

Insurance Europe position on the European Insurance and Occupational Pensions Authority's (EIOPA) macroprudential work

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Contact person:	Alexandru Ciungu, policy advisor, macroeconomics & taxation	E-mail:	ciungu@insurancееurope.eu
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Key messages

- Insurance Europe supports an effective macroprudential framework that mitigates potential systemic risk in the financial system. However, given the limited level of systemic risk originating from the insurance industry, Insurance Europe does not believe that additional macroprudential measures are needed for the insurance sector. This is because a comprehensive macroprudential monitoring framework is already in place (ie, specific reporting requirements for financial stability, the European Insurance and Occupational Pensions Authority's (EIOPA) biannual financial stability reports, stress tests). In addition, the insurance supervisory system already includes many instruments with a macroprudential impact.
- Taken as a whole, the three EIOPA papers do not present a compelling argument for the need for specific additional macroprudential instruments for insurance.
- EIOPA's first paper discusses systemic risk in the banking sector and indirect sources of systemic risk at length. Furthermore, it focusses on systemic risk in a pre-Solvency II era. This does not seem a good enough basis to draw appropriate conclusions, as Solvency II represents a regime change in insurance supervision that also includes many new macroprudential elements, the impact of which will only become apparent over time.
- The essential aspect in the evaluation of the systemic risk potential of insurers is the identification of activities that may give rise to stability concerns and of the transmission channels through which this could occur. However, the first of EIOPA's papers noted that it aims to identify and analyse sources of systemic risk from a conceptual view; it is not addressing these in terms of likelihood or impact. As it does not consider the plausibility of the conceptual sources described, the effectiveness of mechanisms in place to impede transmission, or the likelihood of impact, the paper does not sufficiently demonstrate

that there are systemic risks that warrant additional policy measures. It is therefore difficult to see how additional macroprudential instruments could be justified from a cost-benefit analysis.

- In fact, EIOPA's recent paper, "Failures and near misses in insurance", concludes that the most common causes of failure are due to management & staff competence risk and internal governance & control risk (ie, internal causes rather than external ones). Again, it becomes apparent here that the impact of significant new Solvency II elements like the fit & proper provisions and pillar II requirements were designed with exactly these issues in mind and so need to be considered over time.
- In addition, because the analysis of existing measures in the second of EIOPA's papers only focuses on aspects of Solvency II that EIOPA considers as having macroprudential relevance, it fails to adequately consider Solvency II as a whole. By limiting its focus in this way, EIOPA fails to address elements of Solvency II that may have systemic relevance, such as the risk margin. EIOPA should analyse how certain provisions of Solvency II could damage the stability and effectiveness of the financial system in supporting the EU economy (eg, artificial volatility, incentives for pro-cyclical behaviour, disincentives for long-term investment).
- EIOPA should fully consider not only how existing Solvency II measures mitigate systemic concerns and how any additional tools link to them, but also the existing roles/activities that it and the European Systemic Risk Board (ESRB) have in relation to systemic risk, in order to determine whether there are any deficiencies with these that would warrant additional measures. EIOPA's analysis should cover, eg, the role of EIOPA's stress testing, its preparation of market wide risk indicators, and its regular financial stability reports and risk dashboards.
- EIOPA discusses several potential microprudential measures to enhance the macroprudential framework, but it is rather unclear how EIOPA makes the link between these two levels. The Solvency II framework requires the identification, assessment, monitoring and reporting of short and long-term risks that a (re)insurance undertaking may face. This is already a powerful micro- and macroprudential tool.
- The differences between the business models of banks, insurers and other financial institutions should therefore be appropriately considered in the development of any macroprudential tools and care should be taken that such tools do not conflict with one another, particularly in the case of financial conglomerates. This requires coordination among the European Supervisory Authorities (ESAs).
- An in-depth cost-benefit analysis is required before any of these suggested tools can be fully assessed. In Insurance Europe's view, such an analysis would reveal that many of these proposals would duplicate existing elements in Solvency II and would lead to significantly higher reporting burdens or additional costs, without clear benefits for financial stability or policyholder protection. Against this backdrop, Insurance Europe would like to draw attention to the negative impact of over-regulation on the effectiveness of the insurance industry in its socially-essential roles of risk carrier and as long-term-oriented investor.
- Further consideration of the additional measures currently envisaged is needed to ensure that EIOPA does not jeopardise the calibration of Solvency II agreed at political level. Unnecessarily high capital requirements lead to unnecessary cost and adverse impacts on customers.
- It should be made very clear that the ladder of supervisory intervention starts only when the solvency capital requirement (SCR) is breached and any buffers held above the SCR should be entirely at companies' discretion.
- EIOPA mentions that EU-level work on systemic risk must be consistent with international developments and not pre-empt them, but does not follow this principle: the International Association of Insurance Supervisors (IAIS) is currently developing a holistic approach to systemic risk in insurance and in parallel, while EIOPA has started a separate work stream.
- Throughout the discussion, it should be made clearer that the assessment of systemic risk should be made at group level, given the intention is to address risks to the entire financial system.

