that also includes significant banking, and the majority of small insurers are independent from other financial sectors. Because the traditional insurance products that comprise much of the German life insurers' balance sheets require relatively limited hedging, material linkages to other parts of the financial sector are not through derivatives but through large holdings of mortgage bonds issued by banks. These accounted for 18 percent of the total assets of life and non-life insurers at the end of 2014.

20. Linkages between German banks and insurers declined after the 2008 financial crisis and are mostly domestic. Bank liabilities financed by insurers fell from over 6.5 percent of the total at end-2008 to around 4.5 percent in mid-2015. Similarly, claims of banks on insurers fell from around 0.1 percent of the total to 0.04 percent over the same period. Almost all claims and liabilities of German banks towards the insurance sector in the EU result from linkages with German insurers.

MAIN FINDINGS

A. Key Risks and Vulnerabilities

21. Despite a still generally conservative investment profile, evidence of search for yield has been emerging in the last few years (Figure 1). Against the backdrop of prolonged low interest rates, life insurers increased the share of corporate bonds in total investments from 4.3 percent in 2011 to 6.9 percent in 2014. The average ratings in the fixed income portfolio of life insurers have reduced, including through rating downgrades without active changes in asset allocation. The portion of securities with a AAA rating fell from 44.8 percent to 35.6 percent between 2011 and 2013, while the share of those with a BBB rating rose from 7.1 percent to 12.8 percent, reflecting rating migrations. German insurance groups have also stepped up their investment into non-German sovereign bonds. For example, investment in Italian government bonds increased by 5 percent and in Spanish government bonds by 25 percent from 2013 to 2014, albeit from a low base, while exposures to the German federal government fell somewhat at the same time.

Figure 1. Evidence of Searching for Yield

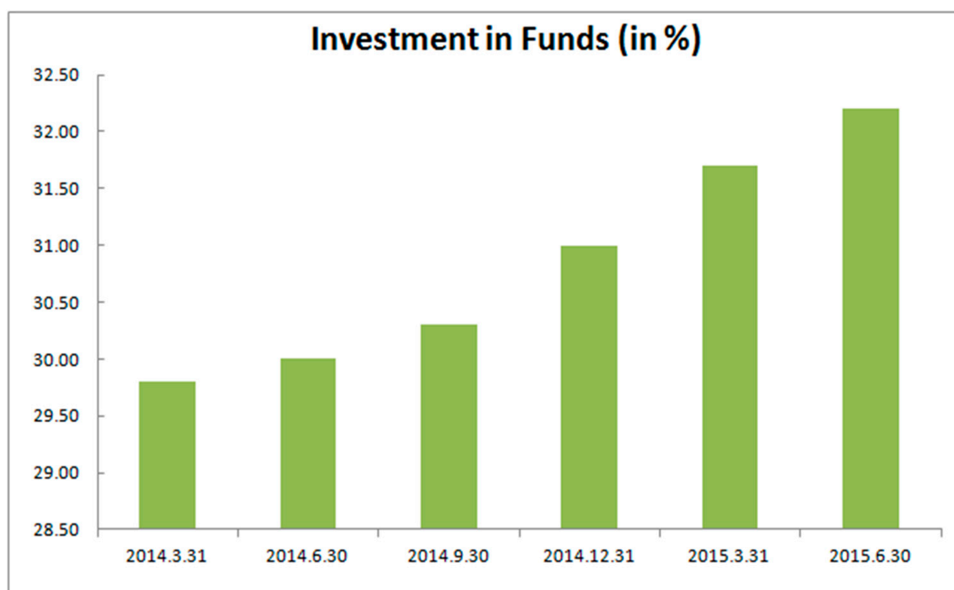
Rating distribution for fixed-income portfolios of German life insurers

Sources : Bundesbank.

22. German insurers have also allocated a significant share of investments into funds (Figure 2). As of the end of 2013, life, health and P&C insurers allocated 23 percent of their assets to bond funds and 3 percent to equity funds. Total investment in funds now exceeds 30 percent of their assets. Most of the securities (including securities lending transactions) in the funds can be looked through by insurers. Funds which cannot be looked through account for less than 2 percent of total assets. BaFin's insurance supervisors do not have access to data on the derivatives used by the funds and have no scope to require additional reporting (the Solvency II reporting templates are stipulated by EIOPA). However, all derivatives are now covered by reporting required under the European Markets Infrastructure Regulation (EMIR) and BaFin's insurance supervisors are cooperating with its securities supervisors on a reporting system for EMIR data that will enable insurance supervisors to access information and analysis on all derivative to which insurers are a party, whether directly or through any type of investment fund.

Figure 2. Investment in Funds by German Insurers

Total investment in funds exceeds over 30 percent of their assets.



Source: BaFin.

23. Life insurers are exposed to the risks from offering significant guarantees on the longest term policies (Figure 3). According to the European Insurance and Occupational Pensions Authority (EIOPA), the average rate for existing products guaranteed by German insurers is one of the highest among European countries. In addition, the duration of liabilities is high compared with other European countries (Figure 4). While the average duration of insurance liabilities is hard to estimate owing to complex contingencies inherent in insurance products and longer duration could entail a degree of resiliency resulting from the promise of future discretionary bonus, it is clear that high guarantees are a key feature of the balance sheet of German life insurers and they need to continue to cover the guarantee costs for substantially longer periods than insurers in other countries.

Figure 3. Share of Products with Minimum Guarantees

Both the share of guaranteed products and the guaranteed rate of existing policies in Germany are high.

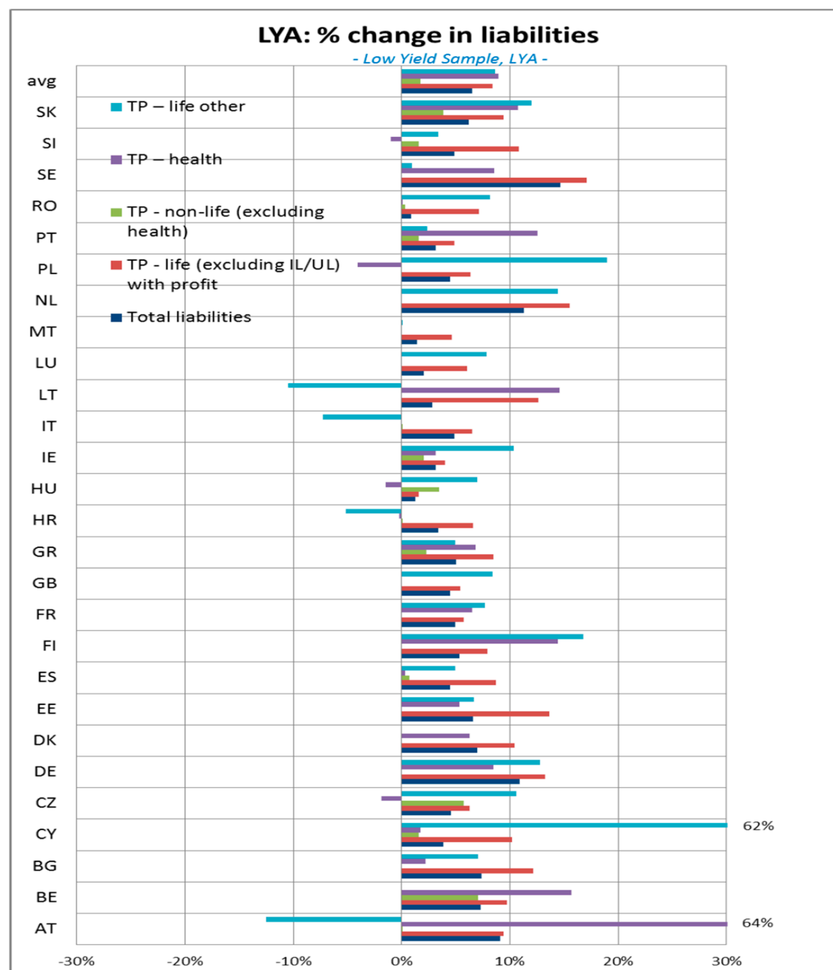
Country	Guaranteed rate on backbook (%)	Maximum guaranteed rate on new business	Share of traditional life reserves	Profitability
Germany	3.00	1.25	70	Negative
France	1.00	0	77	Neutral
Italy	1.60-1.80	0	80	Neutral
Denmark	2.50	0-1.50	71	Neutral
Sweden	3.30	0	57	Neutral
Norway	3.00-3.50	0-2.00	85	Neutral
Finland	3.00-3.50	0-1.50	42	Neutral
U.K.	0.5	N.A.	19	Neutral
Spain	3.00-3.50	1.00	88	Neutral
Austria	2.80-2.90	1.00-1.50	65	Neutral
Netherlands	3.50	N.A.	60	Neutral
Belgium	3.00	1.00-1.75	85	Negative
Switzerland	1.00-1.75	1.00-1.75	92	Neutral

Sources: S&P and BOE.

24. Owing to the dominance of guaranteed products, prolonged low interest rates are affecting the financial soundness of life insurers. While maximum rates for valuation purposes are set by the Ministry of Finance (effectively setting a maximum rate on the guarantee that can be offered on new product sales) and have been reduced gradually in accordance with market rates to 1.25 percent, the maximum rate applies only to new policies and the guarantee rates for existing policies remain as when they were sold and cannot in practice be reduced. The average guarantee rate has gradually reduced to 3 percent. However, the average investment return has declined more rapidly. According to the internal measures of German insurers participating in the 2014 EIOPA stress test, the effective investment spread has already turned negative (-0.4 percent).

Figure 4. Duration of Liabilities

The duration of German Life insurers' portfolios is high compared with other European countries. It shows sensitivity of insurance liabilities under the change from baseline to the Japanese-like scenario ("LYA") used by EIOPA in its 2014 EU-wide stress test. The duration of liabilities of German life insurers could be estimated as approximately 11 years.



Sources: EIOPA.

25. **The authorities have sought to reduce some of the pressures on life insurers through legislative change in 2014 (the Life Insurance Reform Act), although the overall impact has apparently been limited.** Legislators amended the regulatory framework to improve the soundness of life insurers. Key measures were:

- A reduction of the maximum valuation interest rate for new insurance contracts from 1.75 percent to 1.25 percent as of January 1, 2015;

- The limitation of policyholders' dividends from unrealized gains from fixed income instruments; policyholders may now participate in their respective valuation reserves of fixed-income

securities only if the valuation reserves are greater than the amount needed to safeguard the interests of continuing policyholders; and

- Flexibility for insurers to offset loss from investments with gain from insurance risk assumptions (such as mortality), when determining amounts to be allocated to policyholder dividends.

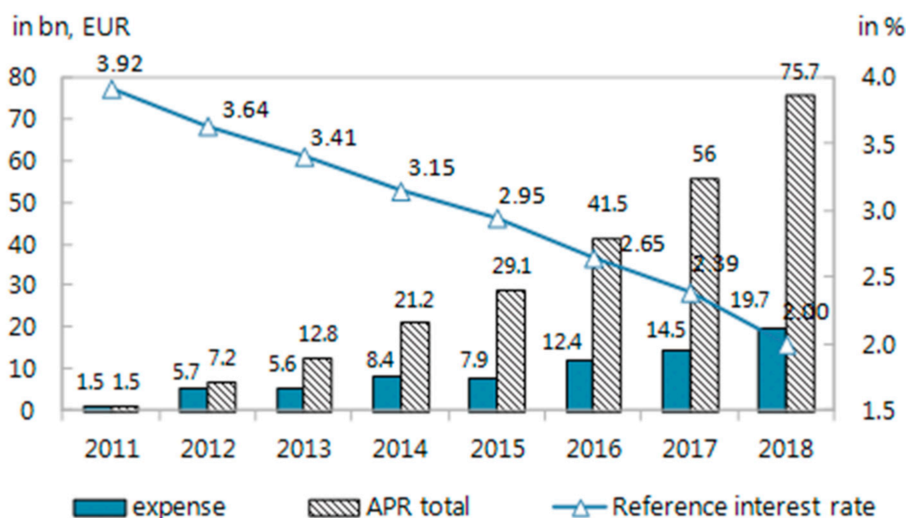
However, these reforms were balanced by measures to increase the minimum allocation of policyholders' dividends from insurance risk assumptions from 75 percent to 90 percent. The reduction in the planned participation of policy-holders when policies mature seems to be particularly significant. On the other hand, as the insurance risk component is the main source of current profit, market participants identify a mixed, though overall net beneficial impact of the reform measures on the long term financial soundness of life insurers.

26. The national GAAP-based valuation requirements under Solvency I are requiring life insurers to build additional reserves (ZZR) to reflect the low interest rate environment. Since 2011, insurers have been subject to an Additional Interest Provision (Zinszusatzreserve or ZZR), which requires them to hold a reserve for each policy that guarantees a return above the reference rate for expected asset returns. The required reserve equals the interest rate shortfall that is expected to arise over the next 15 years. The reference rate is set as the 10-year average of the zero-coupon euro swap rates with a duration of 10 years.

27. Additional ZZR will be needed in coming years (Figure 5). As a consequence of the steady downward movement of rates during the past decade, the reference rate may keep falling for some time in the future. In 2014, a further EUR 8.4 billion was added to ZZR, resulting in over EUR 20 billion having been allocated to the ZZR on a cumulative basis at year-end 2014. If the reference rate moves higher, the ZZR reserves which have been set aside for the policies whose guarantee rate is lower than the reference rate will be released and made available to policyholders.

Figure 5. Estimation of Additional Premium Reserve (ZZR)

Additional Premium Reserve will be increased significantly in the next few years if the current low interest rate environment persists.



Sources : BaFin.

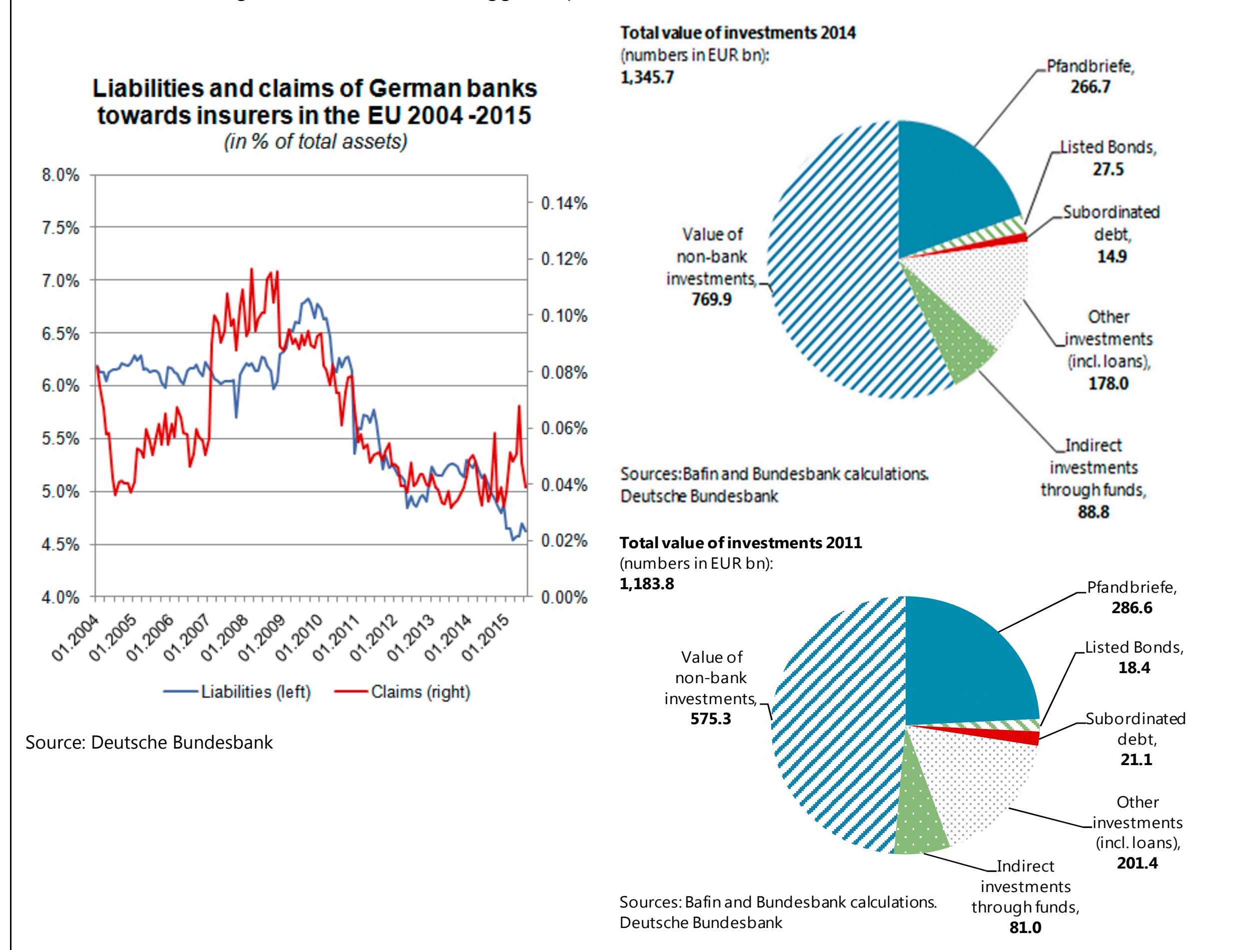
28. In the near future, some life insurers face a risk that their financial situation under national GAAP will worsen and diverge from the Solvency II-based measurement. The existing valuation requirements, including the ZZR, continue to apply after January 1, 2016 for accounting purposes. If the current low interest rate environment persists, life insurers are expected to be required to continue to add to the reserve by more than EUR 10 billion annually from 2016, with cumulative reserves reaching over EUR 70 billion in 2018.

