

# OPINION ON THE USE OF RISK MITIGATION TECHNIQUES BY INSURANCE AND REINSURANCE UNDERTAKINGS

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## Legal basis

1. The European Insurance and Occupational Pensions Authority (EIOPA) provides this Opinion on the basis of Article 29(1)(a) of Regulation (EU) No 1094/2010<sup>1</sup>. This article mandates EIOPA to play an active role in building a common Union supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union by providing opinions to competent authorities.
2. EIOPA delivers this Opinion on the basis of Directive 2009/138/EC<sup>2</sup> (Solvency II Directive), in particular in relation to Articles 101(5) and 110, Commission Delegated Regulation (EU) 2015/35<sup>3</sup> (Delegated Regulation), in particular in relation to Articles 208-214 and 276, EIOPA's Guidelines on Basis Risk<sup>4</sup> and EIOPA's Guidelines on system of governance<sup>5</sup>.
3. This Opinion is addressed to the competent authorities, as defined in point (i) of Article 4(2) of Regulation (EU) No 1094/2010<sup>6</sup>.
4. The Board of Supervisors has adopted this Opinion in accordance with Article 2(7) of its Rules of Procedure.

## Context and objective

1. Risk mitigation techniques and, in particular reinsurance, are efficient tools for insurance and reinsurance undertakings to manage their risks according to their strategy and capacity. It is also an important tool for capital management improving risk diversification and can be used as an instrument to expand the current business and alongside to gain knowledge, via the reinsurance undertaking, of the latest developments in emerging markets and risks.
2. It is understandable that market participants seek to optimise their capital position within Solvency II Directive, and reinsurance is a tool that can be used for that purpose. Since the inception of Solvency II Directive new reinsurance structures started to appear and, in other cases, structures already existing that were not so common in the European market started to

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<sup>1</sup> Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

<sup>2</sup> Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (OJ L 335, 17.12.2009, p. 1).

<sup>3</sup> Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 12, 17.1.2015, p. 1).

<sup>4</sup> [https://www.eiopa.europa.eu/content/guidelines-basis-risk\\_en](https://www.eiopa.europa.eu/content/guidelines-basis-risk_en).

<sup>5</sup> [https://www.eiopa.europa.eu/content/guidelines-system-governance\\_en](https://www.eiopa.europa.eu/content/guidelines-system-governance_en).

<sup>6</sup> Notwithstanding the fact that specific points of this Opinion describe supervisory expectations for insurance and reinsurance undertakings, they are required to comply with the regulatory and supervisory framework applied by their competent authority based on Union or national law.

gain relevance. Some of these emerging structures are complex or have particular interactions with the Standard Formula calibration.

3. Therefore, to ensure a convergent supervision of risk mitigation techniques, this Opinion includes a set of recommendations addressed to supervisory authorities.
4. This Opinion raises awareness and ensures that while the insurance sector continues to use risk-mitigation techniques adequate to their risk profile, prudence and effective risk transfer are duly considered by supervisory authorities when assessing compliance of recognition of risk mitigation techniques in the solvency capital requirement (SCR) calculation.
5. Where there is a calculated capital relief, a commensurate risk transfer is also expected. When this is not the case, these reinsurance structures may lead to a significant deviation of the risk profile of the undertaking from the underlying assumptions of the Standard Formula and the result might be an unbalance between risk reduction and capital reduction.
6. The use of risk mitigation techniques can have a significant impact on the SCR. For non-life insurance it impacts the 'premium and reserve risk' and the 'catastrophe risk'. For life insurance, reinsurance contracts or other contracts that are structured as reinsurance contracts can also impact other risk modules, for example 'lapse risk', 'longevity risk' or even 'expense risk' among others. The overall impact can significantly reduce the SCR of an insurance and reinsurance undertaking and therefore supervisory authorities should give appropriate attention to this subject.
7. Under Solvency II Directive, undertakings are required, as part of the general governance requirements, to manage risk prudently. Although the use of risk mitigation techniques in general is a good tool to mitigate the (insurance) risk, it should be recognised that the transfer of risk might create basis risk and introduce other risks, e.g. a possible increase in counterparty default risk and, depending on the structure, concentration risk.
8. Recognition of risk mitigation techniques for the calculation of the SCR using the Standard Formula is regulated in Articles 208-214 of the Delegated Regulation. In the practical application of these provisions, to recognise a risk mitigation technique in the SCR calculation there should be a proper balance between the effective risk transfer and the SCR relief. To this end, the SCR calculation needs to reflect the substance of the arrangements that implement the risk mitigation techniques.
9. Standard Formula formulas and scenarios are a mean to an end: quantify a risk; but they should not be considered comprehensive in terms of the risk covered, which can adopt many shapes (e.g. mass-lapse risk). Reinsurance structures tailored to Standard Formula scenarios/formulas or other reinsurance structures with complex interactions with the Standard Formula (e.g. split covers as an adverse development cover plus a loan) may endanger the adequacy of the Standard Formula measuring the risk-mitigating effect of the reinsurance structure.

10. Because of the complexity of this assessment, case-by-case analysis is necessary to ensure an adequate consideration of the specificities of the undertaking and the reinsurance structure.
11. Supervisory authorities should also apply this Opinion to insurance and reinsurance undertakings which make use of an internal model to calculate the SCR with the necessary special considerations of each internal models.

### **Consistency between SCR and risk transfer**

12. In principle, risk mitigation techniques reduce undertakings' risks and consequently they are expected to lead to a reduction of the SCR. Some risk-mitigating techniques may create a basis risk or other risks not properly captured in the Standard Formula. Others may, due to its specific design, lead to a SCR relief that is not commensurate with the risk transfer. In both cases, this could lead to a significant deviation of the risk profile of the undertaking from the assumptions underlying the the Solvency Capital requirement as calculated using the Standard Formula. For this reason, where a risk linked to the risk-mitigating technique is not properly captured, i.e. it leads to a significant deviation of the SCR, it should be considered that the risk-mitigating technique does not provide an effective transfer of risk.

