SUMMARY OF THE ANNUAL REPORT 2003 OF THE PENSIONS AND INSURANCE SUPERVISORY AUTHORITY OF THE NETHERLANDS (PENSIOEN- & VERZEKERINGSKAMER)

Review

Insurance: Solvency has fallen along with share prices

Since 1999, the solvency percentage (the percentage between actual solvency and the solvency laid down by law) has fallen fairly sharply, primarily due to the fall in the value of equity investments. In 1999, most insurers had such large equity and reserves that they have been able to absorb the subsequent falls in share prices, which have been extreme in historical terms, without jeopardising their financial positions. The fact that Dutch insurers, unlike those in a number of other countries, had relatively few equity investments in relation to their underwriting reserves for guaranteed benefits, played an important role in this. To the extent that underwriting reserves were composed of equity investments, they related principally to insurance policies, such as unit-linked insurance policies, under which policyholders carry the investment risk and the sharp fall in share prices naturally meant substantial losses for the latter.

Financial position: Source of profit under considerable pressure

The share price falls forced insurers to tailor their investment policies to their financial positions. This is because, in a number of cases there was insufficient, or little, buffer remaining to absorb further falls in share prices. For some insurers this made it necessary to raise further equity. Others reduced their holdings of equity investments sharply, or hedged their positions against further falls in value by taking positions in derivatives, frequently at the expense of the return or the expected return on the investments.

In the second half of the nineties, the increase in share values was the main reason for the rise in capital and reserves, but insurers can no longer count on this source in the short term. However, the other means of increasing capital and reserves, retained profit (after profit sharing and dividends), also came under pressure as a result of low interest rates. The margin between the investment return on fixed-income securities and the guaranteed return accruing to policyholders through underwriting reserves has been the principal source of profits for insurers for decades. This margin is now under severe pressure, as a result of which annual profits have also declined sharply.

The above points to difficult times ahead, particularly for life insurers, because in the life insurance sector, portfolio growth through new policies has declined sharply. Partly as a result of changes in the tax rules, insurers face the risk that income in the form of additional premiums and single premiums will be insufficient in relation to the high costs of writing new business.

Market trends

A further important factor is the currency risk resulting from the sharp fall in the dollar. Converted into euros, dollar-denominated investments have declined in value and premium income where the exchange rate is linked to the dollar also gives a different picture if converted into euros. Both trends may have a negative effect on solvency if this currency risk is not hedged. Interest rates are at very low levels worldwide and, of course, this also has a negative impact on insurers in the Netherlands. A number of neighbouring countries, including Germany and Switzerland, where the role of the actuarial rate is different to that in the Netherlands, cut this rate in 2003. The PVK is of the view that the issue of the actuarial rate is in need of further examination in the Netherlands and the Financial Assessment Framework (*Financieel Toetsingskader*) will focus specifically on this aspect.

The level of new life business was also lower than expected in 2003 and reinsurance premiums have remained high since 11 September 2001. These two factors are further depressing the profitability of insurers. In the year under review, insurers tightened up their underwriting policies and reduced costs by means of cost-cutting programmes. There is now the risk of a shortage of insurance capacity for a number of risks, including in the small and medium-sized business segment.

Insurers are now confronted with a large number of very diverse market trends and the PVK is witnessing the development of appropriate responses to these risks by the insurance sector.

New accounting standards and other developments

During the past year, the forthcoming adoption of the new international accounting standards (IAS/IFRS) has made it necessary for insurers to devote time and human resources to prepare for these changes. Insurers that are listed in the United States have also had to allocate considerable resources in order to comply with the requirements under the Sarbanes-Oxley Act. Partly as a result of the debate about the activities of the Tabaksblat Committee, a further key issue for insurers has been that of corporate governance.

