reinsurance advisory board

November 2020

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

Referring to: EIOPA consultation on supervisory statement on the use of risk mitigation techniques

General Comments

- **Reinsurance is beneficial for both policyholder and consumer protection and should therefore be fully and appropriately recognised by Solvency II**. In fact, a well-structured reinsurance contract from a highly-rated reinsurer can help protect policyholders as well as other stakeholders of the insurance undertaking. Therefore, Solvency II should facilitate reinsurance performing its role of reducing insurers' underwriting risk. It should also achieve the correct balance between recognising the benefits of reinsurance in the standard formula and the complexity of calculations.
- However, **EIOPA in its draft statement appears to disincentivize reinsurance** by:
  - Suggesting that while new or sophisticated reinsurance covers are suspicious, existing covers are fine, without providing evidence.
  - Highlighting specific structures in its statement while noting concerns but not proposing solutions, which by its form as an EIOPA statement encourages cedents to see these covers as suspicious and likely to be challenged by regulators, materially damaging or even eliminating the market for such covers amongst standard formula users.
  - A one-sided approach, focusing on certain reinsurance transactions where the application of the standard formula may give rise to an over-estimation of risk transfer from this overall assessment, while omitting similar situations of known under-estimation of risk transfer, including some in the given examples. Any assessment should be based on the risk mitigation substance, not its form.
  - Positioning capital optimisation in a negative light, instead of recognising that Solvency II is an economic framework that **rightly incentivises capital optimisation** in a risk-based manner, where reinsurance is one (of several) essential tools for this purpose.
  - Using misleading language on reinsurance, such as suggesting reinsurers or their clients have something to hide from supervisors. We are of the opinion that more neutral language and less generalisation should be used.
  - The role of the actuarial function should not be extended to require further assurance on reinsurance transactions. This is neither proportionate nor in line with the spirit of and safeguards in the Solvency II regulation.
- **There is limited evidence in the statement that there is a material issue for EIOPA to address. The existing Solvency II rules already provide the necessary safeguards and guidance in this area**
  - The standard formula has certain limitations regarding the recognition of selected reinsurance structures. The limitations of the standard formula were recognized when Solvency II was developed and were addressed in the design of the framework, therefore **no additional hurdles for the recognition of reinsurance are necessary.**
  - **The identification of under or over estimations should be based on existing instruments within the Solvency II framework**, namely ORSA and Actuarial Function Report. The current supervisory statement would introduce new requirements for regulators and the industry which is not in line with the stated objective of improved supervisory convergence.

- The RAB believes that **the list of examples provided by EIOPA does not demonstrate any single overarching point**. Improving the clarity on assessment of basis risk (for all contracts) might have been a more useful contribution.
  - The views expressed by EIOPA are one-sided and could lead to an interpretation where there is not risk transfer, when generally significant risk transfer is achieved in each of such structures. The default assumption should be that reinsurance contracts which achieve risk transfer should be fully recognised in the standard formula.
  - To the extent that there are deficiencies in the capacity of the standard formula to reflect the specifics of certain reinsurance contracts, this should be addressed by making standard formula more sensitive to the risk mitigating impact of those contracts[1], rather than creating barriers to their recognition which may lead to their exclusion.
  - The statement fails to propose a solution to the perceived issues, leaving the reader to wonder whether EIOPA intends to effectively prohibit certain structures. We oppose the recommendation to apply stricter rules.
  - It is not clear why EIOPA is raising these issues outside the scope of the 2020 review, where there would have been scope to find solutions to some of them.

- **We would invite EIOPA to remove the examples from the statement**. We would also encourage EIOPA to take a more flexible approach to recognising reinsurance under Pillar 1 instead engage further on how any associated risks can be effectively measured and addressed, in particular under Pillar 2.

[1] The RAB has consistently argued throughout the 2018 and 2020 Review of Solvency II that the non-life premium and reserve risk module needs to be made more risk sensitive to the impacts on non-proportional reinsurance covers.

Questions

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

The RAB values EIOPA's views on the use of reinsurance structures. However, we think **that the supervisory statement delivers an unbalanced view of reinsurance**. The statement should recognise that Solvency II is an economic framework that rightly incentivises companies to manage their risk and capital and get economic recognition for this. Reinsurance is one (of several) essential tools for this purpose. The use of reinsurance for sophisticated capital management should not be discouraged as it intrinsically involves risk transfer. In cases where the standard formula is not aligned with a particular entity or business, but insurers are expected to comply with it anyway, this cannot be pointed to as a limitation for the use of reinsurance.

In the statement there is limited evidence that there is a material issue for EIOPA to address. In the absence of a concrete issue, we believe that the existing rules – requiring detailed residual risk analysis in ORSA processes and of evidencing the adequacy of standard formula approaches when used – provide sufficient guidance in this area.

The timing of the supervisory statement during the renewal cycle is also unfortunate and creates unnecessary disruption in the market. Moreover, we question the rationale for this initiative outside of the Solvency II review where the European Commission's Call for Advice specifically requests EIOPA's advice on risk mitigation techniques, and where the RAB has had a productive engagement with EIOPA, in the context of which EIOPA could have raised some of the concerns described herein.[2]

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

The RAB believes that there are in fact **issues with the definition and measurement of material basis risk in the context of risk mitigation measures**. Our opinion is that the current regulatory framework encourages an 'all or nothing' treatment of basis risk whereby the lack of clarity in 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 Commission does not resolve this issue, and this supervisory statement exacerbates it (see comments on the multi-year stop loss example). In September 2019, the RAB sent EIOPA a paper on basis risk, on which the RAB is still waiting for an EIOPA reaction.

[2] European Commission (2019, *Formal request to EIOPA for technical advice in the review of the Solvency II directive,* URL: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190211-request-eiopa-technical-advice-review-solvency-2.pdf

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

While the RAB recognises that **Solvency II should be applied in a consistent way within the Member States**, it is not clearly based on the evidence provided that the issue of inconsistency between supervisory approaches cannot be addressed by applying the provisions already in the Solvency II framework in the manner they were intended. In any case if such inconsistency exists, we would caution against taking a view based on the lowest common denominator position, but rather view the issue in terms of the objectives of Solvency II. In this context, the statement can be useful in reminding companies of the already existing Solvency II elements to address this. In the view of the RAB, **EIOPA should avoid creating new requirements for the recognition of reinsurance and/or expectations by issuing a new statement.**

The RAB draws the attention to the fact that the many established and effective reinsurance structures like non-proportional reinsurance including Adverse Development Covers are not or not fully recognised in the standard formula.

