Position Paper

Response to EIOPA consultation on supervisory statement on use of risk mitigation techniques by insurance and reinsurance undertakings

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General Comment

Insurance Europe welcomes the opportunity to comment on the draft supervisory statement on the use of reinsurance risk mitigation techniques (RMT).

Solvency II should facilitate reinsurance in performing its role of reducing insurers' underwriting risk. It should also achieve the correct balance between recognising the benefits of reinsurance and providing enough safeguards. As noted by the European Insurance and Occupational Pensions Authority (EIOPA), reinsurance is a proven concept which can mitigate risks an insurer either cannot bear on its own or does not have the appetite to do so. It can also assist insurers with the development of their corporate strategy and can be a valuable source of information.

Risk pooling is an essential element of insurance because it creates a beneficial diversification effect without which most insurance contracts would probably not be possible. Reinsurance is risk pooling on a larger scale, beyond the scope of the insurer. Making RMT harder to comply with might deter insurers from reinsuring and thereby increase riskiness and price of insurance substantially. That would not be in the interest of the policyholder.

Several EIOPA statements in the draft advice on the 2020 review of Solvency II, Q&As, as well as the current document appear to seek to make recognition of RMT more difficult for standard formula users because mechanisms for including basis risk and non-proportional reinsurance in the standard formula are either missing or inadequate. Supervisory convergence by restricting the recognition of reinsurance would unjustly increase regulatory burden and result in a general, unjustified increase in capital requirements.

With regard to the draft advice, Insurance Europe highlights the following considerations:

- EIOPA has not provided sufficient evidence of material concerns relating to the use of RMTs to justify the creation of additional regulatory burden related to their use.
- The statement would more likely disincentivise the overall use of reinsurance RMT and create additional barriers to its use rather than its stated intention of improving supervisory convergence.
- Supervisory convergence via the adoption of gold-plated solutions would unjustly increase regulatory burden.

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- Reinsurance which achieves risk transfer should be recognised in Solvency II based on current requirements. No additional EIOPA regulation which serves to restrict the recognition of certain reinsurance contracts (based on an assessment of risk transfer vs SCR relief) is needed.
- The adequacy of the standard formula is assessed at undertaking level and reinsurance should not be an exception to this. To the extent that the standard formula does not capture the specifics of certain reinsurance contracts fully or appropriately, EIOPA should not try to "balance" potential flaws of the standard formula by placing restrictions on the type of RMT that can be used to ensure an effective and efficient management of risks. There are already sufficient protections within the framework to ensure that capital levels remain appropriate to the risk profile of the undertaking.
- Where there are supervisory concerns about the consistent over/underestimation of the impact of a specific RMT across all undertakings, it suggests that the standard formula is miscalibrated. This is the case for the mass lapse submodule, as highlighted previously by Insurance Europe.
- The existing requirements for the recognition of RMT under the standard formula, notably Articles 208-214 of the Delegated Regulation, are already sufficient to address the issues raised by EIOPA.
  - Each undertaking already needs to assess the appropriateness of the standard formula assumptions relative to its risk profile. USPs, (partial) internal models and capital add-ons are regulatory safeguards which can ensure appropriate reflection of different risk profiles. Where the standard formula is deemed to apply to an undertakings' risk profile, that assessment should not change after reinsurance.
- The overall tone of the statement pays insufficient attention to the risk mitigation aspects of reinsurance. Risk mitigating techniques help protect the interest of the policyholder by effectively sharing risks among the (re)insurance industry.

In light of the considerations above, Insurance Europe questions the need for a supervisory statement on the use of reinsurance RMTs, even for the purposes of supervisory convergence.

If EIOPA does continue to pursue the development of the supervisory statement, Insurance Europe would support its enhancement by:

- Recognition of the beneficial and necessary role of reinsurance and RMT in the insurance market;
- Increased transparency on the scale of the issue being addressed;
- Clearer statements which are less open to misinterpretation; and
- The removal of the RMT "blacklist"" detailed in the annex.

Q1. *This Supervisory Statement is the result of the analyses on the use of reinsurance structures by insurance and reinsurance undertakings that optimise the use of capital under the Solvency II framework, when the Solvency Capital Requirement (SCR) is calculated with the standard formula.*

Insurance Europe considers the draft supervisory statement on the use of reinsurance structures to be unbalanced. It is concerned that the statement could be misinterpreted by national supervisory authorities (NSAs) and the wider market and could create unnecessary and detrimental impacts on the functioning of the European insurance market.

As a first step, EIOPA should clarify the materiality of the issues it aims to address with this statement. It is not clear if EIOPA's analyses are based on hypothetical assessments or real-world cases. In the absence of a concrete issue, the existing rules – requiring detailed residual risk analysis in ORSA processes and evidencing the adequacy of the standard formula – provide sufficient guidance in this area.

Risk mitigation techniques (RMT) and reinsurance arrangements form an essential part of an effective and efficient risk transfer and risk mitigation between economies, societies and the (re)insurance industry. The availability of sound reinsurance arrangements is key for the availability and affordability of cover. The use of reinsurance for sophisticated capital management should not be discouraged.