Losses resulting from terrorism

During the year under review, the Financial Transactions Emergency Powers Act (*Noodwet Financieel Verkeer*) was amended. This amendment formed the final element of plans in the Netherlands to cover losses resulting from terrorism. Following the attacks of 11 September 2001, the Dutch Ministry of Finance, the Dutch Association of Insurers (*Verbond van Verzekeraars*) and the PVK concluded that the risk of terrorism could no longer be carried on an unlimited basis by the Dutch insurance market. Through Nederlandse Herverzekeringsmaatschappij voor Terrorismeschaden N.V. (NHT), insurers, reinsurers and the government are working to ensure that there is sufficient cover for losses suffered by Dutch society resulting from terrorism, without jeopardising the solvency of insurers and the stability of the insurance system. Insurers have included terrorism exclusion clauses in their current non-life insurance policies on a wide scale.

Pensions: Certainty dominates the debate

The debate about the Dutch pensions system is currently dominated by the issue of certainty. In other words, to what extent can pension scheme members count on what they have been promised is also actually being paid? And, in more technical terms, what is the maximum acceptable risk of a pension fund having insufficient asset cover, since in such circumstances, if those who contribute to the pension fund, i.e. the employer and the members, are not able or willing to fund the deficit (usually 'automatic' recovery is out of the question), then the promised benefit will be jeopardised.

Cover percentage from a historical perspective

First of all, there is no such thing as 'the' cover percentage. In practice, the 4% standard has always been used to date, in other words, the percentage between assets valued at market value and the nominal value of the pension liabilities discounted at an actuarial rate of 4%. This percentage was fairly stable between 1986 and 1995, thereafter the average cover percentage as defined above rose to more than 150% in 1999 and then fell back to just under 110% within three years. It should be noted that there are still wide variations in this percentage for the various funds and the percentages referred to below are merely averages. Many funds have better percentages, but there are also others with much worse percentages.

The cover percentage based upon market interest rates paints a more realistic picture than the percentage based upon a fixed discount rate, however. Using this approach, the market value of investments is compared with the nominal value of the liabilities whose present value is calculated using the long-term interest rate. The difference between the two cover percentages is the implied scope for index linking that is available to a pension fund. These reserves have been declining for some time, since the beginning of the nineties. This is cause for concern, because these hidden reserves need to be set against deferred liabilities in the form of conditional protected-value schemes. These hidden liabilities become clear if the pension benefits are discounted at the real rate of interest, i.e. the nominal interest rate less the inflation rate, and then the cover percentage declines, even to significantly less than 100%. Conservative calculations indicate that at certain times the cover percentage has been 70 to 75%, which means that the funds no longer had sufficient funds to pay an inflation-protected pension. Certainty about conditional pension index-linking has long been declining, but has been insufficiently recognised.

End of 2002: 197 funds had insufficient asset cover

At the beginning of 2003, 81 pension funds had insufficient financial resources to cover pension liabilities for previous years of service and their cover percentages were therefore less than 100%, assuming that assets were valued at market value and the provision for pension liabilities was calculated using a fixed actuarial rate of 4%.

Of the funds with a higher cover percentage, 116 had insufficient additional buffer capital to cover the necessary provision for general risks. Depending on the particular situation of the individual fund, this provision should be 5% of pension liabilities. In total, therefore, there were 197 funds that did not meet the standard cover percentage and the total deficit of asset cover for these funds was slightly more than EUR 3 billion, purely in terms of nominal liabilities. Where relevant, the funds submitted proposals to restore the level of cover, as referred to in the PVK's policy rule dated 30 September 2002.

In addition, there were also 181 funds that although they did not have a deficit of asset cover, did not have sufficient funds to cover the risks to which they were exposed. Together with the 197 funds referred to above, they submitted plans to rectify the reserve deficit, totalling EUR 37.5 billion, to the PVK.

2003: Putting recovery into practice

The fall in share prices was clearly not a one-off event that was to be followed by a rapid recovery to the old values. The key now is not simply to examine a given pension scheme's recovery plan mechanically, but to analyse the pensions problem as a whole. The funds and the related social partners take this issue very seriously. In the pensions sector there is renewed emphasis on the *price* of the Dutch pension product and a simple calculation will soon demonstrate why. We will base the calculation on a man aged forty-five, earning an average salary, who expects to retire on his sixty-fifth birthday. His pension will then have accrued over a period of forty years to a level of 70% under a final-salary scheme and including the statutory state pension offset. The pension fund's investment policy is to invest 50% in property and shares. These assumptions can be used to carry out sensitivity analyses.

