THE IMPACT OF SOLVENCY II RULES ON MUTUAL BENEFIT SOCIETIES IN THE SECTOR OF SOCIAL PROTECTION

I. Objectives of this paper

The objective of the paper is to provide the European institutions with information and knowledge about mutuals to better assess their current situation, when it comes to the impact of Solvency II rules on them. The paper allows for a reasoned reflection for possible future policy development. It is intended to raise awareness of the European policy makers of mutuals and their specificities.

AIM demands the following changes to ensure the principles of proportionality:

- A clear definition of the principle of proportionality in the directive
- Regulatory capital requirements should take nature, scale and complexity of risks of the enterprise into account.
- Mass Lapse of 40% is too high for the health sector.
- The capital requirement for longevity risk under Solvency II should be simplified.
- Keep the possibility to trigger management actions in the Best Estimate calculation.
- The parameter cost of capital should be more adaptive to actuality.
- Reporting
- Keeping future profits in Pillar 1 Capital.

II. Background:

Mutuals are very much concerned by Solvency II rules. Larger and smaller mutual-type organisations exist numerously in many Members States. They differ from insurance companies, which are often stock companies. Contrary to insurers, mutual-type organizations don't have shareholders. Profits in mutuals are used for the benefit of the members, as the members are collectively the owners of the mutual.

What are the main characteristics of mutuals?

"In the EU, there is a large diversity of legal forms for mutuals, but all have the above key characteristics. **Mutuals are private legal entities, governed by private law**. Mutuals are a grouping of persons (natural persons or legal entities), rather than a pooling of funds. Members own the mutual by providing funds which can mean that these "own funds" remain the property of its current members and are therefore truly collective and indivisible. **The governance of mutuals is democratic**. Voting rights are allocated to the members instead of to the amount of funds contributed. In general, each member has one vote to elect the governance bodies. This principle can be implemented via the use of delegates or interest groups. **The principle of solidarity is important among members**, often enshrined in law. It means that benefits delivered do not depend on contributions. The application for admission of a natural person who meets the criteria for membership cannot be rejected. This principle allows free entry and exit of everyone who fulfils the conditions as agreed upon in the statutes of the organisation. **Profits are used for the benefit of the members, as the members are the owners of the mutual.** Such benefits can be in the form of investments to improve services for the members or the development of the business, to increase "own funds", or to give discounts or rebates on premiums. They can also be used for the benefit of the society/community at large. **Thus, the primary purpose of a mutual is to satisfy the common needs of the members. discounts or rebates on premiums**. They can also be used for the benefit of the society/community at large. Thus, the primary purpose of a mutual is to satisfy the common needs of the members" (Panteia 2012 Commission Study on the current situation and prospects of mutuals in Europe')

Larger mutual-type organisations that are competing with joint-stock competitors often have to grow to achieve appropriate risk diversification and economies of scale. They therefore, need access to external capital while maintaining their mutuality. However, allowing external capital (in any form) has consequences with regard to the mutualistic values. Not allowing external capital can serve as a protection mechanism to maintain mutuality. This has consequences on the capital, which makes a difference, when competing with stock insurance companies. Therefore, the specificities of mutuals should be taken into account, when it comes to Solvency II rules.

III. Challenges for AIM members, when it comes to Solvency II: Proportionality is key

During the last years, the EU Solvency regime has developed into a rather complex framework and is currently under revision. Under the Solvency II regime and as a consequence of the financial crisis, requirements for insurers, have increased significantly to enable them to withstand unexpected losses under stress circumstances. However, the complex regulation also causes challenges to several parties. Mutuals may be overwhelmed by the regulatory costs. Regulatory costs are especially detrimental to small mutuals. Mutuals are in a competitive disadvantage compared to stock insurers, which can raise funds on the capital market. Mutuals do not allow any form of external capital. Proportionality is therefore key to them in order to be able to come up to the requirements of the regulations.

Regulatory regimes should adapt to the types of insurer or their business models in order to give all market players the same opportunities. It creates diversity in the insurance market and as a consequence takes into account the specificities of the sector of social protection. The proportionality principle applied to the Solvency II Directive could help small mutuals to have the same chances as big insurance companies. Proportionality means subjecting smaller or less complex mutuals to simplified requirements to achieve the protection of policyholders´ interests and to maintain financial stability. At the same time, it should give fewer burdens to smaller mutuals.[1] National supervisory authorities often have legal obstacles to apply the principle. Thus, proportionality is not often applied in practice.[2]

[1] Jeffery Yong (Jeffery.Yong@bis.org) and Gunilla Löfvendahl Bank for International Settlements (BIS).
[2] Insurance Europe/AMICE – Solvency II 2020 review, Making proportionality work in practice.

AIM has identified the following change needed to ensure the principles of proportionality:

- A clear definition of the principle of proportionality in the directive

A clear definition of the principle of proportionality is missing. This has led to different interpretations. Proportionality means that regulatory requirements for insurers should achieve prudential objectives such as the protection of member's interests and maintain financial stability. It should not go beyond what is necessary.

- Regulatory capital requirements should take nature, scale and complexity of risks of the enterprise into account

To determine regulatory capital requirements the regulator should reflect the nature, scale and complexity of risks of the particular insurer. Regulatory capital requirements can take two forms – a standardised approach whereby all insurers calculate their regulatory capital requirements based on a formula prescribed by the insurance regulator; or an internal model approach whereby an insurer uses its own internal model, subject to regulatory approval, to calculate its regulatory capital requirements. Regulators can prescribe simplified regulatory capital requirements in the form of a partial or full exemption, simplification of the standard formula, an alternative calculation method and insurer-specific parameters.[3] In Belgium, mutuals would need a sectorial USP (undertaking specific parameter) supported by Belgian legislation.

