IRSG

INSURANCE AND REINSURANCE STAKEHOLDER GROUP

Response to EIOPA Consultation Paper

EIOPA-BoS-26/068 – Annex to Opinion on the Use of Risk Mitigation Techniques: Proportional Reinsurance with Features Reducing Commensurateness

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European Insurance and Occupational Pensions Authority

INTRODUCTION

The Insurance and Reinsurance Stakeholder Group (IRSG) commends EIOPA for its efforts to further develop the regulatory framework for risk-mitigation techniques, with a particular focus on proportional reinsurance. We broadly support the objectives of this Annex. Ensuring that the SCR relief granted for reinsurance arrangements is commensurate with the risks transferred is a legitimate and important supervisory objective. Our comments are intended to support the practical effectiveness and technical precision of the guidance.

We want to especially draw attention to a very relevant aspect: EIOPA's current wording 'if commensurateness is jeopardised, the risk-mitigating effect of the reinsurance treaty should not be recognised in the Standard Formula' could lead to an overly binary treatment of reinsurance treaties: either full recognition or no recognition of their risk-mitigating effect in the Standard Formula. The IRSG notes that even treaties with features reducing commensurateness may still transfer meaningful risk. A complete non-recognition could therefore be too conservative and may lead to over-capitalisation, which would not be fully aligned with Solvency II's objective of encouraging effective risk mitigation.

SECTION 3: PROPORTIONAL REINSURANCE WITH FEATURES REDUCING COMMENSURATENESS

Q1. PLEASE PROVIDE ANY GENERAL COMMENTS ON SECTION 3 OF THE ANNEX ON PROPORTIONAL REINSURANCE WITH FEATURES REDUCING COMMENSURATENESS.

We agree that the features addressed — variable commissions, loss corridors, and loss limits — can have a relevant effect on the effective risk transfer of a proportional reinsurance arrangement. We have realized in our discussions, though, that the usage of the terminology "risk transfer" in the Consultation causes confusion among readers. Distinguishing clearly between "actually ceded risks transferred" and "assessments of risk transfer under certain test scenarios" could help reduce misunderstandings.

We note that such contractual features are common in the European market, particularly for smaller or less strongly capitalised undertakings. Reinsurers may use them to manage their own exposure, create appropriate incentives for the cedant, align the interests of cedant and reinsurer, and make the reinsurance solution viable. In contrast, an overly restrictive treatment in the Standard Formula of features such as loss caps and sliding scale commissions could cause unintended consequences for the availability or cost of proportional reinsurance. It could even incentivise a shift toward non-proportional structures, move risk outside the regulated reinsurance market or limit the effectiveness of risk management actions of the undertakings. Such outcomes would run against the micro and macro prudential objectives of Solvency II to promote a strong risk management culture, and enhance diversification, resilience, and financial stability. We therefore support the Annex's principle-based approach and its recognition that these features require case-by-case scrutiny rather than a general prohibition.

We would also draw EIOPA's attention to a practical implementation issue that applies throughout the Annex. It remains unclear how a quantitative finding of reduced or absent commensurateness — whether based on a Monte Carlo simulation or an ERD test — should translate into an adjustment to the Standard Formula SCR calculation. Quantifying risk-mitigating effects for contracts with commensurateness-reducing features can be resource-intensive. The proportionality carve-out in the blue box is therefore important and welcome. We encourage EIOPA to clarify in the final guidance that full quantitative assessments should be limited to cases of genuine doubt, and that the carve-out is available — and expected to be used — in most cases involving immaterial features.

Q2. DO YOU HAVE COMMENTS ON SECTION 3.1 (PARAGRAPHS 3.1 TO 3.5): DESCRIPTION OF THE CASE?

The IRSG finds the description of the case in paragraphs 3.1 to 3.5 to be clear and helpful.

