Reinsurance Advisory Board comments on EIOPA’s opinion on the 2020 review of Solvency II

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1. General comments

The Reinsurance Advisory Board (RAB) welcomes the opportunity to provide its views regarding the ongoing Solvency II review, and to comment on EIOPA's draft proposals.

The reinsurance sector will be more relevant than ever as a financial shock absorber for unforeseen losses for individuals and institutions alike. In order to play our role at our best, we need the Solvency II framework to appropriately reflect and measure our risks. Getting Solvency II right is key for our capacity to cover risks and make investments that support sustainable European growth, and it is equally key for maintaining our competitiveness in a global context.

The Solvency II review is a key opportunity to improve the framework, including in areas specifically related to reinsurance. We do not envisage an overhaul of the Solvency II framework, and we believe that no changes are needed in areas that have proven to work well.

The recognition of non-proportional reinsurance for ceding companies should be improved. A risk-based regime should foster appropriate risk management incentives via economic recognition of risk mitigation techniques including non-proportional reinsurance.

Diversification is essential to the reinsurance business model which is based on the widest possible diversification of risks, lines of business and geographies. Changes in the calculation of the group minimum SCR have the potential to undermine recognition of diversification in the group SCR and should not be implemented. Standard formula reporting which cannot capture reinsurance risks and their diversification appropriately, should not be required of reinsurers. Additional proposed reporting with respect to internal models and external audit of Solvency II balance sheets would significantly increase the regular reporting burden without bringing tangible benefits. Such reporting would duplicate work already done by supervisors. The group risk margin calculation should allow for diversification of risks across the reinsurance group to reflect the reinsurance business model.

Otherwise, the design of the risk margin can have a material impact on the level and volatility of EU reinsurers' available capital under Solvency II, with implications for the cost and availability of products, capacity of reinsurers to invest and global competitiveness. The RAB believes that there is strong evidence to indicate that the cost of capital rate of 6% used to calculate the risk margin is too high.

Economic recognition of future premiums (and corresponding claims) is the natural consequence of their inclusion in the technical provisions and the build-up of an SCR to account for the associated risks. Consistency in the treatment of future premiums at group level is an important topic for reinsurers, who provide long-term protection contracts and for whom economic recognition of future premiums at group and solo levels is commensurate with the economic recognition of the risks associated with those premiums. Tools exist to make future profits available at a group level, should the need arise. For these reasons, potential capital add-ons on EPIFP fail to recognise that EPIFP are primarily an output of the best estimate reflecting each (re)insurance undertakings' portfolio, and EPIFP should remain a Tier 1 own funds item.

Including reinsurers systematically in pre-emptive recovery planning and detailed resolution planning requirements would neither improve policyholder protection nor contribute to financial stability. Reinsurance is a business-to-business activity, with limited policyholder protection implications, and there is no evidence or history of reinsurance contributing to systemic risk or financial instability. A reinsurer should only be subject to these requirements where a clear policyholder protection or financial stability benefit can be demonstrated. For traditional reinsurance, systemic risk is yet to be demonstrated. Its exposure to bank run-like liquidity stress lacks evidence. Climate change does not either create systemic risk for the insurance sector insofar as the related risks will fully materialize over the longer term, thus allowing (re)insurers to manage their exposure to transition risk and to adjust the pricing of their policies to the changing cost of risk in a timely manner. Since the Great Financial Crisis in 2008 (which was primarily a banking crisis) Solvency II entered into application with requirements that ensure governance and market discipline. Macroprudential capital surcharge would therefore overlap with existing requirements, given the risk-sensitiveness and the holistic nature of Solvency II.

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3. Technical provisions

General comments

Contract boundaries

The RAB believes EIOPA's proposed changes for EPIFP, ie to include all future losses and to reflect the impact of reinsurance, are unnecessarily complicating calculations. The changes therefore appear to be disproportionate and inappropriate, even more so if result in more volatile outputs. In addition, the RAB does not see the added value of introducing a definition for 'the gross expected future profit/loss from servicing and management of funds'.

Regarding contract boundaries, the RAB disagrees with EIOPA's rewording to clarify that the exception allowing for an extension of contract boundaries for contracts where an individual risk assessment has been performed at inception is to be applied only when the undertaking does not have the right legally/contractually to perform again the individual assessment.

The RAB also welcomes EIOPA's definition for Future Management Actions and the clarifications made for expenses.

<u>Comments on paragraphs of the consultation paper and on EIOPA's advice on technical provisions</u>

- Paragraphs 3.73 and 3.74
  - **The RAB disagrees with the amendments to DA Art 260(2) and 260(4)** as proposed in paragraph 3.73 and 3.74.
  - The RAB is concerned with the implied assumption that an HRG may only contain profit- or loss-making policies, irrespective of the underlying risks, and believes this amendment should be dismissed.
  - Furthermore, the grouping of policies according to their profitability is unlikely to be consistent over time as whether policies are profitable may change when conditions change (e.g. through changes in interest rates or mortality rates), resulting in more volatile and unpredictable figures.
  - It would put a disproportionate burden on undertakings to assess – before even setting assumptions – whether policies are profit- or loss-making, in particular for life insurance undertakings. It is also disproportionate to require the whole restructuration of HRG and model points in our systems, let alone the fact that the concept of profitable/unprofitable HRG is questionable and hardly practicable when stochastic valuation methods are used (i.e. the same HRG can be profitable in X scenarios and turn unprofitable in X others or could be unprofitable up to a certain maturity and turns profitable thereafter).This change is costly in terms of implementation and could also lead to a delay in the calculation times that would be incompatible with the already applicable time limits (5 weeks to complete the entire Solvency II quarterly evaluation).
  - The reported figure of EPIFP is positive because it is an own fund item; reporting negative own funds would obfuscate the vision of the firms' solvency. Unprofitable future cash-flows are liabilities and therefore rightly captured in the BEL. EIOPA should clarify whether this amendment would result in two figures, the expected profits and the expected losses, and how they would be interpreted.

Section 3.2 Risk Margin

- **Risk margin impact and relevance for reinsurers**

As carriers of predominantly pure (re)insurance risks which can be long term in nature for life (re)insurance in particular, the design of the risk margin can have a material impact on the level and volatility of EU reinsurers' available capital under Solvency II. This has implications for the cost and availability of long term (re)insurance products for reinsurance clients and ultimately EU consumers and the capacity of reinsurers to invest in the real economy. Furthermore, the design of the risk margin has implications for the competitiveness of EU reinsurers subject to cross border competition from non-EU jurisdictions which do not require a risk margin. The RAB believes that there is strong evidence to indicate that the cost of capital rate of 6% used to calculate the risk margin is too high. We shared this evidence as part of the 2018 review consultation process, supporting a cost of capital below this level. The evidence used by EIOPA to support the current cost of capital calibration (provided as part of the 2018) was chosen very much at the higher end of the range of assumptions, particularly having regard to the market risk premium. The RAB believes that such conservatism is not justified for a base balance sheet parameter.

- **Risk margin diversification**

The reinsurance business model is based on the widest possible diversification of risks, lines of business and geographies. Reinsurers' portfolios are dominated by pure insurance risks which diversify significantly even in times of extreme and correlated market movements. The regulation partially recognises at solo level the diversified reinsurance business model whereby the risk margin calculation allows for diversification between life and non-life reinsurance risks in the same entity (as distinct from insurance risks). However, the regulation should recognise the full economic risk diversification within reinsurance at group level, recognising the reinsurance business model and how reinsurance is managed in practice, and allow full credit for diversification of reinsurance risks across entities in the group risk margin calculation. The lack of an appropriate diversification assumption across entities in the risk margin is particularly penal for reinsurers given the importance of diversification in the reinsurance business model. While balance sheet items should be economically valued, the current risk margin calculation failed to achieve this principle, lacking to recognise the extent of diversification effectively achieved by reinsurers.

4. Own funds

General comments

The RAB welcomes EIOPA's conclusion that differences in tiering and limits approaches between the insurance and banking sectors are justifiable in view of the differences in the sectors' business models and that consequently, the Solvency II Tiering structure should not be changed.

The RAB welcomes EIOPA's view to continue considering EPIFP as Tier 1 capital. Maintaining EPIFP as Tier 1 is essential to preserve insurers' ability to continue to offer long-term products.

The RAB is concerned that the idea to allow for capital add-ons related to EPIFP is inconsistent with the very concept of capital add-ons. Capital add-ons have been designed to address gaps in the SCR calculations. EPIFP arise from the calculation of the BEL and supervisors are granted full power to review BEL calculations, methods and assumptions. The rationale for capital add-ons on the BEL seems therefore very unclear in that it is silent on the type of issues in the derivation of the BEL which cannot be remedied with existing supervisory powers.

Q4.1: What is your view on the treatment of EPIFPs?

- The treatment of EPIFPs should not be changed. Recognition of EPIFP is essential to allow insurers to continue to offer long term products, and as such their eligibility or tiering should not be altered.
- The RAB supports EIOPA's argument to consider that NSAs have the responsibility to monitor and assess the accuracy of the calculation of EPIFPs. The current framework already allows for sufficient supervisory powers to achieve that purpose.
- **Therefore, EIOPA's proposal to not change the treatment of EPIFPs is welcome**.