- Mass Lapse of 40% is too high for the health sector.

Regarding the health insurance sector, the mass lapse of 40% is too high. The mass lapse scenario under Solvency II is calibrated as an instantaneous loss of 40% of the in-force business. In Belgium, for example, Belgian mutual insurance "clients" are "members", and not only for insurance but always for the mutuality too (insurance membership is linked to mutuality membership), so a risk of massive lapse is not very likely, as showed by the experience. Other factors that *discourage lapse* are: waiting times before coverage, insurance premium(s) *penalties* depending on age (when starting the policy), non-covered (or worse covered) pre-existing diseases, etc.

- The capital requirement for longevity risk under Solvency II should be simplified.

The standard approach is for an insurer to calculate the change in the value of its capital resources assuming an instantaneous permanent decrease of 20% in the mortality rates used to calculate its technical provisions. In practice, this requires the mutual insurer to revalue its technical provisions using this set of "stressed" mortality rates. A simpler approach avoids a complete revaluation and instead involves a straightforward formula defined as a function of the 20% factor, the best estimate, the expected average mortality rate and the modified duration in years of payment to beneficiaries. The simplified approach could be allowed when:

- o the simplification is proportionate to the nature, scale and complexity of the risks of the insurer; and
- o the standard calculation is an undue burden for the insurer.

[3] Jeffery Yong (Jeffery.Yong@bis.org) and Gunilla Löfvendahl Bank for International Settlements (BIS).

- **Keep the possibility to trigger management actions in the Best Estimate calculation.**

In some countries individual health insurance products do have the obligation to respect all the terms of the originally signed policy during the entire lifetime of the members (clients). The insurer does not have the possibility to cancel or to change the policy at its own initiative. This lifelong engagement implies that best estimate calculations use > 100 years of projections.

As an exception to this rule these insurers have however the opportunity to adapt the pricing and/or covers when requested, in case the viability of the product or of the company are in real danger. Of course, these product remediations have to be an exception and are strictly controlled by the supervisor.

This practice is modelled through the management actions.

- **The parameter cost of capital should be more adaptive to actuality.**

In reality the cost of capital is dependent on time-linked facts, parameters, or input (e.g.; interest rate curve, etc.). However the cost of capital to be used in calculations is a very rigid equal one. It is not allowed to adapt this cost of capital to an actualized figure. Currently, it is thus too high because actual interest rates which have an impact on this cost of capital are – since a long time - extremely low. This too high cost of capital, combined with an extremely high duration (see else in the position paper) still amplifies the already very high risk margins compared to the SCR. This makes them to amount to 100% of SCR or more. [4]

- **Reporting**

The reporting requirements should be adjusted to the parties based on their nature, scale and complexity. The immense volume of "reporting" appears ineffective in many cases as it represents a high cost for the clients without preventing a bankruptcy and makes review especially difficult. In the social protection and health care insurance sectors quantitative reporting should not be more than **twice a year** (instead of 4 times a year).[5] 4 times a year is time and resource consuming and without real added value in the health care and social protection sectors. We also believe that further simplification is needed on reporting such as the report SFCR. Furthermore, AIM would also like to highlight that the reporting deadlines are very challenging in the Solvency II framework. EIOPA's proposals on reporting as part of Solvency II review will create more complexity with very low added value. Indeed, we believe that most of our members would not actually benefit from simplifications proposed by EIOPA in practice, and additional information requests would require significant effort for undertakings in terms of human resources and changes in the IT systems. Therefore, AIM advocates that deadlines for both annual and – if kept- kquarterly reporting including financial stability reporting should be extended. This also will help undertakings to improve the quality of the data submitted.

[4] See a recent study from the University of Amsterdam on this subject, backing the questions and statements: https://www.uva.nl/binaries/content/assets/subsites/amsterdam-centre-for-insurance-studies/2017/09/presentaties-15-sept/091417-rm-a.pdf

[5] E.g. the Netherlands:

- allow less complex insurers to submit supervisory reports once every three years instead of annually;

- exempt certain smaller insurers from regional supervisory requirements altogether and subjecting them to less extensive quantitative and qualitative reporting at the national level (the Netherlands).

- **Keeping future profits in Pillar 1 Capital.**

The actual system of assigning the future profits in the Pillar 1 Capital category for the Solvency calculations should be maintained, as they seem no good reasons to change this to a lower quality of capital.

AIM and its members are ready to cooperate with EIOPA and the European Commission to explain the specificities of mutual insurers and their needs with regard to a reviewed Solvency II framework.

The International Association of Mutual Benefit Societies (AIM) is an international umbrella organisation of federations of health mutuals and other not-for-profit healthcare payers. It has 57 members from 30 countries in Europe, Latin America and Africa and the Middle East. 33 of its members, from 20 countries, are based in the European Union. AIM members provide compulsory and/or supplementary health coverage to around 240 million people around the world, including close to 200 million people in Europe, on a not-for-profit basis. Some AIM members also manage health and social services. Collectively, they have a turnover of almost €300 billion.
AIM members are either mutual or health insurance fund.
They are: private or public legal entities; solidarity based; not-for-profit oriented organisations: surpluses are used to benefit the members; democratically-elected members play a role in the governance of the organisation.
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