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Consultation Paper on EIOPA's Supervisory Statement on the use of risk mitigation techniques by insurance and reinsurance undertakings

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INTRODUCTION

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.

1800 character(s) maximum

The AAE welcomes the opportunity to comment on the consultation and is grateful that EIOPA takes up this important topic. The potential unjustified recognition of risk mitigation leads to a lack of policyholder protection, while the unjustified lack of recognition of effective risk mitigation potentially costs hundreds of millions of Euros per year spent to finance unnecessary capital to the detriment of customers and businesses in the European Economic Area This is at odds with the well-being of society.
EIOPA should encourage and support the Commission to ensure that the standard formula appropriately recognises a wide range of existing effective risk mitigation techniques, i.e. ensure that the standard formula remains adequate in the presence of such mitigations. Moreover, the regular review process in SII should be used, inter alia, to ensure that the standard formula recognises newly developed effective risk mitigation techniques.
Finally, AAE feels that the examples in the appendix are biased, at least the assessment is. We would be delighted to contribute, potentially in collaboration with other stakeholders, to the development of a more appropriate set of examples.

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.

1800 character(s) maximum

n/a

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.

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We observe a broad variety of local market conditions and environments. Ensuring a level playing field for all market participants within the scope of Solvency II is a very important and highly valued objective of the regulatory framework. In this regard, the current regulation provides already sufficient guidance to prevent an unlevel playing field concerning risk mitigation techniques.
Especially the requirements relating to ORSA and the SCR calculation provide effective tools to treat the issues addressed by EIOPA in the consultation paper.

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.

1800 character(s) maximum

n/a

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 it’s 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.

1800 character(s) maximum

Solvency II requires entities to have a Risk Management Policy which will cover (amongst other items) the risk of risk mitigation techniques used.
Moreover, the wording of statement 5 fails recognise the economic importance of effective risk mitigation techniques: it is not only a means to address a lack of ability or capacity, but it is a means to produce the appropriate level of policy holder protection cost efficiently.

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.

1800 character(s) maximum

We agree, that capital relief has to be accompanied by a real risk reduction.
However, we point out that the design of the standard formula does not follow this principle very strictly. There are counterexamples, such as the 80% adjustment factors for premium risk in the standard formula, which apply even in the absence of any risk transfer or indeed of any reinsurance at all.
Also “complexity” and “new” as indicators can be challenged, as some new solutions are not complex at all or older solutions might be seen to be complex but are standard in the mean-time.
Therefore, the effective risk transfer and corresponding the SCR relief for such solutions need to be assessed on a case by case basis taking into account both the reinsurance policy and the ORSA of the undertaking.

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.

1800 character(s) maximum

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 longevity and mass lapse risk) are not really conceptually new structures but are rather existing structures adapted to other risks. The importance of risk mitigation techniques such as reinsurance 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 in any way to prevent innovation in the insurance market.

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

1800 character(s) maximum

n/a

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.

1800 character(s) maximum

The standard formula from our point of view already adequately reflects counterparty default and concentration risk for reinsurance contracts. Hence, no change in the regulation required.

Especially with respect to the concept of basis risk it is important to note that there is a considerable lack of clarity in the definition of material basis risk. This could be misunderstood and lead to a non-recognition of any non-proportional reinsurance cover, since they typically also include elements such as limits and retentions. If such standard elements of reinsurance is likely not to be recognised as risk mitigation effect, this would substantially limit insurer's ability to mitigate risk in an effective manner. As a consequence this may increase the total risk exposure of insurance.

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.

1800 character(s) maximum

We agree that the risk mitigation techniques used have to be applied with adequate precision both regarding the covered risks and the volume of the cover. Undertakings are required to assess the appropriateness of the standard formula in their ORSA. If NSAs conclude the assessment to be inadequate a direct contact with the undertaking is possible.

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.

1800 character(s) maximum

n/a

BALANCED APPROACH

12. It is important to consider the purpose of the intended risk transfer transaction. In principle, risk mitigation techniques reduces 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.