These will show, for example, that, depending upon age and salary, an average pension that commences three years earlier in terms of pension accrual will be 40 to 100% more expensive than the same pension starting at the age of 65. The costs of index-linking the pension annually and unconditionally by 2% will be 20 to 60% more than the costs of a nominal (non-inflation-protected) pension starting at the age of 65. Finally, a degree of certainty of 99.5% is 5 to 10% more expensive than a degree of certainty of 97.5%.

It is always a good idea to put things into perspective. In this example, the option of retiring early, which until recently was open to a broad spectrum of the workforce, is many times more expensive than funding the certainty of nominal or even unconditional index-linking of benefits by a modest percentage.

Improvement in the average cover percentage

There is evidence of progress and in 2002 many of the weaker funds had already taken measures. For example, twelve funds that were at risk of having a cover percentage of between 80 and 90% at the end of 2002 took measures so that in the end 'only' three funds remained in the category between 85 and 90%. A further positive factor is that not one of the largest 25 pension funds had a deficit of asset cover and twelve did not have a reserve deficit either.

As explained above, the average cover percentage at the end of 2003 was better than at the end of 2002. The largest improvement was seen among the weaker funded funds, which took additional measures to restore a healthy position within a reasonable period. According to the recovery plans that have been submitted, of the funds that had a deficit of asset cover at the end of 2002, at least 75% had made good the deficit by the end of 2003.

Level of certainty and length of the recovery period

At a time when the number of pensioners is increasing relative to the size of the working population, pay-as-you-go or past-service funding is placing an ever increasing burden on the payroll. This can be illustrated by showing the costs of funding index-linking for pensioners and deferred members from contributions. This can be estimated by taking the ratio between accrued pension benefits and the payroll as a guide. In 1990, calculated in this way, each 1% index-linking costed circa 2.6% of the payroll. In 2030, each 1% index-linking is expected to cost circa 4.5% of the payroll, based upon the existing number of final-salary schemes in relation to average-earnings schemes. Even if the only schemes still in existence in 2030 are average-earnings schemes, each 1% index-linking will cost 3.6% of the payroll. As a result, a normal 2% index-linking will require additional pension contributions by active members costing more than 7.2% of the payroll over a period of well over 25 years. Based upon this demographic trend, the expectation is that future working generations will not be willing to accept this funding burden indefinitely.

Supervisory activities

The aim of the PVK is to supervise the sector effectively and efficiently. The PVK's supervisory activities are risk-based and in principle aimed at measuring, testing, adjusting and, where necessary, intervening to prevent more serious problems. If the failure of a pension fund cannot or should not be avoided, the PVK tries to ensure that the interests of the beneficiaries are protected as far as possible.

MARS: Risk-based supervision

In March 2003, the PVK structured its supervisory activities based upon the methodology of risk-based supervision, which the PVK has called MARS (Method of Analysing RiskS). MARS was introduced following a period of intensive preparation and national and international consultation with other supervisory authorities and representatives of the supervised sectors. Nine risk areas were identified within the framework of risk-based supervision: environmental and strategic, operational, information technology, integrity, legal, actuarial/underwriting, matching, market and credit risks. The sensitivity of a given institution in each risk area (inherent risk) is analysed and then the institution's control of the inherent risk is assessed. The level of the residual net risk (inherent risk minus control measures results in net risk) is an important factor in determining the use of supervisory capacity. The results of the analyses of the risks and the control measures are then recorded in an electronic expert system. This structured and standardised recording has played an important role in making the PVK's supervisory activities more clearly defined and transparent, while the introduction of the risk-based supervisory method has made a substantial contribution to increasing the robustness, quality and proactivity of supervision by the PVK.