However, we observed the following. The description is framed almost entirely from the perspective of the cedant. However, undertakings that accept (assume) reinsurance business face a symmetrical situation: the contractual features described — variable commissions, loss corridors, and loss limits — apply equally to the assumed portfolio and give rise to the same commensurateness concern from the assuming undertaking's perspective. We would welcome confirmation from EIOPA as to whether the guidance in this Annex applies equally to assumed reinsurance, or whether a cedant-only scope is intended and, if so, the rationale for this limitation.

Q3. DO YOU HAVE COMMENTS ON SECTION 3.2 (BLUE BOX): THE SUPERVISORY EXPECTATIONS ADDRESSED TO THE ACTUARIAL FUNCTION, INCLUDING THE COMMENSURATENESS FRAMEWORK, THE ORSA DISCLOSURE REQUIREMENT, AND THE PROPORTIONALITY CARVE-OUT?

The IRSG supports the supervisory expectations set out in the blue box. We offer the following observations on three aspects of its drafting.

ON THE SCOPE OF NON-RECOGNITION

The blue box states that 'if commensurateness is jeopardised, the risk-mitigating effect of the reinsurance treaty should not be recognised in the Standard Formula.' As currently drafted, this implies a binary outcome: either full recognition or complete non-recognition of the treaty's risk-mitigating effect.

We note that proportional reinsurance treaties with commensurateness-reducing features may still transfer a meaningful, if reduced, amount of risk. Applying a binary non-recognition rule in such cases would produce a more conservative outcome than the actual risk profile warrants, and could, in extreme cases, result in an over-capitalisation that is in conflict with the broader objective of Solvency II to provide incentives to effectively steer and mitigate risks.

We suggest that EIOPA consider whether the language could be refined to allow for partial recognition, proportionate to the extent of genuine risk transfer demonstrated. A formulation such as 'where the recognition of the risk-mitigating effect of the treaty would lead to a materially greater reduction in the SCR than the reduction in the risk retained by the undertaking, the extent of recognition should be adjusted accordingly' would, in our view, better reflect the principle-based and proportionate approach of Solvency II.

ON THE ROLE OF THE ACTUARIAL FUNCTION

The blue box places the commensurateness assessment within the responsibilities of the actuarial function, which is consistent with the actuarial function's existing mandate under Article 48(1)(h) of the Solvency II Directive and Article 272(7) of the Delegated Regulation to express an opinion on the adequacy of reinsurance arrangements. The IRSG supports this.

However, the quantitative dimension of the commensurateness assessment — particularly Monte Carlo simulation or ERD testing — typically requires substantive input from other functions within the undertaking, including the risk management function and the function responsible for managing reinsurance. The current drafting may give the impression that the actuarial function carries sole responsibility for producing this assessment. We would welcome an acknowledgement in the final text that the actuarial function carries out this assessment in cooperation with other relevant functions.

ON THE ORSA DISCLOSURE REQUIREMENT AND PROPORTIONALITY CARVE-OUT

The IRSG welcomes the ORSA disclosure requirement and notes that it is consistent with our position that the ORSA is the appropriate vehicle for undertakings to assess and evidence deviations from Standard Formula assumptions, including those arising from complex reinsurance arrangements. The proportionality carve-out is also welcome.

Q4. DO YOU HAVE COMMENTS ON SECTION 3.2 (PARAGRAPHS 3.6 TO 3.15): THE GUIDANCE ON QUANTITATIVE AND QUALITATIVE ASSESSMENT APPROACHES (INCLUDING THE ERD TEST AND MONTE CARLO SIMULATION)?

ON THE DEFINITION OF COMMENSURATENESS

The Annex introduces commensurateness as the central concept against which proportional reinsurance features are to be assessed, but neither this Annex nor the underlying 2021 Opinion provides a clear definition. We note that this creates a degree of uncertainty for undertakings attempting to apply the guidance in practice and does not support convergence of this between different European Member States.

