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TECHNICAL NOTE—INSURANCE REGULATION AND SUPERVISION

This Technical Note on Insurance Regulation and Supervision for the Germany FSAP was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in October 2021.

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July 22, 2022

TECHNICAL NOTE

INSURANCE REGULATION AND SUPERVISION

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Germany. 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)
BBk	Deutsche Bundesbank
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
ERM	Enterprise Risk Management
ESRB	European Systemic Risk Board
EU	European Union
FinDAG	Act Establishing the Federal Financial Supervisory Authority (Finanzdienstleistungsaufsichtsgesetz)
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability Committee (Ausschuss für Finanzstabilität)
GAAP	Generally Accepted Accounting Principles
G-SIIs	Global Systemically Important Insurers
IAIG	Internationally Active Insurance Group
IAIS	International Association of Insurance Supervisors
ICS	Insurance Capital Standard 2.0 of the IAIS
ICPs	Insurance Core Principles
IFRS	International Financial Reporting Standards
IT	Information Technology
MCR	Minimum Capital Requirement
MoF	Federal Ministry of Finance (Bundesministerium der Finanzen)
ORSA	Own Risk and Solvency Assessment
P&C	Property and Casualty
SCR	Solvency Capital Requirement
TN	Technical Note
VAG	Insurance Supervision Act (Versicherungsaufsichtsgesetz)
VVG	Insurance Contract Act (Versicherungsvertragsgesetz)
ZZR	Additional Provision to the Premium Reserve (Zinszusatzreserve)

EXECUTIVE SUMMARY[1]

The Financial Sector Assessment Program (FSAP) conducted a focused review of insurance regulation and supervision in Germany. This technical note (TN) provides an update on the insurance sector and highlights risks and vulnerabilities. It analyzes four key aspects of regulatory and supervisory oversight: supervisory powers, independence, and resources; the solvency framework; supervision; and changes of control and resolution.[2] The Federal Financial Supervisory Authority (BaFin) is the federal German insurance supervisor. BaFin is subject to oversight by the Federal Ministry of Finance (MoF), which is accountable to the Federal Parliament. The analysis focuses on supervision within the scope of BaFin's mandate. The TN comments on progress in respect of the implementation of recommendations made by the previous FSAP and offers further recommendations to strengthen the regulatory and supervisory regime.

The insurance industry has generally been stable and has performed well in the face of adverse conditions. The market is diverse by size and type of insurer, market concentration is low, and the number of insurers has been stable. Premium growth has been steady, and the industry remains profitable with high solvency ratios. However, careful analysis is needed in the case of life insurers, some of which have been selling fixed income securities to realize the investment gains created by low market interest rates. Insurers generally invest conservatively. Products with guarantees still dominate the life insurance market, although new sales are shifting toward savings products with lesser guarantees and products that provide protection against biometric risks. Non-life insurance is also dominated by traditional lines of business, but products and pricing mechanisms are evolving to include telematic tariffs, insurance on demand, and cyber insurance products. Distribution channels are mostly traditional, with the majority of sales being transacted through single-tied agents. Bank—insurance linkages and interconnectedness with other parts of the financial sector are limited, compared with neighboring countries.

BaFin and the insurance industry moved to Solvency II in 2016, which has had positive effects on both industry practices and the regulatory and supervisory regime. Implementation has been more complex than in other European Union (EU) countries owing to the nature of the insurance products and the continuing importance of national GAAP in the determination of life insurance policyholder bonuses. Currently 37 insurers are using internal models for solvency calculations, and BaFin takes a thorough approach to model approvals and reporting.

The insurance sector faces diverse risks, including risks related to prolonged low interest rates. Despite a still generally conservative investment profile, there is evidence of search for yield, with maturities lengthening, investments in bonds shifting toward foreign jurisdictions with higher interest rates, and a movement toward alternative investments. Insurers have allocated a significant

[1] This Technical Note was prepared by Michael Hafeman, IMF external expert.

[2] The analysis was based on the laws, regulations and other supervisory requirements and practices in place on October 6, 2021

share of investments into funds, some of which actively use derivatives. Life insurers face an ongoing need to build reserves against the potential cost of guarantees, which might affect their profitability and investment decisions. Technology-related risks also have been growing, along with climate change and other sustainability risks. BaFin will need to continue analyzing these and other risks, highlight the need for insurers to deal with them, and monitor their progress in doing so.

More steps need to be taken by BaFin and the MoF to reduce the real and perceived risks to BaFin's operational independence, as recommended in previous FSAPs. 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. However, the extensive reporting to the MoF and the presence of government representatives and experts from industry on the Administrative Council weaken both the real and perceived operational independence of BaFin.

The solvency regime is comprehensive, but there is scope for further strengthening and simplification to enhance its effectiveness. To enhance the contribution of valuation to solvency assessment, BaFin should consider the impact of more extreme interest-increase scenarios on the funding of the ZZR, prepare for the implementation of IFRS 17 Insurance Contracts, promote the inclusion of an income statement as part of Solvency II reporting, and seek to identify and promote opportunities to harmonize valuation and reporting requirements. Liquidity risk management reporting and stress testing requirements should be strengthened. Efforts should be made to streamline internal model approval and reporting requirements, which impose costs and discourage the use of internal models. Additional guidance could highlight the importance of insurers setting their own target solvency ratios and set out supervisory control levels for Solvency I insurers.

Several actions are required for reinforcing BaFin's approach to supervisory review, which underwent major changes to provide for a more risk-based approach in conjunction with the implementation of Solvency II. BaFin should reassess its guidelines on the minimum and actual frequency of on-site inspections in relation to the Supervisory Categories of insurers, to ensure that inspections are sufficiently frequent to support robust identification and assessment of risks. If concern about the potential cost of an inspection to a particular insurer is a barrier to greater frequency, changes to the system of direct charging should also be considered. Management reporting should be enhanced to facilitate systematic tracking and reporting of the timeliness of off-site and on-site supervisory activities in comparison with established procedures and the supervisory plan, supporting any necessary changes in supervisory priorities throughout the cycle of activities. BaFin should provide more comprehensive feedback to insurers on its supervisory findings, assessments, and concerns, including the highlights of its risk assessment and the market impact and quality ratings assigned to the insurer. This could enhance insurers' understanding and help to encourage improvements in their practices. BaFin should take steps to enhance the effectiveness of intervention in driving improvements, such as using intervention powers more intensively in relation to non-solvency concerns, systematically assessing the effectiveness of intervention measures, and developing and publishing a guide to intervention. Crisis management arrangements for IAIGs should be tested.

Actions to strengthen the resolution regime are needed, particularly to facilitate the resolution of a larger insurer or group. This includes providing BaFin the power to require contingency plans and resolution plans, and expanding the range of powers to facilitate the prompt and orderly exit of failing insurers. The ability of insurance guarantee schemes to identify, prepare for, and fund potential losses should be enhanced. Steps that should be considered include increasing communication between the schemes and BaFin, increasing the capacity of the schemes to raise funds, undertaking contingency planning for dealing with a large failure, providing greater flexibility in the use of funds, and establishing a guarantee scheme for P&C insurers. Continued engagement on these issues at the European level would help to promote harmonization and avoid gaps that might weaken the protection of policyholders and threaten financial stability.

Table 1. Germany Key Recommendations: Regulation and Supervision of Insurers		
Recommendation	**Priority**	**Timeframe**
Supervisory powers, independence, and resources		
1) Take steps to reduce the real and perceived risks to BaFin's operational independence. (¶37)	H (BaFin /MoF)	I
Solvency framework		
2) Take steps to enhance the contribution of valuation to solvency assessment. (¶69)	H (BaFin /MoF)	I
3) Strengthen the requirements around liquidity risk management reporting and liquidity stress testing. (¶70)	M	NT
4) Continue active supervision of capital adequacy, while seeking to streamline internal model approval and reporting requirements. (¶71)	M	NT
5) Consider providing additional guidance on certain aspects of capital adequacy. (¶72)	L	NT
Supervision		
6) Reassess guidelines on the minimum and actual frequency of on-site inspections in relation to the Supervisory Categories of insurers, to ensure that inspections are sufficiently frequent to support robust identification and assessment of risks. (¶114)	M	NT
7) Enhance management reporting to facilitate systematic tracking and reporting of the timeliness of off-site and on-site supervisory activities in comparison with established procedures and the supervisory plan. (¶115)	H	I
8) Provide more comprehensive feedback to insurers on supervisory findings, assessments, and concerns, including the highlights of the risk assessment and the market impact and quality ratings assigned to the insurer. (¶116)	M	NT
9) Take steps to enhance the effectiveness of intervention in driving improvements, particularly in relation to supervisory concerns other than the solvency ratio. (¶117)	H	I
10) Take steps to test the crisis management arrangements for IAIGs. (¶118)	M	NT
Changes of control and resolution		
11) Strengthen BaFin's powers, including providing the power to require contingency plans and resolution plans, and expanding the range of powers to facilitate the prompt and orderly exit of failing insurers. (¶134)	H (MoF)	NT
12) Enhance the ability of insurance guarantee schemes to identify, prepare for, and fund potential losses. (¶135)	M (MoF)	MT
Note: **BaFin responsible for recommendations except where indicated otherwise in parenthesis.** In terms of priorities, H, M, and L stand for high, medium, and low. In terms of time frame, I, NT, and MT stand for immediate (within one year), near-term (within 2–3 years), and medium-term (within 3–5 years).		

INTRODUCTION AND BACKGROUND

A. Scope and Approach

1. **This technical note (TN) provides an update on the German insurance sector and an analysis of certain key aspects of the regulatory and supervisory regime.** The TN has been prepared as part of the 2021 Financial Sector Assessment Program (FSAP). It has drawn on virtual and on-site discussions in Germany from September 20 to October 6, 2021. The analysis refers to the Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups (ICPs), which were issued by the International Association of Insurance Supervisors (IAIS) in November 2019.[3]

2. **The main focus of the TN is on recent developments in the sector and key vulnerabilities, including, for life insurance, those associated with the continuing low interest rate environment; the implementation by the authorities and industry of the Solvency II requirements (which took effect in full on January 1, 2016); and the supervisory approach.** Subsection B of this section summarizes the market structure, insurance products, and industry performance, while subsection C highlights risks and vulnerabilities. The institutional arrangements for financial sector regulation and supervision are outlined in subsection D.

3. **The second section of the TN analyzes German practice in relation to four key aspects of regulatory and supervisory oversight: supervisory powers, independence, and resources; the solvency framework; supervision; and changes of control and resolution.** The analysis was informed by a detailed self-assessment prepared by BaFin in respect of selected ICPs, along with anonymized examples of actual supervisory practices and assessments.[4] ICPs selected for review were broadly those with macrofinancial relevance. However, the TN does not include a detailed assessment of observance of the ICPs.[5] The analysis was based on the laws, regulations and other supervisory requirements and practices in place at the time of the discussions in Germany.

4. **The 2016 FSAP identified recommendations for improvement, including the following that it suggested should receive high 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

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[3] The IAIS ICPs apply to all insurers, whether private or government-controlled. Specific principles apply to the supervision of intermediaries. The Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) was adopted in November 2019. ComFrame is presented in blue boxes within the ICP Introduction and Assessment Methodology as well as within the following ICPs: 5, 7, 8, 9, 10, 12, 15, 16, 23, and 25.

[4] The following ICPs were selected for review: 2, 6, 9, 10, 12, 14, 15, 16, 17, 19, 23, 24, and 25. These were largely the same ICPs analyzed in the 2016 TN, with the addition of ICPs 16 and 23.

[5] The most recent such assessment, conducted on the basis of the 2003 version of the ICPs, was carried out in 2011. An analysis in relation to selected ICPs was performed in November 2015 and is documented in IMF Country Report No. 16/192, Germany 2016 Insurance Sector Supervision - Technical Note.

meeting the new solvency requirements or maintaining a surplus under national GAAP (generally accepted accounting principles);

- BaFin should ensure that companies using the transitional measures under Solvency II have a robust and credible plan for meeting their Solvency Capital Requirements (SCR) 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;
- 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;
- 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.