29. Insurers may face increasingly difficult choices on how to finance the additional reserves in the future. The majority of allocations to the ZZR appear to have been financed by realizing previously unrecognized gains on the assets side of the balance sheet. Some insurers are facing difficulties in finding liquid assets on which to realize gains and are conducting costly transactions (such as the sale and lease back of real estate) to generate gains to meet ZZR requirements.

Figure 6. Liabilities and Claims of German Banks Toward Insurers in the EU 2004–2015

(In percent of total assets)

Shocks in the banking sector would have a bigger impact on the insurance sector than vice versa.



30. While primary insurers' claims on banks make up a significant share of assets, most are internationally diversified, secured claims, bringing limited contagion risk (Figure 6). Life insurers are the largest investors in bank claims, accounting for 67 percent of the total of primary insurance companies. A large share of these are secured investments (e.g., Pfandbriefe/covered bonds). Contagion risks from banks to insurers are limited, unless collateral values deteriorate significantly. About 25 percent of total investments are in German banks and others are invested internationally. These investments constitute about 5 percent of total liabilities of German banks (excluding derivatives). About 50 percent of investments from insurers into banks are claims on the major German banking groups with an international focus. A significant share of total claims is through Pfandbriefbanken.

31. BaFin and the insurance industry are aware of cyber risks. Some market participants see a business opportunity for the insurance industry. The global cyber risk market may now be worth some US$ 2 billion in annual premiums and German reinsurers are active in the market. On the other

hand, cyber risk also brings hidden exposures in general liability household insurance. For example, power outages due to a cyberattack may be covered by such policies. Insurers are seeking to evaluate this exposure and reduce the risk by redesigning policy terms. Insurers are also seeking to improve their IT systems to improve their own resilience to cyberattack and BaFin is monitoring progress, including through the internal model approval process of Solvency II.

B. The Implementation of Solvency II

32. The authorities have been in the process of implementing Solvency II for a number of years ahead of its 2016 effective date. BaFin has worked within the 2014 guidelines of the EIOPA, in particular its two-year preparation phase, which established four key areas of work:

- Requirements for business organization and risk management;
- Forward-looking assessment of own risks;
- Pre-application for internal models; and
- Reporting.

The approach applies to all insurers, reinsurers and groups to which Solvency II applies (around 90 percent of all insurers with a much larger aggregate share of the total market).[6] Even before 2014, BaFin took account of the likely demands of Solvency II in supervisory discussions with insurers, for example on their approach to establishing the control functions required by the final legislation.

33. Revised insurance supervision legislation is in place. The Act to Modernise Financial Supervision of Insurance Undertakings, enacted in April 2015, sets out the new valuation requirements, own funds rules, provisions on the calculation of the Solvency Capital Requirement (SCR), governance requirements for insurers, a new framework for supervision of insurance groups, adjustments available to insurers offering long-term guarantees and Solvency II's transitional arrangements, aimed at cushioning the impact of the new requirements in the 16 years out to 2032.

34. BaFin required insurers to use standardized status reports to track implementation progress. These reports were used to assess the progress being made by individual insurers on each element of the preparatory work, which BaFin further divided into 15 thematic blocks, and to focus supervisory, including on-site work. The standardized reports were also used to test whether insurers' managements were aware of and responding to issues in their implementation programs.

[6] Article 211 of the VAG, which reflects Article 4 of the Solvency II Directive, provides that very small insurance undertakings are excluded from the application of Solvency II and will apply Solvency I requirements. They have market share considerably below 1 percent of the German insurance and reinsurance market (based on gross written premiums). As small insurance undertakings, funeral expenses funds are also not within the scope of the Solvency II Directive (Article 219 of the VAG).

35. A particular emphasis has been placed on the reporting and disclosure requirements. The extent of these new requirements has presented challenges for insurers in ensuring the accuracy and completeness of reporting, at group and company level; and for BaFin in building the required database, analysis and supervisory capacity to make appropriate use of the reporting in its supervisory processes from January 2016. During 2015, BaFin required insurers—on a voluntary basis—to submit both annual narrative and quantitative reporting, as well as third quarter quantitative reporting. Most German insurers submitted their reports in the required new quantitative templates (Quantitative Reporting Template—QRT) using the transmission standard XBRL (eXtensible Business Reporting Language). Furthermore, most of the German insurers also submitted narrative reporting which consisted, similar to the quantitative reporting, of a subset of the envisaged future reporting requirements (Regular Supervisory Report (RSR)).

36. Preparatory work for internal models work has also been a major focus. BaFin established a separate central unit on quantitative issues (now 18 staff, up from 13 in 2010) and worked since 2009 on the pre-application process of the six groups planning to apply for internal models. The objective was to conduct a full review of key model features (together with the other responsible supervisors), including qualitative requirements such as model governance and the "use test" (whether the model is used in key business decisions and controls) ahead of the formal application process, which is limited to six months under the Solvency II directive. The adequacy of documentation was a key focus, as was model validation. The process involved extensive on-site work at the applicant groups.

37. For international groups, the internal models work has been carried out jointly with other supervisors. BaFin has worked with supervisors from the EU and other countries to review models, usually through a core team of supervisors responsible for the most significant parts of the group. BaFin has also participated in EIOPA's Solvency II internal models committee which provided a forum to compare experience (it has no role in respect of individual model approvals). Internal model approval decisions were being made in late 2015 under the collective decision-taking arrangements established by the directive. BaFin has the leadership role in decisions affecting applicant groups for which it is group supervisor, and access to the process and the decision on approving group internal models at groups for which it is host supervisor.

38. In addition to internal models, the new requirements give insurers a number of other options requiring BaFin approval:

Models may be used on a full or partial basis;

- There is provision for the use of undertaking-specific parameters in the Solvency Capital Requirement (SCR) standard formula;
- The use of transitional measures for the calculation of technical provisions;
- The use of the volatility adjustment for deriving the risk-free rate curve; and

- An allowance of ancillary own fund items.

BaFin has made clear to insurers that applications for internal model approval should be made only by companies with the most advanced risk management frameworks. Relatively few insurers were applying for internal model approval compared with some other EU countries, but more were applying for approval to use the volatility adjustment and transitional measures. BaFin has discussed with some life insurers whether they should consider applying for use of such approaches, where they do not already plan to do so, to reduce the likelihood of not meeting their SCR. BaFin's approval is still required.

39. While implementing the new requirements, BaFin has identified issues requiring guidance to insurers. BaFin considers that the specific features of the German insurance market require further explanations to ensure a consistent application of the requirements. It has in particular issued guidance about how to adjust components of own funds (specifically the surplus fund and future discretionary benefits) to avoid double-counting of loss absorption capacity arising from a potential reduction of potential dividends to policyholders. The need for this guidance reflects the arrangements for the allocation of surplus between policyholders and shareholders on traditional life insurance policies in Germany.

40. Surveys have been used to assess the impact of the new solvency requirements on life insurers. A survey based on balance sheets at December 31, 2013, with projected numbers as of January 1, 2016, was conducted in 2014, and insurers were asked, in response to further falls in interest rates, to submit updated numbers in mid-2015 based on their end-December 2014 positions. The results were used by BaFin to identify insurers with less strong solvency positions under the new requirements (below or near the level of the SCR), leading to discussions on potential measures that could be used by these companies in the transition to Solvency II. Life insurance was targeted for this work because of the pressures faced by the sector in the low interest rate environment and all life insurers subject to Solvency II had to submit reports.

41. The surveys showed that significant numbers of insurers were likely to be dependent on the application of transitional measures to meet the minimum requirements from 2016.

- In the initial survey, only a few insurers with a collective market share of less than 1 percent were unable to show that they could meet the new requirements despite having applied the transitional measures. Without these measures, however, about 25 percent of insurers, with a collective market share of about 10 percent, would not meet the SCR as of December 31, 2013.

- In the second survey, based on end-2014 positions, the number of life insurers unable to show they could meet SCR had not increased, but because of the further falls in interest rates, almost half of all insurers were dependent on use of the transitional measures to meet their SCR and would have had a collective shortfall of some EUR 12 billion in own funds (which compares with some EUR 60 billion in total life sector own funds).

42. BaFin has made the aggregate results of its surveys public, emphasizing the challenges for some insurers in a low interest rate environment. A summary of both surveys was published. As well as noting the small number of insurers unable to meet the minimum requirements at 2016, BaFin noted that, as the transitional measures will be gradually phased out over 16 years, insurers will have to make major efforts to strengthen their capital in that period. The survey was conducted on the basis that insurers could take into account their preferred use of long term guarantee measures—in practice the volatility adjustment was the measure most chosen by German life insurers (see Box 1).

Box 1. Long-Term Guarantee and Transitional Measures

The Long-Term Guarantee Impact Assessment run by EIOPA in early 2013 found that under Solvency II, with no long-term guarantee measures in place, more than half of the participating life insurers (across the EU) would have been undercapitalized. Various adjustments were developed in response and these measures are expected to reduce the number of such insurers significantly. The matching adjustment and volatility adjustment may be used by long-term guarantee providers on a permanent basis, while transitional measures are available for 16 years. German life insurers are most likely to use the volatility adjustment as the conditions required under matching adjustment are likely to be hard for them to meet.

- **The matching adjustment** is made to the yield curves for the valuation of predictable liabilities which are cash-flow matched using fixed income assets—where matching assets can be held to maturity and the insurer is consequently not exposed to price movements, only to the risk of default. Supervisory approval is required and is subject to conditions, including that the insurer has determined a portfolio of assets consisting of bonds and other assets with similar payment characteristics and retains the amount; the portfolio is managed separately; there is no essential risk of mismatch, and the policies give limited options to policyholders. Redemption should be limited to the value of the matched assets.
- **The volatility adjustment** aims to avoid pro-cyclical investment behavior of insurers when bond prices deteriorate owing to low liquidity of bond markets or exceptional expansion of credit spreads. The adjustment has the effect of stabilizing the capital resources of insurers and will be set by EIOPA.
- **The 16 years transitional arrangement** will allow insurers, on BaFin's approval, to use discount rates applying in December 2015 for valuation of insurance contracts concluded before the start of January 2016. However, the benefit is to be phased out gradually in each year linearly (for example, the benefit will be reduced by half by 2024) to zero by the end of 2032. BaFin has introduced an additional measure to limit this benefit so that the Solvency II requirements (with this transitional arrangement) are more conservative than insolvency measured by national GAAP.

Insurers using the matching adjustment, volatility adjustment and transitional arrangements are required to disclose Solvency II figures with and without application of these measures. Some large insurers have already announced that they can meet Solvency II requirements without transitional arrangements. The implications for those who do rely on transitional arrangements will need particular supervisory attention, given the transparency which goes with these measures. It may be unclear to policyholders and market participants how to interpret the different bases for solvency, with and without adjustments and transitional measures.

43. Health insurers have been surveyed by their trade association and appear likely to meet the new requirements. In 2014 and 2015, the Association of Private Health Insurers surveyed private health insurers on a basis similar to BaFin's survey of life insurers. Almost all took part and all

were able to meet the new requirements, despite the impact of low interest rates. Unlike life insurers, they are able to adjust premium rates to compensate for the effect of low interest rates.

44. P&C insurers and reinsurers have not been subject to surveys of the same type as life insurers, either by BaFin or other bodies. BaFin took the view that the impact on these types of insurance company was more limited than on life insurers. For major companies, supervisors have held discussions with management and many large and listed companies have made disclosures about the expected impact. While P&C insurers and reinsurers have not been subject to surveys, the majority of insurers have participated in voluntary quarterly and annual reporting exercises and some were included in the EIOPA group level stress test in 2014. In particular, reporting on end-2014 financial positions under the QRT process covered about 90 percent of all insurers.

Assessment

45. The process of Solvency II implementation has been rigorously managed. While some detailed measures were outstanding, the regulatory work was largely complete as at end-2015. BaFin has been able to deploy expert resources on the demanding internal models work, which has also required an unprecedented level of international cooperation. It has carried out extensive internal preparations, including training. Industry feedback to the FSAP mission highlighted the thoroughness of the approach, including rigorous follow-up on issues raised in the preparatory discussions. International coordination was noted as having a major impact, although it was also observed that agreement amongst supervisors had not always been achieved. The implementation process has been facilitated by a 35 percent increase in staff in BaFin's insurance and pension fund supervision directorate since 2010 as well as the growth of the specialist models unit.

46. There remains uncertainty about the likely impact on the insurance sector. While BaFin has executed surveys of the life insurance companies and collected test reporting data, it has taken the view that it is the responsibility of management of insurers to ensure their preparedness for the new requirements. It has also been aiming at a moving target, given developments in markets and the absence of reporting on a Solvency II basis other than the voluntary quantitative and narrative test reports in 2015.

47. BaFin has, however, maintained a watchlist of a number of companies where they may not meet Solvency II SCR. BaFin is having continuing discussions with such insurers. It will need to maintain this intensive supervisory approach through the initial live reporting period and in future periods of market volatility given the relative sensitivity to changes in market prices of Solvency II balance sheets and SCR numbers.

48. The principles underlying Solvency II, particularly market consistent valuation, represent a major change for German life insurance. Under German GAAP, valuation of life insurers' stock of past business has been based on historic cost principles. Liabilities are valued at the valuation rate in force when the contract was sold; assets are valued at the lower of cost and market. Both sides of the balance sheet are insensitive to changing market conditions. Solvency II is based on the principle that valuation should be consistent with current market prices. In a

continuing low interest rate environment, a market consistent approach would require many life companies to raise significant new capital, even if the risks for which the capital would be required may not arise for some years; and even if the insurer remained solvent under a national GAAP measurement. This would be likely to accelerate the changes in business model that would eventually also be required under historic cost accounting.

