

THE CURRENT DUTCH LIFE INDUSTRY

Challenges and opportunities

Commissie Verzekeraars

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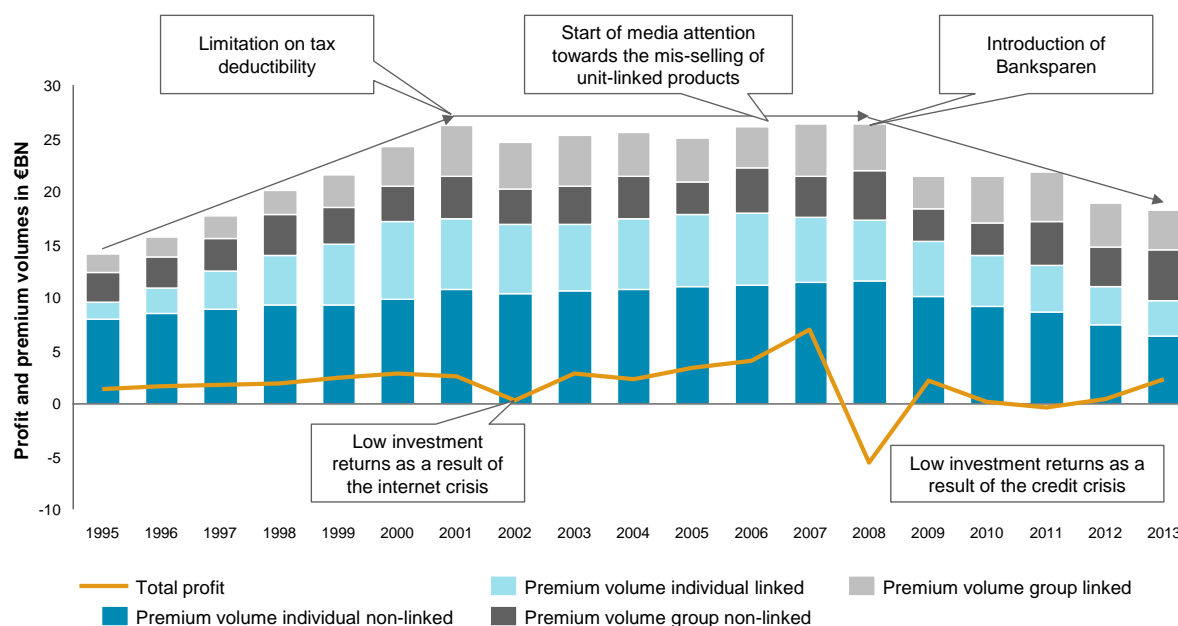
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Executive summary

Since 2006, Dutch life insurers have faced a variety of challenges, such as reputational damage relating to the mis-selling of unit-linked products, the economic downturn and changes in the fiscal regime and regulatory requirements. The increasing pressure from these factors on the life insurance business model raises the question whether a systematic change, led by the major industry players, is required.

Insurance industry from 1995 to 2013

Historic analysis of insurers' premium volumes and profitability has shown that the insurance industry is heavily affected by changes in the regulatory, fiscal and economic landscape.



Until 2001, premium volumes increased, driven by tax advantages, a push from intermediaries and high investment returns. This observed growth stagnated from 2001 onwards due to limitations on tax deductible savings and increasing volatility in investment returns. By the end of 2006, media attention towards the mis-selling of unit-linked products had negatively impacted the sales of new, unit-linked ('beleggingsverzekeringen') products. A subsequent lack of trust, low investment returns and the introduction of Banksparen resulted in a rapid decline in production volumes and profit from 2008 onwards.

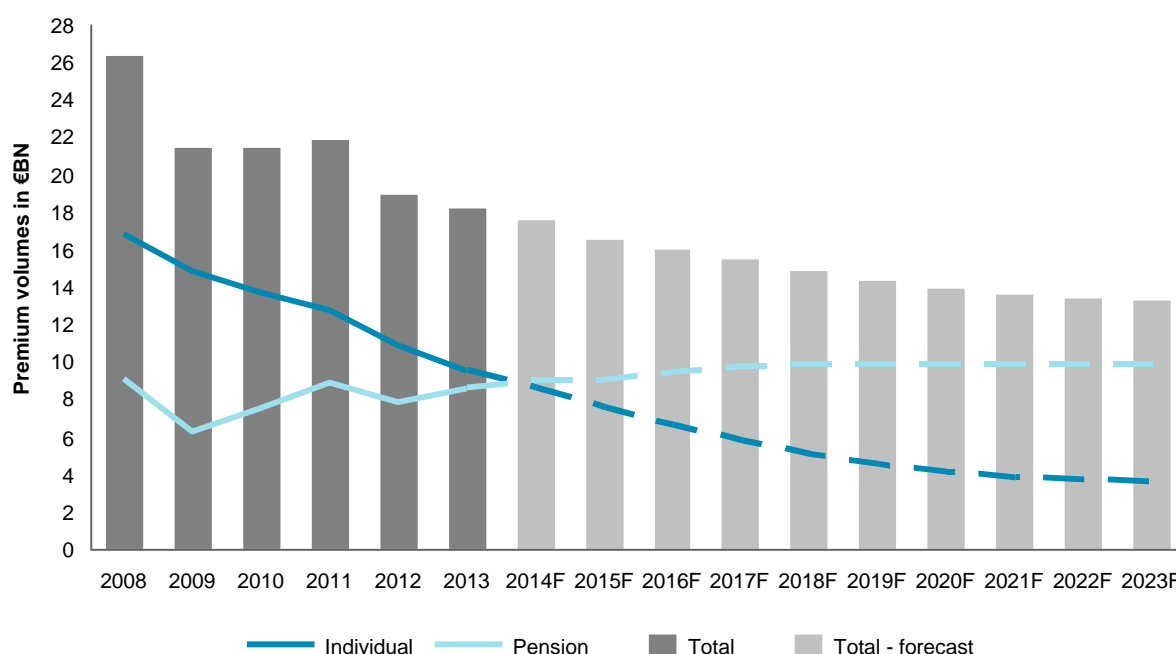
In the pension landscape, there has been a general shift from Defined Benefit (DB) towards Defined Contribution (DC) pension schemes. In parallel, there has been a continuous inflow of DB schemes coming from liquidating small pension funds.

Premium and product outlook from 2013 until 2023

Under current and expected fiscal, regulatory and economic circumstances, we expect the current downward trend for individual life savings products to continue. The demand for protection and annuity insurance products however will remain as Banksparen products cannot offer similar protection towards mortality and longevity risk.

For pensions, renegotiations of contracts at current low interest rates are likely to result in an increase of future premiums for DB contracts. As pension contracts are typically renewed every five years, this impact will be spread over the coming five years and is highly dependent on interest rate changes.

Furthermore, we expect that new limitations on pension accrual will reduce pension premium inflow in 2015 by 0% to 10%.



Assumption: APE for insurance linked products is zero

Balance sheet and profitability

After a peak in 2012, we expect a reduction of the total balance sheet of the insurance market. Based on the combination of a gradual runoff of insurance liabilities and an expected increase of pension premiums, we expect that this process will be slow and the total balance sheet will not fall below pre-2010 levels during the coming 10 years.

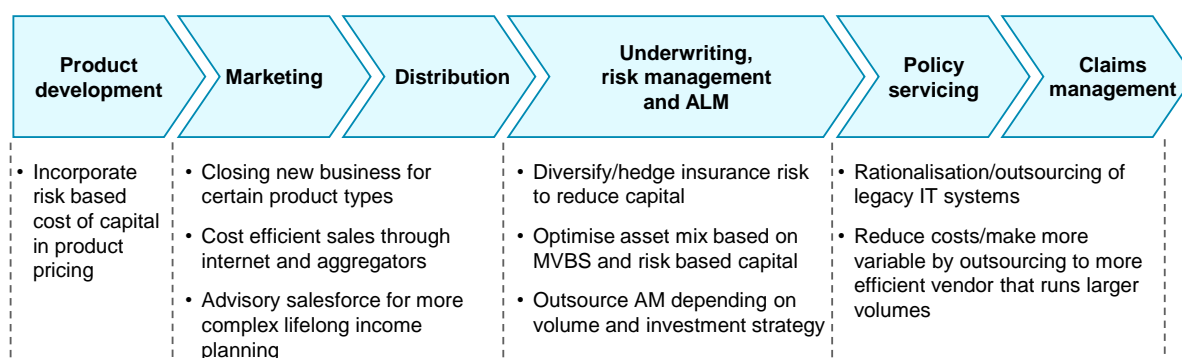
However, profitability of the insurance sector is, and will remain, under pressure. The decrease in demand for individual life savings products has resulted in a focus on individual protection products and group life products. This new industry focus, together with the low interest rate environment, has put severe pressure on the profitability of new production. Depending on future investment returns, insurers can

still make some profit on their 'old' insurance books. As the share of new business (that is not profitable) increases over time, profits will decrease towards zero if the insurance industry does not structurally change in the near future.

Efficiency insurance sector

Due to historically high returns on investments, the insurance industry has paid relatively little attention to efficiency. The efficiency of insurers has therefore lagged behind that of other industries.

With recently declining returns on investments, insurers have now increased their focus on cost reductions. With decreasing premium inflow and historic losses on expenses, costs are being reduced in line with declining business. However, maintaining a competitive position in the current market requires more structural changes along the complete value chain.



Although insurers have already significantly reduced their acquisition expenses, further improvements on cost reduction in distribution are needed. A focus on internet sales, with only the more complex products being sold by a specialized salesforce, will contribute to further reductions.

Cost reductions could also be enabled by improved capital management optimization. Insurers need to increase their focus on optimization of underwriting, risk management and Asset and Liability Management (ALM) under the new Solvency II framework in order improve return on equity.

Cost reductions in IT remain challenging. Most policy administration systems have become very complex due to product changes, alterations in policy conditions and policy conversions. The weight of IT expenses in the total cost loading of insurance companies is therefore increasing. Rationalising these systems requires a large effort and great flexibility from the new systems. Insurance companies do not have the required experience and size to run this type of operation efficiently. Outsourcing IT to more experienced providers with standard solutions could significantly accelerate IT cost reductions.

So far, insurance companies have remained sceptic towards an outsourcing model, due to their lack of experience in working with IT vendors. IT vendors, on the other hand, have not fully engaged in the Dutch insurance market as this requires significant levels of investments and the volumes of IT outsourcing remain small. More recently, a number of providers have started offering low cost cloud platforms in the Dutch market.

Closed books

Many insurers have already decided to close new business for a part or for all of their individual life products. In order to obtain a maximum value from the 'closed book', the insurers focus mainly on cost efficiency.

However, closed book operations provide other opportunities related to ALM and commercial activities. At most insurers, ALM is still generic and is not sufficiently geared to the predictable future cash flows that allow using more illiquid asset classes to generate higher returns with a similar risk profile.

On the commercial side, closed books require a specific client handling by positively managing lapse, converting products to cheaper solutions and in addition, cross- and upsell of new transparent and cost efficient products.

Further consolidation of the life insurance industry in the Dutch market

Currently six big insurers dominate the life insurance industry in the Dutch market. With a small and decreasing market we believe that further consolidation is an important step in efficiently running current individual life portfolios that are decreasing in size. Consolidation between the 'big six' has not yet taken place for a variety of reasons, ranging from state ownership and regulatory reluctance to technological barriers.

Furthermore, the mis-selling of unit-linked products still stands in the way of further consolidation. Insurers and external investors are reluctant to take on the risk of new future claims. An industry wide solution is needed to break the current standing.

Solvency II

Solvency II will replace Solvency I as of 1 January 2016. Solvency II is a major change that will impact the insurance industry on many levels. The product mix of life insurers will be affected, due to the higher risk based capital required for products with guarantees. This will lead to different investment strategies; investment portfolios will be de-risked and matching between assets will increase. Furthermore, Solvency II will lead to a stronger regulatory focus on risk management and will increase the cost of reporting.

The average solvency ratio of Dutch life entities is currently well above 100%, but is relatively low compared to peer countries.

Although Solvency II regulations are principal based, regulation on most topics is relatively prescriptive. There are, however, some areas with an explicit role for the

local supervisor. Within the limitations of the Solvency II guidance, the supervisor can influence how insurers adjust to Solvency II regulations regarding: Internal Model application, ORSA/capital add-on, Transitional measures, and Market valuation of non-quoted assets and liabilities.

Concluding remarks

The insurance industry as previously known is unlikely to return. Fundamental fiscal changes and new pension regimes have driven customers towards Banksparen and new pension vehicles. These alternatives will pose a permanent competition to insurers.

Group pensions have become a more important business due to the consolidation of pension funds. Individual life will focus on term products as competitors cannot offer products with this insurance element.

Operating costs of existing life portfolios (in runoff) will have to continuously decrease and consolidation is to be expected. For new life business, insurers have to sell cost-efficient and transparent products that are based on modern IT platforms, allowing for low operating costs and incorporating the inevitable trend of further digitalization. Overall the size of the industry from an employment perspective will continue to go down for the next few years with another 10-20%, depending on many uncertain factors. DNB has also projected a comparable decrease.

1. Introduction

1.1. Report background

Since 2006, Dutch life insurers have been affected by a variety of factors, such as reputational damage relating to the mis-selling of unit-linked products, the economic downturn, changes in the fiscal regime and regulatory pressure. These factors are challenging the sustainability of the current business model and questions are being asked whether a systematic change, led by the major industry players, is required. In order to examine the future of the Dutch insurance industry, the Ministerial Council has approved a proposal from the Minister of Finance to establish an independent insurance commission ('Commissie Verzekeraars'). This commission focuses on the question: "How can the insurance sector fulfil its social role in the future?"

This report has been written upon request by the commission and serves as input for the full report that will be delivered by the commission.

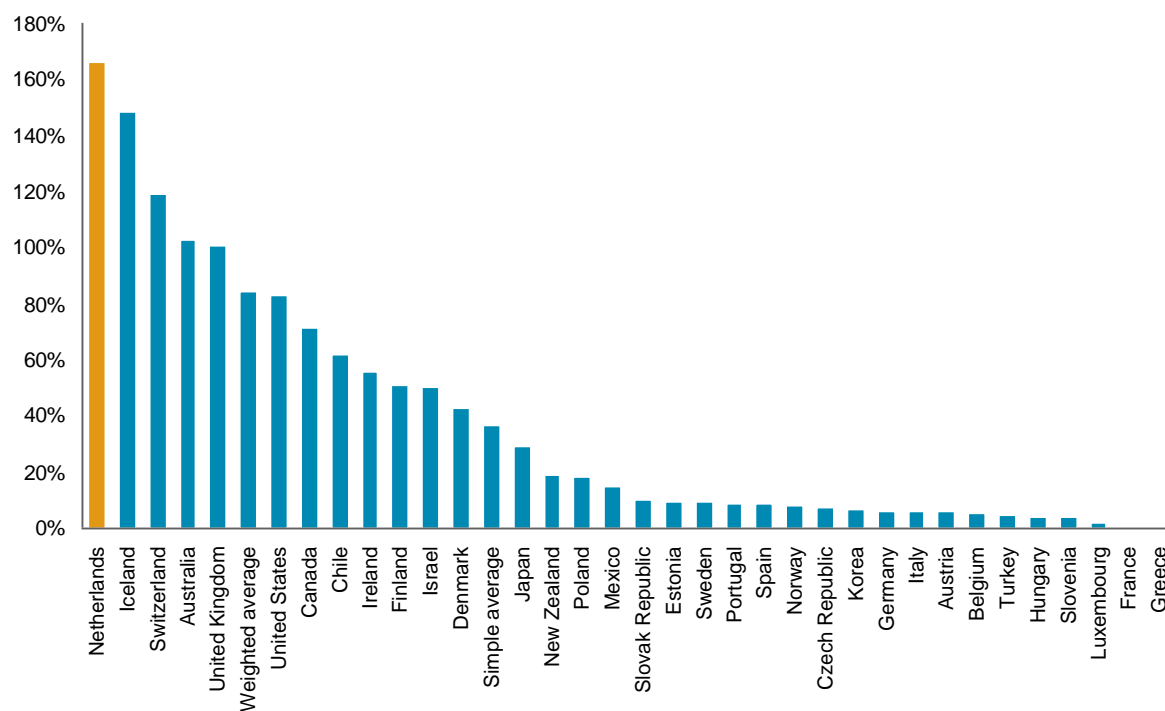
This report focuses on the following topics:

- Is the current downturn in the life insurance industry temporary or permanent?
- What wealth accumulation products will insurers offer in 5 to 10 years and what factors will influence this development?
- How are insurers currently coping with efficiency and how can they improve?
- What are the implications of Solvency II on insurers and what will be the role of the regulator?

