

IRSG

INSURANCE AND REINSURANCE STAKEHOLDER GROUP

Advice on EIOPA's draft Supervisory Statement
on the use of risk mitigation techniques by
insurance and reinsurance undertakings

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Introductory Comments

We understand that EIOPA's main issue in its draft statement on RMT is to warn against possible excessive risk mitigation advantage in net SCR computations of the standard formula.

We would like to underscore that the concerns raised should be dispelled by the strong safeguards provided by the existing solvency II framework. Articles 208 to 214 provide all the necessary basis for avoidance of ill-usage or overstatement of risk mitigation techniques. They serve as guidance for the actuarial and risk management functions to fulfil their respective role of justification and demonstration of the relevance of Pillar 1 computations and against the insurance undertaking's own risk profile.

This also brings us to the fundamental question of whether Pillar 1 Solvency II standard formula works sufficiently well for the reinsurance in place within a specific insurance undertaking. If this would not be the case the framework already provides for an assessment of the appropriateness of the standard formula in the Pillar 2 ORSA and envisages changing the approach to Pillar 1 computations and resorting to an escalation of sophistication through the use of USPs and further partial and full internal models. A last resort measure would be a supervisory capital add-on.

Under all these safeguards we feel not much more is needed and would like to insist on the necessary compromise that the standard formula brings between risk sensitivity and simplicity

1. [This Supervisory Statement](#) is the result of the analyses on the use of reinsurance structures by insurance and reinsurance undertakings that optimise the use of capital under the Solvency II framework, when the Solvency Capital Requirement (SCR) is calculated with the standard formula.
2. [This Supervisory Statement](#) should be read in conjunction with Directive 2009/138/EC (Solvency II Directive), Commission Delegated Regulation (EU) 2015/35 (Delegated Regulation), EIOPA Guidelines on system of governance and EIOPA Guidelines on basis risk.
3. The aim of this statement is to promote supervisory convergence on the assessment of the use of risk-mitigation techniques as it is recognised that potential divergent practices or potential supervisory arbitrage in this area could contribute to an unlevel playing field.
4. [This Supervisory Statement](#) 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 is duly considered when recognising risk mitigation techniques in the SCR calculation.
5. For insurance and reinsurance undertakings it is important to have an appropriate reinsurance policy in place, first of all as a proven concept of mitigating risks that the undertaking is not able to bear on its own, but also 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.

6. It is understandable that market participants seek to optimise their capital position within Solvency II, and reinsurance is a tool that can be used for that purpose. Inevitably, newly designed reinsurance structures are complex and challenging to assess, but if there is a real reduction in risk, it is reasonable that there should also be corresponding capital relief. When this is not the case those reinsurance structures may be seen as designed to arbitrage the regulation in place and the result might be an unbalance between risk reduction and capital reduction.

The statement that “newly designed reinsurance structures are complex and challenging to assess” is too general, implying this is the case for all new reinsurance structures. We would suggest that at the very least the following changes are made to the statement to provide some balance *“Inevitably, **some** newly designed reinsurance structures are complex and **might be** challenging to assess, but if there is a real reduction in risk, it is reasonable that there should also be corresponding capital relief. When this is not the case **some of** those reinsurance structures may be seen as designed to arbitrage the regulation in place and the result might be an imbalance between risk reduction and capital reduction.”*

The use of the term “real reduction in risk” is open to interpretation. The statement implies that where there is “no real reduction in risk”, reinsurance structures are designed to arbitrage the regulation. This fails to recognise that reinsurance is a risk and capital management tool and certain reinsurance solutions may provide a combination of capital support and lower risk reduction. Such structures are designed with capital support or combinations of risk mitigation and capital support, not regulatory arbitrage, in mind. For example, life reinsurance contracts may be designed such that the ceding company pays reduced or nil reinsurance premiums in the initial years of the underlying contract as a means of supporting the ceding company’s new business capital costs.

Any assessment of reinsurance contracts should be based on the risk mitigation substance, not its form. Thus any form of reinsurance should be assessed based on its effective risk mitigation. EIOPA should not provide disincentives to the use of specific forms of reinsurance that effectively mitigate risk by compiling negative lists or creating an administrative burden via an extensive assessment of the limitations of the standard formula. Thus, any assessment should be based on materiality considerations having regard to the impact of the reinsurance contract on the overall risk profile of the undertaking. Solvency II regulation already provides for such considerations.