5. The second section of the TN includes comments on progress in respect of the recommendations made in the previous assessment. Solvency II implementation has required BaFin to address many of these issues, and many of the FSAP recommendations are reflected in its supervisory approach.

6. The author is grateful to the authorities and private sector participants for their excellent cooperation. The author benefited greatly from the inputs and views expressed in meetings with insurance regulators, supervisors, insurance companies and industry and professional organizations.

B. Market Structure, Insurance Products, and Industry Performance

7. There were 393 active insurance companies supervised by BaFin at the end of 2021. The number of insurers has declined only slightly since 2016, from 404. Most of the decline occurred through mergers or takeovers, with only a few insurers suspended by BaFin each year and none closed by BaFin during this period. The market is diverse by size and type of insurer, including both large internationally active insurers and about 127 mutual companies, many of which are small. Market concentration is low, with the top 10 life insurers having a 48 percent share of premiums (lowest in Europe in 2020) and the top 10 non-life insurers having a 52 percent share (second lowest).[6] Premium growth has been steady, averaging 3 percent per annum for life insurers and 4 percent for non-life insurers from 2017 to 2020.

[6] Source: EIOPA.

Table 2. Germany: Number of Active Insurers Supervised by BaFin[1]

Type	2016	2017	2018	2019	2020	2021
Life	87	87	87	85	83	82
Non-life	251	250	248	252	249	249
Reinsurance	22	23	23	24	22	23
Captives	9	9	9	9	9	9
Burial Funds	35	34	33	33	31	30
Total	404	403	400	403	394	393

Note: Numbers at year end
Source: BaFin
[1] The number of active insurers supervised by BaFin includes information received for some undertakings which are supervised by Federal States. About 600 undertakings, most of them relatively small, regional mutual insurance associations, are supervised by individual supervisory authorities of the Federal States, compared to about 700 at the end of 2016.

8. 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 returns on equity in the last three years were 4.0 percent for life, 4.0 percent for property and casualty (P&C) and 11.3 percent for reinsurers. The average solvency ratios (SCR under Solvency II) at the end of 2020 were 374 percent for life insurers, 299 percent for P&C and 270 percent for reinsurers. Life insurers have been required to generate profits to address additional GAAP reserving requirements in place since 2011 (see subsection on the Solvency Framework), and some of these profits have resulted from the sale of fixed income securities to realize the investment gains created by low market interest rates. The underlying performance of life insurers could therefore be much lower than the published figures.

9. German insurers invest conservatively. The largest shares of life insurers' directly invested assets are in government securities (19 percent) and bonds (20 percent).[7] Direct exposures to listed equity and other risky assets are limited (listed equity 0.3 percent of the total, alternative investments 1 percent). Direct loans and investments in real estate also account for small shares (loans 7 percent and real estate 1 percent). Life insurers also invest indirectly through funds set up by asset management companies (34 percent of assets), typically for a particular insurer.[8] But including both direct and indirect investments, the exposure of life insurers to real estate is only about 3 percent of assets. Investment allocation of non-life insurers (P&C and reinsurers) is similarly conservative. The total investments of insurers in 2020 were EUR 1,803 billion (GAAP basis; EUR 2,277 billion Solvency II basis), composed of life insurers (EUR 1,057 billion GAAP; EUR 1,272 billion Solvency II), P&C (EUR 481 billion GAAP; EUR 606 billion Solvency II) and reinsurers (EUR 264 billion GAAP; EUR 399 billion Solvency II).[9]

[7] All ratios in this paragraph are on a Solvency II basis, against total assets unless mentioned specifically.

[8] 60 percent of these investments are in debt funds, with 9 percent in equity funds, 7 percent in real estate funds, 5 percent in asset allocation funds, and the remaining 19 percent in other types of funds.

[9] Total assets of the banks were EUR 9,291 billion.

10. Products with guarantees still dominate the life insurance market. Unlike insurance markets in other advanced economies, products with minimum guarantees (including participating policies) dominate the German insurance markets. Although insurers have been redesigning products to reduce the nature, level, and duration of guarantees applicable to new sales, pure unit-linked products still accounted for less than 10 percent of new business of life insurers in 2020. However, including hybrid products, which combine guaranteed and unit-linked elements, all products with unit-linked elements increased their share of new sales from 31 percent in 2017 to 37 percent in 2020, with industry projecting a further increase to 45 percent in 2024. At the same time the market share of with-profit policies with traditional guarantees had decreased to only 15 percent in 2020 and is projected to further decrease to 13 percent in 2024. With-profit policies with more flexible new kinds of guarantees accounted for 20 percent of new business in 2020 and are projected to decrease to 15 percent in 2024. Life insurers are also increasingly emphasizing products that solely or predominantly provide protection against biometric risks, such as death and disability.

11. Non-life insurance is also dominated by traditional lines of business, such as motor (35 percent of total premium income), property (30 percent), and general liability (14 percent). Products and pricing mechanisms are evolving to include telematic tariffs (“pay as you drive”) in motor business, insurance on demand, and cyber insurance products. The risk from less traditional business lines is currently limited, with credit and surety insurance and cyber-risk insurance together accounting for only about 1 percent of total premium income.

12. Distribution channels are mostly traditional, with the majority of sales being transacted through single-tied agents. The number of agents has declined in recent years, but they still account for about 77 percent of the registered insurance intermediaries, with the balance being brokers. Some agents work for banks, which exclusively sell insurance products of one insurance company or one insurance group. Further distribution channels include direct sales (via employees of an insurer or via the Internet) and comparison websites, which are typically registered as brokers and are mainly active in the field of motor third-party liability insurance and other mass market non-life insurance products.

13. Bank—insurance linkages and interconnectedness with other parts of the financial sector are limited, compared with neighboring countries. 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 holdings of bonds issued by banks. Exposures to banks (half of which is covered bonds) accounted for 16.8 percent of the total assets of insurers at the end of 2021, compared to 19.0 percent one year earlier. The interconnectedness of the German insurance sector with that of other countries does not appear to pose a significant risk. The cross-border insurance business might facilitate the transmission of shocks under a stress scenario, but it also supports risk diversification. Based on direct gross written premiums, Germany was a ”receiver country” in 2020, receiving more

premiums than it subscribed; when reinsurance premiums are included, Germany was a "donor country".

Solvency II

14. BaFin and the insurance industry moved to Solvency II in 2016, which has had positive effects on both industry practices and the regulatory and supervisory regime. The Solvency II Directive was transposed fully into the Insurance Supervision Act (Versicherungsaufsichtsgesetz – VAG) before the start of Solvency II without any introduction of additional requirements. Solvency II applies to insurers that account for more than 99 percent of industry premiums and assets, with the exceptions being very small regional insurers that are subject to insurance regulation under Solvency I (also set out in the VAG). BaFin was actively involved in the development of the Solvency II and uses its understanding of the framework in working to implement it in a consistent and proportionate manner. BaFin provides additional internal guidance to supervisors and also engages with the relevant EIOPA expert networks to promote convergence of supervisory practices.

15. BaFin has been providing guidance to facilitate the application of Solvency II by insurers. This includes publishing interpretation decisions to address identified deficiencies in the application of Solvency II requirements that relate to a larger number of insurers. Articles in the monthly BaFin Journal are also used to communicate supervisory concerns. BaFin also regularly updates clarifying information on quantitative and qualitative reporting requirements.

16. Solvency II implementation in Germany has been more complex than in other European Union (EU) countries owing to the nature of the insurance products and the continuing importance of national GAAP. In particular, policyholder bonuses, a key feature of traditional life products, continue to be determined on a GAAP basis, which differs fundamentally from Solvency II.[10] Life insurers therefore need to project future 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 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 is required to ensure that complexity does not lead to under-valuation or misreporting.

17. Currently 37 insurers are using a full or partial internal model for solvency calculations. Most of these are full internal models. From 2018 to 2020 1,013 model changes, including both minor and major changes, were reported to BaFin. BaFin has deployed expert resources on the demanding internal models work, which also requires extensive international

[10] National GAAP requires a broadly lower-of-cost-and-market value approach, while 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 used in Germany only for solvency (i.e., supervisory) purposes.

cooperation. Industry feedback to the FSAP mission highlighted the thoroughness BaFin's approach to model approvals and reporting.

18. BaFin will assess the need for changes following the Solvency II Review. The European Commission published its draft of the proposed legal changes on 22 September 2021,[11] which has provided more certainty as to which parts of the EIOPA Opinion may be introduced into the Solvency II framework, but the process is ongoing.

C. Risks and Vulnerabilities

19. Despite a still generally conservative investment profile, there is evidence of search for yield against the backdrop of prolonged low interest rates. The share of bonds with maturities of more than 10 years has increased from 43 percent to 56 percent since 2016, raising the weighted average maturity by more than 2 years. Although the share of total assets invested outside Germany has remained stable (42 percent in 2020), greater shares of sovereign and corporate bond investments were outside Germany (58 percent and 61 percent, respectively, in 2020), where interest rates have been higher. In a 2020 survey by BaFin, more than half of the insurers stated that, for new investments, issuers' average creditworthiness has declined over the last five years. The survey also highlighted insurers' plans to increase the proportion of alternative investments, particularly infrastructure and private debt, in their portfolios significantly in the future, from a current base of under 6 percent.

20. Downgrade risk was heightened by the pandemic. The average ratings of the bond portfolios of insurers did not decline between 2016 and 2020. However, the risk of corporate insolvencies is increasingly affecting their portfolios. In 2020, in the wake of the pandemic, the rating of 18 percent of the securities in insurers' portfolios was downgraded, whereas in the two previous years, on average, only 13 percent of securities were affected by downgrades. At the end of 2020, a further 29 percent of the securities also had a negative rating outlook. Life insurers are particularly subject to this risk and those using the standard formula could experience a double impact on their SCR ratios (decrease in own funds and increase in required capital). The downgrade risk has been assessed by BaFin using scenario testing, which shows it to be material but manageable.

21. German insurers have allocated a significant share of investments into funds, some of which actively use derivatives. As of the end of 2020, their total investment in funds exceeds 30 percent of assets. Many are specialized funds, set up by asset management companies just for insurers. Most of the securities (including securities lending transactions) in the funds can be looked through by insurers. BaFin has a database of the contracts for the specialized funds, which includes information such as their intended use of derivatives. Some information with regards to derivatives in funds can be found in the regular Solvency II reporting. Furthermore, 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

[11] Reviewing EU insurance rules: encouraging insurers to invest in Europe's future, https://ec.europa.eu/commission/presscorner/detail/en/IP_21_4783

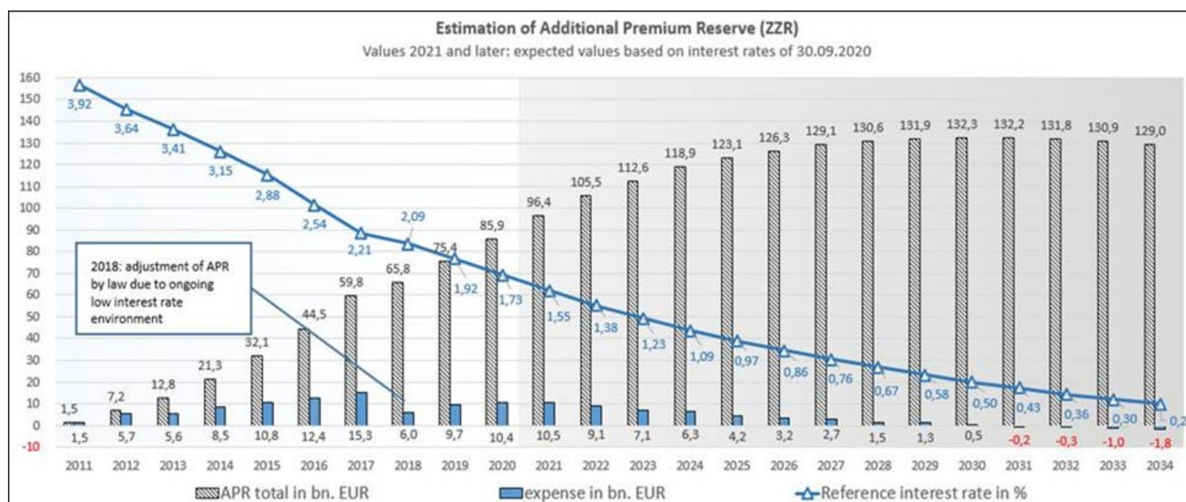
for EMIR data that will enable insurance supervisors to access more readily information and analysis on all derivatives to which insurers are a party, whether directly or through any type of investment fund.