Comments on paragraphs of the consultation paper and on EIOPA's advice on own funds

Section 4.5 Correct attribution of items

- Paragraph 4.141: The RAB supports some NSAs' view that positive EPIFPs should be regarded as a good thing. EPIFP are an output of the economic valuation of the BEL (i.e. the present value of expected *future* cash flows) and the level of EPIFP depends on each undertaking's risk profile (i.e. there is no "good" or "bad" levels of EPIFPs per se). It is also reminded that uncertainties relating to future cash-flows, including future premiums as well as associated claims, are modelled in the best estimate and thus mechanistically reflected in the amount of EPIFP. Unexpected events are accounted for in the SCR (and double-counted effectively in the risk margin by design) and therefore EPIFP gives rise to capital charges. As a consequence, any amount of EPIFP that would contribute positively to the SCR ratio (i.e. in excess of the insurance obligations, risk margin and SCR that they generate) are *de facto* de-risked. EIOPA should not try in the future to limit the eligibility or downgrade the tiering of elements such as EPIFPs, which are a useful tool for insurers to offer long term guarantees.
- Paragraph 4.143: The main critique of NSAs on EPIFP is their availability to absorb losses on an on-going basis and particularly in stress situations. The RAB agrees with the argument that losses affecting technical provisions have immediate loss absorbency. Consequently, the main concern is a stress scenario where cash is needed, eg in case of a financial loss, that does not affect technical provisions.
- Paragraph 4.151: The RAB supports EIOPA's argument to consider that NSAs have the responsibility to monitor and assess the accuracy of the calculation of EPIFPs. The current framework already allows for sufficient supervisory powers to achieve that purpose.

- Paragraph 4.152: The RAB does not share the view that the changes in the calculation of EPIFPs as outlines in the TP section of the consultation paper would result in less volatile estimated EPIFPs, it would be quite the contrary (see previous comments above).
- Paragraph 4.153: The RAB is concerned that the idea to allow for capital add-ons related to EPIFP is inconsistent with the very concept of capital add-ons. Capital add-ons have been designed to address gaps in the SCR calculations. EPIFP arise from the calculation of the BEL and supervisors are granted full power to review BEL calculations, methods and assumptions. The rationale for capital add-ons on the BEL seems therefore very unclear in that it is silent on the type of issues in the derivation of the BEL which cannot be remedied with existing supervisory powers. The RAB would also like to highlight that lapse risk for EPIFP is already accounted for in the SCR as part of the lapse modules for Life, Health and Non-Life. Thus, there is no need to impose any additional capital add-ons for lapse risk associated with EPIFP as suggested in 4.153.
- Paragraph 4.159: The RAB agrees to disregard Policy Option 2 and 3 as it would be inappropriate and inconsistent to reflect the full insurance and lapse risk of the EPIFP in the SCR, but to limit the recognition of future profits in the Own Funds.
- Paragraph 4.160: The RAB welcomes EIOPA's advice to not change the treatment of EPIFPs. EIOPA should not try in the future to limit the eligibility or downgrade the tiering of EPIFPs, which are a useful tool for insurers to offer long term guarantees. The RAB also welcomes that no change to Article 37 of the Directive is retained.

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5. Solvency Capital Requirement standard formula

General comments

Risk mitigation techniques

On the recognition of non-proportional reinsurance, the RAB has published substantial material explaining the status quo of the situation as well as having proposed three non-exhaustive approaches in addressing the issue. RAB would like to emphasise that this has been a long-standing problem which needs to be addressed. Any proposals or improvement to the status quo will be more prudent than the current recognition.

Non-proportional reinsurance

EIOPA has not yet made any proposals to account for NP-Reinsurance and Adverse Development Covers in the Standard Formula even though the RAB has provided arguments for that issue in the past. The RAB has provided four non-exhaustive approaches for EIOPA and the wider industry to consider. This has been a long-standing issue which needs to be addressed. During the 2018 review EIOPA and the industry have not reached an agreement. The RAB would like to work on the topic together with EIOPA to arrive at concrete timeline and actions in order to propel this topic forward.

Basis risk

The RAB has provided substantial material on its views and proposals on basis risk to EIOPA's consideration. While the Solvency II Directive defines basis risk and a guideline exists on basis risk, the RAB is aware of situations where application is unclear and divergent regulatory practice exists.

EIOPA points out two issues in its draft advice:

- Guidelines on basis risk cannot be used as a legal basis to object to undertakings' use of certain risk-mitigation instruments: the industry believes that there is no intrinsic reason why the criteria described in the guidelines on financial risk mitigation techniques could not also apply to insurance risk-mitigation techniques. However, RAB understands that the objective of the guidelines is to provide clarification on aspects relating to material basis risk without entering into excessive detail or prescriptiveness. While there may be valid reasons to modify the guidelines, the industry does not support the transcription of the guidelines unmodified into the delegated regulation. Whether there is a case to object or not to a particular risk-mitigation instrument should be judged on the merits of the instrument in light of the guidelines and not on their legal status.
- Use of the reinsurance for standard formula stress events: EIOPA is concerned about disproportionally increased risk reduction which can result in a capital requirement that would be insufficient at less severe stress scenarios. The industry understands that this concern has arisen in the context of non-proportional reinsurance. The statement appears to contradict insurers' freedom to retain part of the risk in the form of a deductible (as the case of an excess is already covered in the current version of the guidelines). The RAB accepts the notion that in extremis, a shock equal to the amount of the deductible would provide the insurer with capital relief without earnings relief - however, this is no different to any other form of non-proportional reinsurance, or indeed to any form of primary insurance that features a deductible or indeed other mechanisms by which the beneficiary retains part of the risk. Where insurers' capital requirements are determined by the standard formula stress scenarios, it is legitimate that insurers assess the effectiveness of their risk-mitigation measures on them. That a particular instrument is calibrated to a similar level of confidence as Solvency II scenarios should not by itself be seen as a weakness, nor limit a cedant's ability to determine their appetite for risk.

The RAB considers the current rules under Solvency II for basis risk to be unclear in two respects:

- How to interpret the existing guidelines on basis risk in the reinsurance context.

- How an identified basis risk can/should be quantified.

Inconsistencies in these aspects impact the recognition of reinsurance treaties under Solvency II.

The RAB believes the current application is failing to meet the objectives of Solvency II:

- Harmonisation: There is divergence among the individual regulators on what constitutes basis risk and how it should be quantified.
- Effective risk management: The exclusion of high-quality risk mitigation techniques from insurance companies' risk management toolkit is limiting their ability to transfer insurance risks to reinsurers. This issue is compounded by an unwillingness to explore risk mitigation due to the uncertain outcome of potential regulatory review.
- Efficient insurance market: as a result of these real and perceived restrictions, insurers are retaining risk and capital that may otherwise be desirable to transfer to reinsurers in a mutually beneficial transaction.

Reducing reliance on external ratings

The RAB agrees with EIOPA's proposed approach on this topic.

Q5.4: What is your view on the recognition of non-proportional reinsurance in the SCR standard formula? If you consider changes necessary, please make concrete proposals. How does the proposal address the double counting issue regarding non-proportional reinsurance covers between the CAT risk sub-module and other sub-modules impacted by treaties?

The RAB has sent substantial material to EIOPA on this subject and exchanged views on several occasions during the last years. The below summarises the latest positions.

Non-proportional (NP) reinsurance is an important risk mitigation instrument for the non-life sector and a crucial tool for smaller and medium sized companies to manage peak risk.

The current form of the Commission Delegated Regulation (EU) 2015/35 supplementing Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (in the following referred to as "Delegated Act") provides for a flat 20% reduction on the volatility of premium risk for three lines of business. This reduction does not depend on the actual existence of reinsurance and is not available for other lines of business, nor for reserving risk. Concerning the recognition of various types of cover within the catastrophe risk module EIOPA has issued Guidelines (EIOPA-BoS-14/173, Guidelines on the application of outwards reinsurance arrangements to the non-life underwriting risk sub-module), which allow for a principles-based application of complex reinsurance treaties. Thus, more risk-sensitive approaches are generally available within the Solvency II framework.

While the standard formula recognises the impact of NP reinsurance in the Catastrophe sub-module of the non-life underwriting risk module of the SCR, it fails to do so in the premium and reserve risk sub-module. We consider this to be a technical inconsistency of the standard formula that needs to be addressed in the 2020 review. Moreover, allowing the recognition of NP reinsurance would enable a more proportionate application of the standard formula by small and medium sized companies.

The RAB welcomes EIOPA's openness to discussing methods to improve the recognition of non-proportional reinsurance with the industry. However, a balance will have to be struck between risk-sensitivity, complexity, and prudency. The RAB is conscious that the architecture of the standard formula places limitations on what is practically achievable. The RAB is convinced that, given the technical inconsistency in the standard formula, the need to find a solution outweighs the issues that inevitably arise with any new approach. In other words, from the RAB's perspective a maintenance of the status quo is the worst possible outcome and the adoption of any of the approaches described below would be preferable. The RAB welcomes the discussions with EIOPA on this subject and discusses some of the ideas floated in that context below.

Principles for the recognition of NP reinsurance

In general, the RAB recommends that the following principles should be the basis for all reinsurance recognition:

1) The adjustment factors for non-proportional reinsurance (described in Article 117(3) of the Delegated Act) should be calculated to reflect the risk mitigating impact of non-proportional reinsurance for all classes of business, subject to meeting the criteria listed here.
2) The adjustment factors for non-proportional reinsurance should be risk-sensitive, reflecting the particulars of the reinsurance arrangements in place.
3) The assessment of the risk-mitigating impact of non-proportional reinsurance should be broadly based on the impact on own funds of a gross loss scenario equal in magnitude to the gross factor-based capital charge derived using the standard formula [The capital charge for premium and reserve risk equates to the impact of a premium and reserve risk stress event at the 99.5th confidence interval over 1 year (then aggregated with other similarly calibrated risk charges within the non-life underwriting risk module)].
4) There should be no double counting of credit for a particular reinsurance arrangement.
5) The adjustment factor for non-proportional reinsurance should only be applied in respect of reinsurance arrangements that meet the criteria for risk-mitigating techniques in Articles 209 to 213 of the Delegated Act.
6) The assessment of the impact of non-proportional reinsurance on gross losses in the premium and reserve risk module should be coordinated by the competent function within the (re)insurance undertaking and should be subject to a review process within the undertaking.

The RAB explores below ways in which an appropriate gross loss scenario can be derived in order to determine the non-proportional reinsurance impact.