Insurance and reinsurance undertakings, when calculating the Basic SCR, should take into account risk-mitigation techniques as referred to in Article 101(5) of the Solvency II Directive and complying with Articles 208-214 of the Delegated Regulation. Where there is a significant deviation of the SCR due to a reduction in the SCR that is not commensurate with the extent of the risk transferred or due to an inappropriate treatment within the SCR of any 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.

The actuarial function of the undertaking should assess, express an opinion and document the assessments above for any material reinsurance arrangement as part of the task to express an opinion on the adequacy of reinsurance arrangements<sup>7</sup>. This should be reported to the administrative, management or supervisory board in the annual actuarial function report as referred to in Article 272(8) of the Delegated Regulation. A reinsurance arrangement should be considered to be material for this purpose where it could individually affect the assessment of the adequacy of the overall reinsurance arrangements or if all reinsurance arrangements together may lead to a significant deviation of the risk profile of the undertaking from the underlying assumptions of the SCR.

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<sup>7</sup> Article 48(1)(h) of the Solvency II Directive and Article 272(7) of the Delegated Regulation.

The role of the actuarial function as described above is of particular importance in case an insurance or reinsurance undertaking has implemented a new material risk mitigation technique contract.

### **Risk management system**

13. The SCR Standard Formula is intended to reflect the risk profile of an average insurance and reinsurance undertaking. The underlying scenarios of the standard formula (e.g. the mass lapse risk or interest rate risk scenarios) are assumptions of the many forms that the risk can take, i.e. these scenarios are not necessarily comprehensive in terms of risk. Focussing only on these scenarios (e.g. mass lapse) may result in an underestimation of the actual risk (for instance if the risk develops over time). Risk mitigation techniques are a key element of the undertaking strategy and risk management system. Therefore, the appropriateness of the Standard Formula should be valid considering all reinsurance arrangements in place and should be assessed in the own risk and solvency assessment (ORSA).

Insurance and reinsurance undertakings should analyse and assess the risk transferred by the risk mitigation techniques from a holistic perspective. This includes an analysis of the risk profile (not only focussing on the standard formula) of the undertaking, before and after the consideration of the risk mitigation techniques, with special attention to risks like underwriting risk, counterparty default risk, basis risk and concentration risk. This analysis should be integrated in the undertaking's overall solvency needs in the ORSA. Undertakings should be able to evidence the adequacy of the Standard Formula to its risk profile considering all relevant elements including risk mitigation techniques.

14. Another aspect worth paying attention to is whether the complexity of the reinsurance contract leads to a specific interaction with the SCR that may endanger the balance between capital relief and risk mitigation. For example, a simple quota share with a high overriding commission mechanism or deep sliding-scale commissions may lead to a similar economic reality of the one of a loan or non-proportional reinsurance respectively. This will not always lead to material unbalances between capital relief and risk mitigation, however more attention from supervisory authorities may be expected.
15. In some cases a single contract combines two functions (bifurcated cover), for example: the risk mitigation of a deviation of the best estimate and a loan. When the treatment of the two separate contracts on the balance sheet and on the SCR is different from the single combined contract, this indicates that a thorough risk analysis is needed, in particular for long-tail business.
16. Differences in the structures of the reinsurance arrangement and the Standard Formula may create some challenges, as for example multi-year stop-loss covers. For a non-proportional reinsurance multi-risk treaty a full joint

distribution of all risks may be necessary, e.g. to precisely apply the limits of the reinsurance arrangement or to ensure that material non-linear effects after the reinsurance agreement are properly captured, which is not consistent with the the Standard Formula modular design. This will not always lead to material unbalances between capital relief and risk mitigation, however more attention from supervisory authorities may be expected.

Upon request from the supervisory authorities, insurance and reinsurance undertakings should provide the technical details of the risk mitigation techniques and the related contracts and detailed information on any links or combinations with other existing or newly implemented contracts, appendixes or side letters that would allow the understanding of the full impact of the contract and the real risk transfer.

Insurance and reinsurance undertakings should be able to explain to the supervisory authority the relation with the reinsurance policy and the risk management policy, including the policy regarding counterparty default risk, to ensure that all risks are taken into account.

17. In some specific cases, reinsurance structures may have an impact on the Own Funds of the undertaking and EPIFP in particular, e.g. via an implicit extension of contract boundaries or in case of a quota share agreement with a high cession rate. Supervisory authorities should also pay attention to these structures to ensure a recognition and valuation that is consistent with Solvency II principles.

### **Supervisory involvement**

18. All risk transfer transactions need to comply with Articles 208-214 of the Delegated Regulation, however, following a risk-based supervision, it is expected that the most complex ones and those that present specific interactions with the Standard Formula (e.g. multi-year stop-loss covers, bifurcated covers, complex deep sliding-scale or profit commissions, longevity or mass-lapse risk transfer among others) need more attention from supervisory authorities.
19. In these cases, supervisory authorities should engage in an on-going supervisory dialogue with the undertaking, as it is already a common practice in several jurisdictions. For this dialogue to be efficient, it should start sufficiently before the conclusion of the reinsurance agreement to allow supervisory authorities to understand the undertakings' Reinsurance Strategy and its impact on the solvency position of the undertaking. This dialogue is expected to be maintained over time so supervisory authorities are informed in case of any material changes.
20. To ensure a convergent approach, where the reinsurance structure is relevant across multiple jurisdictions, supervisory authorities are expected to coordinate and cooperate in the assessment of such structure.