Position Paper

Response to EC consultation on Solvency II review

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Introduction

The Insurance Europe Reinsurance Advisory Board (RAB) welcomes the opportunity to contribute to the European Commission's consultation on the Solvency II review.

The RAB strongly supports the Solvency II framework and its underlying risk-based, market-consistent approach. It is the most advanced insurance regulatory regime in the world. Several areas of this framework have proven to work well and are essential to reinsurers. For example, an economic reflection of group capital resources and internal models are essential elements of the framework. Hence, RAB does not envisage an overhaul of Solvency II.

Nevertheless, the review is an important opportunity to improve the framework in some areas, including those specifically related to reinsurance (eg, by better recognising the risk-mitigating effect for cedants of non-proportional reinsurance and reviewing the design of the risk margin). The Solvency II review also needs to take account of the fact that **reinsurance is a business-to-business activity, with limited need for policyholder protection**, and that there is no evidence or history of reinsurance contributing to systemic risk or financial instability. The review should therefore clearly **recognise reinsurance as 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.

The review should ensure that EU reinsurers remain competitive internationally and, in light of this, **should not lead to an overall increase in capital requirements** for the pursuit of reinsurance activity. Moreover, technically justified reductions in requirements in parts of the framework where the industry has provided evidence of the need for more risk-sensitive alternative approaches (eg, risk margin, non-proportional reinsurance, basis risk) should be envisioned.

The RAB believes that the review should lead to the following:

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

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- **The uneconomic level and volatility of the risk margin should be addressed** by a review of its calibration, and **the group risk margin calculation should allow for the diversification of risks** across the reinsurance group to reflect the reinsurance business model. **The design of the risk margin has implications for the competitiveness of EU reinsurers** in the face of non-EU jurisdictions that do not require a risk margin of local (re)insurers.
- **Standard formula disclosure** — which is generally not tailored to capture reinsurance risks and their diversification appropriately — **should not be required of reinsurers using an approved internal model**.
- **Consistency in the treatment of future premiums at group level** should be preserved. This is an important topic for reinsurers, as they are providers of long-term protection contracts. Tools exist to make future profits available at group level, should the need arise. Economic recognition of future premiums (and corresponding claims) is the logical consequence of their inclusion in the technical provisions and solvency capital requirement (SCR). The own-fund tiering treatment of future premiums should therefore not be changed.

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Section 1: Long-termism and sustainability of insurers' activities, and priorities of the European framework

Question 1: What could be the renewed objectives of European legislation for insurance companies?

On a scale from 1 to 9 (1 being "not important at all" and 9 being "of utmost importance"), please rate, and if possible rank, each of the following proposals.

	1	2	3	4	5	6	7	8	9	Don't know/ no opinion
Policyholder protection									x	
Financial stability							x			
Fostering investments in environmentally-sustainable economic activities which will be defined in the EU taxonomy[7]		x								
Fostering long-term investments in the real economy and providing long-term financing to European companies, including SMEs		x								
Ensuring a fair and stable single market							x			

If you identify other political objectives, please specify them and give a rating of their importance from 1 to 9 for each of them:

- 8 — Solvency II should allow (re)insurers to bring capacity to close the protection gap in insurance coverage, thus contributing to the resilience of the economy and the EU's climate-change objectives.
- 8 — Solvency II should support the international competitiveness of the European industry and not establish or encourage the establishment of trade barriers at member-state level.

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Question 2: In light of market developments over the recent years, in particular the low or even negative interest rates environment and the Covid-19 crisis, what should be the priorities of the review of the European legislation for insurance companies?

On a scale from 1 to 9 (1 being "low priority" and 9 being "very high priority")? Please rate, and if possible rank, each of the following proposals.

	1	2	3	4	5	6	7	8	9	Don't know/ no opinion
Ensuring that insurers remain solvent			x							
Ensuring that insurers' obligations to the policyholders continue to be fulfilled even in the event that they fail			x							
Ensuring that there are no obstacles for insurance companies to contribute to the investment needs of the European Green Deal, i.e. fostering insurers' investments that help the transition to carbon neutrality by 2050					x					
Ensuring that there are no obstacles for insurance companies to invest in accordance with the objectives of the Capital Markets Union, i.e. fostering insurers' long-term financing of the European economy, including SMEs					x					
Facilitating insurers' ability to offer (sufficiently) high returns to policyholders, even if this implies taking more risks							x			
Facilitating insurers' ability to offer products with long-term guarantees								x		
Ensuring that insurers do not face liquidity issues (i.e. that they have sufficiently liquid assets) to meet at all times short-term obligations[8]		x								
Preventing the build-up of systemic risk and ensuring financial stability		x								

If you identify other priorities, please specify them and give a rating from 1 to 9 to each of them:

- 8 — The legislation should ensure adequate risk-based recognition of risk-transfer mechanisms, such as reinsurance, to diversify risks and contribute to the overall resilience of the sector.
- 9 — It must also preserve (re)insurers' ability to reflect their own assessments of risks and risk profiles through the use of internal models.

Question 5: Do you agree or disagree with each of the following proposed change to quantitative rules in Solvency II?

