

Check against delivery!

Embargo: Start of delivery of speech

Current German and European Insurance Developments

Speech by Dr. Thomas Steffen
Chief Executive Director

Federal Financial Supervisory Authority (BaFin)

at the
XVIII CNSF International Seminar on 28-29 September 2006
in Mexico City

Summary of contents

1. Introduction to BaFin as the German supervisory authority

2. National (German) insurance developments

- 2.1 The German insurance industry
- 2.2 Reform of the Insurance Contracts Act
- 2.3 Reform of the health insurance sector
- 2.4 Implementation of EU Directives
 - 2.4.1 The Reinsurance Directive (2005/68/EC)
 - 2.4.2 The Financial Conglomerates Directive (2002/87/EC)
 - 2.4.3 The Insurance Mediation Directive (2002/92/EC)
 - 2.4.4 The Pension Funds Directive (2003/41/EC)

3. European Supervisory Developments - Solvency II

- 3.1 The three pillars of Solvency II
- 3.2 Assessment of technical provisions, QIS 1
- 3.3 Solvency capital requirements (SCR), QIS 2
- 3.4 The importance of risk management
- 3.5 The supervisory review process (SRP)

4. Solvency II and the preparations within insurance companies and within BaFin

- 4.1 Legal and organizational measures
- 4.2 Supervision of European insurance groups
- 4.3 Training
- 4.4 Risk classification
- 4.5 Insurance sector stress tests

5. Conclusions

=====

1. Introduction to BaFin

Minister, ladies and gentlemen,

the insurance industry in Europe is commonly likened to a super-tanker: slowly but steadily and smoothly sailing the high sea. That image is perhaps no longer quite so apposite - for European waters have become rougher. And the waves will not become any calmer in the future either, since the wind is blowing ever-harder across the oceans to us in Europe.

The challenge for the future is risk control. We as insurance regulators cannot relieve insurance companies of this task. But we can and *will* have a determining influence on quality requirements for tankers, captains and crew and so create the conditions for ensuring that each vessel can reach its destination.

But that's not all there is to it. Regulators must also ask themselves from time to time whether their supervision is adequate and where they should correct their course. For resources are scarce. That makes it all the more important to strike a sensible balance in allocating those resources between the risk-bearers, the insurance undertakings. The current buzz word is risk-based supervision. In Germany it is the Federal Financial Supervision Authority, BaFin, who is responsible for this.

BaFin was created from the merger of three Federal supervisory authorities which had previously been responsible for banking

supervision, insurance supervision and securities supervision as separate authorities. The merger took place in May 2002. BaFin is therefore a very young regulator. But the insurance industry has in fact been the subject of law-based state supervision for 105 (one hundred and five) years. The merger occurred because it was assumed in 2002 that the concept of integrated financial services would become even more widespread. Looking back in 2006, this trend has not been entirely confirmed. On the other hand, the uncomplicated exchange of views and supervisory philosophies under the one roof of a single authority is an inestimable advantage. For that reason, the merger in my opinion made perfect sense.

BaFin employs around 1,500 (fifteen hundred) people. They work in Bonn and Frankfurt am Main and supervise 2,300 (two thousand three hundred) credit institutions, 800 (eight hundred) financial services institutions, 630 (six hundred and thirty) insurance undertakings and 6,200 (six thousand two hundred) investment funds. The insurance supervisors are based in Bonn. Insurance supervision in the strict sense is currently divided into five departments and is organised according to classes of business.

That is, as it were, a brief description of the national (German) regulatory authority. But it provides too narrow a view.

For German insurance supervision is deeply involved in the European arena. That makes sense, since the big German insurance groups do after all play in the major European and

international leagues in tough competition with each other. That makes it all the more important to harmonise insurance supervision as much as possible across all of Europe. For that is the only way to ensure fair competition. This also includes promoting the common European market. This is one of the EU's most important objectives, since a common market is a major prerequisite for growth and prosperity.