1.2. The Dutch life insurance industry

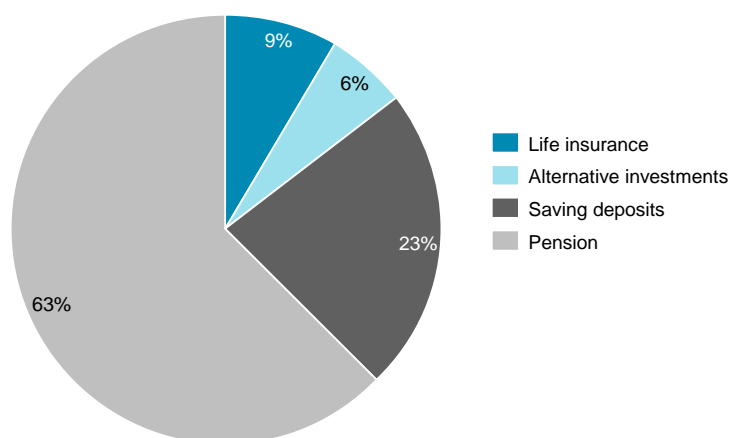
The maturity, complexity and size of the life and pension markets vary greatly around the world. Even within Europe we still see large differences based on cultures, fiscal regimes and economic developments. Historically, pension savings in many developed markets could be divided into three pillars:

- Pillar one: State provided pension schemes
- Pillar two: Employer provided pension schemes
- Pillar three: Additional individual pension products

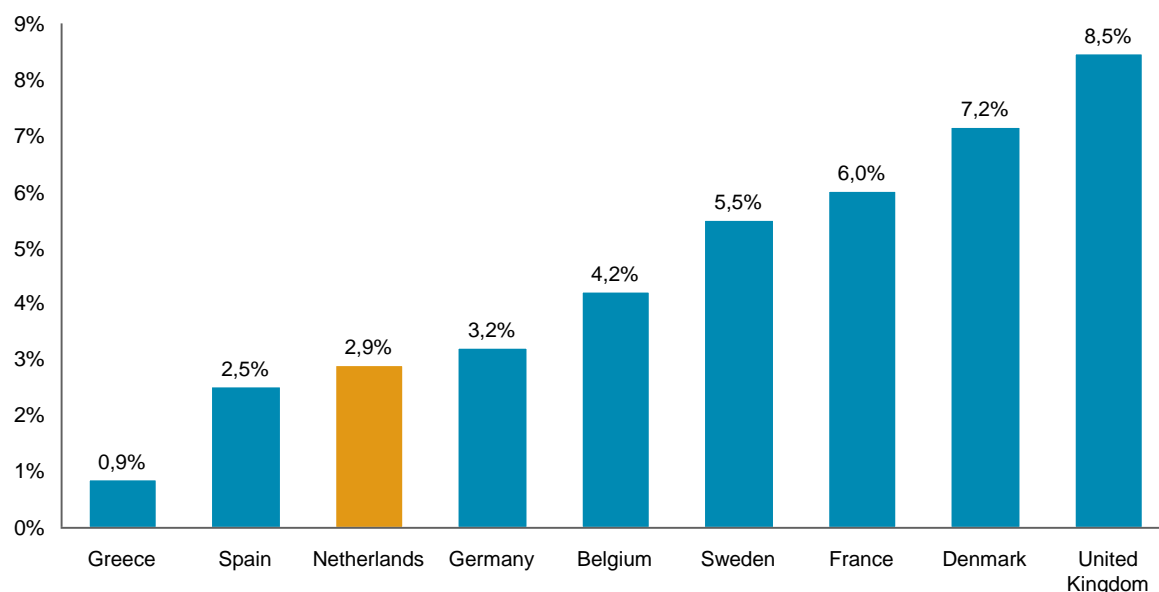
Figure 1: Total pension fund assets per country as percentage of GDP¹

The Netherlands has one of the largest pension savings in the world (see Figure 1), with Dutch households having saved over €1,500 BN (excluding home ownership) as of 2013. The majority of these savings are attributable to pillar two pensions: As seen in Figure 2, this component accounts for 63% of all savings of Dutch households.

¹ Source: OECD library

Figure 2: Saving components of Dutch households in 2013²

Due to the large pillar two savings, the penetration of savings at Dutch life insurers is relatively low compared to other European countries. In the Netherlands, only 2.9% of the Gross Domestic Product (GDP) is spent on life insurance (see Figure 3). This is much lower than, for instance, the United Kingdom (8.5%), Denmark (7.2%) and France (6.0%). It is also worth noting that penetration was much higher in 2008 as Gross Written Premiums (GWP) have declined from €26 BN (2008) to €18 BN (2013).

Figure 3: Penetration life insurance in 2013 (GWP as percentage of GDP)³

Source: AXCO database

² Source: DNB Statistics

³ Axco Insurance Information Services

Roughly to 9% of all household savings is allocated to life insurers. This capital is equal to €150 BN and is being managed and invested by insurers, who employ a total⁴ of more than 50,000 people in the Netherlands.

1.2.1. The function of life insurance in society and the Netherlands in particular

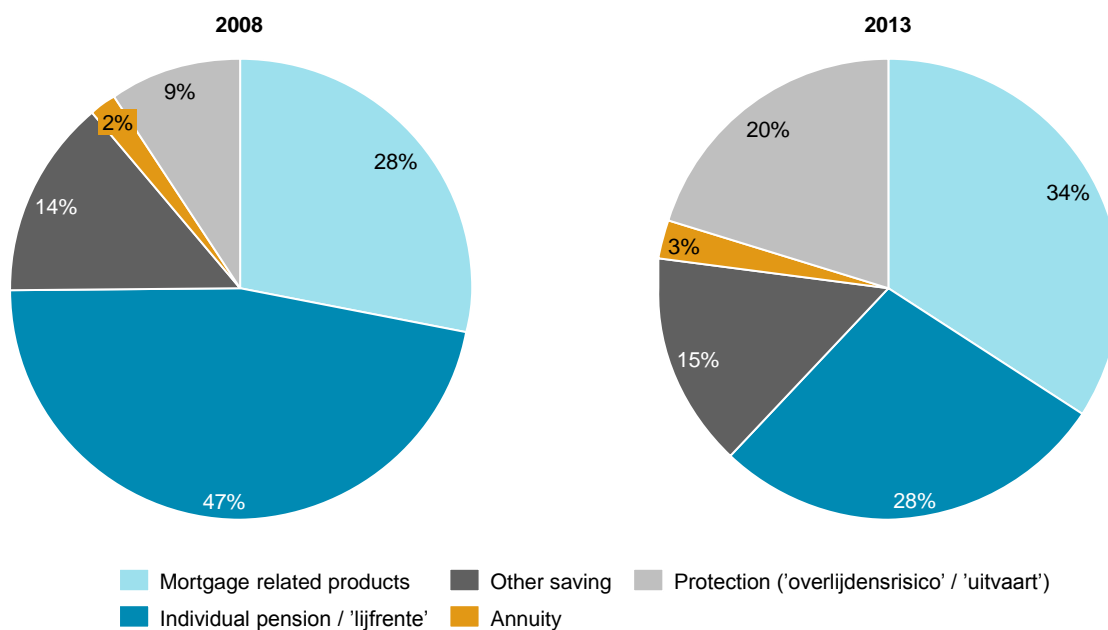
Insurance is one of the oldest financial products in the world. The purpose of insurance is to spread risk amongst a large number of individuals in order to share the financial impact of negative events. Life insurance supports individuals in maintaining a stable financial situation over their lifetime. Current life insurance products provide protection for relatives upon death (term/whole life/funeral insurance), a stable income over a certain period, usually until death (pension and annuities) or a mechanism to save for specific purposes (for instance mortgages).

In the Netherlands, insurance products were not only used for risk sharing. Due to favourable fiscal regulations, insurance products have largely been used to accumulate tax deductible savings. Due to these fiscal benefits, insurance savings products (individual pension and 'lijfrente') showed rapid growth during the 1990s and eventually accounted for 47% of new business in Annual Premium Equivalent (APE)⁵ in 2008.

⁴ Life and Non-life

⁵ APE (Annual Premium Equivalent) value of new regular premiums, plus 10% of any new single premiums written for the fiscal year

Figure 4: New premium distribution of individual life insurance products (% of APE 2006 vs 2013)⁶

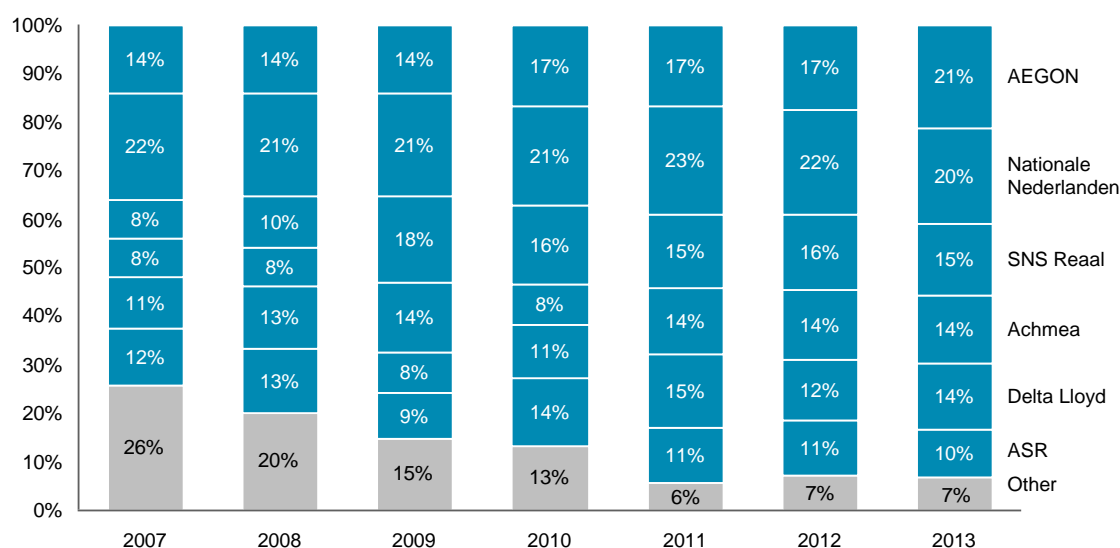


In five years, the total new premiums have decreased from €1.6 BN in 2008 to €0.4 BN in 2013 (APE) and the share of individual savings products has decreased to 28% in 2013. This is partly explained by the increased competition from Banksparen (which have also been included in the fiscally favourable tax regulations since 2008).

1.2.2. Overview of the Dutch life insurance market

The Dutch Life insurance market is currently dominated by six players. Over time, the top six insurers have been able to increase their market share both by a number of acquisitions and organic growth. In 2013 the market consolidated to a level where the big six accounted for 93% of the total premium income (see Figure 5).

⁶ Source: Verbond van Verzekeraars

Figure 5: Dutch Life market share⁷ (% of GWP, 2008–2013)

1.2.3. Long-term characteristics of an insurance business model

The business model of a life insurer is different from other companies. When selling insurance products to clients, an insurer commits to potential future payments for the duration of the contract. Depending on the product, insurance contracts can run from zero to 70 years.

Balance sheet

To account for these long-term obligations, life insurers take expectations of future scenarios into account when writing a product. At the inception of new contracts, these expectations need to be captured accurately to prevent future unforeseen losses or overpriced products. To account for expected future payments to policy holders, insurers hold reserves (technical provisions) on their balance sheet.

Additional to the reservations for expected payments, insurers take the risk of differences between expected scenarios (on market behaviour, mortality rates etc.) and actual future realisation on their balance sheet into account. Due to the large numbers of contracts that insurers hold, most of the risks towards individuals cancel out within the insurance portfolio. However, certain risks remain and insurers have to manage the risks they are exposed to and hold additional capital for unexpected scenarios.

Figure 6 shows a simplified balance sheet of an insurer, where assets are held to cover provisions for expected future payments. Additional risk capital is held for unexpected changes in the market or underwriting results.

⁷ Source: DNB Statistics

Figure 6: Simplified balance sheet of an insurer**Profit and loss statement**

Due to the long-term behaviour of the life insurance business, the annual profit of an insurer does not only depend on the business written in that year, but depends mainly on the business written in previous years. The profit/loss in a certain year is equal to the sum of the technical result on the insurance portfolio, plus the non-technical result on assets not backing technical provisions (investment results on equity).

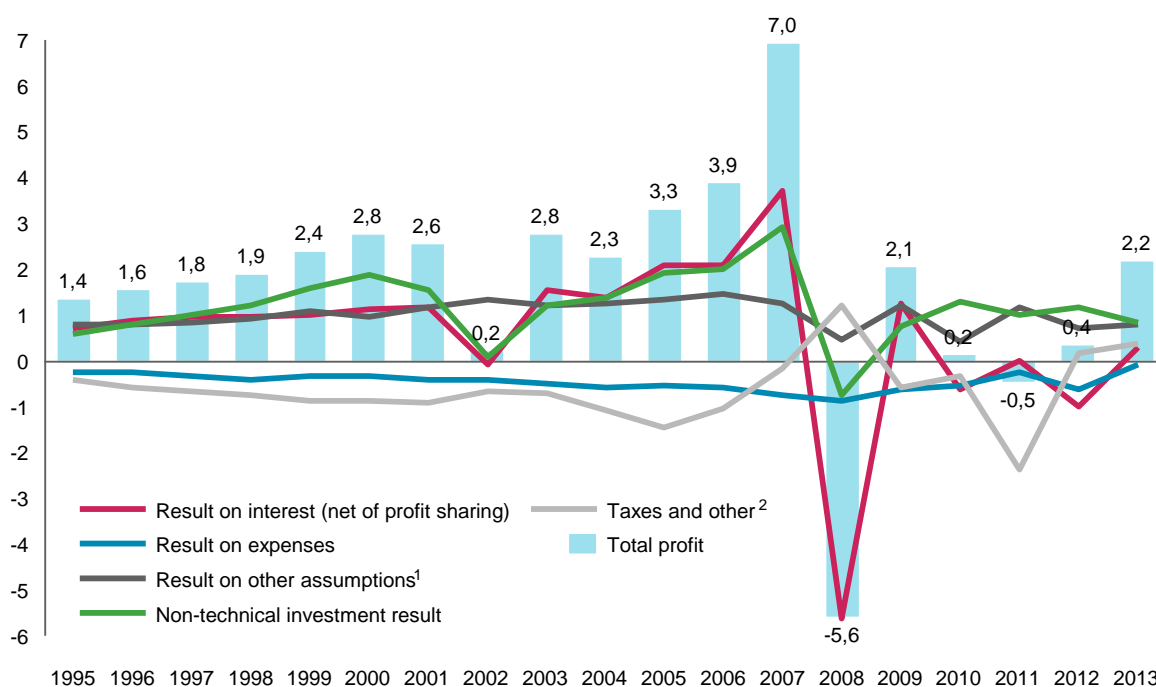
The technical result of an insurance portfolio is the difference between the amount that has been provisioned for (based on expected interest, mortality, expenses, lapse, disability etc.) and the actually realised results. Since the technical result is based on the total insurance portfolio, realised profits/losses in a particular year depend on all in force contracts that have been written up to that specific year. Therefore insurers can write neutral or even loss making business for various years and still report a profit, due to profitable business written in the past.

2. Historic performance

Both market size⁸ and profitability of the Dutch insurance industry have fluctuated over the last 20 years. Figure 7 shows the evolution of profits/losses for the Dutch life insurance market from 1995 to 2013, split by source. The total profit is the sum of technical results (on interest, expenses and other assumptions), non-technical investment results and others (such as tax and changes in non-technical provisions). A comparison of Figure 7 and Figure 8 stresses the difference between profitability and market size. Although profits show an almost continuous growth up to 2007 (with a dip in 2002), Figure 8 shows that premium growth has stagnated as of 2001. Both profits and premium volume have dropped from 2008 and onwards.

The following sections describe the impact of economic, regulatory, fiscal and social changes on historic fluctuations of profitability and premiums. Furthermore, an outlook is given for the next 10 years.

Figure 7: Evolution of profit and loss in the Dutch life insurance segment by source (€BN)⁹

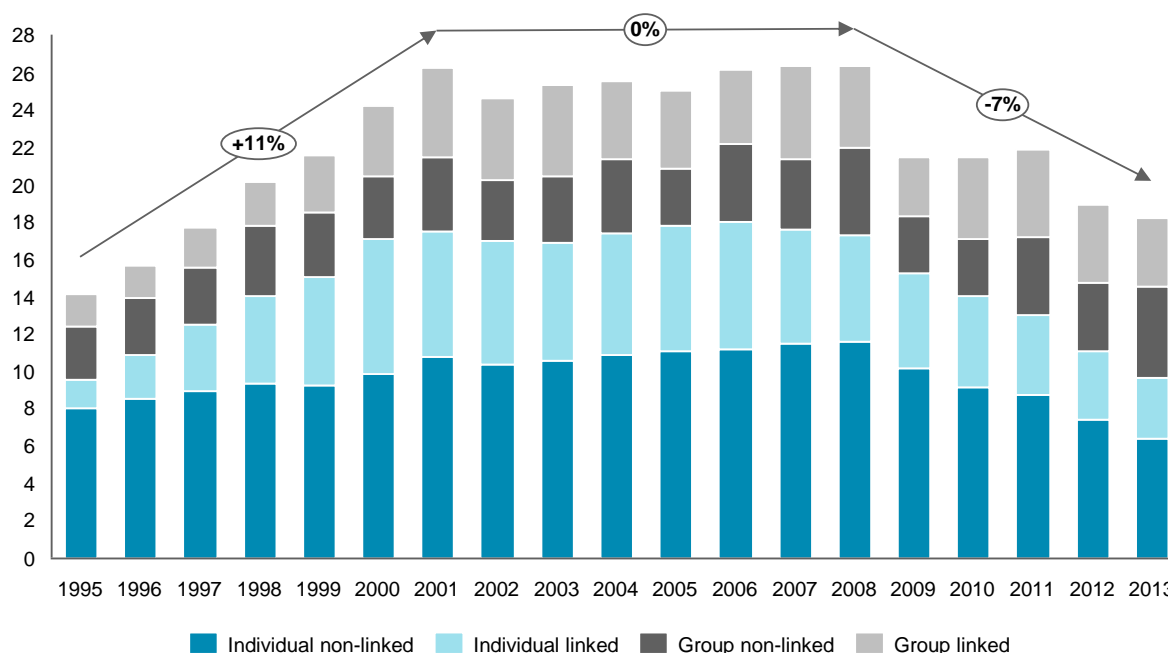


1. Other assumptions: "Kanssystemen" (e.g. mortality/invalidity/evolution of insurance portfolio) and changes in provisions
 2. Other factors: Net of change in other technical provisions, net other technical- and non-technical benefits , closing entry, taxes

⁸ Market size is indicated by the value of gross written premiums per year

⁹ Source: DNB Statistics

Figure 8: Historical development of gross premium income in the Netherlands¹⁰



2.1. Volume driven growth – 1990s to 2000

During the nineties, investment returns were generally both stable and high. In addition, the fiscal regime was favourable for savings with an insurance element. Insurance savings products were also pushed to clients by intermediaries. This push was driven by compensation being based on a percentage of the premium, incentivizing sales of profitable and costly products, rather than providing good advice and transparency to clients. This resulted in a continuous revenue growth of total premium income of 11% per year (compound annual growth rate (CAGR), see Figure 8).