4. 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.

The RAB agrees with the statement that effective risk transfer should be duly considered but highlights that to the extent that the standard formula is judged to apply to an undertaking's risk profile, then it follows that the undertaking should be able to use the standard formula as a measure of the risks it faces and the consequential capital charges. **The standard formula does not prescribe a risk transfer test, arguably because it performs this function itself**. **The use or absence of reinsurance should not affect this fundamental assessment**. We appreciate there may be (many) cases where the standard formula is not in fact appropriate to an undertaking's risk profile, and that this causes issues with reinsurance structures, which is why the option of a (partial) internal model exists, which, however, comes with significant costs and effort for both undertaking and the supervisory authority.

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

While the RAB appreciates and welcomes the fact that EIOPA recognises that it is important that undertakings have an appropriate reinsurance policy in place, it has several concerns on the content and messaging in EIOPA's statement. In particular, it is not usually a question of whether an undertaking is able to bear risks, 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 them accordingly.**

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

In RAB's view no reinsurance structure should be excluded by regulatory fiat, neither should new reinsurance structures be discouraged.

The RAB agrees with the notion that reinsurance contracts must transfer risk in order to be recognised in the standard formula. However, we point out that the design of the standard formula does not follow this principle very strictly as there are counterexamples which apply even in the absence of any risk transfer or indeed of any reinsurance at all.

The meaning of **the phrase 'arbitrage the regulation' is unhelpful and should be deleted**, as it implies that arbitrage is the intent of the parties to complex reinsurance structures. There are likely good reasons for some of the structures' complexity that are a direct and intended consequence of Solvency II, for example 12-month roll-over provisions designed to ensure ongoing cover according to standard formula rules – this is not arbitrage but simple economics. In addition, capital relief is but one of many possible reasons why an undertaking may want to purchase a reinsurance cover, and these may also need to be taken into account in evaluating the structure. The principle described in the previous sentence 'if there is a real reduction in risk, it is reasonable that there should be corresponding capital relief' should be sufficient as it is a better description of the economic relationship.

The RAB also disagrees with the implication that all new reinsurance structures are 'complex and challenging to assess': many of the structures mentioned in the statement, such as mass lapse covers, are very straightforward and are structured in a comparable way to traditional structures for other types of risks such as stop loss covers or CAT covers.

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

The RAB recognises the importance of risk mitigation techniques 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 ensure continued innovation in the insurance market.

In theory, any of the underwriting risks under Solvency II can be reinsured with the appropriate structure. Some of the structures identified in the examples (in particular mass lapse risk) are not really conceptually new structures but are rather existing structures adapted to other risks. As the standard formula increases

undertakings' awareness of their exposures to certain risks such as lapse, it is natural that some companies will seek to reinsure these to keep their exposure within internally-set limits.

The RAB understands the concerns that some non-life reinsurance structures are not or cannot be reflected in the standard formula in a manner which meets EIOPA's first criterion above at contract level. As mentioned under #12, we have a "complex reality" of reinsurance forms and contract features. **Most of the features are necessary to keep the risks "reinsurable"** at all, ie without them (eg unlimited coverage) reinsurance would not be affordable or could not be offered at all.

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

This very specific criterion fails to recognise **that the standard formula captures the average risk profile and by design does not accurately capture the specifics of all risk profiles or individual reinsurance contracts**.

EIOPA also fails to recognize the fact that **there needs to be a trade-off between complexity and risk-sensitivity of the standard formula**. This is true for all elements of the standard formula but in particularly relevant for the recognition of reinsurance standards. It is also the reason for the current non-recognition of non-proportional reinsurance in the premium and reserving risk module of the standard formula. Each individual module of the standard formula either over or underestimates each individual risk of an insurance undertaking. Whether any misstatement is material must be disclosed in the ORSA process.

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

The RAB agrees with the statement but does not see a problem since the increase in other risks – with the notable exception of basis risk – is adequately taken into account under Solvency II. **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. The RAB has sent EIOPA a paper on basis risk in September 2019 that explores some of these issues.

10. Recognition of risk mitigation techniques for the calculation of the SCR using the standard formula is regulated in Articles 208-214 of the Delegated Regulation. In the practical application of these provisions it is expected that to recognise a risk mitigation 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.

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Summary:

The RAB disagrees with the statement from the point of view of the principles underlying Solvency II and the protection already in place in the framework **which also make its application impractical.**

EIOPA may have a broader concern relating primarily to the non-life premium and reserve risk sub-module. However, the RAB believes that the standard formula together with the assessment of the appropriateness of standard formula for the risk profile via ORSA in Solvency II, Pillar 2, is appropriate and sufficient. In any case, if the standard formula is not sufficient to appropriately capture the risk profile of the undertaking (having regard to the reinsurance contracts in place) the supervisor may request the use of a full or partial internal model in line with Directive, Art 119.

Moreover, **this mitigation of the risks mentioned here is already part of ongoing prudential requirements** since Solvency II is a risk-based framework.

Further comments:

The RAB disagrees with the statement from the point of view of the principles underlying Solvency II and the protection already in place in the framework **which also make its application impractical**. In the Life and SLT modules, as well as the Non-life and NSLT Cat sub-modules, risk transfer recognition in the SCR is usually straightforward, as it will usually be possible to model the particulars of the reinsurance structure directly into the cash flow modelling / Cat scenario calculation. EIOPA may have a broader concern relating primarily to the non-life premium and reserve risk sub-module. We see two main potential situations. Either we have:

- **A structure that provides no risk transfer**, in which case we concur that this should not result in capital relief;
- **A structure that combines proportional with non-proportional elements** (e.g. certain kinds of commission), or a purely non-proportional structure that does provide risk transfer, in which case the issue is likely to be where and how to actually recognise the capital relief in the standard formula given its limitations.

We believe that in practice the second case is likely to be much more relevant. Where the standard formula is deemed to apply to an undertaking before reinsurance, we would expect national supervisors to take a proportionate approach in allowing the company to recognise the capital relief that would be warranted from an economic perspective, having regard to the fact that the standard formula SCR is not designed to reflect the substance of the arrangements that implement the risk mitigating techniques in all circumstances.