49. In recognition of the potential impact in Germany and other EU markets, mitigating measures were included in the Solvency II legislation, which supervisors now need to use judiciously in the light of national conditions. Insurers offering long-term guarantees can make a number of adjustments, as mentioned; and all insurers may seek approval to apply transitional measures out to 2032 (see Box 1). The impact of the application of these measures varies by business model and insurer and, on the evidence of BaFin's surveys of the life insurers, can be significant. Furthermore, insurers will be required to make reports (under the disclosure requirements of the new legislation), from 2017 showing their SCR with and without the application of the adjustment and transitional measures.

50. It is important that BaFin continues to plan for management of the transitional period, assuming many companies will be affected. BaFin is aware of the need to ensure that mitigating measures included in the directive are appropriately used by companies most challenged by the adjustment to Solvency II. Insurers using the transitional measures have to submit an annual report to BaFin describing the measures they will take to increase capital or reduce their risk profile to meet the SCR without transitional measures. A structured approach to this process, as well as regular reporting by BaFin on the progress of affected firms on the model of its publication of the surveys in 2014 and 2015, will help to ensure confidence in the integrity of the process.

51. Solvency II Implementation in Germany is more complex than in other EU countries owing to nature of the insurance products and continuing importance of national GAAP. In particular, policyholder bonuses, a key feature of traditional life products, will continue to be determined on a national GAAP basis, which differs fundamentally from Solvency II. Life insurers therefore need to project future national GAAP valuations to derive an estimate of discretionary bonuses payable to policyholders as well as potential movements in deferred tax assets and liabilities and other inputs into the Solvency II calculations. The national GAAP process therefore has a significant impact on the new solvency figures, while the Solvency II framework applies only to the regulatory solvency calculation. Even insurers using the standardized approach available to small insurers need to use complex models to compute their solvency figures. Supervisory oversight will be required to ensure that complexity does not lead to under-valuation or misreporting.

52. The continuing importance of national GAAP for regulatory purposes requires continued attention to GAAP standards for insurers, including the ZZR. The continuing significance of national GAAP in determining policyholder bonus allocations (and so the fair treatment of policyholders), in providing key inputs into the calculation of solvency requirements and as the basis for determining when an insurer is insolvent makes it important that the authorities keep GAAP requirements and their impact on regulatory objectives under review. The contribution to policyholder protection of the additional premium reserves (ZZR) required under national GAAP

since 2011 has been significant. The calibration of the ZZR should be kept under review in the light of prevailing interest rates. The relationship between national GAAP and Solvency II is discussed in more detail in Box 2.

53. Even though the impact of Solvency II market consistent valuation is subject to dampening and transitional measures, expected business model changes are now occurring. The predominance of traditional products in German life insurance business reflects the value which policyholders have placed on guarantees. It also reflects past and present tax advantages, for endowment policies until the late 1990s and at present in respect of annuities. Policies that are sold as a substitute for social insurance (Riester) are required by law to have guarantees. An increasing number of insurers have announced a withdrawal from traditional policies—reflecting a combination of the low rates environment and Solvency II.

54. The impact of such changes on the financial position of life insurers will be slow to take effect. Many of the new products also offer guarantees, although for shorter periods or limited to the value of premiums paid. While sales of hybrid policies (unit-linked with a guaranteed element) are increasing, sales of pure unit-linked policies, where the investment risk is entirely for the policyholder, are limited. As noted, the short term impact of new sales on the risk profile of life insurers is low due to the scale of past business, the inability of insurers to change the guarantee provisions of past policies and the constraints on disposing of old business in the current market environment (despite provisions in law for portfolio transfers subject to BaFin approval). There has also been limited merger activity involving life companies, but this may increase in response to the new requirements. Again, BaFin is well-equipped to assess and approve such changes.

55. Solvency II implementation has also been influencing investment policies. As noted, there is evidence of some search for yield by life insurers in the low interest rate environment. In discussions with the FSAP mission, insurers noted that the expectation of new, more risk-sensitive capital requirements is deterring insurers from taking on more risk in their investment portfolios.

56. BaFin plans to continue with staff training and broader change management to complete the internal transition to Solvency II. The FSAP mission observed a high degree of awareness of the key features of the new regime. The transition started early and has been a continuing process, with most supervisors now experienced in evaluating aspects of the new approach, whether the governance and risk management requirements or the impact on solvency measurement. Supervisors need to continue to maintain an understanding of national GAAP, for its input into the distribution of surplus and solvency calculations, as mentioned, in portfolio transfers and in triggering insolvency. Supervisors of groups with approval to use internal models need to incorporate an understanding of key properties of such models into their supervision. BaFin plans to maintain specialist resources to support this work, with a program of continuing model reviews.

57. The challenges of delivering effective supervision in a more principles and risk-based framework are understood, but are not easily met. While there are extensive detailed requirements in the Solvency II framework, some aspects such as governance and risk management requirements are more principles-based, as are the new investment rules. There is scope for insurers

to use own assumptions. More judgment is likely to be demanded of supervisors than under current requirements. It will not be possible to rely on mainly quantitative analysis or compliance-based supervision. There will be more limited scope to gather evidence of specific non-compliance before intervening, if intervention is to be effective.

58. The FSAP mission observed that while significant change has been delivered, there appears to be scope for more. BaFin is aware of the need to continue with its change management program to effect the necessary change in approach. For example, there could be scope to reduce the time spent on routine or reactive processes (subject to the need to ensure consistency of approach) and the internal reporting on financial returns. The developing risk classification system appears a valuable tool in this regard. It will also be important, in a more principles-based environment, to ensure that the senior management of insurers are fully apprised of the BaFin's supervisory view and the actions they are expected to take. Again, the risk classification seems likely to support this process and BaFin should use the output of the system as the basis for communications with management.

59. External communications on the impact of Solvency II will also need to be carefully managed. Much of BaFin's external communication has been aimed at insurers and market participants and has focused on progress with implementation. Future disclosures will be governed in part by EIOPA's technical standard setting out the scope and granularity of information that supervisory authorities should make public. Guidance for policyholders, agents and others could usefully be prioritized, reflecting the challenges of interpreting insurance company disclosures in Germany given the importance of national GAAP, and the widespread use of transitional measures (see Box 2).

Box 2. The Relationship Between Solvency II and National GAAP in Germany

Solvency II introduces a more market consistent approach to valuation, but in Germany only for solvency purposes. Until Solvency II implementation, German insurers had to use national accounting standards for both financial reporting and supervisory purposes. National GAAP requires a broadly lower-of-cost-and-market value approach. Solvency II by contrast requires broadly market consistent valuation of both assets (market value) and liabilities (the best estimate of future cash flow plus explicit risk margin), but is to be used in Germany only for solvency (i.e., supervisory) purposes.

National GAAP will nonetheless remain important as an input into the solvency calculation and for wider purposes. Even after Solvency II implementation, national GAAP remains the basis for insurers to calculate dividends for shareholders. It will be used in the calculation of bonuses for policyholders under the contractual provisions of insurance life insurance policies, the majority of those outstanding, which give policyholders profit participation rights. National GAAP will therefore also drive key inputs into solvency calculations—because insurers must include future discretionary bonuses payable to policyholders in the calculation of cash flows for valuation purposes and can deduct from capital requirements an amount for loss absorption capacity based on the future discretionary bonus reflected in technical provisions (see Annex, ICP 17). In addition, national GAAP is also the basis for the calculation of the "guarantee assets" which must be held as a source of policyholder protection in case of insolvency (see Annex, ICP 12).

The relationship between national GAAP and Solvency II figures is not straightforward. Under the current low interest rate environment, Solvency II produces a generally more conservative result than national GAAP (i.e., a less strong financial position). However, due to the adjustments made to both national GAAP (such as Additional Premium Reserve requirements or ZZR) and Solvency II figures (including the 16-year transitional arrangement and volatility adjustments—see Box 1), figures based on national GAAP will be the binding constraint on many insurers in the short to medium term. In a normal market environment for interest rates, the relationship between the two measures will be influenced by the impact of critical assumptions in Solvency II (including the Ultimate Forward Rate and basis for extrapolation of longer term rates) which are not as conservative as valuation requirements under national GAAP.

German implementation of Solvency II is therefore relatively complex and communication of the financial position of the industry and the basis for policyholder bonuses will be challenging. Any useful explanation of the financial soundness of the industry cannot be made without also explaining how the two valuation regimes interact, which may be challenging even for market participants with expert knowledge. Establishing whether policyholders are being treated fairly in the allocation of surplus may also be harder. One of the unique features and source of resilience of German life insurers is their high degree of discretion in determining the amount and timing of policyholder bonus payments. While the extent of such payments will continue to be established under national GAAP, actual payments will be determined by an interaction of the two measures. Solvency II figures will be based in part on the assumption that bonuses will be significantly reduced under certain stress scenarios. It may be hard for policyholders to challenge the decisions made by insurers effectively, with potential implications for the credibility of the industry.

There would therefore be advantages in aligning national GAAP with Solvency II valuation as much as possible in the long term. The current dual approach is complex to manage and to explain, resulting in risks of misunderstanding and potentially also of delays in decision-making by policy makers in the face of stress situations. Consideration should therefore be given, in the medium to long term, to aligning the valuation standards used for financial reporting and related purposes (including determination of policyholder bonuses) with those used for solvency requirements as far as possible, building on the steps in this direction already taken with the ZZR.

C. The Supervision of Groups

61. The FSAP mission also had discussions on the evolving approach to major insurance groups. Solvency II implementation has driven significant development of a more risk-based approach to supervision that has allowed for increased resources to be focused on the large insurance groups.

62. BaFin's approach to group supervision differentiates between three overlapping sets of groups:

- **The 14 insurance groups which it regards as significant.** (A number of other groups comprise only a few small firms.) For these groups, BaFin is now applying its framework of risk-based supervision on a group basis, including its risk classification system, although the practical application of this system is still in development. (The framework is applied to solo legal entities in parallel.) The risk classification system now classifies companies and groups by impact (Very High, High, Medium and Low) as well as quality.

- **The 17 insurance groups which have subsidiaries incorporated outside Germany.** BaFin leads colleges of supervisors of these groups, as is now a requirement under EU legislation and German supervisory law, wherever there is a subsidiary in another EU country. It also participates as host supervisor in colleges of supervisors of a further 14 groups based outside Germany. A number of key processes apply to these groups under the EU colleges of supervisors' framework, including group risk assessment, crisis preparedness work and, most significant in recent years, Solvency II internal models approval, where the group has made an application. Implementation of the supervisory approach for these groups is relatively well-advanced. Although the detail of college work relies on the European framework (EIOPA has issued extensive guidelines), BaFin is also involving non-EEA supervisors in the few cases where relevant, subject to being assured of their ability to protect confidential information—which has not been possible so far in all cases.

- **The** one **G-SII for which BaFin is the group supervisor**. BaFin has established both a college of supervisors and a Crisis Management Group (CMG) in accordance with the Financial Stability Board's framework for Global Systemically Important Financial Institutions. It also participates, as host supervisor, in similar arrangements for one other G-SII—and one former G-SII, to which the G-SII arrangements continued to apply as at late 2015. For these groups, college work has also in practice focused heavily on internal models approvals in recent years, but progress has been made on recovery and resolution planning through the CMG, which also provides a forum for discussing other more sensitive issues amongst the small number of supervisors of the largest entities in the group.

63. A number of insurance-dominated financial conglomerates also fall broadly within this framework. There are six financial conglomerates of which BaFin is the coordinating supervisor, four of which are insurance dominated. There are also two financial conglomerates with large insurers in

Germany where other EU supervisors are the coordinating supervisors. BaFin invites the non-insurance supervisors to the colleges that it leads for the four insurance-dominated conglomerates.

64. BaFin has recently reorganized supervisory resources to support a group wide focus to supervision. Since July 2014, one team now supervises all or most elements of each group. All three largest groups (Allianz, Munich Re and HDI/Talanx) are supervised by a single unit each, while other units supervise a varying number of companies depending on scale. The three largest groups and the German operations of the foreign G-SII (and former G-SII) are all supervised in a single department, enabling supervisors to exchange views on supervisory practices and key supervisory issues arising on these groups. Supervision units comprise between 9 and 14 staff supported by a wide range of specialist functions, including the internal models unit. The core supervisory team consists of at least one legal expert, an economist and a mathematician or actuary.

65. For the largest groups, a distinctive approach to group supervision has been developing. This includes core supervisory processes but also puts particular emphasis on:

- A supervisory plan that draws on the risk classification, BaFin's priorities and key risk issues for the insurance sector, the college agenda, and workstreams such as the ORSA review;
- A particular focus on internal management information—an internal group risk report is received quarterly, for example;
- Regular contact with senior management, including the heads of control functions and the responsible actuary;
- Attendance, on an annual basis, at meetings of the group's supervisory board and receipt of papers sent to the board, and minutes of its meetings; and
- Working through the college of supervisors.

66. A common regulatory framework applies to all the groups. The approach until January 1 2016 has been based on the European supplementary supervision framework, which essentially provides an overlay to solo level supervision. In practice, BaFin has built on this to apply requirements on governance and risk management to the group level as well as requirements on intra-group transactions and risk concentrations. Solvency II implementation has deepened the regulatory approach with a much extended reporting framework for insurance groups and providing for internal models to be recognized at group level. BaFin already has direct powers over insurance holding companies, which hold interests only in insurers and mixed financial holding companies (a parent company within a financial conglomerate group), which enable it to take a comprehensive approach to groupwide supervision. There is extensive internal guidance and specialist expertise on group supervision issues.

67. There are no provisions in the law explicitly recognizing a separate status of G-SII. BaFin's work to date on G-SIIs has been undertaken without using specific powers and relying on using its authority over the regulated entities in the group. It has no power, for example, to impose

additional capital requirements on a G-SII (to reflect the characteristics that make it a G-SII), as is planned under the developing IAIS framework for higher loss absorbency capacity (HLA). Nonetheless, as groupwide supervisor, BaFin has implemented elements of the IAIS framework for G-SII supervision agreed to date, including the application of the initial assessment methodology (for identifying G-SIIs) and the requirements of G-SII supervision including requiring a Systemic Risk Management Plan, Liquidity Risk Management Plan and establishment of a CMG.

68. There is scope further to align BaFin's approach to the one German G-SII with other larger groups. Germany's largest insurance groups include reinsurance operations with global reach. BaFin is waiting for outcome of the current IAIS review of its G-SII assessment methodology (including consideration of the approach to reinsurance) before deciding how to develop its approach to these groups. Notwithstanding the different supervisory objectives applicable to reinsurance under German law and the outstanding issues being considered by the IAIS, BaFin could consider the application to reinsurance-led groups of macroprudential tools used in the case of primary insurance, including regular stress tests and recovery and resolution planning.

RECOMMENDATIONS

A. Key Recommendations

- BaFin should continue to maintain a watchlist and continue to require action plans where companies face difficulties in meeting the new solvency requirements or maintaining a surplus under the national GAAP.

- BaFin should ensure that companies using the transitional measures under Solvency II have a robust and credible plan for meeting their SCR requirements by the end of the 16 year-period and, where possible, earlier. This process should include stress testing to ensure that such insurers would meet the SCR even after a plausible shock.

- The calibration of ZZR requirement should be kept under review within a framework of close attention by the authorities to the national GAAP framework as it applies to insurers given its continuing importance in relation to insurance regulatory objectives, including fair treatment of policyholders.

- Supervisory priorities following full implementation of Solvency II should shift to the assumptions used by insurers using the standardized approach and on investments.

- Supervisory and specialist resources should be maintained at their current high level to manage the continuing challenge of implementation and risks that will arise during the early period after the new requirements come fully into effect.