7. 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, due to newly developed structures, 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'. The overall impact can significantly reduce the SCR of an insurance and reinsurance undertaking and therefore supervisory authorities are recommended to give appropriate attention to this subject.

Non-life quota share reinsurance contracts are recognised in the premium and reserve risk module of the standard formula. However non-proportional reinsurance contracts are imperfectly recognised in the premium and reserve risk module, with a flat 20% (non-risk sensitive) factor applied for 3 lines of business. In particular EIOPA should not try to address limitations in the design of the standard formula by placing restrictions on the type of reinsurance contract that can be taken credit for. This paragraph should explain this, in order to provide the appropriate background and context to the treatment of reinsurance in the standard formula.

8. Independently from the eligibility criteria for recognising risk mitigation techniques for solvency purposes, insurance and reinsurance undertakings are expected to ensure that risk mitigation is commensurate with the relief in the SCR calculation when introducing new techniques.

Please refer to comments on paragraph 12.

9. 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 introduce other risks, i.e. a possible increase in counterparty default risk, basis risk and depending on the structure, concentration risk.

Solvency II explicitly deals with these other risks, in particular counterparty default risk and concentration risk. Any discussion of these risks should be considered in the context of these other Solvency II provisions, rather than specifically in the context of this statement on reinsurance contracts. While basis risk is a related topic, EIOPA is separately considering this as part of the 2020 Solvency II review.

10. 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 it is expected that 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.

This paragraph does not recognise that the standard formula SCR is not designed to reflect the substance of the arrangements that implement the risk mitigating techniques in all circumstances. A clear example is non-proportional non-life reinsurance in the premium and reserve risk module.

Notwithstanding this, whilst the Standard Formula under Solvency II, Pillar 1, certainly has its limitations -- as every model inevitably does -- the IRSG believes that the Standard Formula together with the adjustment possibility via ORSA in Solvency II, Pillar 2, is appropriate and sufficient.

In any case, if the standard formula is not sufficient to appropriately capture the risk profile of the undertaking (having regard to the reinsurance contracts in place) may request the use of a full or partial internal model in line with Article 119 of the Solvency II directive.

11. Supervisory authorities are recommended to also apply this Supervisory Statement 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.

BALANCED APPROACH

12. It is important to consider the purpose of the intended risk transfer transaction. In principle, risk mitigation techniques reduces undertakings' risks and consequently it is expected to lead to a reduction of the SCR. However, some transactions may, due to its specific design, lead to an optimisation of the undertakings' solvency position (i.e. by increasing the eligible own funds and/or by decreasing the SCR) without a corresponding transfer of risk. In such a case the transfer of risk has become of secondary importance within the transaction. Therefore, EIOPA underlines the importance of a proper balance between the risk reduction and the capital relief.

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:

the reduction in the SCR or the increase in the eligible own funds is commensurate with the extent of the risk transferred, and there is an appropriate treatment within the SCR of any new risks that are acquired in the process.

The actuarial function of the undertaking should assess, express an opinion and document the mentioned balance as part of the task to express an opinion on the adequacy of reinsurance arrangement[1]. 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.

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

[\[1\] Article 48\(1\)\(h\) of the Solvency II Directive and Article 272\(7\) of the Delegated Regulation](#)

Reinsurance provides a mechanism for insurers to reduce their underwriting risk across a broad range of non-life and life business classes. It thereby enables insurers to strengthen their own solvency and expand their capacity to absorb different types of business and customer risk, both catastrophic and non-catastrophic. In addition, reinsurance helps insurers to reduce the volatility of their earnings, accompanied by positive effects on capital costs, which insurers can pass on to policyholders. Reinsurance facilitates the diversification of primary insurers' risk exposures and can provide liquidity support. By strengthening insurers' resilience to losses, reinsurance increases policyholder protection and by enhancing insurers' capital management, it reduces capital costs which can be passed on to policyholders in the form of lower prices.

The regulatory framework should not create barriers to reinsurance in performing this role. Solvency II should achieve the correct balance between recognising the benefits of reinsurance and providing appropriate safeguards. Overly prescriptive regulation will undermine the benefits of reinsurance.

In this statement EIOPA takes a one sided, overly restrictive approach to reinsurance recognition by establishing a higher standard for the recognition of certain reinsurance risk mitigating techniques in the standard formula than is the case in the Solvency II regulation. This risks placing barriers in the way of reinsurance and undermining the benefits of reinsurance as an efficient risk and capital management tool. Attempting to address a very limited and specific issue in this way risks disincentivising the use of reinsurance RMTs in general thereby reducing the risk bearing capacity in the entire system, ultimately to the detriment of policyholders.