	Agree	Disagree	Don't know/ no opinion
We should make it less costly for insurers to invest in SMEs		x	
We should make it less costly for insurers to invest in environmentally-sustainable economic activities and associated assets (so-called "green supporting factor")		x	
We should make it more costly for insurers (and therefore provide disincentives) to invest in activities and associated assets that are detrimental to the objective of a climate-neutral continent (so-called "brown penalizing factor")		x	

Please explain your reasoning for your answer to question 5 (if needed):

From a regulatory perspective, **RAB supports a risk- and evidence-based approach to capital requirements**. It should not be the role of prudential regulation to encourage sustainable underwriting practices or promote sustainable investing or SME investments. If there is ultimately empirical evidence to show better investment performance for sustainable investments and/or SME investments, the RAB would expect this to be reflected in Solvency II over the medium to long-term.

Question 6: Does Solvency II appropriately mitigate the impact of short-term market volatility on the solvency position of insurance companies?

- Yes

Please indicate how the framework could mitigate the volatility of:

- fixed-income assets
- stock markets

The RAB believes that, overall, Solvency II is appropriate to mitigate short-term volatility, however, some targeted improvements are necessary.

The framework should be based on an economic balance sheet but should not amplify the volatility in the market. In practice, the high level of cost of capital and the absence of diversification of risks at group level unduly inflates the volatility of interest rates over the whole term structure of the risk margin of reinsurers. This penalises the provision of long-term guarantees.

Question 7: Does Solvency II promote procyclical behaviours by insurers (e.g. common behaviour of selling of assets whose market value is plunging or whose credit quality is decreased), which could generate financial instability?

- Yes

Please indicate how the framework could avoid procyclical behaviour by insurers:

Based on reinsurers' experience since the year of application of Solvency II, the RAB takes the view that the framework has worked as intended and has not resulted in any material procyclical behaviour. While reinsurers are at risk of adopting procyclical behaviour as a result of Solvency II, **the amplification of the volatility of interest rates in the risk margin can create an undue strain on the reinsurance capacity brought to the life insurance market**. The amplification stems from the high cost of capital and the absence of diversification of risks at group level in the risk-margin calculation.

Question 10: In light of the Covid-19 crisis, have you identified any major issues in relation to prudential rules that you were unaware of or considered of lesser importance prior to the pandemic?

- No

Please elaborate your answer to Question 10:

The experience of COVID-19 shows that **the framework has performed broadly as intended** and that an overhaul of the regime would be unwarranted in this regard. In particular, there have been no issues surrounding the use of internal models — which are a better measure of risks, especially for reinsurers — that would suggest the need to introduce additional requirements, such as standard formula disclosure.

However, experience also provides a clear illustration of certain **flaws in the framework**, such as:

- The design and calibration of the risk margin amplifies the volatility of interest rates in the balance sheet of long-term guarantees providers.
- The European Insurance and Occupational Pensions Authority (EIOPA) acted beyond its mandate when imposing a blanket ban on dividends regardless of the individual (re)insurers' risks and disregarded the ladder of supervisory intervention already in place. Safeguards should be in place to avoid such undue measures going beyond Solvency II and creating distrust in the framework (see details in comments on Q25).
- EIOPA and national competent authorities have introduced a number of additional ad hoc reporting requirements. Some of them are just slight variations of existing reports. Solvency II reporting requirements should be streamlined to also work in a crisis situation.

Question 11: From the point of view of policyholders, would it be acceptable to waive Solvency II requirements to insurance companies that belong to a group, if the group as a whole is subject to "strengthened" supervision?

- Don't know/no opinion

Please explain your answer to question 11 (if needed):

The RAB is concerned that a setback to Solvency I may be underway, and that the **recognition of group supervision could be undermined**.

Groups are an integral part of the global competitiveness of the EU insurance industry and key to the leading position of RAB members in the world. The **recognition of groups is consistent with Solvency II objectives** (ie, policyholder protection and the preservation of financial stability). Groups have better capacity to access financial markets than individual companies and with lower premiums and the capacity to better diversify risks both geographically and between business classes. A functioning group supervision framework is necessary to the functioning of the internal market and as an enabler for the goals set by the Capital Markets Union (CMU).

Against this backdrop, an essential part of the group supervision framework is the **recognition of economic capital management at group level**. The availability of profits of the in-force business (ie the expected profits included in future premiums) should continue to be recognised in the group own funds by default. Ring-fencing own funds at local level would inevitably clash with the objectives of the CMU. Moreover, the diversification of risks between life and non-life businesses should be duly recognised in the group risk margin, consistently with the recognition of diversification within the group SCR. The absence of diversification in the group risk margin is particularly punitive for reinsurers whose business model, and capacity provided to direct insurers, relies on this economic diversification of risks.

EIOPA has issued proposals in its consultation document that undermine the economic functioning of group capital management. This, coupled with initiatives by a few local supervisors to tighten domestic requirements, undermines the effective supervisory coordination between home and host supervisors and puts too much emphasis on solo supervision.

Question 12: Should the European legislation be amended to better take into account insurers' exposure to and interconnectedness with the broader financial sector and the real economy? Please indicate the statements with which you agree. at least 1 choice(s)

- No

Please specify the additional instruments that you would consider, and the type of systemic/financial stability risks that those instruments would aim to address:

The RAB emphasises that there is **no evidence that traditional reinsurance activity actually poses a systemic risk to the real economy or wider financial system**. 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, as recognised in the 2012 International Association of Insurance Supervisors (IAIS) "Reinsurance and Financial Stability" report (paragraph 91). Moreover, at the end of 2013, the Global Reinsurance Forum conducted a study of systemic risk in the reinsurance industry which categorically concluded that reinsurers cannot represent a systemic risk.