22. Life insurers are exposed to the risks from offering significant guarantees on long-term policies. Guarantees on some policies are as high as 4 percent and in general apply to the whole term of the policy. The term of policies can be very long, with the weighted average years to maturity of German life insurers' liabilities at the end of 2020 being 26.3 years and a modified duration of 13.3 years. These guarantees, together with prolonged low interest rates, are affecting the financial soundness of life insurers. Maximum rates for GAAP valuation purposes are set by the MoF and have been reduced gradually in accordance with market rates, to 0.90 percent in 2017 and 0.25 percent in 2022. This effectively sets a maximum rate on the guarantee that can be offered on new product sales, although most insurers offer lower guarantees than the maximum. However, the guaranteed rates for existing policies remain as when they were sold and cannot in practice be reduced.

23. Life insurers are required to build additional reserves under GAAP to reflect the potential cost of the guarantees in the low interest rate environment. Since 2011, insurers have been subject to an Additional Provision to the Premium Reserve (Zinszusatzreserve – ZZR), which requires them to hold a reserve for each policy that guarantees a return above the reference rate for expected asset returns of the capital market. 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. This requirement imposes a discipline on distributions, as dividends may not be paid to shareholders of a life insurer unless the ZZR has been funded.

24. Additional ZZR will be needed in coming years (Figure 1). The ZZR was amended in 2018 to limit the yearly change of the reference rate. While the final amount of ZZR required was not changed, this recalibration leads to a slower build-up of reserves. This facilitates the preservation of unrealized gains on the assets. However, it also leads to a longer period in which profits cannot be paid out to shareholders but instead must be retained to improve funding of guarantees. Despite the recalibration, significant realizations are still expected in the years 2021 to 2024 (EUR 12 billion in 2021 and EUR 7-9 billion each year from 2022 to 2024) but are expected to decline significantly thereafter.

Figure 1. Estimation of Additional Provision to the Premium Reserve (ZZR) under Assumption of Constant Interest Rate of 09.30.2020



Source: BaFin

25. A movement toward higher interest rates should be beneficial but it could also pose risks.[12] Higher interest rates should ultimately enable insurers to generate more interest income to cover their guarantees. If the reference rate moves higher, the ZZR reserves that have been set aside for the policies whose guaranteed rate is lower than the reference rate will be released. However, an increase in market interest rates might also reduce or eliminate the unrealized gains, making it more difficult for insurers to fund the expense of building up the ZZR.

26. Technology-related risks are growing. Such risks include both operational and strategic risks related to increasing digitization of the insurance sector, which was given increased impetus by the pandemic. Insurtech firms have typically been partnering with insurers, rather than seeking to replace them. Many insurers use cloud service providers, and some insurers have responded to the challenge of assessing their controls, including over data security, by pooling their resources to perform internal audits of the providers. Cyber-risk is both a concern and a business opportunity for the insurance industry. Although the book of business is very small, there are currently about 60 insurers offering such products. Insurers are working to evaluate this exposure and reduce the risk, including through industry collaboration on model terms and conditions of policies, risk assessment tools, and efforts to raise awareness of risks among potential policyholders. BaFin has been highlighting the need for insurers to deal with technology-related risks and has been monitoring their progress in doing so.

27. Climate change and other sustainability risks are also receiving considerable attention. BaFin has an internal sustainable finance network, which provides a mechanism for sharing information and contributing to the development of internal and industry guidance. In

[12] With the weighted average of 10-year swap rates increasing and inflation forecasts revised upwards, EIOPA's January 2022 Risk Dashboard ranked macro risks the highest category of risk currently facing the European insurance sector.

December 2019, BaFin issued a cross-sectoral Guidance Notice on Dealing with Sustainability Risks. BaFin has been participating in EIOPA's studies on transition risk in 2020 and physical risk in 2021. Catastrophe risk was highlighted by a severe flood event in Germany in 2021, which generated gross insurance claims estimated to be as much as EUR 8.2 billion, of which about EUR 6 billion was reinsured. Although the impact of this event on solvency was not of significant supervisory concern, BaFin will continue to assess how insurers are dealing with such risks, including in their internal models and own risk and solvency assessments (ORSAs). Insurers are also responding to these risks through an increasing focus on sustainable finance.

Box 1. Insurance Stress Test and Risk Assessment

Insurance sector risks are assessed at several levels. Insurers are required to perform scenario analysis and stress testing as part of their own risk and solvency assessments (ORSAs). BaFin and EIOPA provide guidance on the ORSAs, but insurers sometimes apply even more severe stresses in their analyses, such as in the level and timing of interest rate shocks. BaFin carefully reviews the results of ORSAs. It also conducts surveys, for example to assess the actions and plans of insurers related to a search for yield, and performs its own scenario testing, for example to assess credit downgrade risk. EIOPA organizes stress tests periodically, in which the largest German insurers and groups participate.

RESULTS

	PRE-STRESS	FIXED BALANCE SHEET	CONSTRAINED BALANCE SHEET*
SCR RATIO	217.9%	125.7%	139.3%
SCR RATIO without transitionals	204.6%	111.0%	123.8%
ASSET/LIABILITY RATIO	110.0%	105.9%	106.2%
ASSET/LIABILITY RATIO without transitionals	109.1%	104.9%	105.7%

*with reactive management actions allowed

Source: EIOPA

The 2021 EIOPA insurance stress test assessed the industry's resilience to a prolonged COVID-19 scenario in a "lower for longer" interest rate environment from a solvency and a liquidity perspective. It confirmed that the main vulnerabilities stem from market shocks, but that insurers would be able to cope. Application of the transitional provisions of Solvency II, together with management actions, would enable an adequate solvency position to be maintained.

The EIOPA exercise did not show liquidity to be a significant vulnerability, and the results for German participants were consistent with the overall results. Results were also consistent with the results reported by insurers in their ORSAs and under liquidity stress tests they had performed at the request of BaFin. BaFin will continue its engagement with the insurers on these issues, for example, regarding the nature and timing of the reactive measures they might employ in response to stress scenarios.

Risks related to climate change, and to sustainability more generally, are also receiving considerable attention. BaFin has an internal network focused on these risks, issued a guidance note to financial institutions, and assesses how insurers model climate risks, along with the results of their ORSAs. EIOPA has undertaken studies of the potential effects of transitional and physical climate risks. For example, a sensitivity analysis was recently performed to assess and quantify the impact of transitional risks on insurers' investment portfolios. This analysis showed results for the German insurance sector to be in line with the European average. However, it also highlighted the need to improve the data available for analysis, for example, through implementing a template to obtain more details on the assets held within pooled funds and in related companies.

D. Institutional Settings

28. BaFin is the federal insurance supervisor. BaFin is part of the executive branch of the German federal government. Its status is that of a federal institution with legal personality governed by public law and is subject to oversight by the Federal Ministry of Finance (MoF). The MoF is accountable to the Federal Parliament. The MoF exercises oversight of 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.

29. The supervision of insurance companies in Germany is based on the VAG. Insurers also have to comply with other acts, codes, ordinances, and circulars issued by the federal government or BaFin. The MoF 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.

30. 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 (Industrie- und Handelskammer – 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.[13]

31. 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. These schemes are further discussed in the subsection on changes in control and resolution.

[13] Insurers are required to conduct business only with intermediaries that are licensed. Multiple-tied agents and brokers have to be authorized by one of the 79 local Chambers of Industry and Commerce, which assesses whether they have well-ordered finances, are fit and proper, possess appropriate professional knowledge and competence, and holds professional indemnity insurance. Single-tied agents are exempt from the authorization requirement, but the insurance company to which they are tied has to assess whether they have well-ordered finances, are fit and proper, and possess appropriate professional knowledge and competence.

REGULATION AND SUPERVISORY OVERSIGHT

A. Supervisory Powers, Independence, and Resources[14]

32. Several German and European institutions and agencies with distinct and complementary mandates are relevant to insurance supervision and regulation.

- **The MoF** is responsible for financial market legislation and the legal (Rechtsaufsicht) and technical (Fachaufsicht) oversight of BaFin (section 2 FinDAG).[15] In the German setup, the MoF bears the political responsibility for BaFin's activities. The subject of the legal and technical oversight is the legality and fitness for purpose of BaFin's administrative actions.[16]

- **BaFin**, a federal institution under the MoF, is an integrated financial sector supervisory authority. It is responsible for the prudential supervision of credit institutions, insurers and pension funds, capital markets intermediaries as well as for market conduct and consumer protection. BaFin's budget needs annual approval by its Administrative Council (which has government, parliament representatives as well as experts from industry and academia), and is funded through fees and charges imposed on supervised institutions.

- **Other German authorities** supervise certain aspects of insurance activities, as indicated in paragraph 30.

- **The European Insurance and Occupational Pensions Authority (EIOPA)** is an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European insurance and occupational pensions sectors. EIOPA plays an important role in promoting convergence of supervisory practices and is mandated to assess risks and vulnerabilities in the EU insurance and occupational pensions sectors.

33. The relationship between the MoF and BaFin is governed by the FinDAG and Principles.[17] These define the purpose of the MoF's supervision (the legality and fitness for purpose of BaFin's administrative actions), its role in chairing the Administrative Council and the Council's budgetary approval powers. The Principles also set out BaFin's reporting requirements to the MoF 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. BaFin's

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[14] The analysis in subsection A has been made with reference to ICP 2 Supervisor.

[15] Act Establishing the Federal Financial Supervisory Authority (Finanzdienstleistungsaufsichtsgesetz – FinDAG).

[16] Different countries use different approaches to ensure the accountability and transparency of decision making by the supervisory authority. The IMF does not prefer a particular structure as long as it respects the operational independence and does not undermine adequate resources of the supervisory authority (see Principle 2 of the ICPs).

[17] The Principles governing the exercise of legal and technical supervision of BaFin by the Federal Ministry of Finance, updated July 2021.

Articles of Association, which take the form of a regulation issued by the MoF, recognize the right of the MoF to issue instructions to BaFin's Executive Board.

34. Both the 2011 and the 2016 FSAPs recommended that the federal government review BaFin's reporting requirements to the MoF and provisions for dismissal of BaFin Executive Board members to ensure they continue to support robust operational independence in the future. *This recommendation has not been addressed.* 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. However, the extensive reporting to the MoF and the presence of government representatives and experts from industry on the Administrative Council weaken both the real and perceived operational independence of BaFin. The MoF has also been involved in the development and oversight of BaFin's reorganization program, which was concluded in December 2021. The MoF and BaFin are in the process of restructuring the reporting regime. Both the MoF and BaFin should ensure that for ongoing supervision (in crisis situations different reporting needs may apply) reporting takes place regularly ex-post, at a predetermined frequency, and at an aggregate sectoral and cross-sectoral level or event-driven.

35. BaFin underwent a wide-ranging reorganization process, which was completed by the end of 2021. Changes include strengthening the role of BaFin's President and establishing three new units reporting to the President (a Data Intelligence Unit, a unit responsible for coordinating a forensically-trained Task Force and the entities under intensive supervision, and a unit dedicated to the continuous development of BaFin). In addition, the changes provide for more centralized and standardized administrative processes under the responsibility of the Internal Administration and Legal Affairs Directorate.