Comments on the tools listed in EIOPA's paper "*Other potential macroprudential tools and measures to enhance the current framework*"

2. Capital and reserving-based tools

2.1. Leverage ratio

EIOPA discusses the concept of leverage ratio at length, rightly concluding that a bank-style leverage ratio as a minimum requirement would make no sense in an insurance context. However, EIOPA does see merit in a leverage ratio as a monitoring tool that would over time track the evolution of own funds over total assets or non-insurance liabilities over own funds. Along with other indicators, EIOPA believes that such a leverage ratio could detect the potential for threats to the solvency position of the market.

EIOPA states that an excessive level of non-insurance liabilities might increase the build-up of systemic risk and interconnectedness across markets and sectors. As a result, risks can emerge in response to market movements or policyholder behaviour, forcing insurance companies to undertake fire sales of assets in a severe scenario.

Insurance Europe believes that EIOPA has not been clear about which risks will manifest and how and on what purpose a leverage ratio would serve. Neither the ratio of own funds to total assets, nor the ratio of the non-insurance liabilities to own funds address the issue of what the extra debt is being used for and whether a risk derives from that use. The SCR coverage ratio (and other solvency indicators) must remain the primary indicator.

EIOPA states that, if introduced, leverage and liquidity ratios will only be used as monitoring tools and there will not be any strict regulatory requirements for these tools. In practice, insurers would still have to take these ratios into account in their reporting and regulatory interactions, affecting company steering, regardless of their formal status. In addition, customers and market participants will probably also focus on these measures. Unlike for banks, the interpretation of leverage ratios in insurance would be very difficult given the differences in business models and the different types of insurance. Therefore, these "monitoring tools" will de facto result in strict requirements for insurers, either directly or indirectly and run the risk of misinterpretations.

2.2. Enhanced monitoring against market-wide under-reserving

At this stage, Insurance Europe does not see a need for additional measures in the reserving process. With Solvency II, the best estimate calculation of the technical provision has been introduced. To ensure the adequacy of technical provisions, insurers must validate the entire calculation. This includes the appropriateness, completeness and accuracy of relevant data, the adequacy of the assumptions and methods and the appropriateness of the level of the technical provisions with respect to all the obligations towards policy holder.

In addition, the risk margin provides an extra layer of security. The responsible actuarial function is required to be independent of the revenue-generating functions and kept free from the influence of the management board. Sufficient evidence for the management board should be included within the Actuarial Function Report to rely on the work carried out. The independent actuarial function must also give an opinion on the underwriting policy, including an analysis of the sufficiency of premiums to cover future claims and expenses.

Regarding the supervisory authority, companies already provide sufficient information on the adequacy of their reserves in the regular supervisory report (RSR) and, in many member states, an external auditor has to audit the Solvency II balance sheet, including technical provisions.

Enhanced monitoring against market-wide under-reserving would likely create additional reporting requirements and make the reserving process more cumbersome. It is difficult to understand how this would protect against systemic risk. EIOPA has not provided evidence of under-reserving that would lead to systemic risk concerns.

2.3. Counter-cyclical capital buffers (time-varying capital tools)

Insurance Europe fully agrees with EIOPA that counter-cyclical capital buffers should not be further considered, as they are not appropriate to the insurance business model.

2.4. Capital surcharge for systemic risk

Capital cannot be the default response to systemic risks. Instead, where real systemic risk exists, other mechanisms, such as ensuring supervisor oversight and good internal controls and risk management, are essential.

