

CEIOPS-DOC-44/09

**CEIOPS' Advice for  
Level 2 Implementing Measures on Solvency II:  
SCR standard formula - Article 111 f  
Allowance of Reinsurance Mitigation Techniques**

(Former CP 52)

**October 2009**

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# 1. Introduction

- 1.1. In its letter of 19 July 2007, the European Commission requested CEIOPS to provide final, fully consulted advice on Level 2 implementing measures by October 2009 and recommended CEIOPS to develop Level 3 guidance on certain areas to foster supervisory convergence. On 12 June 2009 the European Commission sent a letter with further guidance regarding the Solvency II project, including the list of implementing measures and timetable until implementation.<sup>1</sup>
- 1.2. This paper aims at providing advice with regard to the qualitative criteria that reinsurance and SPV arrangements must meet in order to ensure that there has been effective risk transfer to a third party of risks stemming from (re)insurance contracts written by the undertaking as required by Article 111 (f) of the Solvency II Level 1 text.<sup>2</sup>
- 1.3. CEIOPS' advice on the allowance of financial mitigation techniques shall apply where the effect of an arrangement has a similar result to a pure financial contract.<sup>3</sup>
- 1.4. In addition, this paper also addresses the assumptions to be used to assess the changes in risk profile of the undertaking concerned and to adjust the calculation of the Solvency Capital Requirement, when risk mitigation techniques are used.
- 1.5. All other risk mitigation instruments not covered by the scope of this paper fall under the scope of CEIOPS' advice on the allowance of financial mitigation techniques Together these papers cover advice relating to Article 111 (f) of the Solvency II Level 1 text.
- 1.6. This advice shall also be read in conjunction with<sup>4</sup>:
  - CEIOPS' advice on Special Purpose Vehicles (CEIOPS-DOC-32/09)<sup>5</sup>, and
  - CEIOPS' advice on Group Solvency Assessment (CEIOPS-DOC-52-09)<sup>6</sup>
- 1.7. In order to ensure consistency in the use of terms, in this advice
  - references to »risk mitigation technique« shall be consistent with the definition in Section 3 of the Level 1 text and only be in respect of risk mitigation techniques from reinsurance and SPV arrangements;
  - »Undertakings« embrace both insurance and reinsurance undertakings, unless otherwise explicitly mentioned.

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<sup>1</sup> See <http://www.ceiops.eu/content/view/5/5/>

<sup>2</sup> Latest version from 19 October 2009 available at <http://register.consilium.europa.eu/pdf/en/09/st03/st03643-re01.en09.pdf>.

<sup>3</sup> Former CP 31. See <http://www.ceiops.eu/index.php?option=content&task=view&id=579>.

<sup>4</sup> Article 210 of the Level 1 text further foresees the possibility for the Commission to adopt an implementing measure with respect to the monitoring, management and control of the risks arising from finite reinsurance activities.

<sup>5</sup> Former CP36. See <http://www.ceiops.eu/index.php?option=content&task=view&id=584>.

<sup>6</sup> Former CP 60. See <http://www.ceiops.eu/index.php?option=content&task=view&id=611&Itemid=18>.

- 1.8. The paper in general applies both to life and non-life and where appropriate there are separate paragraphs for life and non-life reinsurance applications.

## 2. Extract from Level 1 Text

- 2.1. According to the Level 1 text “risk mitigation techniques” are all techniques which enable insurance and reinsurance undertakings to transfer part or all of their risk to another party.
- 2.2. According to the guiding principles referred to in the Commission’s letter, the legal basis for the advice presented in this paper is primarily found in Article 111 (1) (f) of the Level 1 text, which states:

### Article 111 – Implementing measures

*1. In order to ensure that the same treatment is applied to all insurance and reinsurance undertakings calculating the Solvency Capital Requirement on the basis of the standard formula, or to take account of market developments, the Commission shall adopt implementing measures laying down the following: [..]*

- f) the qualitative criteria that the risk mitigation techniques referred to in point (f) must meet in order to ensure that the risk has been effectively transferred to a third party;*