Whilst the standard formula under Solvency II, Pillar 1 certainly has its limitations, as every model inevitably does, the RAB believes that the standard formula together with the assessment of the appropriateness of standard formula for the risk profile via ORSA in Solvency II, Pillar 2, is appropriate and sufficient. In any case, if the standard formula is not sufficient to appropriately capture the risk profile of the undertaking (having regard to the reinsurance contracts in place) the supervisor may request the use of a full or partial internal model in line with Solvency II Directive, Art 119. This assessment of adequacy of the standard formula for risk profile needs to be carried out at the level of the undertaking in line with Directive Art. 45. The development of a (partial) internal model to allow them to reflect these situations, will create significant costs for both the company and the supervisory authority.

Moreover, **mitigation of the risks mentioned here is already part of ongoing prudential requirements** since Solvency II is a risk-based framework.

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

The concerns with the recognition of risk mitigation techniques in internal models are not stated and therefore **the need for this paragraph is unclear**.

BALANCED APPROACH

12. 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.

Articles 208-214 of the Delegated Regulation already cover reinsurance risk transfer. More generally standard formula provisions could be adjusted in order to better reflect the risk mitigating effect and capital relief.

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

Summary:
The first paragraph **fails to recognise that the standard formula captures the average risk profile and by design does not capture the specifics of all risk profiles.** This is a satisfactory outcome within the overall framework because of the safeguards which are in place in Solvency II where there is a significant departure in risk profile from the assumptions underlying the standard formula. Furthermore, all the elements exist in the current framework and no additional hurdles for the recognition of reinsurance are necessary.

Requiring the actuarial function holder ("AFH") to express an opinion on the "balance" seems to refer to the interaction between the reduction in SCR for a specific reinsurance arrangement and the appropriate treatment of new risks acquired. **This does not recognise that standard formula is not designed to capture the specifics of all reinsurance arrangements**.

The RAB stresses that **the task of the actuarial function as per article 272(8) is sufficient** in the context of the overall framework. The RAB encourages EIOPA to make a reference that such an analysis should be proportionate to the materiality and complexity of the transaction in the context of the risk profile of the undertaking

Further comments:

The first paragraph here sets a higher standard for the recognition of RMTs in the standard formula than is currently the case. **It fails to recognise that the standard formula captures the average risk profile and by design does not capture the specifics of all risk profiles.** This is a satisfactory outcome within the overall framework because of the safeguards which are in place in Solvency II where there is a significant departure in risk profile from the assumptions underlying the standard formula.

Furthermore, there is a requirement under Pillar 2 to assess the significance of any deviation of risk profile from the assumptions underlying the standard formula and as noted in the draft statement, the actuarial function report requires an assessment of the reinsurance strategy. All the elements exist in the current framework and no additional hurdles for the recognition of reinsurance are necessary.

A well-documented aspect of this is the treatment of non-life non-proportional reinsurance in the premium and reserve module of the standard formula where recognition is insensitive to risk transferred. This criterion cannot be introduced without a more fundamental assessment of the design and complexity of the standard formula. To the extent that reinsurance recognition needs to be addressed in Pillar 1, this should be done by addressing the lack of risk sensitivity of the standard formula to reinsurance RMTs rather than placing barriers to certain structures based on their form.

The RAB understands that the "reduction in the SCR or the increase in the eligible own funds" should be reflected to the "extent of risk transfer" or new risk mitigation techniques risks should receive "appropriate treatment within the SCR", but it is **very difficult and often not possible for a user of the standard formula to implement this requirement**. If this ultimately means that the contract is not recognised in the standard formula or a partial internal model has to be introduced for all particularly non-life reinsurance contracts where the standard formula does not determine the SCR in a risk appropriate manner line with EIOPA's criterion, this would hinder standard formula users from implementing certain reinsurance solutions for risk mitigation purposes. It could also have an impact on price-setting as a consequence of a reduced range of reinsurance products, ie limiting the general availability of risk mitigation techniques for insurance.

Requiring the actuarial function holder ("AFH") to express an opinion on the "balance" seems to refer to the interaction between the reduction in SCR for a specific reinsurance arrangement and the appropriate treatment of new risks acquired. **This does not recognise that standard formula is not designed to capture the specifics of all reinsurance arrangements** as per the previous point. It also places a very specific obligation on assessing the standard formula adequacy by individual reinsurance contract. Consistent with this, the actuarial function currently is not required to express an opinion on the adequacy of the standard formula for specific reinsurance arrangements or more generally. This should refer to the role of the AFH on these contracts only insofar as it relates to the AFH's current responsibilities under 272(7) of the Delegated Acts.

The RAB stresses that **the task of the actuarial function as per article 272(8) is** sufficient in the context of the overall framework. The RAB encourages EIOPA to make a reference that such an analysis should be proportionate to the materiality and complexity of the transaction in the context of the risk profile of the undertaking.

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

Summary:

The RAB agrees that the standard formula is a simplification and **insurers' risk management should look at broader scenarios than the standard formula as is already the case through the ORSA**. However, given that insurers' solvency is assessed on the basis of the standard formula, **a transaction that provides risk transfer should grant capital relief under the standard formula**. Clearly companies may believe that the standard formula underestimates or overestimates the risk from their perspective, and thus seek to bring it into line with their risk appetite using reinsurance. It follows that **if the standard formula is deemed to apply even in such cases, then it is deemed that its scenarios adequately estimate the risk, and this assessment cannot then depend on the existence of a reinsurance solution**. We agree however that **for the ORSA, insurers should take a broader view and consider other risks beyond the strict definitions of the standard formula.**

There is a risk that EIOPA, in targeting the outcome that the standard formula never understates required capital at the level of each individual contract, will ensure that the standard formula capital calculation as a whole will systematically overstate required capital.

Alternatively, EIOPA should recognise that the situation described above was anticipated and legislated for in the design of the Solvency II framework.

Further comments:

The RAB agrees that the standard formula is a simplification and **insurers' risk management should look at broader scenarios than the standard formula as is already the case through the ORSA**. However, given that insurers' solvency is assessed on the basis of the standard formula, **a transaction that provides risk transfer should grant capital relief under the standard formula**. To the extent that the standard formula is deemed to apply, focusing on these scenarios is sensible from a capital management perspective and the design of the Solvency II framework (having regard to the other safeguards in place). Clearly companies may believe that the standard formula underestimates or overestimates the risk from their perspective, and thus seek to bring it into line with their risk appetite using reinsurance.