The European insurance industry is of great importance. Take just these few facts: insurers in Europe invest more than five thousand billion euros in the economy. They employ more than one million people and have around one million agents, brokers and financial intermediaries.

My presentation is divided into three parts. In the first part I will give you a brief introduction to BaFin and the German market including current information about German changes in the legal framework. In the second and third part I will talk about the European Solvency II project.

2. National (German) insurance developments

2.1 The German insurance industry

BaFin is responsible for the supervision of around

- 100 (one hundred) life insurance undertakings;
- 200 (two hundred) "pension providers" and death benefit funds;
- 50 (fifty) health insurance undertakings;

- 230 (two hundred and thirty) property and casualty insurance undertakings; and
- 50 (fifty) reinsurance undertakings.

In addition, we supervise around 25 (twenty-five) pension funds.

Viewed overall, the German insurance industry is healthy. That was not always the case just a few years ago. Share prices slumped dramatically in Europe in the period from 2000 to 2002. That caused problems for some insurers. But in most cases the considerable hidden reserves on their investments were sufficient to absorb the losses.

Life insurance undertakings

In 2005 German life insurance undertakings achieved premium growth of around 6% (six percent) to around 73 (seventy-three) billion euros. A very pleasing performance, even though special tax factors played an important part in this. Premium income also looks set to grow in 2006 as well, this time probably by around 4% (four percent). The reason for this is obvious. As life expectancy increases, German society is suffering from over-aging. Many Germans are therefore providing for their old age by saving. Some of these savings are going into life insurance products. Retirement provision is a mega-trend in Germany.

However I am somewhat concerned by the relatively high guaranteed interest rates of up to 4.25% (four point two five percent) that German life assurers have given to some of their clients in the past. Interest rates have been low for several years now, and with ten-year government bond yields currently standing at around 3.8% (three point eight percent) it is difficult to earn enough to meet future guarantees. Fortunately, life assurers have other sources of income with which they can in many cases plug these gaps. We as supervisors are monitoring the situation closely.

As prudent supervisors we are also taking precautions for the future. For instance, the maximum interest rate for interest rate guarantees on new contracts will be cut from the present 2.75% (two point seven five percent) to 2.25% (two point two five percent) from the beginning of 2007. This will alleviate the problem for the future.

Property and casualty insurers

The segment of property and casualty insurers is recording hardly any growth. The level of premium income is stagnating at around 62 (sixty-two) billion euros. The fight for market shares has intensified, especially in the most important property and casualty insurance segment, motor insurance. Nevertheless, I am still expecting a positive underwriting result, although it is likely to be lower than in the previous two very good years.

Reinsurers

The premium income of German reinsurers in 2004 was around 47 (forty-seven) billion euros. In international terms, Germany is therefore one of the most important centres for reinsurers. Being able to manage the risks arising from natural disasters and other major loss events is the crucial issue. I know that German reinsurers withstood the natural disasters of 2005 well. As things stand at present, in comparative terms they were affected less than their international competitors. The results for the first half of 2006 also suggest that it's still a case of onwards and upwards. But I am again a cautious supervisor: the year is still a long way from being over.

Pension funds

Many of you may be surprised to learn that BaFin also supervises pension funds. This type of undertaking has existed in Germany only since 2002. Premium income is still relatively low – around 500 (five hundred) million euros in 2005. Many German industrial undertakings carry very large pension provisions in their balance sheets and do not use the pension fund form of corporate entity. However, the first signs are beginning to emerge of industrial undertakings wanting to transfer their pension provisions to pension funds. I am therefore optimistic that pension funds will gain significantly in importance in Germany in the next few years.

After this brief excursion into the economy I should now like to tell you about some major reform projects in Germany that will tackle the economy.

2.2 Reform of the Insurance Contracts Act

There are two special acts in the insurance sector in Germany, both of which are ultimately intended to protect policyholders. The first is the Insurance Supervision Act, which essentially governs the responsibilities and intervention powers of the financial regulator. The second is the Insurance Contracts Act. As the name suggests, it deals in particular with issues relating to the framing of insurance contracts in order to protect policyholders.