The COVID-19 pandemic has not provided evidence of potential systemic risk stemming from the reinsurance industry. On the contrary, EIOPA noted in its Financial Stability Report (July 2020) that "reinsurers' solvency ratios have been well above the regulatory requirements and should be able to withstand the negative impact of the outbreak".

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 and a proportionate implementation of the IAIS holistic framework. In particular, the RAB considers the following measures envisaged by EIOPA or the European Systemic Risk Board as inappropriate and ill-founded: supervisory intervention before SCR breach, counter-cyclical capital buffers, capital surcharge for systemic risk or concentration limits.

The EU and its member states should design a recovery and resolution framework in line with the Financial Stability Board and IAIS standards. In particular, those standards should be applied in a proportionate way to reinsurers and, at the very least, local entities should not be required to provide recovery plans where a parent group plan exists.

Section 2: Proportionality of the European framework and transparency towards the public

Question 17: How can the framework facilitate policyholders' and other stakeholders' access to the SFCRs?

	Agree	Disagree	Don't know/ no opinion
The current framework is sufficient, as it already requires insurers to publish their SFCR on their website if they own one	x		
The framework should clearly require that insurers' publication on their website is easily accessible for the public	x		
Insurers should be required to send (electronically or by mail) on a regular basis a summary of the SFCR to each policyholder		x	
Insurers should be required to send (electronically or by mail) the SFCR to each policyholder who explicitly requests for it		x	
Other options			

Please specify your answer to question 17 (if needed). In particular, if you identified other options, please elaborate:

If the SFCR is already easily accessible on the company website, **the RAB does not see additional value in sending the report directly to each policyholder**. This would also entail significant additional costs, with no added value, that would ultimately be borne by policyholders.

Question 19: Which information should be provided to policyholders on insurers' financial strength, business strategies and risk management activities? What should be the ideal format and length of the SFCR?

Where policyholders are individual and not corporate, the RAB would expect the policyholders' section to include information on the solvency position of the company (Solvency II own funds, solvency capital requirement and excess capital), risk diversification, the size of the company (for example, premium volume), reinsurance and — at a high level — investments. The RAB would expect the policyholders' section to be short, say around five pages, with simple sentences/graphs.

For reinsurers, the main target audience of the SFCRs are insurance companies, regulators, analysts and investors, not individual policyholders. Reinsurers should be allowed to provide targeted SFCRs for this audience.

Question 22: Some insurers use their own internal models to calculate their solvency requirements, after approval and ongoing supervision by public authorities, and not the prescribed standard approach defined by the legislation. For those insurers that use an internal model, should European legislation require them to also calculate their solvency position using standard methods for information purposes, and to disclose it to the public?

- No, insurers that use their own internal model should not be required to calculate their solvency position using standard methods.

Please explain the issues stemming from such a disclosure:

- **Summary**

The RAB believes that **the requirement to calculate both the internal model and standard formula is onerous and unnecessary**. Such a requirement would effectively undermine not only the internal models but also the suitable process underlying their effective management and supervision.

Internal models are designed and calibrated to reflect a company's specific risk profile and to meet the supervisory expectation to ensure policyholder protection. Any changes to internal models are subject to supervisory monitoring or approval.

The standard formula is designed for a hypothetical average insurer and internal models bring greater risk-sensitivity. Deviations have two well-founded sources: i) the adaptation to individual risk profile; ii) the ongoing revision of the appropriateness of the internal models against the latest usable science and dataset.

Standard formula disclosure could lead to suboptimal strategic and business decisions to the detriment of consumers and shareholders. Internal models are currently fully integrated in the decision-making of firms and their risk management, as per the use test prescribed in Article 120 of the Directive. However, the administrative, management or supervisory body (AMSB) will have no choice but to make decisions based on the standard formula if it is publicly disclosed.

As a result, the RAB considers the requirement to disclose standard formula users to be irrelevant for stakeholders and hence disproportionate. The proportionality principle, as explained in Recital 115 of the Solvency II Delegated Regulation, protects firms from irrelevant information requests, unless there is a specific and justified supervisory request in accordance with the proportionate application of standard formula reporting of Art. 112 of the Solvency II Directive.

The preservation of internal models in Solvency II is important to ensure the global competitiveness of EU insurers. Undermining internal models will require the AMSB to reconsider its strategic and business plans in a way that may limit the provision of insurance cover and investing long-term.

- **Further comments**

The RAB considers **that the requirement to calculate both internal model and standard formula figures is onerous and unnecessary**. Such a requirement would effectively undermine not only the internal models but also the suitable processes underlying their effective management and supervision.

A. The role and benefits of internal models in Solvency II

> **The standard formula is designed for a hypothetical average direct insurer**: It is fit for firms that can demonstrate that their individual risk profile meets the underlying assumptions of the standard formula and their risks are consistent, including over time, with the dataset used for the calibration of the standard formula parameters. As the standard formula was not designed for reinsurance, it does not reflect the risk profile of most reinsurers. By catering for risk profiles that depart significantly from the European average (such as reinsurance) internal models are the critical part of the Solvency II framework for global reinsurers.