36. The 2016 FSAP 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. *This recommendation has been addressed.* As of December 2020, BaFin had 300 staff (full-time equivalent) in insurance supervision, compared with 295 at the end of 2016. Insurance supervision also draws on cross-sector expertise. BaFin has been successful in attracting and retaining staff, with 77 percent of its insurance supervisors having five or more years of supervisory experience. BaFin attaches great importance to broadening and developing its staff's knowledge and skills, including through a variety of internal training programs and secondment to federal government ministries and European and international organizations. For example, training addresses topics such as the special requirements of Solvency II supervision, the audit of internal models, and decentralized data analysis.

Recommendations

37. BaFin and the MoF should take steps to reduce the real and perceived risks to BaFin's operational independence. Such steps build on work currently being undertaken and should include reviewing BaFin's reporting requirements to the MoF, and the organizational levels at which reporting and communication occur, as well as the composition of the Administrative Council.

B. Solvency Framework [18]

38. The ICPs focus on valuation for solvency purposes and Solvency II applies to insurers that account for more than 99 percent of industry premiums and assets. The exceptions are very small regional insurers that are subject to VAG regulations based on Solvency I requirements. However, even for Solvency II insurers, 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 (see also discussion in subsection D). Also, since Solvency II reporting does not include an income statement, GAAP reporting supports BaFin's assessment of insurers' earnings. Therefore, this TN discusses both national GAAP and Solvency II valuation frameworks.

39. Some insurers also prepare valuations for reporting under International Financial Reporting Standards (IFRS) or the ICS (Insurance Capital Standard 2.0 of the IAIS). The German Commercial Code (Handelsgesetzbuch – HGB) requires insurers that raise funds in the capital markets to prepare consolidated financial statements in accordance with IFRS. This applies to six groups, which together account for roughly 40 to 50 percent of premiums in the German insurance market. Three groups are internationally active insurance groups (IAIGs)[19] and prepare valuations on the basis of ICS (currently in a 5-year monitoring period), which are available to the supervisory colleges. Although BaFin reviews the results of the IFRS and ICS valuations for the relevant insurers, such valuations are not the basis for solvency assessments that might result in supervisory intervention. Therefore, this TN does not specifically address either of these frameworks.

40. Under Solvency II, both assets and liabilities are valued on a market-consistent basis. The Solvency II regime stipulates a fully economic, market-consistent, and realistic valuation of assets and liabilities, which fully reflects the risk-adjusted present values of the cash flows. An insurer's own credit standing cannot be recognized in the valuation of liabilities. In most cases an explicit risk margin, determined via a cost of capital approach, must be added to the current estimate (in Solvency II this is referred to as the best estimate of insurance liabilities).

41. The Solvency II 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 risk-free yield curve to derive a present value. The criteria for the derivation of the risk-free interest rate curves are set out in the Solvency II regulation and yield curves are regularly provided by EIOPA. The cash flow projections consider all the cash in- and out-flows required to settle the insurance obligations over the lifetime thereof. This includes current estimates of all

[18] The analysis in subsection B has been made with reference ICPs 14 Valuation, 15 Investments, 16 Enterprise Risk Management for Solvency Purposes, and 17 Capital Adequacy.

[19] The IAIGs are Allianz, Munich Re and HDI. Allianz had also been designated as a G-SII, before such designations were temporarily suspended.

expenses, inflation and all payments to policyholders and beneficiaries, including future discretionary bonuses.

42. The yield curves are determined by referring to market rates up to 20 years. From 20 years to 40 years, an extrapolation method is used to the Ultimate Forward Rate (which is calculated and published by EIOPA on a yearly basis[20]) 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. No German insurers are using the matching adjustment.

- 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 is calculated by EIOPA. Insurers using volatility adjustments are required to disclose two solvency ratios, with and without the adjustment. As at year end 2020, 98 insurers were using the volatility adjustment.

43. 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 regime. Insurers are allowed to apply a transitional deduction from technical provisions which is calculated with regard to valuation principles for technical provisions that applied before the start of Solvency II, i.e., 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. As at year end 2020, two insurers were using the transitional on risk-free interest rates and 60 insurers were using the transitional on technical provisions.

44. 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 under GAAP.

45. The 2016 FSAP recommended that further clarification should be given on how BaFin will use the powers regarding transitional arrangements, and that BaFin should actively use its powers to maximize industry efforts to improve their capital positions without waiting the

[20] For the euro, the applicable UFR is 3.60% during 2021 and 3.45% during 2022, See https://www.eiopa.europa.eu/sites/default/files/risk_free_interest_rate/eiopa-bos-21-090-report-on-the-calculation-of-ufr-for-2022.pdf

full 16 years of the transitional period. It also 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. *These recommendations have been addressed.*

- As first step, BaFin approves any application to use one of these two transitional measures and ensures that the transitional adjustment for the risk-free interest rate and the transitional deduction to technical provisions is adequately calculated and applied.

- Furthermore, if necessary, BaFin imposes a limitation of the transitional deduction to technical provisions to ensure that capital requirements do not fall below the level established before the introduction of Solvency II.

- To ensure that insurers actively manage the transitional period, BaFin closely monitors the impact of the transitional measure on their solvency position.

- Where insurers applying the transitional measures do not comply with the SCR without application of the transitional measures, they have to submit a phasing-in plan, setting out the planned measures to establish the level of eligible own funds covering the SCR or to reduce the risk profile to ensure compliance with the SCR at the end of the transitional period. BaFin assesses these measures to ensure they are sufficient and adequate, accompanied by a close dialogue with the insurer; several insurers were required to amend their phasing-in plans as the measures outlined were not considered to be adequate and sufficient.

- Those insurers also have to provide an annual progress report, setting out the measures taken, and the progress made, to ensure compliance with the SCR at the end of the transitional period. As at year-end 2020, 26 insurers were required to provide such progress reports. They are the key vehicle for BaFin to assess insurers' efforts and to ensure that they comply as soon as possible with the Solvency II provisions.

- To avoid the use of over-optimistic assumptions in the insurers' plans, BaFin published a set of three interest rate term structures (an optimistic, an average and a pessimistic scenario) at the beginning of 2020 and insurers must make their projections under all of these scenarios. This publication was accompanied by an article in the BaFin Journal in May 2020 setting out BaFin's expectations towards the progress reports, in particular in respect of the interest rates.

- To enhance their value as the basis for the supervisory judgement, BaFin developed internal standards for the assessment of the progress reports. It also facilitates central monitoring of the progress of the market and comparisons of progress across insurers. Another article in the BaFin Journal in February 2021 outlines the deficiencies identified in progress reports received so far and BaFin's expectations towards the market. The progress reports received in 2021 are being assessed on that basis. In the internal supervisory program for 2022, BaFin plans to examine whether additional guidance concerning the progress reports is necessary.

- BaFin supports the European Systemic Risk Board (ESRB) recommendation on dividends for the fiscal year 2020 and has issued internal supervisory guidelines for a risk-oriented and case-by-case assessment of insurers' planned dividend distributions.

46. For GAAP valuations, the German Commercial Code sets out the principle of prudence, which encompasses the principles of realization (profits must be shown only after they are realized) and imparity (possible losses must be shown, even if not yet realized). On the asset side, it is underpinned by the principle of lower-of-cost-or-market value. The conservatism of asset valuation is transparent, since the insurer also has to determine the market value of its investments, and the resulting overall hidden reserves or liabilities. The margins in the valuation of liabilities are implicit, but the degree of inherent conservatism is not expected to be excessive, because an insurer is expected to determine its technical provisions at a value which is necessary to fulfill its obligations arising under insurance policies applying reasonable business judgment. In the valuation of life insurance obligations, no explicit allowance is made for future discretionary payments to policyholders. Policyholders having with-profit contracts benefit when margins that are inherent in the valuation of technical provisions can be released. Accordingly, part of the margin represents an implicit allowance for the cash flows for future discretionary benefits. The GAAP valuation of technical provisions for P&C insurance does not explicitly consider the time value of money, but the financial impact of this is limited due to the short duration of the majority of the P&C obligations.

47. Maximum discount rates for GAAP valuation purposes are set by the MoF[21] and have been reduced gradually in accordance with market rates, to 0.90 percent in 2017 and 0.25 percent in 2022. This effectively sets a maximum rate on the guarantee that can be offered on new product sales, although most insurers offer lower guarantees than the maximum. However, the guarantee rates for existing policies remain as when they were sold and cannot in practice be reduced.

48. Under GAAP, life insurers are required to build additional reserves to reflect the low interest rate environment. Since 2011, insurers have been subject to an Additional Provision to the Premium Reserve (ZZR), which requires them to hold a reserve for each policy that guarantees a return above a reference rate. 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. This requirement imposes a discipline on distributions, as dividends may not be paid to shareholders of a life insurer unless the ZZR has been funded.

49. The 2016 FSAP recommended that 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

[21] For life insurers and insurers writing accident insurance with premium refund or providing annuities in accident or liability insurance, the Premium Reserve Regulation (Deckungsrückstellungsverordnung – DeckRV); for the German health insurance similar to life insurance, an ordinance called the Calculation Regulation (Kalkulationsverordnung – KalV).

assets side. *This recommendation has been addressed.* The ZZR was amended in 2018 to limit the yearly change of the reference rate. While the final amount of ZZR required was not changed, this recalibration leads to a slower build-up of reserves. This facilitates the preservation of unrealized gains on the assets, but also leads to a longer period in which profits cannot be paid out to shareholders but instead must be retained to improve funding of guarantees (see paragraph 24 and Figure 1). BaFin monitors the projected development of the ZZR under a range of future interest rate scenarios, which shows the positive effects of the recalibration. The effectiveness is also shown when considering the Solvency II valuation. Before recalibration the heavy reliance on hidden reserves to build up the ZZR led to decreasing own funds as well as increasing solvency requirements under Solvency II. With the recalibration this effect was significantly reduced.

50. BaFin checks compliance with the valuation provisions through both off-site monitoring and on-site inspections. Transparency of the valuation is supported by extensive requirements of confidential reporting to BaFin and by requirements for public disclosure. For Solvency II insurers, this includes the Solvency and Financial Condition Report (SFCR), which contains detailed information on the valuation of the assets and liabilities. Under GAAP, this includes the requirement that an insurer describe in the annex to its annual accounts the methods it has used for the valuation of technical provisions, the market value of its investments, and the resulting overall hidden reserves or liabilities.

51. Investment activities of insurers are subject to comprehensive regulation and guidance. All insurers are required to invest so as to ensure the security, quality, liquidity, profitability, and diversity of the portfolio as a whole, and their investments must be located so as to ensure access and availability. Solvency II insurers are subject to the prudent person principle, along with some principle-based boundaries set out in the VAG. EIOPA's Guidelines on the System of Governance with regard to investments also apply to these insurers, as do several interpretive decisions on investment issues published by BaFin. Solvency I insurers must comply with the investment principles laid down in section 124(1) of the VAG, but their investments eligible for covering technical provisions are also subject to the more detailed requirements in the Regulation on the Investment of Guarantee Assets (Sicherungsvermögen) of Pensionskassen, Funeral Expenses Funds and Small Insurance Undertakings (Anlageverordnung – AnlV).

52. Various requirements and guidance highlight the need for insurers to understand the risks associated with their investments. Insurers are required to perform their own credit assessments and not to rely only on third-party ratings. BaFin has also published an interpretative decision and a circular dealing with this issue. Insurers are expected to document their assessments, including quantitative evidence to support an assessment more favorable than third-party ratings. Insurers are required to invest in a manner that is appropriate to the nature and duration of their liabilities. They are also required to invest solely in assets and instruments whose associated risks they can sufficiently identify, assess, monitor, control, manage, include in their reporting systems, and adequately consider in their ORSA. The use of more complex and less transparent classes of assets and investments in markets or instruments that are subject to less governance or regulation is

implicitly dealt with in section 124 of the VAG. These requirements are supported by explicit guidance in the EIOPA Guidelines on the System of Governance.