For example, the 40% mass lapse shock applies to individual business whether or not it has been historically exposed to high lapse rates and indeed regardless of the existence of incentives to lapse. It follows that **if the standard formula is deemed to apply even in such cases, then it is deemed that its scenarios adequately estimate the risk, and this assessment cannot then depend on the existence of a reinsurance solution**. If not, this would create a double standard of supervision where a different and higher supervisory regime applies to reinsurance users (who have to demonstrate that the standard formula continues to apply after each and every transaction) compared to non-users of reinsurance where the standard formula is simply assumed to apply. If the risk changes over time, the standard formula should and does capture this

through its periodic recalculation. We agree however that **for the ORSA, insurers should take a broader view and consider other risks beyond the strict definitions of the standard formula.**

There is a risk that EIOPA, in targeting the outcome that the standard formula never understates required capital at the level of each individual contract, will ensure that the standard formula capital calculation as a whole will systematically overstate required capital. Under the proposed approach, to the extent that risk transfer and SCR reduction could actually be measured and compared in a straightforward way for a standard formula company if risk transfer is below the reduction in SCR capital for a given reinsurance contract, then - such a contract would fail EIOPA's implied test.

Alternatively, EIOPA should recognise that the situation described above was anticipated and legislated for in the design of the Solvency II framework.

Insurance and reinsurance undertakings should analyse and assess the risk transferred by the risk mitigation techniques from a holistic perspective. This includes an analysis of the risk profile (not only focussing on the standard formula) of the undertaking, before and after the consideration of the risk mitigation techniques, with special attention to risks like underwriting risk, counterparty default risk, basis risk and concentration risk. This analysis should be integrated in the undertaking's overall solvency needs in the ORSA [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.

It is not clear what "prepared to evidence" in the text means. We question whether that should be understood as ad-hoc or as some time after being informed by regulators. To be clearer, it should be edited as "able to provide evidence regarding"

Any assessment required should be based on individual features of the reinsurance structure. If limitations of the standard formula lead to material under – or overestimation in the context of the assessment of the appropriateness of the standard formula for the risk profile of the undertaking as per Article 45 of the Directive, such errors **should be disclosed in the ORSA**.

It is not appropriate that undertakings assess the significance with which the risk profile of the undertaking deviates from the assumptions underlying the SCR in line with Article 45(1) of the Directive at the level of individual reinsurance arrangements. Otherwise, **this would create a higher supervisory burden to users of risk-mitigation instruments** than to non-users. **It should be specified that this is only necessary when that individual reinsurance arrangement is significant for the overall assessment of the risk profile deviation of the undertaking.**

In practice, the issue more commonly faced by companies tends to be how and where to recognise certain covers under Pillar 1 given the standard formula's limitations as identified by both reviews of Solvency II, not how and whether to assess it in the ORSA. We feel that this draft supervisory statement could go much further in identifying this as the fundamental issue.

14. Another aspect worth paying attention to is whether the complexity of the reinsurance contract might be hiding the absence of real risk transfer. For example, a simple quota share with a complex commission mechanism can actually conceal the economic reality of a loan. Another example is where a single contract combines two functions: the risk mitigation of a deviation of the best estimate and

a loan. These two functions can also be found separately in contracts in the market: a reinsurance of the risk of an adverse development and a loan. When the treatment of the two separate contracts on the balance sheet and on the capital requirements is different from the single combined contract, this indicates that a thorough risk analysis is needed.

The RAB notes that it is possible to structure contracts such that there is actually no risk transfer and we agree with the principle that there should not be capital relief where there is no risk transfer. However, these are more of a theoretical possibility seldom seen in the market. A "simple quota share with a complex commission mechanism" usually significantly transfers risk, depending on the exact mechanism.

Moreover, we see such contracts already covered by Article 208(2) of the Delegated Regulation. Article 208(2) of the Delegated Regulation could be adjusted in order to better reflect risk mitigating effect and capital relief.

We object to the notion that there is typically something to 'hide': we believe that in the overwhelming majority of cases **reinsurers and their clients are transparent to regulators.** Furthermore, the supervisor is entitled to ask the cedant each and every question about any reinsurance contract entered into by the cedant

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.

This does not refer to the companies own risk management system but to "Supervisory Involvement". As the supervisor can request this information anyway, **it might be redundant to include it in the respective section**, therefore it should be deleted.

Moreover, the language/tone is unhelpful here ie "reveal"/"fully-clarify", suggesting that companies are trying to hide something or there is something suspicious about reinsurance arrangements. Obviously, companies should not try to conceal anything from supervisors about their reinsurance arrangements and should be fully open with supervisors' requests.

SUPERVISORY INVOLVEMENT

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

As mentioned as a general comment there is no definition for "plain vanilla" / "sophisticated/complex".

The proposed categories "traditional" and "non-traditional" as also expressed in the examples **seems to be misleading**. "Non-traditional" cannot simply be defined by a certain type of cover or risk. In relevant cases,

there are certain features of a reinsurance contract that may reduce/limit the risk transfer rather than the fact the contract is attributable to one of the general categories (longevity, mass-lapse…) given here as examples.

Moreover, we agree that undertakings should have an open dialogue with their supervisor. **We disagree with the implied notion that new/ non-traditional reinsurance structures need a higher level of regulatory** scrutiny as the focus should be rather on complexity. Indeed, some new structures (for example a mass lapse cover) may be identical to existing structures but cover a different risk.

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

The text *"In this dialogue, supervisory authorities should be informed in a timely and comprehensive manner about plans, be satisfied on the approach taken and be kept informed in case of any material changes"*, should be deleted as it might suggest that the supervisory authority must be informed prior to binding the contract, which goes beyond the current requirements. This is notwithstanding the general principle of transparency between undertakings and their supervisor.

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

The wording here could create confusion for companies and supervisors. We struggle to understand how to interpret a "sophisticated/complex" RMT, how and when authorities should be informed in a "timely and comprehensive" manner, and what supervisory response is expected (eg some form of pre-approval). This could put barriers in place to the effective use of RMTs which could undermine good risk management (also in times of crisis when most needed).

See also our response to para 14 and 15

ANNEX: EXAMPLES

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

Highlighting specific structures in its statement while noting concerns but not proposing solutions, which by its form as an EIOPA statement encourages cedents to see these covers as suspicious and likely to be challenged by regulators, materially damaging or even eliminating the market for such covers amongst standard formula users.

