IRSG

INSURANCE AND REINSURANCE STAKEHOLDER GROUP

Advice on supervision of run-off undertakings

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1. IRSG ANSWER TO EIOPA CONSULTATION ON RUN-OFF UNDERTAKINGS – FIRST DRAFT

Consultation can be found *here.*

1.1. IMPACT ASSESSMENT

1. Do you share EIOPA's view that run-off business model is particularly challenging (e.g. due to its specific risk profile, the difficulties of the process and assessment of the change of ownership, the lack of specific provisions on run-off in the Solvency II framework, etc) and that the release of a Supervisory statement by EIOPA will contribute to ensure a high quality and convergent supervision of run-off undertakings/portfolios?

No. The IRSG finds that the run-off business model, partial or whole, needs a different type of involvement and actions than a going-concern business but that it can be managed with a more or less normal ways of business. More than that, we even see that many operations around the run-off portfolios can be less complicated and easier than those for businesses that have also new business. Anyway, we find EIOPA's work to clarify some of the open questions around the run-off business supervision important but still see that the existing Solvency II regulation sets a solid ground also for ensuring proper policyholder protection.

We would also ask EIOPA to clarify and possible reconsider whether a supervisory statement is the right tool to enhance supervisory practices around the run-off businesses, full or partial. Usually supervisory statements are used where there is lack of convergence in the supervisory practices but whether this is the case with the possible issues around run-off could be justified better. If there is not clear rationale and motivation to have a supervisory statement here, then possibly some other ways could be used.

2. Do you agree with the dialogue with NCA, proposed in section 4, with regard to the decision to go into run-off? (If not, please explain the reasons why)

No. We find many of the elements of the supervisory dialogue good and progressive but would underline the differences between partial and full run-off and its impacts on the business model. We would encourage to acknowledge the less needs for an excessive dialogue when only part of the business is put into run-off and where even then normal ORSA process might cover many of the needs. We also would bring out that the company's board makes the decision of a run-off and it would be hard or even impossible in some cases to keep the supervisor part of that decision making. Anyway, we would see that a transparent and open discussion with the supervisor is a good way to ensure that the policyholder needs are satisfied properly.

3. Do you agree with section 5 of the Statement referred to the acquisition of run-off undertakings or transfer of run-off portfolio, that EIOPA proposed in light of the growing interest in such acquisitions, also by private equity or similar investment entities?

Yes, but any new needs for an early dialogue should not hinder the transfer too much as usually there is also several parties involved that might have different commitments. Also the market timing might have an impact that should be taken into account enough well. EIOPA is right on bringing out the various risks from policyholder's perspective but should also acknowledge the various benefits there is which can benefit the end customers in both direct and in-direct ways; better managing of the portfolio usually gives a more stable outcome in a long run which applies to the capital allocation, risk taking ability, expense handling and even profit sharing possibilities.

4. Do you agree with section 6 of the Statement with regard to the on-going supervision of the Business Model (points 6.2 to 6.5)?

Yes, an on-going supervision is a must have, but we also see that the business model is enough well analysed in the ORSA and that any new and sudden need that is of enough importance will trigger an extra ORSA run. The ORSA process is a suitable and holistic way of looking the benefits and risks of a change of a business model.

5. Do you agree with section 6 of the Statement with regard to the on-going supervision of Technical Provisions (points 6.6 to 6.15)?

On the assessment of technical provisions basically yes, but the way the going-concern assumption might need to be relaxed is complicated and affects to the calculations in various ways. Also it is not black'n white, there is various grey areas to look in order to adjust the best estimate calculations properly. We would also bring out that the risk free investment return assumption in the discount rate is prudent already and most likely will create profits during the run-off. Also the way risk margin will decrease and most probably work similarly. These could be analyzed better in the ORSA-process.

We in the IRSG find that more technical analysis needs to be done on how expenses will change in future and this depend highly on the new business model of the owner of the run-off portfolio (the acquirer). Also customer behavior can change a lot and most probably will be different than assumed before the decision to go run-off. EIOPA's thinking around management actions need to be broader as both the management of the business will be different but also it needs to be dealt in the calculation of technical provisions and in the loss absorbing capacity of technical provisions in different ways. Anyway, we see that the current legislation is clear enough when it comes to calculation of technical provisions.

For reinsurance recoverables, an underlying basis of reinsurance is that the reinsurer and cedent have different views and treatment of the underlying risk for various reasons including different risk profiles and this is reflected in the technical provisions. See answers (below) separately to specific points 6.13, 6.14 and 6.15.

6. Do you agree with section 6 of the Statement with regard to the on-going supervision of Investments (points 6.15 to 6.21)?