Approach 1: SAM approach

The approach that is closest to the principles-based nature described above is that taken by South Africa's Solvency Assessment and Management framework (SAM) regime, therein referred to as 'RM_{other}'. This methodology would allow proper recognition of non-proportional non-life reinsurance in the premium and reserve risk module, both at the level of individual lines of business as well as whole account covers. This approach is the preferred option of the RAB since it is used - as a conscious deviation from Solvency II - in a proven regulatory framework close to Solvency II.

While generally striving for Solvency II equivalence, the South African regulator has identified adjustments for risk mitigating instruments as an area where the SAM system should differ in approach from the Solvency II standard formula and allow for stop loss and other reinsurance structures for risk mitigation under RM_{SL} and RM_{other} respectively (FSB, Position Paper 78 (v 7.2) Non-Life Underwriting Risk: Structure and Calibration, 6.3 Conclusions on preferred approach). These RM_{SL} and RM_{other} components have been integrated directly in the calculation of the non-life underwriting risk requirement (see below) – (Prudential Standard FSI 4.3 Non-Life Underwriting Risk Capital Requirement, pp. 3-4). The prudential standard clearly specifies that these components allow for risk mitigation that is not allowed for elsewhere in the non-life underwriting risk module.

$$SCR_{NL} = \sqrt{\sum_{r,c} CorrNL_{r,c} \cdot \ NL_r \cdot \ NL_c} - RM_{SL} - RM_{other} + IMP_{SL\_Other} - ADJLoss_{abs} + SCR_{nl\_fp}$$

It is important to note that the definitions used in this approach ensure that double-counting of any capital benefit due to reinsurance with other modules of the standard formula does not occur.

The SAM approach allows for the recognition of covers affecting a single line of business as well as aggregate covers across lines. This is a clear advantage over the current approach based on non-proportional reinsurance adjustment factors, as these apply to a line of business basis and cannot account for aggregate covers.

Approach 2: simplified economic approach
This approach builds on the RAB's proposals on Adverse Development Covers (ADCs) expanding them to both premium risk and reserving risk and addressing EIOPA's concerns about the application that were voiced in its advice to the Commission for the Solvency II 2018 review.

For the 2018 review, a CRO Forum working group proposed a methodology for recognition of Adverse Development Covers, submitted to EIOPA by email on 12.01.2018. The RAB believes that there is no reason why the methodology would have to be changed conceptually to be valid for covers on premium risk [Please also refer to the RAB response to European Commission consultation on draft Solvency II 2018 review (Better Regulation Initiative)].

EIOPA raised a number of concerns with the proposed methodology. The RAB believes most of these issues can be addressed by making changes to the formula. A revised methodology could include a factor E that would represent a prudence factor to counteract the effect of any double-counting on the reserve risk calibrations, as well as serve to make the method more prudent. As such, the formula presented for ADCs could be expressed as:

$$NP_{adj} = (A - (B - C) \times D \times E) / A$$

Definitions similar to ADC methodology presented as part of 2018 review
A: Impact on the basic own funds (BOF) of premium reserve risk scenario as defined under the SF = Nominal best estimate net reserves x Standard deviation for non-life gross premium or reserve risk of the segment x 3
B: ADC recovery under premium or reserve risk scenario = The lower of the following:

- Nominal best estimate net premiums or reserves covered by the reinsurance structure x (1 + 3 · $\sigma_{(res,s)}$) – reinsurance structure attachment point
- Reinsurance structure cover size

C: Additional reinsurance premium or the equivalent thereof
D: Cession to the reinsurer in %
E: Prudency factor in %

Approach 3: USP-based adjustments to the standard formula
The basis of this proposed option is to implement the Solvency II undertaking-specific parameters (USP) approach directly into the standard formula as an optional calculation not requiring USPs and extending the methodology to reserve risk. The USP approach takes into account the specifics of the NP reinsurance contracts in place for each line of business and therefore respects Principle 3 mentioned above that the credit for reinsurance should be based on the impact on own funds of a gross loss scenario equal in magnitude to the gross

factor-based capital charge. The attractiveness of this option is that it achieves this without making particular assumptions about the number of claims underlying the gross loss scenario.

The main characteristics of the proposal are the following:

- To extend the perimeter of the USP framework of possible NP Factor application by incorporating it in the standard formula;
- To introduce a more risk-sensitive method with respect to the 20% discount;
- To maintain consistency with the existing USP;
- To restore the balance between non-life standard formula insurers and life and/or internal model insurers, who are generally able to recognise non-proportional reinsurance.

The overall effect of the proposal is strictly dependent on the calibration/recalibration exercise and the choice of the respective parameters. On a general basis, the proposal accounts for an extension of the perimeter of LoBs and instruments allowable but it is also more risk-sensitive with respect to the LoBs (MVL, FDP and TPL).

Approach 4: simple conditional factor approach

In a discussion with the RAB, EIOPA raised the idea of extending the adjustment factors for NP reinsurance to all LoBs, as well as to determine criteria for their application. EIOPA argued that it would consider this approach as an addition rather than an alternative to the approaches described above.

The main characteristics of this approach as understood by the RAB are:

- A fixed adjustment factor calibrated ex-ante and enshrined in legislation for all premium and reserve risk lines of business
- Criteria that would determine whether the adjustment factor can be applied for each line of business
- This approach would be part of the standard formula
- The existence of this approach is independent to the currently existing USP on non-proportional reinsurance described under Approach 3

The RAB believes that such an approach would be less risk sensitive than any of the other approached described. However, the RAB recognises that it would still represent an improvement as compared to the status quo. Moreover, the RAB accepts the logic that it may be necessary to introduce such an approach to combat the inconsistency on the standard formula without introducing much complexity, while introducing an alternative approach to be used for companies who require a more accurate treatment of their non-proportional reinsurance programme at the cost of a more complex calculation.

The RAB suggests that, if EIOPA intends to further examine such an approach:

- The criteria that would determine whether an adjustment factor can be applied are sensitive to the actual existence of non-proportional reinsurance covers in such a way that is not unduly onerous. The RAB recommends that the six 'Principles for Recognition' described above be form the basis for determining application.
- The fixed adjustment factors are calibrated in such a way to provide a material benefit to companies where used.
- In addition, the calibration of these factors should not unduly disadvantage users of non-proportional reserve risk covers, which although increasingly used are not as widespread as those for premium risk. With regards to reserve risk covers, the calibration should be developed on an effective use, rather than average use, basis. Unlike premium risk, typically reserve risk covers transfer all or almost all the reserve risk for a particular portfolio. This suggests that the adjustment factor should be large, and its application restricted to those situations where indeed all or almost all of the reserve risk is transferred.

- If the application factors to be used are fixed, the design should ensure that weighted application within a line of business should be possible. This situation would arise if say a certain book within a line of business were covered by non-proportional reinsurance, whereas other books in the same line of business were not. In that case, the covered premiums or reserves as applicable could be used as weights.
- **The implementation of this approach should be without prejudice to the parallel introduction of any of the other proposed approached, which could be optionally used instead.**

Comparison

In the table below the RAB tried to summarise the differences between the approaches with regards to the objectives and challenges in addressing the issue:

Approach	Risk sensitivity	Complexity	Prudency
Status quo	--	++	--
Approach 1: SAM approach	++	-	+
Approach 2: simplified economic approach	+	+	++
Approach 3: USP approach	++	-	++
Approach 4: simple conditional factor	-	+	-

Legend: ++ performs better -- performs worse

Any approach would be more **risk sensitive** than the status quo. The SAM approach or USP approach would be most risk sensitive, but at the potential cost of greater complexity relative to the simplified economic approach. Any approach would be more **prudent** than the status quo, as the status quo effectively grants a capital benefit which is not substantiated by the actual existence of reinsurance. The RAB considers the simplified economic approach sufficiently prudent given the small deviations in EIOPA's past analysis of ADCs, which can be addressed. The USP approach described is no less nor more prudent than the use of the same USP for premium risk reinsurance already requires and is thus considered sufficiently prudent. The simple conditional factor approach is but a small improvement on the status quo, but an improvement nonetheless. Using a combination of approaches could lead to a more positive outcome.

Q5.5: What is your view on the recognition of adverse development covers in the SCR standard formula? If you consider changes necessary, please make concrete proposals.

The RAB believes that adverse development covers would ideally be addressed as part of a broader solution for non-proportional reinsurance in the premium & reserve risk module, as described in question 5.4. Any of the proposed approaches would provide adequate recognition for ADCs as well as other covers. The RAB would further refer to previous extensive input shared with EIOPA on ADCs.

Q5.6: What is your view on the recognition of finite reinsurance in the SCR standard formula? If you consider changes necessary, please make concrete proposals.

As a risk-based framework, Solvency II must take a holistic and risk-sensitive view on measures used for risk mitigation. The RAB accepts that issues have arisen before the advent of Solvency II with certain reinsurance structures featuring limited risk transfer, and that the provisions on finite reinsurance were designed to prevent abuse. However, under Solvency II such constructions would have no effect on the Solvency II balance sheet due to the rules on effective risk transfer, contract boundaries, and time value of money. A revision to the standard formula rules would be reasonable to allow a more targeted framework that recognises the effective extent risk mitigation that can be provided by such contracts.
This refers to:

1) The definition of finite reinsurance (Article 210 of the Directive)

2) The recognition of finite reinsurance in the SCR standard formula (Article 208 of the Delegated Act)

To reflect the fact that under Solvency II issues that had arisen in the past pertaining to the discounting effects are already considered appropriately, the reference to timing risk and the time value of money should be deleted from the definition of 'finite reinsurance'. **Article 210 (3) of the Solvency II Directive** could be adjusted as follows:

"For the purposes of paragraphs 1 and 2 finite reinsurance means reinsurance under which the explicit maximum loss potential, expressed as the maximum economic risk transferred, exceeds the premium over the lifetime of the contract by a limited but significant amount, and there exist contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer."

Article 208(2) of the Delegated Act could be adjusted as well in order to better reflect the risk mitigating effect of finite reinsurance contracts.