Solvency II is an economic framework that rightly incentivises companies to manage their risk and capital and to get economic recognition for this. Reinsurance is one (of several) of the essential tools for this purpose. Reinsurance arrangements which achieve risk transfer are already recognised in Solvency II.

The supervisory statement, if considered necessary given the materiality considerations discussed above, should explicitly recognise the significant and material benefits of reinsurance and the fundamental role it plays in coherent and prudent risk management and that Solvency II correctly incentivises the use of reinsurance and RMT.

Q2. *This Supervisory Statement should be read in conjunction with Directive 2009/138/EC (Solvency II Directive), Commission Delegated Regulation (EU) 2015/35 (Delegated Regulation), EIOPA Guidelines on system of governance and EIOPA Guidelines on basis risk.*

Insurance Europe considers there to be issues with the definition and measurement of material basis risk in the context of risk mitigation measures. The current regulatory framework encourages an 'all or nothing' treatment of basis risk whereby the lack of clarity on the definition of material basis risk could be misused to justify non-recognition of any non-proportional reinsurance cover in addition to some proportional covers. EIOPA's draft advice to the European Commission does not resolve this issue.

Q3. *The aim of this statement is to promote supervisory convergence on the assessment of the use of risk-mitigation techniques as it is recognised that potential divergent practices or potential supervisory arbitrage in this area could contribute to an unlevel playing field.*

Insurance Europe supports EIOPA's objective to promote and improve supervisory convergence across the EU. The consistent application of Solvency II is a key prerequisite for the integration of the EU single market for insurance and will further promote consistent consumer protection and foster fair competition in the EU. However, based on the evidence provided, it is not clear that there is an issue of inconsistency between supervisory approaches in this area.

It is also regrettable that the draft statement takes a one-sided view of the situation, focusing on examples where supervisory practice appears to favour undertakings, while supervisory practices that insert unjustified constraints are not addressed.

- For example, additional national gold plating requirements regarding avoiding reinsurance concentration risk seem unjustified and onerous because they are not within insurers' power to assess or change. Reinsurance contracts should be qualified on their own merits without dependence of market concentration developments.

- In addition, requirements on risk margin losses caused by a default of the reinsurance company are to be considered in determining default losses, while SCR calculation explicitly excludes those RM changes.

Insurance Europe considers that such differences in fundamental views are a more serious issue than the ones EIOPA has chosen to raise.

***Q4**. This Supervisory Statement raises awareness and ensures that while the insurance sector continues to use risk-mitigation techniques adequate to their risk profile, prudency and effective risk transfer is duly considered when recognising risk mitigation techniques in the SCR calculation.*

Insurance Europe supports this statement. However, where the risk profile of an undertaking does not deviate significantly from the assumptions underlying the standard formula, the undertaking should be able to use it to calculate its SCR. The use or absence of reinsurance should not affect this fundamental assessment.

In cases where the standard formula is not appropriate given the undertaking's risk profile, this may also cause issues with reinsurance structures. For these exceptional cases, the option of a (partial) internal model exists.

***Q5**.For insurance and reinsurance undertakings it is important to have an appropriate reinsurance policy in place, first of all as a proven concept of mitigating risks that the undertaking is not able to bear on its own, but also as an instrument to expand the current business and alongside to gain knowledge, via the reinsurance undertaking, of the latest developments in emerging markets and risks.*

It is not only a question of whether an undertaking is able to bear risks which drives its reinsurance policy but whether it wants to from a company strategy perspective, and whether it is economic to do so given the prevailing market prices for transferring that risk.

Solvency II correctly gives companies incentives to manage their capital and their risk, and so it is natural and desirable that companies optimise in accordance with such incentives and their business plan.

***Q6.** It is understandable that market participants seek to optimise their capital position within Solvency II, and reinsurance is a tool that can be used for that purpose. Inevitably, newly designed reinsurance structures are complex and challenging to assess, but if there is a real reduction in risk, it is reasonable that there should also be corresponding capital relief. When this is not the case those reinsurance structures may be seen as designed to arbitrage the regulation in place and the result might be an unbalance between risk reduction and capital reduction.*

Insurance Europe agrees that where real reduction in risk takes place, there should be corresponding capital relief. However, this does not infer that certain reinsurance structures should not be recognised within Solvency II and EIOPA should take care not to discourage the use of RMT.

Insurance Europe does not agree that where there is no "real reduction in risk", reinsurance structures are designed to "arbitrage the regulation".

- The draft statement leaves "real reduction of risk" open to interpretation. However, existing Solvency II regulation (eg. Recitals 70 and 71 of the Regulation) already provides (i) a requirement for risk transfer and (ii) guidance that the risk transferred can be remote.
- It further fails to recognise that reinsurance is a risk and capital management tool. For example, life reinsurance contracts may be designed such that the ceding company pays reduced or nil reinsurance premiums in the initial years of the underlying contract to support its new business capital costs.
- There are other good reasons for some of the structures' complexity that are a direct and intended consequence of Solvecy II: eg 12-month roll-over provisions designed to ensure ongoing cover according to standard formula rules – this is not arbitrage but simple economics.