Yes, we find that on the assessment of investment strategy EIOPA is bringing out several correct issues. Anyway we would highlight that the setting and managing of an investment strategy need to follow the same general principles that any other (going-concern) portfolio; setting of the risk appetite, risk management tools (incl. hedging), ALM-practices, prudent person principle, liquidity and others. Also the owner of the run-off portfolio might have different ways to ensure a stable process and this needs to be taken fully into account in the supervision. Also there might be cases where the run-off is managed under mutual insurance which could also reduce some of the questions around profit sharing but could also trigger new ones, e.g. around capital management.

7. Do you agree with section 6 of the Statement with regard to the on-going supervision of the Reinsurance strategy (points 6.22 to 6.28)?

Some of the proposals on the supervision of reinsurance strategy are not consistent with the Solvency 2 framework. It is sufficient here for EIOPA to remind that supervisors should be aware of the existing requirements in Solvency 2 relevant for the reinsurance strategy and apply these as appropriate to the run-off business model. See answers (below) separately to specific points 6.23, 6.24 and 6.27.

8. Do you agree with section 6 of the Statement on Conduct of business supervision?

Yes, the IRSG finds that EIOPA brings out several important aspects around consumer protection and also agree that the customers should be in the very centre of any run-off portfolio. Anyway we would like to bring out that the management of a run-off can bring a lot of indirect benefits to customers which will further protect them. We also find out that the ways that the product terms and conditions could be changed during the run-off is something to focus also as there might be different ways that national insurance legislations can allow for (or forbid).

9. Is there any supervisory assessment/analysis that it is missing in the Statement that you find relevant to introduce? (If yes, please add a bit of background)

We would bring out that the definition of a partial run-off is important as it might consider potentially a large group of existing policyholders. Especially on the guaranteed rate savings and pensions products there is a lot of product lines in run-off even though the insurers usually still offer new products (e.g. UL-products or lower guaranteed rate products). We would see that this aspect needs to be clarified to avoid misinterpretations.

We also find that when the undertaking is acquired by a non-European party/actor, it is good to recon that the control of the investment capital as well is given for this non-European party/actor. If this would be happening in a large scale, it may lead to societal or capital supply related effects for European communities, since investors (incl. insurers) may have a tendency to find their home markets more attractive.

Finally, it is also good to reckon that not all undertakings look the same neither in terms of organizational form and ownership. In case of, for example, customer-owned mutuals and insurance associations, an important perspective is, that if the policyholders' rights and interests as owners are undermined, it may well influence on their benefits as policyholders as well.

1.2. ADDITIONAL COMMENTS

Please insert here any general comment, if not related to the specific paragraphs and sections above

We would like to bring out few aspects on the transfer of reinsurance portfolios from one reinsurer to another. In general; the transfer of reinsurance portfolios is substantially less regulated than primary insurance. The regulatory principles are basically still the ones that got implemented via the EU-Directive 2005/68/EU (also called EU-Reinsurance-Directive); they have remained more or less unchanged by the implementation of Solvency II.

Anyway, there might be some exceptions to this general view. To name one, supervisors' view might be different if the assuming reinsurer is located and supervised in a third country, ie. a country

- outside the range of Solvency II, as well as
- outside the countries being acknowledged as reinsurance-equivalent under Art. 172 Solvency II (currently Switzerland and Bermuda).

The USA – even though to be regarded as a Third Country based on the above definition – are treated as an exception based on the Covered Agreement between USA / EU under the US / EU dialogue. Therefore, we believe that some of the third countries might be acceptable to the Supervisors, some of them might not be acceptable.

As a conclusion, we see that the current regulation for transfer of reinsurance portfolio under Solvency II is sufficient and it seems to be justified that the regulation regarding the run-off of reinsurance portfolios is substantially 'lighter' than it is for run-off of primary portfolios, keeping in mind possible needs for amendments regarding the third country cases.

1.3. COMMENTS TO SOME OF THE SPECIFIC ARTICLES

6.13. The impact of the cession of some insurance risks to the reinsurer will be accounted for in the Solvency II balance sheet of the ceding undertaking under reinsurance recoverables. It should be ensured by the supervisory authority that the assumptions underlying the recoverables are not overly optimistic and are in line with Article 81 of Solvency II and Articles 41 and 42 of the Delegated Regulation. If both the ceding undertaking and the accepting reinsurer are subject to Solvency II, it is expected that the reinsurance recoverables in the balance sheet of the ceding undertaking (before accounting for expected losses due to default of the counterparty) are broadly in line with the gross technical provisions (referred to the same obligations) in the balance sheet of the accepting reinsurer. It should be noted that the differences can be larger in some cases such as if the ceded business becomes part of a much larger homogeneous risk group e.g. for non-life.