- Given the multiplicity and high transparency of Solvency II numbers that will be available (particularly from 2017 when public disclosure requirements take effect), planning should be undertaken to ensure a high degree of public understanding of the different measures.
- BaFin should consider a more formal approach to intervention in case of a deterioration in the financial position of an insurer as measured under the national accounting framework.
- BaFin should also consider a more systematic approach to communicate requirements based on the ORSA review; and a policy framework for the imposition (and removal) of formal capital add-ons, making use of its powers in the insurance supervisory legislation.
- BaFin could consider the application to all the larger groups of macroprudential tools used in the case of the one German G-SII, including regular stress tests and recovery and resolution planning.
- BaFin should be empowered to place additional regulatory requirements on G-SIIs, including the requirements for higher loss-absorbency capacity being developed by the IAIS.

B. Other Recommendations

More details of these recommendations are provided in the Annex under the section on the applicable Insurance Core Principle.

- The federal government should review BaFin's extensive reporting requirements to the BMF and provisions for dismissal of BaFin Executive Board members to ensure they continue to support robust operational independence in the future.
- BaFin should further develop its supervisory approach to place increased emphasis on peer group analysis and peer review, especially on larger institutions; and to take a more risk-based approach to the allocation of supervisory resources to conduct of business work, for example by including more explicit conduct-related issues in its risk classification system.
- The authorities should review whether the procedures to effect transfers of insurance portfolios to guarantee schemes allow for more complex portfolios readily to be transferred; and whether it would strengthen BaFin's ability to address weak insurers if it were to have a power to require a portfolio transfer to another (willing) insurer as well as to an insurance guarantee scheme.
- In the long term, there would be advantages, from the perspective of insurance supervision, in aligning national GAAP with Solvency II valuation as much as possible to help the authorities and insurers communicate the industry's performance more clearly and to avoid unnecessary uncertainty in the market over valuation and solvency.

- Insurance supervisors should continue to coordinate with securities supervisors to monitor derivatives activities used by investment funds in which insurers are investing, given the significant share of investment allocation by insurers.

- BaFin should use the analysis developed in internal model validations to assess the SCR under the standardized approach, for example whether the assumptions on policyholder dividend reduction under certain scenarios or of taxable income for deferred tax are realistic.

- If the volatility adjustment is to be widely used by insurers, BaFin should encourage them to build up capital resources during periods of low volatility so that the volatility adjustment is used solely for countercyclical purposes.

- The FSC and German government should consider the scope for giving the FSC wider scope to take macroprudential action without the need for legislative change—to address the risk that necessary measures are delayed or not implemented owing to the political cycle.

- BaFin should make use of its powers to require significant insurers to develop recovery plans, starting with higher risk insurers under the risk classification system; and address gaps in the regulatory framework in relation to requiring companies to be ready to report necessary information in case of a crisis and to maintain contingency plans.

Annex I. Detailed Analysis of Selected ICPs

<table>
<tr><th colspan="2">Table 1. Detailed Comments on the ICPs</th></tr>
<tr><td>ICP 2</td><td>Supervisor
The supervisor, in the exercise of its functions and powers:
• Is operationally independent, accountable and transparent;
• Protects confidential information;
• Has appropriate legal protection;
• Has adequate resources; and
• Meets high professional standards.</td></tr>
<tr><td>Description</td><td>BaFin is the federal authority for financial supervision. There are also state (Land) level authorities, responsible for supervising publicly-owned insurers whose activities are limited to the relevant state, as well as private insurers of lesser economic significance, representing in total only 0.1 percent of the total premium income of the market.
Insurance intermediaries are subject to licensing and supervision by the Chambers of Industry and Commerce (IHK).
Governance of BaFin
BaFin’s governance and internal organization are defined in its governing legislation (FinDAG), its rules of internal procedure, an organizational statute (OSBaFin) and the Articles of Association, which set out the functions and powers of governance bodies:
• The 20-member Administrative Council, comprising members from federal ministries, members of the Federal Parliament and representatives from financial services, monitors management and supports BaFin in the execution of its duties; its responsibilities include adoption of the budget and approval of annual accounts; the Bundesbank may be represented at meetings, but has no voting right. The Council does not consider any individual supervisory cases.
• The Executive Board governs BaFin on a day-to-day basis, comprising the President, responsible for strategic direction, and four Chief Executive Directors, one of whom is responsible for insurance and pension fund supervision. The President must report regularly to the Administrative Council on the operational management of BaFin.
There is also a 24-member Advisory Board, providing advice and recommendations on supervisory practice and an Insurance Advisory Council composed of insurance experts. BaFin has an Internal Audit Office, which reports directly to the President.
The President and the Executive Board are appointed by the Federal President on the proposal of the government for eight year terms of office. Members of the Administrative Council are appointed by the Federal Ministries. The Federal President may dismiss a member of the Executive Board on demand or on the basis of a decision of the German government for cause. There is no provision for publication of the reasons for a dismissal. (FinDAG s7-9)</td></tr>
</table>

	The Executive Board is responsible for all decisions on regulatory and supervisory matters and there is no provision for escalation to the Administrative Council or Ministry of Finance. Within BaFin, operational decisions are delegated through the management structure with escalation of decisions of major importance to the Executive Board. ***Responsibility to the Federal Government*** Under the separation of powers between legislative, executive and judiciary provided for by the German constitution, BaFin is part of the executive branch and is responsible to the Federal Parliament via the BMF. Its status is that of a federal institution with legal personality governed by public law and part of the portfolio of the BMF. *(FinDAG s1)* The relationship between the BMF and BaFin is governed by the FinDAG and guidelines (the Principles governing the exercise of legal and technical supervision of BaFin by the Federal Ministry of Finance, May 2013). These define the purpose of the BMF's supervision (the legality and fitness for purpose of BaFin's administrative actions), its role in chairing the Administrative Council and its budgetary approval powers. The Principles also set out the extensive reports which BaFin is required to make to the BMF on organizational and supervisory issues. These include reports on supervisory measures (intended and introduced) that are of material importance in the exercise of supervision under the relevant financial services supervision laws such as noteworthy events occurring at and possible threats to systemically important institutions and extreme events occurring at smaller institutions. *(Principles, section III)* BaFin's Articles of Association, which take the form of a regulation issued by the BMF, recognize the right of the BMF to issue instructions to BaFin's Executive Board. ***Transparency Requirements and Rights of Appeal*** BaFin is required to publish its legal and administrative measures and does so in its monthly Official Bulletin and annual report, both of which are published on the website. Supervisory process and requirements are set out in circulars, guidelines, proclamations and announcements. While there is no requirement or policy for their review on a regular basis, BaFin's requirements are reviewed and reissued as necessary. In practice, they have been subject to major revision on account of Solvency II implementation. BaFin publishes information on the insurance sector and its observations annually, including data on the financial situation of the sector and significant market trends. BaFin's decisions are subject to appeal under the Code of Administrative Court Procedures. However, the supervisory legislation explicitly provides that objections against most of the intervention measures which BaFin may take do not have any suspensive effect (including BaFin's decisions to appoint an auditor, to impose capital add-ons, to require solvency or finance plans, to restrict payments or reduce liabilities, to initiate insolvency proceedings and take any action to address irregularities – see ICP10). ***Confidentiality*** BaFin's staff, experts whom it engages to help in audits, and members of the advisory bodies must not pass on confidential information which they receive in the course of their work and where it is possible to identify the individual insurer. *(VAG2016 s309)* Confidential information comprises business secrets of insurers as well as of the insured and any information that has been provided to BaFin on condition that it is kept confidential. Breach of secrecy is penalized under the Criminal Code.

	However, BaFin may also pass on confidential information to authorities responsible for financial supervision and to central banks, if they need the information to carry out their tasks. There is particular provision to share information with the European Central Bank (ECB), the Eurosystem and other EU authorities. *(VAG2016 s309 (5))* Information can be shared with competent authorities of non-EEA countries only if protection of the information to be communicated is guaranteed by professional secrecy to the same extent as required under the VAG. ***Liability*** BaFin's liability is limited under law. It cannot be liable to third parties, except in cases of an abuse of authority or negligence. *(FinDAG, s4)*. In case of a breach of official obligations by a BaFin employee, liability rests with BaFin, unless the official is guilty of willful intent or gross negligence, in which case BAFin has the right of recourse. ***Resources*** BaFin is financed from fees and charges imposed on supervised institutions and it receives no funding from the federal budget. Main funding sources are fees for specific measures and charges allocated to each sector on the basis of costs of supervision. BaFin's budget is approved by its Administrative Council. BaFin may recruit and deploy staff as it requires. It employs both civil servants and public employees. BaFin may hire, contract or retain the services of external specialists through contracts or outsourcing arrangements. Staff training in recent years has been focused on preparations for Solvency II, including technical training and preparation for the change in supervisory approach. In 2014, professional development per employee averaged 4 days. As at November 2015, BaFin employed 349 staff in its insurance and pension fund department compared with 266 in 2010. Insurance supervision also draws on cross-sector expertise on risk modelling (including 18 working on internal model validation of insurers, up from 13 in 2010), consumer protection and anti-money laundering. ***Professional Standards*** BaFin staff are subject to standards applicable to the nature of their employment and to specific demands of supervisory work. They are subject to a general Code of Conduct on the prevention of corruption. Rules on the acceptance of gifts are laid down in the BBG and TVöD. There is also a Code of Conduct governing share-dealing and investing in supervised companies. These Codes apply to all staff members.
Comments	Responsibilities for regulation and supervision are clearly divided between the federal government and BaFin. As a federal institution, BaFin is subject to the oversight and accountability mechanisms of the federal government, including extensive reporting requirements to the BMF (the government has not reduced these requirements, as recommended by the 2011 FSAP). However, BaFin is operationally independent in the exercise of its supervisory function and is not in practice subject to instruction or intervention by government in relation to supervisory decisions. Funded directly from industry, and with flexibility in its recruitment and remuneration policies, it has been able to recruit and retain staff, including specialist expertise, during the highly demanding Solvency II implementation period. Its approach to the allocation of resources has become significantly more risk-based, resulting in

	greater focus on groups (and large groups in particular) and an appropriate balance between frontline supervisory and specialist resources. Preparations for Solvency II include a change management program to support staff in moving from a relatively rules and compliance-based to the more risk and principles-based approach. It is recommended that: • BaFin continue to keep under review the program of staff development in line with the demands of Solvency II supervision, including integrating the oversight of internal models, once approved, with other supervisory work; and • The federal government review BaFin's reporting requirements to the BMF and provisions for dismissal of BaFin Executive Board members to ensure they continue to support robust operational independence in the future.
ICP 6	**Changes in Control and Portfolio Transfers** Supervisory approval is required for proposals to acquire significant ownership or an interest in an insurer that results in that person (legal or natural), directly or indirectly, alone or with an associate, exercising control over the insurer. The same applies to portfolio transfers or mergers of insurers.
Description	***Changes of Control, Etc.*** Insurance supervisory legislation provides for requirements on insurers, insurance holding companies and those seeking to acquire ownership or a controlling interest. Qualifying holdings are defined as a 10 percent holding of nominal capital or of voting rights or a decisive influence on the management of the insurer. An acquiring party must notify BaFin of a proposal to acquire a qualifying holding or to increase its holding above the thresholds of 20 percent, 30 percent and 50 percent. *(VAG2016 s16-22)* Reductions in shareholdings must also be notified to BaFin by insurers and shareholders. Insurers must notify BaFin annually of their stock of shareholders. *(VAG2016, s47 (7))*. The legislation is clear that direct and indirect holdings are covered and BaFin has power to require notification of ultimate beneficial owners. Insurers themselves are required to notify BaFin when aware of the acquisition of a qualifying holding. *(VAG2016, s47 (5))*. BaFin has 60 working days to make a decision on applications (starting from when the supporting documentation is complete) subject to an extended deadline if it requests more information particularly where the acquirer is from outside the EEA or is not an EEA regulated entity. (VAG2016 s17 (4)) BaFin must consult with the relevant authority. *(VAG2016 s21)*. The criteria for assessing transactions in the legislation are closely aligned to licensing conditions. They include conditions that complex ownership webs or lack of transparency do not hinder effective supervision and that a non-EEA foreign insurer seeking to make an acquisition is subject to effective supervision. *(VAG2016 s18)* BaFin maintains dedicated resources to process such transactions. BaFin has processed a small number of changes in control in recent years, many reflecting internal reorganizations of insurance groups or mergers of insurers, which

	have been averaging eight per year. BaFin has not recently refused a change of control, although it did in one case use its powers to suspend voting rights of a significant shareholder in a small insurance company (which subsequently went into insolvency). ***Portfolio Transfers*** The insurance supervisory legislation requires that transfers of portfolios, by primary insurers and reinsurers, be subject to approval by the applicable supervisory authorities. In relevant cases, only the home state supervisory authority has to give approval. There are requirements for consultation between EEA authorities and specific assurances to be provided where the transfer is to a non-EEA insurer. *(VAG2016 s13, s63, s73, s166, s200).* Where BaFin has authority, it makes its decision based on whether the interests of insured parties are safeguarded and whether there is sufficient evidence that obligations under insurance contracts can be fulfilled at all times. In the case of participating policies, BaFin can approve a transfer only when satisfied that the profit participation of policyholders (in both the transferor and transferee companies) are no less than before the transfer, using a fair value approach to measurement of the assets and liabilities. BaFin acts in place of policyholders in relation to the acceptance of a portfolio transfer and policyholders have rights only after the transfer has been concluded to be informed and to terminate their policy (and only if a change in regulatory authority results from the transfer). *(VAG2016 s13 (7))* BaFin's decision must be published. Once informed, policyholders may apply to a Court for a judgment on whether their rights have been infringed. BaFin processes only a small number of portfolio transfers per year. It has not in recent years refused any applications. Separate requirements apply where the portfolio transfer is of life or health insurance portfolios to an insurance guarantee scheme (see ICP 12). *(VAG2016 s222).*
Comments	The legislation and BaFin's powers ensure that changes in control, broadly defined, are notified to BaFin and that it can prevent changes that could place policyholders at risk. BaFin is well-equipped to address any increase in merger activity in case of industry consolidation. Similarly, BaFin is fully empowered to approve portfolio transfers, on application by insurers, expeditiously and with regard for policyholder interests. It may also, where conditions is the legislation are met, require a portfolio transfer to an insurance guarantee scheme, but cannot otherwise require a transfer to be made. The process creates some risk of uncertainty after a transfer if policyholders challenge BaFin's decision before the Court. However, no such challenge has ever been made.
ICP 9	**Supervisory Review and Reporting** The supervisor takes a risk-based approach to supervision that uses both off-site monitoring and on-site inspections to examine the business of each insurer, evaluate its condition, risk profile and conduct, the quality and effectiveness of its corporate governance and its compliance with relevant legislation and supervisory requirements. The supervisor obtains the necessary information to conduct effective supervision of insurers and evaluate the insurance market.

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Powers to Undertake Supervision

Legal authority for BaFin and a duty to undertake supervision is set out in the VAG, which puts particular emphasis on financial supervision and ensuring that, for primary insurers, the interests of the insured are sufficiently safeguarded. *(VAG2016 s294).*

BaFin has powers to obtain information from:

- Insurers, members of their governing bodies, employees and controllers, which may include documentation given to policyholders (or primary insurers in the case of reinsurers) and outsourcing contracts;
- Other companies in the group of which the insurer is a member to support group-wide supervision, where the insurer itself has not provided the information;
- Insurance agents and brokers, where required for the assessment of an insurer; and
- Outsourced service providers, auditors and trustees.

BaFin also has powers of access to insurers and these other parties (except other group companies). It has a right to attend and speak at supervisory board and general meetings of an insurer. *(VAG2016 s305-6)*

Supervisory Framework

BaFin has been developing a risk-based approach that allocates resources and supervisory priorities to individual insurers and 14 significant insurance groups, according to scale and risk, measured as the quality of the insurer.

Core supervisory processes are off-site analysis based on extensive reporting and on-site supervisory work driven by a risk classification system that assesses the impact of the insurer based on size and quality, drawing on quantitative indicators and supervisory assessment of governance and other qualitative factors. The approach seeks to capture conduct risks through the indicators related to management quality.