> **Internal models bring greater risk-sensitivity** where the standard formula is unsuitable and, as a result, their use can be made mandatory upon the request of the supervisor. Article 119 of the Solvency II Directive

recognises that in principle every (re)insurer should use an internal model and it is only for proportionality purposes that the standard formula is a default approach.

> **Internal models have the flexibility to incorporate the latest usable science and dataset** to enrich their risk sensitivity, while standard formula revisions are based on a political process. The standard formula calibration is not fully transparent, based on limited datasets and strong assumptions and the result is a political compromise. In contrast, internal model documentation is fully transparent to the supervisor and all changes are notified to him/her. The calibration is based on science and the appropriateness to the individual firm's risk profile.

B. The safeguards against model drifts

> **Internal models are fully integrated in the decision-making of firms and their risk management**. Users demonstrate to the satisfaction of their supervisors that they trust their model when taking strategic and business decisions, as per the use test prescribed in Article 120 of the Directive.

> **Internal models are designed and calibrated in accordance with the expectations of the supervisor.** Internal models are approved by supervisors after a thorough examination process, during which they may be adjusted to meet supervisors' requests and conditions. Subsequent major model changes, the firms' policy to make those changes and any changes to that policy, are approved by supervisors and meet their conditions. As a result, an internal model embeds supervisory views in its design and calibration.

> **Internal models are fully transparent to the supervisor and the evolution of results can be tracked.** The full documentation of internal models is available to the supervisor and the history of model changes are reported. The reporting and the public disclosure include an analysis of changes of the SCR from one reference date to another and industry good practices are available to enhance industry standards.

Attempting to use the standard formula as a tool to measure or monitor internal model evolutions over time will not help to advance supervisory objectives. Rather it will give rise to a major supervisory/company reconciliation exercise of analysing the standard formula against internal model movements only to conclude that divergent movements under both metrics arise from the lack of risk sensitivity/inability of the standard formula to capture risk profile/exposure changes for a global reinsurer. Internal model companies already carry out detailed reporting and analysis of internal model movements for internal purposes and public disclosure, which provides significant more insight about internal model movements than attempting to measure to an arbitrary metric such as the standard formula for reinsurance.

C. Level playing field and international competitiveness

> **The level playing field within the internal market must be preserved.** An obligation for internal model users to report both standard formula and internal model figures would create additional costs and burden and distort the level playing field between internal model/standard formula companies for no added value.

> **As per the overarching EU goal of fostering international competitiveness, the framework should allow EU companies to be competitive with foreign firms** in domestic and foreign markets. The cost and burden to put in place the governance over the production of standard formula disclosure are disproportionate and would reduce competitiveness compared to foreign companies and would be incompatible with the EC ambition to strengthen Europe's leadership in the world.

D. Implications of standard formula reporting/disclosure

> **It is <u>normal</u> that internal models deviate from the standard formula**. Those deviations are by and large the purpose of making an internal model, are governed by the AMSB and approved by the supervisor. Deviations have two well-founded sources: i) the adaptation to individual risk profile; ii) the ongoing revision of the appropriateness of the internal models while standard formula's revisions are seldom.

> **Standard formula reporting in Solvency II should be based on exceptional and entity-specific supervisory requests.** Article 112 sets out that the supervisor shall state the reasons justifying those individual decisions. The balance in the current Article 112 between supervisory reach and trust in internal models should be preserved.

> **Standard formula reporting/disclosure will not improve the protection of policyholders**. The AMSB will have no other choice but to make decisions based on the standard formula if it is publicly disclosed to analysts and investors. This situation would lead to suboptimal decisions as the standard formula is unsuitable for internal model users. It would also conflict with Article 120 on the use test. For firms required to use an internal model by their supervisors under Article 119, it would hardly make sense from a policyholder protection perspective to ask them to disclose their solvency position under the standard formula. Article 119 is a reminder that the standard formula has not been conceived as a benchmark to measure how wrong internal models are, quite the contrary.

> **The preservation of internal models in Solvency II is a matter of global competitiveness**. Solvency II is arguably the most advanced prudential regime in the world. Internal models are a significant contribution to the risk sensitivity of the regime. They are also best at capturing and managing the risks of global groups. Sending a signal of distrust would be detrimental to the European stance in the insurance capital standard negotiations at IAIS level. It would also require the AMSB to reconsider their strategic and business plans in a way that may limit the provision of insurance coverage and the holding of long-term investments in Europe. This is particularly the case for the global reinsurance market, which operates on a cross-border basis.

Section 3: Improving trust and deepening the single market in insurance services

Question 23: When the Home authority does not take the necessary measures to prevent excessive risk taking or non-compliance with the European rules by an insurer for its cross-border activities, should the Host authority be provided with additional powers of intervention, in order to protect policyholders?

- No

Please specify the additional powers needed:

The RAB is very much in support of aiming for a consistent level of policyholder protection in Europe. Addressing material differences in supervisory practices is therefore very welcome. However, the supervisory mandate and responsibility of the home authority to protect policyholders within the common market should not be impaired or blurred. In particular, **the host supervisors should not act as secondary safety net**. This would increase or perpetuate undue differences in policyholder protection in Europe, would undermine the single market and could result in higher premium rates for policyholders. The RAB would suggest that **making a more efficient use of existing supervisory cooperation channels and tools would be a better route to explore for potential improvements to the current framework.**

Question 24: Should the supervision of cross-border activities by insurers be exercised by national authorities or by a European authority?