## 3. Advice

### 3.1 Explanatory text

- 3.1. Consistent with the Level 1 text, risk mitigation techniques will include all techniques which enable insurance and reinsurance undertakings to transfer part or all of their risk to another party. For the purpose of the advice in respect of implementing measure (f), risk mitigation techniques have been split into financial risk mitigation techniques and reinsurance risk mitigation techniques according 1.3.
- 3.2. From a regulatory perspective the issue of reinsurance risk mitigation techniques is important because of the impact risk mitigation techniques have on the calculation of the SCR.
- 3.3. CEIOPS proposes that the guidance shall be high level, concentrating on the criteria that the reinsurance risk mitigation technique shall meet in order to be considered. Given the techniques involved and the potential for innovation in this area, detailed rules that might prove unsuitable or inflexible for managing or regulating evolving practices in this area appear inappropriate.

#### 3.1.1. Background

- 3.4. Reinsurance is an important risk management tool used within the insurance industry to spread the uncertain cost of risk exposure over a larger global capital base. The complexity of reinsurance products has evolved substantially in recent years.
- 3.5. The intention of a reinsurance contract may not always be evident in its wording and the balance between the transfer of risk and the resulting effect on capital and reported accounts may be distorted.

Therefore a key issue for allowing to reduce the capital requirement due to reinsurance risk mitigation is, whether the arrangement satisfies the conditions for risk transfer.

- 3.6. Some of the following characteristics may be present within reinsurance contracts:
  - Insurance risk transfer, for example:
    - excess of loss reinsurance, which provides indemnification to the ceding insurer for each covered risk up to a predetermined limit. The ceding insurer is required to meet the obligations of the claim up to a preset amount before the reinsurer becomes liable; or
    - the insurer and the reinsurer share in an agreed ratio, all premiums, losses, and loss expenses arising out of the original business covered under the reinsurance agreement. There are two forms of proportional reinsurance: quota share and surplus share; or

- catastrophe bonds issued to manage peak risks and embedded value securitisation to help undertakings manage their capital more efficiently.
- assumption of significant but limited risk by the reinsurer (e.g., aggregate limit of liability, blended cover, sliding scale and other adjustable commissions, loss corridors and limits or caps);
- transfer of volatility (e.g., multiple lines of business, multiple years of account and multiple year contract terms);
- inclusion of future investment income in price of contract (recognition of time value of money);
- potential profit sharing between parties (e.g. profit-sharing formulas, experience accounts);
- bulk reinsurance or treaty reinsurance (i.e. administration of reinsurance is done on a bulk basis rather than on a traditional policy-by-policy basis, for a block of new or in-force business).

Certain features can sometimes reduce the effective risk transfer considerably under the reinsurance contract. For example, this may be the case for certain finite reinsurance arrangements.

- 3.7. Reinsurance markets are constantly changing and developing so it is impossible to provide a full list of the types of arrangement that an undertaking may enter into.
- 3.8. For advice regarding reinsurance risk mitigation in a group context reference should be made to CEIOPS' advice on Group Solvency Assessment (CEIOPS-DOC-52/09 mentioned before).

### **3.1.2. Criteria to ensure effective risk transfer and the extent of such transfer**

- 3.9. In order to allow for reinsurance risk mitigation, the arrangement must satisfy the principles for risk transfer to a third party.
- 3.10. As it is difficult, to anticipate the specific nature that these risk transfers may take in future years, and in order not to constrain innovation and risk management, CEIOPS would propose to establish high-level principles which would facilitate the ongoing development and evolution of reinsurance risk mitigation techniques within a predefined supervisory framework.
- 3.11. In considering whether the reinsurance risk mitigation techniques effectively transfer risk and the extent to which credit for such transfer of risk may be taken within the calculation of the SCR, the following principles shall be followed:

