FINANSINSPEKTIONEN

Supervision of insurance undertakings

17 MAY 2016

17 May 2016
Ref. 16-3438

TABLE OF CONTENTS

Summary

In order for an insurance undertaking to be able to fulfil its commitments, it must have sufficient capital and manage its risks and conflicts of interest. FI sees clear conflicts of interest in how the management of a mutual insurance undertaking manages the risk capital provided by policyholders, and how any surplus is split between them. The manner in which owners and management manage these conflicts of interest is an important focus of FI's supervision.

FI has observed deficiencies in the insurance undertakings' practical management of surplus and in their internal guidelines for and information to their customers about their surplus management. Clear guidelines and clear information about the distribution procedure are required in order for an individual customer to be able to determine if the distribution of the surplus is fair, and for FI to be able to verify that the undertaking actually follows the principles that have been established for how it should manage surplus. Through its supervision, FI will work to ensure that the undertakings clarify their procedures, increase their transparency and improve information provided to their customers.

The manner is in which life insurance undertakings are handling the low-rate environment continues to be a central focus of FI's supervision. FI's investigations show that the undertakings have the capacity to handle continued low interest rates, although the state of the market also means that they are more vulnerable to other risks. FI has also observed that the low interest rates introduce risks related to the undertakings' surplus management. In general, the low interest rates place high demands on the insurance undertakings' risk management and corporate governance. FI emphasises how important it is that the economic reality, and the risks associated with this reality, are reflected in an undertaking's risk management.

The insurance undertakings' own risk and solvency assessments, ORSA, comprise a central component of an undertaking's governance, and deficiencies could lead to risks for policyholders. Despite the improvement that undertakings have implemented in their preparation for the 2016 ORSA, there are still deficiencies that they need to rectify in order to ensure that they fulfil the requirements of the regulation.

FI ascertains that the transition regulation for occupational pension activities creates incentives for regulation arbitrage among the mixed undertakings. Incorrect application of the regulation could affect a large number of policyholders. Since the "soft separation" of the operations that the undertakings are currently applying will serve as the basis for the actual future separation when a new occupational pension business act enters into force, FI is carefully following the work of the undertakings on this matter.

FI and the insurance market

The insurance market offers individuals and businesses the possibility to manage their risks and secure their future financial welfare. However, there are inherent conflicts of interest within an insurance undertaking that could affect its ability to fulfil its commitments to its customers. In mutual undertakings, where the policyholders are also the owners, the management often has a large discretionary mandate to act in a manner that doesn't lie in the interest of the customers. This applies in particular to how it manages the risk capital provided by the policyholders, and how any surplus is split between them. The way in which the undertakings manage these conflicts of interest is an important focus of FI's supervision.

Insurance undertakings play an important role in the economy in that they compile and even out the risks to which individuals and firms are exposed to and safeguard their future financial welfare. An insurance undertaking commits to taking over the risks associated with a certain event from a large number of policyholders and thus manages the risks more efficiently than the individual policyholders.[1]

The insurance market is broken down into a life insurance market and non-life insurance market. These markets feature a large number of insurance policies and firms. Even if there are many different types of non-life insurance policies, the common denominator is that they provide compensation for damages to property or pay compensation to third parties. In many cases, illness and accident insurance also counts as non-life insurance.[2] Life insurance instead compensates a policyholder who is injured, on sick leave or deceases, or when he or she retires. The life insurance area also features many different types of product. The breakdown is based on who subscribes to the insurance and the type of saving and insurance risk.

While non-life insurance agreements often run one year at a time, and a non-life payment often occurs relatively quickly, the distinguishing feature of life insurance policies is that the payment periods (both inflows and outflows) stretch over a long period of time. Although pure risk insurance exist, most life insurance products contain an important element of savings, which means that the insurance undertaking manages funds that are paid in (premiums) on behalf of the customer. This is an important difference to non-life insurance , where the undertakings primarily manage premiums with the purpose of meeting future claims payments.

The risks in life insurance from the customer's perspective are strongly linked to the type of insurance in question. In unit-linked and deposit insurance, the policyholder decides on the assets in which the premiums shall be invested, and normally the insurance undertaking does not pro-

1 For a more detailed description of insurance business and its conditions, FI refers to the section about FI and the insurance market in the 2015 report, Supervision of Insurance Undertakings, Ref. 15-7744.

2 Illness and accident insurance that applies for longer than five years, for an indefinite period or until the insured has reached a certain age and may usually only be terminated by the insurance provider if specified in the agreement is classified as life insurance.

vide any type of guarantee regarding the size of future disbursements.[3] The value of the insurance is instead linked to the value of the selected assets. It is therefore the policyholder who bears the financial risk.[4]

In traditional life insurance, on the other hand, the insurance undertaking guarantees that a certain amount shall be paid out at a certain time to the insured, for a determined period (temporary payment) or throughout the remainder of the insured's life (life-long insurance). Because the policyholders in a mutual life insurance undertaking[5] are also its owners and provide the venture capital, they are also entitled to any surplus arising, known as bonus. Bonuses also occur in life insurance limited companies that are run in accordance with mutual principles[6]. In these companies, policyholders basically provide all of the venture capital and the owners normally only contribute a small portion of the venture capital. Profit-distributing life insurance limited liability companies normally offer insurance policies with conditional bonuses or without bonus entitlement. In contrast to the bonus in a mutual insurance undertaking, the conditional bonus is individual and is not included in the profit-distributing insurance company's venture capital.

New supervisory process

As part of the preparations for Solvency 2, FI introduced a new supervisory process in 2015. The point of departure is that FI shall be forward-looking in its supervision, and that the supervision shall be founded on a risk-based methodology. A core element of the supervision is to ensure that undertakings and groups have control over their operations and that they comply with their internal control documents and decision-making processes, and to ensure their quality. This approach assumes a flexible supervision that places a focus on analysing and ensuring that a firm or a group is managing its risk effectively while at the same time meeting the quantitative requirements on solvency capital.

FI conducts a risk assessment of all insurance undertakings and groups on an annual basis. The first step of this assessment is a quantitative analysis of the periodic reporting to FI. The second step is a qualitative assessment in which FI takes into consideration the risks and factors in an undertaking or a group that are not captured by the quantitative analysis. These may include previous supervisory experience, knowledge of significant events at the undertaking, the group or on the insurance market in general, or analysis of other qualitative reporting. All of the undertakings and groups are then ranked on a basis of the overall risk assessment. This ranking serves as the basis for the coming year's supervision and the preparation of supervisory plans. A supervisory plan, which can include individual undertakings or groups or a large number of undertakings or groups, presents the supervisory activities that FI will carry out during the year. The activities area adapted to the operations of each undertaking and their identified risks. Depending on what the supervision uncovers, supervisory measures may be taken. FI may carry out

3 Unlike unit-linked insurance, in deposit insurance investments may be made in cash and cash equivalents and securities.

4 It should be noted that unit-linked and deposit insurance are not pure savings, but there are often insurance aspects even in these agreements.

5 A mutual life insurance company or a mutual benefit society.

6 Life insurance companies can be run as either profit-distributing companies or according to the principles of reciprocity (hybrid company). The principles of reciprocity entail that all surplus in the business shall be allocated to the policyholders instead of being shared with the owners.

supervisory activities and take supervisory measures at any time of the year, if and when called for.

More or less all types of asset management on behalf of a third party contain incentive-related problems caused by conflicts of interests between the manager of the capital and the customer. However, these conflicts of interest can be particularly significant within the area of insurance. In a profit-distributing insurance undertaking there are conflicts of interest between the owners, who want a return on the risk capital that they provide, and the customers, who want protection. In a mutual undertaking, where the policyholders are also the owners, this type of conflicts of interest does not occur.

However, the absence of a strong owner means that the management team may be subject to extensive freedom of action in both the undertaking's operations and the asset management, which increases the risk that management will make decisions based on its own financial incentives rather than the best interests of the policyholders. For example, management may have a goal to expand the operations by offering new product types or entering into new geographic markets, or wish to increase the market share in areas where the undertaking is already conducting business. These types of financial incentives do not necessarily coincide with the existing policyholders' interests, which leads to conflicts of interest between management and the policyholders. This type of conflicts of interest could also affect a profit-distributing undertaking, but it can be particularly pronounced in mutual undertakings.

The freedom of the management in a mutual undertaking to take action is enhanced by the limited opportunity of the policyholders to gain insight into and understand the undertaking's operations and financial situation and how it manages its capital. The complexity of the products and the very long contract periods, and the limited ability of customers to "vote with their feet", also amplify conflicts of interest. As a whole, this means there is a risk that the management team will use a surplus in the operations for purposes other than for which it was intended. In the end, this affects the size of the surplus that the insurance collective can take part of. Because the claims of policyholders on equity are not contractual the management can also decide how to distribute the surplus between policyholders or groups of policyholders. This results in a conflict of interest also between policyholders. For example, there is a risk of management choosing to use the surplus of a collective to benefit another collective, or to subsidise new products or customer groups. This could also mean that beneficiaries of an insurance miss out on undistributed surplus if the collective consolidation at the time of payment happens to be at a high level.