Due to relatively strong investment returns, combined with the fiscal benefits, insurers were able to charge high costs to policy holders while still promising good returns on the investments, assuming that the investment climate remained positive. During this period, the increasing sales of new policies promised long-term income for life insurers. Since the focus was on the revenue side, there was relatively low focus on cost efficiency.

2.2. Stabilisation - 2001 to 2006

After the high growth of the 1990s, the volume of new business decreased. With new legislation in 2001 ('wet inkomstenbelasting 2001'), tax deductibility of life insurance savings products was limited to specific saving purposes (for instance to

¹⁰ Source: DNB, Levensverzekeraars uitgebreide set, 2013

compensate a pillar two pension accrual gap). This led to a significant reduction in premiums invested. The number of contracts generated by the high historic volumes still ensured continuous revenue levels. However, the annual growth of premium income stagnated.

On top of the stagnated growth, the internet crisis negatively impacted returns on unit-linked products, so popularity of these products decreased and new production of unit-linked policies also stagnated.

Profitability of insurers was further impacted by reduced returns on investments. Figure 7 shows that both the result on interest and non-technical returns were around zero in 2002, resulting in a dip in profitability for that year.

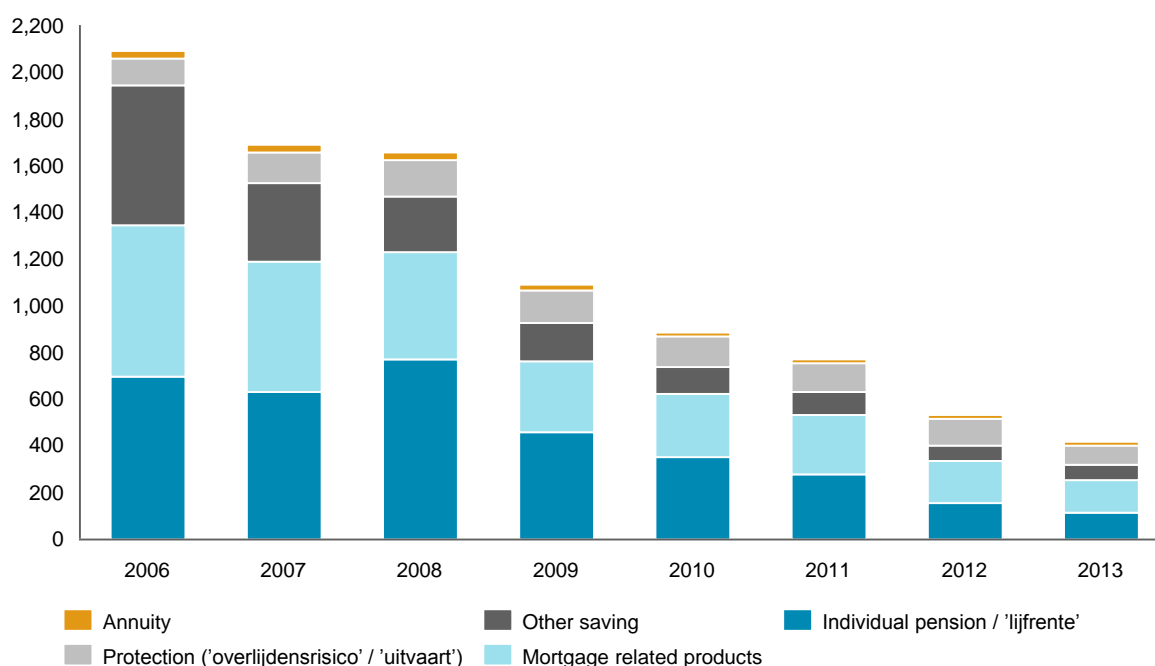
As the trend of reducing fiscal benefits for insurance products continued, additional smaller revenue declines occurred due to abandoning “premie sparen”, “levensloop” and “spaarloon”.

2.3. Fundamental changes in the insurance market – 2006 to 2013

From 2006 the insurance market started to change. Insurers were hit on many fronts:

- Reputation worsened as a result of media attention towards mis-selling of unit-linked products
- Investment returns decreased due to the financial crisis
- Fiscal benefits for insurance savings products were extended to bank savings products
- The start of a significant change in the pension landscape, moving from DB towards DC pension schemes
- New competition for the insurance pension sector was introduced by the premiepensioeninstelling (PPI); entirely based on a DC approach
- The push by intermediaries to sell risky and costly, but profitable products reduced due to a ban on commission
- The increase in life expectancy persisted, putting pressure on insurance mortality results
- The regulatory capital pressure increased due to the introduction of Solvency II

Figure 9 shows the APE of new business from 2006 to 2013 for different product types. The following sub-sections will describe the impact, of the above mentioned changes in the industry, on new business production.

Figure 9: New business APE of individual life insurance per product type¹¹

2006: Media attention towards mis-selling of unit-linked products

Initiated by a report in 2006 from the Authority Financial Markets (AFM) regarding unit-linked saving products, the attention towards the mis-selling of unit-linked products had an immediate impact on the reputation of insurers. For years, insurers have been able to sell policies charging high costs to policyholders in the expectation that returns on investment in the future would make up for these costs. Now that returns were significantly lower than expected, costs have become a substantial part of the accumulated premium payments. Insurers were not only blamed for high cost structures, the main problem was the complexity of the products and their lack of transparency.

After publication of the report, the television program 'Radar' brought the news to the public under the name 'woekerpolis affaire'. Insurers were positioned as greedy and the sale of new unit-linked products dropped by roughly 40% in one year (see Figure 10).

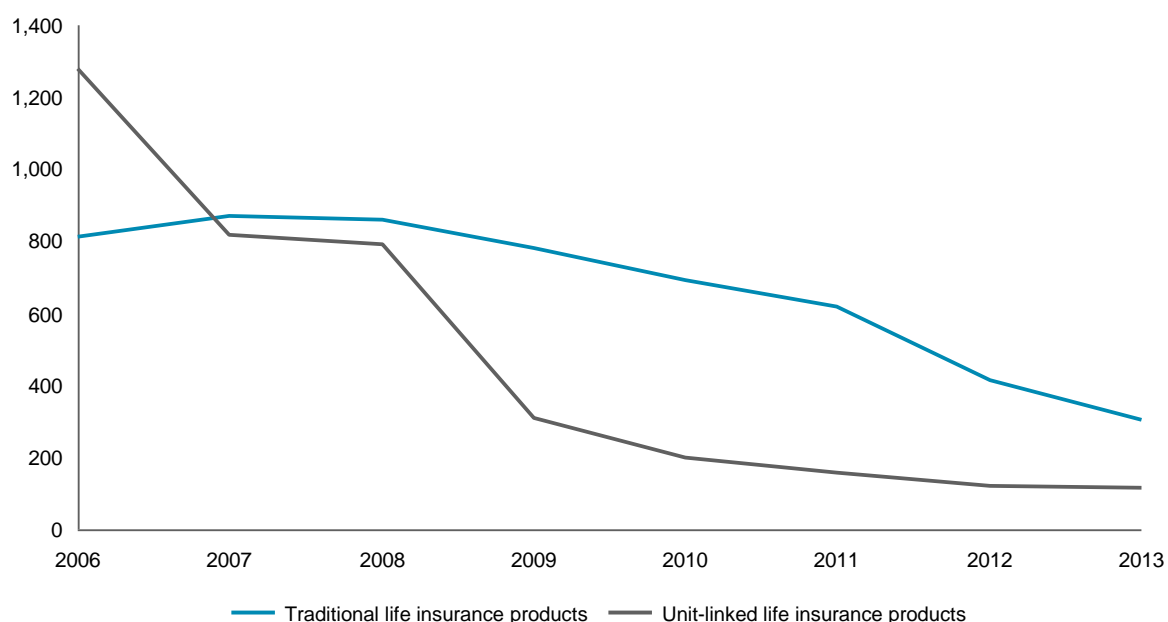
From then on policyholders joined forces through several foundations, demanding compensation for the incurred losses. In 2008 the 'Ombudsman' published a report, concluding that not only insurers but also intermediaries and policyholders were to blame. The 'Ombudsman' stated that 2.5% of accumulated savings (annually) was considered a maximum for a fair costs structure. Following this verdict, insurers started negotiating individually with the foundations, each setting up a separate

¹¹ Source: Verbond van Verzekeraars

compensation scheme that was based on the 2.5%. As pay-out took several years, and, depending on the individual policy, compensation was disappointing for part of the policies.

Due to the individual and slow response by insurance the industry, the reputation of insurers did not improve. The perceived differences between the size and complexity of the problems and the underlying product structures of insurers prevented management of these insurers to initiate an industry solution. Subsequently, there is a continuous threat of new claims against these old portfolios. Lack of mutual trust and the relatively large differences in size of mis-selling portfolios has prevented insurers from joining forces to find a joint solution to this industry-wide issue.

Figure 10: New production of traditional vs unit-linked life insurance policies (APE)¹²



Due to the lack of industry wide solutions combined with continuous media attention, the reputation of life insurers has not yet recovered.

End of 2007: Start of the economic downturn

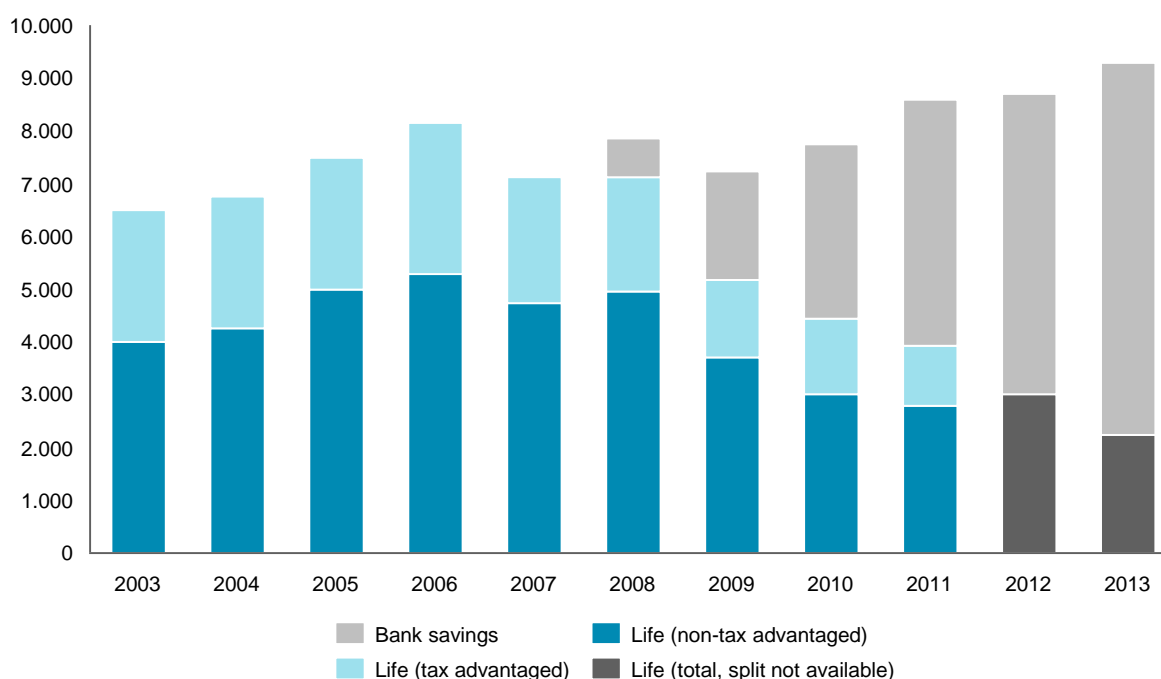
The financial crisis left its mark on profitability across the entire European insurance industry. Low investment returns resulted in a large negative result on interest and other investments (see Figure 7), leaving the Dutch life insurance industry with a total loss of €5.6 BN in 2008. Subsequent low interest rates also negatively impacted the volumes of new business, as offered rates on insurance products were historically low.

¹² Source: Verbond van Verzekeraars

1 January 2008: Introduction of 'Banksparen'

Until 2008, there had not been a focus on cost efficiencies in the insurance industry, as high costs were transferred to policyholders and the beneficial fiscal treatment of these products outweighed these costs. In order to increase competition in the savings market, the Dutch Government decided to extend fiscally friendly savings from insurance products to banking products.

Figure 11: Life insurance and Banksparen annual new business volume 2003 to 2012 (in €MM)¹³



As of 1 January 2008, banks started offering tax friendly pension savings products, directly competing with the insurance savings products.

Traditionally, banks had relatively long-term assets and short funding (liabilities). With new Basel requirements, banks have been in need of longer funding. Banksparen fits this need well. Furthermore banking products do not offer protection on mortality or longevity risk and therefore banks do not have to hold capital for these risks. Therefore banks have been able to offer relatively good rates on Banksparen products compared to those on insurance products.

Combined with lower operational costs and the damaged reputation of insurance products, bank savings products took over a large part of the new insurance business (see Figure 11). Figure 9 shows that as of 2008, insurance pension savings products decreased in size by 85% (measured in new production APE).

¹³ Source: DNB bulletin (estimation), DNB Statistics, CBS

Besides competing with insurance savings products, banks started selling products that offer a constant payment for a fixed period, directly competing with the annuity products at insurers (that offer a lifelong payment), leaving term ('overlijdensrisico') insurance as the only individual life insurance product that does not suffer from competition from banking products.

1 January 2011: introduction of the PPI

As of 1 January 2011, Dutch regulations allow a new vehicle to execute DC pension schemes: The PPI. The PPI introduces new competition to insurers for their DC pension contracts. So far PPI's have not gained significant market share.

1 January 2013: Introduction ban on commission

Following the mis-selling of unit-linked products, a ban on payment of commissions was imposed on new sales of life insurance products in the Netherlands. As a result, there is less drive by intermediaries to sell high margin products. The effect of the removal of this previous sales-push of life savings products is expected to have a significant impact on life insurers' distribution model for individual life products.

However, the impact on the group pension market is expected to be limited as these customers are less price-sensitive and more willing to pay for advice.

Implementation of Solvency II

The introduction of Solvency II regulations in 2016 has already influenced the European insurance industry. Insurers have been preparing for future reporting and governance requirements. Furthermore, Solvency II regulations make guarantees in insurance products capital intensive. In addition, risk based capital requirements put pressure on investment returns, as risky assets require more capital that cannot be used for other investment returns.

2.4. First response of the insurance industry towards recent changes

As described above, many factors have changed in the last few years, impacting the business of the life insurance industry. Some changes came suddenly (reputational damage, economic downturn), whilst others were announced upfront (Banksparen, PPI, ban on commission and Solvency II). Insurers have taken some initial steps to counter these adverse changes, including:

Banksparen

In order to retain customers and to maintain volumes in their assets under management, most life insurers have started a bank that offers banking products. However, margins on these products have been relatively low and market penetration is still limited.