## **Principle 1: Effective Risk Transfer**

- 3.12. The risk mitigation technique shall effectively transfer risk from the undertaking. The undertaking needs to be able to show the extent to which there is an effective transfer of risk in order to ensure that any reduction in SCR or increase in available capital resulting from its reinsurance arrangements is commensurate with the change in risk that the insurer is exposed to.
- 3.13. The transfer of risk from the undertaking to the third party shall be effective in all circumstances in which the undertaking may wish to rely upon the transfer. Examples of factors which the undertaking shall take into account in assessing whether the transaction effectively transfers risk and the extent of that transfer include:
- whether the documentation associated with the reinsurance reflects the economic substance of the transaction;
  - whether the extent of the risk transfer is clearly defined and beyond dispute;
  - whether the transaction contains any terms or conditions the fulfilment of which is outside the direct control of the undertaking. Such terms or conditions may include those which:
    - would allow the third party unilaterally to cancel the transaction, except for the non-payment of monies due from the undertaking to the third party under the contract; or
    - would increase the effective cost of the transaction to the undertaking in response to an increased likelihood of the third party experiencing losses under the transaction; or
    - would oblige the undertaking to alter the risk that had been transferred with the purpose of reducing the likelihood of the third party experiencing losses under the transaction; or
    - would allow for the termination of the transaction due to an increased likelihood of the third party experiencing losses under the transaction; or
    - could prevent the third party from being obliged to pay out in a timely manner any monies due under the transaction; or
    - could allow the maturity of the transaction to be reduced;
    - whether the transaction is legally effective and enforceable in all relevant jurisdictions.
- 3.14. An undertaking shall also take into account circumstances in which the benefit to the undertaking of the transfer of risk could be undermined. For instance, where the undertaking, with a view to reducing potential or actual losses to third parties, provides support to the transaction, including support beyond its contractual obligations.
- 3.15. In determining whether there is a transfer of risk, the entire contract shall be considered.

- 3.16. The entire legal relationship between the cedant and reinsurer shall be taken into account in this determination.
- 3.17. The mere fact that the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote does not of itself mean that the reinsurer has not assumed significant risk.
- 3.18. Some special purpose vehicles do not compensate directly the claims made on the undertaking. Instead, payments are made according to certain external indicators, for example an earthquake index or general population mortality. In this case, special attention shall be given to the basis risk involved in the arrangement:
- There shall be no allowance of reinsurance risk mitigation instruments in the calculation of the standard formula SCR unless the undertaking is able to demonstrate that the basis risk is not material compared to the mitigation effect.
  - If allowance of the reinsurance risk mitigation technique in the calculation of the SCR is made, the calculation shall account for the basis risk in line with the 99.5% confidence level of the SCR.
- 3.19. For the non-life premium and reserve risk module under the standard formula SCR, one of the underlying assumptions of the design of the non-life premium and reserve risk sub-module (and the corresponding health risk sub-module) is as follows that for a reinsurance arrangement, the ratio of net risk to gross risk (on a 99.5% Value-at-Risk level) is less than (or at least not significantly greater than) the net-to-gross ratio of best estimate provisions and premiums. Where this assumption is not valid, the sub-module produces a wrong estimate of the net risk:
- Recoverables and premiums for reinsurance shall only be taken into account in the determination of the volume measures "net best estimate" and "net premiums" of the non-life premium and reserve risk sub-module, if the ratio of net to gross risk is not overly large in relation to the reinsurance part of the best estimate and the premium. This would mean that the ratio of net to gross risk does not significantly exceed the net-to-gross ratio of premiums and best estimate provisions.
  - In particular, no allowance shall be made for finite reinsurance or comparable SPV constructions of the non-life premium and reserve risk sub-module in the standard formula.

## **Principle 2: Economic effect over legal form**

- 3.20. Reinsurance risk mitigation techniques shall be recognised and treated equally, regardless of their legal form or accounting treatment, provided that their economic or legal features meet the requirements for such recognition. The economic effect of the transaction shall be considered over the legal form.

- 3.21. The design of the standard formula SCR shall allow for the changed risk profile by reflecting the economic substance of the arrangements that implement the technique. Thus in principle the SCR shall reflect:
- a reduction in requirements commensurate with the extent of risk transfer, and
  - an appropriate treatment of any corresponding risks that are acquired in the process.
- 3.22. Where practical and appropriate, to provide a verifiable and objective framework for the overall treatment of reinsurance risk mitigation techniques in the context of the standard formula calculation of the SCR, it is advisable to separate these two effects.
- 3.23. The impact on the risk associated with the reinsurance risk mitigation technique shall be treated consistently, regardless of the legal form of the protection.
- 3.24. Where reinsurance risk mitigation techniques are recognised in the SCR calculation, the undertaking shall identify any material new risks and include them in the calculation of the SCR in accordance with the standard formula.
- 3.25. The undertaking shall take account of low probability events that may trigger material changes in the way the reinsurance operates. For example, if reinsurance is recaptured (e.g. through accepted retrocession), that could result in recapture of reinsurance premiums but the risk would no longer be mitigated.