In order to conduct operations in the interest of the policyholders, an undertaking must have satisfactory internal governance and control and be able to handle this type of conflicts. How insurance undertakings ensure the internal governance and control, and how they handle conflicts of interest are questions that are constantly present in FI's supervision.

The insurance undertakings surplus management

The contribution principle aims at ensuring that an insurance undertaking fairly distributes surpluses between its policyholders. However, the issue of how a surplus is distributed is complex. Since the regulations offer limited guidance in how undertakings should apply the principle, it is difficult in practice for policyholders to assess whether or not they have been treated fairly and for FI to monitor that the undertakings are actually following its guidelines. FI has seen deficiencies in how undertakings are actually distributing surpluses. Through its supervision, FI will therefore work to ensure that the undertakings clarify their procedures, increase their transparency and improve information provided to their customers.

THE CONTRIBUTION PRINCIPLE REGULATES SURPLUS MANAGEMENT

An insurance undertaking that offers life insurance policies with savings must have rules for how any surplus shall be distributed between policyholders, and between groups of policyholders. This primarily applies to agreements in which the insurance undertaking guarantees a certain level in SEK (or another currency) for the amounts that can be paid. The fairness principle applies to life insurance policies taken out before 2000.[7] For other life insurance policies, the contribution principle[8] applies insofar that another agreement has not been reached or other distribution is set down by the insurance undertaking's articles of association or the insurance association's by-laws. The contribution principle is thus non-mandatory in the sense that the terms of the insurance contract, or the content of the articles of association or by-laws, determine whether or not it applies.

As stated above, any right to conditional bonuses in a profit-distributing life insurance company in principle is always stated by the terms in the insurance contract, which also states when a reduction of the conditional bonus may occur. For unit-linked insurance, regardless of whether it is provided by a mutual or a profit-distributing company, undertakings are in practice responsible for losses on the commitments related to operating expenses and for risks associated with the insured's mortality, longevity, disability or illness (i.e. biometric risks). The undertaking thereby also keeps any gains associated with the outcome of these risks. Deposit insurance is instead built around conditional bonuses. In both cases, the management of surplus is managed by the terms of the insurance policy. The Contribution Policy is thus primarily relevant for mutual life insurance undertakings that offer traditional insurance policies with financial guarantees.

The legislator had not defined in more detail either in laws or in preparatory works how the distribution of surplus in accordance with the

7 The Fairness Principle when applied to life insurance consists of three parts: premium and cost fairness, fairness in the terms and conditions and fairness in claims adjustment.

8 See Chapter 11, section 18, Chapter 12, section 69 and Chapter 13, section 23 of the Insurance Business Act (2010:2043).

contribution principle should occur. However, it has stated a number of overarching principles and starting points.

In the preparatory work for legislation, it is stated that the contribution principle means that the distribution of surplus in a life insurance undertakings should "to the greatest extent possible" be based on each individual policyholder's contribution to the surplus, and that the distribution between different groups and generations should be fair. It furthermore states that each line of operations should be assessed individually. Every branch should therefore be self-supporting. This means that the premiums should be set in a way that one insurance line does not subsidise another one.[9]

The preparatory work also states that the contribution principle targets insurance undertakings and thus cannot be applied by individual policyholders. It also states that the principle may not be applied too extensively. Insurance implies evening out risks between policyholders, and traditional life insurance evens out not only biometric risks but also risks related to return on capital and operating expenses. Since, in many cases, it is only possible to determine if there is a surplus or not first after a line of operations has been closed, the contribution principle can be difficult to apply in full. This also means that the distribution of surplus, regardless of the method, will include trade-offs, which in principle means that individual policyholders may receive different amounts of remuneration based on when their contribution and disbursement periods have occurred.[10]

The wording of the Insurance Business Act on 31 December 2015 stated that a life insurance undertaking's technical guidelines should contain in part principles for the distribution of bonuses to policyholders and other beneficiaries. However, there were relatively few rules regarding bonuses and consolidation funds and these were supplemented by FI's general guidelines (FFFS 2011:12) regarding technical guidelines and the technical basis for calculations. These guidelines state that an insurance undertaking should specify in its technical guidelines the principles it applies for determining and following up on the factors that are significant for crediting bonuses and how the distribution of assets between occupational pension insurance and other life insurance affects the bonuses credited in each operation. FI's general guidelines also stated that an undertaking should determine a level for its collective consolidation and limits within which the collective consolidation will normally be allowed to vary. The guidelines stated that an undertaking should state its consolidation policy, i.e. the level and limits and the principles for how they are determined, in the technical guidelines or in a separate policy document.

Following the implementation of Solvency 2 the provisions of the law no longer regulate the content of the technical guidelines, but rather FI has been granted the powers to issue regulations on this matter. As part of its efforts to improve the undertakings' internal control of surplus management, governance of the consolidation fund and the consolidation level, FI implemented stricter requirements at the start of the year on the contents of the undertakings' technical guidelines.[11] One of

9 SOU 2006:55 p. 71f.

10 SOU 2006:55 p. 71ff.

11 See Chapter 9 of Finansinspektionen's regulations and general guidelines (FFFS 2015:8) regarding insurance business.

these requirements is that the guidelines must state more clearly which insurance policies or groups of insurance policies are entitled to bonuses and how differences between the insurance policies' contribution to the return on capital, insurance risks and operating expenses affects the bonus distribution. The regulations further state that the technical basis for calculations must complement and describe in more detail these principles by describing, for example, the assumptions and formulas that serve as a basis for the calculations.

SURPLUS MANAGEMENT BY MUTUAL LIFE INSURANCE UNDERTAKINGS

SSurpluses, and deficits, arise because the insurance undertaking in its calculations of the premium makes assumptions about biometric risks and the size of future operating expenses and returns. These assumptions may subsequently prove to deviate from the actual outcome. Surplus also arise since there are safety margins built into the assumptions.

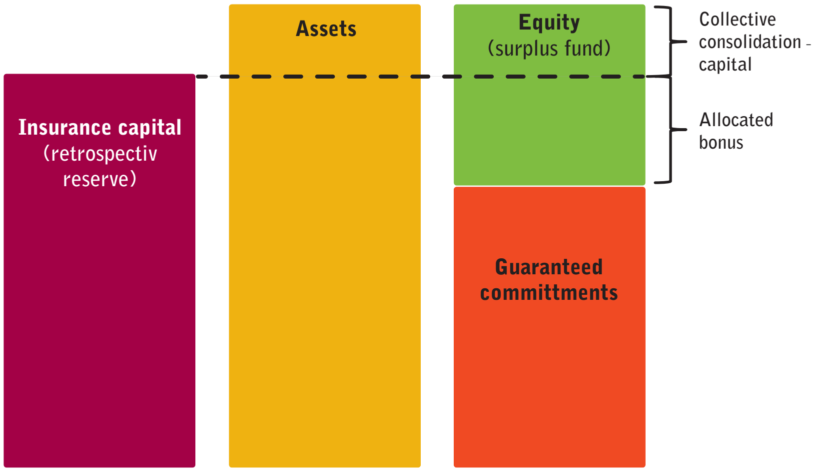
Mutual life insurance undertakings that offer traditional insurance distribute the surplus as allocated bonus. This bonus is not guaranteed, but rather form a part of the undertaking's risk capital. The undertaking thus can withdraw the allocated bonus if necessary to cover losses. As a result, the bonus could both increase and decrease during the term of the insurance. Normally, the bonus is assigned on an ongoing basis during the disbursement period – and thus only becomes guaranteed in conjunction with each payment occasion. The bonus can often constitute a significant portion of the amount the policyholder receives.

The total commitment for an insurance contract is specified by the retrospective reserve. The value of the retrospective reserve increases with paid premiums, returns including bonuses and any risk gains (for example, inheritance profits on some pensions) and decreases due to fees for operating expenses, payments and any deductions for risk expenses (for example premium waivers). The retrospective reserve is the value of an insurance that is normally communicated to the policyholder in the annual benefits statement and is often called insurance capital. If the insurance capital exceeds the guaranteed value of an insurance, the undertaking has allocated bonus to the policyholder.

In order to distribute bonuses, most insurance undertakings use the retrospective method. The purpose of this method is to distribute bonus between the insurance policies based on their respective contribution, while also avoiding the value of the insurance being fully affected by short-term variations in the size of the surplus. The undertaking distributes the capital return and the risk and operating profit between the policyholders using a bonus interest rate. The bonus interest rate is intended to reflect the future actual capital return, evened out over time, and includes both the guarantee pledged by the undertaking and any bonus. If the bonus interest rate is greater than the guaranteed rate, the preliminarily distributed bonus increases. If it instead is lower than the guaranteed rate, the bonus decreases, which even can lead to the insurance capital falling short of the guaranteed value.

The bonus interest rate is largely determined by the expected return on assets and is normally reviewed regularly by the undertaking. It is also influenced by the size of the undertaking's collective consolidation capital, which is the difference between the market value of the insurance undertaking's total distributable assets and the sum of the retrospective reserves. The collective consolidation ratio (expressed as a percentage) refers to the ratio between the value of the all assets held by the undertaking on behalf of the policyholders and the sum of the retrospective reserves. If the collective consolidation ratio is larger than 100 per cent, the actual value of the undertaking's net assets is larger than the sum of the retrospective reserves, and vice versa.