Each insurer is assigned an impact and a quality score. Neither is communicated to the insurer itself, although the aggregate results for insurers (as in the table below) are published. BaFin is concerned that insurers could disclose the risk classification, if communicated to them.

	Undertakings in %	Quality of the undertaking				Total
		A	B	C	D	
Market relevance	high	0.9	7.3	3.3	0.0	11.5
	medium	1.5	14.4	6.4	0.0	22.3
	low	8.5	38.7	17.1	1.9	66.2
	Total	**10.9**	**60.4**	**26.8**	**1.9**	**100.0**

Source: BaFin Annual Report 2014

The approach to impact (or “market relevance” in the above table) has recently been extended with an impact category of Very High – to identify a small number of the most significant companies for the German market. The implications for the supervisory approach to these companies are being developed.

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	The main output of risk classification to date is the prioritization of on-site work in the annual BaFin plan. There are also minimum requirements on the frequency of on-site work for medium impact insurers (eight to ten years) and low impact (ten to twelve). ***Organization and Resourcing of Supervision*** Supervision is undertaken by units of between 9 and 14 staff supported by specialist functions within the Insurance and Pension Fund Supervision Directorate and an internal models unit which is to become part of the Directorate in 2016. The core supervisory team consists of at least one legal expert, an economist and a mathematician or actuary. Since July 2015, the organisation of supervision has been based on groups. One team now supervises all or most elements of each group, providing a focus on the group that will be further developed with the increased reporting by groups under Solvency II. Each of the three major groups is supervised by a single unit within one department, while other units supervise a varying number of companies depending on scale. ***Supervision in Practice*** All insurers regardless of risk classification are subject to off-site supervisory review based on quarterly and annual reporting, including financial reporting (which are received initially in draft soon after the year-end); the external auditor's report; the actuary's report; and the risk report, a key internal document that BaFin requires companies to share (to be superseded in due course by ORSA reporting). Supervisors submit to team managers written analysis on key reports within specified periods after receipt. Stress testing has been undertaken annually in recent years and the reporting integrated into the supervisory process as well as being an aspect of macroprudential supervision (ICP24). The current approach is being replaced in 2016 with reviews of insurers' ORSAs. In addition to prescribed regular reporting, BaFin undertakes ad hoc surveys of all or relevant insurers, for example on their response to adverse market developments. Reporting to BaFin is being greatly enhanced under the Solvency II requirements from 2016. More detailed reports on the financial position and risks of insurers will be required in the form of a Solvency and Financial Condition Report (SFCR) that insurers will publically disclose and Regular Supervisory Report (RSR). Beside these narrative reports BaFin will receive detailed quantitative information both quarterly and annually. Reporting of group information, previously based on the EU framework of supplementary supervision as well as published information, will be extended. BaFin was in process, at the time of the FSAP, of adapting its internal systems (including its database and analysis IT systems), and its risk classification approach. On-site work has in recent years been focused on preparations for Solvency II. For those groups applying for approval, this has involved extensive on-site evaluation, in Germany and other countries, of the technical and broader aspects of the model. Regular on-site work has also been undertaken on these groups, again with a particular focus on Solvency II issues, including the risk management requirements (and adequacy of control functions) and the impact on business models. Other issues have also been covered, where rated a significant risk or in response to an event at a particular insurer.

	Routine on-site reports are for one or two weeks, are carried by BaFin supervisors and are followed up promptly with reports to management. BaFin almost always uses its own staff for on-site work rather than contracting external experts. For the largest groups, an approach to group supervision has been developing which includes core supervisory processes but which puts particular emphasis on: • A supervisory plan that draws on the risk classification, BaFin priorities, college agenda, and workstreams such as the ORSA review; • A particular focus on internal management information – the risk report is received quarterly, for example; • Regular contact with senior management, including the heads of control functions and the responsible actuary; • Attendance, on an annual basis, at meetings of the supervisory board and receipt of papers sent to, and minutes of meetings of the supervisory board; and • Working through the college of supervisors (ICP25). Supervisory responsibilities in respect to insurer conduct of business also fall to the supervisory teams, supported by a specialist unit, which leads on the cross-firm projects (including a number of recent surveys) and issues related to the indirect supervision by BaFin of intermediaries (see ICP19). Recent examples on on-site supervisory work carried out by supervisors are on sales practices at an insurer and on claims handling. As noted in the 2011 FSAP, there is no direct obligation on insurers to report promptly to BaFin any material changes or incidents that could affect their condition or customers, except where the company is insolvent (see ICP12). From 2016, they are required to report major changes in corporate governance and must submit outsourcing contracts to BaFin before they are concluded.
Comments	BaFin's approach to supervisory review is undergoing major changes to provide for a more risk-based approach in conjunction with the preparation for Solvency II. It is rebalancing from routine and reactive work to more forward-looking supervision covering both core financial soundness work, in which BaFin has particular expertise, and risk management and other qualitative requirements, as well as conduct of business. To maintain momentum, it is recommended that BaFin consider: • Whether and how to place increased emphasis on qualitative aspects of its supervisory process, for example by integrating qualitative and quantitative dimensions of the off-site review process; placing more weight on qualitative elements in the risk classification framework and ORSA review; and imposing capital add-ons for qualitative concerns; • The development of enhanced peer group analysis as well as peer review and challenge in the process for agreeing risk assessments and supervisory planning, especially on larger institutions; • Whether it could better communicate to insurers, particularly larger companies, its key concerns and supervisory priorities, for example by disclosing the risk classification findings; and

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- Whether it can take a more risk-based approach to the allocation of supervisory resources to conduct of business work, for example by including more explicit conduct-related issues in its risk classification system.

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<tr><td>ICP 10</td><td>Preventive and Corrective Measures

The supervisor takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.</td></tr>
<tr><td>Description</td><td>

Unauthorized Insurance Business

It is a statutory offence to conduct insurance activities without a license. *(VAG2016 s331)* BaFin also has powers to order the discontinuation and winding-up of unauthorized business and to appoint a liquidator as well as powers of investigation and access. *(VAG2016 s308)* A specialist unit within BaFin is responsible for such work and has taken action against unauthorized insurance business under the equivalent provisions of the pre-2016 legislation.

BaFin's Powers to Take Preventive and Corrective Measures

The legal framework for supervision requires the BaFin to exercise supervisory oversight of licensed insurance companies, while granting discretion over how it responds with preventive and corrective actions, as required. It is explicitly required to apply the principle of proportionality *(VAG2016 s296).*

BaFin has a wide range of powers:

- To restrict or prohibit the disposal of assets when the insurer has inadequate technical provisions (calculated for solvency capital purposes or under the German Commercial Code) *(VAG2016 s133(1), (2))*; and in circumstances when a recovery plan or financing plan are required (see below). *(VAG2016 s134(7), s135(3)).*
- To take any action in respect of the insurer, members of its management board, other members of senior management, or controllers that is appropriate and necessary to remedy irregularities (defined as weaknesses or deficiencies identified by BaFin in the supervision process). *(VAG2016 s298).*
- To prevent the insurer from entering into new insurance contracts *(VAG2016 s300).*
- To require the dismissal, after due warning has been given, of any person leading the insurer or performing key tasks (or a member of the supervisory board) in case that person has willfully or negligently breached requirements of relevant legislation. *(VAG2016 s303).*
- To appoint a special commissioner to take over all or part of the management of the insurer *(VAG2016 s307).*
- To revoke authorization in case the requirements for authorizations are no longer met or the insurer seriously breaches requirements under the law. *(VAG2016 s304).*

It may also reject a reinsurance or retrocession agreement. *(VAG2016 s298(3)).*

These powers may also be exercised, as applicable, in respect to insurance holding companies and mixed financial holding companies (for financial conglomerates).

In respect to solvency requirements, the 2016 legislation sets out control levels drawn from the EU Solvency II Directive:

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	• Non-compliance with the SCR (or threat of non-compliance within three months) will trigger a requirement for immediate notification to the supervisor, and, where the SCR has been breached, for a recovery plan to be submitted within two months, showing the measures to be taken to restore compliance within six months (which may be extended to nine months). • Non-compliance with the MCR (or threat of non-compliance within three months) will trigger a requirement for immediate notification to the supervisor, and, where the MCR has been breached, for a finance scheme to be submitted with one month with measures to restore compliance within three months. Provision of an obviously inadequate finance scheme or failure to re-establish compliance with the MCR within three months are grounds for revocation of authorization. In the pre-2016 legislation, which otherwise contains similar provisions, BaFin is also able to require a financial recovery plan, where the insurer is meeting minimum requirements but there is evidence it may be unable to fulfil its insurance liabilities in future. *(VAG s81b (2a))* This power is not reflected in the EU Solvency II framework. Instead, BaFin will seek to identify and react to indications of potential future financial weakness especially through the regular review of the insurer's ORSA as well as its stress-testing exercises. BaFin has powers to impose a "capital add-on" (i.e., a capital requirement increasing the SCR applying to all companies subject to Solvency II requirements) on an individual insurer in prescribed conditions—in particular that the risk profile of the company deviates from the assumptions underlying the solvency requirement or that its business organization (governance etc.) falls short of required standard with detrimental effects for risk management. *(VAG2016 s301)* It also has powers to impose an add-on on a group, for similar reasons or, where a group internal model is used, where the risk profile deviates significantly from the assumptions underlying the model. *(VAG2016 s264-5*). BaFin had no equivalent power under pre-2016 legislation (except in connection with a requirement for a recovery plan); it is not currently expecting to use the new power except on an occasional basis and as a last resort. ***BaFin's Approach to Preventive and Corrective Measures in Practice*** BaFin takes a graduated approach to corrective actions in relation to individual firms. It generally starts with informal exchanges with the company concerned in which it seeks to confirm its analysis and to clarify whether there is, or is likely to be, a breach of regulatory requirements. In most cases, in BaFin's view, these exchanges result in issues being resolved or concerns allayed. BaFin's supervisors meet with executive management but can and do escalate issues to the supervisory board as necessary. Where it establishes that there is evidence of a breach of requirements, BaFin will write a formal letter to the management of the company, referring to specific powers and formally requiring corrective actions or imposing measures. Use of powers in recent years has been limited. All cases have involved actual or potential breaches in financial requirements. In the last three years it has asked three times for a financial recovery plan, twice for a solvency plan and three times for a financing plan under (the pre-2016) VAG, section 81b. BaFin has also imposed restrictions on disposal of assets and writing of new contracts. In the case of one small P&C insurer, the escalation of supervisory actions as the financial condition of the company worse led to the opening (in March 2015) of insolvency

	proceedings, initiated by BaFin. BaFin has also been taking action to respond to a deterioration in the financial position of a number of life insurance companies due to the low interest rate environment and taking into account the change to a new solvency regime under Solvency II. The focus has been on potential rather than actual breaches of current or future requirements. In line with its general approach, BaFin has initiated exchanges (in writing and in person) with senior management, has reviewed their responses and has formally required specific actions where necessary (this process is continuing).
Comments	BaFin has extensive powers and a high degree of discretion to take preventive and corrective actions as it considers necessary. While there is no formal requirement to use particular powers in specific circumstances, internal guidance supports supervisory decision-taking on the exercise of each power, including escalation in case an insurer fails to take remedial measures or its financial situation deteriorates. Clear solvency control levels apply, leading ultimately to withdrawal of authorization. While intervention is triggered by actual or potential breaches of the Solvency II measure, BaFin also monitors and responds to the development of the financial soundness of an insurer as measured under the national accounting framework, which remains the measure for determination of insolvency. As BaFin is aware, it will be important that in the future the ORSA process is used effectively to supplement this framework by providing for a clear basis for intervention before the SCR is at risk of being breached. BaFin has had relatively limited recourse to formal powers in recent years, particularly in relation to sound business practices (i.e., qualitative requirements). Formal powers have been used in cases of financial weakness. In practice, BaFin relies heavily on exchanges with senior management of insurers to bring about remedial actions. As implementation of Solvency II proceeds, it is recommended that BaFin continues to adapt this practice both to accommodate judgments on regulatory issues where the new Solvency II requirements are expressed more as principles than as rules, and to emphasise the importance of early intervention. In particular, it is recommended that: • BaFin considers its approach to intervention in case of a deterioration in the financial position of an insurer as measured under the national GAAP framework, so as to ensure it intervenes to reduce the risk of financial weakness and ultimately insolvency on this measure. • As BaFin's work on ORSAs develops, it considers the introduction of a system of target minimum solvency requirements to be communicated to insurers based on the ORSA review; and develops an internal policy framework for the imposition (and removal) of formal capital add-ons, making use of its powers in the insurance supervisory legislation. • BaFin continues to develop its approach to early and effective intervention on the full range of regulatory and supervisory issues, building on existing Solvency II work (including its internal change management program) to reflect the particular challenges of a more principles-based regulation.

ICP 12	**Winding-up and Exit from the Market** The legislation defines a range of options for the exit of insurance legal entities from the market. It defines insolvency and establishes the criteria and procedure for dealing with the insolvency of insurance legal entities. In the event of winding-up proceedings of insurance legal entities, the legal framework gives priority to the protection of policyholders and aims at minimizing disruption to provision of benefits to policyholders.
Description	The legislative framework for insurer insolvency is set out in the supervisory legislation (VAG), insurance contracts law (VVG) and in general insolvency law (Insolvenzordnung—InsO). There is provision for insurers to withdraw from the market by renouncing their authorization, which also lapses if the insurer has ceased to carry on insurance business for six months. Whenever the license is renounced or revoked, the insurer is prohibited from writing new business, and from increasing or renewing existing policies and BaFin's powers, for example to restrict or prohibit disposal of assets, continue to apply. *(VAG2016 s304)*. Only BaFin is empowered to make an application to the insolvency court for the initiation of insolvency proceedings and only the court may decide to open proceedings and appoint an administrator. An insurer that is insolvent must notify BaFin immediately. *(VAG2016 s311-312)* In recent years, there has been one insolvency, of a small P&C insurer, started in March 2015. BaFin's powers enable it to take a wide range of measures to prevent insolvency and the termination of many types of insurance contracts that insolvency entails (although policyholders may claim their share of guarantee assets – see below). *(VAG2016 s316)*. In addition to powers to require preventive and corrective measures (see ICP10), and the power to restrict or prohibit transfer of assets, BaFin has powers: • Temporarily to prohibit payments, including of insurance benefits, profit distributions and, for life insurance, surrenders or policy loans or advances *(VAG2016 s314 (1))*. • To reduce the liabilities of a life insurer under its insurance contracts in accordance with its financial situation. *(VAG2016 s314 (2))* These powers may be exercised when according to the findings of an audit, an insurer will no longer be able permanently to meet its liabilities and BaFin considers it to be in the best interests of the insured to avoid insolvency proceedings. *(VAG2016 s314 (1))*. ***Insurance Guarantee Schemes*** In case an insurer has notified that it is insolvent or it is otherwise clear that the company cannot meet its liabilities and other measures that could safeguard the interests of the insured are insufficient, BaFin is required to order the transfer of the entire portfolio of business, including associated assets, to an insurance guarantee scheme, where the insurer is a member. *(VAG2016 s222)*. There are two schemes at present, Protektor, for life insurance, and Medicator, for private health insurance (i.e., insurers authorized to provide substitutive health insurance). Unlike in many other countries where the focus of the guarantee scheme is to

	compensate policyholders of insolvent insurers as early as possible for loss up to a limited amount, the role of both German schemes is to run off insurance contracts, although they may also seek to transfer them to other insurers. All life and health insurers must be a member of the relevant scheme *(VAG2016 s221)* and BaFin is responsible for supervision of the schemes. *(VAG2016 s1)* Both schemes have not been used in their current form. Both were established as voluntary industry-based schemes and in that form Protektor (as the private insurance company Protektor Lebensversicherungs AG) acquired the insurance portfolio of Mannheimer Life in 2003. The government subsequently assigned to Protektor the management of a new public guarantee fund for life insurance. Medicator functions similarly for health insurance. (The law provides for a public body to provide insurance guarantee schemes, but also allows the function to be assigned to a qualifying private body.) • Protektor is financed ex ante and has accumulated funds of EUR 897 million (1 per mille of the net technical provisions of all members). Additional special contributions up to EUR 863 million can be levied, if necessary, and beyond that point BaFin is required to use its powers to impose a 5 percent reduction of liabilities. Under separate, private arrangements German life insurers have committed to provide additional funds up to a further 1 percent of net technical provisions (some EUR 9 billion at present). • Medicator is financed on an ex post basis. A maximum of 2 per mille of members' net technical provisions may be raised (EUR 388 million). For motor vehicle liability insurance, a guarantee scheme, "*Verkehrsopferhilfe*" (assistance for victims of car accidents), provides compensation where a person has been injured or suffered damage in a car accident and BaFin has filed a petition for the opening of insolvency proceedings against the motor vehicle liability insurer. ***Protection of Guarantee Assets*** Where an insurer is subject to insolvency proceedings, policyholders, including those with outstanding claims, are protected by the requirements on insurers to hold restricted assets in trust for policyholders ("guarantee assets"), making them effectively the highest class of creditors in case of insolvency. *(VAG2016 s125-130)* The objective is to enable an insolvency administrator to meet all the claims of policyholders, beneficiaries and third parties with a claim on the insolvent insurer, as well as premium refund claims (provided the insurance contract was cancelled or rescinded before the opening of insolvency proceedings). Guarantee assets therefore have to be at least equivalent to the balance sheet values (or fair value, if lower) of the relevant liabilities calculated under the national accounting framework. Eligible assets remain as defined for all insurers under the pre-Solvency II legislation (see ICP15). Companies must select higher quality assets first when choosing which to register as guarantee assets. Guarantee assets must be held within the EEA, managed separately from other assets and recorded in a register set up for the purpose. The insurer must appoint a trustee to monitor the guarantee assets and make arrangements so that they can be released only with the consent of the trustee and if the residual assets do not fall below the required amount (the trustee and insurer function as joint custodians).