The views expressed by EIOPA in the examples below are one-sided and could lead to an interpretation where there is no risk transfer, when generally there is risk transfer in each of such structures. More positive aspects and actual benefits could be highlighted in relation to these risk mitigation covers. For example, insurance companies get a better understanding of a risk or book in the process of writing the covers, by obtaining data and technical expertise from the reinsurers, etc.

We would encourage EIOPA to remove these examples from the statements.

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

Yes, and it would be important not to make any conclusion about a particular structure in isolation of its application in a specific transaction.

Example 1 - "Proportional Quota Share"

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

It is possible to structure QSs in ways described by EIOPA such that the capital relief may be overstated in view of the economics. In such cases a reduction of the capital relief may be appropriate. We note however that (a) the structure may be pursued for reasons other than capital; and (b) the failure of the standard formula to take into account non-proportional elements on the commissions of a proportional structure is a symptom of the larger issue of insufficient recognition of non-proportional reinsurance in the premium & reserve risk in the standard formula. From an economic perspective, the economic capital surcharge should have the effect of increasing the non-proportional adjustment factors for those companies that do not have this risk mitigation. In the case of a cover without risk transfer the increase in capital requirements through the adjustment factors would exactly compensate any relief in the premium measure. Indeed, the issues observed by EIOPA should not arise for life proportional covers, because the approach fully takes the non-proportional as well as the proportional elements of reinsurance into account.

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

Some contracts with sliding scale commission provide effective peak risk protection similar to more traditional XL/stop-loss solutions but with the key advantage of covering potential path dependencies to adverse loss scenarios events as they are structured as quota-share in the first place and are not bounded by a pre-defined list of loss scenarios. **In the way the standard formula is currently designed, this problem will not disappear within Pillar 1**.

If the variable commission affects only "good" scenarios, i.e. the minimum commission is sufficient to largely recover the cedant for its own related expenses net of related income, the reinsurer broadly follows the fortune of the cedant

In order to better reflect non-proportional reinsurance (or in this case, a non-proportional element of proportional reinsurance) the calculation of capital relief in the standard formula should be changed to better align capital relief with risk transfer.

For this reason, we proposed a simplified formula, which allows a partial solvency relief in the non-life standard module for reinsurance in our comments on EIOPA's opinion on the 2020 review of Solvency II, question 5.6.

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

Summary:
Typically, the aim of these reinsurance contracts is not solvency relief. Since there are usually no risk-limiting features included in such reinsurance contracts, **reinsurance contracts with a high fixed commission should be fully eligible in the non-life standard module**. However, if there are loss-limiting features, a more risk-adequate approach to the quantification of the extent of cover is of course more appropriate and should be addressed by changing the risk sensitivity of the standard formula to reinsurance. Absent this, the requirements in Solvency II provide safeguards that the Pillar 1 capital overall remains appropriate to the undertaking's risk profile as discussed in our responses to paragraphs 12 and 13.

In general, **a higher commission level not only implies an overestimated risk on the cedant's level, but also leads to a higher risk transfer level than a lower commission.**

Further comments:
The RAB is familiar with this type of reinsurance contracts, and contests that the commissions 'disguise' anything. Rather, they are part of an overall portfolio assessment of a client relationship or are motivated by the need to compensate the cedent for high expenses in this line for business. Typically, the aim of these reinsurance contracts is not solvency relief.
From a portfolio perspective, a reinsurer is often only in a position to write certain high-risk reinsurance contracts if reinsurance also includes less volatile business. 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. Since there are usually no risk-limiting features included in such reinsurance contracts, **reinsurance contracts with a high fixed**

commission should be fully eligible in the non-life standard module. However, if there are loss-limiting features, a more risk-adequate approach to the quantification of the extent of cover is of course more appropriate and should be addressed by changing the risk sensitivity of the standard formula to reinsurance. Absent this, the requirements in Solvency II provide safeguards that the Pillar 1 capital overall remains appropriate to the undertaking's risk profile as discussed in our responses to paragraphs 12 and 13.

From a commercial perspective, in many of these cases the risk premium of the primary insurer is the premium less commission as the commission mainly covers expenses/acquisition costs. So, the primary insurer might well overestimate the premium and reserve risk on a gross basis. This is partially offset by reinsurance. The reduction might be comparably high, but it actually reduces conservatism in the primary insurance SCR.

In general, a higher commission level not only implies an overestimated risk on the cedant's level, but also leads to a higher risk transfer level than a lower commission.

Example 2 - Mass lapse reinsurance

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

Whether a mass lapse cover is appealing or not will depend on the perceived remoteness of the 40%/70% shock given the underlying business. We agree that for some business with low lapse rates the shock is very remote and a cover that exits at the stress factor rate can be appealing. This suggests that the shock in the standard formula for that company represents a scenario more extreme than a 1-in-200-year loss. Assuming the standard formula has been deemed appropriate for an undertaking and the undertaking's capital requirements are being measured under the standard formula, then nothing should prevent an undertaking from reinsuring this risk and obtaining the capital relief. Indeed, one cannot simultaneously argue that capital should be held for lapse risk in the absence of reinsurance, but no capital relief can be granted if it is transferred. **If EIOPA has reasons to believe that the shock is consistently beyond the 1-in-200-year level across a wide range of companies and/or lines of business, it then follows that the shock is mis-calibrated and that EIOPA should propose to lower it.**

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

We broadly agree with EIOPA's analysis, but disagree that it can be said as a general rule that the hedging costs can be substantially lower than the implied capital relief benefits, as reinsurer and insurer will often disagree on what constitutes 'far out of the money' in the specific case. Whether 20% is a suitable attachment point will depend on the ceding companies' risk profile, i.e. whether the company is willing to retain

the risk until this point given the reinsurance premium will increase if the retention is lower. We note that this consideration is identical to that for Cat risk, where the price for higher layers is typically lower as these are less exposed. We believe these should be treated consistently.

24. The lapse risk is defined as the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level or volatility of the rates of policy lapses, terminations, renewals and surrenders. The standard formula capital requirement for this risk in all its manifestations is defined as the maximum of three lapse scenarios: a one-year mass lapse, a structural raise of lapse rates, and a structural decline of the rates. In many cases, the mass lapse scenario is dominant among these three scenarios. Lapse risk can e.g. also occur as multi-year raises of lapse rates, but such scenarios are not selected for the standard formula. For instance, multi-year increases of lapse rates are observed in cases of unemployment, interest rate movements, and 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.

Summary:
The standard formula already takes this issue into account as undertakings need to calculate their capital requirements on the basis of the larger of the three scenarios.

