insurance europe

To: Mr. Klaus Wiedner
Head of Unit Insurance and Pensions Unit
Directorate General Internal Market and Services
European Commission
Spastraat 2 - 1049
Brussels, Belgium

Your reference: -

Our reference: RAB-13-004

Subject: Insurance Europe's RAB letter on the non-proportional reinsurance factor

Brussels, 27 May 2013

Dear Mr. Wiedner,

Insurance Europe, the European insurance and reinsurance federation, and its "Reinsurance Advisory Board" (RAB)[1] continue to see the need for a better recognition of non-proportional reinsurance in the standard formula of Solvency II. We are writing this letter to you in order to present a proposal on how to achieve a more adequate treatment of reinsurance in this particular matter.

Scope

This letter provides a framework for a more flexible application of the non-proportional-adjustment factors in the Solvency II standard formula. It carries forward the issues raised in the joint letter of Insurance Europe and RAB from 22nd June 2012 (Appendix I) and demonstrates the need for alternative USP methods for appropriate recognition of non-proportional reinsurance in the standard formula.

We propose an extension of the framework provided in the Level 2 draft implementing measures as of October 2011 and the Level 3 pre-consultation[2] as of December 2011. As a follow-up to our discussion of this topic with national experts of the European Commission on 20th September 2012, we have been asked to provide further input, i.e. demonstrating the need for the extension and providing guidance on the selection of the appropriate method depending on the individual portfolio. The application criteria as presented below intend to facilitate this.

Proposal: Alternative USP method based on market calibration

The non-proportional adjustment factors attempt to provide for a more detailed coverage of non-proportional reinsurance in non-life insurance in the Solvency II standard formula. The factors are part of the framework for undertaking specific parameters (USP).

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[1] The Insurance Europe RAB's membership represents about 60% of worldwide reinsurance business and is represented at CEO level by the following major European reinsurers: Gen Re, Hannover Re, Lloyd's, Munich Re, Partner Re, SCOR and Swiss Re.

[2] Draft proposal for Implementing Technical Standard on Undertaking Specific Parameters: Methods.

The current Level 2 and Level 3 drafts offer several options to account for non-proportional reinsurance in the premium risk module of the standard formula:

Option 1): Apply standard factors (80% for liability, motor, property and 100% for all other line of business (lob)).

Option 2): Apply undertaking specific parameters. The factors need to be calibrated using the company's own historical data for the lob's claim volatility and the company's reinsurance structure.

Option 3): Apply a (partial) internal model.[3]

We understand that the standard factor approach (option 1) is based on an average as reported under QIS 5 where an approach based on undertaking specific data similar to the Level 3 USP method (option 2) was chosen. Therefore, it can be assumed that option 1) represents a market-average claim volatility calibration and a market-average reinsurance program as of QIS5.

While in practice reinsurance programs can be quite different, a method that is based on the individual cover might be more appropriate for many undertakings. However, we question whether a USP method similar to the EIOPA Level 3 approach (option 2) would be a workable alternative for all companies.

First, for small and medium undertakings the amount of calculation involved can be such a major impediment in applying option 2) that a simplified version of option 2) is required. Also, option 2) assumes that the company can make a reliable calibration of the tail of the distribution, while it is much more complicated in practice. Therefore, the list of allowed USP methods should at least be flexible. We further propose to extend the existing USP framework in Level 3 with the following additional options (see Appendices II and III):

Option 2a): Market calibration: Apply undertaking specific parameters using a market-average volatility calibration for the lob's claim volatility[4]
The USP method that was tested under QIS 5 was generally perceived as difficult which has been a barrier for its application. Therefore we see the need for a simplified prescribed option. We assume that a company has easy access to the parameters describing its (non-proportional) reinsurance structure. We moreover assume it can be a challenging task for a (small) company to estimate its claim volatility. Therefore, we expect that the market-wide calibration (method 2a) would provide a large benefit for these companies.

Option 2b): Additional USP methods
By assuming a Log Normal distribution for the whole range of claims EIOPA Level 3 proposal does not recognize that usually, insurance claim severity has an heavy tail behaviour. Therefore we propose an approach that accommodates this concern by requesting that large claims be modelled separately from small ones. This approach also obviates some additional drawbacks of the EIOPA Level 3 proposal as described in the paper submitted by Insurance Europe to the European Commission in July 2011 (see appendix II). Instead of using a unique set of parameters for the claim volatility, two separate sets have to be used, one for small losses and another one for large losses. The set of parameters dedicated to small losses can be calibrated using the company's own historical data for the line of business (LoB).