Regarding the question on the recognition of finite reinsurance in the SCR standard formula, the RAB understands the concerns of EIOPA that the recognition of some finite reinsurance contracts under the standard formula can result in a higher SCR relief compared to the risks transferred to the reinsurer. This is especially the case for proportional reinsurance with result dependent conditions. In view of the large range of finite reinsurance contracts, where some of them still transfer significant risk to the reinsurer, the RAB proposes a simple calculation method which takes account of this fact. This method allows the undertakings to get partial solvency relief for finite reinsurance depending on the insurance risks transferred.

For proportional reinsurance, the RAB proposes a standard deviation approach which measures the ratio between the situation with and without loss mitigating features of result dependent conditions in an extreme loss scenario in comparison to the situation at the expected loss. The extreme scenario is defined as the expected loss plus three times the standard deviation of losses, which is taken as an approximation of the 200-year-event.

The numerator depicts the difference in reinsurance result between the expected loss scenario and the extreme loss scenario. The denominator depicts the difference in reinsurance results as before, but without loss mitigating features.

This defines the Allowance Ratio, which should be the basis for calculation of the solvency relief of a proportional reinsurance contract in the premium and reserve risk module of the SCR standard formula.

Allowance Ratio = (Reinsurance Result Ratio with loss mitigating features @ expected scenario - Reinsurance Result Ratio with loss mitigating features @ extreme scenario) / (Reinsurance Result Ratio without loss mitigating features @ expected scenario - Reinsurance Result Ratio without loss mitigating features @ extreme scenario)

Reinsurance Result Ratio = Reinsurance result / Reinsurance premium, calculated once at an extreme scenario and once at the expected scenario

Example: E(LR) 70% with a commission of 25%, standard deviation 5%, commission of 15% at a loss ratio of 85% (=70%+3*5%)

Reinsurance Result Ratio with loss mitigating features:
Reinsurance Result Ratio with loss mitigating features @ expected scenario: 100%-70%-25%=5%
Reinsurance Result Ratio with loss mitigating features @ extreme scenario: 100%-(70%+3*5%)-15%=0%

Reinsurance Result Ratio without loss mitigating features:
Reinsurance Result Ratio without loss mitigating features @ expected scenario: 100%-70%-25%=5%
Reinsurance Result Ratio without loss mitigating features @ extreme scenario: 100%-(70%+3*5%)-25%=-10%

Allowance Ratio:
Numerator: (Reinsurance Result Ratio with loss mitigating features @ expected scenario) less (Reinsurance Result Ratio with loss mitigating features @ extreme scenario) = 5% - 0% = 5%
Denominator: (Reinsurance Result Ratio without loss mitigating features @ expected scenario) less (Reinsurance Result Ratio without loss mitigating features @ extreme scenario) = 5% - (-10%) = 15%

Allowance Ratio = (5%-0%) / (5%-(-10%)) =33%

The calculation of this Allowance Ratio can be simplified to:
Numerator: Commission @ extreme scenario + 3 * standard deviation of loss ratio – commission @ expected scenario.
Denominator: The denominator corresponds to the difference in loss ratio scenarios, i.e. is three times the standard deviation, which is based on the fact that premium and commission should be constant for a contract without loss mitigating features.

Allowance Ratio: (15%+3*5%-25%) / (3*5%) =33%

Q5.7: If EIOPA would to recommend a consistent treatment of contingent instruments (contingent capital and convertible bond instruments) between standard formula and internal models, one possible way of implementing this principle would be to clarify that the definition of SCR (Article 101 of the Directive) does not include planned basic own funds increases. What do you think about this clarification?

A key feature of internal models is to provide flexibility to properly capture risk profile where standard formula cannot do so appropriately. Current regulation which allows the internal models to capture risk profile correctly and recognise the economic impact of contingent instruments under close supervisory scrutiny (via internal model approval processes) is appropriate and does not need to change. The differences that arise naturally between a one-size-fits-all standard formula and more advanced internal model methods should not mechanistically be seen as "inconsistencies".

Comments on paragraphs of the consultation paper and on EIOPA's advice on SCR

- Paragraph 5.293: According to Article 1 of the Solvency II directive, "'basis risk' means the risk resulting from the situation in which the exposure covered by the risk-mitigation technique does not correspond to the risk exposure of the insurance or reinsurance undertaking". To better define what is included under this definition, the RAB has considered the three potential sources of basis risk in the following table:

Description	**Example - Life UW risk**	**Example - Non-Life UW risk**	**Example – Market risk**	**Why we consider this basis risk**
If the gross portfolio (underlying business) of risks is matched with a risk mitigation	A general population index is used to reinsure a longevity exposure.	A reinsurance cover that pays out based on industry losses or a parametric basis.	Hedging equity exposures with an index-based derivative.	Deviations in the economic outcome.

technique of similar, but not identical exposure, deviations in the economic outcome could occur.				
	The risk cover pays a fixed amount for each incurred claim, irrespective of the size of the loss incurred by the original risk taker			
	Different wording used in policies for assumed risk vs ceded risks, e.g. due to use of different languages, definitions of covered events/perils, UW basis etc.			While exclusions can indeed lead to basis risk, in the usual case they will not lead to material basis risk.

- It is important to note that the Solvency II definition refers only to the mismatch in "exposure". If there is no difference between the risk exposures of the insurance undertaking and the risk mitigation technique, then there can't be any basis risk. In particular, potential shortcomings of the standard formula modelling to appropriately reflect the risk exposure are explicitly not basis risk and would form a separate question.

- For completeness, we have noted the following potential points of interest in relation to risk mitigation that we do not consider appropriate to classify as basis risk:

Other points of interest	**Description**	**Example - Life UW risk**	**Example - Non-Life UW risk**	**Example – Market risk**	**Why we consider this is not basis risk**
Risk appetite or risk tolerance decisions Guideline 1.12	Where the insurance undertaking makes an explicit choice to retain a part of the risk, the exposure up to this retention/attachment point is not relevant in the assessment of whether a risk mitigating technique contains basis risk.	In case of an excess of loss reinsurance, losses below the retention are not included in the assessment of basis risk. In case of a stop loss, loss ratios below the attachment point are not included.	An excess of loss reinsurance with a detachment point below the 1-in-200 scenario.	An equity put option with a strike below the current stock (or index) price.	A conscious decision by the insurer to retain the risk up to a certain level should not affect the existence of basis risk in the cover.
Difference in the duration of exposure	Risk mitigation that covers a fixed term which is less that the full run-off of the portfolio results in a	A 12 month stop-loss cover to protect an underlying	A 3-year CAT bond protecting underlying property	A long-put option with a time to maturity of 2 years to	This is a bifurcation of the risk portfolio similar to only mitigating a proportion of the risk i.e. there is retention of the

Guideline 1.12	difference of exposures.	portfolio of multi-year mortality policies.	policies with 1-year durations.	protect against downward shocks on buy-and-hold stocks.	exposure beyond the fixed term. It would be straightforward under the existing standard formula stresses to reflect the retained risk for the durations beyond the risk mitigation duration.
Less than 12 months forward looking coverage Guideline 1.9. b)	The Solvency II SCR scope is defined as the 12 month forward looking horizon.	A 12-month cover incepting in January must be taken into account for the capital position on 30 June.			The appropriate treatment for situations where less than 12 months coverage is in place is explicitly covered by Article 209(2), separate from the basis risk rules.
Roll-over risk Guideline 1.12	Mitigating short term shock events with short term risk mitigation techniques gives rise to the risk of the exposure over the medium to long term not being mitigated to the same extent as the short-term shock event.	Rolling over a long-term risk with successive 12 month covers.			The RAB believes this is adequately reflected in the SCR long-term scenarios such as mortality trend, as well as the ORSA provisions.
The knock-on effects of the stress scenario Guideline 1.10 (c)	In case of a certain extreme scenario happening, some other stress scenarios could also materialise and lead to an overall worsening of the capital position.	A reduction in the size of the portfolio leads to an increase in the base expense per policy.			These knock-on effects can be taken into account in the capital calculations and hence in the underlying cover.

- To address the issues discussed above, RAB proposes the following changes to the Guidelines on basis risk (EIOPA-BoS-14/172):
  - Proposal 1: extend treatment of material basis risk in the delegated regulation
    - Article 86 specifies a treatment for material basis risk in currency mismatch. It is not clear why this particular kind of basis risk is deserving of special treatment and mention in the delegated regulation.

The RAB proposes striking the mentions of currency risk and the specific treatment for currency mismatch from article 86. The appropriate place for any provisions on currency risk is in the guidelines along with the other relevant considerations on basis risk.

- Article 86 would therefore read:

  Article 86 Material Basis Risk

  Notwithstanding Article 210(2), where insurance or reinsurance undertakings transfer underwriting risk using reinsurance contracts or special purpose vehicles that are subject to material basis risk from a currency mismatch between underwriting risk and the risk-mitigation technique, insurance or reinsurance undertakings may take into account the risk-mitigation technique in the calculation of the Solvency Capital Requirement according to the standard formula, provided that the risk-mitigation technique complies with Article 209, Article 210(1), (3) and (4) and Article 211 and the undertaking has made an appropriate deduction for the material basis risk.

- Proposal 2: Scope of the guidelines
  - The guidelines on basis risk provide under 1.4 that:

    These Guidelines are aimed at facilitating convergence of practice across Member States and at supporting undertakings in calculating their capital requirement for market risk under Solvency II.

  - The RAB believes that this statement could mislead the reader to believe that the Guidelines are only concerned with market risk. Guideline 3 is explicitly dedicated to insurance risk-mitigation, therefore the RAB suggests that 1.4 should instead read:

    These Guidelines are aimed at facilitating convergence of practice across Member States and at supporting undertakings in calculating their capital requirement under Solvency II.

  - Guidelines 1.10 to 1.12 should therefore be also applying in the case of Insurance risk-mitigation techniques with no material basis risk.