Solvency II is a Risk Based Capital' approach with the simple principle that whatever risk is borne, there needs to be sufficient risk bearing capital for it. Hence a risk mitigation tool is suitable if there is risk transfer, and/ or there is risk capital provided for that risk; that is exactly the effect of reinsurance. We would emphasise here there is always risk transfer in reinsurance, otherwise it would not be classified as reinsurance.

The EIOPA proposals would require that reinsurance RMTs be taken into account in the standard formula only where the reduction in SCR or increase in eligible own funds is "commensurate" with the extent of risk transferred. This very specific criterion fails to recognise that the standard formula captures the average risk profile and by design cannot accurately capture the specifics of all risk profiles or individual reinsurance contracts and this is a satisfactory outcome within the overall framework because of the safeguards which are in place in Solvency II where there is a significant departure in risk profile from the assumptions underlying the standard formula as described in the next paragraph. The text which states that the reduction in the SCR or the

increase in the eligible own funds is commensurate with the extent of the risk transferred should not be included in this statement.

The standard formula has significant limitations regarding the recognition of certain reinsurance structures. This can give rise to under or over estimations of the extent of risk transfer. The limitations of the standard formula were recognised when Solvency II was developed and were addressed in the design of the framework. The safeguards in the Solvency II framework include undertaking specific parameters, partial and full internal models and supervisory capital add-ons where the risk profile of a standard formula firm deviates significantly from the assumptions underlying the standard formula SCR under Pillar 1. Furthermore, there is a requirement under Pillar 2 to assess the significance of any deviation of risk profile from the assumptions underlying the standard formula and as noted in the draft statement, the actuarial function report requires an assessment of the reinsurance strategy. All the elements exist in the current framework and no additional hurdles for the recognition of reinsurance are necessary. To the extent that this issue needs to be addressed in Pillar 1, this should be done by addressing the lack of risk sensitivity of the standard formula to reinsurance RMTs rather than placing barriers to certain structures based on their form.

The concept of additional reinsurance regulation is not in line with the concept of Solvency II i.e. measuring the individual risk profile / risk portfolio of an insurance company rather than controlling the effect of reinsurance.

EIOPA's approach to reinsurance here whereby individual arrangements should be looked at in isolation of the overall framework could be applied to other aspects of the standard formula e.g. when a company underwrites a certain risk or invests in a certain asset, is the reflection of that risk in the standard formula capital calculation "commensurate" with the actual risk undertaken. This is not consistent with how the standard formula fits into the overall Solvency II framework.

The proposed one sided approach appears to be attempting to "carve out" reinsurance transactions which may give rise to an over-estimation of risk transfer from this overall assessment by applying a level of standard formula validation at individual reinsurance RMT contract level. The role of the actuarial function should not be extended to require this. This is neither proportionate nor in line with the spirit of and safeguards in the Solvency II regulation. The current regulation on this in article 272(7) of the delegated regulations which requires, that regarding overall reinsurance arrangements the opinion of the actuarial function shall include analysis on the undertaking's risk profile and the expected cover under stress scenarios in relation to the underwriting policy, is sufficient.

EIOPA's wording on the final sentence above should be reworded to reflect the actual role of the actuarial function "*The role of the actuarial function as described above is of particular importance*

in case an insurance or reinsurance undertaking has implemented a new risk mitigation techniques contract with impact on reinsurance recoverables and consequently own funds”

13. The SCR standard formula is intended to reflect the risk profile of insurance and reinsurance undertakings. However, the standard formula is a simplification of the complex reality (like every model). In line with this principle, 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. Focussing only on these scenario’s might result in an underestimation of the actual risk (for instance if the risk develops over time). The appropriateness of the standard formula should also be valid with the 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 prepared to evidence the adequacy of the standard formula to its risk profile after the risk transfer when challenged by supervisory authorities.

[1] IAISICP13.2.2 states: “The ceding insurer should ensure that the characteristics of its reinsurance programme, including the credit risk posed by the reinsurer, are reflected in its capital adequacy assessment as well as its ORSA”

The Solvency II standard formula can in certain instances lack risk sensitivity both in the gross capital calculation and in the recognition for reinsurance. This is a feature of a standard formula, like any model, as a simplified representation of reality.