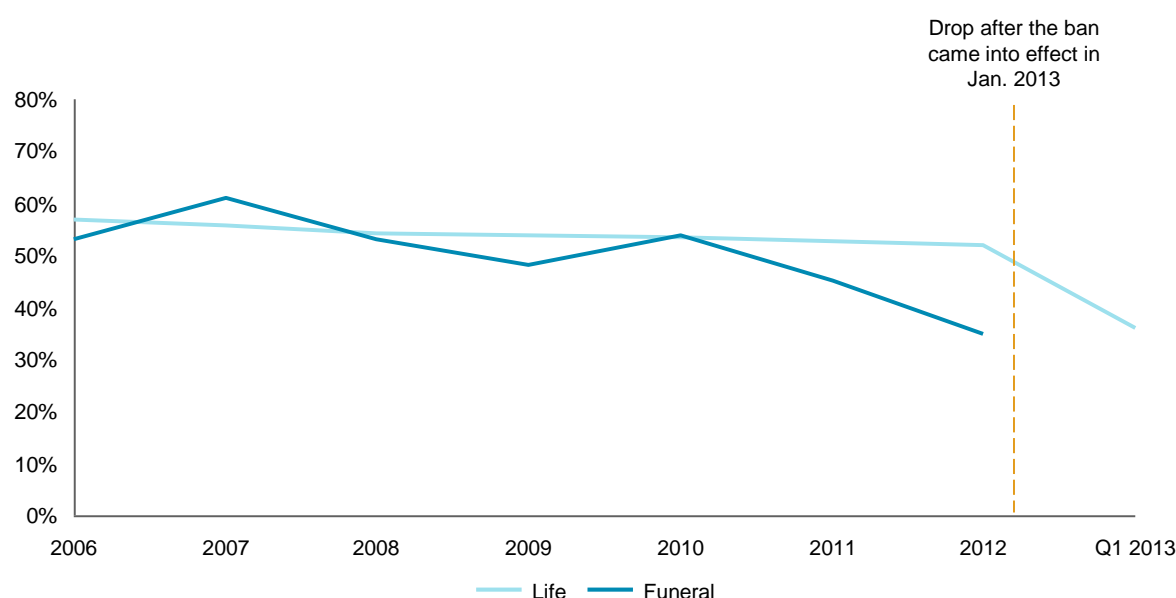
Ban on commission

The ban on commission has resulted in a decrease in the share of intermediaries in new business. Insurers have prepared for this by investing in direct channels (see Figure 12). Furthermore, the market share of insurance comparison websites that directly sell insurance products has increased.

Introduction of the PPI

Since the introduction of the PPI's, most insurers have started a PPI themselves or have started an alliance with a PPI. By doing so, insurers aim to maintain their market share in the DC pension scheme market.

Figure 12: Share of Life market premiums captured by intermediaries (as a % of premiums sold)¹⁴



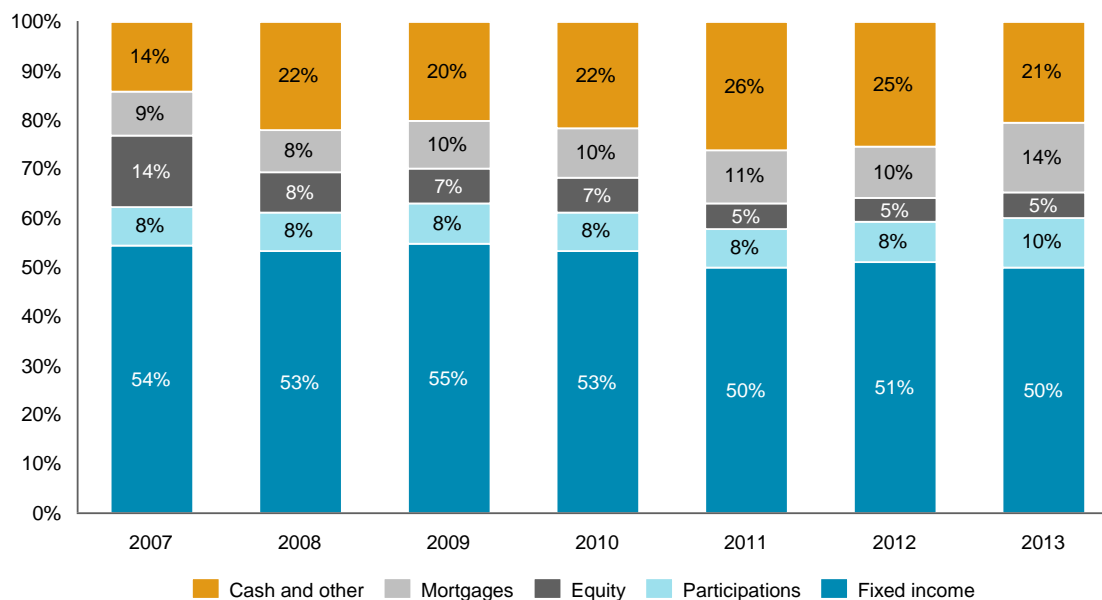
Solvency II

The introduction of Solvency II has forced insurers to steer on risk based capital and a market value balance sheet. As a result, insurers have decreased the sale of capital expensive annuities and insurance savings products with guarantees.

On the asset side of the balance sheet, insurers have reduced exposure to equity investments and increased the ratio of fixed income based investments. In particular, the share of mortgages has increased significantly resulting from capital favourable treatment under Solvency II.

¹⁴ Personal advisors are considered intermediaries; Internet, telephone & via post are considered direct channels.
Source: GfK TOF Tracker 2006–2013

Figure 13: Evolution of investment mix (excluding investments for risk of policyholder) of Dutch insurers over time¹⁵



Furthermore, insurers have increased their natural hedge against changes in interest rates by matching asset and liability cash flows (either by acquiring long-term fixed income or by acquiring interest rate swaps).

¹⁵ Source: DNB Statistics

3. Current climate

Insurers are still facing difficult times. With the historically low interest rates (see Figure 14), insurers are unable to offer clients good returns on their savings. The tax advantage of insurance products compared to bank savings products has been taken away. Therefore, charges for expenses and for capital are becoming increasingly important in the competition with bank savings products.

Figure 14: Evolution of the 10 year Eurozone government bond rate over time (%)¹⁶



Solvency II brings a new regulatory burden and introduces higher capital requirements on insurance products that offer guarantees, making it increasingly difficult to compete with the already favourable banking products.

With the decrease in sale of insurance savings and annuity products, insurers aim to maintain volume by focusing on the individual term and pension markets. The excess in supply of these products has put pressure on their profitability. As recently written business is still a relatively small percentage of the total portfolio, current profits are still relatively good. However, the profitable business will runoff and the new business will impact future profits more and more.

Changes in the pension landscape

As of 1 January 2015, fiscal regulations regarding pillar two pensions have been restricted. Tax-free contributions from employers will be reduced from 2.25% to 1.875%¹⁷ of the pensionable base (gross salary minus offset). This is primarily driven by the fact that eligible retirement age has been raised from 65 to 67 (as of 2010).

¹⁶ Source: DNB Statistics

¹⁷ Maximum tax free premium paid based on percentage of pensionable base (capped salary minus offset) that will be paid from retirement until death

Furthermore, the pensionable salary cap has been lowered from €162 K to €100 K. Both reductions will put further pressure on the insurance premium income of the pension business.

Besides the PPI, that allows execution of DC pension schemes, the government is discussing the possibility to allow new vehicles to execute DB pension schemes (API or APF). Traditionally, most DB schemes were executed by pension funds. With the reduction of the number of funds, this was a natural area of growth for insurers. The introduction of APIs/APFs could negatively impact this new premium inflow as new competitors will potentially take up market share.

Volatility of balance sheet and profit and loss

Solvency II will be effective as of 1 January 2016. Furthermore, new standards for accounting insurance contracts (IFRS 4 phase II) are in development and will potentially be effective as of 1 January 2018 (the precise date is still uncertain). Besides an additional burden of new changes to reporting standards, both regulations step away from the book value approach and will therefore likely increase volatility of the balance sheet and profit and loss (P&L) statement (for IFRS 4 phase II).

Since insurers will also be exposed to market fluctuations in their balance sheet and P&L, solid asset and liability management will play an increasingly important role in reporting stable figures to investors.

4. Future scenarios

As described in chapter 0 and 3, insurers are facing difficult times. This chapter describes how these changes will potentially impact the future of life insurance. By analysing the individual life and pension products, we can then evaluate the size of the insurance book based on assumptions around new business and the runoff period of the current book. This enables us to explore future scenarios for the insurance industry.

4.1. Individual life product analysis

This section investigates the future of individual life products currently being offered by insurers. The products are split into savings, mortgages, annuities and protection.

Traditional and unit-linked savings products

Savings insurance products include individual pension, 'lijfrente' and other savings products:

- Individual pension and old age endowment products with an annuity clause ('lijfrente') benefit from tax deductions in the saving period. At the end of that period, the saved amount has to be used to buy a fixed income product such as an annuity. The fixed income is then taxed but since these payments are at retirement, the tax rate is typically lower.
- Other savings products include those with a benefit payment at the end of the saving period and potentially a benefit payment in case of death before contract termination.

Insurance savings products have benefitted heavily from favourable tax treatments. With the introduction of Banksparen, policyholders now have an alternative for these saving purposes. The only difference is that Banksparen cannot offer the term insurance component. However if needed (for instance in relation with mortgages), this term insurance component can be bought separately.

Currently, policyholders prefer bank savings products over insurance savings products (see Figure 11). As insurers do not have much extra to offer compared to bank savings products, we expect this trend to remain. Current individual life savings products are expected to (almost fully) disappear (see Figure 15).

Mortgage related products

Traditionally, mortgage endowments were used to save money to pay off mortgages. By saving in an endowment instead of paying off the actual mortgage, policyholders benefitted from the tax deductibility in the Netherlands for mortgage interest payments. Recently, the regulator has classified the products as not being fit for purpose. Therefore new insurance savings policies linked to mortgages are not being sold anymore. However, the term component that is frequently linked to a mortgage cannot be replaced by other products. We therefore expect the sale of these term products to continue.

Annuities

Annuities provide a fixed income over a certain period. In most cases a lump sum is paid upfront by the policyholder (often released from a pension or endowment savings product). Insurance annuities can provide lifelong payments that stop when the policyholder dies.

Bank products that pay out over a certain period have become increasingly competitive with insurance annuities. Since banks are not exposed to insurance risk, banks do not have to hold capital for this where insurers do. However, banks cannot offer a lifelong payment. Payments are set for a fixed period. If the policyholder dies earlier, the remaining money is transferred to the policyholder beneficiaries. If the policyholder lives longer than the contract period, no more payments are received.

Despite this difference in product characteristics, the insurance annuity market has decreased significantly (see Figure 9). Since there is a fundamental difference between the insurance and banking product, we expect the decrease to slow down and to stabilise in the coming two years (see Figure 15).

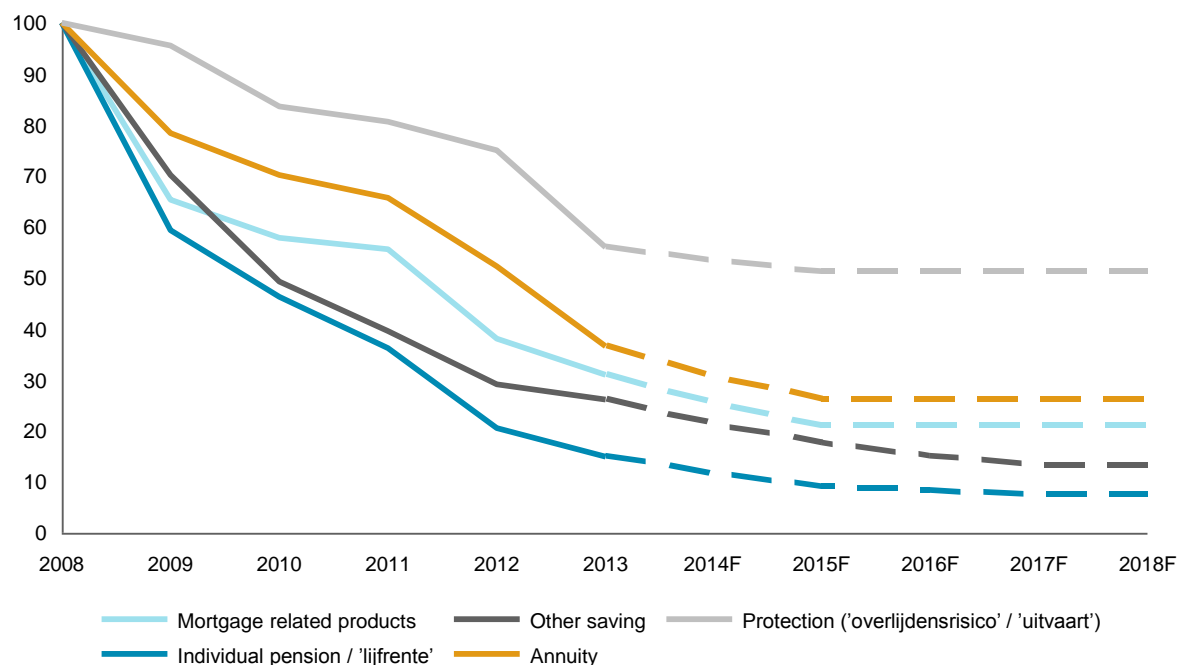
Protection

There are several products that protect survivors at death of the policyholder:

- Term insurance is a fixed premium contract for a fixed period. The premium is used to cover the risk that the policyholder dies within the contract period. If the policyholder dies within the contract period, a predetermined benefit is paid out to the survivor.
- Whole life insurance is a fixed premium contract for a fixed period. Part of the premium is used to cover the risk that the policyholder dies within the contract period; another part of the premium is used to save for after the contract period. If the policyholder dies within or after the contract period, a predetermined benefit is paid out to the survivor.
- Funeral insurance works similarly to whole life insurance. The difference being that the benefit paid upon death is used to pay for the funeral.

Banks cannot offer these product types and the need for these products has not fundamentally changed. Therefore, besides fluctuations, protection products have decreased less than savings and annuity products over the last seven years (see Figure 9). We expect new business to be relatively stable for the coming years (see Figure 15).

Figure 15: New business APE of individual life insurance products (indexed 2006 = 100), actual (2006-2013) and forecast (2014-2018)¹⁸



4.2. Pension product analysis

The Dutch pension market is both sizeable and mature, as participation in pension plans is mandatory for most sectors and professions. Historically, companies either run their pension at an industry pension fund, company pension fund, occupational pension fund or an insurer. Since 2011, companies can also choose for a PPI for DC pension schemes.

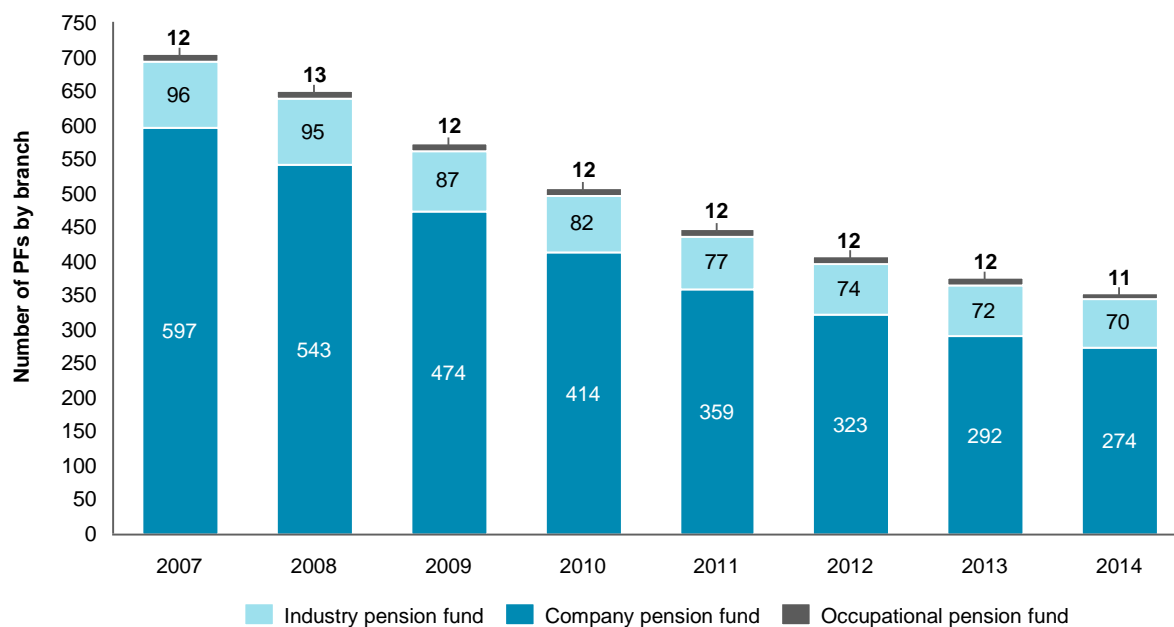
Over 90% of employees have a collective pension scheme with their employer and three-quarters of all employees participate in an industry-wide pension fund. Pension insurers typically provide services to SMEs, which tend to have limited access to large pension funds.

Consolidation of the pension market

Over the last decade there has been a consolidation amongst pension funds (see Figure 16). Cost efficiency has become the prime focus of pension funds, leading to consolidation or liquidation of many smaller sized funds. Life insurers benefit from the consolidation of pension funds as, in the case of liquidation, liabilities are sometimes transferred to pension insurers. Due to this, premiums for pension insurers have proven volatile over the past few years (see Figure 17).