- Proposal 3: the assessment of basis risk should take into account the threshold as well as the cap
  - The guidelines on basis risk provide under Guideline 2 1.12 that:

    Where the terms and conditions of a risk-mitigation technique specify a cap on the maximum loss protection as a proportion of the initial exposure, undertakings should apply the assessment only to the proportion covered by the risk-mitigation technique when determining whether the basis risk is material.

  - The RAB believes that this provision should reflect the existence of thresholds as well as caps in insurance risk-mitigation techniques. Therefore, 1.12 should read:

    Where the terms and conditions of a risk-mitigation technique specify a cap on the maximum loss protection, undertakings should apply the assessment only to the part covered by the risk-mitigation technique when determining whether the basis risk is material.
    Where the terms and conditions of a risk-mitigation technique specify that the risk-mitigation technique sets in after certain thresholds are exceeded, undertakings should base their assessment on whether the basis risk is material on those scenarios in which the thresholds are exceeded.

- Proposal 4: the existence of material basis risk in a cover should be corrected for in the capital relief provided
  - Solvency II rules have a principles-based definition of material being something that "could influence the decision-making or judgement of the intended user of that information, including the supervisory authorities". If the basis risk can be quantified as laid out in the Appendix below, one could look at the solvency ratio difference with and without the basis risk adjustment and test whether the difference would result in significantly different decisions by internal/external stakeholders. This test would determine whether the basis risk is material or not and its extent.

  - The RAB requests that where an insurer is able to quantify the basis risk in a cover as per the methods shown in the Appendix below and such basis risk is established to be material, the insurer should be able to subtract the extent of the basis risk from the benefit of risk mitigation under the standard formula, while still being able to recognise the remaining capital relief for the remaining part. Our working group considers this a preferred alternative to the approach described in EIOPA Q&A 1597.

  - The RAB suggests that the following text is added to the Guidelines:

    Where a risk-mitigation technique does not satisfy the conditions listed in Guidelines 1, 2 and 3, i.e. there is material basis risk, and the undertaking is able to appropriately quantify the extent of such basis risk, the risk-mitigation technique may be reflected in the calculation of the Solvency Capital Requirement with the standard formula, provided it is reduced by the amount of material basis risk.

- Proposal 5: expansion of the explanatory text to the Guidelines
  - The RAB suggests that section 2. "Explanatory text" of the Guidelines is expanded to include examples relating to Guidelines 1.9, 1.10, 1.12, 1.13 of situations with basis risk and of situations not constituting basis risk, similar to the cases outlined in the table above that contains a reference to the Guideline to which the example pertains.

- Appendix: proposal on how to quantify material basis risk where it exists. It does not aim to replace or amend the definition of basis risk included in the guideline.

  - Quantification of basis risk is not possible using a single prescribed formula. The RAB proposes the following basic principle-based approach for the three types of basis risk that it has summarised above.
    - Understand what basis risk (type 1-3) is present and why it is necessary in the risk mitigation
    - Analyse the nature of the basis risk – how much of the portfolio is affected and what is different
    - Quantify the impact of the difference by applying SII standard formula 1-in-200-year stresses combined with appropriate additional parameters

1) Mismatch in underlying exposure
   a. The risks associated with the unhedged exposure (A) and the hedge (B) are assigned appropriate probability distributions, calibrated to the relevant standard formula stress.
   b. The unhedged portfolio and the hedge need to be analysed to determine the nature of the mismatch:
      i. A may be a subset of B (e.g. insured vs population)
      ii. B may be a subset of A
      iii. A and B may partially overlap without being subsets
      iv. A and B may have no overlap

The RAB proposes that for whichever of the four cases listed applies, the insurer is free to assign a correlation factor between A and B based on past data and/or judgment.

c. Using the appropriate correlation factor, the combined solvency capital requirement for the hedged portfolio is calculated: $\mathrm{SCR_{A+B}} = \sqrt{\mathrm{SCR_A^2} + 2 * \mathrm{Corr} * \mathrm{SCR_A} * \mathrm{SCR_B} + \mathrm{SCR_B^2}}$

d. The basis risk can be quantified by comparing $\mathrm{SCR_{A+B}}$ to $\mathrm{SCR_A} + \mathrm{SCR_B}$.

2) Mismatch in measurement of losses

In this case there is no difference between the hedged and unhedged exposure per se, only in their measurement.

a. The insurer assigns appropriate probability distributions to the possible losses from the underlying business: as incurred (X) and as measured by the hedge instrument proxy (Y).

b. The difference in loss distribution given by X-Y can be simulated to derive a 1-in-200-year outcome. This outcome is a measure for the basis risk of the hedge.

3) Excluded events

In this case the basis risk arises from a difference in the events covered.

a. The insurer assigns a probability distribution to the loss associated with the excluded events.

b. The loss associated with a1-in-200-year event under the assumed distribution is a measure for the basis risk.

- In each case, stress testing can be used to better understand the range of possible quantifications.

  - Worked example A (mismatch in exposures):

The underlying exposure (A) is that of a life insurer operating in a single country. A reinsurer assumes a portion of the mortality risk in the portfolio through a hedge (B). Reinsurance claims are linked to the experience in the general population of that same country. The experience in the general population is calculated with reference to the same age and gender mix as that in the unhedged portfolio.

The insurer determines appropriate distributions for A and B based on existing data (own/industry table + national statics) and calibrated to the 1-in-200 event of the SII SCR stress. The standard formula implies an SCR for the insurer of $\mathrm{SCR_A} = 100\mathrm{m}$ for the unhedged portfolio and an SCR of $90\mathrm{m}$ for the reinsurer, i.e. $\mathrm{SCR_B} = -90\mathrm{m}$.

Having analysed its own experience and the available national statistics, the insurer determines that 0.99 is an appropriate correlation factor for the two exposures given the age and gender mix. The SCR of the hedged portfolio is therefore $\mathrm{SCR_{A+B}} = \sqrt{100^2 - 2 * 0.99 * 100 * 90 + 90^2} \approx 17\mathrm{m}$ and the basis risk of the hedge is $17 - (100 - 90) = 7\mathrm{m}$ or 7/90≈7% of the risk mitigation.

  - Worked example B (mismatch in measurement of losses):

The risk mitigation is calculated on total number of policies that claim whereas the underlying exposure is to the total amount of claims. The insurer has full distribution data so can analyse the variation in policy size.

The distribution of losses of the unhedged portfolio X is given by $\sum_{i=0}^{N} \mathrm{S_i}$ where N is the distribution of the number of claims (calibrated to a 1-in-200-year event) and $\mathrm{S}_i = \mathrm{S}$ is the claim size distribution (fitted to past claim size data and adjusted for inflation and actuarial judgement). The distribution of losses of the risk mitigation Y is given by $N * c$ where c is a constant.

Then the basis risk can be quantified by calculating the 99.5% VaR of $\sum_{i=0}^{N}(S_i - c)$.

- Worked example C (excluded events):

The claim frequency and claim severity for the unhedged portfolio are given by N and S respectively. The distribution of the total claim amount is $\sum_{i=0}^{N} S_i$ as above.

Some of the claims are not (fully) covered by the risk mitigation, the relative claim severity of the hedged claims is given by $x_i S_i$ where x_i takes can take values between 0 and 1.

Due to lack of credible experience data, the insurer assumes x_i=98% in all instances.

Then the basis risk can be quantified as the 99.5% VaR of $\sum_{i=0}^{N}(S_i - X_i) = 2\% * \sum_{i=0}^{N} S_i$, i.e. 2% of the SCR of the unhedged portfolio.

7. Reporting and disclosure

General comments

Standard formula disclosure for internal model companies

The RAB does not see any benefit – but only costs and a risk of creating misunderstanding in the reporting of standard formula numbers by internal model users. The proposal for internal model users to report standard formula results would create significant additional costs and challenge the real value of internal models. Reinsurance undertakings using Solvency II internal models do so because the standard formula does not reflect their risk profile well enough. Further, supervisors already have tools available to them to ensure that internal models continue to generate prudent SCR numbers, such as regular monitoring and approval of internal model changes (for which EIOPA is proposing an additional template).

Single RSR

EIOPA rejected the introduction of a Single RSR. Though reasons for decision are provided, the arguments are not convincing. A single RSR could reduce costs and be proportionate to the risk profile of the undertaking.

Comments on paragraphs of the consultation paper and on EIOPA's advice on reporting

- Paragraph 7.146: The RAB welcomes the simplification to delete Article 360 (3) from the Delegated Regulation, in relation to Language Requirements.
- According to the first wave of consultation on reporting and public disclosure, the SFCR is separated into a policy holder section and a section for "other stakeholders". With this change the language requirements for the "other stakeholders" section of the Group and Single SFCR are unclear.
    - For international reinsurers with significant cross-border business and business-to-business client relationships only, providing a Group or Single SFCR in local language is not fit-for-purpose. There is generally no benefit for international cedants, international analysts and for supervisors other than the NCAs to have a public document in local language.
    - Duplicating the document in both English and national language is excessive with only limited added value for the addresses of the report.
- On the Single RSR, the RAB is disappointed that the option to report a Single RSR was disregarded. Generally, most of the concerns raised referred to special cases. In these cases, both undertakings and regulators need to balance the advantages and disadvantages of a Single RSR. However, this should not be an argument to disregard the availability of such an option in the first place.
    - The RAB agrees that the document might be quite long. Therefore, it would be in the interest of the supervisor to merge the Solo and Group document to avoid unnecessary duplication without value-added. Without duplication a combined document would be easier to read than several individual documents.

9. Group supervision

General comments

The RAB does not support EIOPA's option regarding the scope of application of Group Supervision, under Article 213 of the SII Directive. The RAB believes that EIOPA's suggestion to grant NSAs a right to form an EU holding company for non-equivalent third-country group is an excessive measure which should either be rejected at all or only be allowed as last resort measure based on clear and restrictive principles.