The simplified structure of the standard formula gives rise to the situation where the recognition of reinsurance contracts can be binary i.e. either the contract is recognised in full, in which case full SCR relief is granted or the contract is not recognised at all, with no SCR relief. This is the outcome of the balance required in the standard formula between simplicity/ease of implementation, and risk sensitivity.

The IRSG understands that EIOPA’s concern is around an excessive reduction in the SCR of standard formula companies arising from certain reinsurance structures. EIOPA indicates that such structures may in some cases be designed to maximise the reduction in standard formula risk capital.

EIOPA’s proposal to address this is to materially restrict the recognition in the standard formula of reinsurance structures i.e. where risk transfer is not commensurate with the SCR reduction.

To the extent that risk transfer and SCR reduction can be measured and compared in a straightforward way for a standard formula company (which is in itself a major assumption), assume that risk transfer is below the reduction in SCR capital.

Such a contract will fail EIOPA's test and EIOPA, in targeting the outcome that the standard formula never understates required capital at the level of each individual contract, will ensure that the standard formula capital calculation as a whole will systematically overstate required capital. Where reinsurance contracts have been written which achieve risk transfer but which do not meet EIOPA's new test, the standard formula calibration will go beyond a 99.5% VaR level. Under EIOPA's proposal such an outcome is 100% guaranteed.

Alternatively, EIOPA should recognise that the situation described above was anticipated and legislated for in the design of the Solvency II framework. Continuing with the above example, the current standard formula, designed to recognise the risk transfer in reinsurance contracts by default, will recognise the reinsurance contract in the capital calculation.

If as a result of the recognition of this contract (or indeed the suite of contracts which constitute the overall reinsurance programme pursued by the undertaking) the standard formula no longer appropriately reflects the risk profile of the company, the protections in place in the Solvency II framework, to identify and where appropriate to address this, will ensure that there is no systematic understatement of capital by

- The assessment of the significance by which the risk profile of the undertaking deviates from the standard formula assumptions as per Article 45 of the Directive
- The role of the actuarial function as set out in Article 48 of the Directive, in paragraph (h) to express an opinion on the adequacy of reinsurance arrangements and paragraph (i) to contribute to the effective implementation of the risk management system including "to the assessment referred to in Article 45 (as described above)".
- Article 110 of the Directive which provides for the use of undertaking specific parameters where risk profile deviates significantly from standard formula assumptions
- Article 119 of the Directive which describes the consequences where there are significant deviations from the assumptions underlying the standard formula i.e. the undertaking may be required to develop a full or partial internal model

Under Solvency II, the risk management system shall cover reinsurance and other risk mitigation techniques as set out in Article 44(2) of the Directive. Paragraph 260(1)(g) of the Delegated Acts further requires the risk management system to provide for actions to be taken by the firm to ensure the selection of suitable reinsurance. This provides protection against the purchase and use of reinsurance unsuitable for an undertaking's risk profile.

So even in the case where the risk transfer is below the assumed reduction in SCR capital (on the basis of the major assumption that this can be carried out), there are significant provisions in

Solvency II to ensure that this does not result in an unbalanced outcome or systematic understatement of the SCR to achieve protection at the 99.5% VaR level.

Finally, it is worth remembering that potential changes would affect particular institutions differently. The standard formula reflects the concept of the insurance market and its potential diversity. Small and medium companies, including mutual insurers took much effort to adjust to Solvency II requirements, very often using more reinsurance. There is a threat that more restrictive regulations could make their situation even more difficult. Any changes should take this into account.

14. Another aspect worth paying attention to is whether the complexity of the reinsurance contract might be hiding the absence of real risk transfer. For example, a simple quota share with a complex commission mechanism can actually conceal the economic reality of a loan. Another example is where a single contract combines two functions: the risk mitigation of a deviation of the best estimate and a loan. These two functions can also be found separately in contracts in the market: a reinsurance of the risk of an adverse development and a loan. When the treatment of the two separate contracts on the balance sheet and on the capital requirements is different from the single combined contract, this indicates that a thorough risk analysis is needed.

Insurance and reinsurance undertakings should fully clarify the technical details of the risk mitigation techniques and the related contracts and to reveal to the supervisory authority 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 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.

The language and tone is misleading here regarding the role of reinsurance i.e. “reveal” / “fully clarify”, suggesting that companies are trying to hide something or there is something suspicious about reinsurance arrangements. More neutral language should be used.