¹⁸ Source: Verbond van Verzekeraars, Oliver Wyman analysis

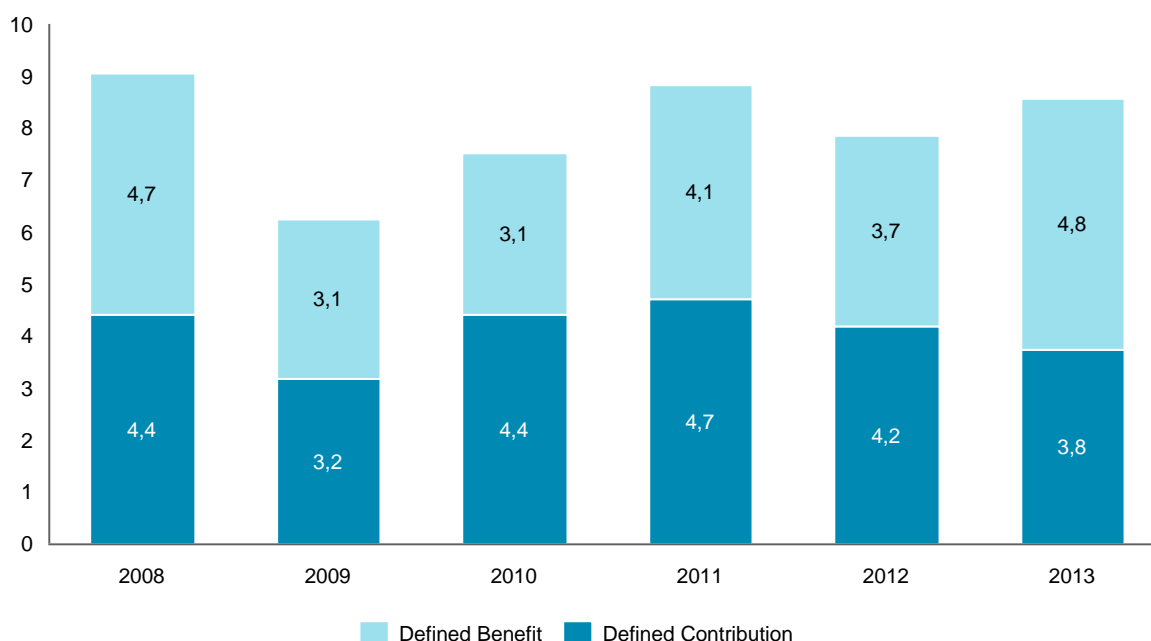
Figure 16: Consolidation in the Dutch pension fund market from (number of pension funds)¹⁹



The Dutch supervisor recently addressed 60 Dutch pension funds and encouraged them to think about their future with regard to their cost structure and their decrease in number of active participants. This could lead to a number of future liquidations of pension funds.

However, with current low interest rates, pension funds generally have low funding ratios. In order to transfer liabilities from a liquidating fund, the fund has to transfer a sufficient amount of assets to an insurer. With a low funding ratio this is difficult. However, it is still possible to transfer the liabilities to another pension fund as long as the outlook of the new pension fund is not worse than that of the liquidating fund. This will limit new premium inflow to insurance companies due to new liquidations of pension funds.

¹⁹ Data for 2014 is Q3; all other data points are Q4. Source: DNB Statistics

Figure 17: Historic pension insurance premiums (€BN)²⁰

Changes in pillar two pension regulations

Recently there have been two regulatory changes that impact the pillar two pension market: The ban on commission for intermediaries and the changes in the fiscal regime for pension saving.

The commission ban is expected to have limited impact on the pension market, since there are limited substitute products that could constitute an alternative. For group contracts, advisory costs are a relatively small percentage of total annual premiums (since these usually regard a large number of employees). Therefore the introduction of fee-based advice will not be too significant.

The reduction of the pillar two pension accrual rate from 2.250% to 1.875% (for average-pay pension schemes) will adversely affect premium inflows for the pension industry. All current pension schemes that are above the new limits will have to be reduced. However, from the schemes that are above the new accrual limit, many companies have lowered the offset of the pensionable base to compensate for the reduction in accrual rate. We therefore expect a limited negative impact due to this regulation change on future GWP (between 0% and -10%).

Impact on low interest rate on future premiums for Defined Benefit pension

Pension contracts typically have a term of five years. After this period the contract premiums will be renegotiated. Most old DB contracts are still based on a 3% or 4%

²⁰ Source: DNB Statistics

interest rate. Contracts that have been closed in the last two years are usually based on an interest rate of 2%. With current low interest rates (see Figure 14) the rates offered for new pension contracts are typically around 1.5%. With an average duration of new premiums of around 30 years, this change will increase premium payments of DB contracts between 30% and 50%. DC contracts remain unaffected. Note that this assumption is highly dependent on the future interest rate.

4.3. Forecast future premiums

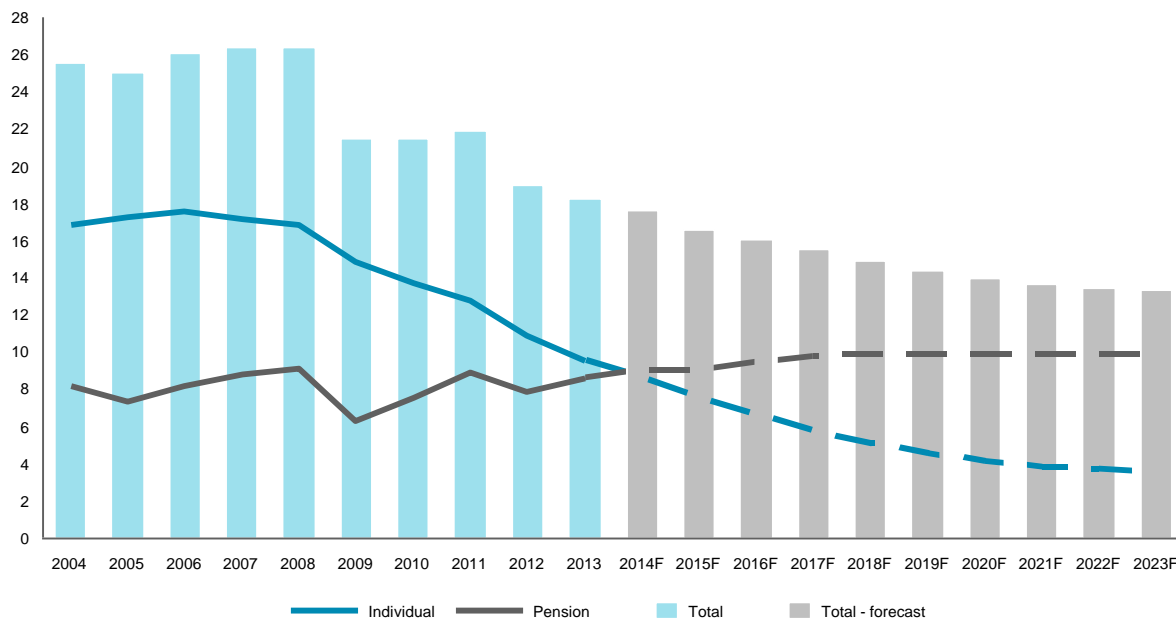
Based on the analysis in sections 4.1 and 4.2, we have forecasted future new and existing premiums. Figure 18 shows the historic and forecasted premiums of individual life and pension insurance.

Individual life is expected to continue to reduce and flatten over the coming 10 years, reaching a new steady state that mainly consists of protection and some annuity insurance.

Pension premiums are expected to increase due to renegotiation of new DB pension contracts at lower interest rates. This impact is partly offset by changes in new pension regulations as of 2015. Premium inflow due to liquidation of pension funds is assumed to remain equal to that of 2013.

Note that this estimation is highly dependent on actual changes in future interest rates, realised inflow due to pension fund liquidations and actual sale of individual life insurance policies. The outlook does not take into account the impact of changes in composition of the population, new regulatory changes and changes in the supply of new life insurance products.

Figure 18: GWP individual life and pension (€BN), actual (2004-2013) and forecast²¹



4.4. Forecast individual life balance sheet

Based on premium income and ‘typical’ runoff of the different insurance products, Figure 19 shows the forecasted development of the technical provisions of the total insurance industry. The chart shows that the loss in technical provisions in individual life is largely compensated by an increase in technical provisions for pension insurance.

²¹ Source: Verbond van Verzekeraars, DNB Statistics, Oliver Wyman analysis

Figure 19: Technical provisions individual life and pension (€BN), actual (2007-2013) and forecast (2014-2023)²²

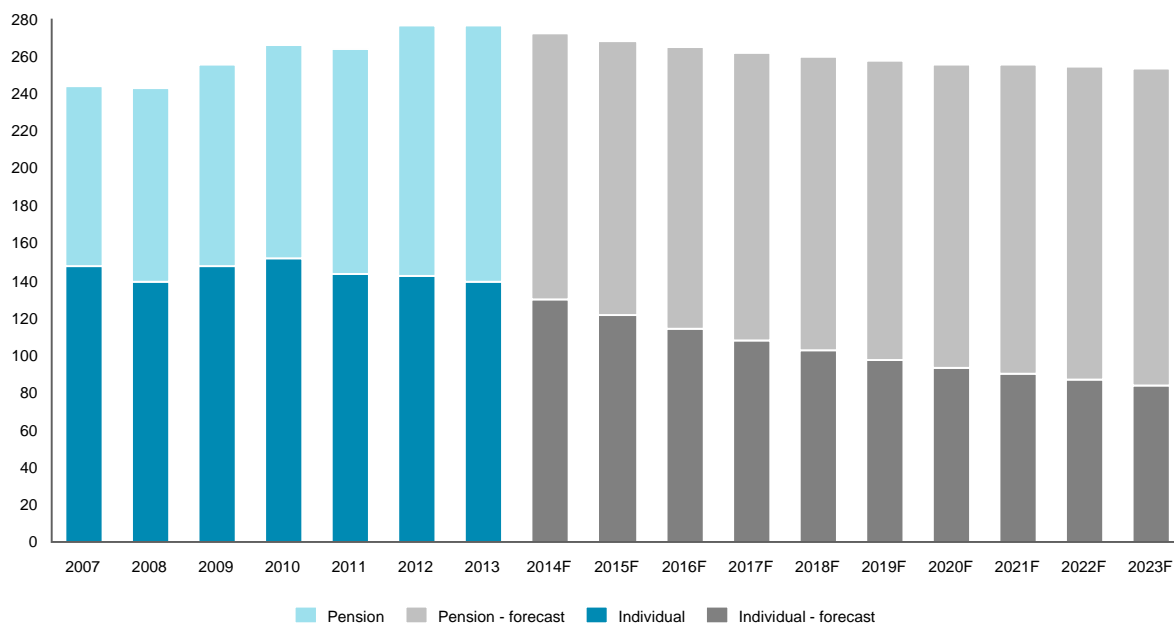
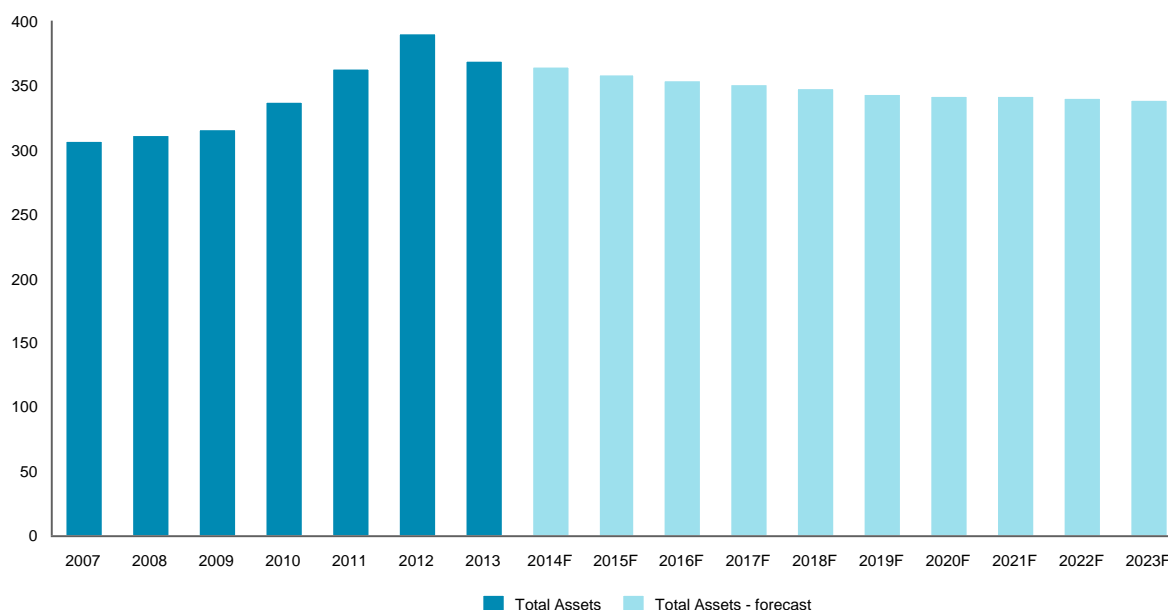


Figure 20 shows the forecast of the combined assets of all Dutch life insurers based on a fixed ratio between technical provisions and total assets as of 2013. Note that the small outlier in the curve in 2012 is mainly attributable to a change in the revaluation reserve for Nationale Nederlanden. This reserve was back to 'normal level' in 2013. The figure shows that after the maximum combined assets of €370 BN in 2012, the balance sheet will slowly decline but will remain above pre-2010 levels.

²² Source: Verbond van Verzekeraars, DNB Statistics, Oliver Wyman analysis

Figure 20: Total assets life insurance entities (€BN), actual (2006-2013) and forecast (2014-2023)²³



4.5. Analysis of future profitability

Figure 15 shows that new business for individual life savings and annuity products have decreased drastically. In order to maintain size, insurers have shifted focus to individual protection products. Together with the low interest rate environment, this has put severe pressure on the profitability of new business.

The annual profit that an insurer reports is the sum of technical and non-technical results. The non-technical result is the return on assets that are not backing insurance liabilities and depend on the economic climate. The technical result is the result on the insurance book.

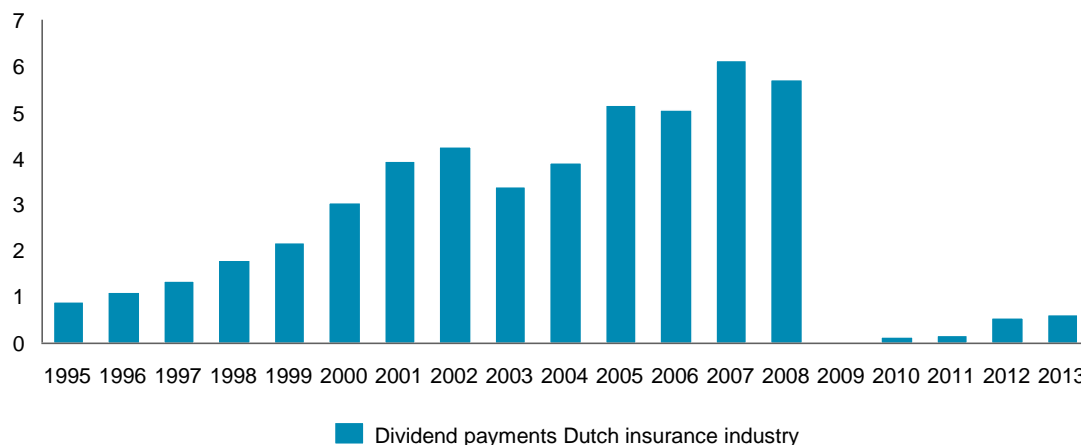
Although the insurance industry is still a profitable business, technical results on interest, mortality and lapse have been decreasing since 2007. This negative trend is partly offset by a decrease in result on expenses (see Figure 7). With historic profitability running off and new business with neutral profitability flowing in, the technical result on the insurance books is expected to decrease further in the coming years.

On top of this decrease in technical result, insurers still face the risk of future claims regarding the mis-selling of unit-linked products. These potential claims could put additional pressure on future profitability.

²³ Source: Verbond van Verzekeraars, DNB Statistics, Oliver Wyman analysis

Figure 21 shows that dividend payments have decreased significantly since 2007. As the profitability of the life insurance industry is not expected to improve, dividends are expected to remain low.

Figure 21: Evolution of dividend payments of Dutch insurers (€BN)²⁴



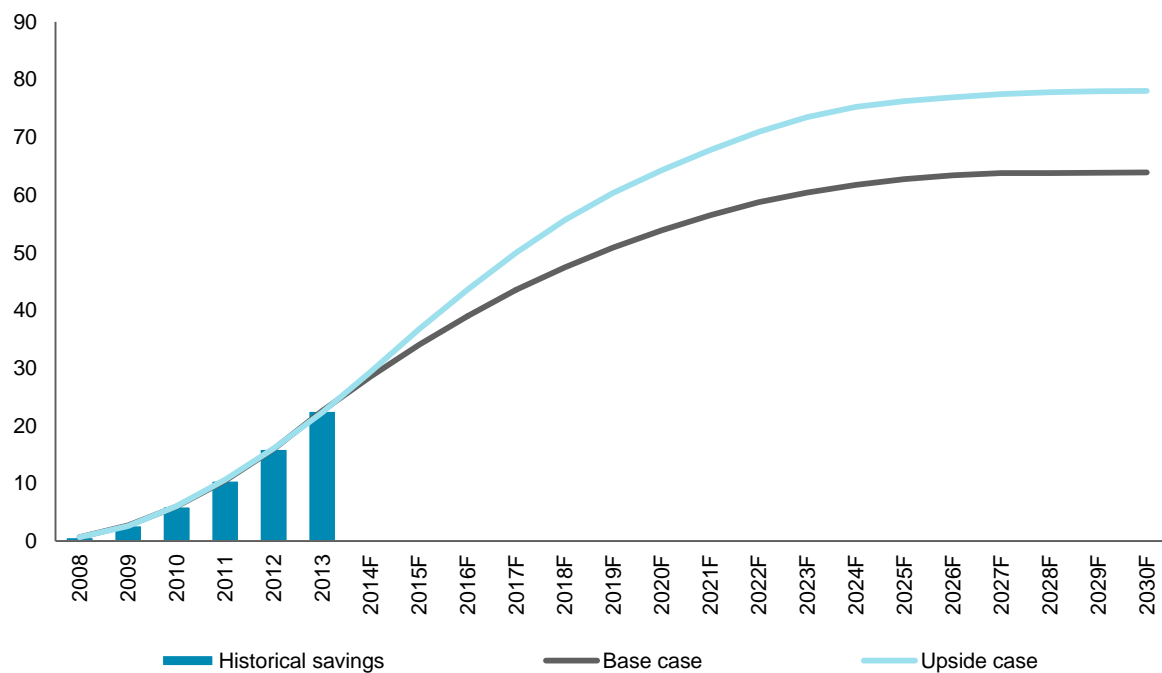
4.6. Future of Banksparen

In order to compensate for the loss of new individual life production, most insurers successfully started a bank that offers Banksparen products. Figure 11 shows that the market share of Banksparen has grown rapidly; in 2013 Banksparen covered more than 75% of new business.