53. The 2016 FSAP 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. *This recommendation has been addressed.* BaFin regularly monitors investment activity and analyzes key and emerging risks related to investments.

- BaFin reviews insurers' investment policies to see if they meet the requirements and guidelines.
- Insurers submit data on their investments, including details on individual assets, which BaFin analyzes. Analyses examine the investments with respect to their types, countries, sectors, duration, collateral, valuation basis (market, model, other), listed or not, and other issues. Comparisons are made over time and of an insurer versus its peer group. Analyses are performed quarterly or annually, depending on the risk classification of the insurer. The portfolio might be manually compared to the insurer's investment policy. Off-site analysis of investments also includes review of audit and actuarial reports.
- These analyses provide the basis for further in-depth analyses (e. g., during on-site inspections) and dialogue with the insurers (e.g., challenging investment decisions and discussing which investment risks the insurer is willing to take).
- At the end of 2020, BaFin conducted a survey on investment behavior, which helped to identify insurers with above-average exposures to asset classes deemed higher risk. This was used as a starting point for supervisors to contact insurers for further information and discussions regarding investment strategies and risk management.
- BaFin might perform on-site review of investment activities in response to the off-site risk analysis or as part of an internal model review. BaFin also conducts surveys in response to market disruptions, to assess their impact and attempt to avoid adverse developments.

54. The 2016 FSAP recommended that 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. *This recommendation has been addressed.* BaFin insurance supervisors have been coordinating with securities supervisors on these issues and further development is underway (see paragraph 21).

55. The enterprise risk management (ERM) activities of insurers and groups, including ORSAs, are subject to extensive regulation and guidance. It is set out in the VAG (section 26 and others); Article 260 of the Solvency II Delegated Regulation; BaFin's circular 02/2017, Minimum

requirements on the system of governance of insurance undertakings (MaGo); and EIOPA Guidelines on System of Governance (GSG). Requirements include the following:

- Insurers and groups must introduce strategies, processes and reporting procedures in order to identify, evaluate, control, monitor and report all risks to which they are or could be exposed. This requirement relates to all reasonably foreseeable and relevant material risks and includes their link to capital management.

- Particular risks that must be considered are specified, including insurance, market, credit, liquidity, concentration and operational risk, strategic risks, and risks relevant at group level. Risk interdependencies must also be considered.

- Groups are required to maintain a consistent enterprise risk management (ERM) framework across their legal entities. The framework is required to consider intra-group transactions (IGT), including tracking them, assessing their risk through the ORSA, and managing the risk.

- Risks must be assessed as part of ERM and in the ORSA, using assumptions and methods suitable and appropriate to the risks. They must determine which risks are material and which are not. If a risk is possibly material, stress tests are also required.

- The ERM framework is required to be based on the risk strategy and to reflect the relationship between the insurer's risk appetite, risk limits, regulatory capital requirements, economic capital and the processes and methods for monitoring risk and to be recorded in written policies.

- The ERM framework is required to include various policies, including on investments, asset-liability management (ALM), and underwriting, and to address liquidity risk. Requirements and guidance deal with the expected content of the ERM policies.

- Insurers and groups are required to review the ERM framework from several perspectives, in order to ascertain that it remains fit for purpose. This includes as part of broader reviews of governance, assessments by the risk management function, and assessments by a member of the management board, the results of which must be reported to other members. Internal audit is also expected to review ERM.

56. Insurers and groups are required to perform an ORSA at least annually and also in the case of material changes in their risk profile. Primary sources of the requirements and guidance on ORSAs are the VAG and BaFin Interpretive Decisions on the ORSA. Requirements include the following:

- The Board and Senior Management are required to be responsible for the ORSA. The ORSA must be the basis for strategic decisions.

- An ORSA is required to consider all material risks to which an insurer or group is or could be exposed in the medium and, if applicable, long-term. If the risks from macroeconomic stresses or counterparty exposures are material, they must also be assessed in the ORSA. In the case of a

group, the group-wide ORSA must consider all material risks of the group, including those that arise for the group as a result of legal and management structures or from strategic measures that have an impact on the group's risk profile. Risks must be considered individually and in aggregate.

- Stress testing is required as part of the ORSA, as well as within the assessment to verify the continual compliance with regulatory requirements.
- The ORSA must include a determination of prospective capital requirements and resources. BaFin expects the ORSA report to specifically address the origin of capital within a group as well as circumstances that affect its availability, transferability or fungibility.
- The ORSA must be based on the normal planning horizon of the insurer or group, which is usually three to five years. Insurers that provide long-term guarantees must use significantly longer forecast periods, extending at least to the end of the Solvency II transitional period. All aspects of the medium and longer-term strategy must be considered, along with other strategic measures or management actions that might be taken but are not yet reflected in the strategy.

57. With a view to sustainability risks, EIOPA published its Opinion on the supervision of the use of climate change risk scenarios in ORSA in April 2021. It is expected that companies will have to assess sustainability risks (if they are material for them) in the ORSA with very long-term stress tests (up to the year 2100).

58. BaFin requires insurers and groups to evaluate in advance their specific risks and options in possible recovery scenarios and can require that they prepare a general recovery plan. The general recovery plan must describe scenarios that could represent a risk to the insurer or group and describe the corrective measures intended to combat such risks. In order to be able to comply with the 80 percent market coverage required by EIOPA for recovery plans, BaFin has established criteria for insurers or groups that have to submit a recovery plan, which are based on size, risk profile, business model, cross-border activities, lack of networking, and substitutability. In general, a recovery plan would be updated every three years or when there are material changes. BaFin has the power to require that actions be taken for recovery if solvency is jeopardized. All insurers and group are required to have effective internal information systems, which includes the ability to produce information relevant to the recovery plan.

59. BaFin reviews the ERM frameworks, and the ORSA reports are a key input to its risk assessments. BaFin receives the ORSA reports annually. The line supervisor reviews the ORSA report, assisted by the output of a text-mining system that analyzes the reports against requirements, to identify where various topics are dealt with. The supervisor would use this to see whether any of the information is new. Typically, the supervisor would also read the ORSA, as one of the key reports. BaFin plans to expand the capabilities of the text-mining system and provide further training to supervisors, in order to maximize its value. The frequency of on-site review of ERM depends on the size and risk rating of an insurer. Where necessary, BaFin requires strengthening of the insurer's ERM framework, solvency assessment and capital management processes.

60. Most German insurers are subject to the capital adequacy requirements established under Solvency II. Solvency II applies to insurers that account for more than 99 percent of industry premiums and assets, with the exceptions being very small regional insurers that are subject to insurance regulation under Solvency I and the VAG (see also subsection B of the Introduction and Background). Given the wide coverage of Solvency II, the discussion of capital adequacy in this TN focuses on those requirements.

61. The regulatory requirements of Solvency II are set out at several levels. On the first level, the Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II Directive) sets the framework. On the second level, the Commission Delegated Regulation (EU) 2015/35 (Solvency II Delegated Regulation) provides further details. The Solvency II Directive is transposed into national law, in Germany the VAG, while the Solvency II Delegated Regulation is immediately effective in the European Union. Further regulatory requirements are set by several Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS), for example, regarding approval processes for internal models. The requirements are supplemented by supervisory interpretations, on European level in the form of EIOPA guidelines, opinions, and decisions. To support supervisory convergence at the European level, a non-public handbook on the Supervisory Review Process (SRP), the EIOPA SRP handbook, has been developed, covering also internal models. To deal with the specifics of national insurance markets or administrative law, the EIOPA Guidelines are supplemented by local interpretations; in Germany by circulars ("Rundschreiben") and interpretative decisions ("Auslegungsentscheidungen"). BaFin also maintains assessment guidance ("Prüfleitfäden") and shares practical cases of general relevance in principles notes ("Grundsatzvermerk").

62. Solvency II takes a total balance sheet approach to capital adequacy. In general, it 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. Solvency II has two levels of regulatory capital requirements, Solvency Capital Requirement (SCR) and Minimum Capital Requirement (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.

63. 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), and credit derivatives. 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 in the overall SCR calculations.

64. Insurers have to assess their ability to meet regulatory capital requirements at all times as part of the ORSA. They have to report the ORSA result to BaFin within two weeks of completion of the ORSA. Non-compliance with the SCR or MCR triggers a requirement to submit a

realistic recovery plan within two months or a realistic finance scheme within one month, respectively, for supervisory approval. Insurers are required to recover from any non-compliance with the SCR within six months, which BaFin can extend by three months. The recovery period for breaches of the MCR is three months and cannot be extended. BaFin does not formally intervene as long as insurers hold enough capital to meet the SCR, but would communicate any concerns regarding the sufficiency of the level of capital to ensure that the SCR can be met continuously, given that it is subject to fluctuations. BaFin has the power to impose capital add-ons and is currently developing internal guidance to facilitate the assessment of the conditions for their imposition and ensure a uniform approach in a manner consistent with the legal requirements under Solvency II. Groups are required to report annually on their capital adequacy at the group level and to meet requirements at all times. A wide range of actions is available to supervisors for dealing with group solvency concerns, on which BaFin has developed internal guidance.

65. Solvency II incorporates both standardized and more tailored approaches to determining regulatory capital requirements. As noted above, MCR is based on a simple formula. For the calculation of the SCR, Solvency II provides a standardized method (called the standard formula). In addition, more tailored approaches to determine the SCR can be applied, subject to BaFin’s approval, in form of insurer-specific parameters within the standard formula, or partial or full internal models. Internal models must be calibrated to the same confidence level as the standard formula. Although the technical provisions cover expected losses only from the existing business, the SCR covers both unexpected losses from the existing business and expected losses from new business written in the following 12 months. Diversification effects between different risks and risk categories play an important role in the SCR calculation. The standard formula aggregates risks via correlation matrices, while internal models allow for more advanced approaches to aggregation, such as the use of copulas.

66. Solvency II differentiates between available capital resources (own funds) and eligible capital resources to meet regulatory capital requirements. Available own funds are classified into three tiers and the characteristics follow their quality to absorb unexpected losses and their availability on a going-concern basis or in case of winding up. The own funds eligible to meet the SCR and MCR are determined by considering specific eligibility criteria defined in the Solvency II Delegated Regulation. Tier 2 and Tier 3 are subject to certain limits; for example, the sum of Tier 2 and Tier 3 cannot exceed 50 percent of the SCR. In practice, Tier 1 capital forms a majority of capital resources of German insurers (94 percent of the capital eligible to meet the SCR at the end of 2020). Upon BaFin’s approval, insurers can also use the volatility adjustment (VA), 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 is set by EIOPA. Insurers using volatility adjustments are required to disclose two solvency ratios, with and without the adjustment.

67. The 2016 FSAP recommended that if the majority of German insurers plan to use the volatility adjustment (VA), 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. *This recommendation has been addressed.* For all insurers applying the VA, the implications on the valuation of technical provisions, the SCR and their solvency position are monitored closely. Insurers provide information on the quantitative impact of applying the VA as part of the regular quantitative reporting and also provide qualitative information as part of the regular supervisory report (RSR) and their ORSA. This information allows BaFin to assess the relevance of the application of the VA and its functioning under different economic (spread) situations, and its implications on risk management and investment behavior. Based on its assessment, BaFin is satisfied that the VA has been working adequately for the German market and the insurers applying it, and that no immediate action was necessary.