According to para 9.40, EIOPA suggests granting NSAs with a right to request changes to the structure of a de-facto group in order to allow for group supervision. For instance, entities part of a third-country group might be required to form an EU holding company. This is an invasive measure that would significantly interfere in property rights. If at all, it should therefore only be allowed as a last resort measure based on clear and restrictive principles.

EIOPA should also evaluate whether the supervisory objective could be achieved through exchange of existing information between the respective supervisors instead.

Inclusion of own fund items to cover the contribution of the solo to group SCR (Policy Issue 1)
Q9.5: Taking into account that the availability assessment of own fund at group level is a complex issue, EIOPA would like to request feedback from stakeholders on which possible principle-based rules could be considered to reflect more appropriately the effective amount of available own funds at group level.
In particular, how could the minimum required quality of own funds, which solo insurers must comply with at all times, be reflected in the availability assessment at group level? (i.e. the question is not querying on the quality of the solo own funds at a given point in time, but how the availability assessment by the group supervisor can take into account the impact of a (potential) transfer of own funds within a group on the composition of solo own funds and on ongoing compliance with solo tiering limits – As an illustration, please refer to the case presented on the identification of the policy issue, paragraphs 9.325 to 9.327).

Principle-based rules already exist to reflect the effective amount of available own funds at group level and it is not surprising that most of the NSAs are very comfortable with the current approach as highlighted in the consultation report. The availability assessment does not intend to assess "the impact of a (potential) transfer of own funds within a group on the composition of solo own funds and on ongoing compliance with solo tiering limits". How would such a transfer be defined, for which entity and to which purpose? The Solvency II framework considers that solo own funds which can be made available at group level cover at the same time the requirements of the group – which is logical because a group consists of its solo entities. Solvency II considers that if an own fund item cannot be made available at group level, then it can only be available at the solo entity level (and therefore is limited at group level to the contribution of the entity to the Group SCR – however this principle describes the case where a group would only cover its SCR at 100% – if a group covers its SCR at (100+x)%, solo own funds items which cannot be made available at group level could be included in group own funds up to (100+x)% of the contribution of the entity to the Group SCR, because we should assume that the solo contribution to group SCR indicates the relative contribution of this entity to generating losses within the group).

Availability assessment at group level and EPIFPs (Policy Issue 4)
Q9.6: Which methods/tools would be possibly used to make own funds available within 9 months from one undertaking to another when large amounts of EPIFP exist?

- The RAB disagrees with EIOPA's view that EPIFP should be assumed to be not available at group level by default. Art. 330 of the DR already gives the supervisors the power to challenge the availability of own funds items that are assumed available. Supervisors are also granted full power to review the best estimate calculations, knowing that EPIFP are just an output of the economic value of insurance liabilities. EIOPA's proposal would create legal uncertainty without bringing any value to the existing framework.
- EPIFP should continue to be treated as an assumed available own fund item at group level since there are several methods to monetise EPIFP and make future profits available at group level, should the need arise. This can be done eg through a sale of legal entities, customer portfolios, through re-insurance arrangements, or insurance-linked securitisations. In the past some insurers already used these transactions to fund M&A activities. Securitisation of future in-force profits is a further method.
- The time span of 6–9 months to monetise is ambitious but realistic. Of course, a sale of sub-portfolios that involves policyholder sharing is more complex, but the general argument persists.
- As a matter of principle, it is reminded that whether large amounts of EPIFPs exist is linked to each undertaking's risk profile (i.e. there's no "good" or "bad" levels of EPIFPs per se). Changing the default assumption could distort existing business and lead to regulatory arbitrage as EPIFP would be treated differently depending on its location (parent vs subsidiary) rather than its economic value to the insurance group.

<u>Comments on paragraphs of the consultation paper and on EIOPA's advice on group supervision</u>

Section 9.3.13 Availability Assessment of Own Funds (groups)

- Paragraph 9.347: EIOPA should ask NSAs how this is done in practice before stating this as an issue.
- Paragraph 9.356: the RAB strongly disagrees that EPIFPs should be treated as non-available by default and be subject to transferability assessment. Art. 330 of the DR already gives the supervisors the power to challenge the availability of own funds items that are assumed available. Supervisors are also granted full power to review the best estimate calculations, knowing that EPIFP are an output of the economic value of insurance liabilities. EIOPA's proposal would create legal uncertainty without bringing any value to the existing framework. The discussed availability assessment of EPIFP for group own funds is a very critical issue for the economic relevance of the group capital assessment. In particular, there should not be such restrictions on contributions to group excess capital once the group SCR has been covered by local contributions. The fact that EIOPA did not give a corresponding advice is welcome. The issue which EIOPA is trying to address is already being addressed directly by the company under existing regulation on the Risk Management Function and by the supervisors using their existing powers (e.g. SRP).

Section 9.3.15 Minimum Consolidated Group SCR

- Paragraph 9.399: EIOPA's proposal to calculate notional SCR/MCR for IHC in all cases and through a prescribed (and simplistic) methodology is neither risk-based nor proportionate. The issue that EIOPA tries to address is particularly unclear insofar as IHC do not bear insurance-related risks. Should there be group arrangements that necessitates a closer scrutiny, this should be done by the group supervisor through normal SRP rather than by a one-size-fits-all compulsory approach.
- In addition, EIOPA's proposal may lead (pending the right interpretation of the consultation report) to material double-counting of risks. If the participations in the subsidiaries of the IHC should be included on the basis of a look through approach or otherwise instead of being excluded from the notional SCR (EIOPA clarification on this point is critical), then the notional SCR will capture the exact same risks as the SCR of the IHC's subsidiaries. For example, if an IHC "A" holds a participation in another IHC "B" which holds a participation

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in the insurance company "C", then $〚SCR〛\_A \approx SCR\_B \approx SCR\_C$ leading to an artificial duplication of risks recognition.

- Furthermore, EIOPA's proposal would end up with ballooning minimum consolidated group SCR since SCR_A and SCR_B would each generate a notional MCR equal to 35%*SCR_C.
- EIOPA's proposal would therefore clearly overshoot its objective, whatever it is. And many unintended consequences may arise as a result, for instance regulatory arbitrage (the capital position of the group would be dependent on its structure instead of the risks taken) and inappropriate intervention ladder (with minimum consolidated Group SCR>Group SCR). Further to the fact it is inappropriate for non-risk sensitive minimum consolidated Group SCR to be prevalent on risk-sensitive Group SCR, the strong capital management consequences of breaching the minimum consolidation Group SCR make the risk of an inversion of the intervention ladder even more concerning.

10. Freedom to provide services and freedom of establishment

General comments

The RAB generally welcomes EIOPA's recommendations on enhancing cooperation between home and host supervisors in relation to the supervision of cross-border business within the EU. The RAB agrees that issues identified in EIOPA's Article 242 Report should be addressed without jeopardizing the home country financial supervision approach (paragraph 10.9).

Reinsurance is an international business, conducted across national borders. The Solvency II Directive reflects this and does not place specific notification or reporting requirements on reinsurance undertakings carrying on business within the EU on a freedom of services or establishment basis. The RAB supports the continuation of this approach.

Unlike other sections of the consultation document, this section refers to EIOPA's preferred options without saying what the options not chosen are. This makes analysis of the proposals more difficult.

<u>Comments on paragraphs of the consultation paper and on EIOPA's advice on freedom to provide services and freedom of establishment</u>

Section 10.6 Efficient information gathering during the authorisation process

- Paragraph 20: The RAB agrees with the intention behind this proposed new paragraph in Article 18 of the Directive, although it questions whether it will be effective in practice. It could be quite easily side-stepped because the individuals behind an undertaking refused authorisation in one member state can dissolve that entity and re-establish a new undertaking in a different member state. The second entity would not have been refused authorisation, so there would be no rejection or withdrawal to be declared.

Section 10.7 Information exchange between home and host supervisors in case of material changes in the FoS activities

- Paragraph 29: The RAB supports the principle underlying this proposed new paragraph in Article 149. However, it is unclear what difference it will make. In so far as there is a problem here, it appears to relate to ambiguity in Articles 147 to 149.

- On the face of it, Article 149 requires an insurance undertaking carrying on business on an FoS basis to notify its home supervisor of <u>any</u> change in the nature of the risks or commitments it covers. The home supervisor is then required, within one month, to provide the same Article 148 information to the host supervisor that it gave when the undertaking first proposed to carry on FoS business. In practice, this may not be happening, particularly if the concept of "the nature of risks or commitments" is not well-understood by undertakings or supervisors.

- The difference between "any material change in the business pursued" and change in the nature of the risks or commitments covered is not immediately apparent. A better approach might be for the new paragraph to replace the existing Article 149, making the notification obligation on insurance undertakings somewhat clearer. However, there would still be room for misunderstanding over the meaning of "material" change. The RAB could envisage a more prominent role for EIOPA in the implementation of these requirements.

A related and important issue that, in the RAB's view, should be addressed in the upcoming review concerns the current fragmented NCA approach towards third-country reinsurance being offered to European cedants on a cross-border basis. At this stage, Articles 162-171 of Directive 2009/138/EG do not address the market access of third country undertakings that exclusively conduct reinsurance activities. This leads to a fragmented and inconsistent regulatory landscape, as some Member States impose a local presence requirement or set similar pre-requisites for conducting cross-border reinsurance while others do not. As a result, European cedants are confronted with an unlevel playing field if they consider ceding (re)insurance risks to undertakings located outside the European Union on a cross-border basis which for some (re)insurers forms an essential part of their risk management strategy. Therefore, the market access of third country (re)insurers for the conduct of reinsurance business should be harmonised in accordance with international standards. Member States under the WTO's GATS have committed not to limit access for cross-border reinsurers. Considering that the standard formula already accounts for potential additional risk due to cessions to third-country reinsurers, not based and licensed in an equivalent jurisdiction, within the counter-party default module, it cannot be argued that an additional local presence requirement falls within the NCA's or Member States' leeway of the prudential carve-out. Furthermore, Insurance Core Principle 13.4 of the International Association of Insurance Supervisors (IAIS) emphasises the cross-border nature of reinsurance transactions and the market sophistication of the parties involved. This should be translated into a regulation that ensures that Member States grant market access third-country reinsurers for cross-border business. As an additional, albeit more political, aspect it should be mentioned here that the implementation of the commitments under the Bilateral Agreement between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance will necessitate the opening of those markets that currently foresee the described barriers to US reinsurers. The RAB believes that the markets that will have to take action to that extent should open the market for all third-country reinsurers in order to not create discriminating market access regimes that hinder the prudent conduct of the reinsurance business model which is global by nature.