Collective consolidation capital in life insurance undertakings



Life insurance undertakings normally have a consolidation policy where they state the target interval within which the collective consolidation ratio may fluctuate. If the undertaking's actual collective consolidation ratio exceeds the target interval, it can be adjusted downwards by raising the bonus interest rate. If it instead falls below the target interval, the undertaking can lower the bonus interest rate so the consolidation ratio can return to the interval. An undertaking can also opt to do an instantaneous allocation, which means that an extra distribution of bonus is made to the insurances as a one-time event. If the collective consolidation ratio is lower than desired, the undertaking can similarly do an instantaneous reallocation, i.e. at a single point in time repossess all or parts of the bonus that was previously allocated to the insurance policies.

Some life insurance undertakings apply a return interest rate instead of a bonus interest rate. This rate is set retroactively and is close to the actual capital return achieved during the previous period. Since the return interest rate corresponds to the actual outcome of the capital return, in principle there are small differences between the actual value of the undertaking's total assets and the sum of its retrospective reserves. An undertaking that applies a return interest rate has a collective consolidation ratio that is stable at around 100 per cent.

Different models for surplus management have different advantages and disadvantages. Regardless of the model an individual undertaking chooses, there are a number of issues that it will need to manage within the framework of its internal governance and control. This applies, for example, to how an undertaking should even out its risk and return over time and how it can achieve fairness and risk-smoothing between different policyholder collectives, products and customer groups. Ultimately, the issues deal with how an undertaking, based on the model it has chosen, achieves a long-term approach and a reasonable measure of risk-taking in its management. The model the undertaking chooses also affects how the information to the customer needs to be designed in order to ensure that the customer understands, and is confident in, their choice of insurance.

FI ascertains that from a policyholder perspective there are several advantages associated with smoothing the bonus interest rate and allowing the insurance undertaking to build up a buffer in the form of a consolidation fund. For example, this better enables the undertaking to apply a more long-term approach to its asset management and to avoid the need for short-term policy changes. Policyholders also have different levels of acceptable risk, for example depending on how much time is left until disbursement . By holding a joint portfolio for all policyholders, the undertaking can spread the financial risks between different customers and thus achieve a satisfactory balance between risk and return. From an information perspective, a bonus interest rate also can be perceived as safer for the policyholder, who does not need to worry about abrupt shifts in the size of the insurance capital.

Risks facing the customers

Even if there are advantages to the surplus management applied by many undertakings, there are also risks for the policyholder. In an undertaking where old customers – who have contributed to building up a surplus in the undertaking – and new customers – who have not yet been able to contribute to the same extent – are given the same bonus interest rate, there is a risk that the older customers will be systemically discriminated. This is because the new customers will be able to receive a part of the surplus that older customer previously built up.

The risks for customers are enhanced by the complexity in the practical surplus management, and because legislation does not regulate in detail how the surplus management according to the contribution principle should be applied. The fact that the customer is facing an information asymmetry with regard to the design of the products, what the products include and how smoothing is carried out in practice, further aggravates the risks. On the whole it can be noted that the manner in which each individual undertaking applies the contribution principle can cause significant redistributions between different customer segments, without individual consumers having an opportunity to judge whether or not they have been treated fairly.

Risks facing the undertaking

Many life insurance undertakings apply a general bonus interest rate based on the financial result and where the aggregate value of the retrospective reserve serves as the basis for pension payments. Such a model can introduce risks in certain market situations. When interest rates fall and the market value of the interest-bearing assets rise, the collective consolidation ratio also rises. This may lead to the undertaking raising its bonus interest rate. Since the value of the technical liabilities typically has a stronger reaction to a decrease in the interest rate, such a development on the market normally has the opposite effect on the solvency, which falls. In such a situation, the surplus is allocated to the policyholders without taking into consideration how the cost to meet the guaranteed commitments has changed and that the solvency ratio has weakened. There is therefore a risk that an undertaking will pay too much to policyholders in the disbursement phase. In a market where interest rates fall and are persistently low, the result can be that the solvency ratio gradually weakens. From a contribution and fairness perspective, too much of the surplus is allocated to the insurance policies in disbursement, which affects the solvency ratio over time and risks reducing the possibilities to achieve a high return on other insurance. These are the types of risks that undertakings with this type of bonus model need to monitor.

FI AND THE CONTRIBUTION PRINCIPLE

As described above, the contribution principle means that an insurance undertaking must fairly distribute any surplus between its policyholders. Even though it is of great significance for policyholders how the surplus is distributed, the legislation and its preparatory works only provide limited guidelines on how the contribution principle should be applied. FI has observed that if an undertaking does not provide clear information in advance about how it will handle the surplus, it is difficult for individuals to determine if the distribution is fair and for FI to check that the undertakings are actually following the guidelines they have set up for their surplus management.

FI's observations of how undertakings manage surpluses

As described on several occasions, for example in the last years' Consumer Protection Reports, FI has seen deficiencies in how life insurance undertakings treat their customers in terms of surplus distribution, such as bonus capital or bonus disbursement. This means that customers are not receiving the money to which they are entitled and are forced to refrain from receiving surplus. In several cases, FI has observed that established surplus was used to design attractive offers for new customers. FI has also observed that the undertakings' information to customers about the models they apply for surplus management and the consequences of this model do not enable customers to determine whether they have received what they are entitled to, both during the contribution and disbursement period.

FI has noted an industry trend to attempt to handle these issues. A number of undertakings have switched to another bonus model, for example by holding separate asset portfolios for different parts of the portfolio with different bonus interest rates. There are also undertakings that apply an individualised bonus interest rate. Even if there are also risks associated with this type of model, it does reduce the problems related to contribution and information.

The issue of how surplus should be distributed can be complex, particularly in an undertaking with several portfolios that show differences in guarantee levels, terms of agreement or age. This places high demands on the undertakings' analysis of and procedures for surplus management. This also highlights how important it is for the undertaking to describe this in its internal guidelines, and for the guidelines to be sufficiently detailed so that they can be used as a governance tool for surplus management and fulfil a function in the undertaking's calculation principles for bonuses. However, in its supervision FI has identified deficiencies in the undertakings' technical guidelines for surplus management and distribution of bonuses in that they are generally very broadly worded, which has led to confusion and a lack of clarity in the actual handling of bonuses. Even in terms of the governance of the consolidation fund, FI has observed that the internal guidelines of the insurance undertakings are in many cases unclear.

FI's continued focus on surplus management

As FI has described, there are conflicts of interest that are inherent in surplus management, which the executive management of the undertakings need to handle. The identified deficiencies in the undertakings' principles and procedures for distribution risk having a negative financial impact on individual customers or groups of customers. An improper distribution of bonuses over a long period of time can have a great effect on both the amount the policyholder ultimately receives and the undertaking's solvency. Furthermore, ambiguity in the undertakings' guidelines and information that it gives its customers about how surplus is distributed make it difficult, or even impossible, for individuals to make a well-informed choice of both insurance undertakings and type of insurance.

As part of its efforts to ensure that customers' right to surplus is managed appropriately and clearly, FI will in its supervision review how undertakings describe surplus management in their internal guidelines. FI considers there to be three central questions that the undertakings should address in their surplus management:

- Which surplus should be distributed in accordance with the contribution principle?
- To whom and how should the surplus be distributed?
- When should the surplus be distributed?

As part of this, FI will also look more closely at how the undertakings in their guidelines describe how any smoothing of the bonus interest rate between different collectives is applied, how new policyholders are handled and the principles that apply to the surplus right in conjunction with the introduction of new products. This work includes investigating how the undertakings apply the new, stricter requirements on their technical guidelines. FI will also conduct onsite visits to review the undertakings' practical application of the guidelines.

In order to ensure that the area is subject to good consumer protection, it is also important that customers understand what a surplus is made up of and what rights they have to receive part of the surplus. FI notes that the more complex an undertaking's model for surplus management is, the higher are the requirements that the policyholders are able to feel confident that they understand the information they receive about the surplus management. FI will therefore also review how the undertakings inform their customers about how surplus arise and how it is distributed, and whether the information reflects the undertaking's internal guidelines for surplus management. Important information which FI believes an undertaking should provide to its customers includes:

- How does the undertaking view fairness between different customer groups as regards surplus management? How does the undertaking ensure that fairness is achieved?
- How is the bonus interest rate computed, and how is it affected by the undertaking's total return?
- Which principles form the basis of any smoothing of the bonus interest rate – between different policyholder collectives and products, and over time?

The aim of the work is to prompt companies to clarify their procedures, increase their transparency and improve their information to customers.