68. The 2016 FSAP recommended that BaFin continue to devote resources to on-going validation and continue to require insurers to improve their internal models. It also 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. *These recommendations have been addressed.* Currently 37 insurers are using a full or partial internal model for solvency calculations. Most of these are full internal models. From 2018 to 2020, 1,013 major and minor model changes were reported to BaFin. BaFin deploys expert resources on the demanding internal models work, which also requires extensive international cooperation. Industry feedback to the FSAP mission highlighted the thoroughness of BaFin’s approach to model approvals and reporting. The following examples illustrate BaFin’s approach:

- The Solvency II Directive allows only six months for the model approval process. To facilitate a thorough assessment, BaFin introduced a pre-application phase, which allow for discussion of the details and completion of the formal steps of the process during the six-month timespan.

- Examination of the model consists of several stages, including meetings, desk-based documentation study, and on-site interviews. The on-site inspections regularly take one or two weeks, and their results form the core part of the opinion on whether the model should be approved or not.

- The approved models are permanently subject to ongoing supervision. Each insurer regularly delivers a package, which was specified within the approval process. It includes documentation on setting of parameters and assumptions and of validation activities. This documentation package is the basis for desk-based supervision, with further examination conducted where necessary.

- Several steps are taken in order to ensure consistency among insurers and to identify the different levels of (relative) regulatory capital requirements. BaFin regularly creates tables and plots that compare the quantitative model outputs of German insurers, also split into peer-groups. It also holds regular expert group meetings or colleges. On a European level, BaFin participates in various EIOPA comparative studies, which foster understanding of the approaches taken, compare the model outputs, and promote consistency in supervisory approaches.

- BaFin has a special department of quantitatively-trained supervisors to perform examinations of internal models. Their assessments include, for example, the appropriateness of the methodology, the plausibility of the assumptions, the data quality, and the simulation techniques. These aspects are also part of the validation that the insurer performs, and BaFin checks that the validation is appropriate.

Recommendations

69. BaFin and the federal government should take steps to enhance the contribution of valuation to solvency assessment. Steps that should be considered include:

- Extend the assessment of GAAP results to consider the impact of more extreme interest-increase scenarios on the funding of the ZZR;

- Continue to monitor the progress of the relevant insurers on the implementation of IFRS 17 Insurance Contracts and prepare to utilize the resulting financial statements as part of the supervisory assessment;

- Continue to encourage EIOPA and other national authorities to include an income statement as part of Solvency II reporting, which would facilitate the assessment of insurers' earnings, an important determinant of future solvency; and

- Seek to identify and promote opportunities to harmonize valuation and reporting requirements, while recognizing the potential barriers to doing so, because the multiplicity of valuation bases creates costs and complexity, along with the potential for providing conflicting signals to insurers, BaFin, and other stakeholders. For example, this could include reforming the ZZR to make it more congruent with Solvency II requirements and the Solvency II prudent person principle for investment management, which could also remove the incentive to sell low-risk fixed income securities to realize the investment gains created by low market interest rates in order to help finance the ZZR.

70. BaFin should strengthen the requirements around liquidity risk management reporting and liquidity stress testing. Requirements and guidance exist in relation to various liquidity risk management processes, including stress testing (generally), maintenance of liquid assets, and contingency plans. The ORSA report is a key source of information for BaFin regarding the exposure of an insurer or a group to liquidity risk. However, they are not required to submit reports on their management of liquidity risk to BaFin, although the liquidity information requested during the COVID-19 pandemic will be maintained as an annual reporting requirement.

71. BaFin should continue its active supervision of capital adequacy, while seeking to streamline internal model approval and reporting requirements. Several insurers expressed concern that BaFin's approach is more onerous than that of other national authorities, which imposes costs and discourages the use of internal models.

72. BaFin should consider providing additional guidance on certain aspects of capital adequacy. For example, such guidance could highlight the importance of insurers setting their own target solvency ratios and identifying in their ORSA actions that management would take if the solvency ratio fell below this level. BaFin could then monitor proximity to the target solvency ratios as part of its supervision. Guidance could also set out supervisory control levels for Solvency I insurers.

C. Supervision[22]

73. BaFin's approach to supervisory review underwent major changes to provide for a more risk-based approach in conjunction with the implementation of Solvency II. Core supervisory processes are off-site analysis based on extensive reporting and on-site supervisory work driven by a risk classification system. BaFin has extensive documentation to guide the application of its framework. The processes and documentation are regularly reviewed and revised where necessary to reflect changes, such as in legislation or internal organization.

74. The 2016 FSAP 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. *This recommendation has been addressed.* The information technology (IT)-based risk classification system for insurers and insurance groups was enhanced in 2020 and reflects qualitative aspects. BaFin is currently developing internal guidance on capital add-ons to facilitate the assessment of the conditions for their imposition and ensure a uniform approach in a manner consistent with the legal requirements under Solvency II.

75. BaFin monitors insurers based on various sources of quantitative and qualitative information, including regular supervisory reporting, communications with the insurer, and other information such as stress test results, unscheduled data requests (e.g., during the COVID-19 pandemic or after natural catastrophes with high damages), and market data. BaFin continues to expand its use of technology to support the monitoring and risk assessment processes, such as in data validation, data visualization, text mining of narrative reporting (e.g., ORSA reports), and dashboarding. A risk dashboard provides sector-level information to supervisors, while the recently-introduced Cockpit IT tool provides insurer-level risk metrics and ratings by category and will facilitate drill-down once the system is complete. Supervisors are required to submit to team managers written analysis on key reports within specified periods after receipt and to review and update risk ratings periodically.

76. The risk classification system is used to identify and assess current and future risks to which the insurers are or may be exposed, as well as their ability to identify, assess, monitor,

[22] The analysis in subsection C has been made with reference to ICPs 9 Supervisory Review and Reporting, 10 Preventive Measures, Corrective Measures and Sanctions, 19 Conduct of Business, 23 Group-wide Supervision, 24 Macroprudential Supervision, and 25 Supervisory Cooperation and Coordination.

manage and report on those risks. BaFin assesses the impact of an insurer based on market impact 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. Risk classification data, indicators, and processes are thoroughly validated at least once every five years, with less extensive checks done annually.

Table 3. Germany: Risk Classification Results for 2020

Undertakings in %		Quality of the undertaking				
		A	B	C	D	Total
Market impact	very high	0.0	2.3	1.0	0.0	**3.3**
	high	1.3	7.2	3.0	0.0	**11.5**
	medium	3.8	17.6	6.5	0.4	**28.3**
	low	4.8	38.4	12.6	1.1	**56.9**
	Total	**9.9**	**65.5**	**23.1**	**1.5**	**100.0**

* The table shows the assessment based on the data as at 31 December 2020.
Quantity: A=very high quality and D=very low quality
Source: BaFin

77. The 2016 FSAP recommended that BaFin consider 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. *This recommendation has been addressed.* Standard reports have been developed for Solvency II insurers that can be used to compare a selected insurer with a peer group, usually the insurers operating in a selectable line of business and according to their market impact. Ad hoc peer group analyses are also prepared, drawing on the statutory accounts and Solvency II data.

78. BaFin establishes supervisory priorities and allocates resources to individual insurers and insurance groups based on its risk assessments.

- The multi-annual supervisory plan contains a list of topics with high priority, which is reviewed at least annually. This list also indicates whether a topic will be dealt with through on-site inspection and the expected intensity of inspection. For example, the current plan includes inspection of Solvency II models used in calculating the technical provisions and market risk of real estate assets.

- An overall audit plan for the following year is prepared by mid-December. It includes the on-site inspections, other planned supervisory meetings and visits, IT and internal model audits, and planned participation in supervisory board meetings. On-site inspections are typically targeted in scope. It is up to the supervisor to decide which areas to focus on, but it is typical to look at governance, outsourcing, risk management functions, and asset management (in which specialists participate). Management receives reports on progress against the plan, which is reviewed and updated quarterly.

- For off-site monitoring, insurers are divided into four groups with different intensity of supervision, ranging from "basic supervision" to "intensified supervision", based on their risk classifications and other considerations.

- Supervisory plans are developed at both solo and group levels. For IAIGs, such plans include an annual risk assessment in accordance with comprehensive EIOPA guidelines.

79. The 2016 FSAP recommended that BaFin consider 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. *This recommendation has been partly addressed.* The risk classification of insurers is built around five main sections: asset and financial position, profit position, future viability, business organization, and holders of significant holdings. Although there is no section specifically focused on conduct of business, BaFin considers conduct-related issues, such as sales remuneration, product-approval process, and compliance function, under the business organization section.

80. BaFin has developed a guideline for scheduling on-site inspections, in which the regular interval for on-site inspections without special cause is based on the market impact and quality of an insurer (see risk classifications above), with the insurers grouped into four Supervisory Categories. BaFin's aim is to strike a balance between its human resources, its need for additional information, and the appropriateness of charging insurers for the costs of on-site inspections. The guideline calls for frequencies of up to 12 years, in the case of an insurer with low market impact and very high quality. Deviations from the guideline are permissible, if necessary, but the reasons for doing so must be documented by the supervisor. Based on the plans for 2021, inspections are being performed more frequently than required by the guideline. For IAIGs, on-site inspections are done on a regular basis every 7 to 9 years at the level of the Head of the IAIG and as necessary. BaFin has organized or taken part in some joint on-site inspections of IAIGs.

81. The 2016 FSAP recommended that BaFin consider whether it could better communicate to insurers, particularly larger companies, its key concerns and supervisory priorities, for example by disclosing the risk classification findings. *This recommendation has not been fully addressed.* BaFin contacts insurers via telephone, e-mail, or letter regarding risks or concerns arising from its off-site analysis. At the end of an on-site inspection the findings are assessed, and a final discussion is held on-site, in which a summary of irregularities (defined as weaknesses or deficiencies identified by BaFin) and recommendations is given to the insurer. These findings and recommendations are also documented in a formal letter. BaFin does not communicate to an insurer the market impact and quality ratings it has assigned, as it considers the ratings to be an internal control tool. Some insurers indicated to the mission that they would appreciate more comprehensive feedback on supervisory findings.

82. BaFin has comprehensive powers to require preventive and corrective measures and, if necessary, impose sanctions against insurance groups, individual insurers, and responsible persons. Legislation (VAG section 298) provides BaFin with general supervisory powers to take any action in respect of an insurer, members of its management board, other members of senior

management, or controllers that is appropriate and necessary to remedy irregularities. In addition to its general supervisory powers, BaFin has a wide range of specific powers to require preventive and corrective measures. These powers may also be exercised, as applicable, in respect to insurance holding companies and mixed financial holding companies (for financial conglomerates).

83. BaFin takes a graduated approach and is explicitly required by the VAG and German administrative law to apply the principle of proportionality. In most cases, informal exchanges result in issues being resolved or concerns allayed. BaFin typically meets with executive management but escalates issues to the supervisory board, as necessary. Where it establishes that there is evidence of a breach of requirements, BaFin writes a formal letter to the management of the insurer, referring to specific powers and formally requiring corrective actions or imposing measures against the insurer or the persons involved. BaFin has not published an intervention policy but has prepared internal guidance on actions that might be taken in relation to insurers under close supervision. To ensure consistency of treatment, a supervisor that wants to intervene is required to inform a designated unit and serious cases are escalated for review by management.

84. The 2016 FSAP recommended that 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. *This recommendation has been partly addressed.* BaFin has a strong focus on dealing with solvency concerns, including both current and projected failures to meet solvency requirements. However, it appears to give less attention to interventions in relation to other supervisory concerns. For example, the management information systems do not facilitate tracking and reporting on the nature, timelines, and progress of intervention measures.

85. The 2016 FSAP 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. *This recommendation has been addressed.* In case of a mild deterioration of the financial position, BaFin uses informal measures and suasion, which it indicates is usually successful. Section 132 of the VAG requires insurers to have appropriate processes in place to identify a deterioration of their financial situation and to immediately notify BaFin where a deterioration could jeopardize solvency or compromise the ability to meet its insurance obligations. BaFin has been taking steps to strengthen the value of this early warning tool. It began with a pilot survey to evaluate insurers' practices, followed up by an external communication to set out the expectation that all insurers critically review their systems and processes in light of deficiencies identified, and a more in-depth and wide-ranging survey in 2020. BaFin is using the findings to develop guidance for insurers in order to improve their identification of a deteriorating financial condition.