11. Macroprudential policy

General comments

While the RAB accepts that there are certain activities that can be carried out by (re)insurers that can be a source of systemic risk, we emphasize that there is no evidence that traditional reinsurance activity actually poses a systemic risk to the real economy or wider financial system. This is even more so from an entity-based or a behaviour-based perspective. Rather it is an important tool in the management of risk that facilitates the ability of societies to deal with shocks that would otherwise cause them substantial economic harm.

In other words, reinsurance mitigates systemic risk, rather than causing it. As the 2012 International Association of Insurance Supervisors (IAIS) report "*Reinsurance and Financial Stability*" says (paragraph 91):

"…we find that traditional reinsurance – including the reinsurance of peak risks – is unlikely to contribute, or amplify, systemic risk. While reinsurance establishes intra-sector connectivity, the hierarchical structure of the insurance market dampens the propagation of shocks through the insurance market."

In November 2019, the IAIS agreed to adopt a holistic framework for systemic risk in the global insurance sector. From 2020 onwards, we expect jurisdictions worldwide to implement measures to bring the holistic framework into effect. The EU should therefore ensure that anything that it puts in place on macroprudential policy is aligned with the IAIS holistic framework, as global supervisory cooperation is an important element in the mitigation of systemic risk.

The Commission Call for Advice stipulates that EIOPA's response on macroprudential policy "should be based on strong supporting evidence". In this context, we note EIOPA's statements that "*The understanding of the effectiveness of macroprudential policies implemented is still rather preliminary and limited*" (Box 11.3), "*The discussion on systemic risk and macroprudential policy is less developed in insurance than in banking*" (paragraph 11.13 and "*The challenge to provide sound empirical evidence also applies to insurance*" (Box 11.3). These imply that evidence supporting EIOPA's proposals on macroprudential policy is limited.

The Call for Advice included a "closed list" of four items on which the Commission asked EIOPA to advise, a list which aligns with the IAIS international holistic framework. In these circumstances the RAB thinks that EIOPA's advice should focus on the items specified by the Commission. It should not be recommending the adoption of tools not on the closed list, as they are outside the terms of reference of this exercise.

The RAB does not believe it is appropriate to consider a macroprudential framework that goes beyond the Commission Call for Advice for the purposes of the 2020 review.

Q11.1: What principles should be taken into account by NSAs in their decision to trigger, set, calculate and remove capital surcharge for systemic risk?

The RAB does not believe that a capital surcharge is necessary particularly as core reinsurance activities per se are not systemic, in fact, the RAB does not believe that any insurance activities per se are systemic: major (re)insurers are comfortably capitalized, well diversified and used to cope with major external shocks at a global level (e.g. natural/man-made catastrophes). Furthermore, they strictly follow a liability-driven business model reducing to the extent possible their exposure to major asset risks.

Solvency II is a comprehensive regime, designed to cover the full range of risks credibly facing insurers and reinsurers. The justification for applying further capital surcharge beyond those already present in the Solvency II regime is not made sufficiently clear by EIOPA. Capital should not be the default response to systemic risk, as it would miss its purpose. An increase in the SCR could simply tie up capital the firm could use more effectively elsewhere and limit the firm's ability to respond flexibly to macroeconomic stresses.

Q11.2: What factors should be taken into account by NSAs when setting soft thresholds at market-wide level?

Setting market-wide investment limits is at odds with a risk-based approach, lacking to reflect each undertaking's risk profile, diversification policy and ALM strategy. It is hard to fathom how it can work as intended. If mechanistically applied across EU jurisdictions, it could foster divestments and prove pro-cyclical. If loosely applied, it may give rise to inconsistent treatment from one jurisdiction to another. It is also unclear how EIOPA would reconcile investment limits with e.g. ECB's monetary policy. The search for yield for instance cannot be seen in isolation with the unconventional monetary policy.

Q11.3: How to ensure that the relevant macroprudential information from the ORSA reports of undertakings can be extracted and used at national level for macroprudential purposes?

The RAB believes that greater prescriptiveness in the ORSA is counterproductive with regards to its purpose and diminishes its value to companies. To the extent that companies decide to include macroprudential scenarios in the ORSA of their own accord, the RAB agrees that the decision to do so and the scenarios included may provide valuable insights for national regulators.

Q11.4: What are the relevant factors to be taken into account to determine the scope of undertakings subject to SRMPs?

The RAB does not think that the reinsurance (as well as the insurance) business model are systemically relevant. Therefore, reinsurers should not be systematically required to complete SRMPs.

Q11.5: What are the relevant factors to be taken into account to determine the scope of undertakings subject to LRMPs?

The scope of undertakings should be limited and based on a proportionality assessment. Since traditional (re)insurance business is not exposed to bank-run type of systemic stress, the SRMP should be limited to those (re)insurance undertakings pursuing material non-traditional activities. For traditional (re)insurance business, systemic stress is more a solvency issue than a liquidity issue as (re)insurance obligations do not settle overnight as it may be the case for bank deposits.

<u>Comments on paragraphs of the consultation paper and on EIOPA's advice on macroprudential policy</u>

Section 11.3 Identification of the issue

- Paragraph 29: It is not clear, but this paragraph appears to be suggesting an entirely new section or chapter in the Solvency II Directive covering macroprudential policy and surveillance. The reasons for advocating this approach, rather than incorporating additional material on macroprudential supervision into the existing framework, are not stated. The RAB questions whether drafting a new provision in this way is the best way forward, in view of the overlap between macroprudential and microprudential measures and the need for macroprudential supervision to by fully integrated into overall supervisory processes.

Paragraph 29 also refers to a specific macroprudential objective. It would be helpful to clarify whether EIOPA is suggesting inserting such a new objective in the Solvency II Directive. Any such initiative should be compatible with Solvency II's existing supervisory objectives. Solvency II Directive Article 27 says that the main objective of supervision is "the protection of policy holders and beneficiaries"; Article 28 sets out a secondary objective relating to financial stability and pro-cyclicality, which appears to cover the same ground as the reference to an objective in this paragraph.

- Paragraph 30: Says that the proposals "*primarily focus on the principles or fundamental elements of each tool*". EIOPA does not define operational details in a comprehensive manner. It adds "*the full technical details could be addressed by means of technical standards, guidelines or recommendations once the relevant legal instrument has been enacted*".
  The lack of detail on the macroprudential supervisory proposals makes assessment more difficult. The process by which important operational details are put in place requires careful oversight, to ensure that the new regime is effective, proportionate and not too burdensome. Checks and balances help ensure optimal regulatory policy design and the new provisions on macroprudential supervision should be subject to the EU's usual legislative processes, not left in purely supervisory hands.

11.4.1 Capital surcharge for systemic risk

- Paragraph 39: Solvency II Directive Article 37 says that National Supervisory Authorities (NSAs) may set capital add-ons "in exceptional circumstances": the situations in which they may be set are carefully defined and additional requirements are set out in Chapter X of the Delegated Regulation. The RAB questions the necessity to give NSA's additional capital add-on powers.
  Systemic risk in insurance is a nebulous concept that covers a range of perceived issues. Analysis of the subject is theoretical rather than evidence-based and the Consultation Paper's discussion of the topic falls back on subjective language such as "excessive", "inappropriate" and "risky behaviour". If capital add-ons can be justified by reference to a loosely-defined concept of "systemic risk", there is a risk that they will be imposed inappropriately.

- Paragraph 40: An entity-based approach (EBA) should recognise that, in macroprudential terms, size can be viewed as a strength, rather than a weakness. A requirement to hold additional capital on these grounds can be questioned, particularly when the Financial Stability Board is seemingly moving away from EBA, as they have not updated the G-SII list for a number of years. The RAB notes that the scope of institutions to which a capital add-on could be applied is expanded beyond the global to include 'domestic systemically important insurers' and others (Table 11.4). The RAB is concerned at this extension of the scope of capital add-ons: there must be sufficient checks on their application.

- Box 11.5: IAIS references to capital surcharge: This quotes from a IAIS consultation published in November 2018. However, the IAIS final document, Holistic Framework for Systemic Risk in the Insurance Sector, published in November 2019, does not mention capital add-ons.

11.4.3 Expand the use of the ORSA to include the macroprudential perspective

- Paragraph 88: Suggests that supervisory action may follow if an NSA finds that there are diverging views on a risk for different firms with similar business models. However, diversity in views may be considered a strength at the market-wide level, as differentiation may make the system more resilient overall. If NSAs try to homogenise approaches to macroprudential issues within their markets, they could contribute to behavioural systemic risk.

11.4.4 Expand the prudent person principle to take into account macroprudential concerns

- Paragraph 101: EIOPA notes that the ESRB considers that undertakings could be incentivised to consider macroprudential concerns when analysing the diversification and liquidity of their own investment portfolios, for example decisions that could lead to procyclical behaviour.
  This could introduce conflicts of interest for senior management. If, for instance, it is in the immediate best interests of a firm to sell assets at a particular time, it should not refrain from doing so because it could be seen to be contributing to procyclical behaviour. Deference to the PPP could therefore give rise to additional risks, particularly as it is non-quantitative and therefore relies on judgement.
  The suggestion that NSAs should provide information to undertakings on trends and patterns that may pose systemic risk has merit. It would be important to ensure that this did not encourage "herding" behaviour, and thereby exacerbated systemic risk.