1800 character(s) maximum

We agree with the intention to achieve a proper balance between the risk reduction and the capital relief. However, we believe this is already extensively considered by undertakings, as required by Article 210 (1) of

the Delegated Act.
'The contractual arrangements governing the risk-mitigation technique shall ensure that the extent of the cover provided by the risk-mitigation technique and the transfer of risk is clearly defined and incontrovertible.'
Sufficiency of risk transfer must be considered as part of the IFRS classification or for some local GAAP which is an important additional control in place. Convergence of these requirements might be considered as an objective. The Independent Audit process also act as a check on the sufficiency of risk transfer.
Transactions which achieve a proper balance of risk reduction and capital relief should be taken into account within the SCR.
The huge variety of possible solutions can impede an easy assessment. As a principle based regulation the Solvency II framework provides already measures to adequately assess the full scope of the reinsurance cover also in this regard. Governance requirements and the ORSA should make sure that risk mitigation and risk transfer are balanced. A regulation should not prevent insurers from choosing flexible solutions but should hold the options open to adequately deal with new or adverse developments and risks.

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

[1] Article 48(1)(h) of the Solvency II Directive and Article 272(7) of the Delegated Reguation

1800 character(s) maximum

The actuarial function is responsible for expressing an opinion on the adequacy of reinsurance arrangement (art. 272 (7) DR). This would be expected to include also comments on the adequacy of such arrangements and the impact on the SCR. Where reinsurance is a material issue for an entity, this can give the Board comfort over the approach adopted. Where a material new transaction is undertaken or non-standard or new reinsurance structure is being put in place, particularly one where there is a question over the balance between risk reduction and capital relief, the Board will often look to the Actuarial Function to provide an actuarial perspective on the techniques adopted.

In the event that a firm were to enter into a new complex reinsurance transaction it would be standard practice for the Actuarial Function to call out that transaction within their Actuarial Opinion unless the expected impact is immaterial.

While the Actuarial Function has an important role to play here, the Board of the undertaking should ensure the reinsurance governance process includes sufficient analysis of new arrangements that they are not entirely reliant on an annual opinion from the Actuarial Function (often submitted at the same time as year-end results are submitted for approval) to identify issues with the risk mitigating techniques employed. In a lot of cases, this will be more of a detective than a preventative control, and while it is important, it only works in the context of a robust overall governance process.

RISK MANAGEMENT SYSTEM

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).

1800 character(s) maximum

Reinsurance can help to protect the interest of the policy holder by effectively sharing risks among the (re) insurance industry. Undertakings have to reflect adequately the effects resulting from their perhaps complex protections. Within the standard formula this might not always be straightforward. The standard formula necessarily is a simplification of a complex reality. There may be areas where it might not be appropriate, and assessment and quantification as part of the ORSA would be sensible.
The adequacy of the underlying assumptions has to be assessed regularly as part of the ORSA. This includes reinsurance and the risk mitigation provided by the reinsurance contracts. Some reinsurance arrangements can contain non-trivial features which would require would require a robust validation process including various scenarios.
However:
1. The principles of materiality and proportionality need to be considered including if:
a. the block of business covered or reinsurance transaction is not expected to be material in terms of overall impact on the SCR
b. similar transactions have been in place in past so impacts are relatively well known
c. the level of consideration of the appropriateness of the standard formula required will depend a lot on the complexity and uniqueness of the transaction. The use of a (partial) internal model should not be required if the adequacy of the standard formula is already justified by the undertaking, e.g. in the ORSA.

2. It is likely that in the event of a significant reinsurance transaction is being considered by an undertaking then extensive discussions / reviews will be carried out by the undertaking itself, its Independent Auditors and where appropriate, perhaps even by the relevant supervisory authority.

Insurance and reinsurance undertakings should analyse and assess the risk transfered by the risk mitigation techniques from a holistic perspective. This includes an analysis of the risk profile (not only focussing on the standard formula) of the undertaking, before and after the consideration of the risk mitigation techniques, with special attention to risks like underwriting risk, counterparty default risk, basis risk and concentration risk. This analysis should be integrated in the undertaking's overall solvency needs in the ORSA[1]. Undertakings should be prepared to evidence the adequacy of the standard formula to its risk profile after the risk transfer when challenged by supervisory authorities.