The existing miscalibration of some Solvency II risk submodules (eg mass lapse) lead to an exaggeration of the capital requirements which (re)insurance companies face when managing these risks for many lines of business.

Insurance Europe also does not consider it inevitable that all newly designed reinsurance structures are complex and challenging to assess: eg covers for mass are very straightforward and similar to traditional structures, such as stop loss covers.

***Q7**. The use of risk mitigation techniques can have a significant impact on the SCR. For non-life insurance it impacts the 'premium and reserve risk' and the 'catastrophe risk'. For life insurance, due to newly developed structures, reinsurance contracts or other contracts that are structured as reinsurance contracts can also impact other risk modules, for example 'lapse risk', 'longevity risk' or even 'expense risk'. The overall impact can significantly reduce the SCR of an insurance and reinsurance undertaking and therefore supervisory authorities are recommended to give appropriate attention to this subject.*

Insurance Europe recognises the importance of RMT such as reinsurance which should have proportionate attention from the insurance regulator. However, no (newly) developed reinsurance structure should be excluded beforehand and neither should new reinsurance structures be discouraged to prevent innovation in the insurance market.

***Q8**. Independently from the eligibilty criteria for recognising risk mitigation techniques for solvency purposes, insurance and reinsurance undertakings are expected to ensure that risk mitigation is commensurate with the relief in the SCR calculation when introducing new techniques.*

Insurance Europe considers that the assessment of risk transfer should be done individually (by the undertaking), as a particular structure may ensure appropriate risk mitigation in some cases, but not in others.

However, it is unclear what EIOPA intends to achieve with this statement beyond what is already required of undertakings as per Articles 208-214 of the Delegated Regulation.

There are supervisory safeguards in place, including USPs, (partial) internal models and capital add-ons, which ensure that any significant deviation of the risk profile of standard formula users from the assumptions underlying the standard formula is already addressed within the framework. In addition, standard formula users have to assess the deviation of their risk profile from the assumptions underlying the standard formula in their ORSA (Art 45 of Directive).

If the risk profile, at the level of the undertaking, has been assessed to have an acceptable level of deviation, then the requirements of Articles 208-214 should ensure that the relief in the SCR calculation from the risk mitigation technique should already be commensurate.

***Q9**. Undertakings are required, as part of the general governance requirements, to manage risk prudently. Although the use of risk mitigation techniques in general is a good tool to mitigate the (insurance) risk, it should be recognised that the transfer of risk might introduce other risks, i.e. a possible increase in counterparty default risk, basis risk and depending on the structure, concentration risk.*

Insurance Europe agrees that risks arising from the use of risk mitigation techniques should be assessed by the insurer. However, it notes that this is already a requirement in Solvency II. Any discussion of these risks should be considered in the context of these other Solvency II provisions, rather than in the context of a statement on reinsurance.

Basis risk should not be seen as an 'other risk', but as a risk inherent to the application of a structure to a particular transaction and, where relevant, should be quantified and accounted for in that transaction.

***Q10**. Recognition of risk mitigation techniques for the calculation of the SCR using the standard formula is regulated in Articles 208-214 of the Delegated Regulation. In the practical application of these provisions it is expected that to recognise a risk mitigation techniques in the SCR calculation, there should be a proper balance*

between the effective risk transfer and the SCR relief. To this end, the SCR calculation needs to reflect the substance of the arrangements that implement the risk mitigation techniques

EIOPA is requested to clarify the purpose and expected practical application of this paragraph.

***Q11**. Supervisory authorities are recommended to also apply this Supervisory Statement to insurance and reinsurance undertakings which make use of an internal model to calculate the SCR with the necessary special considerations of each internal models.*

EIOPA's concerns about the treatment of RMT within internal models have not been provided. The intention of this statement is therefore unclear.

Insurance Europe notes that most examples provided refer to SCR calculation under the standard formula and that there are already several requirements in Solvency II (IM approval, use test, model validation etc) that prevent entities from improper modelling within their internal model. In any case, supervisory concerns about the treatment of RMT within an internal model should be part of the ongoing supervisory discussion.

BALANCED APPROACH

***Q12**. It is important to consider the purpose of the intended risk transfer transaction. In principle, risk mitigation techniques reduce undertakings' risks and consequently it is expected to lead to a reduction of the SCR. However, some transactions may, due to its specific design, lead to an optimisation of the undertakings' solvency position (i.e. by increasing the eligible own funds and/or by decreasing the SCR) without a corresponding transfer of risk. In such a case the transfer of risk has become of secondary importance within the transaction. Therefore, EIOPA underlines the importance of a proper balance between the risk reduction and the capital relief.*

Insurance Europe agrees that capital relief should be proportionate to the actual transfer of risk which, as noted previously, is already a requirement of Solvency II. Where this is not the case, it is agreed that these cases should be subject to appropriate assessment by the NSA.

In most cases highlighted by EIOPA, the "imbalance" arises due to the standard formula's failure to adequately take non-proportional reinsurance or non-proportional elements of proportional reinsurance structures (such as commissions) into account, particularly for non-life structures.