This is not appropriate and would be a resource-wise and time-wise 'overkill' to oblige the cedant to proactively explain all reinsurance structures to the supervisor. Rather, as already today, the supervisor is entitled to ask the cedant each and every question about any reinsurance contract entered into by the cedant.

It is of course entirely appropriate that companies should not try to conceal anything from supervisors about their reinsurance arrangements, and should be fully open with supervisors

requests. Good risk management practice is for companies to have already prepared and available demonstrations of the impact of reinsurance arrangements. Furthermore, the IRSG believes it is wrong to assume that a loan is a bad thing in itself, rather the term needs to be differentiated according to the terms and conditions of its repayment.

- If there was an unconditional obligation for the cedent under the reinsurance contract to repay such a loan, then this structure would most probably not contain underwriting risk transfer i.e. this transaction would not be acceptable as a reinsurance contract.
- If, however, the repayment of such a loan would be effected if and only if the reinsured portfolio would turn out to be profitable and if the repayment would be limited to the extent of such profit, the respective reinsurance structure would be likely to provide real risk transfer. For example, this financing element has traditionally been used in Life Financing Reinsurance supporting the cedent growing its life insurance portfolio.

SUPERVISORY INVOLVEMENT

15. Although both traditional reinsurance and non-traditional risk transfer (like cat-bonds, longevity or mass-lapse transfer) need to comply with Articles 208-214 of the Delegated Regulation, it is expected that the non-traditional risk transfer transactions will need more attention than ‘plain vanilla’ reinsurance contracts.

16. In case more ‘sophisticated/complex’ risk mitigation techniques are implemented, supervisory authorities are recommended to engage in an on-going supervisory dialogue with the undertaking. In this dialogue, supervisory authorities should be informed in a timely and comprehensive manner about the plans, be satisfied on the approach taken and be kept informed in case of any material changes.

Supervisory engagement needs to be proportionate to the risk taken and the impact on the overall risk profile of the undertaking, otherwise this will result in counter-productive delays, costs and burdens in the implementation of appropriate reinsurance strategies. Where the reinsurance contract structure is relevant across multiple jurisdictions, supervisors need to co-ordinate and co-operate in coming to a view on the structure to avoid different approaches across jurisdictions. All of this can be achieved within the current framework.

The wording here could create confusion for companies and supervisors; how to interpret a “sophisticated/complex” reinsurance RMT, how and when authorities should be informed in a “timely and comprehensive” manner and what supervisory response is expected (e.g. this could be interpreted some form of pre-approval?). The elements here could be disproportionate to implement and unduly burdensome. These elements could put barriers in place to the effective

use of reinsurance RMTs which could undermine good risk management (also in times of crisis when most needed).

ANNEX: EXAMPLES

17. In this annex examples some recently developed reinsurance structures, where there is a need for a reinforced supervisory dialogue, are presented. This is not a closed list and is only meant for illustration of cases where special attention regarding the balance between risk transfer and capital relief is expected.

18. As mentioned in the statement above, every structure should be assessed individually on a 'case by case' basis.

Example 1 - "Proportional Quota Share"

19. According to the Solvency II framework, the SCR for non-life premium risk is determined on the basis of the so-called volume measure. This volume measure for non-life premium risk is defined as (earned) premiums minus the reinsurance premiums [1]. Apart from premiums going to the reinsurance undertaking, there are also commissions flowing back to the cedent. The question is how to consider not only the premiums for reinsurance contracts but also these commissions [2] paid by the reinsurance undertaking. This question becomes especially relevant when the commissions are so material that they change the risk mitigation character. We mention here two cases where that happens.

[1] Article 116(5)(a) of the Delegated Regulation

[2] Commission is a payment from the reinsurance undertaking to the cedent to compensate for acquisition cost, administrative costs and other costs. Sometimes the commission is also used to let the cedent share in the profit the reinsurance undertaking earns.

1a with deep sliding scale commissions[5]

20. Deep sliding scale commissions alters the dynamic of the contract, in a way that it is more akin to a non-proportional excess of loss coverage with a large retention and only covers the tail of the risk. This in contrast with the usual (proportional) quota share contracts, where the reinsurer broadly follows the fortunes of the cedant's experience. Therefore, in this case, the standard formula calculation, based on proportional cession overstates materially the reduction in the SCR requirement, recognising greater risk transfer than merited.