Given the comprehensive nature of Solvency II, risks which could lead to systemic concerns (such as losses in asset portfolios or mass customer policy surrenders), are already covered. Therefore, it is unclear why there would be need for additional capital. However, even if there could be a justification for specific situations where additional capital may play a role (and as EIOPA's third paper acknowledges), Solvency II already allows for capital add-ons.

These add-ons are allowed in cases where supervisors conclude that the risk profile of the insurer deviates significantly from the assumptions underlying its SCR calculation, or its systems of governance deviate significantly from the standards set out. It therefore already caters for eventualities where risks are not adequately reflected and does not limit the nature of those risks. Additionally, these capital add-ons are not permanent uplifts but need to be cancelled by the supervisor if the specific situation ends. Therefore, the supervisor has a certain incentive or control function.

For financial conglomerates, it is important to consider how different buffers for banks, insurers etc. should be used, otherwise these buffers for conglomerates can be unreasonably large.

3. Liquidity-based tools

While liquidity risk is not one of the main risks insurers face, Insurance Europe accepts that this type of risk can be relevant for certain activities and that supervisors may want to monitor these. Solvency II already sets requirements relating to liquidity risk (see comments on 3.1 below). Any additional monitoring should be based on data that is already available and metrics currently used within companies, to avoid additional cost and strain on implementation capacity. No additional capital requirements related to liquidity risk should apply at the level of individual companies, as these would likely overlap with existing requirements in Solvency II (Articles 37 and 232). The monitoring of liquidity risk should be done from a macro perspective; only when the market situation deteriorates, should regulators engage with insurers on an individual basis and/or support measures that would alleviate liquidity risk.

3.1. Additional reporting on liquidity risk

In EIOPA's paper on "Failures and near misses in insurance", 180 cases are analysed but illiquidity does not play a role in any of them. This confirms that while liquidity risks are not and should not be ignored, concern over the issue should not be exaggerated and an extension of requirements or additional ratios, like in the banking sector, seems unjustified. Solvency II requires insurers to invest in a manner that ensures portfolio liquidity; there are already microprudential constraints on liquidity. Furthermore, Solvency II requires insurers to implement an effective liquidity risk asset-liability-management (Art. 44 2 lit b) and d) of the Solvency II-Directive). Mass lapse risk already measures a significant part of liquidity risk. The additional burden of liquidity risk reporting and ratios can be considerable and should be minimised.

3.2. Liquidity risk ratios

Insurance Europe points out that, depending on their design, liquidity risk ratios may be in contradiction with the long-term nature of the insurance business as they may not capture the complexity of cash flows in a (re)insurance group. Forcing entities to report simplistic ratios would ultimately limit the ability of the risk management function to assess and monitor this risk using appropriate existing tools.

In addition, such ratios would require a clarification of what qualifies as “high quality unencumbered assets” or “liquid assets”, within an insurance company’s balance sheet. While the purpose of a bank’s liquid assets is essentially to meet very short-term liquidity needs, insurance portfolios, although conservative, do not have to be constructed to meet such needs, given that the risk of a run or of a liquidity squeeze affecting insurers is very limited. Rather, insurers typically require long-term investments to meet long term liabilities. Therefore, an insurance portfolio will contain a range of assets including illiquid securities. As long as companies have robust risk management to ensure liquidity needs are met, this is not a cause of concern. Conversely, any clear-cut definition of “liquid assets” for insurers, (eg, “investment grade” fixed income securities) would have undesirable pro-cyclical effects. Therefore, it should be left at the discretion of insurers to monitor their liquidity, as is currently required under the existing regulatory framework.

Using a Belgian-style liquidity risk ratio as described in Box 4 will punish insurers that invest to a higher degree in equities and property, as these assets will not be considered liquid. It can be questioned how it will benefit policyholders if life insurance companies invest more in very liquid assets with low returns, such as government bonds. In addition, many of these liquidity measures (particularly those that include premiums) are not adapted for insurance companies that are closed for new written premiums.

3.3. Liquidity requirements

The paper does not concretely define what is meant by a liquidity-based measure. However, Insurance Europe points out that insurance liquidity risk events do not generally occur instantaneously, unlike in banking. Solvency II’s risk-based nature and its embedded capital buffers ensure that sufficient assets are available to cover liabilities. Similarly, companies have strong incentives for managing their liquidity to meet liabilities as they fall due. Within this framework of sound risk management introduced by Solvency II, (re)insurers have payment deadlines that do not make them immediately subject to liquidity events and give them the needed time to appropriately manage and mitigate any crisis situations.