The PVK's supervisory strategy

At the end of 2003, the PVK formulated and published its mission and supervisory strategy paper. The introduction to this paper (see also www.pvk.nl) reads as follows:

"Insurance is an economic activity that is far from being without obligation and it is, in fact, one of the most onerous. To insure means to make certain or secure, guarantee or ensure. The sector itself defines its activities as the assumption of risk in return for remuneration. An insured person must be able to rely on the fact that the risk has really been transferred, so that if it occurs, cover is provided. This also applies to a pension entitlement. A pension beneficiary will want to be assured that he or she will receive the agreed benefits if he or she lives until his or her retirement date. In other words, insurers and pension funds have far-reaching commitments, which not infrequently involve large and fairly fundamental interests, such as income protection. Supervision of these matters is the role that has been delegated to the Pensions and Insurance Supervisory Authority of the Netherlands (*Pensioen- & Verzekeringskamer* / PVK). This paper analyses the mission of the PVK within this framework and also its supervisory strategy.

Essential features of insurance and pensions are that there is virtually always a particular time period, which is often also long, between the conclusion of the contract, or the commitment to pay the benefit, and its fulfilment, and that the fulfilment is conditional on the occurrence of a particular risk. In the case of insurance, this risk aspect is usually an essential part of the contract and it is also a factor in the case of pensions: the 'risk' that the pension beneficiary is actually living on the retirement date and continues to do so for a further period after this date. Both aspects, the term of the risk and the risk factor, have a major impact on the PVK's supervisory role.

The mission formulated by the PVK and DNB (*De Nederlandsche Bank*) as a prelude to their merger is to ensure the stability of the financial system and the institutions that form part of it.

Good supervision is not an objective in itself, but it contributes to confidence and stability. We are talking about the confidence of society as a whole; the confidence of the public who need to be able to rely on the obligations towards them being complied with and on the fulfilment of the commitments made to them; the confidence of institutions in the fact that the supervisory authority operates in a clearly defined and predictable manner and according to transparent criteria, and that it also applies these criteria consistently. The supervision has a statutory basis and meets the requirements laid down by supervisory authorities in internationally accepted principles."

Supervision of integrity

Confidence is a prerequisite for a healthy financial sector and therefore the safeguarding of the integrity of this sector constitutes an important element of the role of supervisory authorities. In 2003, the PVK's activities in relation to the supervision of integrity included the handling of fraud cases in institutions, action against insurers that were operating without a licence (enforcement) and the testing of policy makers and those who help to make policy. Since the integrity of an institution's employees forms an essential element of the integrity of the institution concerned and of the sector as a whole, the integrity of policy makers and those who help to make policy must be tested. The PVK's testing forms part of the appointment procedure and a small number of criminal acts will lead *a priori* to a negative opinion of an individual's integrity by the PVK.

In 2003, the PVK received a total of 1,488 applications for policy makers and those who help to make policy to be tested. There were no cases of a negative decision, but a number of candidates withdrew before the testing procedure had been completed.

In four cases, action against unlicensed insurers led to a transfer of the portfolio in question to a licensed insurance company and to the termination of unlawful activities. In one case the PVK exercised its statutory power to petition for the winding up of the company concerned.

Supervision of the Internet jointly with DNB and the AFM (*Autoriteit Financiële Markten* / Netherlands Authority for the Financial Markets) has become a permanent aspect of enforcement policy. The PVK has been examining compliance by life insurers with the Disclosure of Unusual (Financial Services) Transactions Act (*Wet melding ongebruikelijke transacties*) and the Financial Services Identification Act (*Wet identificatie bij financiële dienstverlening*). The key question is what measures have insurers taken to avoid becoming culpably involved in money laundering? The results of this survey will be published in 2004.

The Financial Action Task Force on Money Laundering, of which the Netherlands is a member, regularly issues warnings about transactions with countries where there is a high risk of money laundering. In 2003, the PVK liaised with supervised institutions about this on a number of occasions.