### **Principle 3: Legal certainty, effectiveness and enforceability**

- 3.26. The reinsurance contracts used to provide the risk mitigation together with the action and steps taken, and procedures and policies implemented by the insurance undertaking, shall be such as to result in risk mitigation arrangements which are legally effective and enforceable in all relevant jurisdictions.
- 3.27. To the extent that the effectiveness or ongoing enforceability cannot be verified or the mitigation technique is not documented, the benefits of the mitigation technique shall not be recognised in the SCR calculation, but the calculation shall recognise any additional risks in accordance with the formula.
- 3.28. The SCR standard formula shall to the extent practicable be increased to allow for the possibility that reinsurance protection will not be renewed on expiry or will be renewed on adverse terms.

### **Principle 4: Valuation**

- 3.29. The design of the standard SCR calculation shall recognise reinsurance risk mitigation techniques in such a way that there is no double counting of risk mitigation effects.

3.30. Where the reinsurance risk mitigation techniques actually increase risk, the SCR shall be increased.

**Principle 5: Credit quality of the provider of the reinsurance risk mitigation instrument**

3.31. Undertakings shall consider the credit quality of the providers of reinsurance risk mitigation contractual arrangements and shall only take into account effective risk transfer having regard to the credit quality.

3.32. Subject to meeting all other relevant criteria and principles laid down in this advice:

- For reinsurance with entities subject to the Directive (other than SPVs): reinsurance should not be recognised if the entity does not meet the SCR;
- For reinsurance with entities subject to equivalent supervision (other than SPVs): reinsurance should not be recognised if the entity does not meet the equivalent of the SCR;
- For reinsurance with entities (other than SPVs) not subject to the Directive or equivalent supervision: reinsurance should not be recognised if the entity has a lower rating than BBB (stable) or if the undertaking is not able to demonstrate that the entity meets a standard of at least BBB (stable).
- For reinsurance with SPVs subject to the Directive: reinsurance should not be recognised if the requirements of the Level 1 text on SPVs are not met.
- For reinsurance with SPVs not subject to the Directive: reinsurance should not be recognised if the requirements of the Level 1 text on SPVs are not met by the SPV or the supervisor of the undertaking has not been provided with information equivalent to that required for the authorisation and supervision of a SPV subject to the Directive.
- For reinsurance with SPVs not subject to the Directive reinsurance shall be recognised only when:
  - the undertaking has provided the supervisor with the information equivalent to that required for the authorization and supervision of a SPV subject to the Directive;
  - the undertaking has informed the supervisor of the applicable regulations in the relevant jurisdictions that may affect the SPV or the rights of the undertaking to receive the expected protection; and
  - the supervisor considers that the requirements of the Level 1 text on SPVs are met by the SPV.

3.33. Notwithstanding the above, to the extent that collateral, meeting the requirements of CEIOPS' Advice on the allowance of financial mitigation techniques (CEIOPS-DOC-26/09 mentioned before), has been provided, the reinsurance shall be recognised up to the amount of the collateral.

- 3.34. In determining the strength of an entity with which an undertaking has reinsured or the compliance of a SPV with the mandatory conditions, the undertaking shall use the latest available information not older than one year.
- 3.35. Credit quality shall be assessed using objective techniques according to generally accepted practices.
- 3.36. Risk mitigation may be used to mitigate the credit risk arising from reinsurance counterparties, subject to CEIOPS' Advice on the allowance of financial mitigation techniques in the standard formula. This shall be complemented by CEIOPS' advice on counterparty default risk (CEIOPS-DOC-23-09).<sup>7</sup>