[1] IAIS ICP13.2.2 states: "The ceding insurer should ensure that the characteristics of its reinsurance programme, including the credit risk posed by the reinsurer, are reflected in its capital adequacy assessment as well as its ORSA"

1800 character(s) maximum

We agree that undertakings should integrate the consideration of any significant reinsurance transaction within their overall solvency needs within the ORSA and be able to evidence their consideration of these

items. However, again the principles of proportionality and materiality are key. These considerations are already likely to be extensively considered within the actuarial opinion on technical provisions as well as the ORSA (especially for any new or complex transactions).

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

1800 character(s) maximum

The focus is on the risk transfer. Thus we acknowledge the concern of the supervisor to exclude contracts which do not contribute to this purpose. A thorough analysis considering all aspects of a contract already included in existing instruments like ORSA or the statement of the actuarial function is necessary. In case of quota share with unexpected high commissions (as indicated infra in point 21), it would be more appropriate to apply the proportional factor to the reinsurance premium net of commissions.

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.

1800 character(s) maximum

Subject to proportionality and materiality considerations we agree. If there is a risk mitigation resulting from reinsurance contracts, the relevant aspects of these contracts should be disclosed to supervisor. In addition to counterparty default risk, concentration risk should be considered appropriately.

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.

1800 character(s) maximum

The proposed categories “traditional” and “non-traditional” (also expressed in the examples) are misleading and are not in line with the principles based nature of Solvency II.

EIOPA’s expectation that the non-traditional risk transfer transactions will need more attention than ‘plain vanilla’ reinsurance contracts implies that plain vanilla reinsurance contracts are less risky. It seems there is a bias towards plain vanilla reinsurance contracts which could be dangerous. These contracts can be a lot

more risky to reinsurers and less effective for insurers than more flexible solutions. A distinction is made between complex and plain vanilla. It is unclear what aspects splits these two categories;

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.

1800 character(s) maximum

If there is uncertainty regarding the interpretation of the existing regulation with respect to a possible reinsurance solution both the insurer and the reinsurer will be naturally inclined to discuss the possible construction with their NSA. In these cases, the NSAs should be able to individually understand and assess the possible solution in a binding and appropriately timed manner. An ex ante exclusion of certain risk mitigating techniques or imposing further requirements is not consistent with the principle based approach of Solvency II.

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.

1800 character(s) maximum

These examples should not be seen as basis for the derivation of additional rules to be implemented. Instead, they might inform local supervisors to lead ongoing discussions with insurance companies about the implementation of such risk transfer solutions.

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

1800 character(s) maximum

Structured appropriately the example transactions listed can achieve a good balance of risk reduction and capital relief. The inclusion of these specific examples might suggest to companies or regulators that EIOPA has a negative view on the use of such transactions in terms of whether they can achieve a risk reduction that can be considered within the SCR. EIOPA should ensure that listing them as examples does not discourage firms from considering these options in the cases when they provide additional policyholder protection.

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.

[1] Article 116(5)(a) of the Delegated Regulation
[2] Commission is a payment from the reinsurance undertaking to the cedent to compensate for acquisition cost, administrative costs and other costs. Sometimes the commission is also used to let the cedent share in the profit the reinsurance undertaking earns.

1800 character(s) maximum

1a with deep sliding scale commissions[5]

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.

[5] Commissions can be executed in a sliding scale manner, where the profit sharing / commission increases and decreases based on the result of the ceded portfolio.

1800 character(s) maximum

Firstly, the height of a commission does not affect the risk transfer as the proportion of quota share will remain the same and the claims will be ceded following this proportion. Thus the height of the commission is not related to a higher risk retained.
Secondly, we agree that the standard formula could result in an overstating of the SCR requirement.
It may be useful to consider how some of these issues being considered for IFRS17. A discussion paper is here:
https://www.ifrs.org/-/media/feature/meetings/2018/september/trg-insurance/ap03.pdf

1b high overriding commissions

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.

1800 character(s) maximum

It could be more appropriate to apply the proportional factor to the reinsurance premium net of commissions.

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).

1800 character(s) maximum

n/a

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 an suitable value when a substantial tail risk is to be transferred.

1800 character(s) maximum

Is EIOPA intending to imply that using an attachment point other than 20% would not be sufficient from their perspective? It may not be realistic to suggest that this would hold true for all types of contracts, blocks of business. Specifically, for a block of business of a different average duration or profile of customers or during a different economic scenario a higher attachment point might achieve significant risk reduction.