The regulatory framework should not create unnecessary barriers to reinsurance performing its role as a tool for companies to manage risk and capital. Solvency II should therefore achieve the correct balance between recognising the benefits of reinsurance and providing appropriate safeguards. Overly prescriptive regulation will undermine the benefits of reinsurance.

Insurance and reinsurance undertakings, when calculating the Basic SCR, should take into account risk- mitigation techniques as referred to in Article 101(5) of the Solvency II Directive and complying with Articles 208-214 of the Delegated Regulation where:
the reduction in the SCR or the increase in the eligible own funds is commensurate with the extent of the risk transfered, and there is an appropriate treatment within the SCR of any new risks that are acquired in the process.
The actuarial function of the undertaking should assess, express an opinion and document the mentioned balance as part of the task to express an opinion on the adequacy of reinsurance arrangement [1]. This should be reported to the administrative, management or supervisory board in the annual actuarial function report as referred to in Article 272(8) of the Delegated Regulation

The role of the actuarial function as described above is of particular importance in case an insurance or reinsurance undertaking has implemented a new risk mitigation techniques contract with a material impact on the SCR.
[1] Article 48(1)(h) of the Solvency II Directive and Article 272(7) of the Delegated Regulation

Insurance Europe agrees that this should be the task of the actuarial function. However, EIOPA should make a reference that such an analysis should be proportionate to the materiality and complexity of the transaction, which is broader than the current wording.

The concept of additional reinsurance regulation is not in line with the concept of Solvency II: ie measuring the individual risk profile of an insurance company rather than controlling the effect of reinsurance. The proposed one-sided approach "carves out" RMT and could overestimate risk transfer from the overall assessment by failing to recognise RMT due to a requirement to applying a level of standard formula validation at individual RMT contract level.

Insurance Europe suggests the following edits to this paragraph.
"*The actuarial function … on the adequacy of reinsurance arrangement [1].* ***When a new RMT contract has a material impact on the SCR****, this should be reported to the administrative, management or supervisory board …..."*

Also see comments to question 8.

RISK MANAGEMENT SYSTEM

Q13*. The SCR standard formula is intended to reflect the risk profile of insurance and reinsurance undertakings. However, the standard formula is a simplification of the complex reality (like every model). In line with this principle, the underlying scenarios of the standard formula (e.g. the mass lapse risk or interest rate risk scenarios) are assumptions of the many forms that the risk can take. Focussing only on these scenario's might result in an underestimation of the actual risk (for instance if the risk develops over time). The appropriateness of the standard formula should also be valid with the reinsurance arrangements in place and should be assessed in the own risk and solvency assessment (ORSA).*

This seems to be in contradiction with recital 71 of the Delegated Regulation which specifically allows risk transfer to be remote:

> *(71) The assessment of whether there has been an effective transfer of risk should consider all aspects of the risk-mitigation technique and the arrangements between the insurance and reinsurance undertaking and their counterparties. In the case of risk mitigation provided by reinsurance, the fact that the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote should not, of itself, mean that the reinsurer has not assumed risk*

Where the standard formula is deemed to apply to an undertaking, the scenarios define the risk for capital management purposes, and companies should not be disadvantaged if the regulator believes that the scenario over/underestimates the risk.

- Consistent over/underestimation of risks on the part of the standard formula for a specific undertaking would suggest the standard formula is not appropriate for that undertaking.
- Consistent over/underestimation across all undertakings would suggest the standard formula is miscalibrated. This is noted to be the case for the mass lapse submodule, as highlighted previously by Insurance Europe.

Insurance and reinsurance undertakings should analyse and assess the risk transfered by the risk mitigation techniques from a holistic perspective. This includes an analysis of the risk profile (not only focussing on the standard formula) of the undertaking, before and after the consideration of the risk mitigation techniques, with special attention to risks like underwriting risk, counterparty default risk, basis risk and concentration risk. This analysis

should be integrated in the undertaking's overall solvency needs in the ORSA[1]. Undertakings should be prepared to evidence the adequacy of the standard formula to its risk profile after the risk transfer when challenged by supervisory authorities.
[1] IAIS ICP13.2.2 states: "The ceding insurer should ensure that the characteristics of its reinsurance programme, including the credit risk posed by the reinsurer, are reflected in its capital adequacy assessment as well as its ORSA"

Any assessment should be based on the individual features of the reinsurance structure. If limitations of the standard formula lead to under – or overestimation, such deviations should be disclosed in the ORSA. However, the text appears to apply this test at the level of individual reinsurance arrangements. It should be specified that this is only necessary if an individual reinsurance arrangement is significant for the overall assessment of the risk profile deviation of the undertaking. Thus, any assessment should be based on materiality considerations.

Further, undertakings should not have to show the adequacy of the standard formula after the risk transfer if the adequacy of the standard formula was taken as a given before risk transfer. Otherwise this would create a higher supervisory burden to users of risk-mitigation instruments than to non-users, which is not proportionate and runs counter to the economic nature of Solvency II.