## 3.2 CEIOPS' advice

- 3.37. This Paper covers the advice in respect of the qualitative criteria that reinsurance and SPV arrangements must meet in order to ensure that there has been effective risk transfer to a third party of risks stemming from (re)insurance contracts written by the undertaking. CEIOPS' advice on the allowance of financial mitigation techniques shall apply where the effect of an arrangement has a similar result to a pure financial contract.
- 3.38. In addition, this Paper also addresses the assumptions to be used to assess the changes in risk profile of the undertaking concerned and to adjust the calculation of the Solvency Capital Requirement, when risk mitigation techniques are used.
- 3.39. All other risk mitigation instruments not covered by the scope of this paper fall under the scope of CEIOPS' advice on the allowance of financial mitigation techniques. Together these papers cover advice relating to Article 111 (f) of the Solvency II Level 1 text.
- 3.40. In considering whether the reinsurance risk mitigation techniques effectively transfers risk and the extent to which credit for such transfer of risk may be taken within the calculation of the SCR, the following principles shall be followed:

### **Principle 1 – Effective Risk Transfer**

- 3.41. The risk mitigation technique shall effectively transfer risk from the undertaking. The undertaking needs to be able to show the extent to which there is an effective transfer of risk in order to ensure that any reduction in SCR or increase in available capital resulting from its reinsurance arrangements is commensurate with the change in risk that the insurer is exposed to.
- 3.42. The transfer of risk from the undertaking to the third party shall be effective in all circumstances in which the undertaking may wish to rely upon the transfer. Examples of factors which the undertaking shall take into account in assessing whether the transaction effectively transfers

<sup>7</sup> Former CP 28 merged with former CP 51. See <http://www.ceiops.eu/index.php?option=content&task=view&id=576>.

risk and the extent of that transfer include:

- whether the documentation associated with the reinsurance reflects the economic substance of the transaction;
- whether the extent of the risk transfer is clearly defined and beyond dispute;
- whether the transaction contains any terms or conditions the fulfilment of which is outside the direct control of the undertaking. Such terms or conditions may include those which:
  - would allow the third party unilaterally to cancel the transaction, except for the non-payment of monies due from the undertaking to the third party under the contract; or
  - would increase the effective cost of the transaction to the undertaking in response to an increased likelihood of the third party experiencing losses under the transaction; or
  - would oblige the undertaking to alter the risk that had been transferred with the purpose of reducing the likelihood of the third party experiencing losses under the transaction; or
  - would allow for the termination of the transaction due to an increased likelihood of the third party experiencing losses under the transaction; or
  - could prevent the third party from being obliged to pay out in a timely manner any monies due under the transaction; or
  - could allow the maturity of the transaction to be reduced;
- whether the transaction is legally effective and enforceable in all relevant jurisdictions.

3.43. An undertaking shall also take into account circumstances in which the benefit to the undertaking of the transfer of risk could be undermined.

3.44. The mere fact that the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote, does not by itself mean that the reinsurer has not assumed risk. The entirety of the contract needs to be considered.

3.45. In determining whether there is a transfer of risk, the entire contract shall be considered. Further, where the contract is one of several related contracts the entire chain of contracts, including contracts between third parties, shall be considered in determining whether there is a transfer of risk. In addition, the entire legal relationship between the cedant and reinsurer shall be taken into account in this determination.

3.46. When a reinsurance risk mitigation technique includes basis risk:

- There shall be no allowance of such reinsurance risk mitigation instruments in the calculation of the standard formula SCR unless the undertaking is able to demonstrate that the basis risk is not material.
- If allowance of the reinsurance risk mitigation technique in the calculation of the SCR is made, the calculation shall account for the basis risk in line

with the 99.5% confidence level of the SCR.

- 3.47. For the non-life premium and reserve risk module under the standard formula SCR, one of the underlying assumptions of the design of the non-life premium and reserve risk sub-module (and the corresponding health risk sub-module) is as follows that for a reinsurance arrangement, the ratio of net risk to gross risk (on a 99.5% Value-at-Risk level) is less than (or at least not significantly greater than) the net-to-gross ratio of best estimate provisions and premiums. Where this assumption is not valid, the sub-module produces a wrong estimate of the net risk.
- Recoverables and premiums for reinsurance shall only be taken into account in the determination of the volume measures "net best estimate" and "net premiums" of the non-life premium and reserve risk sub-module, if the ratio of net to gross risk is in proportion with the reinsurance part of the best estimate and the premium. This would mean that the ratio of net to gross risk does not significantly exceed the net-to-gross ratio of premiums and best estimate provisions.
  - In particular, no allowance shall be made for finite reinsurance or comparable SPV constructions of the non-life premium and reserve risk sub-module in the standard formula.