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.

1800 character(s) maximum

As far as we understand the structural raise of lapse rates by 50% is intended to capture a multi-year (actually permanent) increase in lapse rates. If there were different stress scenarios for lapse in the standard formula reinsurance cover regarding lapse may or may not apply. To us this does not contradict risk mitigation regarding a sudden increase – potentially beyond any empirical evidence – in lapse rates. Firstly, lapse risks as other insurance risks can be effectively transferred via reinsurance. Generally classifying lapse risk transfers as problematic does not adequately reflect the nature of such covers. Secondly, to adequately assess such solutions, we agree that an analysis within the ORSA is adequate and no further measures are needed.

The described multi-year impact on lapse rates could also be included in e.g. a lapse up shock. The mass lapse scenario (e.g. like a bank run) is also given the size more expected to occur over a shorter timeframe than the suggested 4 years. It is unclear from the example what the demarcation should be between lapse

up and mass lapse.

Furthermore, if a parallel is sought between what the memo suggests are more ‘plain vanilla’ reinsurance structures it is unclear what the intention is. In case of Non-life Catastrophe risk the cedent sets its own risk appetite, e.g. at 25 retention. If in four consecutive years a windstorm occurs with losses of 15, we doubt that this could suggest that the non-proportional reinsurance is ineffective and no capital relief is allowed anymore.

Example 3 - "Contract boundary reinsurance"

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 are recognised only for the period until the next renewal date in the Solvency II balance sheet because the profits beyond the renewal are outside the contract boundary (i.e. one year). It is possible to structure a reinsurance contract that allows undertakings to monetise a portion of the future profits not recognised in EPIFP due to contract boundary restrictions which covers mortality and lapse risks. One could question whether such a contract does actually cover insurance/biometric risks or rather covers commercial/business risks (i.e. the risk not to renew the contracts) that would impact only the solvency position. Reinsurance contracts with similar effects are known under the name of VIF securitisation /monetization.

1800 character(s) maximum

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

A risk transfer in such covers is often evident. The reinsurer has either made an upfront payment or is obliged to pay the cedent annually an amount in exchange for assuming the annual risk and reward from the underlying portfolio. Especially lapse risks but also to some extent further biometric risks are transferred effectively. Generally an individual risk transfer test is carried out and could be supplied to the NSAs upon request if the NSA is concerned about too little insurance/biometric risk transfer.

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.

1800 character(s) maximum

n/a

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.

1800 character(s) maximum

n/a

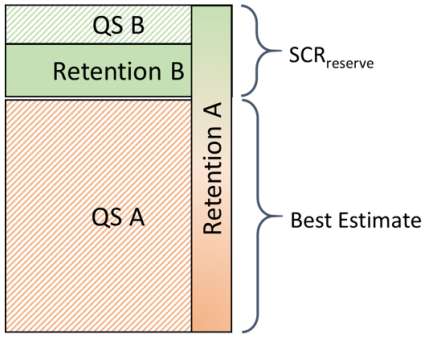

Figure 1 Illustration of an Adverse Development Cover where "QS B" mitigates reserve risk and "QS A" generates recoverables and thus considerably reduces the capital requirement for reserve risk

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.

1800 character(s) maximum

n/a

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.

1800 character(s) maximum

n/a

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.

1800 character(s) maximum

n/a

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.

1800 character(s) maximum

We also understand that this example makes use of the fact that the economic effect of reinsurance is non-linear in the change of the underlying risk factor. As this is, however, a crucial assumption in the standard formula, a more detailed analysis in the ORSA is recommended.
If the risk mitigating effect of the reinsurance is considered for each sensitivity of the standard formula then clearly we have double counting, which is not in line with the delegated act.

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

1800 character(s) maximum

n/a

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

1800 character(s) maximum

An adequate representation of risk mitigation techniques in intragroup transactions is very relevant. Special structures of groups together with possible interdependencies might require a deeper analysis, however, similar principles should be applied and also arm's length principles might need to be considered.

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

1800 character(s) maximum

The same principles should apply as to external reinsurance transaction but also ensuring that the transaction is at arm's length.

Contact

Contact Form