The terrorist attacks in the United States were a warning for companies and financial institutions worldwide that they needed to be on their guard about conducting business or entering into transactions with the Afghan Taliban and other organisations that are suspected of terrorist links. In 2003, five circulars were issued about legislation on sanctions, relating primarily to Al Qaeda and the Taliban, but EU regulations concerning Burma/Myanmar, Angola and Somalia were also covered in the relevant circulars.

Periodic consultation

In the year under review, the PVK conducted periodic consultation with 368 insurers and 179 pension funds. During these meetings with the management or directors of the institutions, policy matters were discussed, including the effects of stock market falls in 2002 and 2003 on the institutions' financial positions and solvency, the governance structure, risk analysis and control by institutions, administrative arrears, and financial relationships with and within the groups of which the institutions were members.

Supervision of conglomerates by DNB/PVK

Cooperation between the PVK and DNB further intensified in 2003. This cooperation is based upon the Protocol governing the supervision of credit institutions and insurers that are members of conglomerates ('*Protocol inzake het toezicht op kredietinstellingen en verzekeraars van conglomeraten*'). This protocol provides for frequent consultation between the PVK and DNB as supervisory authorities, covering developments relating to the holding companies of conglomerates and the associated credit institutions and insurers. The PVK and DNB also jointly consult with the directors of these holding companies. At an earlier stage, the two supervisory authorities jointly produced a 'group profile' of each conglomerate, which includes risk analyses as well as the legal structure, size, financial position and strategy. These profiles not only cover the insurers and credit institutions that are subject to supervision, but also the holding companies and the related head office departments.

Cooperation with foreign supervisory authorities

The PVK works closely with the other supervisory authorities in the European Union. This cooperation is governed by the Helsinki Protocol, under which the supervisory authorities meet twice a year to further refine supplementary supervision of insurers, examine problems from the field and put forward solutions.

For those Dutch insurers with foreign subsidiaries, or with a parent that is registered abroad, there are coordination committees, on which the supervisory authorities concerned discuss and coordinate matters relating to the group concerned.

During the year under review, the PVK organised three meetings and attended nine.

Safety net for life insurers

On the recommendation of the Dutch Association of Insurers and the PVK, the Dutch Minister of Finance set up the Confidence Promotion Committee (*Vertrouwenscommissie*) in the middle of last year to advise the Executive Board of the PVK on the safety net scheme for life insurers. The PVK is drawing up a policy rule in consultation with the sector to put this safety net in place. The Confidence Promotion Committee will advise on the implementation of the scheme, its form and on payments to insurers. Initial consultation has now taken place between the PVK's Executive Board and the Confidence Promotion Committee and cooperation procedures have been agreed.

Based upon the safety net scheme, the PVK may call on an insurance company that is not able to hold sufficient solvency to reinsure its portfolio or to transfer it formally to a special-purpose company, Opvang NV.

Further decline in the number of pension funds

The number of pension funds that are subject to supervision reduced from 926 in 2002 to 884 by the end of 2003. The fall is comparable to that in the previous year and is largely attributable to the fall in company pension funds. In addition, 73 of the pension funds subject to supervision at the end of 2003 also decided to liquidate, but the liquidations have not been completed yet.

New developments in the field of supervision

The PVK believes that the quality of supervisory policy is very important in order to be able to exercise effective and efficient supervision aimed at maintaining a sound pensions and insurance sector in the Netherlands. To this end, it aims to play a proactive role in and to make a major contribution to the internal and external formulation of supervisory policy.

Preparations for legislation

In 2003, further progress was achieved in relation to preparations for the Financial Supervision Act (*Wet financieel toezicht* / WFT), which will result in the existing Acts governing financial supervision, including the Wtv 1993 (*Wet toezicht verzekeringsbedrijf 1993* / Act on the Supervision of the Insurance Industry 1993) and the Wtn (*Wet toezicht naturauitvaartsverzekeringsbedrijf /* Act on the Supervision of Prepaid Funeral Services Insurance) being replaced by a single Act.