Calibration of large losses parameters is of course the main driver while evaluating a non-proportional reinsurance cover. Nevertheless it can be a challenging task for a (small) company to estimate its large claim volatility. Therefore, we expect that the market-wide calibration would provide a large benefit for these

[3] This option will not be further discussed in this paper.
[4] By the lob's claim volatility we refer to the characteristics of the loss frequency and the loss severity which are both components of the existing USP method.

companies. On the other hand, companies which have a sufficient data set can calibrate their own set of parameters for large losses.

Application criteria

The three options in Level 2 and 3 to account for non-proportional reinsurance in the standard formula, and the proposed additional options 2a and 2b, come with different assumptions on the company's risk and reinsurance profile. We propose the following criteria for the application of the different options.

Option	Criteria for application	Principles for assessing these criteria
1	Individual risk scenarios within the scope of the standard formula, e.g. regarding global and sector exposures, and a market-average non-proportional reinsurance structure	A company's non-proportional reinsurance structure for a given line of business is market-average, if its reinsurance premium paid for this reinsurance program does not significantly deviate from the market average reinsurance premium for this line of business. For this purpose the reinsurance premium shall be measured relative to the gross premium for this line of business.
2	Individual risk scenarios within the scope of the standard formula, e.g. regarding global and sector exposures	The prerequisites set in the Level 2 draft apply.
2a	Same as method 2, and a market-average portfolio	A company's portfolio for a given line of business is market-average, if the company's products offered under this lob do not – apart from a possible geographical specialization – significantly deviate from market standards, or the underlying exposure does not significantly deviate.
2b	Distinction between large claims and small claims	A company can distinguish between types of claims when it has a meaningful market share or when the underlying exposure on large claims does not significantly deviate from market average in the case Market data on large claims is available

The assessment of the criteria for application of the different methods requires some kind of judgment and that is why there is supervisory approval for USP. We anticipate that this kind of judgment will be expected in the context of the ORSA (Own Risk and Solvency II Assessment), too, so that a consistent treatment under Pillar I and Pillar II could be achieved.

Conclusion and next steps

We propose to allow for alternative USP methods for non-proportional reinsurance in the standard formula. The proposed methods fit well in the existing Level 2 and Level 3 framework for USPs and address two specific needs.

Firstly, the need for a method that is less complex than the existing USP method. QIS 5 has shown that the effort that is caused by the calculation is important. We believe that a simplified method will lead to broader

application of the USP methods. This in turn allows to update the standard factors (option 1) based on a broader data set. In order to include the new method, it is necessary to provide market parameters for the average gross claim and volatility per lob. The industry is prepared to support this calibration.

Secondly, the need for a method that recognises the different impact of non-proportional reinsurance program on large and small claims. This other solution is provided by method 2b, which can be applied either on market parameters for large losses or on company specific data (if sufficient data on large losses are available), small losses being calibrated on company specific data anyway.

We provided guidance for their application based on the situation of the undertaking. We believe that the method can be introduced without amendments to the Level 2 text. We refer to our proposed amendments to the Level 3 for the alternative USP methods in appendix IIa (option 2a) and appendix IIb (option 2b).

We are looking forward to discuss this proposal and ready to support the implementation.

Yours sincerely,

Michaela Koller
Director General
Insurance Europe

Ulrich Wallin
Chairman of the Executive Board, Hannover Re
Chairman of the RAB, Insurance Europe

CC: Mr Gabriel Bernardino, Chairman of the European Insurance and Occupational Pensions Authority (EIOPA)

Appendix

I. RAB letter to the Commission from 22nd June 2012 (separate document)
II. Proposed amendments to the Level 3 text (see page 5 of this document)
   a. Proposed amendments to the Level 3 text to support an USP method based on market parameters
   b. Proposed amendments to the Level 3 text to support USP method as described in ECO-SLV-11-562
III. CEA (now Insurance Europe) paper ECO-SLV-11-562 (separate document)

Appendix II

a) Proposed amendments to the Level 3 text to support an USP method based on market parameters:

We propose to insert the paragraph 3.5.11.a as shown below into the current level 3 text (see "Draft proposal for Implementing Technical Standard on Undertaking Specific Parameters: Methods").

> 3.5.11.a
> Subject to the insurance or reinsurance undertaking complying with Article SCRS1 the adjustment factor for non-proportional reinsurance may be calculated using market parameters for 'average gross claim' and 'volatility per lob' instead of the individual estimates calculated in accordance with 3.5.11.

b) Proposed amendments to the Level 3 text to support USP method as described in ECO-SLV-11-562:

We propose to insert a new sub section titled "Other methods" after the sub section "Additional Requirements and Considerations" under section 3.5 ("NP Factor per LoB"). The new section will describe the USP method as depicted in ECO-SLV-11-562