The Insurance Contracts Act is out-of-date. The "old" Insurance Contracts Act dates back to 1908 and many aspects of it need updating in order to bring it into line with modern ways of operating insurance business. The Ministry of Justice has presented a draft for a new Insurance Contracts Act. The main objectives of the reform are:

- To further strengthen consumer protection;
- To ensure a fairer balance of the interests of insurance companies and policyholders; and
- To modernise the life insurance branch.

For insurance companies the rules will be extended regarding information duties and disclosure requirements. This will lead to a greater degree of transparency.

The reform focuses on the sharing by policyholders of hidden reserves for all classes of business offering with-profits policies. This fundamental modification results from a judgment of the German Federal Constitutional Court in 2005. In order to arrive at a figure for the hidden reserves, the reform introduces fair value accounting for those assets which are the basis for the calculation of the surplus available for distribution.

Under the terms of the first draft, policyholders will acquire an irrevocable right to their share of the hidden reserves, not upon termination of the contract, but during the life of the contract. It has been pointed out to the Ministry of Justice that this might result in greater volatility of assets, more insolvencies of insurance companies and less investment in shares and may therefore affect the capital market. At present we have strong indications that the draft will be modified on that particular point.

2.3 Reform of the health insurance sector

The German government is working on a fundamental reform of the healthcare system. At present there is a two-tier healthcare system. Firstly, there are the private-sector health insurers, which are supervised by BaFin. These health insurers use part

of the insurance premiums to create pension provisions. Secondly, there are public-sector health insurance funds which operate on a pay-as-you-go basis. This means that, after deduction of costs, each year's insurance premiums are all used to fund that year's healthcare costs.

The question is whether there should be an ongoing competition between the two systems or whether and how to bring these systems more into line or merged into one system. It might be that by political decision the current private health insurance model will become a "discontinued line". In that case, supervision of private health insurers would also, of course, become a "discontinued line".

2.4 Implementation of EU Directives into German law

It is one of the core concerns of the EU to create a common *single* and functioning EU internal market. In order to achieve this objective, the EU draws up what are known as Directives governing the contents of regulation. Each Directive lays down a time-frame within which it has to be transposed into each Member State's national law. Each national legislative assembly is responsible for the implementation. This basic process is the same for all EU Directives.

For the next few minutes I should like to discuss the most recent Directives in the insurance field. These are

- The Reinsurance Directive;

- The Financial Conglomerates Directive;
- The Insurance Intermediaries Directive; and
- The Pensions Funds Directive.

2.4.1 The Reinsurance Directive

The EC Directive on reinsurance supervision came into force on 10th December 2005.

The Directive covers four main areas:

- The authorisation procedure, including the introduction of the single European passport;
- The introduction of minimum regulatory standards;
- Rules governing finite reinsurance;
- The enactment of supervision for non-EC reinsurance undertakings which conduct reinsurance business in Germany.

"Single European passport" means that if a reinsurer is granted authorisation by BaFin to conduct business in Germany, this authorisation is sufficient to enable it to operate throughout the whole of the EU. With just the one authorisation the reinsurer can establish branches and provide services on a cross-border basis in all EU Member States. A further important point is that the financial supervision of the reinsurer takes place only in Germany, the undertaking's "home country". This system has applied in the EU for direct insurers for many years now. It has stood the test of time.

Transposition into German law - Amendment of the Insurance Supervision Act

Part of the Directive has already been transposed into German law by way of the 2004 amendment of the Insurance Supervision Act.

The ordinance relating to the capital resources of reinsurance undertakings came into force in October 2005. It contains rules for calculating the solvency margin and the minimum amount of guarantee funds for professional reinsurers.