Comment:

Comparing reinsurance recoverables in the ceding company balance sheet to the gross technical provisions of the reinsurer will not be valid or practical in most cases. An underlying basis of reinsurance is that the reinsurer and cedent have different views of the underlying risk for various reasons including different risk profiles and this is reflected in the technical provisions. Leaving aside that the gross technical provisions would include the accepting reinsurer's risk margin, there are perfectly valid reasons why the best estimate liabilities may be different in the balance sheet of the reinsurer and the ceding company for a reinsured block of business, including different valuation methodologies applied which could vary depending on the nature and relative materiality of the business lines and granularity at which the best estimate liabilities are calculated, different assumptions about the emergence of future experience (the reinsurer may have a broader portfolio on which to base assumptions), a different level of granularity at which assumptions are set (given the relative sizes of the portfolios), different expense bases and so on.

This is not to mention that reinsurer technical provisions by client (or by treaty) are not publicly available and the ceding company will have no means to carry out the check proposed. Furthermore, reinsurers are unlikely to be in a position to share details of their technical provisions (and by implication potentially how business is priced) at the level of granularity that would be required without undermining sensitive commercial treaty negotiations.

6.14. The reinsurance recoverables typically are based on probability weighted cash flows assuming scenarios with and without the reinsurer's default. The cash flows under the scenario of a reinsurer default will be determined by the insolvency legislation the reinsurer is subject to, which is used to determine the recovery value. In case of a third country reinsurance undertaking, it is possible that the valuation of the recovery value is materially different from a valuation under the insolvency legislation the ceding undertaking is subject to. The assumed credit loss might therefore be lower than the actual loss due to these legal valuation differences before considering economic losses resulting from the defaulted reinsurer not having sufficient funds to reimburse the cedent. The supervisory authority should ensure that this additional credit risk resulting from *valuation differences is accounted for in the assumption used to calculate the reinsurance recoverables (e.g. in the Exposure-at-Default and Loss-Given-Default assumptions).*

Comment:

The first sentence in the above paragraph should be more specific, referring to the regulatory framework in place rather than the generic comment on what is deemed typical practice i.e. "Article 42 of the Solvency 2 delegated act specifies how adjustments to take into account losses due to default of a counterparty shall be calculated as the expected present value of the change in cash flows underlying the amounts recoverable from that counterparty if the counterparty defaults." It is unlikely to be proportionate to require all companies to have intimate knowledge of the insolvency legislation of all of their reinsurers' jurisdictions. This should be reserved only for those cases where a very material counterparty risk concentration exists vis-à-vis a single or very few reinsurers.

6.15 Typically, the reinsurance recoverable is settled on a recurring basis based on the immediate past financial result or cash flow in a backward-looking manner considering the characteristics of the reinsurance treaty. In case of material reinsurance, the additional credit risk amongst others resulting from valuation differences can be limited by introducing a clause in the reinsurance treaty which settles the reinsurance recoverable if the position exceeds a predefined threshold. This would be a more forward-looking way of addressing possible credit risks and would ensure that the open position with respect to the reinsurance counterparty never exceeds a certain size.

Comment:

Solvency 2 provides a robust framework for ensuring that ceding companies' reinsurance management is appropriate having regard to their overall risk management framework. Article 44 of the Solvency 2 directive requires that the risk management system covers reinsurance and article 260 of the delegated acts requires the insurer's policies to ensure selection of suitable reinsurance and the assessment of the most appropriate arrangements.

Given the robust and coherent Solvency 2 framework in place and the principles underlying this framework, it is not appropriate to prescribe or recommend specific points on how reinsurance contracts should be drafted. The reinsurance treaty contract represents the outcome of a commercial negotiation between the ceding company and the reinsurer. The ceding company and the reinsurer will negotiate the treaty in the round having regard to their reinsurance risk management policies and framework and Solvency 2 regulation.

Furthermore, as noted, the underlying basis of reinsurance is that the reinsurer and cedent have different views of the underlying risk for various reasons including different risk profiles and this is reflected in the technical provisions. The fact that a difference in valuation exists cannot be by itself a reason to settle recoverables and certainly not before claims have been made, as such an action would create a misalignment of incentives between cedent and reinsurer.