- By national authorities, with European coordination where needed.

Please elaborate on your answer to question 24:

The home supervisor should exercise supervision of activities, including cross-border activities. European authorities should support home supervisors as needed, if their supervisory activities are insufficient to ensure an appropriate target level of policyholder protection. Please also see the answer to Q23.

Question 25: Do you consider that insurers and public authorities are sufficiently prepared for a significant deterioration of the financial position or the failure of an insurer and that they have the necessary tools and powers to address such situations, in particular in a cross-border context?

- Yes

Please specify the instruments or harmonised powers that are needed at each stage of preparation (i.e. recovery planning, resolution planning, resolvability assessment) and at various stages of intervention (i.e. during early intervention, recovery or resolution):

The RAB believes that Solvency II provides for an appropriate set of measures for supervisors to intervene in cases of deteriorating financial conditions or the failure of insurance undertakings. Solvency II ensures that supervisors have an informed position to observe and investigate potential negative developments. The breach of the SCR sets a clear level for supervisory intervention well above the Minimum Capital Requirement (MCR). **The Solvency II Directive already embeds a forward-looking view on compliance with the SCR** and Article 138 provides for the situation "where there is a risk of non-compliance in the following three months". Additional "early-intervention" measures applied at an SCR >100, on top of existing rules, must be avoided as they undermine the credibility of the SCR. Crucially, **Solvency II must remain an economic and risk-based regime** so that it performs in a predictable manner, including in crisis periods.

In this regard, EIOPA statements to ban dividends and other distributions in H1 2020, while the average solvency ratio in the EU during the peak of the financial turmoil was 175% as reported by EIOPA, have added uncertainties without achieving convergence, as supervisors proved to have diverging views on this tool. Such discretionary early intervention powers are unsuitable in insurance supervision, notably because there are already multiple safeguards in Solvency II to prevent distributions when the risks justify it:

- Companies must already demonstrate a continued coverage of solvency requirements in the ORSA.
- They write and review risk management policies on capital and liquidity management, including risk tolerance limits.
- The framework already provides NSAs — and therefore group supervisors — with the power to ban dividend distribution where it would lead to a breach of the SCR.

This precedent may have long-lasting effects on the attractiveness of the European insurance sector for investors.

Besides, requirements for recovery and resolution planning and resolvability assessments must provide for the proportionate implementation of these measures by individual companies having regard to their specific circumstances. **Recovery plans should be at group level and local recovery plans should not be required where a parent group plan exists.**

Please also see response to Q12.

Question 26: Should it become compulsory for all Member States to set up an IGS, in order to ensure that a minimum level of policyholder protection is provided across the EU?

- No

Please explain your reasoning for your answer to question 26 (if needed):

The RAB believes that **no insurance guarantee schems (IGS) should be introduced for reinsurance**. IGS are meant to be triggered under retail commercial contracts to protect policyholders. Therefore, it would not be appropriate to have such schemes applied to reinsurance activities where there is only a business-to-business relationship. This approach would also be consistent with nearly all national member states' existing schemes.

Reinsurers have been and will remain supportive when IGS are set up.

Question 27: Which of the following life insurance products should be protected by IGS?

- Don't know/no opinion

Question 28: Which of the following non-life insurance products should be protected by IGS?

	Should be covered	Should not be covered	Don't know/ no opinion
Health			x
Workers' compensation			x
Insurance against Fire and other damage to property			x
General liability			x
Accident (such as damage to the driver)			x

Suretyship for home building projects			x
Other			x

Question 29: Should all mandatory insurance be covered by IGS?

- Don't know/no opinion

Question 30: If your insurer fails, what would you prefer?

- Don't know/no opinion

Question 31: The coverage level of IGS determines the level of protection provided to policyholders. Should the European legislation set a minimum coverage level at EU level?

- Don't know/no opinion

Question 35: In your view, should the framework provide for flexibility to alleviate certain regulatory requirements during exceptional adverse situations?

- No

Please specify which additional provisions/measures would provide for sufficient flexibility of the framework, and which regulatory requirements would need to be alleviated during exceptional adverse situations:

Solvency II must remain an economic and risk-based regime so that it performs in a predictable manner, including in crisis periods. Solvency II has performed as intended during the COVID-19 outbreak and its economic and financial fall-out, and the (re)insurance sector has not sought temporary alleviations of the prudential framework.

Sufficient flexibility is already embedded in the framework, since the SCR is used as a target and not a minimum floor, as per the Directive. This, combined with the extension of the recovery period after a breach of SCR in exceptional circumstances, provides an adequate buffer to handle crisis situations in an orderly manner.

Section 4: New emerging risks and opportunities

Question 36: Are there additional types of natural catastrophes that might become relevant to the broader insurance sector in the next years and therefore warrant an inclusion in the standard approach for the calculation of capital requirements (e.g. drought or wildfire)?

- No, additional types of natural catastrophes will continue to have lesser relevance for insurers and they can be addressed by internal models and qualitative requirements (Pillar 2).