Full implementation of these standards will come into force with the latest amendment of the Act, in all likelihood at the end of 2006. It will include Finite reinsurance. The Bill includes a covering law in section 121e of the amended Act which rules that only reinsurance contracts involving a significant risk transfer will be treated as reinsurance contracts by the supervisory authority. It also incorporates authority to issue an ordinance governing the identification and eligibility criteria of significant risk transfer, the administrative and reporting procedures to ensure adequate documentation and transparency as well as the reporting requirements.

As supervisor I very much welcome the considerable extension of the supervision of reinsurance undertakings. The extension will mean improved indirect protection of policyholders by largely ensuring reinsurance undertakings' ability to meet their liabilities to ceding insurance undertakings. Another plus point

is that the stability of the financial system will be further strengthened. Furthermore, confidence in Germany as a financial centre will also be increased.

2.4.2 The Financial Conglomerates Directive

The Financial Conglomerates Directive has been enshrined in German law by Act of Parliament. The Act came into force on 1 January 2005. What is the philosophy and contents behind the directive?

The Directive is aimed at financial groups which operate not only in the banking and investment services industry but also in the insurance industry. Quite a lot of these players operate on a cross-border basis and are among the largest financial groups. Problems at any of these players could seriously jeopardise financial stability.

However, up to now there have been hardly any or even no supervisory rules relating to financial conglomerates in the EU Directives. The Financial Conglomerates Directive eliminates this loophole by introducing new supplementary supervision elements at the conglomerate level on an EU-wide basis.

According to the definition in the Financial Conglomerates Directive, a financial conglomerate is deemed to exist when the group operates predominately in the financial sector and does a considerable proportion of its business on a cross-sectoral basis

covering both the banking and investment services industry and in the insurance industry. For this purpose certain thresholds have to be calculated on the basis of balance sheet totals and solvency requirements. If a group exceeds the thresholds, it is a financial conglomerate.

The most important new supervisory elements of the Financial Conglomerates Directive are:

1. Proof of capital adequacy at the financial conglomerate level;
2. Intra-group transactions and risk concentrations;
3. European cooperation;
4. Qualitative rules for risk management.

Financial conglomerates will in future have to prove that they comply with minimum capital adequacy standards. The financial conglomerates solvency calculation encompasses the consolidated capital and solvency requirement calculation on the basis of the sectoral rules. The consolidated capital has to exceed the requirement. The result of the calculation is an important indicator of the financial conglomerate's financial strength.

The Directive imposes a mandatory requirement on financial conglomerates to report intra-group transactions and risk concentrations to the supervisory authority. However, this is often likely to already be an existing component of risk management within groups anyway. This reporting requirement

will lead to greater transparency for supervisors and further enhance groups' awareness of these aspects.

The Directive stipulates that for every financial conglomerate a single coordinator should be appointed from among the competent authorities involved. In each case the coordinator is the supervisory authority of the EU Member State which authorised the regulated entity at the head of the group. If the group is not headed by a regulated entity, as a general principle the coordinator is the authority which authorised the entity with the largest balance sheet total in the most important financial sector.

The first foundations for an efficient organisation and the exchange of information regarding international financial conglomerates have already been laid in the EU-level working groups. For instance, a preliminary list of all financial conglomerates operating in the EU has been drawn up. The list also contains the names of the authorities who are the coordinator in each case. As an integrated financial supervisory authority, BaFin has an organisational advantage, since it is the only authority responsible for supervising financial conglomerates in Germany and is thus the central point of contact.

2.4.3 The Insurance Mediation Directive (2002/92/EC)

As I said earlier we have around 1 million intermediaries operating in the European Union. On that basis the main purpose of the EU Insurance Mediation Directive is to strengthen consumer protection. For that reason insurance intermediaries will in future have to be able to prove their knowledge of the subject. In addition, a register is to be created and maintained. There will also be monitoring functions.