3.4. Temporary freeze on redemption rights

Supervisory and/or management actions should be considered when faced with the extremely remote risk of mass surrender, as such actions can be effective in controlling liquidity risk. More specifically, in many cases insurers have the contractual ability to delay surrenders and/or resolution authorities have the power to apply temporary stays. In fact, it is no coincidence that in markets where products have flexible surrender options supervisors typically have the power to intervene. Such powers must be taken into account when assessing the actual systemic risk because they serve as an important transmission blocking mechanism.

Therefore, Insurance Europe views the power of supervisors to temporarily freeze redemption rights as an important tool because it would address the extremely remote risk of mass surrender, preserving value and potentially preventing the need to use more drastic measures within the resolution toolkit. Besides, it could prevent the unequal treatment of customers who surrender their policy in a crisis and those who do not. In addition, this tool has proven its effectiveness in the few cases when it was used. Although mass lapses are extremely unlikely in practice, such powers would create an absolute limit to insurers’ exposure to very significant forced “fire sales” of assets and contagion.

In the unlikely case of individual company mass lapses, supervisors are, in any case, able to intervene unilaterally after the SCR has been breached as part of the ladder of intervention. Intervention should only be possible before the SCR has been breached if requested by the company. Insurance Europe would add that stay and suspension powers could not only be applicable to cashing out annuities, but also to switching. This is one

of the very few areas where changes to existing situation can be justified to ensure that all supervisors across Europe have the necessary stay and suspension powers.

4. Exposure-based tools

The exposure-based tools put forward for further discussion by EIOPA are all proposals to extend microprudential tools to the macroprudential sphere. Insurance Europe questions the potential benefit these tools offer in the identification and mitigation of systemic risk. Existing supervisory processes, tools and forums already offer the opportunity for National Supervisory Authorities (NSAs), EIOPA, the ESRB and other authorities to monitor and discuss potential areas of systemic risk.

4.1. Concentration thresholds

EIOPA raises the idea of implementing thresholds on the investment exposures of insurers, for example on individual assets classes, derivatives or sectorial/geographical exposures. It proposes that these take the form of “soft” thresholds which would effectively create a trigger point for discussion with the local supervisor rather than “hard” limits on investment exposures.

As EIOPA notes in its analysis, the current Solvency II framework has a number of tools already in place to address this risk at a microprudential level: eg. the prudent person principle (PPP), own risk and solvency assessment (ORSA), asset concentration risk charge. These tools were designed to address the risk of excessive concentrations and to encourage appropriate risk management and appropriate diversification.

EIOPA also notes that insurers’ exposures to concentration risk clearly depends on the products they offer and hence on their individual asset strategies (which vary across countries). Insurance Europe considers this a good example of why aggregate data at a market level would have very limited usefulness in decision making, as the data would need to be considered in the context of the insurer.

While it may be interesting and valid from a systemic risk standpoint to monitor the aggregate level of various investment exposures, Insurance Europe does not agree that the calibration of “soft” thresholds for implementation at a company level could contribute significantly to mitigation of systemic risk. It is therefore difficult to see this as a macroprudential tool.

Insurance Europe further notes that the information required to monitor the aggregate level of exposure is already available to EIOPA as part of regular supervisory reporting. EIOPA should therefore first justify the need for an additional tool in this area.

Finally, EIOPA disregards important factors when it considers concentration thresholds. For example, to reduce the currency risk that arises due to liabilities in one specific currency, an insurer holds assets denominated in the same currency as the liabilities. For smaller currency areas, it can therefore be well-motivated that the insurer has a geographical concentration in specific types of assets. In this circumstance, it is very questionable that the geographical concentration should be limited through concentration thresholds, as this will lead to more (currency) risks for insurers in those countries (currency areas).

In addition, there is a lower risk that insurers in smaller currency areas will sell-off their assets during a crisis, as there is a limited amount of assets denominated in that currency that insurers can invest in. It is also important to point out that imposing concentration thresholds goes against one of the key intentions in the transition from Solvency I to Solvency II, focused on removing allocation limits and instead allowing insurers discretion over their strategic and tactical asset allocations, within the Solvency II qualitative and quantitative safeguards on investing.