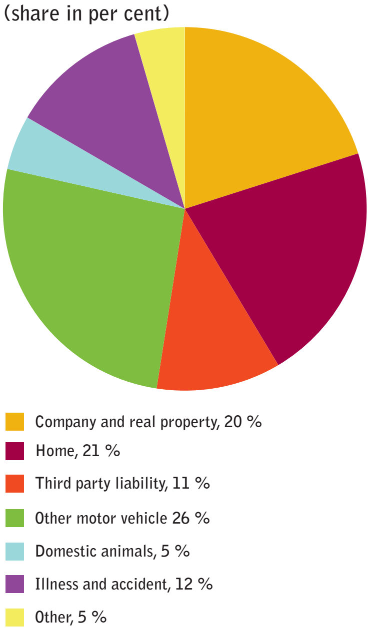
Supervision of insurance undertakings

In FI's opinion, the solvency of the life insurance undertakings enables them to manage the low-rate environment. However, protracted low interest rates leads to the undertakings' sensitivity to other risks increases, which places great demands on their risk management and governance. This applies to surplus management, for example, where FI sees that the interest rate environment potentially poses risks to policyholders. FI also sees a risk of the mixed companies exploiting regulatory disparities in a way that also poses risks to policyholders.

DEVELOPMENTS AMONG INSURANCE UNDERTAKINGS

In Sweden, there are just over 300 Swedish insurance undertakings and mutual benefit societies.[12] The majority, around 70 per cent, are non-life insurance undertakings. The five largest non-life insurance undertakings account for over 80 per cent of the non-life insurance market, expressed as a share of total premium payments.[13] Due to stricter demands and heightened administration, several mergers have taken place both between Swedish undertakings, and between Swedish and foreign ones. This has led to a reduction in the number of Swedish non-life insurance undertakings in the last few years. For the same reason, the number of foreign undertakings that conduct cross-border operations in Sweden, or that conduct operations out of a branch and agency (secondary establishment), has increased.

PREMIUMS CONTRIBUTED FOR NON-LIFE INSURANCE
(share in per cent)



The largest segments of non-life insurance consist of motor vehicle insurance, company and real property insurance, as well as home and home contents insurance. From 2009 to 2015, premium income for direct Swedish insurance increased by 22 per cent from SEK 56 billion to SEK 69 billion. The increase is partly explained by claim inflation (i.e. the average cost of a claim has increased and the undertakings have therefore hiked their premiums), and partly by population growth and related increase in the stock. Also, the standard and value of the insured objects has increased.

The non-life insurance undertakings have been displaying healthy profits for a long time. The technical outcome has, in the past five years, been at 8 per cent of the premium, although the outcome varies between segments. The most profitable segments over the period have been motor vehicle insurance, illness and accident insurance and livestock and domestic animal insurance, for which the technical outcome has been between approximately 7 per cent and 13 per cent. For third party motor vehicle insurance which, unlike motor vehicle insurance, is compulsory, the undertakings instead show a zero result. The difference in profitability is tax-driven, because the premium for third-party motor vehicle insurance is taxable, while that for motor vehicle insurance is not. Many undertakings have used this to their own competitive advantage, packaging the two insurance types together for sale to customers. Overall, profit was just over 10 per cent on average. Aside from third party motor vehicle insurance, the redundancy allowance and home and home contents segments have been the least

12 In addition, there are just shy of 80 pension foundations, over which FI has limited supervision.

13 AFA Sjuk is not included in the figures because of its special business and premium-setting. AFA insurance is determined by collective or other agreements between labour market parties. Trygg-Hansa is included, however, despite the fact that it merged with Codan in 2015 and is now a branch of the Danish parent company.

profitable. In this context, it should be mentioned, however, that the outcome for redundancy allowance is highly cyclical, and the outcome in the past six years has varied sharply.

In the past years, the premium level has increased in several insurance segments, primarily for private insurance. For example, the premium level for Home and home contents rose by SEK 3 billion, or 26 per cent, between 2009 and 2015. To some extent, the increase can be explained by the fact that some undertakings have extended the scope of the cover provided by home contents insurance, for instance by including the cost of claims caused by identity theft.

Pricing new risks, such as cyber risk or climate-related natural disaster risk, poses a challenge to the undertakings because there is no data regarding the costs of insuring such risks. However, the problem should not be exaggerated. Insofar that claims emerge rapidly, and the cost of them are relatively easy to appraise, the risk should be manageable. However, it is not merely a case of appraising the total cost. In order to distribute charging premiums and avoid a distorted selection of policyholders, leading to higher than calculated costs of claims (adverse selection), it is also important for the undertakings to understand how the risk changes within different groups of policyholders. If it takes too long for an undertaking to analyse new types of claims risks and increased claims costs, it might incur major losses, which could lead to it failing to honour its obligations towards its policyholders.

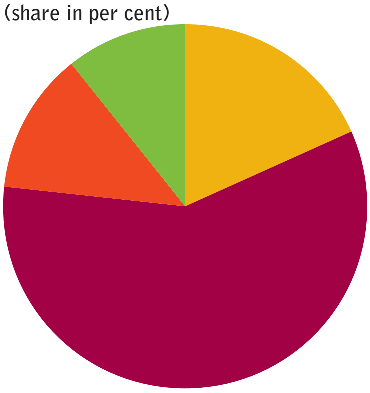
Heightened digitalisation and interconnectedness – a trend that brings risks

Heightened digitalisation enables efficiencies and improvements, but leads at the same time to vulnerabilities in the information flow, expertise and contingency in the event of failure of some part of the architecture. Services and business lines in the financial sector are increasingly dependent on IT and also have a growing IT content, such as through applications and self-service online. It is not uncommon for insurance undertakings to have old systems that need to be moved to more modern technical platforms. At the same time, new solutions must be integrated with old ones. The implementation of Solvency 2 also affects how the undertakings work with IT in terms of continuity and data quality. On the whole, the development increases the complexity of the undertakings' technical architecture. As a growing number of entities move online, the risk of attacks on various parts of the infrastructure increases, because the number of points of entry into, and integration with, the infrastructure increases. This poses operational risks which the undertakings must manage.

Solvency 2 imposes requirements on an insurance undertaking having appropriate systems, resources and procedures so as to enable continuity in the business, and a contingency plan for restoring the business in the event of incidents.[14] In light of the developments and the new regulations, in 2016 FI is conducting an investigation aimed at assessing the extent to which the undertakings fulfil the continuity requirement. Another aim of the investigation is to identify appropriate focus areas for supervising the IT operations of insurance undertakings, and whether there are concentration risks in terms of the subcontractors appointed by the undertakings for their infrastructure and platform services.

14 See Chapter 10, section 3 of the Insurance Business Act.

INSURANCE CAPITAL 2015, LIFE INSURANCE SAVINGS
(share in per cent)



Defined-benefit occupational pension insurance, 18 %
Defined-contribution occupational pension insurance, 58 %
Private pension insurance, including capital pension, 13 %
Endowment insurance, 11 %

In 2015 premium contributions for life insurance amounted to SEK 222 billion – an increase of almost 13 per cent from the previous year. Premium income for the same year was SEK 250 billion, i.e. 13 per cent higher than premium contributions. An important explanation for this is that transferred capital does not count as a premium contribution, but is included in premium income.[15] The share of premiums not exposed to competition, which largely refers to defined-benefit occupational pension, makes up just shy of 9 per cent of total contributions. Because the trend in the major collective agreements is headed increasingly towards defined-contribution occupational pension for new policies, the share of defined-benefit occupational pension will shrink in the future. Contributions into private pension savings will also sharply contract now that the tax break for private savers will practically be abolished as of 2016.[16]

The aggregate insurance capital, i.e. the capital allocated to policyholders, for life insurance products with an element of saving amounted to SEK 3,140 billion at the end of 2015, so it has increased by 8 per cent annually on average since 2010. Just over 50 per cent of the capital is managed by the five largest life insurance undertakings. The lion's share of the stock consists of traditional insurance, and approximately two thirds are linked to occupational pension business. Only 12 per cent of the stock consists of private pension insurance. Because of the abolished tax break, combined with the fact that pension disbursements will increase, the share of private pension savings out of total savings in insurance will decline in future.

MiFID II, IDD and kick-backs

MiFID regulates trade in financial instruments and trading venues and aims to strengthen investor protection and increase competition. The directive has been replaced by a new directive, MiFID 2, which entails stricture rules in many respects. For example, the rules on managing conflicts of interest and third-party remuneration in investment advice are stricter. The new insurance distribution directive (IDD) contains similar minimum rules for insurance distribution.