Under #22-23 it is expounded that **the lapse risk sub-module of the Solvency II standard formula can be challenged on an economic basis** since apparently another risk measure (e.g. a tail risk assessment) might be considered as more appropriate. However, neither EU law nor the currently ongoing Review of Solvency II consider changing this assessment.

If in addition to the standard formula requirements, a more detailed assessment of the so-called tail risk as well as an analysis of any multi-year impact is required at individual contract level, accompanied by the potential non-recognition of the contract, this implies a change to the standard formula framework.

However, from an economic point of view such a distinction of the measurement basis between the risk assumed by the undertaking and the risk ceded will lead to a misevaluation of the risks retained. It could further incentivize a selective risk management strategy in general and inhibit the undertakings possibility to efficiently manage a capital expensive risk. Moreover, from a legal point of view, such discrimination of certain risk mitigation techniques can be seen to be contradictory to the general objective and specific wording of the Solvency II Directive and also the legislator's intention as described in our responses to paragraphs 12 and 13.

Further comments:
The standard formula already takes this into account as undertakings need to calculate their capital requirements on the basis of the larger of the three. Should an undertaking's mass lapse risk drop below the trend lapse risk, then the trend lapse risk becomes the relevant risk as per the existing formula: this is fully in line with the definition of lapse risk in the standard formula.

Under #22-23 it is expounded that **the lapse risk sub-module of the Solvency II standard formula can be challenged on an economic basis:**

- The value at risk approach, leading to a mass lapse stress of 40%, that is inherent in Solvency II may not be appropriate since the probability of a less severe stress (of e.g. 20%) is much more probable than a 40% shock. Therefore, for risk mitigation solutions with an attachment point at 20% it should be assessed whether this is suitable in view of the transfer of substantial tail risk.
- Multi-year lapse effects may not be measured appropriately by the lapse risk-submodule. But given SII's 12-month forward-looking view, on this basis a lapse risk mitigation with a 12-month focus cannot be challenged. What is apparently not mentioned in # 23 is that the so-called "lapse-up scenario" exactly provides such an assessment of the multi-year effects.

In view of the arguments provided, one should consider that the European Legislator decided – after extensive discussion – to use the Value-at-Risk approach with a 12 month time horizon to measure the capital requirement (Article 101 (3) of the Directive), both in the standard formula and for internal models. Based on this the mass lapse scenario has been calibrated at a one-year shock of 40%. In economic terms this form of risk assessment might be challenged, since apparently another risk measure (e.g. a tail risk assessment) might be considered as more appropriate. However, neither EU law nor the currently ongoing Review of Solvency II consider changing this assessment. While there may be issues with multi-year mass lapse that can be properly taken into account in the ORSA, there is no legal basis to use such arguments as impediments for undertakings' ability to recognise capital relief for a 12-month mass lapse cover. Again, the treatment between mass lapse and CAT is instructive: while the same dynamics apply, we are not aware that EIOPA or supervisors have made this argument about CAT risks in the past.

The Regulation moreover specifies that risk mitigating techniques need to be reflected when determining the Solvency Capital Requirement using the same Value-at-Risk approach (Article 101 (5) of the Directive and Article 83 (4)) of the Delegated Act) and – in terms of timing – need to cover any point in time in the following 12 months (Article 101 (3) of the Delegated Regulation).

Lapse risk mitigation is typically provided by reinsurers in the 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, e.g. at a mass lapse event of 20%, during a 12-month period. Therefore, the impact of the critical Value-at-Risk scenario taking the offsetting effect of the risk mitigation technique into account limits the loss of own funds for a mass lapse event up to the retention level.
The wording of # 22 and 23 suggest that a transfer of part of the risk referenced within the standard formula may not be a suitable transfer of risk

The concern raised appears to be that the standard formula shock based on a VaR assessment of 99.5% or the calibration of that shock at 40% as not appropriate, since the risk beyond a 20% shock is considered to be remote. If this is the case, either the calibration of the mass lapse shock is to be adjusted to provide a better risk measurement, or the VaR approach, provided by the Directive, is seen as inappropriate for defining the SCR. If in addition to the standard formula requirements, a more detailed assessment of the so-called tail risk as well as an analysis of any multi-year impact is required at individual contract level, accompanied by the potential non-recognition of the contract, this implies a change to the standard formula framework.
However, from an economic point of view such a distinction of the measurement basis between the risk assumed by the undertaking and the risk ceded will lead to a misevaluation of the risks retained. It could further incentivize a selective risk management strategy in general and inhibit the undertakings possibility to efficiently manage a capital expensive risk. Moreover, from a legal point of view, such discrimination of certain risk mitigation techniques can be seen to be contradictory to the general objective and specific wording of the Solvency II Directive and also the legislator's intention as described in our responses to paragraphs 12 and 13.

25. According to the Solvency II framework the expected profits included in future premiums (EPIFP), stemming from a book of policies are recognised, through the calculation of the best estimate liabilities, in the Solvency II balance sheet as long as they are within the contract boundary of the insurance obligation for business in force. Consequently, EPIFP stemming from a book of annually renewable group policies covering, for instance, death is 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.**

Summary:

The contract boundaries with upfront commission from the reinsurer provide effective peak risk protection similar to more traditional XL/stop-loss solutions but with the key advantage of covering potential path dependencies to adverse loss scenarios events as they are structured as a quota-share in the first place and are not bounded by a pre-defined list of loss scenarios.

In our view, **this type of contract always includes adequate risk transfer and hence should not be challenged neither economically nor from a regulatory point of view:**

- **Economic assessment**: The reinsurer has either made an upfront payment or is obliged to pay the cedent an annual amount in exchange for assuming the annual risk and reward from the underlying portfolio. For providing that guarantee, the reinsurer requires a compensation.
- **Solvency assessment**: By construction, the undertaking will recognize a reinsurance recoverable based on Article 41 of the Delegated Regulation reflecting the agreed payments the reinsurer is obliged to provide. Moreover, Article 105 (3f) specifies that, amongst others the risk of loss from changes in the level renewal is to be measured in the life underwriting risk module. It is exactly the "renewal risk" beyond the contract boundary that is – beside other risk, for example lapse risk and to certain extent also biometric risks – transferred under the reinsurance treaties discussed here.