	These arrangements do not apply to reinsurance companies as they have no policyholders as defined for these purposes. There is therefore no preferment of primary insurers' claims in case of the insolvency of a reinsurer. ***Point at Which Insurers Are No Longer Permitted to Operate*** The insurance legislation sets out the conditions for revocation of a license. These include cases where the insurer is in breach of the minimum capital requirement and has submitted an obviously inadequate financing plan or where the BaFin otherwise considers that it will not be able to fulfil the plan. *(VAG2016 s304).*
Comments	There is a wide range of powers and procedures providing for the prompt and orderly exit of failing insurers. BaFin has discretion to assess by which means the interests of insured parties will best be served. In life and health insurance, this is likely to be through transfer of their contracts to the applicable guarantee scheme, in so far as the scheme has capacity to absorb losses, which is likely to be sufficient in the case of a small to medium-sized insurance company failing. There may be a need to review the procedures for the guarantee schemes to effect transfers of insurance portfolios and associated assets to ensure that more complex portfolios may readily be transferred (for example, where the sufficiency of assets depends on hedges using derivatives or there are reinsurance arrangements). In P&C insurance, the absence of a guarantee scheme other than for motor vehicle third party liability insurance, exposes insured parties to potential reductions in policyholder liabilities imposed by BaFin or to delays in settling claims due to the insolvency process. The arrangements for guarantee assets should generally, however, provide for full recoveries and the avoidance of loss. In respect of larger insurers, where guarantee scheme capacity would be inadequate, and particularly the larger groups including the major reinsurance companies, the arrangements need to be supplemented in due course by resolution planning, as has begun in the case of G-SIIs (see ICP26). It is recommended that BaFin and the federal government review whether it would strengthen BaFin's ability to address weak insurers if it were to have a power to require a portfolio transfer to another (willing) insurer as well as to an insurance guarantee scheme.
ICP 14	**Valuation** The supervisor establishes requirements for the valuation of assets and liabilities for solvency purposes.
Description	ICP 14 is applicable to valuation for solvency purposes, which will have to be carried out under the Solvency II framework, as implemented in Germany, from January 2016. However, Solvency II offers insurers a 16-year transitional arrangement, which many German life insurers are expected to use. Even though these transitional measures will be phased out over 16 years (and can be withdrawn if conditions are not met by a particular insurer), MCR and SCR without transitional measures will not form binding constraints for most insurers in the short to medium term. Valuations under Solvency II and German national accounting requirements (national GAAP) differ and valuation under national GAAP remains an important measurement for

	various purposes closely related to solvency, such as measurements for dividends to shareholders and policyholders and calculation of the guarantee assets which must be held as a key source of policyholder protection in case of insolvency (ICP12). According to discussions held with market participants in Germany for the purposes of this assessment, national GAAP figures, together with Solvency II figures, will form the binding constraint on many insurers, at least in the short to medium term. Information provided by the authorities and market participants also supports this view. National GAAP was the basis of Solvency I requirements in force at the time of the assessment. Therefore, this assessment covers both national accounting and Solvency II valuation frameworks. **General Purpose Accounting (national GAAP)** *Assets* Valuation of assets is underpinned by the principle of lower-of-cost-or-market value. As a basic principle, investments of insurers (stocks, investment trust units, other fixed-income and variable-yield securities) have to be treated as current assets and even temporary losses in value to an amount below the acquisition price have to be written down at the balance-sheet date. However, insurers are allowed to adopt a treatment under which they use cost basis accounting for a wide range of assets (including liquid shares and properties), if and to the extent that the assets held by insurers serve business operations on a permanent basis. While a figure for usage is not available, this exceptional treatment seems to be widely used by insurers and supports insurers in stabilizing dividends to policyholders. Impairment needs to be recognized if there is a lasting depreciation. One indicator of a need for further investigation by BaFin is if the book value is lower than market value by more than 10 percent. According to the authorities, unrecognized losses from this exceptional treatment seems to be limited at this point owing to current market conditions, particularly the low interest rate environment and levels of equity and property prices. Derivatives and security lending transactions remain off-balance sheet. BaFin is monitoring both derivatives and security lending transactions and does not see material increase in the recent years. However, BaFin does not access to derivative transactions conducted within investment funds. *Liabilities* Future discretionary benefits are not explicitly included in insurance liabilities, while some part of margins in the insurance liability includes implicit allowance for future discretionary bonus payments. A maximum technical interest rate for valuation purposes and rate of zillmerisation have been issued by the Ministry of Finance: • The maximum technical interest rate has been set by referring to historical (5 – 10 years) average of Bunds' yield of 10-year duration and has been gradually reduced from 2.25 percent in 2011, to 1.75 percent in 2014 and to 1.25 percent in 2015. The reduction from 2015 has been made as a part of Life Insurance Reform Act 2014. The maximum technical interest rate is used only for national GAAP (insurers are required to use the rate for discounting new policies for valuation), and insurers may use different rates for premium and guarantee setting. However, to avoid loss recognition on new policy sales, most insurers use the same rate for premium and

guarantee setting. Ministry of Finance is at present considering whether to abolish or reduce the maximum technical interest rate from 2016, due to the implementation of Solvency II and it is uncertain how insurers will define discount rates for GAAP purposes from 2016.

- The maximum zillmerisation rate determines the maximum one-off acquisition costs which can be amortized through the entire period of the insurance policy. As a part of Life Insurance Reform Act, the rate has been reduced from 4 percent to 2.5 percent of total premiums. While the rate is only for national GAAP purposes and insurers can use different rates for commissions paid to agents, life insurers may be starting to reduce the commission to avoid accounting loss from new policies.

Mortality tables are published by the German Actuarial Society. However, insurers can develop and use its mortality table. While BaFin does not approve it, it is monitoring through off-site and on-site. The value of technical provision for P&C does not explicitly take into account the time value of money.

From 2011, an Additional Interest Provisions (Zinszusatzreserve or ZZR) was introduced into the valuation regulation, which requires life insurers to hold a reserve for each policy that guarantees a return above the reference rate for expected asset returns. The reserve equals the interest rate shortfall that is expected to arise over the following 15 years.

The reference rate is the 10-year average of the zero-coupon euro swap rates with a duration of 10-year. As a consequence of the steady downward movement of rates during the past decade, the reference rate may keep falling for some time in the future. The costs allocated to the additional ZZR reduce the minimum allocation to the provision for policyholder bonus. In 2014, EUR 8.4 billion was made to ZZR, resulting in over EUR 20 billion on a cumulative basis at year-end 2014. If the reference rate increases, amounts which have been reserved to meet ZZR requirements for the policies whose guarantee rate is now lower than the reference rate will be released.

If current low interest rates persist, life insurers are expected to be required to continue to add to ZZR by more than EUR 10 billion annually from 2016 to 2018 and cumulative reserves will reach over EUR 70 billion. A majority of reserves seem to have been financed by selling assets to realized unrecognized gains on the asset side.

Valuation for Solvency II

Assets

Asset should be valued at an amount at which they may be exchanged between expert independent business partners willing to enter into a contract—which is generally recognized as a market consistent valuation of assets.

Liabilities

Valuation of liabilities shall be also assessed at an amount at which they may be transferred or settled between expert independent business partners willing to enter into a contract without any adjustment for the creditworthiness of the insurer. The value of technical provisions should equate to the sum of best estimate and risk margin. Best estimate corresponds to the probability-weighted average of the present values of the future cash flows associated with insurance liabilities discounted using a specified yield curve.

Yield curves and adjustments

	The yield curves will be provided by the EIOPA by referring to market rate up to 20 years. From 20 years for 40 years, an extrapolation method is used to the Ultimate Forward Rate (which is set by EIOPA as 4.2 percent) beyond 60 years. With the approval of BaFin, insurers may use: • A matching adjustment in the yield curves for the valuation of predictable liabilities which are cash-flow matched using fixed income assets. The predictability of the portfolio means that matching assets can be held to maturity and that the insurer is consequently not exposed to price movements, only to the risk of default. The approval will be provided if several conditions are met. For example, the insurer has identified a portfolio of assets consisting of bonds and other assets with similar payment characteristics and retains the amount; the portfolio is managed separately; there is no essential risk of mismatch, and the policy has limited options for policyholders, redemption is limited to the value of the matched assets, etc. Insurers using matching adjustments are required to disclose two solvency ratios, with and without the adjustment. • Insurers can also use a volatility adjustment, which aims to avoid pro-cyclical investment behavior of insurers when bond prices deteriorate owing to low liquidity of bond markets or exceptional expansion of credit spreads. The adjustment has the effect of stabilizing the capital resources of insurers and will be calculated by EIOPA. Insurers using volatility adjustments are required to disclose two solvency ratios, with and without the adjustment. In addition, on BaFin's approval, a 16-year transitional arrangement is allowed for technical provisions for insurance contracts concluded before the start of the Solvency II regimes. Insurers are allowed to use discount rates for valuation that applied in December 2015. The transitional measures will be phased out on a linear basis over the transitional period. They are aimed at smoothing the transition to Solvency II for contracts concluded under the previous solvency regime, which might otherwise risk disturbing the insurance market. Insurers using transitional arrangements are required to disclose two solvency ratios, with and without the transitional arrangement. They are also required to submit an annual report to BaFin describing the measures necessary to increase capital positions or reduce the risk profile to meet the SCR without transitional measures. BaFin also has a power to limit the impact of transitional arrangements if the application could lead to a situation in which the solvency requirements become lower than requirements in national GAAP.
Comments	**National Accounting** • ZZR should be also amended in the medium term to encourage insurers to improve their solvency position in meaningful ways (such as reduction of dividends, cost cutting and other restructuring) without relying mainly on recognizing unrealized gain and undertaking costly transactions to realize such gains on the assets side. **Solvency II Valuation** • Further clarification should be given on how BaFin will use the powers regarding transitional arrangements. BaFin should actively use its powers to maximize industry

	efforts to improve their capital positions without waiting the full 16 years of the transitional period. It is recommended that BaFin develop a communication strategy to the public on how to address potential concerns over the significance for insurers' soundness where they are using transitional arrangements.
ICP 15	**Investment** The supervisor establishes requirements for solvency purposes on the investment activities of insurers in order to address the risks faced by insurers.
Description	**Investment Requirements under Solvency II** The investments eligible for covering technical provisions are regulated under section 54 of VAG. The guarantee assets (which must correspond to technical provisions under national GAAP) may be invested only in the listed assets such as loans receivable, bonds and participation rights, real property, etc. As a result, insurers (including reinsurers) may not be able to invest in higher risk assets, such as non-investment grade bonds and private equities, etc. Regulations issued on the basis of section 54 (3) of the VAG require insurers to ensure qualified investment management, appropriate internal investment rules and control procedures. In addition, the investment principles are laid down in section 124 of the new VAG. After the implementation of Solvency II, all quantitative investment requirements described under this section will be abolished and investment requirements will move from a rules-based to a principles-based approach (the prudent person principle). However, small insurers which will be exempted from Solvency II will remain subject to quantitative investment requirements. **Investment Requirements Regarding Investment Funds** Investment funds reached over 30 percent of the total assets of insurers at end 2014. Investment funds must be looked through by insurers in complying with investment requirements and BaFin is monitoring asset allocation and investment mandates through off-site and on site supervision. Securities lending activity is monitored by BaFin. It is limited now, maybe because of low security lending fees in current market conditions. However, BaFin cannot look through to the derivative exposures conducted within investment funds. BaFin also does not require insurers to take account, for the purposes of investment requirements, of potential FX risks from investment funds whose AUM are denominated in Euro, even if the underlying assets are non-Euro foreign currency denominated. **Internal Controls** Circular 4/2011 "Guidance Notes on the Investment of Restricted Assets of Insurance Undertakings" sets risk management requirements. Risk management is required to assess whether the internal investment limits are appropriate and the insurance undertaking's ability to meet its obligations on a sustainable basis. Internal stress tests must be performed at least every quarter for this purpose. Circular 4/2011 contains comprehensive guidelines on risk management and internal

	control procedures and stipulates minimum requirements for procedures, such as limits, authorizations, reporting of violations, independent price verification and updates of risk control procedures. Frequency of reports are also specified such as daily reporting to the head of investment management, monthly to the management board and independent risk control function. Monthly reports must contain the results of stress tests. **Security / Liquidity / Currency** Speculative investments are prohibited. As a general rule each investment must be disposable and transferable at all times. In the case of fund investments, if a fund has more than 3 percent in assets lower than B- / B3, insurers must ensure that those assets are sold or removed from the fund. However, if insurers have adequate capital, investments can be made into high-yield bonds that have at least a speculative grade rating of B- or B3. The entire investment portfolio must be structured in such a way that there is always an amount of liquid or easily realizable assets available to meet essential operating liquidity requirements. Borrowing is only allowed in exceptional cases. The level to be regarded as prudent is determined by the individual situation of the insurers, in particular its risk-bearing capacity. VAG requires that at least 80 percent of investments must be denominated in the currency in which the liabilities must be settled. **Diversification** Section 3 (2) to (6) of the Investment Regulation (AnIV) contains special minimum diversification requirements. Those include: • Loans to German governments, EEA and OECD countries, etc.: 30 percent, but it excludes security investment. • Certain debt instruments: 15 percent limit. • Investments into land: 10 percent • All investments in a single issuer: 5 percent • Directly or indirectly held portion of high-yield bonds: 5 percent • AnIV Section 4 stipulates that equity investments in one entity should not exceed 1 percent of the restricted assets. **Complex and Less Transparent Classes of Assets** There are specific requirements in individual circulars for certain more complex and less transparent asset classes, including asset-backed securities (circular 1/2002) and hedge funds (circular 7/2004). • Asset backed securities and credit linked notes should not exceed 7.5 percent of the guaranteed and other restricted assets. • Hedge funds and funds linked to commodity risks may not exceed 7.5 percent of the guaranteed and other restricted assets. • Loans to foreign institutions may not exceed 5 percent of guaranteed and other restricted assets. • Equity investments (including some subordinated debt investments) may not exceed 35 percent of the guaranteed and other restricted assets.