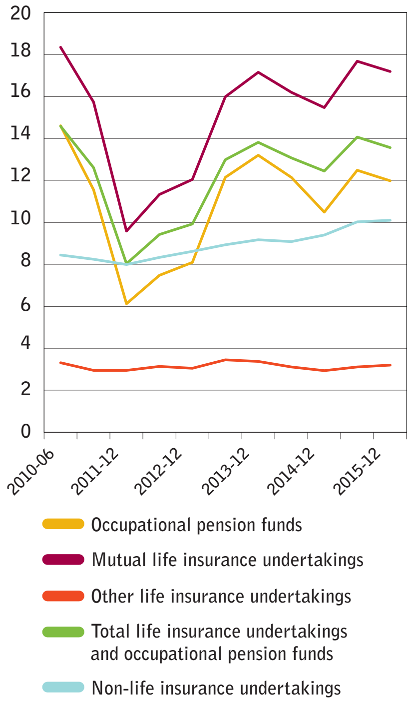
In Sweden work is in progress to prepare new legislation based on the aforementioned directive. An important question for the insurance undertakings is how the rule in IDD regarding remuneration shall be interpreted and introduced. FI's inspection of the insurance undertakings' reliance on kick-backs (a commission received by unit-linked insurance undertakings from fund management companies when they invest large amounts) shows that many unit-linked insurance undertakings are dependent on income from such commissions. For a handful of undertakings, kick-backs are the sole source of income. FI advocates a ban on commissions in advice on financial instruments in life insurance, irrespective of whether it is an insurance intermediary or an insurance undertaking providing the advice. It is difficult to say how large a share of sales of unit-linked insurance occurs through advice. Also, it has not yet been decided how the rules in IDD will be introduced in Sweden. In light of the significance of kick-backs for the revenues of unit-

15 Premium income covers all premium payment, transferred capital and the addition of any paid-up policies in defined-benefit occupational pension from both new and older life insurance.

16 The self-employed may make tax deductions for private pension savings of up to 35% of income from business activity. The deduction may amount to no more than 10 price basic amounts.

linked insurance undertakings, a ban – depending on how it is devised – might bring on a financial risk which must be managed by the undertakings.

SOLVENCY RATIO
FOR INSURANCE UNDERTAKINGS



Insurance undertakings' investment assets

At the end of 2015, the aggregate investment assets[17] of insurance undertakings were just over SEK 4,000 billion. The vast majority of the assets are managed by the life insurance undertakings on behalf of their customers. Around SEK 2,500 billion consists of savings in traditional insurance. Unlike unit-linked insurance, in which the policyholders themselves bear the financial risk, the financial guarantees in traditional insurance mean that life insurance undertakings and mutual benefit societies have major future obligations, which they must be able to fulfil.

For savings products, asset management is an important element in creating value growth and bonuses. Annual total return for the undertakings with traditional insurance was on average 7.1 per cent during the period between 2011 and 2015. However, the return of the undertakings varies between approximately 3.5 per cent and 9.5 per cent, one reason being differences in investment strategy.[18]

The insurance undertakings mainly invest in equities and bonds. Because of this, undertakings with traditional obligations are exposed to financial risk, primarily equity price risk and interest rate risk. The largest single risk for most undertakings is the equity price risk, i.e. the risk of the value of equity holdings or equity-related holdings being adversely affected by a change in the market value of equities. For undertakings with long-term obligations with financial guarantees, changes in market interest rates affect both assets and liabilities, because the present value of future obligations is calculated using a discount rate that is partially based on market interest rates. The size of the interest rate risk largely depends on how well the assets and liabilities of an undertaking are matched; in other words, on the extent to which the undertaking's assets reflect the nature and duration of its obligations.

The development of insurance undertakings' solvency

In the latter part of 2015, long market rates rose compared with 2014, while at the same time the valuation of the equity market was more or less on a par with the end of the previous year. Combined, this caused solvency ratios to increase during the year for both life insurance undertakings and occupational pension funds. The solvency ratios of non-life insurance undertakings rose too.

Solvency 2 brings about a fundamental change in how the undertakings' solvency is calculated. Because the undertakings shall report for for the first quarter of 2016 by the end of May at the latest, FI is not able to describe at present the state of solvency based on the new regulations. Generally speaking, however, it can be said that Solvency 2 sharply increases the capital requirement. The outcome of the preparatory reporting carried out in 2015 indicates that the solvency capital requirement will on average be six times higher than under the former regulations, and around 40 per cent higher than the requirements of the

17 This includes, for example, equities, fixed-income securities, real estate and loans.

18 Insurance Sweden's industry statistics no. 1/2016.

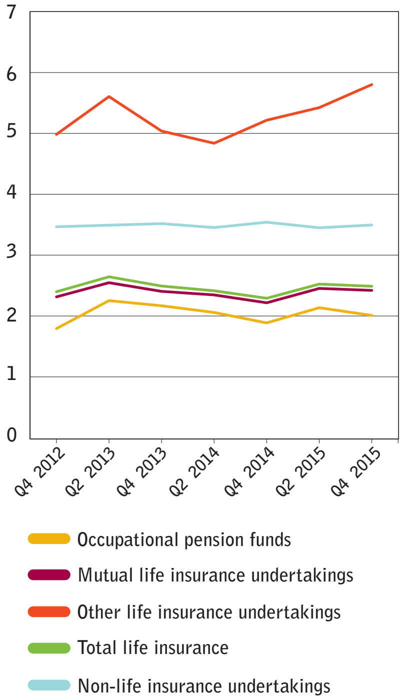
traffic light test. It should be emphasised, however, that the former solvency rules imposed a safety margin in the valuation of the technical provisions, which now disappears. So, part of the expected increase in the capital requirement comes from making former buffers visible.

The solvency capital requirement in Solvency 2 – a risk-sensitive solvency measure

Solvency 2 marks a major transition in how an insurance undertaking is to calculate the capital requirement. The regulations contain two capital requirements – a minimum capital requirement (MCR) and a solvency capital requirement (SCR). Unlike in the former rules, under which the undertaking in its calculation, proceeds on the basis of the technical provisions on the liabilities side of the balance sheet, SCR is calculated based on all quantifiable risks to which the undertaking is exposed, both on the liabilities and assets sides. Not least, the interaction between assets and liabilities is taken into account. Risk-reducing measures, such as reinsurance, are also taken into account. The purpose is for SCR to better reflect the actual risk level of the individual undertaking, and incentivise the undertaking to manage its risks.

MCR is intended to be the solvency level which, if not met, would entail too high a risk for policyholders if the undertaking is permitted to continue with its business. MCR is calculated more simply than SCR, and shall amount to between 25 per cent and 45 per cent of SCR.

TRAFFIC LIGHT RATIO FOR INSURANCE UNDERTAKINGS



The traffic light test

In the traffic light model, FI measures an insurance undertaking's resilience to changes in asset prices and in insurance outcomes. The purpose of the traffic light test is to identify undertakings with such high levels of risk exposure that they cannot, with sufficient certainty, fulfil their obligations. The objective is to prevent an undertaking from taking excessive risk in relation to its capital buffer, and to enable earlier intervention from FI than would otherwise have been the case.[19]

Conversely to the trend in 2014 the capital buffer of life insurance undertakings and occupational pension funds increased more than the capital requirement in relative terms. On the whole, the traffic light ratio rose by around 8 per cent during the year. For non-life insurance undertakings, the traffic light ratio is basically unchanged compared with the end of 2014.

FI adapts the traffic light test for occupational pension business

As of 2016, the insurance undertakings covered by Solvency 2 will no longer report under the traffic light test. However, the transition rules for occupational pension business entail that older solvency provisions apply to such operations until the end of 2019. FI has therefore decided that undertakings with occupational pension business shall continue to report under the traffic light test. A life insurance undertaking conducting both other life and occupational pension business, and which applies the transition rules for its occupational pension business, shall report under the traffic light test only for that part.

19 The capital buffer in the traffic light model consists of subordinate liabilities, untaxed reserves and equity.

FI is now reviewing and adapting the traffic light model to the operations still subject to reporting, and to FI's supervisory requirements. This could be a case of the valuation on which the model is based, and the stress tests applied. FI expects that the new traffic light model will start to apply as of the first quarter of 2017.

RISK MANAGEMENT IN A LOW INTEREST RATE ENVIRONMENT

In the first part of 2015, market interest rates continued to fall to exceptionally low levels in a historical perspective. Therefore, even greater attention has turned to the risks ensuing from persistently low interest rates for life insurance undertakings with financial guarantees, which FI has highlighted in the past few years. Although long market interest rates rose somewhat in the latter part of 2015, FI sees many risks linked to the state of the market. This places great demands on the undertakings' risk management.

Solvency risk

The vulnerability of life insurance undertakings to low interest rates is the result of the major obligations of the sector in the form of pension commitments with a long maturity, combined with the fact that the liabilities often have a longer average maturity (duration) than the interest-bearing assets intended to cover them. When the value of liabilities increases while at the same time return on fixed-income securities decreases, the financial position of an undertaking is adversely affected. In order to reduce the financial risks, the undertakings can be forced to reallocate in their asset portfolios by selling equities and increasing investments in fixed-income securities. This can, in turn, further reduce the undertakings' ability to attain sufficient return. A sustained and protracted period of low interest rates thus brings a heightened solvency risk for the undertakings, and a risk of the undertakings failing to honour their obligations to customers.

Considering the state of the market, and following up on the stress tests from 2014 of EIOPA (European Insurance and Occupational Pensions Authority), in 2015 FI conducted an investigation aimed at assessing the risks at a number of large insurance undertakings ensuing from persistently low interest rates. FI also evaluated the undertakings' governance in terms of control, management and reporting of such risks. The results were published in a report from 18 November 2015.[20]

The results show that the participating undertakings have the capacity to handle continued low interest rates. Furthermore, the calculations show that it suffices for investment assets to maintain their value for the undertakings to fulfil the guaranteed pension obligations – thus, no future return on investment assets is required. In order to fulfil the solvency requirements if interest rates remain low, the undertakings must however have some return on investment assets.