There are around 500,000 (five hundred thousand) intermediaries in Germany. That threatens to be an awful lot of red tape. To be honest, that is one of the reasons why we had been sceptical to take over supervision. However the Federal government has put forward a Bill to implement the Directive. BaFin is to be responsible for tied agents, by way of indirect supervision of the intermediaries via insurance undertakings. BaFin will of course need more staff to carry out this new task. The additional requirement has been registered.

2.4.4 The Pension Funds Directive (2003/41/EC)

Many countries in the EU are suffering from the problem of a decline in their population accompanied by an aging of the population. Old age pension provision has therefore become one of the major European issues of the future. Mexico is in the

fortunate position of having a population that is still growing. That also means great prospects for the future.

The Pension Funds Directive introduces the European passport for pension funds. This is something new and the result of the EU-wide introduction of minimum regulatory standards. If a pension fund is granted authorisation in one EU Member State it can therefore operate in all other Member State on a cross-border basis.

However, the European passport is not as comprehensive as it is under the Reinsurance Directive. This is because each individual EU country in which the pension fund operates has to monitor the fund's compliance with the provisions of its own national employment and social welfare legislation. In the event of any irregularities the competent authority of the home-country Member State must be informed immediately. The latter, in consultation with the competent authority of the host country, must take the necessary measures to rectify the situation.

For BaFin this means yet another new task. Not only is it going to have to get to know and understand the essential provisions of national employment and social welfare legislation and update them on an ongoing basis; it will also be responsible for monitoring that foreign providers comply with the provisions of national employment and social welfare legislation.

In addition to the introduction of the European passport for authorisation purposes, the Directive also contains provisions on capital adequacy and provisioning and "fit and proper" rules for staff.

As you can see, the legal and economic environment in which supervision takes place is constantly changing on the national as well as European level. What is our main challenge for the future?

3. European supervisory developments - Solvency II

3.1 The three pillars of Solvency II

Solvency II is the most important project for the insurance sector at the EU level. It is concerned with developing a new, comprehensive and risk-oriented solvency and supervisory system for life and non-life insurers and for reinsurance undertakings. The project is not restricted to solvency capital requirements. Rather, it covers all areas of the insurance company. And it is this which also makes the project so complex.

Solvency II covers the following three areas:

Pillar 1: Quantitative requirements: this area is concerned with the solvency capital requirements;

Pillar 2: Supervisory activities: this area focuses on risk management and the supervisory review process;

Pillar 3: Disclosure obligations: this is concerned with supervisory reporting and public disclosure.

This basic structure is based on Basel II and shows that both projects are similar to one another. However, Solvency II is restricted to the EU, while Basel II is of global relevance.

The EU Commission is lead-managing the Solvency II project and currently working on drawing up a draft framework Directive on Solvency II. The framework Directive is intended to bring together the fundamental features of Solvency II. The Commission is planning to adopt the framework Directive on Solvency II within the second half of 2007. Compared with the previous schedule this would be a delay of about 6 months. However we are sticking to the original plan to have the project implemented by 2010.

The insurance supervisory authorities have been involved from the very start: the EU Commission has asked the European insurance supervisors, who have joined together to form CEIOPS, for advice in the form of so-called "Calls for Advice". Overall three sets of queries about how a future supervisory system should be structured have been answered by CEIOPS. Each set is also described as a "wave". Because the programme of work is enormously extensive, it has taken all those involved to the limits of their staff capacity.

The operational project work is being carried out by a number of CEIOPS working groups whose members are seconded from the European insurance supervisors. The working groups draft responses to the EU Commission's queries. Once they have been approved by CEIOPS and other bodies, the responses then move into the consultation phase. For instance, interested specialist groups are given the opportunity to state their opinion on the respective subjects. Following the consultation phase, CEIOPS makes whatever amendments to the responses may be necessary, and then sends the consolidated and therefore final version of the proposals to the EU Commission. The Commission then uses these proposals to draw up the framework Directive for Solvency II.