## **Principle 2: Economic effect over legal form**

- 3.48. Reinsurance risk mitigation techniques shall be recognised and treated consistently, regardless of their legal form or accounting treatment, provided that their economic or legal features meet the requirements for such recognition. The economic effect of the transaction shall be considered over the legal form.
- 3.49. The SCR shall reflect the economic substance of the arrangements that implement the technique. In principle, this would be through:
- a reduction in requirements commensurate with the extent of risk transfer, and
  - an appropriate treatment of any corresponding risks that are acquired in the process.

Where practical and appropriate, to provide a verifiable and objective framework to the overall treatment of reinsurance risk mitigation techniques in the context of the standard formula calculation of the SCR, it is advisable to separate these two effects.

- 3.50. The impact on the risk associated with the reinsurance risk mitigation technique shall be treated consistently, regardless of the legal form of the protection.

### **Principle 3: Legal certainty, effectiveness and enforceability**

- 3.51. The reinsurance contracts used to provide the risk mitigation together with the action and steps taken, and procedures and policies implemented by the insurance undertaking, shall be such as to result in risk mitigation arrangements which are legally effective and enforceable in all relevant jurisdictions.
- 3.52. To the extent that the effectiveness or ongoing enforceability cannot be verified or the mitigation technique is not documented, the benefits of the mitigation technique shall not be recognised in the SCR calculation, but the calculation shall recognise any additional risks in accordance with the formula.
- 3.53. The SCR standard formula shall to the extent practicable be increased to allow for the possibility that reinsurance protection will not be renewed on expiry or will be renewed on adverse terms.

### **Principle 4: Valuation**

- 3.54. The design of the standard SCR calculation shall recognise reinsurance risk mitigation techniques in such a way that there is no double counting of risk mitigation effects.
- 3.55. Where the reinsurance risk mitigation techniques actually increase risk, the SCR shall be increased.

### **Principle 5: Credit quality of the provider of the reinsurance risk mitigation instrument**

- 3.56. Undertakings shall consider the credit quality of the providers of reinsurance risk mitigation contractual arrangements and shall only take into account effective risk transfer having regard to the credit quality.
- 3.57. Subject to meeting all other relevant criteria and principles laid down in this advice:
- For reinsurance with entities subject to the Directive (other than SPVs): reinsurance should not be recognised if the entity does not meet the SCR;
  - For reinsurance with entities subject to equivalent supervision (other than SPVs): reinsurance should not be recognised if the entity does not meet the equivalent of the SCR;
  - For reinsurance with entities (other than SPVs) not subject to the Directive or equivalent supervision: reinsurance should not be recognised if the entity has a lower rating than BBB (stable) or if the undertaking is not able to demonstrate that the entity meets a

standard of at least BBB (stable).

- For reinsurance with SPVs subject to the Directive: reinsurance should not be recognised if the requirements of the Level 1 text on SPVs are not met.
- For reinsurance with SPVs not subject to the Directive reinsurance shall be recognised only when:
  - the undertaking has provided the supervisor with the information equivalent to that required for the authorization and supervision of a SPV subject to the directive;
  - the undertaking has informed the supervisor of the applicable regulations in the relevant jurisdictions that may affect the SPV or the rights of the undertaking to receive the expected protection; and
  - the supervisor considers that the requirements of the Level 1 text on SPVs are met by the SPV.

3.58. Notwithstanding the above, to the extent that collateral, meeting the requirements of CEIOPS' advice on the allowance of financial mitigation techniques, has been provided, the reinsurance shall be recognised up to the amount of the collateral.

3.59. In determining the strength of an entity with which an undertaking has reinsured or the compliance of a SPV with the mandatory conditions, the undertaking shall use the latest available information.

3.60. Credit quality shall be assessed using objective techniques according to generally accepted practices.

3.61. Risk mitigation may be used to mitigate the credit risk arising from reinsurance counterparties, subject to CEIOPS' Advice on the allowance of financial mitigation techniques in the standard formula. This shall be complemented by CEIOPS' advice on counterparty default risk (CEIOPS-DOC-23-09)