Please elaborate your answer to question 36:

The answer to the first part of the question (Are there additional types of natural catastrophes that might become relevant to the broader insurance sector in the next years) would be yes, but data would be hard to calibrate. However, overall, the answer is no. **The fact that these perils are becoming more relevant** (in terms of adding to the natcat loss burdens of insurers) **does not mean that individually they become relevant for the balance sheet from a capital perspective.**

Instead of the choices above, an alternative answer to the question could be: "Yes, but inclusion should be weighed against the materiality of other peak perils in a given country". Calibration of capital requirements, while still crude, is possible and will improve as more data on these perils is captured.

Question 37: Beyond the general rules on the use of data, should Solvency II rules explicitly require insurers to assess whether the data used in the valuation of liabilities to policyholders captures sufficiently trends caused by climate change?

- No

While the RAB agrees that reinsurers should assess whether the data used in the valuation of liabilities captures any trends caused by climate change where appropriate, this should be true for any material risk. Article 19(3)(d) of the Delegated Acts requires (re)insurers to do just that, but in a principle-based manner.

It is deemed more appropriate to **keep this principle-based approach**, rather than introducing emphasis on some risks in the regulation.

Question 38: Beyond the general rules on the use of data, should Solvency II rules explicitly require insurers to assess whether the data used in an internal model captures sufficiently trends caused by climate change?

- No

While the RAB agrees that internal model users should assess whether the data used in the valuation of liabilities captures any trends caused by climate change where appropriate, this should be true for any material risk. Article 121 of the Directive requires internal model users to cover all the material risks to which they are exposed and, for this, to use accurate, complete and appropriate data.

It is deemed more appropriate to keep this principle-based approach rather than introducing emphasis on some risks in the regulation.

Question 39: Should Solvency II rules for insurers explicitly require climate scenario analyses as part of the qualitative rules ("Pillar 2")?

- No

Please explain your answer to Question 39:

The RAB supports the EU's ambition to move towards sustainability and the commitment to carbon-neutrality by 2050. Reinsurers are key contributors to sustainability and to the fight against climate change.

In the area of risk management, **sustainability-related risks should be considered according to their materiality to an insurance company**. Part of the value of ORSAs is that companies can tailor them to their material risks, so prescriptiveness should be avoided.

The member companies of the RAB have been modelling the impacts of natural catastrophes since the mid-1990s. This includes understanding the risks associated with climate change in order to inform strategic and business decisions with respect to, for example, pricing, capacities, retrocessions or ALM.

Open dialogues between supervisors and the industry are taking place in various fora (eg, the UK Climate Financial Risks Forum or the French Climate and Sustainability Committee, in which the UK PRA and FCA and France's ACPR and AMF have respectively gathered the industry). It is critical to maintain this constructive atmosphere to maintain a European edge in the understanding and management of climate risks. **Any attempt to make it a compliance exercise, disconnected from business reality because it is overly standardised, may compromise this objective.**

Question 40: In your view, does Solvency II contain rules that prevent the practice of impact underwriting by insurers?

- No

Question 41: Do you have proposals for changes others than those provided in your answers to Question 5 and Questions 36 to 40 that would make Solvency II a more conducive framework for sustainable activities by insurance and reinsurance companies?

Reinsurance activity is, by design, one of the main climate adaptation enablers. To bring reinsurance capacity or invest in sustainable projects at the right price and the right pace, **Solvency II should remain an economic and risk-based regime and all unnecessary hurdles should be reviewed.**

Question 42: Should the European legislation introduce enhanced requirements for insurers to monitor and manage information and communication technology (ICT) risks, including cyber-risks as part of their risk management practices ("Pillar 2")?

- No

Please specify your answer to Question 42:

ICT risks are already part of the integrated risk management system of all insurers regulated by Solvency II, as a component of operational risks (Art. 13 Solvency II Directive). ICT risks are therefore taken into account in capital requirements, governance and reporting.

The RAB believes that regulators need to be cognisant of the fact that **prudential regulation is not an appropriate vehicle through which to address ICT management in depth**. While prudential regulation is expected to be principle-based, Solvency II is already very detailed, notably on outsourcing. ICT risk management evolves at speed in the face of threats and is best addressed through specific international cross-industry cyber security frameworks (NIST CSF, ISO 27001) and standards (ISO 27002, CIS, NIST SP 800-53). Integrating further ICT requirements into Solvency II runs the risk of making it constantly outdated and inconsistent with best-in-class industry practices. Also, the added value of additional prudential soft law is questionable. For example, the recent EIOPA guidelines on ICT security and governance essentially mirror existing industry standards and will need to be continuously updated to stay relevant.

Prudential regulation should not become a catch-all regulation or it will lose its inherent coherence and become unmanageable for both the industry and supervisors.

Question 43: Should the European legislation consider that cyber-insurance is a distinct class of insurance, which would need to be subject to its own authorisation process by public authorities?