In IFRS17, the same situation arose initially, but at a later stage the economic reality has been recognised. **When the insurer receives a payment from the reinsurer then in our view it could be recognised as own funds under Solvency II.**

Further comments:

The contract boundaries with upfront commission from the reinsurer provide effective peak risk protection similar to more traditional XL/stop-loss solutions but with the key advantage of covering potential path dependencies to adverse loss scenarios events as they are structured as a quota-share in the first place and are not bounded by a pre-defined list of loss scenarios.

Reinsurance contracts in question get particular attention in view of the contract boundaries defined under Solvency II, since the reinsurer's payment obligation is due irrespective of any contract boundary of the underlying portfolio. Under # 24 this form of reinsurance is challenged since the undertaking is not only long-

term immunized by the reinsurer but can also recognize a reinsurance recoverable referring to EPIFP beyond the contract boundary.

In our view, **this type of contract always includes adequate risk transfer and hence should not be challenged neither economically nor from a regulatory point of view:**

- **Economic assessment**: The reinsurer has either made an upfront payment or is obliged to pay the cedent an annual amount in exchange for assuming the annual risk and reward from the underlying portfolio. This is a valuable guarantee that should be recognized accordingly. Especially lapse risks but also to some extent further biometric risks are transferred effectively. For providing that guarantee, the reinsurer requires a compensation. However, by construction of any treaty of this form, that compensation will never exceed the net income the undertaking can recognize from the underlying portfolio under best estimate assumptions.
- **Solvency assessment**: By construction, the undertaking will recognize a reinsurance recoverable based on Article 41 of the Delegated Regulation reflecting the agreed payments the reinsurer is obliged to provide. This can have a positive impact on the company's own funds. Since the reward the reinsurer expects refers to business that is not yet recognized, it would be misleading (and not in accordance with Delegated Regulation) if these payments would be required to be taken into account here as well. In # 24 it is argued that such a contract would not cover underwriting risk which is not correct: Article 105 (3f) specifies that, amongst others the risk of loss from changes in the level renewal is to be measured in the life underwriting risk module. It is exactly the "renewal risk" beyond the contract boundary that is – beside other risk, for example lapse risk and to certain extent also biometric risks – transferred under the reinsurance treaties discussed here.
    - Insurance/biometric risk versus commercial/business risk: The argument made under #24 indicate that EIOPA seems to distinguish such different forms of risk. We would like to remark that "insurance risk" and "biometric risk" are not well-defined terms in the Solvency regulation, but rather traditional intuitive notions which allow for a wide range of interpretation. As such deals are typically structured on the basis of a quota share, underwriting risks are typically transferred in proportion to the cession. Note that lapse risk is part of the life underwriting risk module and is typically transferred to the reinsurer with such structures, because having paid an upfront commission, it is the reinsurer that loses out on future profits. It is unclear what other "insurance risk" EIOPA has in mind. Moreover, Article 13 (7) of the Derivative defines "reinsurance" in general as the activity of "accepting risks ceded by an insurance undertaking. To our understanding, this definition clearly allows the transfer of any form of "commercial" or "business" risk as well.
- **Traditional VIF financings**: In order to avoid misunderstandings, it should be clear that covers involving a repayable commission will have no capital impact under Solvency II. To the extent the reinsurer is compensated by proceedings from in-force business (within the contract boundary) a liability against the reinsurer is established that should offset the EPIFP. In the past, the non-recognition of that liability in Solvency I accounts sometimes gave reason for disputes with regulators where a reinsurance asset (or income) was recognized ignoring future outflows to the reinsurer. Since Solvency II requires to take into account all cash-flows within the contract boundary, such an arbitrage is excluded by the very concept. This is in contrast to VIF monetisation where the reinsurer is not compensated, where there is typically significant risk transfer and consequent capital relief.
    - We would also like to mention that there is an opposite effect in non-proportional reinsurance with fixed minimum premiums. In this case, the undertaking must recognise own funds reducing obligations immediately without recording future recoverables.

This is, for example, the case if a reinsurance contract provides coverage for policies signed at a future date (eg reinsurance contracts on risk attaching basis), ie only recoverables that relate to existing policies signed can be included in the Solvency II balance sheet of an undertaking. However, all future premiums payable to a reinsurer (eg future instalments of minimum premiums or other fixed premiums payable) have to be recorded at the moment and to the amount to which the undertaking is contractually committed under the reinsurance contract.

In IFRS17, the same situation arose initially, but at a later stage the economic reality has been recognised. **When the insurer receives a payment from the reinsurer then in our view it could be recognised as own funds under Solvency II.**

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

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

We assume EIOPA is referring to an Adverse Development Cover (ADC) that is attaching above the best estimate being sold in combination with a Loss Portfolio Transfer (LPT). This is a usual method to create some upside to the reinsurer beyond a flat premium for the ADC.

For this example, we also understand the situation regards the treatment of a Loss Portfolio Transfer (LPT) as QS A that provides for a loss corridor above or slightly above the reinsured best estimate reserves with a non-proportional element simultaneously in place. We note this is not a good example of a bifurcated cover, as typically undertakings wish to transfer the timing (LPT) as well as the adverse development (ADC) risks. Although it is theoretically possible to have either without the other, this does not often happen in practice and in any case under the correct treatment it should not make a difference whether the contracts are considered together or separately as we shall see. This should be addressed by changing the risk sensitivity of the standard formula to reinsurance. Absent this, the requirements in Solvency II provide safeguards that the Pillar 1 capital overall remains appropriate to the undertaking's risk profile as discussed in our responses to paragraphs 12 and 13

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

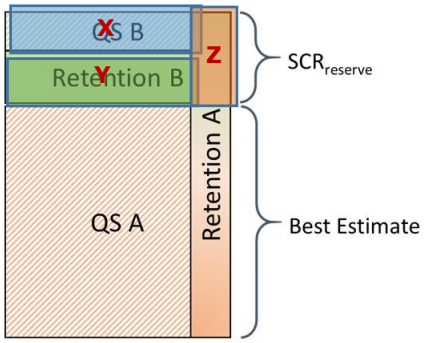

Figure 1 Illustration of an Adverse Development Cover where "QS B" mitigates reserve risk and "QS A" generates recoverables and thus considerably reduces the capital requirement for reserve risk

Because the situation as illustrated cannot be recognised in the standard formula as it stands, the RAB has proposed a methodology for the recognition for ADCs based on changing the adjustment factors. We trust that our proposal solves the issues highlighted by EIOPA. This would then result in an upper layer that transfers real (adverse development) risk and comes with SCR relief.