Assuming an average contract duration of 10 years, Figure 22 shows that Banksparen will accumulate to total savings of somewhere between €60 and €80 BN. Currently banks that are part of an insurance group have an approximate market share of 35%, which is not enough to cover for the loss of volume. Furthermore Banksparen has a relatively low profitability, and depends heavily on the interest spread realised. Most fixed rates offered are close to or exceeding market risk free rates. As no additional costs are charged, profit consists of realised return over paid interest. Therefore, low costs (and hence volume) are vital for the profitability of Banksparen products.

²⁴ Source: CBS StatLine

Figure 22: Banksparen total savings outlook (€BN), estimate (2008-2013) and forecast (2014-2030)²⁵



²⁵ Source: DNB estimation, Oliver Wyman analysis

4.7. Potential next steps for product innovation

It is clear that the historic market conditions will not return in the next few years. This is due to the fact that current consumer trust and interest rates are low. Furthermore, investment returns on stock markets are volatile. We expect consumers to remain cautious when investing their money. Currently Banksparen is the only saving product consumers are willing to buy. Government policies for pensions and therefore individual savings pensions are still under scrutiny. There is as yet no stability from which both consumers and insurers can draw comfort to start buying insurance products again.

Based on the analysis of this report, new business in insurance based products will be very limited. Continued growth is expected in Banksparen, but this is a low margin business.

For pension savings, the current tendency is to be very cautious and straightforward and use Banksparen like solutions. However, as we have significant demographic changes and growing financial literacy, new transparent and ethical insurance products could find their way to consumers again. Solutions for old-age income and healthcare financed by illiquid consumer resources (i.e. financial reserves in-houses) can potentially find its way to the consumer, opening up new opportunities for insurance companies.

Furthermore, modern consumers, supported by comparison sites that are gaining (distribution) ground very rapidly, demand simple and transparent products. Benefits and conditions need to be modular and costs transparent to survive in the current market. Insurers will have to continue to invest resources to ensure that products fit the current demand. If insurance products do not show up in the correct comparison lists, then these products will quickly disappear from the market.

Special attention should be paid to social media. Obtaining references from peers is another important dimension of the sales process, which will only gain importance. Various research reports have shown that advice from peers is very important and perceived to be an at least as reliable source of information as professional advice when consumers make their buying decisions.

5. Efficiency of Dutch insurers

Historically, insurers have been making losses on their technical result on expenses (see Figure 23). Until 2008, these losses were easily made up for by investment results and results on mortality (see Figure 7). With current low interest rates, increasing longevity and reduced profit margin on new production, the necessity for efficiency has increased. Figure 23 shows that as of 2008 insurers have put more focus on efficiency. This effort has resulted in a reduction in the annual technical loss on expenses of €784 MM.

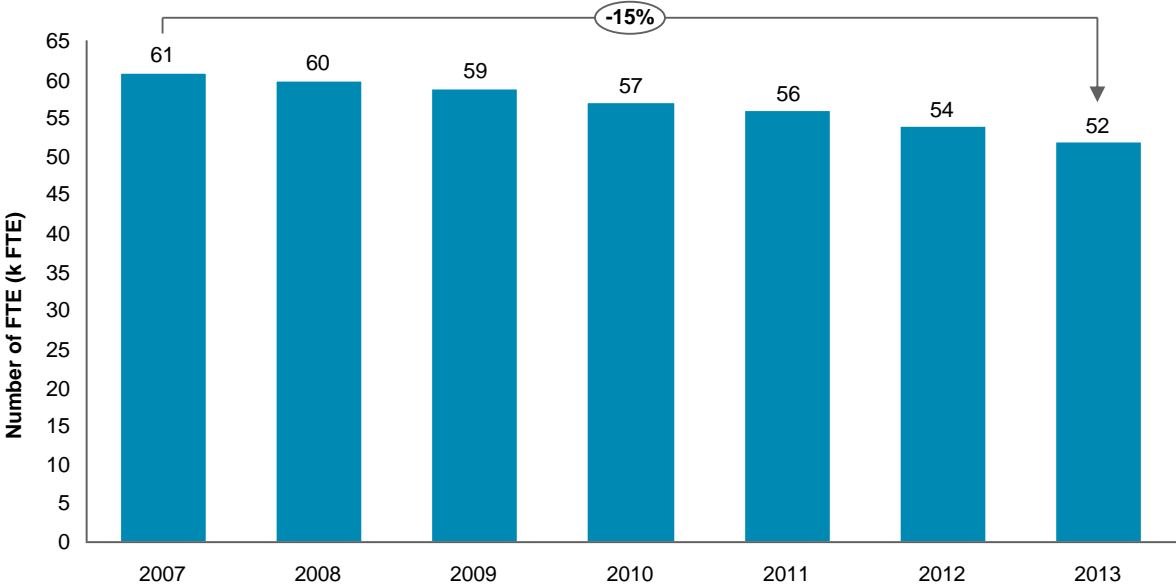
Figure 23: Result on expenses Dutch life insurers (€MM)²⁶



This trend is confirmed when looking at the number of FTE working in the insurance industry (including non-life and health, see Figure 24). As of 2007, the number of Full Time Equivalent (FTE) went down by 15%. With non-life and health business remaining relative stable over the last few years, most of the reductions are due to FTE reductions in the life insurance entities.

²⁶ Source: DNB Statistics

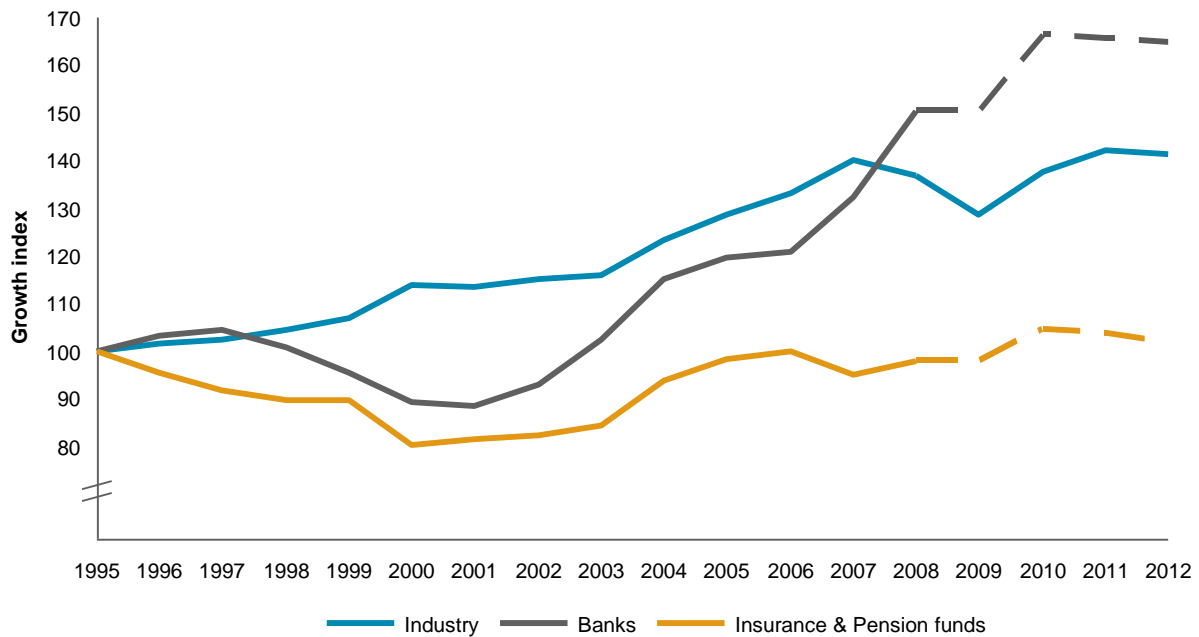
Figure 24: Total FTE for Dutch insurance industry (x 1000 FTE)²⁷



When looking at the productivity of insurance, Figure 25 shows that insurance and pension funds are lower when compared to banking and other industries. Since the insurance industry focused on volume, efficiency has dropped from the 1990s onwards. When new business volumes stabilised from 2001, productivity increased slightly. However, improvement in efficiency has lagged behind that of banks and other industries.

²⁷ Source: Verbond van Verzekeraars

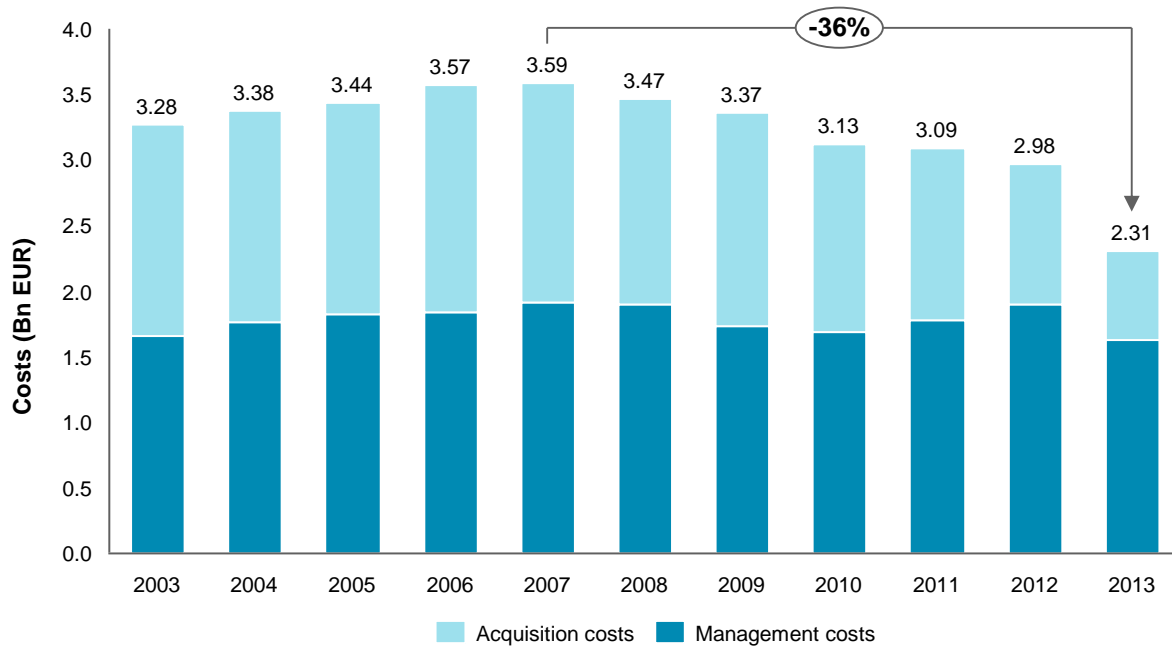
Figure 25: Comparison of multifactor productivity by industry (indexed 1995 = 100)²⁸



5.1. Historic acquisition and management expenses

Expenses can be split into two categories: Acquisition costs and management expenses. Figure 26 shows the evolution of expenses at insurers between 2007 and 2013. Over this period, insurers have managed to reduce expenses by 36%. This reduction is mainly attributable to the reduction in acquisition expenses.

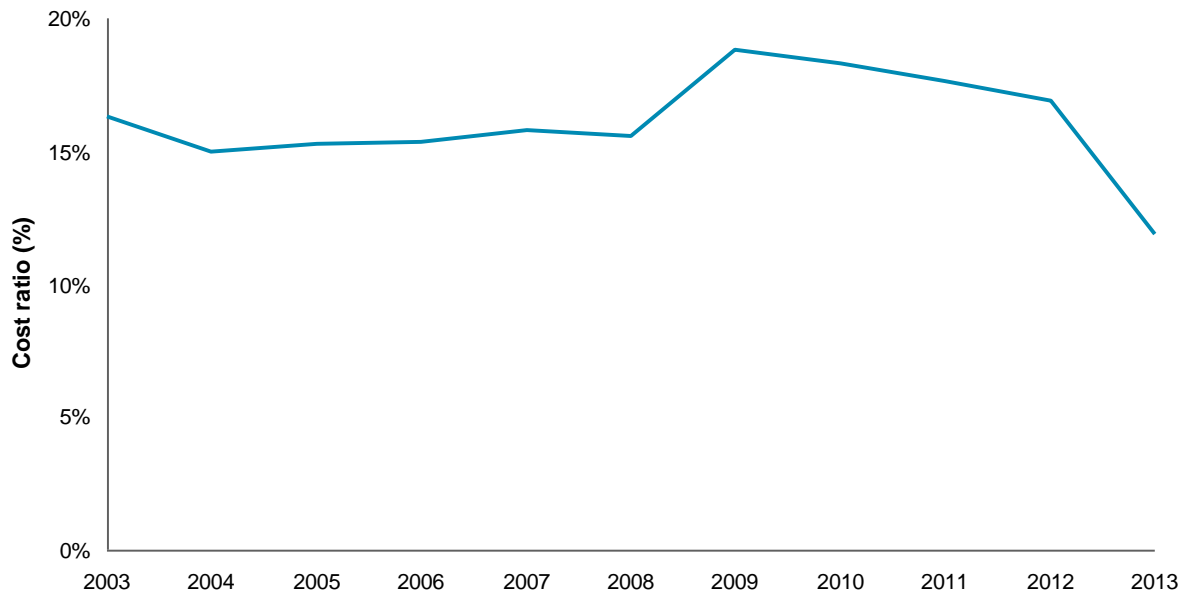
²⁸) Multifactor productivity is based on the change in consolidated production given equal means of production (e.g. capital, labour, energy, raw materials and services). Trends for banks and insurance & pension funds are not available after 2008. Sector forecast has been generated based on the response to market movements for the combined sector Financial Services and averaged as a multiple. Source: Centraal Bureau voor Statistiek – Statline, Oliver Wyman analysis

Figure 26: Evolution of expenses at Dutch life insurers (€BN)²⁹

5.1.1. Acquisition expenses

As of 2007, new premium income has reduced significantly. Until 2008, insurers were able to reduce acquisition expenses at a similar rate and thus managed to keep the expenses per new premium constant. With the start of the financial crisis and the introduction of Banksparen, new business premiums declined faster than insurers were able to reduce acquisition expenses. However from 2009 onwards, insurers have demonstrated their ability to speed up cost reductions.

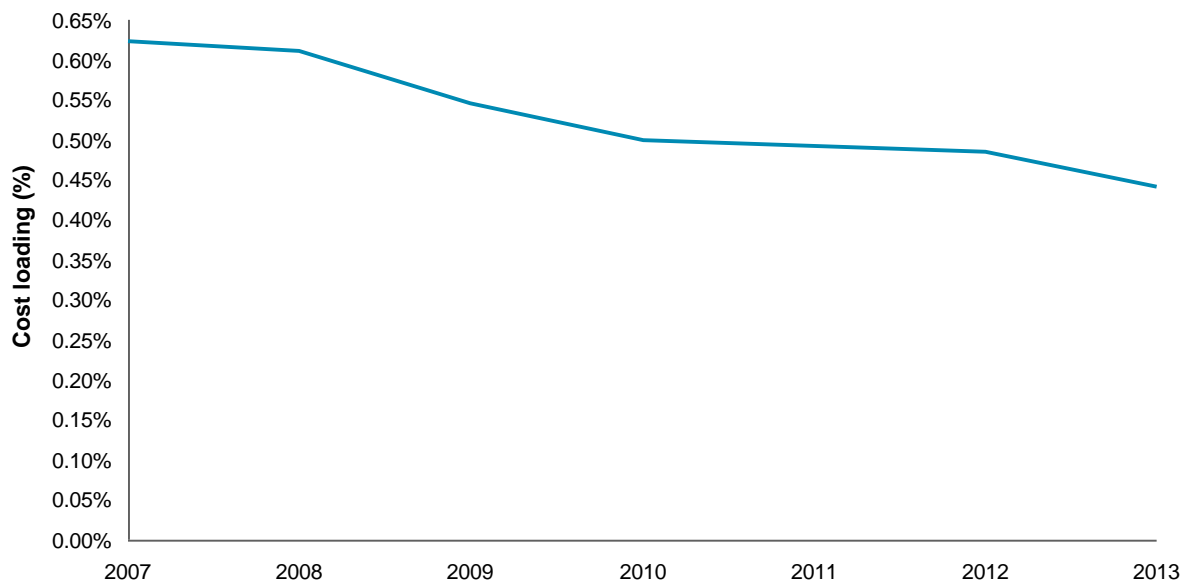
²⁹ Source: DNB Statistics

Figure 27: Acquisition expenses ratio as percentage of new premium income³⁰

5.1.2. Management expenses

Management expenses include expenses for administration, IT, investments and support functions. Figure 28 shows the management expenses as a percentage of the total balance sheet of life insurers. Over the last few years, the value of the total balance sheet of insurers has increased while management expenses have decreased slightly. Combined, insurers have been able to slightly reduce expenses. Recently DNB executed some confidential industry research into cost levels. A short message published on their website indicates that further cost reductions are expected.