Germany is represented in all the Solvency II working groups. I am pleased to say that we also hold the chairmanship of the Pillar II working group. This working group deals with important subjects such as risk management and the role of supervision.

3.2 Assessment of technical provisions, QIS 1

Solvency II will contain new rules on the assessment of technical provisions. One aim of Solvency II is to harmonise the calculation of technical provisions throughout the EU – a truly mammoth task, given the many national peculiarities.

The assessment of technical provisions is intended to be carried out on the basis of a given explicit safety level. There are two blocks within the technical provisions: First, the realistic best estimate; and second, the explicit risk margin. The safety level could, for example, be a confidence level of 75% (seventy-five percent).

CEIOPS is, of course, striving to achieve compatibility with international financial reporting standards (IFRS).

The Solvency II project is being backed by a number of Quantitative Impact Studies (referred to for short as QIS). These studies are intended to examine the quantitative effects of the planned regulations on the solvency balance of European insurance companies. Analysis of QIS I results has shown that there is no cause for concern with regard to the adequacy of the technical provisions of German insurance undertakings.

3.3 Solvency capital requirements (SCR), QIS 2

The current capital requirement – we call it Solvency I – is derived from variables such as premiums, claims or the amount of mathematical provisions; risks arising from investments are largely ignored.

Solvency II instead requires undertakings to record *all* quantifiable risks. The IAA risk classification is the basis for the

different risk categories. The risk types are: technical risks, market risks, credit risks, operational risks and liquidity risks. The requirement (target) is calculated on the basis of the risks as quantified. The calculation of the requirement and of the capital resources can be carried out either in accordance with the "standard approach" or by using internal models. Additionally, there will be minimum capital requirements.

QIS 2, which is intended to give an insight into capital adequacy, is being analysed right now, and the results are expected to become available in October. BaFin does not expect Solvency II to have significant effects on capital adequacy overall.

It's not only when internal models are used that the question naturally arises of the supervisory rules for investments. In Germany we currently have not only qualitative provisions but also detailed quantitative rules for investments. What might these quantitative rules look like under Solvency II? The "prudent person plus" principle describes the direction in which we are moving in respect of investments. There are three aspects in this regard:

Firstly: the qualitative requirements regarding the risk management of investments will increase in future. The stricter requirements will serve to make up for the fact that the quantitative restrictions have been partially done away with.

Secondly: the risk level of the investments is an important variable in determining solvency requirements. The greater the risk, the higher the solvency requirement.

Thirdly: a safety net is also being brought in: eligible types of investment are being prescribed, as are quantitative constraints in order to limit risk concentrations.

Overall, there will be considerably fewer regulations from the supervisory authorities regarding investments. On the other hand, we will have tougher requirements for investment management and of course the link between investments and solvency capital requirements that is so urgently needed.

Of crucial importance is the question of how the relationship between risk-oriented calculation of solvency capital requirements and investment constraints is balanced.

3.4 The importance of risk management

Ladies and gentlemen, please allow me at this point to make a brief digression into the history of shipping.

The Titanic set off on 10th April 1912 on its maiden voyage to New York with great joy and pride. There was every reason for this, as the ship was a masterpiece of human technology. Such was the great trust in the technology that the Titanic was regarded as unsinkable. But as we all know, the voyage ended

in tragedy. On 14th April 1912 the Titanic hit an iceberg and sank a few hours later.

What has all this got to do with Solvency II? It has to do with risk measurement, risk controlling and risk limitation.

The history of the Titanic highlights the factors on which this will depend. The Titanic did not sink because of the way it was built. It sank because the wireless operator did not deliver the crucial message about the imminent danger to the captain in good time. The crew in the radio room did not apply the dual control principle. I therefore believe that the Titanic venture failed due to faulty risk management.