- Paragraph 106: EIOPA proposes to include a reference in Article 132 of the Solvency II Directive explicitly referring to the need for undertakings to consider macroeconomic concerns when deciding on their investment strategy. NSAs would thereafter need to take into account macroeconomic concerns when assessing compliance with the PPP.
  Whilst consideration of the macroeconomic variables listed is good in theory (and probably already practised by firms), the usefulness of including this within the PPP by be limited. Macroeconomic factors, such as the credit cycle and economic downturns, are inherently unpredictable. Nor do NSAs have an inherently superior ability to assess them relative to firms' ability to do so.
  The RAB supports the PPP as a key feature of the Solvency II framework. However, the RAB believes that the PPP is already comprehensive enough to address macroprudential concerns that may arise from concentration risks. Article 260 on Risk Management Areas of the Solvency II Delegated Regulation requires in particular the risk management function to consider "possible risks of contagion between concentrated exposures". Furthermore, it should be made clear that it is not expected from (re)insurance firms to behave against their best interests and the best interests of their ceding companies/policyholders when taking into account NSAs' macroprudential concerns.

- Paragraph 113: in EIOPA's proposal, SRMP's purpose is to "address the systemic risk that the institution may pose in the financial system". Further to the fact that the RAB does not think that the reinsurance (as well as the insurance) business model are systemically relevant (see response to Q11.4), the RAB believes that the SRMP would not even be practicable in practice. As opposed to micro-prudential risks, it is nearly impossible for a (re)insurance undertaking to assess the systemic risk that it represents to the wider financial system as it lacks access to other confidential financial institutions data, reported only to supervisors. Only central competent authorities like central banks can combine cross-sectoral data at scale (gathering relevant data for the insurance, banking, asset management, derivative markets and so forth) to estimate the systemic risk under market-wide stress tests.

12. Recovery and resolution

General comments

There are many developments going on in the field of recovery and resolution. Among others, this includes the IAIS Application Paper on Recovery Planning that provides guidance with respect to draft supervisory material related to recovery planning in the Insurance Core Principles (ICPs) and the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). In particular, it is related to the draft revised material in ICP 16.13 and ComFrame 16.13 (ICP 16 Enterprise Risk Management for Solvency Purposes) and is also relevant to supervisory cooperation and coordination arrangements set out in ICP 23 (The Group-wide Supervisor) and draft revised ICP 25 (Supervisory Cooperation and Coordination). The FSB Key Attributes for Effective Resolution and related materials contain information regarding recovery planning for G-SIIs. The EU should ensure that anything that it puts in place on recovery and resolution is aligned with the standard setting stakeholders, such as the IAIS and the FSB, to avoid regulatory burden for the reinsurance sector and have an equal global level playing field.

Q12.1: How should the very significant market coverage across the Member States be determined? What are relevant factors to take into account?

The RAB firmly believes that including reinsurers systematically in pre-emptive recovery planning and detailed resolution planning requirements would neither improve policyholder protection nor contribute to financial stability. Reinsurance is a business-to-business activity, with limited policyholder protection implications, and there is no evidence or history of it contributing to systemic risk or financial instability. A reinsurer should only be subject to these requirements where a clear policyholder protection of financial stability benefit can be demonstrated. Please refer to our comments on Box 12.2 below for more background on this.

Q12.2: How should the significant market coverage across the Member States be determined? What are relevant factors to take into account?

See comments above on Q12.1 and Box 12.2 below.

Q12.3: What factors need to be considered by NSAs for early interventions?

The RAB believes that the case for missing additional "early intervention" powers (Box12.1) is not well founded, in particular in view of Article 141 which grants comprehensive rights to supervisors in case of deteriorating solvency positions. It is reminded that, under Solvency II, the SCR is a solvency target and not a minimum floor. Breach of SCR should not mean nor be interpreted as the firm being in peril but rather as an early warning for firm's remediation actions. Extending early intervention powers on top of the existing intervention ladder is in contravention with that the SCR is a target and would conversely make it the de facto MCR.

<u>Comments on paragraphs of the consultation paper and on EIOPA's advice on recovery and resolution</u>

- Box 12.2: the RAB disagrees with the statement according to which reinsurance activity would generate systemic risk while in fact it is quite the contrary: reinsurance activity contributes to the overall resilience of the insurance market by pooling and diversifying risks across lines of business and geographies. EIOPA should seek to incentivise risk mitigation through reinsurance rather than stifling it through excessive costly burdens. The whole box seems to be rather a theorical construct than an evidence-based demonstration.
- The international financial crisis originated in the banks' off-balance sheet activities, but reinsurers are not (materially) engaged in non-traditional, non-insurance activities. Reinsurance business is usually not per se

considered as systemic, but rather as a stabilising factor by taking on risks. End 2013, the Global Reinsurance Forum conducted a study of systemic risk in the reinsurance industry. The conclusion of the study is categorical; reinsurers cannot represent a systemic risk. Reinsurance actually helps to reduce systemic risk in the insurance industry as a whole, enabling risk transfer, broad dispersion of risk into the industry's capital base and for peak exposures to be protected against. Insurance-linked securities (ILS) capital and the re/insurance sectors use of the capital markets are now augmenting this effect considerably, further diversifying the capital, spreading the risk and reducing any interconnectedness even further. Furthermore, the disappearance of a reinsurer does not happen overnight. It is a long and orderly process where the reinsurer itself or the liquidator will honour all or parts of the payment of claims. Repudiation of previously signed contracts is not possible. This run-off situation may spread over many years and can be performed also by specialized companies. Therefore, recovery and resolution plans for reinsurers should be triggered by SCR breaches (recovery) and MCR breaches (resolution) only.

- Regarding entity-based systemic risk, the 3 biggest reinsurers in the EU combined total assets represent 0.1% of the total financial assets in the world (as computed by the FSB in the *2018 Global monitoring report on NBFI)*. The 10 biggest global reinsurance groups represent no more than 0.3% of the total financial assets in the world.
- Regarding activity-based systemic risk, reinsurance is primarily about property, casualty and biometric risks. Those risks are not linked to the financial cycle and therefore traditional reinsurance activities are not subject to "bank-run" or risk of fire sales.
- Regarding behaviour-based systemic risk, reinsurance activity covers in particular long tail risks. This feature combined with the fact that reinsurers are balance-sheet light compared to other financial institutions and their activity not correlated to the financial cycle mean that they are not prone to herding behaviour.
- The fact that the reinsurance market is dominated by global players should be seen positively. This concentration allows risks to be pooled and then diversified on a global scale, thus mitigating the impact of external shocks. In addition, the reinsurance market is highly competitive and therefore reinsurance portfolios are easily transferable and entities easily substitutable.

  Despite the importance of reinsurance to mitigate tail risks, the linkage between reinsurers and primary insurers should not be overstated. In fact, 5% of primary insurers' written premiums are ceded globally to reinsurers.
- The interconnections between reinsurers are also low. Retrocessions accounts for only 13% of global reinsurance premiums and 0.6% of the global primary insurers' written premiums. There is no retrocession of retrocession and retrocession generally occurs between Tier 1 and Tier 2 reinsurers. Moreover, the retroceded premiums are still accounted for in the technical provisions of the cedant reinsurers such that retrocessions have no similarity with off-balance sheet securitisations.
- Should the reinsurance market experience a spike of natural or man-made catastrophes, there is always the possibility to increase the reinsurance premiums to sustain the reinsurance business.
- The 2008 great financial crisis was primarily a banking crisis. The near-bankruptcy of AIG was caused by non-traditional insurance activities. Since then, Solvency II entered into application with Pillar 1 capital requirements calibrated over one in two hundred years stress events and accompanying Pillar 2 and Pillar 3 requirements that ensure proper governance and market discipline.
- The bottom line is that reinsurance business is utterly dissimilar to banking business and its exposure to bank run-like liquidity stress lacks evidence. Moreover, the failure of a reinsurer (even a Tier 1 reinsurer) is not susceptible to generate a financial crisis as the size and channels for this are not material enough and the safety nets (Solvency II, national insurance schemes, national macroprudential and resolution policies) already very conservative. Regarding the impact of reinsurance failure on the insurance sector, box 12.2 fails to mention that direct insurers are already subject to extensive Solvency II regulation with respect to their reinsurance activities across all 3 pillars, which serves to ensure that the impact of reinsurer failure on a direct insurance undertaking will be minimised. The failure of a direct insurer will directly impact an insurance

policyholder. However, the failure of a reinsurer will only do so if such failure occurs in combination with the failure in the risk management framework of the ceding insurer to appropriate capture risks relating to its reinsurance activities. The application of regulation to reinsurance needs to be proportionate in taking this into account.

- Box 12.2 also refers to circumstances where primary reinsurers also write reinsurance business in making the link between reinsurance and direct policyholders. Where it is deemed appropriate by supervisors to require a recovery / resolution framework in specific circumstances, this would not justify a systematic application of the framework across all reinsurers.

14. Other topics of the review

Comments on paragraphs of the consultation paper and on EIOPA's advice on other topics

Restriction of directly reinsured companies (Article 13 (7) (a))

- There is a restriction in the Directive regarding the purchase of reinsurance, which is defined as the risk transfer between insurance undertakings that fall under Solvency II (see Article 13 (7) in conjunction with Articles 2 – 10 and Article 14). Consequently, public health insurers, small insurers, certain mutual insurers and certain pension funds can only buy reinsurance protection via the detour of a primary insurer, which means increased transaction costs and additional counterparty risk. The RAB would assume that this was not the intention when the wording of the directive was drawn up.
- The restriction under consideration can be eliminated by a minor adaptation of the text of the directive. The RAB would suggest for example supplementing Article 13 (7) (a) as follows:
  - (…) "reinsurance" means either of the following:

  (a) the activity consisting in accepting risks ceded by an insurance undertaking or third-country insurance undertaking or by another reinsurance undertaking or third-country reinsurance undertaking; *or an undertaking that conducts insurance activities but is excluded from the Scope of this Directive regulation based on Articles 2 to Article 10, or* (…)