86. The 2016 FSAP recommended that, 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. *This recommendation has been partly addressed.* As noted above, BaFin is currently developing internal guidance on capital add-ons to facilitate the assessment of the conditions for their imposition and ensure a uniform approach in a manner consistent with the legal requirements under Solvency II. However, BaFin has not introduced a system of target minimum solvency requirements above the SCR, on the basis that it could not require additional capital unless the amount of an insurer's capital would be insufficient to ensure that the insurer is able to meet the SCR continuously.

87. BaFin's supervisory objectives encompass conduct of business (the primary objective of supervision is to protect policyholders and the beneficiaries of insurance services). Its responsibilities include monitoring of compliance with regulatory requirements and handling complaints made directly to BaFin by customers of primary insurers. Different ministries have the responsibility for regulations on financial consumer protection. Although insurance intermediaries are licensed and supervised by their local Chamber of Commerce and Industry, BaFin has an indirect regulatory and supervisory role through the requirements on insurers and its monitoring of their use of intermediaries. BaFin's circular 11/2018 sets out the conditions under which insurers are allowed to cooperate with intermediaries. Insurers are required to conduct business only with intermediaries that are licensed and are also required to respond to complaints about intermediaries working for them and to conduct the necessary investigations.

88. The 2016 FSAP recommended that the limitation of conduct of business requirements to primary insurers be reconsidered. *This recommendation has been addressed, but no change has been made.* The scope of application for conduct of business requirements is regularly reconsidered, with the objective of protecting those who need protection—generally, retail consumers. Insurers are considered to be professional clients with the knowledge and the power to bargain terms of contracts, without the need for special protection. Accordingly, the VAG provides, for example, that certain sections are not applicable to reinsurance intermediation.

89. Insurers and intermediaries are required to establish and implement policies and procedures on the fair treatment of customers. Conduct requirements are set out in the VAG, the Insurance Contract Act (Versicherungsvertragsgesetz – VVG), and related legislation, including circular 11/2018 and circular 2/2017. The requirements are comprehensive, including the following:

- Insurers must make the fair treatment of customers part of their business strategy, product design, product distribution and product performance;
- Insurers must have an internal process to consider the interests of different types of consumers when developing and distributing insurance products;
- Insurers and intermediaries must have arrangements in place in dealing with each other to ensure the fair treatment of customers;

- Insurers and intermediaries must avoid or properly manage any potential conflicts of interest; and
- Insurers and intermediaries must have internal controls that enable the identification, collection and evaluation of management information and generation of management reports that support the monitoring and measuring performance with respect to fair treatment of customers.

90. There are comprehensive requirements regarding the promotion of products and disclosure to customers. These requirements are set out in the VVG and the Ordinance on Information Obligations for Insurance Contract (VVG-InfoV), with further details on the promotion of products and forbidden sales practices set out in the Act Against Unfair Competition (Gesetz gegen den unlauteren Wettbewerb – UWG). Disclosure requirements deal with pre-contractual and contractual information, including disclosures specific to Internet sales or sales through other digital means. Where customers receive advice before concluding an insurance contract, insurers and intermediaries are required to consider the customer's disclosed circumstances and to explain and document the basis for their recommendations.

91. Insurers are required to service policies appropriately through to the point at which all obligations under the policy have been satisfied, including providing relevant disclosures. Extensive requirements regarding the handling of claims and complaints are set out in the VAG, the VVG, the Civil Code, and related legislation, including circular 3/2013. Insurers are required to have in place reliable policies and procedures so that they are able to handle claims in a timely and fair manner.

92. 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 recognize 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.

93. The 2016 FSAP recommended that BaFin review whether it can reduce the volume of individual customer complaints it handles, by ensuring that these are directed to ombudsman services. *This recommendation has been addressed.* BaFin deals with complaints because of the right of petition under section 17 of the German Constitution. BaFin also considers complaints an important source of information regarding the conduct of an insurer and potential weaknesses in its organization. To reduce the number of complaints that are in the nature of informational requests, BaFin publishes responses to the most common questions related to insurance. In addition, BaFin has a project underway that seeks to reduce the resources involved in complaint processing by implementing technical, procedural, and organizational changes. In cases where the involvement of ombudsman services seems suitable, BaFin's responses to complainants regularly include a reference to these services.

94. The General Data Protection Regulation (GDPR) and applicable national data protection laws lay down the privacy rules insurers and intermediaries have to observe in dealing with data of their customers. Compliance is supervised by special authorities of the Bundesländer (federal states). Also, BaFin can take administrative measures when an insurer systematically breaches legal provisions concerning data protection.

95. BaFin publishes data about its complaints handling activities in its annual report and information on consumer protection issues is published on its website and through the monthly BaFin Journal. BaFin also publishes brochures to promote customers' understanding of insurance contracts and maintains a consumer helpline, which offers co-browsing and a service for people with hearing difficulties. As necessary, BaFin issues warning notices to consumers in order to avoid transactions with insurers that are unlicensed or subject to a suspended or revoked license.

96. BaFin applies the European rules regarding group-wide supervision, as set out in the Solvency II Directive and the VAG. Although there are no specific rules regarding IAIGs in the VAG, BaFin seeks to address the expectations for their supervision through its supervisory practices and the rules for group-wide supervision more generally.

97. BaFin, in cooperation with the other involved supervisors, has identified three German insurance groups as IAIGs. The groups have been notified of these determinations, which are reviewed annually. All German insurance groups are subject to Solvency II, and all legal entities of a group have to be reported in the relevant Solvency II template. The VAG provides for the exercise of group supervision at the level of the ultimate parent company, which is generally the head of the group, and the Solvency II Directive also deals with identification of the head of the group. BaFin cooperates with other involved supervisors on this and related matters, such as the scope of group-wide supervision. The scope of group-wide supervision is not narrowed on the basis of a lack of legal authority or supervisory power over particular legal entities.

98. One BaFin unit supervises the largest groups, including all IAIGs. Smaller groups are distributed to other units, depending on the nature of the dominant insurer. Some of the smaller groups have cross-border business, but they are either too small or the share of their business that is international is too small for them to be considered an IAIG. Any group with a foreign subsidiary has a supervisory college, which is a standard EIOPA practice. BaFin has internal colleges for most of the groups that include banks and asset management companies.

99. BaFin performs risk assessments at both the solo and group levels. The relative attention paid to solo versus group-wide supervision depends on the nature of the group (more international means more emphasis at group level), the size of the entities (very large dominant solo entities receive more emphasis), and the risk ratings of the solo entities. Stress testing is done at both solo and group levels.

100. The German Financial Stability Committee (Ausschuss für Finanzstabilität – FSC)[23] is the central committee for macroprudential surveillance in Germany. The MoF, Deutsche Bundesbank (BBk), and BaFin each have three voting representatives on the FSC. In addition, BaFin has one non-voting advisory representative responsible for BaFin's bank resolution mandate.

101. The 2016 FSAP recommended that the FSC and German government consider giving the FSC 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. *This recommendation has been addressed.* The macroprudential framework is subject to regular review and amendments. Germany feels comfortable with the macroprudential setup it has chosen. The FSC has been designed as an integrated body to internalize all relevant perspectives and competences when it comes to macroprudential risks, their identification, and adequate measures to tackle them. Its structure and powers resemble those of the ESRB, and it can issue warnings and recommendations. In 2020, the FSC updated and streamlined its macroprudential strategic approach, considering the experiences since its foundation in 2013.

102. BaFin collects a broad range of information, much of which supports its assessment of sectoral developments and trends. This includes the regular information submitted periodically by insurers, along with special data requests made to a small or large number of insurers. Data collected cover a broad range of topics, such as detailed information on the assets and liabilities. BaFin analyzes income statement data (which is not part of the Solvency II reporting) to obtain further insight on insurers' financial condition. Additionally, BaFin monitors broader financial market developments in order to identify developments that could impact the insurance sector. Through its relationships with other organizations, including BBk, European Central Bank (ECB), EIOPA, ESRB, Financial Stability Board (FSB), and IAIS, BaFin obtains information and analyses such as the European Risk Dashboards.

103. BaFin's analyses focus on inward risks to the resilience of the insurance sector. This includes regular stress tests, as part of the EIOPA program. BaFin also conducts analyses with respect to the low interest environment, risks from the COVID-19 situation, downgrade risks, risk management practices of the insurers. BaFin also requires insurers to make long-term projections and conducts surveys. BaFin's database and tools facilitate the preparation of both standard and customized reports. This includes its regularly-updated Risk Dashboard, which summarizes qualitative and quantitative data and risks for the insurance sector, for each line of business and relating to European and international developments. BaFin publishes the results of some of its analyses on its website, for example, on the residual debt insurance market and alleged age discrimination. It also publishes statistical information on the insurance sector, which is updated annually and includes information on lines of business, premiums, investments, results, and staff.

104. BaFin does not have a formal process for identifying systemically important insurance groups. It assesses the systemic importance of insurers as part of its risk classification approach and

[23] The 2021 FSAP will produce a separate TN on Macroprudential Policy and Tools, which will also cover the role of the FSC.

has expanded its matrix to include a "very high" level of market impact. BaFin has not identified any insurer that it considers systemically important, but it has identified up to 20 insurers (with quarterly fluctuations) that are under intensified supervision due to their current risk exposure.

105. BaFin uses the results of its macroprudential supervision when developing and applying supervisory requirements. For example, it has required 15 insurance groups to prepare recovery plans, selecting them based on their interconnectedness, size, risk profile, systemic relevance, business model, cross-border activity, membership of a financial conglomerate, and substitutability. BaFin holds annual discussions with the management boards of at least 15 insurance groups to learn about market trends and developments. BaFin's analysis of developments in relation to the low-interest rate environment was an input to changes to the ZZR and the maximum guaranteed interest rate for new business.

106. The 2016 FSAP recommended that, 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. *This recommendation has been addressed.* The larger reinsurers generally head or are a dominant part of an insurance group, and as such are subjected to extended group reporting, such as the filing of recovery plans and special inquiries. Reinsurers are generally required to provide comprehensive information on their business and the risks associated with it, which are comparable to those of primary insurers, including stress tests and scenario analyses.

107. The 2016 FSAP recommended that 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. *This recommendation is not currently relevant.* The FSB has temporarily discontinued the global systemically important insurer (G-SII) designations until 2022 in order to give room for the development and application of the Holistic Framework that the IAIS developed and adopted in November 2019. The review on potentially discontinuing the G-SII designation permanently in 2022 will take the experience of the first 3 years of application and the Implementation Assessment into account. In absence of a G-SII designation the IAIS has not continued its work on the HLA and HLA is not part of the Holistic Framework. Therefore, no additional steps have been undertaken to prepare for HLA.

108. The 2016 FSAP noted that the approach to supervisory cooperation and coordination was still developing and agreeing risk assessments for each group and using these to inform group wide supervisory coordination remained a particular challenge. BaFin has improved its approach consistent with the EIOPA Guidelines on the supervisory review process. It standardized its risk classification process for groups, the results of which feed into the coordinated creation of work plans by the supervisory colleges. Solvency II and the VAG require the establishment of colleges, except where a group has only domestic activities, and BaFin has run colleges for all major groups and IAIGs at least since 2016.

109. BaFin discusses and agrees with the involved supervisors which of them is the group-wide supervisor for cross-border insurance groups operating in Germany. Since the role might shift as groups develop, a discussion on the role of the group supervisor may happen annually. If a joint decision cannot be reached, EIOPA would be consulted and the mechanism for binding mediation set out in the EIOPA Regulation applied. BaFin participates in the supervisory colleges of several IAIGs, including Allianz, Munich Re, and HDI as group-wide supervisor and Generali and Axa as a host authority.