- No

Please specify your answer to question 43:
<u>Summary</u>

- The RAB **does not support cyber insurance being considered as a distinct class** of insurance or subject to separate authorisation for the following reasons:
  - **Ambiguity** of authorisation: It **would not be appropriate to extract the triggering element of the policy from the subject insured** in order to create a separate class of insurance. This is similar to the trigger of theft under motor or home insurance, for example.
  - **Stifling effect** on market innovation: Making cyber a distinct regulated class of business would **lead to a standardisation of cover** which would have the effect of:
    - **stifling innovation** in a still maturing cyber market;
    - deterring insurers' ability to adapt and **offer products tailored to the needs** of customers;
    - preventing the cyber insurance market from **reaching a desirable maturity point**; and,
    - **hampering the international competitiveness** of European insurers.
  - **Additional reporting burden**: The separation of cyber as a class of business would have implications for firms' reporting obligations and therefore their systems and processes.
  - International trade: Given the uniquely influential nature of Solvency II in international fora, care should be taken to avoid any **unexpected impact that a change to Solvency II could have on international trade or international standards**.
    - For example, when agreeing a liberalisation of trade in general liability policies with a third country, this would encompass a good deal of cyber insurance. If, however, cyber insurance was considered under the EU prudential system to be a separate class of insurance, this **might complicate negotiations and prejudice the chances of liberalisation applying to cyber insurance**. From the RAB perspective, the liberalisation of insurance trade in such classes is desirable because it globalises such trade, thereby avoiding national barriers.

- **<u>Further comments</u>**

The RAB sees no justification for cyber insurance to be considered as a distinct class of insurance or for it to be subject to separate authorisation for the following reasons:

Ambiguity of authorisation
Cyber insurance may be purchased as a stand-alone policy covering various elements, or as coverage under a wider policy such as general liability or property. Where coverage is provided under a wider policy, the "cyber" element of "cyber insurance" often denotes the triggering event, rather than the subject matter insured. This is similar to the trigger of theft, which may be under motor policies, home policies or marine policies, or the trigger of war, which may be under marine or aviation polices. As with theft or war, it would not be suitable to extract the triggering element of the policy from the subject insured in order to create a separate class of insurance. Creating a distinct class of cyber insurance could create an artificial distinction between situations in which cyber

denotes the subject matter insured (eg, ransomware) and in which it is trigger under a wider policy (eg, property or liability). This distinction could lead to unnecessary and undesirable ambiguity around an insurer's authorisation status.

Maturing market
The effect of introducing ambiguity to insurers' authorisation status, the market dislocation that might be occasioned by this, and the standardisation of cover that would likely result would all have undesirable effects on the maturing cyber market. While the market is still maturing, it is important that many insurers are able to offer a wide variety of products, thereby giving rise to innovation and to the tailoring of products to individual customers' needs. Subverting this process may prevent the cyber insurance market from reaching a desirable endpoint and could hamper the international competitiveness of European insurers. As reinsurers of this developing market, and of European insurers generally, the RAB opposes action that would needlessly constrict innovation or reduce the competitiveness of European insurers.

Reporting
Depending on how it were achieved, the separation of cyber as a class of business could have implications for firms' reporting obligations and thus their systems and processes. This impact would likely be felt in terms of policy administration systems, actuarial systems and processes and other systems and tools used to extract and report data. Such changes inevitably add a financial burden to firms in the (re)insurance ecosystem, which the RAB believes should only be imposed where the change is objectively necessary and proportionate.

International trade
Given the uniquely influential nature of Solvency II in international fora, care should be taken to avoid any unexpected impact that a change to Solvency II could have on international trade or international standards. In terms of international trade specifically, the RAB considers that cyber insurance would be most advantageously considered to be a part of other classes of insurance, rather than a separate class for which liberalisation might need to be sought through bilateral or multilateral trade liberalisation agreements. Where, for example, liberalisation of trade in general liability policies might be agreed between the EU and a third country or third-country trading bloc, this would encompass a good deal of cyber insurance. If, however, cyber insurance was considered under the EU prudential system to be a separate class of insurance, this might complicate negotiations and prejudice the chances of liberalisation applying to cyber insurance. From the RAB perspective, the liberalisation of insurance trade in such classes is desirable because it globalises that trade, thereby avoiding national barriers and making it more accessible to RAB members as reinsurers.

Question 44: Should the legislation differentiate intragroup and extra-group outsourcing, and introduce "lighter" requirement in the former case?

- Yes, and those lighter requirements should not be conditioned by any additional criteria.

Please specify which requirements should be alleviated in the case of intra- group outsourcing, and the criteria to be satisfied at the level of the group to benefit from the "lighter" requirements:

Solvency II outsourcing requirements apply to each outsourcing agreement, whether the receiving company is controlled by the group of the insurer or is a fully external service provider. **The RAB believes that the same treatment of intra-group and external outsourcing is not justified**. The service provider, as part of a group, is part of the regulated organisation that is responsible for the implementation and execution of the internal control and management functions across the group.

As a result, the potential risks associated with the outsourcing of a function or a service differ significantly between intra-group outsourcing and the outsourcing to external partners. Solvency II provides for strict requirements for the internal control, risk management and reporting for the regulated group. The group-wide systems are applied consistently across the group — including internal service providers and the outsourcing company. The group-wide application of a group-wide management system includes aspects that are in the scope of existing outsourcing requirements, eg IT security, data protection, etc. Automatically, this leads to consistent data protection or contingency planning. In principle, the strategy of the outsourcing company and the service provider are subject to the same coordinated strategy across the group. As a result, unilateral arbitrary behaviour and the associated risk of such behaviour are eliminated.