	Circular 3/2000 seems to allow yield enhancing operations with a wide range of options (short call, IR and FX swaps, etc.)
Comments	While Solvency II implementation will discourage insurers from investing in risky assets because of the need for adequate capital, there is a risk that insurers using the standardized SCR approaches may take risks which are not captured in Solvency II capital requirements, such as sovereign bonds and illiquid assets. Moving from a rules-based to a principles-based approach to investment regulation will be challenging, both for supervisors and insurers. It is recommended that BaFin supervisors implement planned investment analysis by peer comparison of investment limits, discussions about risk tolerance statements, and that they actively challenge investment decisions, making investment a priority focus for supervision in the early days of Solvency II implementation. Insurance supervisors should continue to coordinate with securities supervisors to monitor derivatives activities used by investment funds, given the significant share of investment allocation by insurers and potential risk of excessive leverage through investment funds.
ICP 17	**Capital Adequacy** The supervisor establishes capital adequacy requirements for solvency purposes so that insurers can absorb significant unforeseen losses and to provide for degrees of supervisory intervention.
Description	Solvency II will be applied to insurers except small insurers which meet certain criteria (such as EUR 5 million gross written premium incomes and EUR 25 million of technical provisions, etc.). About 90 percent of insurers will be subject to Solvency II from January 2016. While Solvency I requirements will continue to apply to small insurers, given the wide coverage of Solvency II implementation from January 2016, this description solely focuses on capital adequacy requirements under Solvency II. **Total Balance Sheet Approach** Solvency II, in general, provides for a consistent and economic measurement of assets and liabilities and explicit identification and consistent measurement of risks and their potential impact on material components of the balance sheet. This is reflected in the German implementing legislation. **Target Criteria** Solvency II has two levels of regulatory capital requirements, Solvency Capital Requirements (SCR) and Minimum Capital Requirements (MCR). SCR is calibrated to correspond to the Value-at-Risk with a confidence level of 99.5 percent over a one-year period and several methods are allowed (including a standard formula, partial and full internal models). MCR is based on a simple formula and subject to a floor (25 percent) and cap (45 percent) of SCR. SCR and MCR need to be calculated at least annually and quarterly respectively. **Risk Factors and Diversification** Solvency II covers a wide range of risk factors, including market risk, counterparty default risk, underwriting risk and operational risk. Market risk also covers comprehensive risks,

	including ALM, equity, property, spread (bonds), credit derivatives, etc. Underwriting risk covers risks including longevity, lapse and catastrophe risks. In the standardized approach, a prescribed correlation matrix is used to recognize diversification benefits twice, within market risk and overall SCR calculations. **Solvency Control Levels** Under Solvency II, the law will no longer provide for BaFin to require an explicit recovery plan at levels above the SCR. However, insurers have to assess their ability to meet regulatory capital requirements at all times going forward as part of the Own Risk and Solvency Assessment (ORSA). Insurers have to report the ORSA result to BaFin within two weeks of completion of the ORSA. Submission of a recovery plan or a finance scheme in case of non-compliance with the SCR and MCR will be mandatory within a certain period (two months for SCR and one month for MCR). Timeframes for remedial measures are also prescribed. Compliance with the SCR needs to be re-established within six months or a maximum of nine months where BaFin grants an extension. Compliance with the MCR has to be re-established within three months. There are no prescribed consequences where an undertaking fails to comply with the SCR again at the end of the recovery period, but BaFin would decide on short term measures which the insurer would have to introduce to re-establish compliance with the SCR. If an insurer were unable to re-establish compliance with the MCR within three months, it would be mandatory for BaFin to withdraw the authorization of the insurer (see also ICP10). **Variation of Capital Requirements** Section 301 of the VAG stipulates the conditions where BaFin can increase the SCR and those conditions include when internal models are under development, usage of LTG measures, etc. The capital add-on has to be proportionate to the deficiency. BaFin must review any capital add-on annually. BaFin will use capital add-ons as temporary measures. There is only once set of circumstances where a capital add-on could be in place for some time. This is when: 1) an insurer uses standard formula; 2) the formula does not adequately reflect its risk profile; and 3) the insurer cannot be required to develop an appropriate internal model. **Adjustment of Capital Requirements** The majority of life insurance products include policyholder profit participation with a minimum return guarantee. German insurers have wide discretion to reduce the bonus in case of lower performance of investments, adverse realization of loss event or higher than expected cost. After the implementation of the Life Insurance Reform Act 2014 (LIRA), life insurers are able to offset investment losses with gains from the risk and expense components of return and to assume higher loss absorption capacity in case of further stressed situations. Solvency II (both the standardized approach and internal models) allows insurers to recognize such loss absorption capacity and deduct the amount from their capital requirements subject to a cap which is determined by the amount of future discretionary bonus embedded into the technical provision.

	BaFin has provided guidance to insurers so that the surplus fund for Solvency II purposes and future discretionary bonus (which is used to cap the amount of loss absorption capacity) is adjusted to avoid double counting of loss absorption capacity. Insurers are required to calculate provisions for future discretionary bonus without taking into account future bonus payments arising from surplus funds. According to reporting by insurers under the preparatory arrangements, as of the end 2014, future discretionary bonus is about 4.6 times larger than surplus funds. **Internal Models** Use of an internal model on a full or partial basis is allowed upon approval of BaFin. BaFin has devoted significant resources to validation to make sure that internal models meet requirements, including a statistical quality test, use test and documentation. The statistical quality test is conducted thorough intense onsite inspections. One example of the test is sampling of single contracts and a check whether the contracts are correctly mapped to the risk factors and BaFin requires insurers to recalibrate the model. BaFin has also required insurers to improve model documentation significantly over the years of preparation for applications for model approval. The use test is also applied to the level where insurers must be using the model not only for pricing but also for compensation schemes for managers. Insurers approved to use internal models are required to set aside capital for sovereign exposures, which is not required (for spread and concentration risk, although it is required for interest rate risk) under the standardized approach. According to BaFin, only a handful of insurers will be finally using internal models from 2016 and some of them are not using a full internal model. **Capital Resources** Solvency II allows a wide range of capital instruments as capital resources, including Tier 2 and Tier 3 with certain limits. For example, the sum of Tier 2 and Tier 3 cannot exceed 50 percent of the SCR. In practice, Tier 1 capital will form a majority of capital resources in German insurers. According to the QRT (Quantitative Reporting Template) in a survey among life insurers submitted at the end of 2014 which is not representative for all German insurers, 97 percent of the capital resources come from Tier 1 instruments, such as Surplus Funds and Reconciliation Reserves. Upon BaFin's approval, insurers can also use the volatility adjustment, which aims to avoid pro-cyclical investment behavior of insurers when bond prices deteriorate owing to low liquidity in bond markets or exceptional expansion of credit spreads. The adjustment has the effect of stabilizing the capital resources of insurers and will be set by EIOPA. Insurers using volatility adjustments are required to disclose two solvency ratios, with and without the adjustment. While capital resources resulting from the application of the volatility adjustment may not fully meet the quality and suitability criteria (such as availability and permanence) described in the ICP, insurers using the volatility adjustment will be required to demonstrate that they will continue to comply with regulatory requirements going forward as a part of their ORSA requirements. In addition, the amount of capital resources derived from the volatility adjustment will be immaterial under normal market conditions, where spreads in bonds are not exaggerated and purely reflective of the underlying risks.

	Tier 1 Components The surplus funds (RfB), which is the amount set aside for policyholders for future dividends but where the insurer has discretion about the actual allocation to individual policyholders and the timing, is recognized as Tier 1 capital. In addition, the excess of assets and liabilities under Solvency II valuation would be recognized as Reconciliation Reserves and form part of Tier 1. Guidance has been provided to insurers to avoid the double counting of the loss absorption capacity both into surplus fund and Loss Absorption Capacity.
Comments	BaFin has made significant efforts to ensure that internal models capture risks appropriately and that use of the model is embedded into insurers' management. It is recommended that BaFin continue to devote resources to on-going validation and continue to require insurers to improve their internal models. While the Solvency II standardized approach may not meet the definition of "Internal Model" of this ICP, some components depend significantly on companies' assumptions, such as interest rate risks and loss absorption capacity. Some of the assumptions and calibrations have significant impacts on overall requirements. Therefore, it is recommended that BaFin use the analysis that they have developed through internal model validations to assess the SCR under the standardized approach, for example whether the assumptions on policyholder dividend reduction under certain scenarios or of taxable income for deferred tax are realistic. This would mitigate the risk that insurers which are using the standardized approach are computing capital requirements too optimistically. If the majority of German insurers plan to use the volatility adjustment, BaFin should consider encouraging them to build up capital resources during periods of stable volatility through ORSA process so that volatility adjustment is used solely for countercyclical purposes.
ICP 19	**Conduct of Business** The supervisor sets requirements for the conduct of the business of insurance to ensure customers are treated fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied.
Description	This section covers mainly BaFin's responsibilities for insurers' conduct of business. These include monitoring of compliance with regulatory requirements and handling complaints made directly to BaFin by customers of insurers. BaFin's supervisory objectives encompass conduct of business (the primary objective of supervision is to protect policyholders and the beneficiaries of insurance services). However, the legislation clarifies that BaFin's responsibility to ensure that the interests of the insured are sufficiently safeguarded applies only to primary insurers. Reinsurers are in practice not subject to requirements on the treatment of policyholders. *(VAG2016 s294)* The Ministries of Justice and of Health and Social Affairs have responsibility for regulations on financial consumer protection. Insurance intermediaries are licensed and supervised by the German Chambers of Industry and Commerce (Industrie- und Handelskammer – IHK) under the 2007

	Insurance Mediation Law (VersVermG). (ICP18 on insurance intermediaries is not being covered in this FSAP.) However, BaFin has an indirect regulatory role for intermediaries through the requirements it places and monitors for insurers in relation to their use of intermediaries. BaFin's circular 10/2014 (VA) sets out the conditions under which insurance companies are allowed to cooperate with intermediaries. Insurers are also required to respond to complaints about intermediaries working for them and to conduct the necessary investigations. Conduct requirements for insurance companies are set out in the Insurance Contracts Act and related legislation. • The requirements for disclosure to customers are set out in the Ordinance on Information Obligations for Insurance Contracts (VVG-InfoV). Customers must be given a product information document. They can withdraw their application for an insurance contract within a specified time after the conclusion of the contract. The insurer must to give advice to the customer on an ongoing basis. *(VVG s4)* • When selling products, insurance companies and intermediaries have to ask for the needs of the customer and give appropriate advice which takes into account their interests. *(VVG s6 (1), 61 (1))* In case of inappropriate advice, the customer can claim for any damages. • At the first business contact, the intermediary has to inform the customer about their status (e.g. broker or tied agent), so that the customer is aware of a potential conflict of interests. • Life and health insurers have to inform their customers about the costs of concluding an insurance contract. The main part of these costs is the remuneration which has not to be disclosed explicitly. *(VVG-InfoV, s2)* • Details for the promotion of products and on forbidden sales practices are laid down in the Act against unfair competition (UWG). • Special requirements during the lifetime of a contract are also stipulated in section 6 (4) of the VVG-InfoV. • Policyholders receive also an annual statement about their profit participation for life insurance contracts. • Contractual changes need to be communicated and sometimes give the consumer a cancellation right. *(VVG s40)* • Insurance companies must have in place reliable policies and procedures so that they are able to handle claims in a timely and fair manner. BaFin's tasks include the handling of consumer complaints. A dedicated unit handles complaints submitted by consumers. If BaFin cannot resolve the issue, the complainant is referred to the ombudsman or to the courts. Most insurers recognise one of the two ombudsmen (for health insurance and all other sectors). The ombudsman is an independent body that reports publicly on at least an annual basis. BaFin's approach reflects the EIOPA guideline on complaints management for insurers. It requires insurers to take responsibility for observance of this guideline in respect of their tied agents also under the indirect approach to agent supervision.

	The Federal Data Protection Act (BDSG) lays down the privacy rules which insurers and intermediaries have to observe whilst dealing with data of their customers. Compliance is required by law and is supervised by special authorities of the Bundesländer (federal states). Also BaFin can take administrative measures when an insurance company systematically breaches legal provisions concerning data protection. BaFin also publishes data about its complaints handling activities in its annual report and information on consumer protection issues is published on BaFin's website and through the monthly BaFin-Journal.
Comments	It is recommended that: • The limitation of conduct of business requirements to primary insurers be reconsidered; and • BaFin review whether it can reduce the volume of individual customer complaints it handles, by ensuring that these are directed to ombudsman services.
ICP 24	**Macroprudential Surveillance and Insurance Supervision** The supervisor identifies, monitors and analyses market and financial developments and other environmental factors that may impact insurers and insurance markets and uses this information in the supervision of individual insurers. Such tasks should, where appropriate, utilize information from, and insights gained by, other national authorities.
Description	***Role of BaFin*** BaFin conducts regular analysis of market conditions for internal and external reporting purposes, drawing on: • The supervisory reporting by insurers; • Analysis undertaken by domestic and international authorities such as the Bundesbank, European Systemic Risk Board and EIOPA (the Financial Stability Committee process); and • Observation and analysis of public information such as financial reporting by insurers and market indicators (share prices and credit default swaps). A section in BaFin's insurance directorate (Research and Financial Stability) is responsible for the regular insurance-specific analysis and reporting, using an internal information system that allows for standard analysis and individual queries. This section also maintains a list of current risks applicable to the insurance sector. A section within one of BaFin's central departments, Analysis and Strategy, undertakes broader market and economic analysis and manages: • The identification and monitoring by BaFin's Risk Committee (a cross-BaFin senior management forum which reports to the Executive Board) of a list of key risks, including those published by BaFin as key priorities such as the low interest rate environment and IT/cybercrime risks; and • BaFin's input into the quarterly meetings and other work of the Financial Stability Committee chaired by the BMF, of which Bundesbank as well as BAFin are members (see below).