***Q14**. Another aspect worth paying attention to is whether the complexity of the reinsurance contract might be hiding the absence of real risk transfer. For example, a simple quota share with a complex commission mechanism can actually conceal the ecomic reality of a loan. Another example is where a single contract combines two functions: the risk mitigation of a deviation of the best estimate and a loan. These two functions can also be found separately in contracts in the market: a reinsurance of the risk of an adverse development and a loan. When the treatment of the two separate contracts on the balance sheet and on the capital requirements is different from the single combined contract, this indicates that a thorough risk analysis is needed.*

While recognising that it is theoretically possible to structure contracts such that there is no risk transfer, Insurance Europe objects to the notion that there is typically something to 'hide': (re)insurers are transparent to regulators.

Solvency II provides for all means for NSAs to investigate the RMT which cedants engage in. The draft statement does not appropriately reflect the use of RMT in the EEA insurance market and the suggested measures to require the cedant to proactively explain all RMT to the supervisor would be excessive for insurers and supervisors.

It is, of course, entirely appropriate that NCA can investigate and that companies are required to provide NSAs with their RMT arrangements in an open and transparent measures. Implementation of good risk management practice should ensure that companies are prepared and able to present the impact of its RMT arrangements.

Insurance and reinsurance undertakings should fully clarify the technical details of the risk mitigation techniques and the related contracts and to reveal to the supervisory authority any links or combinations with other existing or newly implemented contracts, appendixes or side letters that would allow the understanding of the full impact of the contract and the real risk transfer.
Insurance and reinsurance undertakings should explain to the supervisory authority the relation with the reinsurance policy and the risk management policy including the policy regarding counterparty default risk to ensure that all risks are taken into account.

Insurance Europe suggests the following edits to this paragraph as a more appropriate phrasing.

*"Insurance and reinsurance undertakings should **provide, when requested,** the technical details of the risk mitigation techniques and the related contracts and **information on** any links or combinations with other existing or newly implemented contracts, appendixes or side letters to the supervisory authority that……."*

SUPERVISORY INVOLVEMENT

***Q15**. Although both traditional reinsurance and non-traditional risk transfer (like cat-bonds, longevity or mass-lapse transfer) need to comply with Articles 208-214 of the Delegated Regulation, it is expected that the non-traditional risk transfer transactions will need more attention than 'plain vanilla' reinsurance contracts.*

EIOPA should consider whether it provides disincentives to the use of specific forms of reinsurance that effectively mitigate risk by (i) compiling negative lists (ii) creating an administrative burden via an extensive assessment of the limitations of the standard formula.

Insurance Europe does not agree with the general statement that non-traditional reinsurance structures need a higher level of regulatory scrutiny. The focus should be rather on complexity and materiality.

It is noted that non-life CAT reinsurance also significantly reduces the SCR, but this type of reinsurance appears to be generally accepted. It is unclear why risk mitigating techniques specifically in the area of life (re)insurance are treated with (upfront) suspicion of being capital arbitrage or questioned whether actual risk is transfers

***Q16**. In case more 'sophisticated/complex' risk mitigation techniques are implemented, supervisory authorities are recommended to engage in an on-going supervisory dialogue with the undertaking. In this dialogue, supervisory authorities should be informed in a timely and comprehensive manner about the plans, be satisfied on the approach taken and be kept informed in case of any material changes.*

A common definition of "sophisticated/complex" needs to be provided for this statement to have the intended effect of supervisory convergence.

EIOPA should also amend this statement to reflect the need for proportionate supervisory involvement. Otherwise this will result in counter-productive delays, costs and burdens in the implementation of appropriate RMT strategies.

Where the RMT structure is relevant across multiple jurisdictions, supervisors need to co-ordinate and co-operate in coming to a view on the structure to avoid different approaches across jurisdictions. All of this can be achieved within the current framework.

ANNEX: EXAMPLES

***Q17**. In this annex examples some recently developed reinsurance structures, where there is a need for a reinforced supervisory dialogue, are presented. This is not a closed list and is only meant for illustration of cases where special attention regarding the balance between risk transfer and capital relief is expected.*

Insurance Europe is concerned that the use of the arrangements which EIOPA identifies as examples for the purpose of the draft statement might be prohibited or considered invalid. Such a preclusion should be avoided as these arrangements can provide for an effective risk transfer and, therefore, support the aims which EIOPA identified in paragraph 5 of this paper.

While Insurance Europe agrees that RMT should include a genuine transfer of risk, it is necessary to underline that EIOPA should not preclude companies from engaging in the identified arrangements per se. The identified structures are not 'invalid' as such, they may just not provide capital relief.

It is also not clear whether use of these structures has resulted in supervisory divergence or inappropriate capital treatment, or whether EIOPA is addressing them just because they could theoretically lead to problems. If EIOPA is to proceed with the statement, Insurance Europe proposes that the annex of examples is excluded.

***Q18**. As mentioned in the statement above, every structure should be assessed individually on a 'case by case' basis.*

Not only should each structure be assessed individually, but each individual transaction as well. A structure can behave quite differently under different conditions/lines of business.