³⁰ New business for pension is assumed to be constant from 2006 to 2013. Source: DNB Statistics, Oliver Wyman analysis

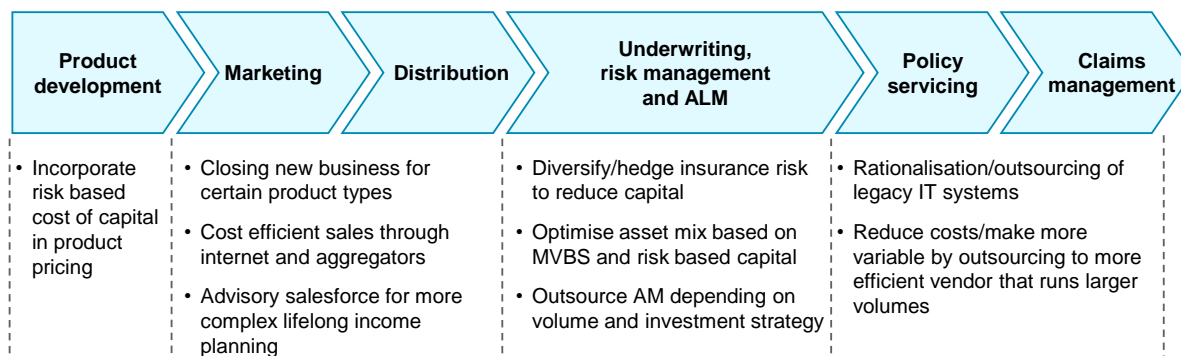
Figure 28: Management expenses as percentage of total balance sheet³¹

5.2. Options for future improvements

With decreasing volumes of premium income and subsequently decreasing balance sheets, insurers will have to find ways to further reduce their costs. On top of this, the profitability of new business has reduced: In the current economic environment, insurers cannot rely on interest profit and returns on other investments. Furthermore, with current competition levels, new business pricing does not allow much room for profit margins on other factors such as mortality.

Traditionally, insurers service most parts of their value chain in-house. With decreasing volumes, certain services are potentially more efficient when outsourced. Throughout the value chain of an insurance company, there are several options for efficiency improvement (see Figure 29).

³¹ Source: DNB Statistics

Figure 29: Value chain of an insurer and potential for improvements

5.2.1. Product development

With Solvency II approaching, insurers are increasingly using risk adjusted return on capital indicators to measure their profitability. However, cost of capital is not always adequately captured in product pricing. Insurers should incorporate the marginal Solvency II capital cost into their product pricing.

5.2.2. Marketing and distribution

Due to a decreasing demand for insurance individual savings products, many insurers have partly or completely closed down new business for these product types. Furthermore, the decreased willingness to physically visit financial advisory offices for simple products combined with increased transparency of internet comparison websites has resulted in a shift towards internet sales.

The above developments have already enabled insurers to significantly reduce salesforce costs (see Figure 27). By setting a clear strategy that focuses on internet sales, combined with online advice, insurers should be able to further reduce acquisition costs.

Consumers are only willing to pay higher advisory costs for individually tailored advice involving a holistic view on their lifetime income planning. This requires trained personnel that focus on the advisory component. By retraining the part of the current salesforce for these more complex tasks, insurers can prepare themselves for their new business model with a clear split between simple internet sales and more complex advisory for lifetime planning.

5.2.3. Underwriting, risk management and ALM

The core business of an insurance company is to take risk on the balance sheet and to manage these risks. With the introduction of a market value balance sheet and risk based capital under Solvency II, it has become increasingly important to manage these risks in order to decrease capital requirements and volatility in the balance sheet. The introduction of IFRS 4 phase II reporting standards will only enhance the necessity to manage volatility.

Underwriting and insurance risk management

Most Dutch life insurers are overexposed to longevity risk. With the continuous increase of life expectancy in the Netherlands, life insurers have taken additional provisions for this exposure. However, most Dutch life insurers are still exposed to a further increase in life expectancy. Under Solvency II, risk capital is based on the risk that an insurer is actually exposed to. Therefore insurers can also limit capital increases by smart underwriting or hedging.

For instance, mortality risk negatively correlates with longevity risk. Therefore increasing exposure to mortality risk potentially reduces the total capital requirement. By making smart underwriting decisions, insurers can limit their risk profile and therefore reduce their risk capital.

Another option is to increase hedges or swap risks with other insurance companies with different risk profiles. Reinsurance is an effective option to offload certain risks. However this can be a costly option. Another option is to swap longevity risk to another (re)insurer that has an overexposure to mortality risk; this option is becoming increasingly popular.

Asset liability management

Portfolio diversification

As opposed to Solvency I, Solvency II explicitly rewards insurers for diversified asset and liability portfolios. Therefore insurers can benefit from restructuring their portfolio in order to optimise diversification between and within asset classes. Insurers should constantly search for the optimal investment mix to optimise risk adjusted return on equity.

Hedging interest rate risk

The liabilities of Dutch life insurers usually have a long duration (typically around ~20 years). Therefore changes in interest rates that are used to discount liability cash flows significantly impact the value of liabilities. To mitigate exposure to interest rate risk, insurers hold assets that respond similarly towards changes in interest rates as their liabilities. Since most bonds have shorter durations, life insurers often acquire a variety of interest rate swaps to match assets and liabilities as closely as possible.

With the introduction of the Ultimate Forward Rate³² (UFR), the matching of assets and liabilities has become more complex; cash flows from liabilities with a duration of more than 20 years are discounted on an extrapolated interest rate, while assets are valued based on market rates. In order to minimise volatility in the balance sheet, insurers should take the impact of the UFR into account in their asset mix. However,

³² The Ultimate Forward Rate is an extrapolation method of the risk free curve. After the 20 year point, interest rates are not based on quoted market (swap) rates, but on an extrapolation according to the Smith-Wilson methodology

interest rate risk capital according to Solvency II requirements is calculated based on a method where changes in interest rates for assets and liabilities are similar. Therefore insurers face a trade between hedging volatility in the balance sheet and minimising risk capital.

Besides hedging interest rates, current low interest rates pose a challenge to insurers to make sufficient returns; risky assets like equity are capital intensive and liquid bonds give low returns. A better option is to acquire illiquid fixed income assets. As life insurers have predictable cash flows, they can afford to buy and hold these illiquid assets without risking selling them at a loss. Selecting the right assets will give insurers a premium for this illiquidity. On top of this, the most recent Solvency II regulations provide the option to use this premium for illiquidity on assets in order to increase the discount rate for liabilities covered by these assets (and therefore lowering the liability). If managed well, insurers can use illiquid assets to both improve returns and solvency ratio.

Asset management

As long as the balance sheet of an insurer does not significantly decrease in size, insurers remain able to manage their fixed income assets and quoted equity within their own asset management department.

However, investments that require more specific expertise such as property, private equity and hedge fund investments require large volumes. Due to increased capital charges on these riskier investments, insurance companies have reduced exposure to these asset classes. Keeping in-depth expertise in-house to fully benefit from excess return is costly with low volumes. Therefore insurers could either choose to outsource the management of these assets or to fully stop investing in these asset classes.

Further cost reductions can be realised by using a hold to maturity or a passive investment approach. This strategy will reduce transaction costs/management fees for asset classes with low expected returns (covered bonds, EUR government bonds) or low expected alpha (e.g. EuroStoxx equities).

Current maturity level

Although first progress has been made in aligning underwriting, risk management and ALM to the new Solvency framework, there are still many steps to be taken to fully optimise risk adjusted return. Since underwriting, risk management and ALM are the core of an insurance company, significant benefits are to be gained by aligning these areas to the new Solvency framework. Insurers should therefore focus on these areas in the near future.

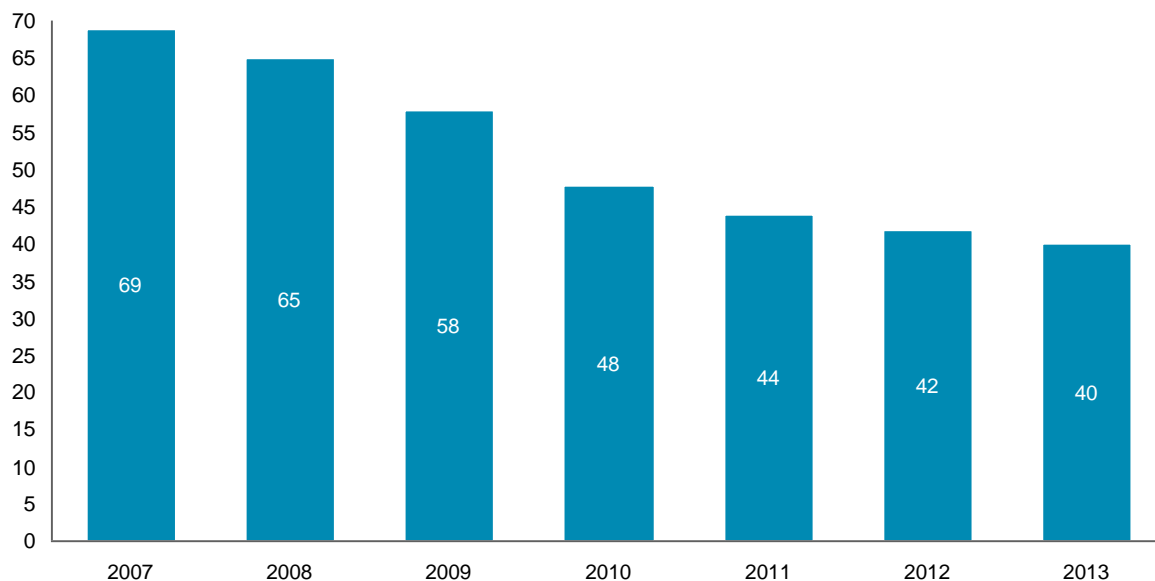
5.2.4. Policy servicing and claims management

In order to increase efficiency, insurers have been consolidating over the last few years. Figure 30 shows that the number of life insurance entities has decreased from 69 to 40 within the last six years. As shown in Figure 23 and Figure 25, this consolidation has had a positive effect on the overall efficiency.

However, obtaining efficiency by rationalisation of IT systems from different brands and entities has proven to be a challenge for insurers. Due to product changes, changes in policy conditions and policy conversions, most policy administration systems have become very complex. With insurance portfolios running over a number of decades and consolidation of different entities with different systems, most insurance companies have to maintain a large number of these complex IT systems. As a result, IT expenses are increasingly pressing on the total cost loading of insurance companies.

Furthermore, as part of the Solvency II market value balance sheet, insurers have to hold provisions for future expenses. These high and potentially increasing IT expenses are pressing more and more on the balance sheets. Reducing costs by IT rationalisation will significantly improve the financial position and stability of insurers.

Figure 30: Evolution of numbers of Dutch life insurance entities³³



However, rationalising these systems requires large investments and greater flexibility from the new systems. Insurance companies do not have the required experience and size to efficiently run these operations.

³³ Source: DNB Statistics

Outsourcing to more experienced providers with standard solutions and sizes that make investments worthwhile could significantly accelerate cost reductions. Furthermore, expenses will be more variable which fits well to the decreasing individual life market. This would allow insurers to focus more on their core competencies.

So far insurance companies have remained sceptic towards an outsourcing model, due to their lack of experience in working with IT vendors. On top of this, IT vendors have not fully engaged the Dutch insurance market as this requires significant levels of investments, and the sizes of IT outsourcing remain small. More recently, some providers are offering low cost cloud platforms in the Dutch market.

5.3. Closed books

Many insurers have already decided to close new business for a part or all of their individual life products. These 'closed books' are now in runoff and require tailored treatment. In order to obtain maximum value from the closed book, there is a focus on cost efficiency.

However, there are other opportunities for closed book operations in the area of ALM and commercial activities. At most insurers, ALM is still generic and is not sufficiently geared to the predictable future cash flows that allow using more illiquid asset classes to generate better returns with a similar risk profile.

On the commercial side, most insurers put the closed books aside in runoff mode, including dealing with the customers. However, other international insurers can be seen pro-actively engaging with clients to create a wealth of opportunities: Positively managing lapse, converting products into cheaper solutions and in addition cross- and up-selling new, transparent and cost efficient products are levers that need to be explored to fully optimise profitability of closed books.

On cost reductions, most approaches focus on slicing costs where possible, rather than on large (strategic) restructurings. As the books will further diminish in size, slicing costs is not the way forward. Reduction of the number of individual underlying books is crucial. Through technical and commercial conversion, IT systems and administrative processes can be reduced. This will lead to less activities and a lower number of IT systems, which in turn leads to permanent cost reductions. As described in Section 5.2.4, this is a complex exercise.

Eventually Dutch closed books will need to be merged to maintain crucial size. Either one of the Dutch life insurers starts acquiring other Dutch life books, or books are sold to experienced integrators, such as Resolution or Swiss Re.

Another option would be to create a shared service centre owned by a number of insurers (or even the whole industry). This shared service centre could specialise in the operations of shrinking portfolios, keeping costs as variable as possible and optimising the most effective IT platform possible to contain costs. With a large number of life insurers combined, investments for setting up the new service centre

could be shared. By starting from scratch, choices on IT, location and resource could be made to optimise efficiency for the runoff period of the current books.

5.4. Further consolidation of the life insurance market

Currently, six big insurers dominate the life insurance industry in the Netherlands. With a small and decreasing market we believe that further consolidation is an important step in efficiently running current decreasing individual life portfolios. Consolidation between the 'big six' has not taken place as of yet for a variety of reasons, ranging from state ownership and regulatory reluctance to technological barriers. If the big six insurers want to continue to sell individual life, they should sell and execute the new business using new IT platforms, which are low cost and much more variable than the old mainframe solutions. In addition, further digitalisation of the client interface is crucial. Modern consumers are more willing to provide input digitally in the sales process, as well as entering and maintaining data. This will further reduce costs of operations. Successful examples in non-life exist and it is expected that this will be introduced to individual life products too.

Transactional barriers

Three of the 'big six' players have effectively been out of the market as buyers (due to acquisition bans) or as sellers (due to privatisation dates predetermined by the state).

- ASR and SNS Reaal have been under state control since 2008 and 2013 respectively, and the Dutch state has delayed their privatisation until certain internal (financial track record, viability) and external (market saturation, financial stability, likely RoI) factors were favourable. State ownership has limited ASR and SNS Reaal's scope to engage in transactions. More recently, the Life and pensions group of SNS Reaal was renamed 'VIVAT' to prepare for a separation. Furthermore, it has been publicly confirmed that ASR (with support from some other international players) is considering acquiring VIVAT.
- The acquisition ban on ING Group, in place due to state aid received in October 2008, has prevented it from carrying out any takeovers. As the split of the bank and insurer has taken place, and all aid has been repaid, NN might be able to become more active in this market.
- Some mis-selling issues remain unsolved. The possibility of claims without limits has made international and local investors very shy of buying and integrating life insurance businesses.

Back book consolidation challenges

Rationale for consolidation may not have been as compelling, with uncertainty around operational efficiency gains. Cost savings from back-book consolidation are not self-evident due to technological barriers, some of which have started to be broken down by providers of low cost cloud platforms which offer relatively easy migration. However, setting up a (national) shared service centre could make cost reduction for the closed book achievable. The size of that entity would allow for significant IT investments, as well as the conversion of products and systems to the

new platform. Even though the upfront investment is high, the period to recoup this investment is long enough. Furthermore, this prevents a possible spill-over effect to healthy business in the case an unconsolidated back book becomes loss-making, short of capital or illiquid.

Risks with regard to the mis-selling of unit-linked products

Over six million policies that carry potential compensation claims were sold, mainly between 1998 and 2008; a significant part of these policies are still part of the current portfolio of life insurers. Largely due to the vast range of specific product types and policy details, but also because of the case-by-case legal process, it has proved impossible to estimate a total industry exposure to this mis-selling of unit-linked products.

This constant threat of potential future claims has been a large barrier for further consolidation. With the potential for large claims, insurers have become impossible to price, preventing injection of private capital for further acquisitions. Furthermore, insurers do not want to bear the risk of additional potential claims.

The potential solutions are challenging to implement, but it is essential that the Dutch life industry launches a series of committed efforts to bring the whole episode to a satisfactory end. Approaches whose detailed application to the Dutch situation must be fully studied are:

- Bottom-up policy reviews
- Top-down exposure capping/tail risk reinsurance
- Public/private partnership
- Pooled compensation arrangements

The solutions highlighted above are examples of practical actions that are suited to the Netherlands and have been proven in the international arena.