	Key findings from BaFin's analysis are published in the annual report or in its monthly bulletin BaFinJournal. Recent reporting has focused on the risks to life insurers from the low interest rate environment, including the role of the Additional Interest Provision (Zinszusatzreserve) requirement in ensuring that life insurers will be able to meet policyholder obligations; and the need for insurers to develop and market new products that meet customer requirements and are appropriate to the low rate environment. BaFin also publishes select statistical information and analysis on its website such as a regular report on reinsurance. Supervisory teams are required to take account of the key risks to the insurance sector, as identified in the insurance directorate or wider BaFin risk committee process, in establishing their supervisory priorities and plans for individual insurers and groups as well as the results of risk classification etc. (see ICP 9). BaFin has been developing its approach to horizontal reviews of insurers through: • Its regular stress tests, which have been conducted since 2004 on life, health and P&C companies (although not reinsurance companies); these have been significantly expanded in recent years in the case of life insurance to supplement, since September 2013, an annual projection requirement with a five years horizon (the longest period for which, in BaFin's view, projections would be meaningful); supervisors use the results to identify insurers showing significant risk of being unable to meet obligations to policyholders; these findings have, for example, helped BaFin to identify small and medium-sized companies which should be subject to closer supervision than would normally be carried out under its risk-based framework; and • Regular ad-hoc surveys of a sample of insurers, requiring early responses on particular exposures, lines of business or specific products (for example, banking-type products); or the impact of the developments in the business environment. In parallel with the extensive work undertaken with individual insurers on Solvency II implementation, BaFin carried out two surveys on the quantitative impact of the new solvency requirements on life insurers, as at end-2013 and end-2014. Summaries were published. The results of the surveys have been used to support supervisory work on insurers shown to be furthest from being able to satisfy the new requirements. ***Role of and Coordination with Other Authorities*** Macroprudential responsibilities are shared with other members of the FSC: • The Bundesbank undertakes monitoring and analysis of the insurance sector, focusing mainly on life insurance at present, for publication (for example in its annual Financial Stability Review) and as an input into the FSC; it collects no information directly from insurers (and has no powers to do so), but may ask BaFin to share supervisory reports; the Bundesbank is invited to the BaFin's Risk Committee, but it develops its own analysis and conclusions in line with its status as an independent authority; • The BMF is the executive authority responsible for the regulatory process, which (in relation to macroprudential objectives) has included imposition of the Additional Interest Provision (Zinszusatzreserve) requirement (part of the regulation on calculation of insurers' premium reserves) and the Act to Ensure Stable and Fair Benefit Payments for Life Insurance Policyholders (also known as the Life Insurance

	Reform Act) of 2014, a package of regulatory changes, aimed in part at relieving some of the pressures on life insurers in the low interest rate environment. The FSC's key responsibility is to issue warnings and recommendations to prevent financial stability risks. FSC is the main forum for cooperation and coordination between the BMF, BaFin and Bundesbank on macroprudential analysis and policy action and regular reviews of insurance issues are included on its agenda. ***Systemic Importance of Insurers*** BaFin is the group-wide supervisor for one Global Systemically Important Insurer (G-SII) and cooperates with other EU national authorities in the supervision of two others as host supervisor (for one other G-SII – and one former G-SII, to which the G-SII arrangements nonetheless continued to apply as at late 2015). BaFin does not have a specific process to identify and monitor non-insurance and non-traditional lines of business in other insurers on a continuing basis, but it expects to identify relevant business through its supervision work of individual companies and the market. It has looked, for example, to identify the writing of products associated with increased capital market risks such as variable annuities; and it monitors the extent (limited at present) to which insurers use derivatives other than for routine asset and liability management purposes in relation to core insurance business. In relation to large companies and groups, during 2015 BaFin has: • Reorganized their supervisory teams to bring together all the supervisors responsible for individual groups and to concentrate supervision of the major international groups in one department: this development is aimed at supporting comprehensive groupwide supervision, including the identification of non-traditional and non-insurance business and broader risk; and • Developed its risk classification system (see ICP9) so that in addition to the impact categories of High, Medium and Low, it now has a category of Very High, for the largest entities and groups; development of the supervisory approach associated with this classification is continuing, but the largest groups are already subject to continuous oversight facilitated by relatively large supervisory teams. BaFin is engaged in the development of macroprudential supervision in the IAIS. In relation to the one G-SII for which it is the groupwide supervisor, it has implemented elements of the IAIS framework agreed to date, including the application of the initial assessment methodology (for identifying G-SIIs) and the requirements of G-SII supervision including requiring a Systemic Risk Management Plan (SRMP), Liquidity Risk Management Plan (LRMP), and establishment of a CMG (see ICP26). Two of Germany's largest insurance groups include large reinsurance operations with global reach. BaFin is waiting for the outcome of the current IAIS review of its assessment methodology (including consideration of the approach to reinsurance) before deciding how to develop its approach to these groups. BaFin's work to date on G-SIIs has been undertaken on a largely voluntary basis. There are no provisions in the law explicitly recognizing a separate status of G-SII, for example in relation to the ability of BaFin to impose additional capital requirements on a G-SII, as is planned under the developing IAIS framework for higher loss absorbency capacity (HLA).

Comments	Macroprudential supervision of insurance has been developed in close alignment with IAIS policies and practices, including in relation to potentially systemic insurers other than reinsurers. Within BaFin the organizational structure and resourcing of supervisory work on individual groups and cross-firm issues supports a macroprudential approach, as does the development of tools such as the five-year stress tests of life companies. The creation of the Financial Stability Committee (AFS—Ausschuss für Finanzstabilität) has facilitated more coordinated macroprudential analysis and action on insurance at the national level at a time when pressures on life insurers have made this timely and important. To strengthen the approach further, it is recommended that: • The AFS and German government consider giving the AFS more scope to take macroprudential action without the need for legislative change – to address the risk that necessary measures are delayed or not implemented owing to the political cycle; • Notwithstanding the different supervisory objectives applicable to reinsurance and the outstanding issues being considered by the IAIS, BaFin consider the application to the larger reinsurers of macroprudential tools used in the case of primary insurers, including regular stress tests and recovery and resolution planning; and • Consideration be given and plans developed for the implementation of the IAIS framework of higher loss-absorbency capacity (HLA) for G-SIIs to ensure that there are no legal or policy obstacles.
ICP 25	**Supervisory Cooperation and Coordination** The supervisor cooperates and coordinates with other relevant supervisors and authorities subject to confidentiality requirements.
Description	***Legal and Policy Framework*** Cross-border cooperation, including through supervisory colleges, has been a feature of BaFin's approach for many years, consistent with the EU framework (the Insurance Groups Directive and Helsinki Protocol). At the time of the assessment, its approach had been in transition to Solvency II, with its increased emphasis on group supervision and specific processes (for adoption by EU supervisors) such as group internal model approval. *(VAG2016 s278)*. Changes in the insurance law that took effect in April 2015 empowered BaFin to establish colleges and to share information and cooperate on internal models approval work. From January 1, 2016, colleges are mandatory for each EU group with cross-border activities, regardless of its size. Binding decisions will be taken by the group supervisor or by college members, including model approvals and decisions on the equivalence of non-EU supervisory regimes for group solvency or group supervision purposes. There are provisions for choosing the group supervisor, whose responsibilities include: • Coordination of information gathering, including in an emergency; • Supervisory review and assessment of the financial situation of the group; • Assessment of compliance of the group with the rules on solvency and of risk concentration and intra-group transactions;

	• Assessment of the governance of the group; and • Planning and coordination of supervisory activities, including in an emergency. Coordination arrangements governing the establishment and working arrangements of colleges, including confidentiality provisions, are to be established by initiative of the group supervisor. *(VAG2016 s283(4))* A standard format as well as guidelines on college operations are set out in EIOPA's Guidelines on operational functioning of colleges, 2014. *(EIOPA-BoS-14/146 EN)* BaFin has substantially implemented these guidelines, including their provisions on decision-making processes, the college work plan; joint on-site examinations; risk assessment; and the decision making process for the group internal model. All supervisory authorities where a group subsidiary (but not a branch) has its head office are members of EU colleges, as is EIOPA. Central banks and ministries are not members, but may participate as appropriate. Where the group is a financial conglomerate, supervisors of all the financial activities, wherever located, are invited to be members of a single college. In relation to wider international arrangements, BaFin is a signatory of the IAIS Multilateral Memorandum of Understanding (MMoU) and has established MoUs with several non-EEA authorities. Non-EEA supervisors may become members of a college and signatories to a coordination arrangement, usually at the same time as an MoU is signed, but only where the non-EEA supervisor is subject to confidentiality requirements consistent with ICP 3 and the IAIS MMoU. BaFin maintains, in its international division, a list of countries which have been assessed for these purposes, which supervisors must refer to before they establish a new college or accept a new college participant from a non-EEA country. ***Supervisory Cooperation in Practice*** BaFin is the group supervisor for 17 insurance groups and is a college member, as a host supervisor, of another 14 colleges. For all colleges, it expects to conclude coordination arrangements by end of 2015. BaFin aims to adopt a two-tiered approach to college formats, with an EU college and a global college. In practice, college meetings take a number of formats, including: the global college, EU only, and EU internal model college (for countries with the greatest interest in the approval process); in addition, for the G-SIIs, the Crisis Management Groups (CMGs) are evolving into a core college format, where only the supervisors of the most significant elements of the group are represented (CMGs are covered in more detail under ICP26). BaFin has been involving non-EEA supervisors in global colleges as far as possible, inviting all supervisors to join its G-SII college for example. Not all these supervisors are from countries that have been assessed and approved for exchange of confidential information. Supervisors have been seeking to involve such supervisors in non-confidential college work or by agreement with the group management that particular information may be shared. However, it is only the largest groups which have non-EU members and only a few of the group operations in non-EU countries are significant. Most colleges have only EU members, reflecting the balance of their international operations.

	Global colleges are focusing more on information-sharing at this stage of their development. BaFin aims in principle to attend all colleges to which it is invited as a host supervisor. It has, however, declined to participate in one case where the operations in Germany are particularly small. The priority work of the colleges has been to establish good channels of communication and information flow and to develop an overview of the group via a mapping of legal entities and subsequently an overview of overall risks. For a number of colleges, the internal model approval process has been a major focus of the work, although it has involved as much specialist as supervisory resource. Only limited joint examination work has been undertaken apart from internal model assessments. BaFin will be further developing, as group-wide supervisor, the overall assessment of the risk and solvency of the group, drawing on the group ORSA, drawing on solo level assessments.
Comments	BaFin has invested significantly in the development of arrangements for colleges of supervisors, within the context of a more general enhancement of its approach to groupwide supervision. It has benefited from (as well as contributing to) the EIOPA framework, including the EIOPA attendance at college meetings, but has also taken a global approach, as far as is consistent with constraints on exchange of confidential information. The approach is still developing and agreeing risk assessments for each group and using these to inform group wide supervisory coordination remains a particular challenge.
ICP 26	**Cross-border Cooperation and Coordination on Crisis Management** The supervisor cooperates and coordinates with other relevant supervisors and authorities such that a cross-border crisis involving a specific insurer can be managed effectively.
Description	BaFin's main focus in relation to cross-border crisis management is on cooperation with other EU supervisors, within the framework of the colleges of supervisors and the EIOPA guidelines; and on the particular agenda, including recovery and resolution planning, for the G-SIIs. The crisis coordination arrangements within the EU focus on crisis preparedness, including the maintenance of contact details and ensuring access to the information about a cross-border group that would be required to manage a crisis effectively. There is no EU framework as yet for recovery and resolution planning for insurers. There are also limited insurance-specific provisions in German domestic law, although the BaFin has significant powers in relation to insurers that may be unable to meet their obligations (see ICPs 10 and 12); and there is no resolution authority in Germany for insurers. BaFin's work in this area with G-SIIs is being conducted on a largely voluntary basis. BaFin's readiness has not been tested recently by a significant crisis involving an insurance company. It has recent experience of the insolvency of a small, domestic P&C insurer in 2015; and of the failure in 2003-4 of the life insurance operations, all of which were in Germany, of the Mannheimer group. At that time the EU framework was less

	developed and there were no safety net arrangements in Germany. BaFin has participated in EIOPA's testing of its crisis coordination arrangements. ***EU Colleges Work on Crisis Preparedness*** Cooperation on crisis preparedness is one of the issues covered by the EU arrangements for college of supervisors. *(EIOPA Guidelines on operational functioning of colleges: Annex 1.E – Emergency plan)* The group supervisor is responsible for preparing an Emergency Plan for each company for which there is a college of supervisors as an annex to the coordination arrangement (see ICP25). Emergency plans are designed for insurers in crisis – defined as one that is potentially unable, partially or totally, to settle claims and to pay policyholder benefits. The objective and approach of the Emergency Plan are to: • Facilitate the exchange of confidential information at short notice within the college—a list of contacts is maintained by EIOPA as part of the Helsinki List arrangements; • Create transparency with regard to the group structure—informed by an exercise to map the group structure and organization; • Secure an early crisis alert to maximize time for coordinated action - by committing supervisors to notify college members of any potentially serious financial disturbance at group level and to assess the nature of the crisis in cooperation with other supervisors and EIOPA as a basis for any decision to intervene; and • Secure information flow within the college and to the public in case of an insurer experiencing stress. Meetings of the colleges of supervisors review the crisis management arrangements, generally and with a view to identifying potential systemic implications of an insurance company failure. ***BaFin's Approach*** BaFin is developing emergency plans based closely on the EIOPA guideline in the context of finalizing coordination arrangements for all the colleges for which it is group supervisor. It plans to complete the process by the end of 2015. The inclusion of non-EEA supervisors, where applicable, within the coordination arrangements will extend the relevant provisions on crisis management to the global group of supervisors. BaFin has also implemented elements of the EIOPA guidelines into its internal guidance for supervisors, including its guideline on the supervision of groups (although the scope of this document is on group supervision generally rather than the supervision of cross-border groups). There are no explicit requirements on insurers in relation to: • Their being capable of supplying, in a timely fashion, the information required to enable the supervisor to manage a financial crisis; and • Their maintaining contingency plans and procedures based on their specific risks for use in a going-concern and gone-concern situation—except in the context of planning for business interruption. However, BaFin places certain expectations on insurers to address these issues in the

	context of risk management requirements. BaFin has also established a Crisis Management Group (CMG) for the G-SII for which it is the group supervisor and participates in CMGs for one other G-SII—and one former G-SII, to which the G-SII arrangements continued to apply as at late 2015 and for which it is a host supervisor. CMGs have more limited membership than colleges, enabling them to focus in depth on crisis preparedness, including recovery and resolution planning. ***Recovery and Resolution Planning*** BaFin has powers, in the context of the risk management requirements of the supervisory legislation, to require insurers to prepare "general recovery plans" setting out scenarios that could represent a risk to the insurer and describing the corrective measures it would take in order to address such risks. More detailed requirements may be set out in an ordinance. *(VAG2016 s26 & s34)* These powers have not been formally exercised as yet, although recovery planning is being undertaken with G-SIIs. BaFin is considering whether to require plans for any insurers other than G-SIIs, taking into account the nature of risk in the insurance sector (for example the long term focus of the business model in life insurance), the experience of recovery plans in the banking sector and the general principle of proportionality. BaFin also has extensive powers to take action in relation to particular insurers and groups in case of an actual crisis (see ICPs 10 and 12). These powers do not explicitly refer to requirements on insurers in relation to resolution planning. However, BaFin has other extensive powers to obtain relevant information that could be used to inform resolution planning. For financial conglomerates, there are explicit requirements in law to contribute to adequate recovery and resolution procedures and plans, when necessary, and to develop such procedures and plans. These powers have not so far been used. (*Finanzkonglomerate-Aufsichtsgesetz – FKAG, s25).* The CMGs for the group of which BaFin is group supervisor and those for the two groups where it is a host supervisor are preparing resolution plans, taking into account the Key Attributes framework issued by the FSB, including Annex 2 on the resolution of insurers. These are at an early stage of development.
Comments	BaFin has been putting in place (and was expected to complete by end-2015) extensive crisis management arrangements within the framework of its colleges of supervisors based on EU guidelines. Its inclusive approach to college membership makes for a comprehensive approach that is also resulting in the sharing of information, including on the structure of groups and the potential impacts of a crisis. Recovery and resolution planning is currently confined to G-SIIs, with BaFin functioning as de facto resolution authority as well as supervisor. The overall framework for resolution of insurers falls short of the expectations of the FSB Key Attributes, an issue that is on the agenda of the EU. It is recommended that: • BaFin make use of its powers to require significant insurers to develop recovery plans, recognizing that insurers may have relatively few options for recovery actions, starting with higher risk insurers under the risk classification system and taking into account the immediate priority of Solvency II implementation; • As also recommended under ICP24, BaFin should consider the application to all the

	larger groups (not only G-SIIs) of recovery and resolution planning, reflecting the scale and global importance of these groups and the FSB requirement that insurers that are systemically significant or critical upon failure should be subject to a requirement for an ongoing process of recovery and resolution planning; and • Gaps in the regulatory framework in relation to requiring companies to be ready to report necessary information in case of a crisis and to maintain contingency plans be filled in due course.