110. As a group-wide supervisor, BaFin works with the college of supervisors to build understanding of the group and lead its supervision. The operations of colleges are supported by individual college coordination arrangements, which generally provide for a free flow of information among members. BaFin undertakes a comprehensive mapping exercise, in cooperation with the group and the other involved supervisors, to identify the group structure and assess its significant and material entities. Other involved supervisors are consulted on the agendas for college events and the agreed follow up actions are documented in the minutes. BaFin provides an overall assessment of the risk and solvency of the group, on the basis of the group ORSA and information generated at the solo level. In the case of an IAIG, BaFin also provides the results of the ICS calculation and relevant supporting data and facilitates a discussion within the college and with representatives of the group.

111. Where it is another involved supervisor, BaFin supervises solo insurers operating in Germany and seeks to join supervisory colleges to obtain complementary supervisory information and to review the interactions and interconnectedness of these insurers within the group. BaFin takes steps to overcome problems hampering participation in a college or seeks to establish a bilateral information exchange. BaFin exchanges non-public supervisory information with eligible partners such as other signatories to the IAIS Multilateral Memorandum of Understanding on Cooperation and Information Exchange (MMoU) and other authorities that were found equivalent in terms of professional secrecy. It maintains a database of equivalence assessment results (with respect to professional secrecy) coming from assessments undertaken by EIOPA, the IAIS (under the MMoU), and on its own.

112. BaFin seeks to formalize cooperation and coordination within colleges via written coordination arrangements. These arrangements are based on comprehensive European regulations and guidelines. They are supported by BaFin's internal process handbook and a comprehensive intranet knowledge base regarding colleges of supervisors, which includes legal background on colleges, process-oriented information, and identifies who can be consulted internally for advice.

113. For one of the IAIGs a separate crisis management group was established when the group was identified as a G-SII, while for the other two IAIGs the college currently plays this role. The coordination of crisis management preparations is required by Article 355 of the Delegated Regulation, which calls for an emergency plan to be agreed by the college of supervisors. BaFin has documented the processes and procedures for crisis management in a special Annex E "Emergency Plan" of the coordination arrangements. These crisis management arrangements have

not been tested, other than a test that was organized by EIOPA to determine whether the identified contact persons could be reached.

Recommendations

114. BaFin should reassess its guidelines on the minimum and actual frequency of on-site inspections in relation to the Supervisory Categories of insurers, to ensure that inspections are sufficiently frequent to support robust identification and assessment of risks. Both the minimum and actual frequencies are quite long, for all Supervisory Categories. If concern about the potential cost of an inspection to a particular insurer is a barrier to greater frequency, changes to the system of direct charging should also be considered. BaFin should also consider publishing information on the guideline and actual frequencies of its on-site inspections.

115. BaFin should enhance its management reporting to facilitate systematic tracking and reporting of the timeliness of off-site and on-site supervisory activities in comparison with established procedures and the supervisory plan. Such enhancements could support any necessary changes in supervisory priorities throughout the cycle of activities.

116. BaFin should provide more comprehensive feedback to insurers on its supervisory findings, assessments, and concerns, including the highlights of its risk assessment and the market impact and quality ratings assigned to the insurer. This could enhance insurers' understanding and help to encourage improvements in their practices.

117. BaFin should take steps to enhance the effectiveness of intervention in driving improvements, particularly in relation to supervisory concerns other than the solvency ratio. Such steps might include using intervention powers more intensively in relation to non-solvency concerns; developing management information systems to facilitate systematic tracking and reporting of the nature, timeliness, progress, and effectiveness of intervention measures; and developing and publishing a guide to intervention.

118. BaFin should take steps to test the crisis management arrangements for IAIGs. This might include crisis simulation exercises involving the supervisory colleges or crisis management groups, perhaps organized in cooperation with EIOPA.

D. Changes of Control and Resolution[24]

119. 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. Qualifying holdings are defined as a direct or indirect holding equivalent to at least 10 per cent of the capital or voting rights of an insurer or another arrangement in which significant influence can be exercised over the management of the insurer. A person must notify BaFin of a proposal to acquire a qualifying holding, to increase its holding above thresholds of 20 percent, 30 percent, and

[24] The analysis in subsection D has been made with reference to ICPs 6 Changes in Control and Portfolio Transfers and 12 Exit from the Market and Resolution.

50 percent, or to dispose of a qualifying holding or to reduce its below such thresholds. Insurers are also required to notify BaFin when aware of such acquisitions or disposals and must notify BaFin annually of their stock of shareholders. BaFin has power to require notification of ultimate beneficial owners. The criteria for assessing transactions are closely aligned to licensing conditions and BaFin maintains dedicated resources to process such transactions. Although there has been no trend toward industry consolidation, BaFin is well-equipped to address any increase in merger activity should it arise.

120. Similarly, BaFin is fully empowered to approve portfolio transfers expeditiously and with regard for policyholder interests. The VAG requires that transfers of portfolios, by primary insurers and reinsurers, be subject to approval by the applicable supervisory authorities. 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) is no less than before the transfer, using a fair value approach to measurement of the assets and liabilities.

121. Where an insurer is subject to market exit proceedings, policyholders, including those with outstanding claims, are protected by the requirements on insurers to hold restricted assets in trust for policyholders ("guarantee assets"). This effectively makes them the highest class of creditors in case of insolvency. 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 canceled or rescinded before the opening of insolvency proceedings). Guarantee assets have to be at least equivalent to the balance sheet values (or fair value, if lower) of the relevant liabilities calculated under GAAP.

122. Guarantee assets must be held within the European Economic Area (EEA), managed separately from other assets, and recorded in a register set up for the purpose. Insurers must select higher quality assets first when choosing which to register as guarantee assets. The insurer must appoint a trustee to monitor the guarantee assets and arrange 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). The value of the assets in this register are controlled, assessed, and confirmed in writing by the trustee, a responsible Board member and the external auditor. BaFin also checks the registers during on-site inspections. These arrangements do not apply to reinsurance companies, so there is no preferment of primary insurers' claims in case of the insolvency of a reinsurer.

123. There is a wide range of powers and procedures providing for the prompt and orderly exit of failing insurers, although some gaps exist. BaFin can use a variety of formal powers and informal ways to influence the resolution of an insurer. The aim of such measures is to protect the interests of the policyholders and to avoid an insolvency proceeding. Nevertheless, there are some gaps in relation to the minimum set of powers that a supervisor and/or resolution authority should

be able to exercise for the resolution of an IAIG, as set out by the IAIS. BaFin also lacks the legal power to require resolution plans. Proposals are currently being considered at the European level to address these shortcomings. Several recommendations were made by the 2016 FSAP in relation to these powers and procedures, as discussed in the next three paragraphs.

124. The 2016 FSAP 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. *This recommendation has been addressed*. BaFin has extended the requirement for recovery plans to a total of 15 insurance groups in Germany, which fulfills the more than 80 percent market coverage required by the EIOPA Opinion on the 2020 review of Solvency II. The supervisory teams responsible for the respective groups are engaging with them and all but one of the required recovery plans have been submitted to BaFin.

125. The 2016 FSAP recommended that 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. *This recommendation has been addressed*. In addition to its actions on recovery planning, BaFin has resolution planning in place for the former G-SII group, even after the designations have been temporarily discontinued. BaFin has assessed the need to extend resolution planning to other groups, considering the systemic risk they might pose and whether they perform a critical function, and has concluded that it is not currently necessary to do so.

126. The 2016 FSAP recommended that 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. *This recommendation has been partly addressed*. Section 43 of the VAG requires insurers to provide all necessary information in a timely manner at the request of BaFin, which would also apply to crisis situations. EIOPA outlines in its Guidelines on System of Governance that insurers falling under Solvency II need to have contingency plans in place as part of their ERM, but BaFin's power to require such plans could be more explicit.

127. In Germany, resolution is regulated not only by insolvency law, but also by corporate law, as resolution can also take place independent from financial distress. In this court-based system, so far, no official resolution authority for insurers has been established. In the absence of an explicit official EU provision implemented in the VAG, BaFin functions as the German resolution authority for insurers, except for the few insurers being supervised by Länder authorities. BaFin would exchange information via the college of supervisors or the Crisis Management Group (CMG), in the case of a resolution with cross-border implications.

128. In some situations, BaFin is required to order the transfer of a portfolio to an insurance guarantee scheme. In case an insurer has notified BaFin that it is insolvent, or it is otherwise clear that the insurer cannot permanently meet its liabilities, and if it is necessary to safeguard the interests of the insured, BaFin is required to order the transfer of the entire portfolio of primary insurance contracts, including associated assets, to an insurance guarantee scheme, where the insurer is a member. BaFin can order such a transfer without consent from the insurer, the guarantee scheme, or policyholders.

129. 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). All life and health insurers in Germany must be a member of the relevant scheme; the only exception is branches of insurers that are based in another country of the EEA. BaFin is responsible for supervision of these schemes. There is no guarantee scheme for P&C insurers other than for motor vehicle third party liability insurance.

130. The role of the guarantee schemes in life and health insurance is to provide continuity of insurance policies. 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. The schemes do not guarantee to fully compensate any loss caused by an insurer’s failure. For example, if a policy provides for a minimum interest guarantee along with the possibility of higher returns being credited, the guarantee scheme covers only the minimum interest guarantee. 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.

131. The capacity of the guarantee schemes to absorb losses is limited. The scheme for life insurers has ex ante financing arrangements. The life insurance scheme is funded up to 1 per mille of the net technical provisions of all members. Currently the fund for life insurance has about EUR 1.075 billion in assets. Should these be inadequate to support a transferred portfolio, special contributions of another 1 per mille 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 assets (about EUR 10 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. The capacity of the guarantee schemes is likely to be sufficient in the case of a small to medium-sized insurer failing. In respect of larger insurers and groups, guarantee scheme capacity would possibly be inadequate, depending on the size of the coverage gap potentially created.

132. In P&C insurance, the arrangements for guarantee assets should generally provide for full recoveries and the avoidance of loss. However, 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.

133. The 2016 FSAP 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. *This recommendation has been considered but has not been implemented*. Because of the fundamental right of property in German law, an impending insolvency situation is a prerequisite for a forced transfer of an insurer's portfolio. However, in 2020, legislation was changed to ensure a procedurally secure process in the event that the portfolio of a life or health insurer has to be transferred to an insurance guarantee scheme.[25]

Recommendations

134. The federal government should strengthen BaFin's powers, including providing the power to require contingency plans and resolution plans, and expanding the range of powers to facilitate the prompt and orderly exit of failing insurers. Such expansion should deal with gaps in relation to the minimum set of powers that a supervisor and/or resolution authority should be able to exercise for the resolution of an IAIG, as set out by the IAIS. This recommendation might be addressed, at least in part, by a proposed Insurance Recovery and Resolution Directive that is currently being discussed.[26]

135. The federal government and BaFin should enhance the ability of insurance guarantee schemes to identify, prepare for, and fund potential losses. Steps that should be considered include:

- Increasing communication between the schemes and BaFin, to facilitate the identification of potential failures and the preparation by the schemes to deal with them;
- Increasing the capacity of the schemes to raise funds, to better enable them to deal with the possible failure of a large insurer or group (depending on the size of the coverage gap potentially created);
- Undertaking contingency planning for dealing with a failure whose costs might be beyond the capacity of the scheme;
- Providing greater flexibility to the schemes in the use of funds, which might enable them to reduce the losses to which policyholders would be subject;
- Establishing a guarantee scheme for P&C insurers; and
- Continuing to engage on these issues at the European level. Seek to avoid gaps related to international business that might weaken the protection of policyholders and threaten financial stability.

[25] Article 6 of the German Risk Reduction Act (Risikoreduzierungsgesetz – RiG).

[26] See https://ec.europa.eu/info/business-economy-euro/banking-and-finance/insurance-and-pensions/insurance-recovery-and-resolution_en