



Position Paper

Why proportionality matters and how to make it work!

Executive Summary

- While **proportionality is a key principle in Solvency II**, insurance companies are unsatisfied with its **application**.
- We need a **shared understanding of the advantages of proportionality** to drive the reform process forward.
- Proportionality can contribute to important European projects, such as the **Green New Deal**, the **European capital market union** or the **economic recovery**.
- Three guiding principles can ensure the effectiveness of reforms: a **risk-based approach to proportionality, simplicity and transparency**.
- To make proportionality work, we present two **concrete, and feasible policy proposals: the automatization via the proportionality toolbox and improving supervisory dialogue**.
- Last but not least, an **efficient and proportionate regulation** is key for insurance companies to **prosper economically** and to create value for customers and further societal stakeholders.



Götz Treber
Head of
Centre of Competence
Corporate Management
and Regulation
030 2020-5470
g.treber@gdv.de

High aspiration & limited progress

The **basic idea of proportionality** in Solvency II is to regulate insurance companies according to their “**nature, scale and complexity of the risks inherent**”. Hence, in theory, an insurance company with a low risk profile does not require the same regulation as an insurance company with a high risk profile. However, in practice, companies with a low risk profile only have very limited possibilities to implement the framework in a simplified way. For example, EIOPA recently conducted an extensive peer review on supervisory practice with focus on Regular Supervisory Reports (RSR). This peer review shows that only “around one-third of the NCAs apply, to a certain extent, the principle of proportionality [...] by performing risk-based supervision and setting the frequency of submission of the full and summary RSRs.”¹ Despite controversial discussions, regulators, supervisors, and the insurance industry show high willingness to make progress. Accordingly, making proportionality work is not primarily a question of will, but rather more of clear and convincing concepts.

In this positions paper, we address the challenge to **make proportionality work** in three steps. First, we contribute to a better understanding of the **advantages of proportionality**. Second, we propose **three guiding principles that promote effective reforms**. Third, we put forward **two concrete policy proposals**: The **automatization via the proportionality toolbox** and **improving the supervisory dialogue**.

We need a shared understanding of the advantages of proportionality

There are widespread reservations about proportionality. For example, there have been worries that a non-restrictive application of proportionality could expose policy holders to additional risks. In another way, there have been concerns that proportionality is exclusively for small competitors and bigger companies cannot benefit from it. Indeed, critics have a point, as they mainly refer to scale-based approaches to proportionality. In our opinion, reform approaches have had limited success because the involved actors still have no shared understanding of the **manifold advantages of risk-based proportionality**.

¹ EIOPA (2020): Findings of the Regular Supervisory Report (RSR) Peer Review Published. Online available at: https://www.eiopa.europa.eu/content/findings-regular-supervisory-report-rsr-peer-review-published_en

Proportionality as driver for European projects

- 1 Green New Deal
- 2 Capital Market Union
- 3 Economic Recovery
- 4 Sustainable Finance

First of all, proportionality can **reduce the compliance costs**, which **unfolds financial and human resources** for insurance companies with a low risk profile. In the next step, financial resources can increase investments in forward-looking projects such as technological or product innovations that will increase the **competitiveness** of the European insurance sector. In a similar vein, unfolded human resources can **strengthen the risk management** that helps to identify future risks and develop suitable strategic responses. Policy holders can also benefit because proportionality can provide incentives for insurance companies to **take risks in a prudent and responsible way**. In addition, unfolding resources and increasing investments will foster the future solvency of insurance companies and consequently the security of policy holders. Also, if proportionality provides a reliable process to identify low-risks undertakings, NSAs will be able to **increase the security of policy holders** because they can better focus on undertakings yielding higher risks.

If well-implemented proportionality unfolds resources, insurance companies can stem new long-term investments, which cause benevolent effects for broader parts of the society. For example, making proportionality work can increase urgently needed investments in **digital and green innovations** flanking the **Green New Deal**. Also, proportionality can provide important impulses for the economic recovery in times of the Covid-19 pandemic without burdening state budgets. In consequence, proportionality will help the **insurance sector** to better contribute to **global challenges** such as **climate change or the digital transformation**.

We need guiding principles for effective reforms

In general, proportionality must rely on a **risk-based approach** to serve the protection of policy holders. The size of companies does not necessarily correlate with the risk profile of an insurance company. As a case in point,

there are also bigger companies with a low risk profile and smaller companies with a high risk profile. However, size could be a secondary criterion when determining the scope of proportional treatment to foster the stability of financial markets. Hence, in general, all companies – regardless of size – should be able to receive a proportional treatment, if a prior risk assessment confirms a low risk profile. The **application of proportionality must be simple and clear** to serve the needs of policy holders, supervisory and insurance companies. In many cases more complex regulation does not foster the security of policy holders as it complicates the challenge of NSAs to focus on the important tasks and creates double structures that unnecessarily bind resources. The initiated paradigm shift from rule-based to principle-based regulation under Solvency II is an ongoing challenge for NSAs as well as insurance companies because they have to **improve their accountability** and become **more transparent about their decision making**. In particular, NSAs can benefit from improving their accountability to foster trustworthy relationships towards companies and promote the provision of useful feedback.