Improving risk management is the central concern of Solvency II. The key word in this regard is Pillar II. Pillar II also goes under the name of "Supervisory activities". The name gives the impression that the focus is on the supervisory authorities. This is, however, not the case. After all, the main concern is risk management by the insurance undertakings themselves and not risk management by the insurance supervisors. Solvency II draws a distinction between governance, risk management and internal controls. Detailed concepts are going to be worked out. Due to time constraints, I will skip any further discussion of these and move on to the future role of the supervisor.

3.5 The supervisory review process (SRP)

In the supervisory review process (SRP), the supervisory authority checks whether the insurance undertaking is complying with the supervisory requirements. The aim is more to carry out a process control rather than to analyse quantitative aspects.

What duties does the insurance supervisor have to perform under Solvency II? The insurance supervisor checks whether the processes are complete and embedded in the organisational structure. This also includes checking whether the mechanisms for recording all relevant risks are appropriate.

The starting basis consists of the internal specifications for the undertaking's business and solvency capital strategy. The risks to be recorded are derived from its business activities. These risks must be quantified and give rise to the target solvency requirement. The undertaking itself has to compare the required solvency capital level with its actual risk profile, draw conclusions from this and communicate the result and the consequences. Deviation analysis will show whether and, if so, where any changes in the business and solvency capital strategy are required. This organisational control-loop to determine the solvency capital is checked and evaluated by the supervisory authority.

The insurance supervisor will make an assessment as to whether the actual risk profile is captured adequately. If so, no further demands will be made. If not, corrective measures should be necessary. In individual cases capital add-ons may be imposed and/or the undertaking may be required to introduce a partial or full internal model. This procedure will serve as an incentive for the undertaking to optimise its risk assessment and quantification process. Hence the insurance supervisor is primarily a system controller in this respect.

4. Solvency II and the preparations within insurance undertakings and within BaFin

4.1 Legal and organizational measures

In preparation for Solvency II, BaFin has created the post of SRP representative reporting directly to me. Her task is to develop plans for the future supervisory review process under Solvency II. The SRP representative is also involved in all BaFin projects (e.g. risk classification and IT projects) which may be influenced by Solvency II. This is meant to ensure that the possible future impact of Solvency II is adequately taken into account.

At present BaFin plans to introduce

- new legal requirements for risk management into supervisory law; and
- reporting duties requiring insurance undertakings to notify the supervisory authority of risks they have identified.

These plans have been approved by the Ministry of Finance and have generally been agreed with the German Insurance Association, which was given a say in the drafting of the new rules. The Bill to introduce the new requirements into supervisory law is scheduled for 2007.

The new rules are to be supplemented by a Circular interpreting the legal requirements from the supervisory point of view and specifying minimum standards for risk management. Drafting of the Circular, which is to be principle-based, is well under way. The Insurance Association and industry representatives are cooperating in this drafting procedure as well. After a public consultation procedure, the Circular is also expected to come into effect in 2007.

BaFin would like to start checking internal models quite some time before the introduction of Solvency II. Undertakings can take advantage of the potentially lower solvency capital requirements associated with the use of internal models under the new regime right away. This goal cannot, however, be achieved without an increase in staff numbers. BaFin has already given consideration as to how internal models should be checked and how many additional staff will be necessary to fulfil this function. The work is to be supported by BaFin's new Risk Modelling Group who specialise in risk modelling.

The insurance industry as well is preparing for Solvency II not only individually but through the work of the German Insurance Association (GDV) and the German Association of Actuaries

(DAV) as well. Both associations have set up several working groups to deal with Solvency II related issues.

By participating in these groups BaFin is learning about the practical problems the industry is facing over Solvency II and is able to introduce questions that need to be answered. To improve cooperation and the exchange of information between the supervisory authority and the industry BaFin has also established two committees itself, one to cover external expertise and a second to cover internal models.

The latter committee will provide BaFin with more detailed knowledge about the internal models of German undertakings. The industry representatives will hopefully learn how BaFin intends to check internal models. This will help to remove uncertainty from the approval process and to avoid bad investment decisions.