Pensions Act and supervision: Framework for the future

In connection with the new Pensions Act (*Pensioenwet*), intensive consultation took place in 2003 regarding the future structure of the financial supervision of pension funds. This process started with a period of consultation between the Dutch Ministry for Social Affairs and Employment, the Dutch Ministry of Finance and the supervisory authorities in the Netherlands. The ministries then discussed the results with the social partners, resulting in December 2003 in a draft framework for the future financial supervision of pension funds.

Council of Financial Supervisory Authorities

The Council of Financial Supervisory Authorities (*Raad van Financiële Toezichthouders* / RFT) is the consultative body representing the PVK, DNB and the AFM. In the year under review the matters on which consultation took place included the testing of integrity, the reorganisation of the Financial Expertise Centre (*Financieel Expertise Centrum* / FEC), the future form of cooperation between the financial supervisory authorities and completion of research into financial conglomerates and legal firewalls.

The PVK, DNB and the AFM have issued a joint paper on enforcement policy, which sets out a transparent policy and also explains the principles underlying the policy regarding enforcement under administrative law and the instruments that can be deployed to achieve this.

White papers support proposals for the Financial Assessment Framework

During the year under review, further proposals were drawn up regarding the Financial Assessment Framework (*Financieel Toetsingskader* / FTK). This process included the publication of white papers, i.e. consultation documents on aspects of the FTK. In March 2003, the white paper on the Solvency Test was published and the feedback regarding the proposed technical operation of the test received to this paper was constructive. Virtually all of the respondents were positive about the proposed standardised method and risk classifications. The large number of responses contributed to a fine-tuning of the ideas published in the white paper and the paper also resulted in useful discussions with various experts from the pensions and insurance world.

September 2003 saw the release of the white paper on the Continuity Test and once again the responses resulted in an improvement in the proposals.

International contacts relating to the Financial Assessment Framework

The substance of the new Financial Assessment Framework is closely related to that of the Solvency II project and for this reason the PVK maintains contacts with other European supervisory authorities about the progress of the FTK.

Focus on new insurance standards

International trends, at both a global and European level, have a major impact on the PVK's work. This applies to the PVK's policy formulation and also to the exercise of supervision. For this reason, the PVK plays a very active role in the international community of supervisory authorities, and where applicable, does so in close cooperation with DNB. At an international level, the following supervisory authorities are particularly important: the International Association of Insurance Supervisors (IAIS), where Wil Dullemond, PVK's Director of Insurance, has been appointed chairman of one of the principal subcommittees, Solvency, Solvency Assessments and Actuarial Issues; the Joint Forum, whose members are the IAIS; the Basel Committee on Banking Supervision (BCBS); the International Organization of Securities Commissions (IOSCO); and the International Network of Pension Regulators and Supervisors (INPRS).

The activities of the international supervisory organisations largely consist of the development of standards that carry weight throughout the financial and supervisory community, such as the Insurance Core Principles, resulting from the general revision of insurance standards and published by the IAIS in 2003. These revised standards serve as guidelines for the organisation and exercise of supervision by IAIS members and are used by the IMF when it carries out a Financial Sector Assessment Program (FSAP) to analyse any weaknesses in the financial sector and supervision in a particular country. Since October 2003, the Netherlands has been the subject of an FSAP. This program will assess the stability of the financial sector, the quality of the financial infrastructure, including prudential and conduct of business supervision, and also measures to prevent money laundering and the financing of terrorism.

Europe: New committee structure for the financial sector

As part of a new committee structure for the financial sector, the Conference of EU/EEA Insurance Supervisory Authorities was reorganised at the end of 2003 to form the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS). This committee will advise the European Commission on the technical aspects of pensions and insurance legislation and will also contribute to consistent implementation of European legislation and further convergence of supervisory practice. It will also appoint a panel to consult interested parties. The first European legislative project for the insurance sector, which is the fundamental review of the solvency testing of insurers, or 'Solvency II', will be implemented using this new formula.