4.2. Enhancement of the ORSA

EIOPA discusses extending the current scope of the ORSA process to include a specific macroprudential aspect in order to check the ORSA reports against macroprudential risks. To this end, it envisages a “macroprudential authority” that aggregates input from NSAs on individual company ORSAs, analyses this information and then provides macroprudential input to the NSAs which can be used as part of the ORSA process.

Insurance Europe would caution against greater prescriptiveness in the ORSA process, as the liberty to choose relevant scenarios is a key component to the ORSA's value. “Enhancing” the ORSA as EIOPA suggests would actually increase its complexity and diminish its usefulness to insurers and its wider financial stability benefits. In addition, ORSAs are already assessed by the relevant supervisory authorities and Insurance Europe does not agree that the addition of another layer of macroprudential supervisory approval is warranted, justified or desirable.

Insurance Europe further questions whether the potential benefit of analysing the process and organisation of many thousands of ORSAs would justify the cost of such a process. It seems impossible to collect ORSA data and to ensure comparability, due the fact that the ORSA is the company's own analysis. This means that insurers' ORSAs differ greatly in terms of, for example, focus, content and design. And to require insurers to follow certain templates for the ORSA (in order to facilitate data collection by EIOPA) goes strongly against the purpose of the ORSA. It is therefore questionable whether such an exercise would be useful in decision making, or would provide additional insights above those obtained from current EU stress testing exercises.

Insurance Europe believes that a more proportionate and pragmatic approach would be for NSAs to continue to assess the ORSA on a standalone basis and to discuss any macroprudential concerns with the relevant macroprudential authorities, such as the ESRB.

4.3. Enhancement of the Prudent Person Principle

As with the extended scope of the ORSA, EIOPA discusses enhancing the PPP by providing a role for a “macroprudential authority” to extract macroprudential feedback for supervisors from insurer's investment strategies.

Given the diverse range of investment strategies employed across Europe, the overall feasibility of this exercise is questionable. Even assuming that it is feasible, the potential benefits of such an exercise are doubtful. Insurance Europe notes that supervisors can already monitor the implementation of the PPP through the investment strategy described in the RSR.

Insurance Europe strongly supports the PPP and does not believe any changes are necessary. It does not support any changes or enhancements which would result in rules and restrictions.

5. Pre-emptive planning

5.1. Request of recovery plans

EIOPA discusses a requirement for insurers to develop and maintain pre-emptive recovery plans even when the SCR is above 100%. This would go further than what is currently foreseen by Solvency II, which requires the development of a recovery plan once an insurer breaches, or is likely to breach, in the short-term the SCR.

While Insurance Europe acknowledges that recovery planning at the group level can be a good risk management practice in helping companies identify and understand key vulnerabilities, a regulatory requirement for pre-emptive recovery planning should only be considered at group level and only for insurers where it would provide a tangible benefit to financial stability. To determine this, relevant supervisory authority should consider all information that is already available under Solvency II (ie, ORSA, stress test results, medium-term capital management plans and contingency plans).

Insurance Europe agrees with EIOPA that proportionality is a key factor here and that a power for Member States and/or NSAs to waive this requirement for certain insurers based on a set of harmonised criteria is appropriate.

EIOPA states that the costs of developing recovery plans are generally deemed not to be very high compared with the benefits accrued; while this may be true for global-systemically important insurers (G-SIIs), it is not true for less complex insurers. This is why these insurers should not have to devote unnecessary resources developing such plans when the relevance of doing so is rather limited and could be counter-productive where it acts as a distraction for more effective preventive measures.