[5] Commissions can be executed in a sliding scale manner, where the profit sharing / commission increases and decreases based on the result of the ceded portfolio.

1b high overriding commissions

21. Another way to alter the intended impact of the risk mitigation techniques on the standard formula can be observed if the quota share structures also include the proportional cession of unexpected high commissions (including the acquisition costs). Because the reinsurance premiums are first deducted from volume measure and then returned to the cedent 'disguised' as overriding commissions the consequence is that the SCR is calculated through a reduced volume measure for premium risk even though the ceded commissions are given back to the cedent in order to bear the associated expenses.

We would point out here that EIOPA's example does not prove as claimed a 'material overstating of the reduction in the SCR requirement' (cf. no. 20) but the limitation of a so-called volume measure (cf. no. 19).

A brief consideration should clarify the insufficiency of a volume measure approach. Indeed, let us consider that the insurance premium is just made up of two components: the pure underwriting risk and the costs to be borne by the insurer. Regardless of the distribution between these two components, the amount of the premium risk sub-module (based on a risk factor applied to the insurance premium) will be identical, even though its goal is only to measure the pure underwriting risk. This is a well-known weakness of the standard formula. It should be kept in mind that the commission rate paid by the reinsurer is intended to participate in the insurer's actual costs and is generally consistent with it. Depending on the business, these expense rates may be higher or lower, and then high commission rates paid should not cause suspicion or concern on the part of the supervisor. Indeed, the higher the flow back to the cedant via 'overriding commissions' the more beneficial to the own funds of the ceding company it is without any change to the ceded pure risk part. From our point of view, there could be a problem only if the claim cession rate is lower than the premium cession rate which should not happen by construction.

Example 2 - Mass lapse reinsurance

22. Solvency II requires insurance and reinsurance undertakings to apply a one-size-fits-all 40% stress for mass lapse risk (70% for group risk business).

23. As such, this part of the standard formula lends itself very well to capital management hedging transactions, since the hedging cost vs. the capital benefit can be very appealing. This holds particularly true if the hedge is structured as a non-proportional reinsurance. As a consequence of the linearity of the Solvency II stresses, the hedging costs for a far out-of-the money hedge can be substantially lower than the implied capital relief benefits. More specifically, the most common mass lapse covers used an attachment point around 20% (lapse rate over a year, and is approximately half of the mass lapse stress) and a 40% detachment point (the 1:200 stress in the standard formula for mass lapse risk). While the detachment point is simply driven by the lack of

capital benefit in hedging further than 40% (i.e. the Solvency II stress), the 20% seems to be a suitable value when a substantial tail risk is to be transferred.

24. The lapse risk is defined as the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level or volatility of the rates of policy lapses, terminations, renewals and surrenders. The standard formula capital requirement for this risk in all its manifestations is defined as the maximum of three lapse scenarios: a one-year mass lapse, a structural raise of lapse rates, and a structural decline of the rates. In many cases, the mass lapse scenario is dominant among these three scenarios. Lapse risk can e.g. also occur as multi-year raises of lapse rates, but such scenarios are not selected for the standard formula. For instance, multi-year increases of lapse rates are observed in cases of unemployment, interest rate movements, and mis-selling practices. While the impact within a single year can still be limited, the total, multi-year impact might be significant. A hedge or reinsurance of only the mass lapse scenario, leaves the insurance undertaking vulnerable to such kinds of lapse patterns, while the capital requirement following from the standard formula has been lowered by the mass lapse risk mitigation techniques. The insurance undertaking should analyse within its ORSA these risks, which are not included within the standard formula.

If life insurers protect themselves with attachment points at 20% for mass lapse risk, it might indeed be indicative of the excessive calibration of the mass lapse risk under the standard formula in line with the experience of recent financial crisis rather than an intention to distort the real level of the risk”

Example 3 - "Contract boundary reinsurance"

25. According to the Solvency II framework the expected profits included in future premiums (EPIFP), stemming from a book of policies are recognised, through the calculation of the best estimate liabilities, in the Solvency II balance sheet as long as they are within the contract boundary of the insurance obligation for business in force. Consequently, EPIFP stemming from a book of annually renewable group policies covering, for instance, death are recognised only for the period until the next renewal date in the Solvency II balance sheet because the profits beyond the renewal are outside the contract boundary (i.e. one year). It is possible to structure a reinsurance contract that allows undertakings to monetise a portion of the future profits not recognised in EPIFP due to contract boundary restrictions which covers mortality and lapse risks. One could question whether such a contract does actually cover insurance/biometric risks or rather covers commercial/business risks (i.e. the risk not to renew the contracts) that would impact only the solvency position. Reinsurance contracts with similar effects are known under the name of VIF securitisation/monetization.