Example 1 - "Proportional Quota Share"

***Q19**. According to the Solvency II framework, the SCR for non-life premium risk is determined on the basis of the so-called volume measure. This volume measure for non-life premium risk is defined as (earned) premiums minus the reinsurance premiums[1]. Apart from premiums going to the reinsurance undertaking, there are also commissions flowing back to the cedent. The question is how to consider not only the premiums for reinsurance contracts but also these commissions[2] paid by the reinsurance undertaking. This question becomes especially relevant when the commissions are so material that they change the risk mitigation character. We mention here two cases where that happens.*
[1] Article 116(5)(a) of the Delegated Regulation
[2] Commission is a payment from the reinsurance undertaking to the cedent to compensate for acquisition cost, administrative costs and other costs. Sometimes the commission is also used to let the cedent share in the profit the reinsurance undertaking earns.

Insurance Europe agrees with EIOPA's assessment that it is possible that commissions paid from the reinsurer to the cedant might mask the level of premiums and hence risk transferred to the reinsurer. However, often contractual arrangements foresee that commissions to the cedant are only repaid when claims are as per best estimate (or close). If there are adverse scenarios, the downside risk is transferred to the reinsurer. That is what the reinsurer holds capital against and commissions are not/only partially repaid. Therefore, such agreements can be a very effective and sound measure to mitigate risk as they can transfer downside risk properly – and fulfil the aim of risk mitigation contracts. That there may be issues with the standard formula treatment of such covers for non-life reinsurance typically relates to undertakings' inability to adequately reflect commissions in the standard formula. Such cases are typically not an issue in life reinsurance.

For this reason, we proposed a simplified formula, which allows a partial solvency relief in the non-life standard formula (so-called "allowance ratio") for finite reinsurance in our comments on EIOPA's opinion on the 2020 review of Solvency II, question 5.6 (here).

1a with deep sliding scale commissions[5]

***Q20**. Deep sliding scale commissions alters the dynamic of the contract, in a way that it is more akin to a non-proportional excess of loss coverage with a large retention and only covers the tail of the risk. This in contrast with the usual (proportional) quota share contracts, where the reinsurer broadly follows the fortunes of the cedant's experience. Therefore, in this case, the standard formula calculation, based on proportional cession overstates materially the reduction in the SCR requirement, recognising greater risk transfer than merited.*
[5] Commissions can be executed in a sliding scale manner, where the profit sharing / commission increases and decreases based on the result of the ceded portfolio.

Sliding scale commissions align the incentives of cedant and reinsurer. If loss ratios increase, the commission decreases. Therefore, both cedant and reinsurer benefit from a lower loss ratio. Although such contracts should indeed not lead to an overstatement of the risk reduction, the intention of such sliding scales can be different than EIOPA indicates here.

1b high overriding commissions

***Q21**. Another way to alter the intended impact of the risk mitigation techniques on the standard formula can be observed if the quota share structures also include the proportional cession of unexpected high commissions (including the acquisition costs). Because the reinsurance premiums are first deducted from volume measure and then returned to the cedent 'disguised' as overriding commissions the consequence is that the SCR is calculated through a reduced volume measure for premium risk even though the ceded commissions are given back to the cedent in order to bear the associated expenses*

Reinsurance contracts are often part of a portfolio assessment of a client relationship. A reinsurer is often only able to write certain high-risk reinsurance contracts if reinsurance is also concluded with less volatile business. However, this does not mean that the reinsurer is not exposed to risk for this less volatile business. The reinsurer usually assumes the full downside risk. The high fixed commission enables the primary insurer to participate in the upside of the reinsurance treaty, as well as in those cases where the underlying business has a high expense ratio. Since there are usually no risk-limiting features included in such reinsurance contracts, reinsurance contracts with a high fix commission should be fully eligible in the non-life standard module.

Example 2 - Mass lapse reinsurance

***Q22**. Solvency II requires insurance and reinsurance undertakings to apply a one-size-fits-all 40% stress for mass lapse risk (70% for group risk business).*

The mass lapse calibration is too simplistic and too large even for a standard model, particularly in light of real experience. There should be some distinction between a portfolio distributed through a concentration of brokers, tied agents, banks or a mix of these. Where brokers are involved, the potential lapse risk is magnified. Also, particular features in policy conditions (eg surrender penalties), tax rules etc should be considered. Through reinsurance of lapse risk, the (reinsurance) market makes allowance for the one-size-fits-all (and too large) stress.

***Q23**. As such, this part of the standard formula lends itself very well to capital management hedging transactions, since the hedging cost vs. the capital benefit can be very appealing. This holds particularly true if the hedge is structured as a non-proportional reinsurance. As a consequence of the linearity of the Solvency II stresses, the hedging costs for a far out-of-the money hedge can be substantially lower than the implied capital relief benefits. More specifically, the most common mass lapse covers used an attachment point around 20% (lapse rate over a year, and is approximately half of the mass lapse stress) and a 40% detachment point (the 1:200 stress in the standard formula for mass lapse risk). While the detachment point is simply driven by the lack of capital benefit in hedging further than 40% (i.e. the Solvency II stress), the 20% seems to be an suitable value when a substantial tail risk is to be transferred.*

The appealing cost vs. capital benefit is an indicator that the reinsurance market in many cases considers mass lapse stress levels above 20% as extremely unlikely, and thereby attractive to reinsure.