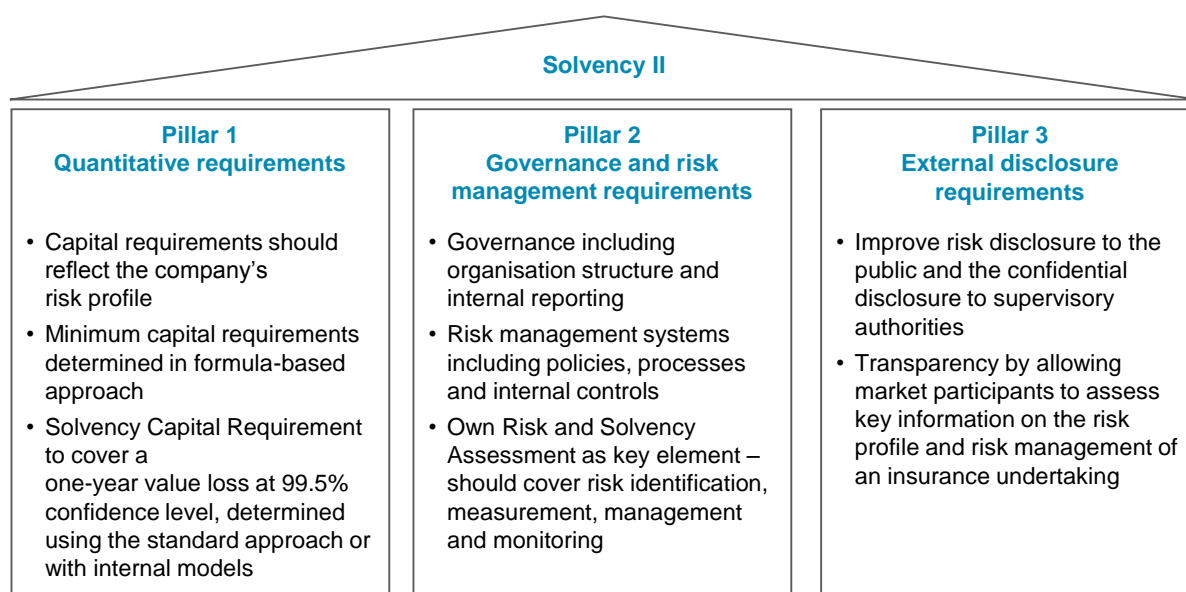
6. Solvency II

Solvency II is the updated set of regulatory requirements on capital adequacy and risk management for insurance firms that operate in the European Union, and will become binding from 1 January 2016. Solvency II has the following objectives:

- Create a level playing field across European insurers
- Improve protection offered to policyholders
- Introduce a risk-based, market consistent approach to solvency capital
- Encourage and incentivise insurers to understand and manage their risks better
- Establish consistent and comparable regulatory framework across the EU and across life and non-life business
- Enhance transparency and quality of public disclosure

Solvency II will replace Solvency I and is based on a three pillar structure (see Figure 31).

Figure 31: Solvency II according to the three pillar approach³⁴



Pillar I introduces a risk based solvency capital requirement which is calculated by applying stressed scenarios to a market value balance sheet. Pillar II imposes new governance requirements on insurers and Pillar III describes new reporting requirements.

³⁴ Sources: European Commission: "Amended framework for consultation on Solvency II", April 2006. MARKT/2515/06. European Commission: "Amended Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (SOLVENCY II), February 2008

Besides the increase in regulatory burden of Pillar II and Pillar III, the Pillar I solvency requirements have a major impact on the business model of insurers:

- The market value balance sheet introduces additional volatility for insurers
- The introduction of risk based capital has changed capital intensity of product types (products with guarantees for instance have become increasingly capital intensive compared to products without guarantees)
- Solvency II imposes risk charges per asset classes. Explicit cost of capital of certain investments has changed the risk weighted return per class
- Solvency II explicitly rewards insurers for holding diversified assets and liabilities. Capital charges for certain risks will therefore differ across different insurers, depending on their overall risk profile (for instance, insurers with dominating exposure towards longevity risk can attract mortality risk cheaply)



6.1. Solvency II in the Netherlands

As part of current Dutch regulations on financial supervision ('Wet Financieel Toezicht'), insurers have to perform a liability adequacy test ('Toereikendheidstoets' or TRT). This test measures whether the market value balance sheet of an insurer is able to cover the Solvency I capital. The Dutch supervisor (DNB) and Dutch insurers have hence been familiar with the concept of a market value balance sheet long before Solvency II. However, regulatory risk based capital is new.

6.1.1. Preparatory steps until 2015

Before the official implementation date of Solvency II, the Ministry of Finance and DNB have started a number of initiatives (see Table 1). With the implementation date of Solvency II delayed, DNB started to impose Own Risk and Solvency Assessment (ORSA) exercises from 2012 onwards. Together with the impact studies, DNB created early insight into the current standing on risk based solvency ratios.

Table 1: Timetable risk based supervision, Europe vs Netherlands³⁵

Europe	2004 -	2009 --	2012	2013	2014	2015	2016
	Start preparation Solvency II	Framework Directive adopted	Start negotiations Omnibus II	Long term guarantee assessment	Jan: First preparatory guidelines in force	Jan: Reporting preparatory guidelines in force	Jan: Solvency II in force
	Various Quantitative Impact Studies (QIS)				Mar: publication Omnibus II	Feb: Deadline objection period delegated acts	
					Sep: Proposal delegated acts ready	Apr: start approval processes	
Netherlands	2004 -	-	2012	2013	2014	2015	2016
	Dutch insurers have participated in QIS exercises		ORSA exercises	ORSA exercises	Jan: First preparatory guidelines in force	Jan: Reporting preparatory guidelines in force	Jan: Solvency II in force
			Impact studies: parallel run and basis impact study	Impact study TSC			Jan: Solvency II basic in force
			Jul: Introduction UFR in Dutch discount rate for LAT				

Being one of the first in Europe, DNB introduced the Ultimate Forward Rate (UFR) for insurers in July 2012. This extrapolation of the discount rate had been part of European discussions on Solvency II and has subsequently been included as part of the so-called 'Long-term Guarantee package' proposed by EIOPA.

In order to prepare both insurers and DNB on the new regulations, DNB has started the ORSA exercises already - four years before the start of Solvency II. On top of that, DNB performed a series of impact studies to monitor solvency ratios on a Solvency II basis.

In 2013 the Ministry of Finance introduced the 'Theoretisch Solvabiliteitscriterium' (TSC). The Ministry claimed that, due to the financial challenges of life insurers, waiting for the implementation was irresponsible³⁶. The 40 largest life insurers were

³⁵ Source: Annual Report DNB 2013

³⁶ Source: <http://www.rijksoverheid.nl/documenten-en-publicaties/kamerstukken/2013/11/19/solvency-ii-en-het-theoretisch-solvabiliteitscriterium.html>

forced to report solvency ratios according to a new set of guidelines. These guidelines were based on simplified risk based capital calculations. In case of insolvency according to TSC, DNB could prohibit life insurers to pay out dividend. By implementing this measure, DNB could influence the solvency ratios of Dutch insurers at an early stage.

6.1.2. Principle based regulations

Although Solvency II regulations are principal based, regulation on most topics is relatively prescriptive. There are, however, some areas with an explicit role for the local supervisor. Within the limitations of the Solvency II guidance, the supervisor can influence how insurers adjust to Solvency II regulations.

Internal model application

Solvency II regulations allow insurers to apply for an Internal Model which could then be used to calculate the Solvency Capital Requirement (SCR) under Solvency II. In doing so, insurers are allowed to hold capital according to their own model rather than the prescribed Standard Formula. However, the insurer first has to go through an application process. During this process, the local supervisor assesses, based on guidance from Solvency II regulations, whether the Internal Model is fit for purpose. Based on this assessment, the supervisor can choose to approve the Internal Model.

ORSA/capital add-on

As part of pillar II requirements, insurers have to perform an ORSA. The supervisor uses this internal assessment to check robustness of insurers against certain adverse scenarios. Based on this, a supervisor can decide to impose a capital add-on. Such an add-on serves as capital for risks that are not adequately captured by the SCR calculations.

Transitional measures

Solvency II regulations leave room for certain transitional measures, such as grandfathering of own funds or phasing in of the Solvency II risk free rate. These transitional measures may have significant impact on the solvency ratios of insurers and require supervisory approval.

Market valuation of non-quoted assets and liabilities

As the Solvency II balance sheet is based on market valuations, non-quoted assets and best estimate liabilities include expert judgment. The supervisor can challenge assumptions used in these valuations.

Furthermore, Solvency II introduces the Matching Adjustment. This adjustment on the risk free interest rate curve is based on the fact that some illiquid assets provide a spread on risk free interest that is not explained by expected default rates. This additional spread can, in some circumstances, be transferred to the discount rate of liabilities that match the cash flows of these assets. In order to be allowed to use this Matching Adjustment, insurers need approval from the supervisor.

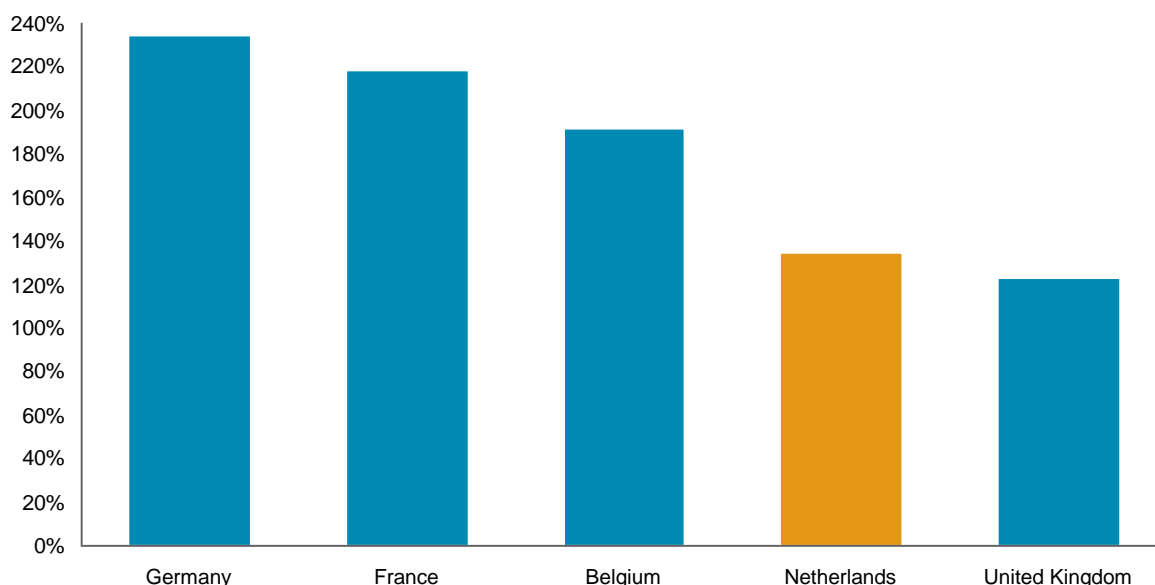
6.2. Current solvency ratios

In 2014 EIOPA designed a stress test on European insurers. Although participation was voluntary, market coverage of more than 60% technical provisions was achieved. Figure 32 shows that the solvency ratio of life insurance entities in Netherlands are relatively low compared to peer countries.

Note that these ratios regard the ratios of individual entities and not the solvency ratios at group. Some insurance groups aim to upstream as much capital as possible from entities to group (and therefore keep solvency ratios at entity level low on purpose) to optimise capital management at group level. In case of decreasing solvency ratios in a specific entity, group can then decide to inject capital to that entity. The above is particularly true for markets with large insurance groups. In markets with a lot of medium and smaller sized insurers, the effect will be less visible (Germany for example).

The displayed solvency ratios therefore do not provide accurate information on the solvability of Dutch life insurers in general. For better comparability of the numbers below, further analysis is required.

Figure 32: Current Solvency II ratios according to the Solvency II standard formula³⁷



³⁷ Based on a market-subset covering 60% of gross technical provisions of total market. German subset includes roughly 20% health similar to life. Belgium subset includes roughly 5% non-life and 5% health similar to life. Source: EIOPA Stress Test 2014

As part of the stress test, insurance entities were exposed to a number of adverse scenarios. One of these scenarios regarded a 'Japanese-like scenario' embodying a persistent low interest rate environment.

Figure 33: Pre- and post- persistent low interest rate environment stress scenario Solvency II ratios according to the Solvency II standard formula³⁸

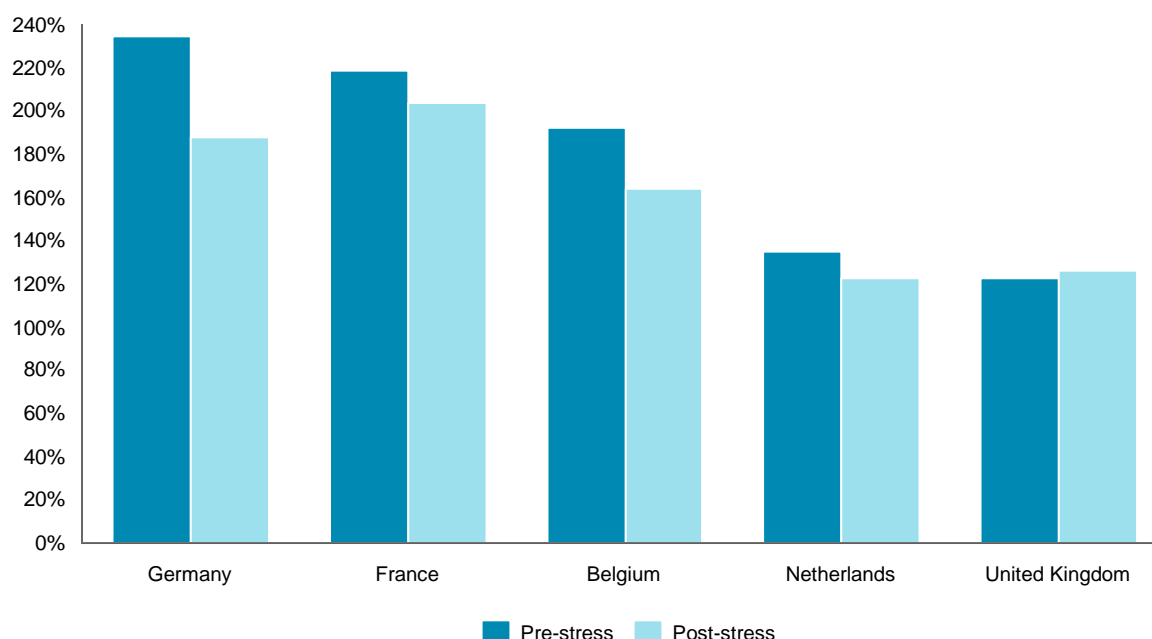


Figure 33 shows that the average Solvency ratio of the Netherlands is low compared to Germany, Belgium and France. However the balance sheet is relatively vulnerable towards a persistent low interest rate scenario compared to Germany and Belgium.

The United Kingdom has the lowest initial ratio of the presented peers. However, as the average duration of assets supersedes the average duration of liabilities, United Kingdom balance sheets are least vulnerable to low interest rate scenarios.

6.3. Conclusions

In conclusion, Solvency II is a major change that will impact business on many different levels. It will impact the product mix of life insurers due to risk based capital that requires higher capital for products with guarantees compared to other products. It will lead to a different investment strategy; investment portfolios will be de-risked and matching between assets will increase. Furthermore Solvency II will lead to a stronger regulatory focus on risk management and will increase cost of reporting.

³⁸ Source: EIOPA Stress Test 2014

The average solvency ratio of Dutch life entities is currently well above 100%, but is relatively low compared to peer countries.

7. Concluding remarks

The insurance industry has changed permanently. Due to fiscal and regulatory changes, individual life will remain at a much lower level than pre-2008 volumes. Clients have moved to Banksparen as a cheaper option than insurance life savings products. Low investment returns and low interest rates make insurance life products very unattractive, as guarantees in the product have become expensive.

The continuous lack of trust by the public is also limiting any growth. Insurance back books are marginally profitable, but will become unprofitable in the near future if insurers do not act. The too high operating costs and inadequate asset and liability management need to be addressed. Solutions should be found in drastic measures of cost reductions through shared services or outsourcing, in order to reduce operating costs and improve returns on the very predictable portfolios through adequate ALM. New individual life should be built on agile and low cost IT platforms with a focus on digitalising client interfaces. Scale, lack of investment- and risk competencies, and recent pension regulation changes have driven small pension funds to the insurers, PPI's and in the future, potentially to API's. This will help life insurers to maintain a healthy balance sheet and P&L in the group pension business. However, an increased focus of the large life insurers on pensions has put pressure on the profitability of new business.

Abbreviations

€BN	Amounts in billions of Euros
€K	Amounts in thousands of Euros
€MM	Amounts in millions of Euros
APE	Annual Premium Equivalent
BE	Belgium
CAGR	Compound Annual Growth Rate
DB	Defined Benefit
DC	Defined Contribution
DNB	De Nederlandsche Bank (Dutch Supervisor)
EIOPA	European Insurance and Occupational Pension Authority
FR	France
FSCS	Financial Services Compensation Scheme
FTE	Full Time Equivalent
GE	Germany
NL	Netherlands
ORSA	Own Risk and Solvency Assessment
P&L	Profit and Loss
SCR	Solvency Capital Requirement
TRT	Toereikendheidstoets (Dutch Liability Adequacy Test)
TSC	Theoretisch Solvabiliteitscriterium
UFR	Ultimate Forward Rate
WFT	Wet Financiële Toezicht

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