Insurance companies, in their normal business practice expect future profits or losses from the variety of business lines within which they operate. Depending on a particular business line, a contract can be made with a third party to transfer the future profit or loss stemming from the line of business. The payments can be year on year or up-front. This creates an actual impact on own funds and on the balance sheet risk profile. Therefore, the impact of this contract needs to be taken into account in the Solvency II balance sheet and in the SCR.

Then before calculating the best estimate liabilities, contract boundaries are taken into account thus restricting the economic view excluding part of the business which in reality certainly exists. But this interpretation is independent from any third-party contract that exists and will therefore only affect the best estimate as a result of the contract boundary definition.

The two different aspects, an actual impact on the business and the technical restrictions in best estimate need to be seen as separate issues. In any case the contract boundary reinsurance should be appropriately recognized as described above, covering risks widely. Also the eligible own funds, been increased (decreased) because of the contract made covering future profits (losses), should be valued free from any encumbrances to fully cover the economic risk profile and the wide set of risks it covers.

Example 4 - "Bifurcated (split) cover for long tail business"

26. In order to reduce the capital requirement due to non-life reserve risk, a reinsurance arrangement consisting of two parts is tailored. It consists of an adverse development cover (upper part) that mitigates the loss development risk, but with a retention well above the best estimate, and a finite reinsurance type of cover (lower part) that generates reinsurance recoverables, although not beyond the best estimate. By generating recoverables, the lower part reduces the volume measure for the standard formula SCR calculation of premium and reserve risk.

27. Although the reinsurance arrangement is given as one single contract, it actually can be seen to combine two completely independent contracts: an upper layer that transfers real risk but does not come with any significant SCR relief and a lower layer leading to a considerable SCR reduction without mitigating any of the loss development risk. The reduction in the SCR can be materially greater than the risk mitigation of the arrangement. In a situation like this an undertaking may consider the appropriateness of applying the standard formula.

28. An insurance undertaking can reinsure the risks related to its life insurance portfolio by making use of a multi-year stop loss life. Under this reinsurance treaty the total annual local Gaap profit and loss of the following years are considered with almost no exclusions. All risks are therefore included such as market and credit as well as life underwriting and operational risks.

29. These annual profit and losses will then be capitalised until the term of the contract to define the cumulative capitalised profit and losses (CCPnL). The intervention of the reinsurance undertaking is then calculated based on the CCPnL. The reinsurance undertaking will typically intervene if the CCPnL is more negative than a certain deductible which can equal zero and the intervention will be capped at a limit.

30. This non-proportional reinsurance treaty will therefore apply to all risks. The standard formula however is based on a Var-Covar assumption to arrive from these risks to a total SCR. Typically for a non-proportional reinsurance multi-risk treaty a full joint distribution of all risks would be necessary to calculate the impact in a precise manner were the possible non-linear effects are also considered (e.g. where simultaneous market and life underwriting risks amplify each other). An undertaking must therefore reconsider the appropriateness of applying the standard formula for such more complex treaties.

Example 5 - Multi-year stop-loss

31. Furthermore, for such treaties the possible impact on SCR calculations can be very material such that counterparty and basis risks can increase significantly. To cover such risks, an appropriate collateralisation is necessary where a possible negative CCPnL is collateralized with high quality assets in a short term. If not, residual counterparty and basis risks will remain.

32. Lastly, in the case of a single reinsurance undertaking and given the material impact of the reinsurance treaty a concentration risk can arise.

ADDITIONAL QUESTIONS TO STAKEHOLDERS

Stakeholders are welcome to highlight their views with respect to the applicability/expectations with regard to Groups in relation to the use of risk mitigation techniques

Intra-group reinsurance forms an effective means by which companies can manage their individual entity and group risks and capital. The regulation and supervision of groups which forms an integral part of the Solvency II framework, including the supervisory reporting of certain intra-group reinsurance transactions, ensures that the current framework is sufficient in this regard. This framework provides for a holistic assessment at the group level of risks within the group.

Stakeholders are welcome to highlight their views on the topic of intragroup transactions in the context of Internal Reinsurance

See previous response.