In their contacts with FI, the undertakings have stated that common measures for managing solvency risk have been to make changes to the product offering and to the financial guarantees offered by the undertakings. For example, today they only offer insurance with single premiums in series, enabling them to adapt the guarantee continually during

20 See www.fi.se, Ref. 15-13038.

the premium contribution period. Insurance with running premiums, for which the guarantee that applied upon taking out the insurance also applies to all future premium contributions, is no longer offered. The undertakings state that further measures will be implemented, mainly in the form of reduced guarantee levels or by limiting the guarantee so that it only covers parts of the premium.

FI concludes that persistently low interest rates substantially increase vulnerability to other risks. For example, an adverse trend on equity markets could give rise to solvency problems. Even though the undertakings are considered to have the capacity to handle a protracted low-rate environment, they have a responsibility to fulfil their obligations no matter how capital markets perform. The ability to cope with further difficulties places great demands on the financial risks being reflected in an undertaking's risk management. An important part of risk management is the surplus management process. As FI has pointed out previously in this report, it is crucial that an undertaking – in order to avoid paying out more bonuses than can be accommodated in the long term – in its surplus management fairly takes into account the financial risks inherent in its applied bonus model.

Since market interest rates can be expected to remain low in the foreseeable future, the risks ensuing from this will remain in the focus of supervision. Follow-up will be performed by means of, for instance, participation in the planned European stress tests in 2016, in which an evaluation of the effects of protracted low interest rates will be in focus. The outcome will be used in FI's future analysis of the risks in Swedish undertakings. In addition, interest rate risks and other market risks will be evaluated in IMF's stress tests as part of the 2016 FSAP.

What is FSAP?

FSAP stands for Financial Sector Assessment Program and is the International Monetary Fund's (IMF's), evaluation of a country's financial system. Since the financial crisis, it is compulsory for the world's 29 largest economies to undergo an FSAP every five years. Sweden is participating in an FSAP in 2016, and last participated in 2011.

In the inspection, IMF analyses the financial sector, authorities, legislation and supervision. The report subsequently prepared by IMF also describes the identified deficiencies and risks. IMF also provides proposals for measures to address these.

Risks in a model-based discount rate curve

Through the Solvency 2 regulations, insurance undertakings shall apply a discount rate curve, the technical specifications of which are set out by the regulations and which, in certain parts, differ from the rate curve previously applied by the undertakings.[21] However, there are many similarities too. An important similarity is that interest rates for longer maturities are modelled in both cases based on macroeconomic assumptions regarding a long-term interest rate level (Ultimate Forward Rate, UFR), which is set at 4.2 per cent. The similarities between the

21 Life insurance companies that apply the transition rules for operations pertaining to occupational pension insurance and occupational pension funds shall continue to apply the discount rate curve established by FI (FFFS 2013:23).

rate curves have made the transition relatively easy for Swedish undertakings.

However, FI determines that the discount rates for longer maturities according to the new rules are higher than the equivalent rates in FI's rate curve. This increases the risk of the undertakings failing to satisfactorily manage the market risks, and the risk of the guarantees they provide exceeding the return they can attain. FI also sees a risk of the rate curve, in combination with low interest rates, leading to failure to comply as intended with the contribution principle. This is because policyholders in the disbursement phase risk benefiting at the expense of other policyholders (see page 8 for a more detailed description of the risk).

In 2015 FI carried out an investigation of the sensitivity of life insurance undertakings to changes in the new discount rate curve. The investigation included changes to the long-term interest rate level and credit risk adjustment. The results show that a change to the long-term interest rate level has the greatest impact on the value of technical provisions. However, different parameter changes affect the undertakings to varying degrees. Life insurance undertakings with unit-linked insurance and traditional insurance with loss-absorbing conditional bonus are affected less by a change in interest rates. Mutual life insurance undertakings with traditional insurance are greatly affected by it, however. The size of the effect depends on the duration of the liability, with a longer duration giving a greater effect.

Because of the prevailing low interest rate environment, many have questioned whether the long-term interest rate level used is reasonable. In this context, it is important to point out that it is intended to reflect an average long-term interest rate level in a 100-year horizon. In order to ensure the credibility and appropriateness of the model used, it is however important to regularly test the model and the assumptions on which it is based. The European Insurance and Occupational Pensions Authority EIOPA is currently conducting a consultation on the method for how the long-term interest rate level for the discount rate curve is devised. In parallel with this, an initial evaluation is being performed of the mechanisms in the Solvency 2 regulations which insurance undertakings with long guaranteed commitments may apply. During the period 2016–2020, EIOPA will annually evaluate and report the effect of these mechanisms to trialogue parties – the European Commission, the Council and the Parliament – ahead of a more extensive review by the Commission no later than 1 January 2021. The work, in which FI is participating, is in the initial stages and FI finds that it is crucial that the undertakings carefully follow the work with both the long-term interest rate curve and the specific mechanisms for long-term guaranteed commitments.

FI will, through future reporting, continue to monitor how the insurance undertakings capture the model risks and how they work in the long term to fulfil the guarantees provided. An important part of this is to analyse how the undertakings, in their own risk and solvency assessments (ORSA), assess and evaluate the risks associated with the discount rate curve.

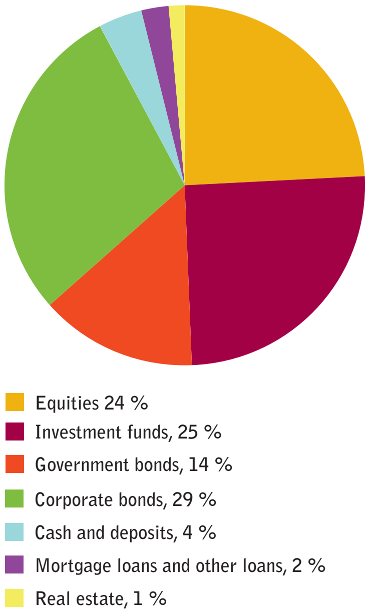
FI emphasises the importance of an undertaking taking account of both the quantitative requirements and actual financial reality so that it may fairly analyse its risk profile in its ORSA.

Heightened investment in risky assets

As the low return on interest-bearing assets persists, the incentives of insurance undertakings to find alternative investments that provide an opportunity for greater return increase. The undertakings may thus seek markets about which they lack both knowledge and experience, and in which both transparency and liquidity may be limited.

In its review of the undertakings' investment strategies, in the latter part of 2015 FI analysed their asset reporting in the preparatory reporting for Solvency 2. The review provides a snapshot of the composition of the undertakings' asset portfolios.

ALLOCATION OF ASSETS, LIFE INSURANCE UNDERTAKINGS



Note. The chart is based on information that a limited amount of life insurance undertakings have reported in the preparatory reporting, and concerns only assets related to traditional life insurance business.

FI observes that Swedish life insurance undertakings have a relatively high share of investments in equities compared with the rest of Europe, which confirms the findings of previous investigations. Out of the undertakings' investments in fixed-income securities, just over one quarter consists of corporate bonds, while covered bonds make up just shy of one quarter. However, some undertakings show a much higher share of covered mortgage bonds. At the same time, FI observes that the creditworthiness of the undertakings' holdings is generally high, limiting the risks. However, a factor that cannot be disregarded is that increased risk appetite may be reflected in investments with poorer credit quality in future.

In previous investigations, several undertakings have expressed an ambition to increase investments in alternative assets, such as in private equity funds and infrastructure assets. While such investments can give greater diversification, they can also give rise to other types of risk than more traditional assets. In several cases, such assets also feature lower liquidity. Based on the preparatory reporting and previous investigations, FI sees that alternative assets still make up a minor part of the undertakings' investments, but that there has been some increase.

FI's overall assessment is that the undertakings' investments in risky assets do not currently pose a significant risk, but that developments should be carefully monitored. Through Solvency 2, FI has much better possibilities to monitor developments in the reporting. FI will continually analyse and follow up on the undertakings' asset reporting to ensure that assets are invested according to the prudent person principle.

THE IMPORTANCE OF ORSA TO CORPORATE GOVERNANCE

IIn 2016 FI is dedicating a great deal of its resources in the insurance segment to reviewing how the undertakings comply with the rules that came into effect at year-end and which implement the Solvency 2 directive. A core question in the supervision is how the undertakings work with corporate governance, for instance in terms of their suitability assessment of board members, executives and heads of central functions. FI also maintains its focus on how the undertakings manage conflicts of interest and outsourced operations. Because the work has only just begun, FI cannot currently provide any general conclusions, but will revert to this in other contexts.

Another focus area is the undertakings' own risk and solvency assessments, ORSA. FI has observed that the ORSA requirement is one of the new features with which the undertakings have worked most in their preparations. The process is critical for many reasons, not least because it means that an undertaking, on top of calculating the capital requirements according to the regulations, must make its own assessment of its solvency situation. This means that the board of directors and CEO are expected to formally judge how much capital is required, in view of its risk profile, by the undertaking's own operations. Furthermore, ORSA ties the three regulatory pillars – capital requirements, corporate governance and reporting – into a single process, which shall result in a report containing quantitative and qualitative conclusions. Without solid knowledge about both the regulations and the undertaking's own business, and satisfactory overall competence in both the board and the organisation, FI determines that it is difficult for an undertaking to perform an appropriate ORSA.