6.23. Supervisory authorities should discuss with the undertakings with high cession rates in particular to assess the following:

- reinsurance concentration: in case of material reinsurance with a high cession rate with respect to a single or few reinsurers, a concentration risk can arise with respect to the reinsurance counterparty. This concentration risk might not be fully reflected in the SCR e.g. for the case of a downgrade of the single reinsurer or when financial or underwriting stresses increase the probability of default of the single reinsurer;

- collateral: the counterparty risk could be reduced if collateral would be posted. Risk-based haircuts can be used to incentivise the reinsurer to use high-quality, liquid and short-term assets as collateral. Lastly, the adjustment of the collateral or the margining should be considered to ensure that this occurs within a sufficiently short delay when needed;

- retrocession: in case of high retrocession the reinsurer is merely fronting and not taking on any risk and the final risk-taker is the retrocessionaire. Specific attention is needed in case the retrocessionaire is not based in the EU. Other legislation with regard to the valuation of the technical provisions or the required solvency margin might be applicable. The ceding insurance undertaking as well as NCAs should ask for information on retrocession in cases where this seems relevant.

Comment:

Concentration risk management is already reflected in the Solvency 2 delegated regulation, whereby companies are required to have policies to identify and limits concentration risk as part of risk management framework as per article 260. As the purpose of the first point above seems to be to remind supervisors of points in the existing regulation, then it should just refer to the existing regulation.

The second point on collateral implies EIOPA support for collateral arrangements in reinsurance treaties. This point should be removed, as any such implication for treaties with reinsurers subject to Solvency 2 (or any equivalent framework) must be avoided, having regard to the principles underlying Solvency 2 and the regulation of EU reinsurers under that Directive. In particular Article 134 of the Solvency 2 directive prohibits regulatory requirements for the pledging of assets where the reinsurer is EU authorised (similarly for article 173 for equivalent reinsurers). The paragraph also goes further in describing how collateral arrangements should be structured. Please refer to comments on 6.15 regarding the inappropriateness of potentially influencing contract negotiations in this way.

The final point on retrocession seems to have very particular arrangements in mind i.e. where risks are fully retroceded outside the EU. If this is the case then it should be made fully transparent, otherwise this point risks a broader application than is intended, creating confusion and uncertainty. As a general comment, the information which the reinsurer can provide to the ceding company on its retrocession arrangements is likely to be limited to publicly available information. Solvency 2 already provides for extensive disclosure for EU reinsurers and this is sufficient. To the extent that the local NCA has any concerns about the EU reinsurer it should consult that reinsurer's NCA in the first instance.

6.24. As indicated in EIOPA's Opinion on the use of risk mitigation techniques, insurance and reinsurance undertakings – when calculating the Basic SCR – should take into account risk-mitigation techniques as referred to in Article 101(5) of Solvency II and complying with Articles 208-214 of the Delegated Regulation. Where the reduction in the SCR is not commensurate with the extent of the risk transferred or there is not an appropriate treatment within the SCR of any material new risks that are acquired in the process, insurance and reinsurance undertakings should consider that the risk-mitigating technique does not provide an effective transfer of risk.

Comment:

The second sentence in the above paragraph should be deleted as it does not provide the full context, but rather a selected excerpt of the EIOPA Opinion and the regulation.

6.27. If the material reinsurance counterparty default and concentration risk is not fully captured by the
SCR as demonstrated within the ORSA, and to make sure that the solvency position of the cedent remains guaranteed, the supervisory authority can request the undertaking to:
- limit the cession rate to an upper bound. A minimum retention of risks by the undertaking can be required by the supervisory authority;
- incorporate collateral or a reinsurance deposit consisting of high quality investments with a swift margining mechanism;
- incorporate financial guarantees to ensure that capital will be injected if the solvency ratio drops below a specific threshold.

Comment:

The points in this paragraph again do not recognise the existing risk management requirements under Solvency 2. The wording is very strange and does not recognise the principles of Solvency 2 (e.g. the supervisor needs to make sure the solvency position of the cedent remains "guaranteed") or the ladder of supervisory intervention under Solvency 2. Regarding the sub-bullets

- This implies that a supervisor can have the power to intervene directly in an existing reinsurance contract in the circumstance described, thereby over-ruling the law on which that contract is based. It is questionable whether supervisors would have a legal basis to use such a power even if they were prepared to do so (see comments under 6.15 regarding supervisory inference in new reinsurance contracts).

- See comments on collateral under 6.23 comments above.
- The final point is very unclear, is not specific to the reinsurance section and should be placed elsewhere in the paper if maintained (presumably the parent would inject capital under a range of circumstances, not just related to reinsurance specifics).

This paragraph needs to be either completely deleted or amended to be consistent with and include appropriate references to Solvency 2 regulations.

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