An important technical observation in this context is that, due to the non-linearity of the SCR calculation under the Standard Formula arising in particular from its aggregation structure, including diversification effects and correlations across modules, even a pure proportional reinsurance treaty — one with no commensurateness-reducing features — does not produce a proportional reduction in the SCR relative to the cession percentage. The inherent structure of the Standard Formula means that 'proportional risk transfer' does not translate into 'proportional SCR relief'. Any test or definition of commensurateness must therefore be calibrated against this baseline, rather than implying a simple linear relationship between cession percentage and capital reduction. We would encourage EIOPA to acknowledge this non-linearity explicitly in the final Annex, and to clarify how the baseline comparator for a 'plain proportional treaty' (referred to in paragraph 3.12) should be constructed in light of it.

ON THE ERD TEST

The IRSG welcomes the inclusion of the Expected Reinsurance Deficit (ERD) as a recognised and widely-used method for assessing risk transfer. We have two technical concerns about the definition as presented in footnote 9.

First, the term 'loss' in the expressions P(loss) and E(Severity|loss) is ambiguous. A ~~practitioner~~ reader may interpret 'loss' in the claims sense — i.e., incurred losses on the ceded portfolio — rather than the intended meaning, which is that the reinsurer incurs a net financial loss on the contract as a whole. We suggest making this distinction explicit by defining the 'loss event' as the event in which, at the outset of the reinsurance contract, the present value of all cash flows specified in the contract represents a net outflow from the perspective of the reinsurer.

Second, the denominator is defined as 'reinsurance premium net of reinsurance commissions' without specifying which types of commission should be deducted. This is particularly relevant where variable commissions are involved, since their value is uncertain at inception and the choice of commission treatment can materially affect the ERD result. We would suggest that the final Annex either specifies the treatment of each commission type in the ERD denominator, or provides a reference to established actuarial literature on this definitional question, so that practitioners have a principled and consistent basis for their calculations.

ON THE MONTE CARLO APPROACH AND THE QUALITATIVE/QUANTITATIVE HIERARCHY

The IRSG generally supports the Monte Carlo simulation approach outlined in paragraph 3.11 as a sound method for measuring risk-mitigating effects relative to the Standard Formula SCR. It must be noted, though, that such an approach is very complex and might lead to modelling approaches close to a fully fledged partial internal model. This cannot be EIOPA's expectation of model quality and we would appreciate that EIOPA more explicitly suggests adequate approximations rather than full modelling.

The suggestion that simulations may be run using Standard Formula assumptions as a baseline — while permitting undertakings to use alternative assumptions that better reflect their risk profile — is a sensible and proportionate approach. We would encourage EIOPA to be explicit in the final guidance that the qualitative assessment referred to in paragraph 3.14 should, in most cases, be the primary analytical tool, with full quantitative testing reserved for situations of genuine doubt.

Finally, and as noted under Q1, it would be helpful for the final Annex to explain how the outcome of a quantitative commensurateness assessment — whether a Monte Carlo result or an ERD comparison — is practically incorporated into the Standard Formula SCR calculation. Without this, undertakings may find it difficult to translate the analytical exercise into a coherent solvency calculation. Here, EIOPA could also add more explicitly how a partial recognition could be applied.

SECTION 4: COMMISSIONS IN THE VOLUME MEASURE FOR NON-LIFE PREMIUM RISK (Q&A 1898)

Q5. DO YOU HAVE COMMENTS ON SECTION 4 (PARAGRAPHS 4.1 TO 4.5): THE TREATMENT OF FIXED AND VARIABLE REINSURANCE COMMISSIONS IN THE STANDARD FORMULA NON-LIFE PREMIUM RISK VOLUME MEASURE?

The IRSG welcomes the consultation as an opportunity to clarify Q&A 1898.

Reinsurance commissions should generally not be included in the non-life premium risk volume measure of the cedant, which should only reflect premiums net of premiums ceded through techniques complying with Article 210 of the Delegated Regulation 2015/35.

High fixed reinsurance commissions typically strengthen the cedant's own funds. Including them in the cedant's volume measure would favour low-commission structures over contracts with lower loss ratios and higher commissions, which would be counterintuitive from an economic perspective.