Because the ORSA is to be a core component of an insurance undertaking's governance, deficiencies therein could lead to inadequate governance and bad decisions. For example, this could be manifested in an undertaking's board and management failing to prepare sufficiently for managing any deficits that might arise. Ultimately, this could lead to the undertaking failing to honour its obligations to customers.

As part of their preparations, undertakings and groups for 2014 and 2015 have conducted a forward looking assessment of own risks (FLAOR) in accordance with the principles that apply for an ORSA. Although FI's review of the 2015 FLAOR reports is not yet complete, some preliminary observations can be made. In general, FI sees that the quality of the reports has improved compared with 2014. In the reports, many undertakings provide rationale about the solvency needs of their own business, and perform different types of analysis of adverse future events, such as stress tests and scenario analyses. Some undertakings also choose to perform reverse stress tests, aimed at showing the adverse conditions for which own funds would no longer suffice to fulfil internal or external requirements. Finally, FI sees many undertakings putting words into action by proposing or deciding on measures ensuing from the conclusions that emerged in the ORSA process.

Despite the improvements, FI still sees deficiencies for many undertakings to address ahead of the 2016 ORSA. In many cases, the deficiencies were raised by FI in its feedback to the undertakings on the 2014 FLAOR reports. FI observes that an undertaking's assessment of its own solvency need, and what it is based on, is often unclear. Although the undertakings' stress tests of their own forecasts have improved, it is often unclear how the findings have affected the solvency assessment. Furthermore, some undertakings base their assessments of the solvency need on the capital requirements in the regulations, and not on the risks to which they are, or could become, exposed. In FI's opinion, this in itself does not suffice to fulfil the ORSA requirements. FI points out that an undertaking shall proceed on the basis of the risk profile of its own operations, and that the ORSA must therefore contain a clear link between the risk profile and the solvency assessment. FI will, in separate feedback to the undertakings concerned, bring up the deficiencies identified. FI also emphasises the importance of the undertakings implementing the improvements needed in order for their 2016 ORSA to fulfil the regulatory requirements.

TRANSITION RULES PRESENT A RISK OF REGULATORY ARBITRAGE

In both Sweden and the EU, an overview is currently being performed of the rules governing occupational pension business. The transition rules introduced by the legislator for life insurance undertakings that conduct occupational pension business are intended to enable such undertakings to switch to new occupational pension regulations once such rules are in place.

Transition rules for occupational pension business

An insurance undertaking that conducts occupational pension business shall, over a four-year period, apply some of the old rules for that business. This includes the provisions about how to calculate the solvency requirement, about the valuation of technical provisions, and about assets that are to cover liabilities. An undertaking that conducts both occupational pension and other life insurance business – a mixed undertaking – shall apply the older requirements for occupational pension business, and the Solvency 2 requirements to the other life insurance business. If the other life insurance business is negligible, the older rules shall be applied to the entire operations. An insurance undertaking that conducts occupational pension business may however choose to apply Solvency 2 to its entire business.

According to the transition rules, a mixed undertaking shall calculate a theoretical capital requirement for the occupational pension business. This capital requirement shall form part of the aggregate capital requirement to be reported by the undertaking under Solvency 2. In order to calculate a separate capital requirement, the undertaking must break down its balance sheet, including the surplus accumulated, into the two businesses. The motives for the provision describe how to perform such a "soft separation". It is explained that a mixed undertaking shall perform a breakdown each time the solvency capital requirement is to be calculated. The undertaking shall also establish and document the principles of separation.

FI has been able to determine that the transition rules create incentives for regulatory arbitrage among the mixed undertakings, resulting in heightened risks for policyholders. An undertaking may, for example, have an incentive to control the capital requirements by transferring risky assets to the occupational pension business, hence enabling it to take on more financial risk for such assets. While this theoretically enables greater return, in practice it gives rise to non-harmonised consumer protection. FI also determines that an undertaking that transfers assets in this manner, and which at the same time applies the same bonus interest rate to both businesses, does not apply the contribution principle in the intended manner.

A survey sent out by FI in December 2015 shows that eleven mixed undertakings apply the transition rules. These undertakings account for around 40 per cent of the total assets under management by life insurance undertakings. An incorrect application of the regulations could thus affect a large number of policyholders. In the latter part of 2016, FI will study in more detail how the undertakings concerned apply the separation requirement. FI will review the undertakings' documentation and application of the separation principles. The purpose is to find out if an undertaking breaks down the businesses in order to reduce the aggregate capital requirement, and whether the breakdown is consistent with the contribution principle. Since the "soft separation" is the basis for the actual separation of the businesses that an undertaking will need to do when the occupational pension regulations are in place, FI will carefully monitor the work of the undertakings on this matter. If FI sees that the separation requirement is not applied as intended, it might be necessary to commence discussions with the Ministry of Finance on clarifying the rules on this.

INSURANCE UNDERTAKINGS AND NATURAL DISASTER RISK

As FI described in its 2015 report, changes in weather can have an adverse impact on the non-life insurance undertakings that are exposed to various types of natural disaster risk. In order to protect themselves against extensive and expensive natural disasters and limit their risk, the undertakings often purchase reinsurance. The reinsurance cover can be devised to provide cover in the event of major individual claims, but can also cover the undertaking if it is sustains a high frequency of natural disasters, which together result in major claims expenses.

Because major natural disasters are relatively seldom, the undertakings mainly use modelled assumptions when setting premiums and in their choice of reinsurance cover. There are concerns about a heightened probability of extreme weather, and that both the frequency and expense of claims in certain vulnerable areas will increase ahead. For undertakings to be able to honour their obligations towards customers, they must continually review their assumptions.

In 2015 FI investigated how a selection of non-life insurance undertakings manage their natural disaster risk. The investigation is based on the undertakings' own assessments of the risks and on the modelling which the undertakings choose to do, and provide a snapshot of their management of the risks. Provided that the undertakings, in their modelling, fairly judge their exposure to natural disasters, the findings indicate that the undertakings are well reinsured. At present, FI does not find any further measures necessary in the area, although the data may be used as reference in any future follow-up.

Current regulatory matters

Intense work is under way to develop new supervision models due to Solvency 2. FI determines that developing the principles for how the rules shall be applied takes time. A question that is still important to both FI and the industry is how regulation of occupational pension undertakings will be devised. FI emphasises the importance of the government responding to this question as soon as possible. At the same time, work is under way at EU level which the insurance industry should carefully follow.

SOLVENCY 2 – FROM REGULATION ISSUANCE TO APPLICATION

Work with Solvency 2 has been in progress for many years and FI has been active in both the European work and in the preparation and implementation of the regulations in Sweden. Most insurance undertakings have also long been preparing for the rules, partly through the quantitative impact studies (QIS) carried out by EIOPA, and partly through the undertakings' internal adaptation of processes and procedures.

Solvency 2 features qualitative and principle-based requirements, providing undertakings with greater flexibility in how to fulfil the requirements. However, some parts of the regulations contain highly detailed quantitative requirements. A core task in supervision will be to ensure that an undertaking – through its internal procedures and processes – actually fulfils the set requirements.

At FI and in the EU, intensive work is under way on developing new supervision methods, and new supervisory practices also need to be developed. Through Solvency 2, the national supervisory authorities will have a standard toolkit and will implement their supervision uniformly. FI must therefore adapt its supervisory procedures to the EIOPA requirements. Developing practices and reaching consensus on how the rules are to be interpreted and applied is time-consuming, not least regarding the elements of the regulations that are of a qualitative nature, and which offer greater scope for interpretation. FI finds it important that all parties now jointly work to ensure that the rules take full effect in practice.

AMBIGUITIES REGARDING OCCUPATIONAL INSURANCE REGULATION

As described by FI in its 2015 report, the Occupational Pension Undertaking Inquiry proposed new regulations for occupational pension undertakings.[22] In its consultation response, FI emphasised that a simultaneous entry into force of the amendments to insurance business legislation and new regulations for occupational pension undertakings was desirable in order to enable existing undertakings with occupational pension business to convert into occupational pension undertakings, in accordance with the inquiry's proposal. Indeed, FI found that any lag between the entry into force of the two sets of regulations could be addressed using transition rules. However, FI also expressed that such a procedure might potentially have negative effects on consumer

22 SOU 2014:57.

protection because the proposed conversion period would be significantly shortened in that case.

The transition rules introduced by the legislator for life insurance undertakings that conduct occupational pension business have the very intention of enabling the undertakings concerned to switch to forthcoming occupational pension regulations. However, it is currently unclear when the regulations can be in place and how they will be devised. The Government has announced that it is working on the matter, but there are many question marks. Other inquiries affecting the occupational pension segment are also in progress, which may affect the work, particularly the Occupational Pension Taxation Inquiry's review of the rules of the Pension Obligations Vesting Act and the inquiry regarding how the directive on the acquisition and preservation of occupational pension shall be implemented in Swedish law.[23] At the same time, a "trialogue" is in progress in the EU; the European Commission, the Council and the Parliament are to agree on a joint proposal for an updated occupational pension directive, IORP 2. The work on national legislation and on the European directive is of course closely linked because the Swedish legislative work must consider the work taking place in the EU.