This clearly indicates the miscalibration of the mass lapse shock within the standard formula and should trigger a recalibration of the mass lapse stress, as proposed previously by Insurance Europe. Undertakings cannot be blamed for the poor calibration of the mass lapse scenario of the standard formula. The 40% / 70% risk factors are too high by far. As EIOPA rightly states, attachment points around 20% seem to be suitable values when a substantial tail risk is to be transferred. Therefore, from a risk point of view, hedging in the range of 20% to 40% seems to be reasonable. In general, misuse should not be assumed.

EIOPA's description might imply that the attachment point for mass lapse cover has to be no more than 20% to ensure a sufficient transfer and that mass lapse covers might only be allowable if they comply with this limit. This would be an arbitrary requirement. Capital relief should be granted to the extent that the cover transfers risks up to the defined stress factor, assuming that the standard formula is deemed to apply to the undertaking.

Please also see our comment on paragraph 24.

***Q24**. The lapse risk is defined as the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level or volatility of the rates of policy lapses, terminations, renewals and surrenders. The standard formula capital requirement for this risk in all its manifestations is defined as the maximum of three lapse scenarios: a one-year mass lapse, a structural raise of lapse rates, and a structural decline of the rates. In many cases, the mass lapse scenario is dominant among these three scenarios. Lapse risk can e.g. also occur as multi-year raises of lapse rates, but such scenarios are not selected for the standard formula. For instance, multi-year increases of lapse rates are observed in cases of unemployment, interest rate movements, and misselling practices. While the impact within a single year can still be limited, the total, multi-year impact might be significant. A hedge or reinsurance of only the mass lapse scenario, leaves the insurance undertaking vulnerable to such kinds of lapse patterns, while the capital requirement following from the standard formula has been lowered by the mass lapse risk mitigation techniques. The insurance undertaking should analyse within its ORSA these risks, which are not included within the standard formula.*

The above narrative describes a scenario with a multi-year impact on lapse rates. From the description, the suggested scenario could also be included in, eg a lapse up shock. It is unclear from the example what the regulatory issue is, and whether EIOPA is questioning the maximum formula of lapse up/down and mass lapse defined in the Delegated Regulation.

EIOPA's view appears to be that, this specific point-dependent design of the SCR, based on a Value-at-Risk (VaR) approach, raises questions regarding the appropriate consideration of reinsurance. However, this is not a specialty of lapse risk and crucial point is always whether there is a sufficient risk transfer. It is, therefore, difficult to understand how hedging some of the most severe lapse events (one year mass lapse) without simultaneously hedging every other conceivable lapse pattern can be criticised as it is just the typical case of reinsurance where an important part of the loss distribution is covered, but not the entire distribution.

Lapse risk mitigation is typically provided by reinsurers in form of an indemnity based stop-loss reinsurance (which is a traditional form of non-proportional reinsurance), where the reinsurer compensates the cedent for any loss of own funds above a retention scenario: eg at a mass lapse event of 20%, during a 12 months period. Therefore, the impact of the critical VaR scenario taking the offsetting effect of the risk mitigation technique limits the loss of own funds for mass lapses up to the retention level. This represents a substantial transfer of risk.

Example 3 - "Contract boundary reinsurance"

***Q25**. According to the Solvency II framework the expected profits included in future premiums (EPIFP), stemming from a book of policies are recognised, through the calculation of the best estimate liabilities, in the Solvency II balance sheet as long as they are within the contract boundary of the insurance obligation for business in force. Consequently, EPIFP stemming from a book of annually renewable group policies covering, for instance, death are recognised only for the period until the next renewal date in the Solvency II balance sheet because the profits beyond the renewal are outside the contract boundary (i.e. one year). It is possible to structure a reinsurance contract that allows undertakings to monetise a portion of the future profits not recognised in EPIFP due to contract boundary restrictions which covers mortality and lapse risks. One could question whether such a contract does actually cover insurance/biometric risks or rather covers commercial/business risks (i.e. the risk not to renew the contracts) that would impact only the solvency position. Reinsurance contracts with similar effects are known under the name of VIF securitisation /monetization.*

The example describes that the reinsurance covers mortality and lapse risks but in the next sentence it is mentioned that one could question whether such a contract does actually cover insurance/biometric risks. It does, as EIOPA itself has pointed out. If the reinsurance covers mortality, then one would assume biometric risk is covered. Furthermore, if the reinsurance provides for a certain payment in cash now, versus an uncertain payment in cash in the future, then one would assume risk is transferred. If EIOPA does not see business risk such as lapse as a real risk, then it must also question whether capital needs to be held for lapse risk. Lapse is a business risk.

The potential difference between insurer and reinsurer contract boundaries is a well-established feature of the Solvency II regime. In such cases, the insurer and reinsurer SCR would be consistent with their respective contract boundary and the difference between contract boundaries. As long as contract boundary provisions are applied consistently in the best estimate liability and the SCR calculations, this is not an issue.