Insurance Europe would suggest the following principles that should be followed when drafting a recovery plan:

- In general, if the probability of a company to enter in regulatory recovery is low, an additional pre-emptive recovery plan is less or not necessary.
- A group recovery plan should be sufficient and should automatically satisfy requests for setting up national plans for subsidiaries, as recovery measures concern the whole group (eg, intra-group capital injections). A myriad of local recovery plans would not only be confusing but would unduly increase the regulatory burden without bringing any added value. In addition, a group recovery plan would be deemed sufficient as increased cooperation and coordination between relevant authorities (eg, through the supervisory college) will have ensured that such a plan is appropriate. This should apply to both groups based in the EU and groups based outside the EU but with subsidiaries in Europe.
- The plan should be set up to include all material legal entities which make up a substantial part of the group's total assets and operating profits. A broader scope would not yield any new recovery options.
- The recovery options should be commensurate to the stresses they are seeking to address. The modelled stresses should be restricted to a few meaningful ones and an idiosyncratic one. The number of large-scale recovery options is limited, so using a larger number of tests would not help identify more recovery options.
- Data privacy must be secured when sharing the recovery plan among relevant supervisors and the confidentiality of the recovery plan must be ensured.
- The plan should include the identification of possible recovery options, such as actions to strengthen the capital situation.
- In line with the principle of proportionality, and considering the long-term properties of life insurance business, insurers should be allowed to provide updated recovery plans at longer intervals and also when there are material changes in risk or business structure.

5.2. Request of resolution plans

Insurance resolution does not have the same urgency as bank resolution, nor does it involve the same degree of counterparty exposure and tools such as portfolio transfer and run-off facilitate this longer-term process. Authorities should therefore be able to adapt their approach and plans as the situation evolves.

This is why, while Insurance Europe does not have a strong view on a possible requirement for pre-emptive resolution plans, it seems reasonable to apply proportionality and flexibility considerations, to facilitate the task of the group supervisor. Operational resolution plans need to be tailored to the circumstances of the insurer and should also be flexible, allowing authorities to consider the circumstances of resolution. At the same time, overreliance on resolution plans may obstruct the clear view on the causes for a crisis and the adequate measures to cope with them.

In order to avoid excessive burdens for insurers, resolution authorities should try to limit the information required from insurers (in the context of drafting the resolution plan) to what is essentially needed and cannot be gathered from other sources, such as secondary data and existing information from the ORSA, medium-term capital management plan, contingency and emergency plan and from reporting of intragroup transactions. An annual adjustment of the pre-emptive resolution plan would only be needed in case of material changes to the insurers risk profile, business or group structure. Otherwise, just a confirmation of the main assumptions used for the preparation of the plan should be sufficient.

There will necessarily be differences between the content of recovery plans and resolution plans. Recovery plans focus on business continuity and therefore are broad in scope, whereas resolution plans should be clearly focused on detailed contingency planning for material legal entities within a group to avoid the planning process becoming unduly burdensome for both the insurer and supervisors without providing material added benefit. The results from the pre-emptive recovery planning should also be considered and, in general, if recovery planning is realistic then resolution planning will be less necessary.

With respect to the methodology, the stated objective of EIOPA is “to protect systemic functions”: EIOPA should first identify and assess such functions and then consider how to protect them. Regarding the fact that EIOPA mentions the lack of resolution powers in some Member States: such powers should be carefully considered to not reduce the fungibility of capital within a group. In particular, reinsurance is a global activity and should be considered as substitutable and not systemic.

In the context of financial conglomerates, EIOPA has not considered that any recovery and resolution planning requirements should be coordinated with those in other financial sectors (eg, in the Bank Recovery and Resolution Directive) and should also be harmonised with existing rules for financial conglomerates, in order for the conglomerates to fulfil all regulatory requirements in a reasonable and practical manner.

5.3. Request of Systemic Risk Management Plans

Insurance Europe does not believe that it is reasonable to expect insurers to be able to identify and address the systemic risk they may pose to the financial system by requiring a systemic risk management plan (SRMP). Monitoring and analysing potential systemic risks in the insurance sector (as far as it is needed) is the task of macroprudential supervisors at national and European level and a comprehensive macroprudential surveillance framework is already in place.

5.4. Request of Liquidity Risk Management Plans

It is generally accepted that liquidity risk is not a primary risk for the wider insurance sector. Any request of such plans should be focussed on a limited number of insurers and be duly justified (for example, insurers heavily involved in non-traditional activities, banking or other financial activities). Like recovery and resolution plans, liquidity management plans requirements should be applied subject to the proportionality principle.

Insurance Europe is the European insurance and reinsurance federation. Through its 35 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe’s economic growth and development. European insurers generate premium income of more than €1 200bn, directly employ over 950 000 people and invest over €10 100bn in the economy.