4.2 Supervision of European insurance groups

Considering the issue of the recognition of internal models for solvency calculation purposes has a huge European dimension. For if, for example, BaFin recognises a German insurance group's internal model, the question arises of whether the supervisory authorities of other EU Member States should also recognise this model. I think they should. For it is important for the bureaucratic cost to the insurance industry to be kept as

low as possible. I am optimistic that there will be progress in this field.

Even now it is customary for the European regulators of large insurance groups to meet once a year to exchange information. Sometimes the directors of the companies also attend these meetings, give presentations and take questions. For all European insurance groups there is a contact list containing the individual companies, the names of the competent financial regulators and their e-mail addresses. This is a little bit of practical Europe at work and a positive example of European cooperation. However, I must be honest with you and not hide the fact that there are most definitely also difficulties and setbacks in European cooperation. We are a family, but like all families, we do not always share the same view.

4.3 Training

It is important that regulators keep up with the all these winds of change and undergo training on a permanent, ongoing basis. For that reason BaFin has set up an in-house training programme. This programme is also heavily used by young members of staff. Training needs are very high. This is because BaFin has taken on a lot of new staff in the last few years due to new tasks and staff retiring.

BaFin also provides support for supervisory authorities from other EU Member States, especially authorities from those

countries that have recently joined the European Union. These countries frequently need to adapt their national regulations so as to ensure that they comply with EU Directives.

Our activities are not limited to the EU. Only yesterday BaFin received a visit from twelve junior staff from insurance companies in Latin America and Asia. They have five to eight years' professional experience. During their stay they gained an insight into my authority. Other items on the agenda for their visit were reinsurance and the investments of German insurance companies. I should be pleased if we could consider such an exchange with the Mexican supervisory authority.

4.4 Risk classification

BaFin is moving further towards risk-based supervision. In order to do this, we classify the quality of an institution and its significance for the financial market in a 12-field matrix. This system applies to banks, insurance companies and financial services institutions.

A risk-based approach is used not only in solvency supervision and the monitoring of internal control requirements but also in the supervision of compliance with anti-money laundering legislation. In this context, BaFin will concentrate mainly on those institutions which have deficiencies with regard to the money-laundering prevention systems or which show higher

risks with regard to their individual company, customer or business structure.

The revised methodology's goal is a redistribution of supervisory capacity which is based on a "traffic lights" system. There are four lights. Green represents high-quality. Red represents low-quality. Two other colours represent qualities lying somewhere in between.

Supervisory attention is focusing increasingly on undertakings which do not receive good ratings for quality and on undertakings with a high market impact. The rating that an undertaking is given influences, for instance, the frequency of on-site inspections.

4.5 Insurance sector stress tests

The results of our stress tests constitute a major component of our risk classification system. BaFin has been using stress tests for direct insurers for several years now. The stress tests help BaFin to identify possible problem cases in good time. Recent stress test results based on end-2005 balance-sheet data confirm the assessment of the insurance sector's financial strength and its ability to withstand short-term adverse market developments. The scenarios are:

- a loss in the market value of shares of 35%;
- a loss in the market value of bonds of 10%;

- a simultaneous loss in the market value of shares of 20% and of bonds of 5%; and
- a simultaneous loss in the market value of shares of 20% and of real estate of 8%.

BaFin stress tests have proved successful as a quantitative element in the risk management of investments and that we cannot imagine our "supervisory toolkit" without them. So as you can see, insurance supervision in Germany has become considerably more risk-oriented in the last few years.

5. Conclusions

Ladies and gentlemen, my words today might have expressed how insurance supervision in Europe and in Germany is being overhauled from top to bottom. Gaps have also been plugged. This process itself naturally involves risks; for it is always difficult to find the right middle way between regulation and corporate freedom. However we as German and European supervisors are not in a position to stop the process we are in.

Lee Iacocca, the former chair of Chrysler, once said:

"Sometimes you've just got to take a risk - and correct your mistakes as you go along".

Muchas gracias por su atención.