Given EIOPA's illustration below we believe EIOPA would agree that in this case, from an economic perspective, the appropriate economic treatment would be where the adjustment factor for non-proportional reinsurance NPadj = X/(Y+Z) – where X is the reinsured layer net of the proportional retention, Y is the retained layer net of the proportional retention, and Z is the proportional retention. We believe that, if the LPT "QS A" is indeed limited to the Best Estimate, it is inappropriate to recognise the effect of the cover in the volume measure, as where there is a retention layer Y > 0, simply reflecting the cover in the volume measure by multiplying with proportional retention Z would indeed overestimate the risk transfer. (We remind that if QS A has no upper limit, or its limit exceeds BE + SCR reserve, then it would be correct to apply it directly to the volume measure.) We note however that in the case where the area Y = 0 (i.e. there is no retentive layer above best estimate), reflecting the cover in the volume measure would lead to exactly the same outcome. Since to our knowledge most ADCs attach at or near the money, we doubt that doing this would make much of a difference in practice, even if it is "unclean" from an economic perspective.

We further note that it cannot be stated based on the example as given that 'the reduction in the SCR can be materially greater than the risk mitigation measure of the arrangement', as in our experience, in the status quo, the lack of capital relief for ADCs means that there will be **no reduction in the SCR**, despite there being risk transfer. The problem is then typically the opposite of the situation described by EIOPA. Trying to recognise the capital relief of the ADC in the LPT instead would not be possible or economically correct in the current design of the standard formula, but we appreciate that in reality supervisors may encourage companies to do so to arrive at an economically equivalent outcome.

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

As highlighted by EIOPA **these can be very useful and important structures for undertakings**. We understand that EIOPA's assessment implies that the capital relief under the standard formula is underestimated

for such covers as the market and credit SCR stresses are applied in turn rather than simultaneously. If so, we agree, and this is another reminder of the previously-mentioned point on the need to improve the treatment of non-proportional reinsurance under the standard formula, even for life. We agree that the counterparty risks and concentration risks can increase significantly but see no concern with the existing standard formula treatment of both risks. We do not see an inherent increase in basis risk – indeed arguably basis risk is minimal in a stop loss compared to other covers as typically such covers pay when triggered regardless of the ultimate reason that led to them being triggered, and so encompass a wider universe of risks than the standard formula.

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

Typically, this is the case.

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

EIOPA is correct that a full joint distribution would be necessary to calculate the impact in a precise manner. This is because the standard formula actually underestimates the capital relief, as the scenarios are applied independently (whether in the premium & reserve risk submodule or the L&H UW submodules), rather than simultaneously. In fact, it is conceivable that a stop loss cover might not provide any capital relief under the standard formula – if it would not be triggered by any specific scenario – while at the same time providing extensive risk transfer if non-linear effects were considered. Such effects are taken into account in reinsurance pricing. The assessment of the standard formula for risk profile can identify this issue, and the other Pillar 1 solutions to address this can be implemented as noted in response to Q12 and Q13. Otherwise the standard formula could be made more risk sensitive by an adjustment outside the submodules, such as what is done for LAC TP. We would be happy to engage further with EIOPA to address such consistent underestimation.

Example 5 - Multi-year stop-loss

31. Furthermore, for such treaties the possible impact on SCR calculations can be very material such that counterparty and basis risks can increase significantly. To cover such risks, an appropriate 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.

It is not clear why this solution would need to be collateralised as counterparty credit risk is appropriately taken into account in the standard formula. If collateralised, not clear why short-term assets should be used given the potential multi-year nature of the treaty. Whether there are basis risks depends on the

particular case, however since the standard formula typically underestimates any capital relief that might be granted, this should not be an issue in practice.

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

It's not clear why a concentration risk would arise, if counterparty credit risk is appropriately allowed for and/or if the deal is collateralised. We remind that counterparty credit risk already takes the number of reinsurers into account.
Solvency II explicitly deals with concentration risk. Any discussion of this risk should be considered in the context of these Solvency II provisions. In our view **there is no need to set new rules here**

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

Both the national supervisors and the national tax authority set rules on intragroup transactions (such as reinsurance) within an insurance group. An internal insurance company paying a non-economic reinsurance premium to the internal reinsurer and/or terms and conditions in the reinsurance contract that are not being set at arms-length, will not be accepted in daily practice as prices for a wide range of comparable external reinsurance structures are available in the market. **In our view there is no need to set additional (new) rules here since the risk of inaccuracies, both in price and balance-sheet valuation, are very limited.**

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

Summary:
Intragroup reinsurance is an indispensable tool for an effective group-wide risk management. In this context we highlight the following **positive aspects**:

- **Diversification**: equalising the risk over portfolios represents 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. Putting regulatory constraints on this will increase the cost of bearing the risk locally.
- **Capital management**: reinsurance is an efficient capital management tool. In our view any limitation on the use of reinsurance for capital management purposes (as long as risk mitigation satisfies the criteria provided in Article 209f of the Delegated Regulation) would violate the principles of a European Single Market.

Institutions must already have risk management processes in place for intra-group agreements and positions to safeguard controlled and ethical operations. The group's policy is laid down in strategies, procedures and measures to control relevant risks and it must be integrated into the insurance group's business processes and procedures. Therefore, in our view **there is no need to set additional (new) rules here.**

Further comments:

Intragroup reinsurance is an indispensable tool for an effective group-wide risk management. In this context we highlight the following **positive aspects**:

- **Diversification**: within an insurance group, different entities 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 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.
- **Capital management**: reinsurance is an efficient capital management tool. Instead of supporting a subsidiary with additional own funds a reduction of its capital requirements by transferring risk within the group can be much more efficient in view of timing and of legal constraints regarding capital injections (and potential withdrawals). In our view any limitation on the use of reinsurance for capital management purposes (as long as risk mitigation satisfies the criteria provided in Article 209ff of the Delegated Regulation) would violate the principles of a European Single Market.

National supervisors are supervising intragroup relationships in insurance groups or financial conglomerates as part of their group supervision activities pursuant to the relevant articles in the Solvency II Directive and the Financial Conglomerates Directive. and in view of the risks that intra-group agreements and positions may pose to solvency and resolvability, **institutions must already have risk management processes in place for intra-group agreements and positions to safeguard controlled and ethical operations.** The group's policy is laid down in strategies, procedures and measures to control relevant risks and it must be integrated into the insurance group's business processes and procedures. Therefore, **in our view there is no need to set additional (new) rules here.**