We need to automatize the application via the proportionality toolbox

As regards proportionality the **legal framework is neither clear nor systematic**. First, the risk-based criteria to assess the nature, scale and complexity of risks of an individual insurance company are not defined under Solvency II. Second, proportionate simplifications and waivers are scattered over various different pieces

of legislation. Third, proportionate waivers are not possible, if they are not explicitly mentioned in the regulation. Moreover, if proportionate measures are granted, the application remains usually temporally limited. For example, the current period of one year for the exemption from quarterly reporting is very short leading to **high uncertainty about future exemptions**. This is a severe concern, because adapting to new requirements is particularly burdensome. In sum, insurance companies often decide to fulfil high requirements instead of trying to apply proportionality.

Against this backdrop, the GDV strongly supports implementing the proportionality toolbox proposed by Insurance Europe. The **proportionality toolbox is a mechanism that automatically links the risk assessment to proportionate measures**, and thus decreases transaction costs for supervisors and companies alike. Additionally, the toolbox improves clarity and legal certainty which concrete proportionality measures can be applied. Additional and specific targeted proportionate solutions should be still possible as a result of supervisory dialogue.

First, **assessing the individual risk profile and solvency situation** is the initial step of any proportionate treatment. To do so, NSAs need transparent criteria that trigger the application of the toolbox measures. As a starting point, the GDV recommends the following **risk-based criteria** for a simple and accurate assessment of individual risk profiles: **solvency ratio, volatility of the SCR, ratio of eligible own funds to balance sheet total and systemic relevance**. Further basic criteria could be the weight of risky investments on total company's investments, the weight of risky products and significant changes of risk profile. When the defined criteria are met, the company should automatically be entitled to apply the proportionate measures without an additional approval of the NSA. Of course, supervisors should be able to interdict the automatic application, but should need to justify their decision towards the affected company.

Three basic rules for a consistent and fair application of proportionality

- 1 The better the risk and the solvency situation, the greater should be the individual freedom of application design.
- 2 Requirements should be only obligatory, if they correspond to the risk and solvency situation of an undertaking.
- 3 Proportional measures should go as far as the non-application of individual requirements (proportional "if").

Proportionality Toolbox

Simple risk-assessment

- Solvency ratio
- Volatility of the SCR
- Ratio of eligible own funds to balance sheet total
- Systemic relevance

automatic
→
application

List of proportionate measures

- **Pillar I:** simplified calculations
- **Pillar II:** simplified procedures
- **Pillar III:** lower frequency and extend of reporting

Second, the proportionality toolbox provides a **consolidated, non-exhaustive list with proportionate measures** that increases transparency and practicability. This list should cover all three pillars of Solvency II and include simplified procedures (e. g. simplified calculations in Pillar I, simplified ORSA), the frequency and timing of requirements (e. g. ORSA Report, internal review of the system of governance), and the extent of requirements (e. g. no appropriateness assessment of the standard formula in ORSA). **As the toolbox is a risk-based, clear and transparent mechanism, it will reduce uncertainty and transaction costs for companies and supervisors alike.** Also, it provides useful benchmarks for supervisory dialogue.

Important to note, **the toolbox is no substitute for the necessary increase of the thresholds** for the application of Solvency II. Indeed, the requirements of Solvency II overstrain very small companies. Consequently, very small companies that only operate nationally should fall under national regulation to promote competition and secure market heterogeneity.

We need to improve the supervisory dialogue

Due to the paradigm shift from rule-based to principle-based regulation, **constructive supervisory dialogue is key to find individual solutions** for proportionate measures. However, companies and supervisors occasionally report on difficulties in dialogues because they both expect from the other to take the initiative and make concrete proposals how to apply proportionality properly. Against this backdrop, the GDV encourages NSAs to bundle knowledge of different departments and establish clear and harmonized procedures. As a case in point, NSAs can **foster quality management and create a public good-practice-library to promote the consistent and fair application of proportionality.**

To make proportionality work is also a **matter of cultural change** that requires time and constant learning efforts. On the one hand, supervisors can benefit, if they better explain their decision making regarding proportionality. On the other, companies can benefit, if they become more proactive and justify proportionate measures with clear references to their risk profile. Against this backdrop, the GDV propose to **conduct regular evaluations** of the application of proportionality to identify areas of improvement and initiate institutional learning. More concretely, the committee on proportionality, recently created by the EIOPA, should publish a report about the application of proportionality on a yearly base. Overall, **improving the supervisory dialogue will foster the legitimacy and quality of NSAs' decision making.**

Outlook

Although, there is still a long way to go, the GDV is deeply convinced that proportionality yields huge potentials for policy holders, supervisory and insurance companies. Furthermore, proportionality can contribute to important **European projects** such as the Green New Deal and the Capital Market Union. Reforms will be successful, if regulators take a **risk-based approach, keep regulation simple and clear**, and foster the **mutual accountability** of supervisors and companies. While our policy proposals shall stimulate the debate, we also think they are feasible and have concrete advantages for all involved actors. Last but not least, an **efficient and proportionate regulation** is the basic condition for insurance companies to **prosper economically** and to **create value for customers** and further societal stakeholders.

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Gesamtverband der Deutschen Versicherungswirtschaft e.V.
Wilhelmstraße 43/43 G, 10117 Berlin
Postfach 08 02 64, 10002 Berlin
Phone +49 30 2020-5000, Fax +49 30 2020-6000
www.gdv.de, berlin@gdv.de



Person responsible

Götz Treber
Member of the extended Management Board
Phone 030 2020-5470
E-Mail: g.treber@gdv.de

Publication assistant

Heike Strauß

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Authors

Margarita Winter
Dr. Jan Winkin

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