Paragraph 4.3 states that fixed commissions frequently represent exposure to risk for the cedant — specifically where expense risk is not transferred through the proportional reinsurance treaty — and that they should in such cases increase the volume measure. In practice, a fixed commission may combine elements of compensation for acquisition costs (which are directly linked to the expense risk retained by the cedant) and elements of compensation for more general administrative or overhead expenses (where the link to retained risk exposure may be less direct).

In non-life insurance, expense risk is generally limited (policies are short-term, lapse risk is absent, and pricing can be adjusted annually). While acquisition and administrative costs are not volatile, some expense risk may only arise from volatile loss management expenses. Expense risk is typically embedded as a second-order component in non-life premium risk, through the prudent calibration of the standard deviation, and in reserve risk through stressed best estimates, which include loss management expenses and their volatility.

Under proportional reinsurance, reinsurers generally cover claim-related expenses (e.g. loss adjusters' and legal fees), while internal claims handling costs are typically reflected in reinsurance commissions. Reinsurance commissions primarily reflect the economic balance of proportional treaties, covering acquisition costs, fixed expenses, and the cedant's remuneration (including cost of capital), as well as market conditions. Only a limited portion may relate to residual expense volatility, which remains modest in non-life insurance. Reinsurance commissions should therefore not be treated as a proxy for expense risk.

Increasing the volume measure by the amount of fixed reinsurance commissions (4.3) is not justified:

- It would introduce inconsistencies in the calculation of premium risk SCR, including asymmetry between cedant and reinsurer, as commissions are not deducted from the reinsurer's volume measure.
- It would lead to a significant overestimation of risk by applying premium risk calibration to the full amount of commissions, rather than to the limited portion potentially linked to expense volatility.
- It would reduce solvency relief despite higher commissions strengthening own funds and would therefore not appropriately reflect the underlying risk.

Where residual expense risk is material, it should be addressed through a proportionate and targeted adjustment, rather than through a systematic increase in the volume measure.

For clarity, the IRSG therefore recommends the following amendments:

- The last sentence of Q&A 1898, which refers to the 'premiums entering the volume measure', should refer to 'the premiums for reinsurance contracts – which are deducted from premiums entering the volume measure calculation".
- Section 4.3 to 4.5 should be clarified as follows:

"**4.3** Expense risk corresponds to the exposure to volatile expenses, as opposed to fixed expenses. Although expense risk is usually limited in non-life insurance, some part of fixed reinsurance commissions may represent residual exposure to expense risk for the cedent. For example, in case expense risk is not transferred through a proportional reinsurance treaty, reinsurers pay back the part of the proportional premium ceded that covers the residual volatile expenses of the cedent, i.e., some limited part of the commission may represent the cedent's exposure to expense risk. In general, fixed reinsurance commissions should be considered to be part of the premiums for reinsurance and, therefore, should not increase the cedant's volume measure.

If for certain lines of business, material expense risk is not largely transferred through a proportional reinsurance treaty, its impact through reinsurance commissions on the premium risk SCR should be considered, if significant. However, only a limited part of fixed commissions, and only a modest part of the standard deviation calibration for the premium risk may correspond to expense risk. Moreover, fixed reinsurance commissions, if not covering adequately the cedant's non-transferred expense risk, already have an impact on the cedant's own funds – as reflected in the SCR and MCR ratios. Therefore, a proportionate adjustment to the cedant's volume measure will in most cases not be needed."

"**4.4** [last sentence …] Therefore, variable commissions also shall not lead to any adjustment"

"**4.5** However, case by case analysis is needed as variable commissions may still include some elements representing exposure to expense risk for the cedent that is not transferred through a proportional reinsurance treaty and that should be considered. For example, high minimum commissions of variable reinsurance commissions might replace a fixed reinsurance commission, of which some part may represent a material exposure to expense risk for the cedent. In this case, the impact should be considered, in addition to the commensurateness assessment, as discussed in 4.3."

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