Additionally, Art. 41 of the Delegated Act provides that *"The amounts recoverable from reinsurance contracts and special purpose vehicles shall be calculated consistently with the boundaries of the insurance or reinsurance contracts to which those amounts relate."* In some instances, the contract boundary is a non-economic feature that addresses the difficulty to model the interaction between repricing and customer behaviour. Consistently with the Art 41, the cedant should be able to recognise the economic effects of reinsurance that replaces the uncertain future payments with a certain day one payment.

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

***Q26**. In order to reduce the capital requirement due to non-life reserve risk, a reinsurance arrangement consisting of two parts is tailored. It consists of an adverse development cover (upper part) that mitigates the loss development risk, but with a retention well above the best estimate, and a finite reinsurance type of cover (lower part) that generates reinsurance recoverables, although not beyond the best estimate. By generating recoverables, the lower part reduces the volume measure for the standard formula SCR calculation*

of premium and reserve risk.

Insurance Europe recognises EIOPA's concerns regarding the treatment of a loss portfolio transfer combined with an adverse development cover that provides for a loss corridor above or slightly above the reinsured best estimate reserves.

***Q27**. Although the reinsurance arrangement is given as one single contract, it actually can be seen to combine two completely independent contracts: an upper layer that transfers real risk but does not come with any significant SCR relief and a lower layer leading to a considerable SCR reduction without mitigating any of the loss development risk. The reduction in the SCR can be materially greater than the risk mitigation of the arrangement. In a situation like this an undertaking may consider the appropriateness of applying the standard formula.*

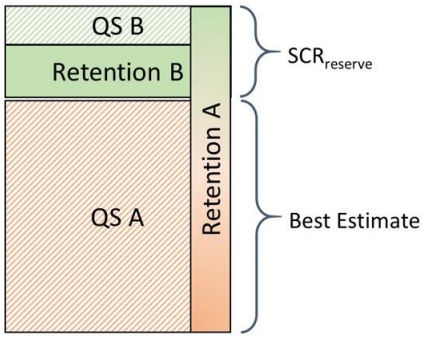

Figure 1 Illustration of an Adverse Development Cover where "QS B" mitigates reserve risk and "QS A" generates recoverables and thus considerably reduces the capital requirement for reserve risk

Example 5 - Multi-year stop-loss

***Q31**. Furthermore, for such treaties the possible impact on SCR calculations can be very material such that counterparty and basis risks can increase significantly. To cover such risks, an appropriate colateralisation is necessary where a possible negative CCPnL is collateralized with high quality assets in a short term. If not, residual counterparty and basis risks will remain.*

Insurance Europe agrees that specific attention should be paid to counterparty risk. Counterparty risk covers potentially large-scale losses which might indicate cumulative risks to the interconnectedness of the sector. This is already taken into account in the appropriate Solvency II sub module. It is not clear whether EIOPA is suggesting the current treatment is inappropriate.

Insurance Europe strongly considers the concept of multi-year stop-loss to be valid. If a reinsurance cover caps a cedants' maximum loss from all risks, it should be allowed to apply that cap to the SCR, assuming that it can demonstrate that those caps would trigger reinsurance payments in a stressed environment. It would be appreciated if EIOPA can clarify that such a cover is valid, when accompanied by appropriate risk analysis.

***Q32**. Lastly, in the case of a single reinsurance undertaking and given the material impact of the reinsurance treaty a concentration risk can arise.*

Having more reinsurers doesn't necessarily reduce the risk as the companies might all be affected by the same macro/market events. In any case, the counterparty credit risk calculation is sensitive to the number of reinsurers.

ADDITIONAL QUESTIONS TO STAKEHOLDERS

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

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

The reference to basis risk in the use of RMT makes the dialogue with supervisory entities more challenging. A real life example where a single (extreme) scenario in the context of a potential reinsurance transaction was pre-discussed with the supervisor led to the non-allowance of the RMT and the comment: "we see this as a basis risk and we think it is material". This view is clearly subjective. Although basis risk is indeed a key element in any risk transfer, the current broad possible interpretation does not allow for a level playing field.

For example; in case a cedant decides to reinsure its property portfolio under a (plain vanilla) XL contract and consciously decides not to include terrorism in this cover. This can be viewed as:

- A risk appetite decision.
- Basis risk in the risk transfer.

Depending on the supervisory interpretation, the cedant is allowed either partial capital relief or no capital relief.

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

Intragroup reinsurance is an indispensable tool for an effective group-wide risk management. The following positive aspects are highlighted:

- Diversification: Different entities within an insurance group are exposed to different types of risks. Their ability to "digest" the effects of a severe shock scenario may also differ. Equalising the risk over portfolios represents to the core principle of insurance. Intragroup transactions applied for this purpose should not be hindered by additional or more restrictive solvency regulation.

- Management of external reinsurance relations: In view of administrative expenses, human resources, technological competences and negotiation power against third parties some insurance groups try to concentrate reinsurance at a central entity. In order to do this in an efficient way, group internal reinsurance is indispensable. Putting regulatory constraints on this will increase the cost of bearing the risk locally.