FI emphasises the importance of the Government notifying of the focus of forthcoming occupational pension legislation. The question as to whether undertakings that have chosen to fully apply Solvency 2 can be converted is a key question to which the industry needs an answer. In this context, FI wishes to emphasise once more the need to ensure a sufficient conversion period in order to safeguard the rights of policyholders. As already pointed out by FI, it is also important that the legislative work considers the effects on consumer protection potentially brought about by disparities in the regulations for occupational pension undertakings and for life insurance undertakings.

REGULATORY DEVELOPMENTS AT EU LEVEL

The European Commission currently has a major focus on consumer protection matters, not least in the financial segment. In the insurance segment, a great deal of work is in progress that may affect the undertakings, and which Swedish insurance industry should therefore carefully follow.

Recovery and resolution

In light of experience from the last financial crisis, with several countries resorting to the use of public funds to bail out failed banks, the EU established regulations to handle credit institutions and investment firms in crisis – the Bank Recovery and Resolution Directive.[24]

The Bank Recovery and Resolution Directive

TThe Bank Recovery and Resolution Directive aims to enable the government to reconstitute or wind up credit institutions and investment firms without substantial disruptions in crucial civic functions (known as "resolution"), while at the same time letting the owners and creditors of the firm bear the costs of incurred losses. Another purpose is to avoid individual firms sustain-

23 SOU 2015:68 and Dir. 2015:45.

24 Directive 2014/59/EU of the European Parliament and of the Council.

ing difficulties that could force resolution. The directive therefore contains provisions about the resolution procedure, preparations for such a procedure, and preventive supervisory actions. The directive gives the competent authorities partially new powers to prevent and manage crises. For example, they have possibilities, and, in certain cases, obligations to write down the liabilities of the bank in crisis or convert the liabilities into shares in the bank. In Sweden, the National Debt Office is responsible for resolutions of credit institutions and investment firms, partly in cooperation with FI. The Swedish legislation that implements the directive came into effect on 1 February 2016.

In the next few years, the European Insurance and Occupational Pensions Authority EIOPA will commence work on devising regulations for the recovery and resolution of insurance undertakings. Also, the International Association of Insurance Supervisors (IAIS) has taken initial steps to prepare regulations for the recovery and resolution of globally operating groups. In these efforts, the Financial Stability Board (FSB) is also a driving force.

Although the work is only on the starting blocks, FI finds it very important for both supervisory authorities and the insurance industry to engage and commence preparations in advance of future regulatory changes. This applies not least to undertakings that form part of an international group.

Guarantee scheme

Since 1996, a deposit guarantee has been in place whereby the Government, in accordance with certain set rules, guarantees the deposits of customers held with banks, credit market companies and certain investment firms.[25] Under the guarantee, depositors are compensated by the government up to a certain amount if a firm files for bankruptcy or when FI decides that the deposit guarantee shall come into effect. The purpose of the deposit guarantee is to strengthen the protection of public deposits and add to the stability of the financial system. The guarantee is financed by fees from the firms covered by it. There is no equivalent protection, in the form of a guarantee scheme or insurance guarantee, for policyholders in Sweden today. In 1998 an inquiry put forth a proposal for one, but it did not lead to any legislation.[26]

In 2010 the European Commission published a white paper that looked at guarantee schemes in the insurance segment in certain member states.[27] The white paper is intended to form the basis of a proposal for European regulations with minimum requirements on national guarantee schemes. The Commission's initiative has not yet led to any proposal for a directive, but means that the question has become relevant. IAIS has also expressed interest in guarantee schemes; in 2013 it performed an international survey thereof. In a acceding analysis, IAIS states that the design of a guarantee scheme must not lead to increased risk-taking among the insurance undertakings. It is also expressed in the analysis that although a guarantee scheme can be a positive factor in recovery and resolution, it is not a replacement for appropriately devised systems for supervision and the wind-up of undertakings.

25 The guarantee applies to all types of accounts and provides compensation for up to EUR 100,000 per customer and bank.

26 SOU 1998:2 2.

27 White paper On Insurance Guarantee Schemes COM(2010) 370.

EIOPA expects the European Commission to raise the question of a common standard for guarantee schemes in 2016. In this work, it is crucial to obtain national input on how a guarantee scheme should be appropriately devised in order to safeguard consumer protection, while at the same time giving consideration to any specific national characteristics. FI therefore urges the Swedish insurance industry to take the time to engage in this work, together with the European industry organisation Insurance Europe. FI would also find cooperating with the industry on this matter positive.

Glossary

Adverse selection A distorted selection of policyholders for the insurance undertaking that leads to claims expenses being higher than calculated, and which might lead to the undertaking finding it difficult to fulfil its obligations.

Branch Operations in the form of a branch office with independent administration but which is not a separate company. The branch can conduct operations in a country other than the undertaking's home country.

Defined-benefit pension insurance Traditional pension insurance in which the insurance undertaking promises that pension shall be a certain percentage of the pensionable salary which the person has upon retirement.

Defined-contribution pension insurance Traditional pension insurance in which the policyholder is guaranteed a certain minimum return. Ultimate pension is determined by e.g. the size of the premiums contributed and return on them.

Deposit insurance Life insurance of the saving kind in which the policyholder selects how premiums and return are invested. The capital can be invested in, for example, securities or investment funds.

Discount rate The rate used to calculate the present value of a future payment.

EIOPA European Insurance and Occupational Pensions Authority. A union body in the EU since 2011. EIOPA is a part of the European system for financial supervision and is also an independent advisory body to the European Parliament and the Council.

Equity price risk Sensitivity measure of the value of equity holdings or equity-linked holdings that measures how the value changes when the market value of equities changes.

FLAOR Forward looking assessment of own risks. Part of the preparations ahead of Solvency 2 with the purpose of ensuring that the insurance undertakings can cope with the solvency requirements from the date on which the rules come into effect. FLAOR shall be conducted in accordance with the principles that apply for an ORSA.

FSB, Financial Stability Board An international body set up by the G20 countries that monitors and issues recommendations regarding the global financial system.

IAIS International Association of Insurance Supervisors. IAIS is the most important body at global level for cooperation on rules and supervision regarding insurance.

Interest rate risk A measurement of the sensitivity of financial assets and liabilities. Interest rate risk measures how the value of financial assets and liabilities changes when the market rates rise or fall.

Mutual insurance undertaking An insurance undertaking that is owned by its policyholders and in which all surplus is returned to the policyholders. If the undertaking incurs losses, the policyholders' surplus is used to cover them.

Non-mandatory rule A provision that can be eliminated by agreement or be neglected, and which hence does not need to be followed. The opposite is compulsory provisions, i.e. rules that cannot be eliminated by agreement.

Occupational pension insurance Insurance that pertains to pension benefits that are linked to professional activities and which are based on an agreement regarding pension benefits between an employer and an employee, or their respective representatives.

ORSA Own risk and solvency assessment. Part of the risk management system of an insurance undertaking in which the undertaking, based on its risk profile, risk tolerance and business strategy, shall calculate how much capital is needed to conduct operations in both the short and long term. The ORSA shall provide the management of the undertaking with an understanding of the risks in the operations, and shall therefore form an integral part of the business strategy and be taken into consideration in strategic decisions.

QIS Quantitative Impact Study that is to serve as a basis for new rules prepared in the EU.

Recovery plan A plan prepared by a financial firm aimed at identifying measures which the firm, in various scenarios, intends to take in order to preserve or restore its financial position and vitality following a significant deterioration in its financial situation.

Reinsurance Risk distribution method whereby an insurance undertaking insures its own commitments with one or several other insurance undertakings.

Resolution A specific procedure for the efficient reconstitution or wind-up of a failing financial institution, entailing a low risk of the need for government support.

Solvency The ability to honour obligations towards policyholders.

Solvency ratio An insurance undertaking's own funds divided by the undertaking's solvency margin.

Solvency 2 The new solvency rules for insurance undertakings developed in the EU and which came into effect on 1 January 2016.

Stress test Analysis of various scenarios to test resilience to unforeseen and negative events.

Technical provisions The provisions that an insurance undertaking must have to cover future disbursements to policyholders and costs for insurance administration.

Traditional insurance Life insurance in which the insurance undertaking guarantees a certain minimum return on savings, usually through an agreement on a guaranteed insurance amount level.

Unit-linked insurance Life insurance in which the policyholder selects the funds in which premiums and return shall be invested.

White paper Proposal from the European Commission for initiatives in a certain area. If a white paper is received positively in the Council it can result in a program of actions in the area in question.

Finansinspektionen
Box 7821, 103 97 Stockholm
Street address Brunnsgatan 3
Telephone +46 8 408 980 00
Fax + 46 8 24 13 35
finansinspektionen@fi.se

www.fi.se