Consistent group supervision under direct Solvency II supervision, or Solvency II equivalence, ensures regulatory compliance with the standards of Solvency II. This lowers the risk associated with an outsourced activity even further, as not only the outsourcing entity's compliance with the outsourcing requirements but also that of the service provider is included in the Solvency II group supervision or equivalent regimes.

Please specify which requirements should be alleviated in the case of intra- group outsourcing:

Requirements that should be removed when differentiating intra-group outsourcing include:

- The cost/risk/benefit assessment currently required prior to any outsourcing
- The notification to supervisors
- Requirements relating to contractual clauses

Section 5: Additional inputs

If you want to provide further inputs, or to share evidence in relation to the above questions, you are invited to upload a document.

Recognition of risk-transfer mechanisms

The RAB would like to draw the Commission's attention to the topic of **risk mitigation**; an important topic not otherwise covered in the consultation. **The RAB would like to encourage the Commission to examine the issue of recognition of risk-transfer mechanisms,** where it believes that improvements to the framework are justified on technical grounds. In particular, the issue of recognition of non-life, non-proportional reinsurance in the premium and reserve risk sub-module in the standard formula is important as **the current framework does not assess the risks in an economic risk-based manner**. An improvement to and correction of the framework would better recognise effective risk transfer and lead to better incentives to good risk management without leading to excess complexity.

Non-proportional reinsurance

Non-proportional (NP) reinsurance is the predominant risk-mitigation instrument for the non-life sector and a crucial tool for smaller and medium-sized companies when managing peak risk.

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. The RAB considers this to be a technical inconsistency in 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** and help them manage their volatility by transferring risks to reinsurers.

The RAB would like to stress that **it is important that the proposal ultimately introduced by the Commission allows for both premium and reserve risk recognition.** Under Solvency II currently there is 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, The RAB also believes that it is important that any proposal recognises adverse development covers, as these are one of the few risk-mitigation techniques available to companies to manage reserve risks.

The approach must also be sufficiently risk-sensitive to allow for per risk and per event covers.

Basis risk

On the use of **basis risk** and other issues with the recognition of reinsurance, a **clarification of and improvement on the current rules would be welcome**, as the approach in force takes an "all or nothing" view of material basis risk, which creates significant uncertainty for both insurers and reinsurers and is inconsistent with a risk-based approach. Despite a Solvency II definition of basis risk and EIOPA guidelines, the RAB is aware of situations in which application is unclear and divergent regulatory practice exists. The RAB is aware of concerns by regulators that some covers are designed primarily with capital optimisation in mind and will invoke basis risk as a reason not to recognise the cover. The RAB believes that **the recognition of risk-mitigation techniques should be based on the extent to which risk** — as defined under Solvency II — **is effectively transferred**. It considers the current rules under Solvency II for basis risk in the standard formula 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 for standard formula users.

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 in the standard formula.
- **Effective risk management**: The exclusion of high 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 uncertainty over the potential outcome of the 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.

In the call for advice for the 2020 review of Solvency II, the Commission asks EIOPA to examine the topic of basis risk as part of risk-mitigation techniques. In its draft advice, **EIOPA proposes to include the guidelines on basis risk as part of the Delegated Regulation. The RAB does not believe that this is appropriate, as it does not solve the underlying issues.**

Instead, **the Commission should consider giving insurers the option of estimating the basis risk** that may be found in a risk-transfer arrangement and deduct it from any capital requirement that may be due in that risk-transfer arrangement. This prevents an "all or nothing" situation in cases where some basis risk may be inevitable, but a judgement on its materiality is difficult.

EU market access for non-equivalent, third-country (re)insurance undertakings that exclusively conduct reinsurance activities

While Article 172 of Directive 2009/138/EG deals with the equivalence concept for third-country reinsurers, Articles 162–171 do not address the market access of non-equivalent, third-country (re)insurance undertakings that exclusively conduct reinsurance activities.

This leads to a **fragmented and inconsistent regulatory landscape**, as some member states impose a local presence requirement on such undertakings while others do not. As a result, insurance and reinsurance undertakings headquartered in the member states that impose such local presence requirement are confronted with an unlevel playing field if they consider ceding (re)insurance risks to undertakings located in a non-equivalent jurisdiction outside the EU on a cross-border basis. Therefore, the EU market access of third-country (re)insurers that only operate reinsurance business should be harmonised in accordance with international standards. Insurance Core Principle 13.4 of the 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 requires member states to grant market access if the third-country (re)insurer is authorised to conduct reinsurance business in its jurisdiction and national competent authorities deem adequate the supervision performed by and the cooperation with their third-country counterparts. Such an approach would also be in line with the equivalence concept for third-country reinsurers pursued by Article 172 of Directive 2009/138/EG as it applies to the treatment of reinsurance contracts for solvency purposes only.

Insurance Europe's Reinsurance Advisory Board (RAB) is a specialist representative body for the European reinsurance industry. It is represented at chief executive officer (CEO) level by the seven largest European reinsurance firms: Gen Re, Hannover Re, Lloyd's, Munich Re, PartnerRe, SCOR and Swiss Re, with Insurance Europe providing the secretariat. Through its member bodies, the RAB represents around 60% of total worldwide reinsurance premium income. The RAB promotes a stable, innovative and competitive market environment. It further promotes a regulatory and trading framework that facilitates global risk transfer through reinsurance and other insurance-linked capital solutions.