# SUPERVISORY STATEMENT ON SUPERVISION OF RUN-OFF UNDERTAKINGS

07 April 2022

European Insurance and Occupational Pensions Authority

# 1. BACKGROUND

## 1. Legal basis

1.1. The European Insurance and Occupational Pensions Authority (EIOPA) provides this Supervisory Statement on the basis of Article 29(2) of Regulation (EU) No 1094/2010[1]. This Article mandates EIOPA to play an active role in building a common Union supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union.

1.2. EIOPA delivers this Supervisory Statement on the basis of Directive 2009/138/EC (Solvency II)[2].

1.3. This Supervisory Statement is addressed to the competent authorities, as defined in Article 4(2) of Regulation (EU) No 1094/2010[3].

1.4. The Board of Supervisors has adopted this Supervisory Statement in accordance with Article 2(7) of its Rules of Procedure[4].

## 2. Context and objective

2.1. Run-off business model – when properly and fairly managed – can potentially bring benefits to the insurance market, for instance by making possible to use capital to support more profitable business, enabling cost and complexity of business reduction which can be beneficial for all parties involved, including the policyholder depending on the profit participation. Furthermore, run-off as a growing and increasingly commoditised business can help to (re)insurance undertakings to orderly exit from the market. It can also be a pre-emptive measure to avoid materialisation of risks with impact on new policyholders.

2.2. At the same time, supervision of run-off undertakings/portfolios is particularly challenging because of the specific risk profile, the difficulties of the process and assessment of the change of ownership and the lack of specific regulation on run-off in the Solvency II

[1] Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

[2] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (OJ L 335, 17.12.2009, p. 1-155).

[3] Notwithstanding the fact that specific points of this Supervisory Statement describe supervisory expectations for insurance and reinsurance undertakings, they are required to comply with the regulatory and supervisory framework applied by their competent authority based on Union or national law.

[4] Decision adopting the Rules of Procedure of EIOPA's Board of Supervisors, available at: https://www.eiopa.europa.eu/sites/default/files/publications/administrative/bos-rules_of_procedure.pdf

framework. Understanding the design of run-off undertakings together with the motivation to discontinue the business is also very important.

2.3. The number and size of run-off portfolios are increasing and a growing interest has been observed from investors in acquiring such portfolios.

2.4. The aim of this Supervisory Statement is to ensure that a high-quality and convergent supervision is applied to run-off undertakings/portfolios, subject to Solvency II, taking into account their specific nature and risks[5] as well as the principle of proportionality and the prudent person principle.

2.5. This Supervisory Statement sets out supervisory expectations for the supervision of run-off undertakings in the context of portfolio transfers, acquisitions of qualifying holdings and mergers (ownership changes) as well as on-going supervision. It addresses some issues that are not exclusive to run-off undertakings/portfolios, however, experience has shown that some issues may lead to stronger and more concerning consequences in that context.

2.6. This Supervisory Statement should be read *inter alia* in conjunction with Article 29, 30, 34 and 36 of Solvency II, EIOPA Guidelines on system of governance[6], EIOPA Guidelines on basis risk[7], Joint Guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the financial sector[8] (Joint Guidelines) as well as EIOPA's Approach to the Supervision of Product Oversight and Governance[9].

## 3. Definition of run-off

3.1. The term "run-off" describes a variety of situations where the (re) insurance undertaking has stopped underwriting new business[10] or old underwriting years[11] of an active portfolio are being transferred from one active (re) insurance undertaking to another. The term run-off undertaking may refer to different cases:

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[5] In this context, EIOPA advised the European Commission to amend the Solvency II framework with regard to the expenses assumptions considered in the calculation of technical provisions of undertakings not underwriting new business (see section on expenses of the EIOPA's Opinion on the 2020 review of Solvency II).

[6] https://www.eiopa.europa.eu/content/guidelines-system-governance_en

[7] https://www.eiopa.europa.eu/content/guidelines-basis-risk_en

[8] https://esas-joint-committee.europa.eu/Pages/Guidelines/Joint-Guidelines-on-the-prudential-assessment-of-acquisitions-and-increases-of-qualifying-holdings-in-the-banking,-insuranc.aspx

[9] https://www.eiopa.europa.eu/content/eiopa-approach-supervision-product-oversight-and-governance_en

[10] Covering also the cases where businesses are limited or closed to new policyholders, but still have the ability for renewals for existing policyholders based on the same terms and conditions.

[11] Covering also cases where only claims provisions are being transferred.

1) Undertakings running-off a portfolio of contracts[12] not representing their whole business (*partial run-off undertakings or undertakings with run-off portfolio*);
2) Undertakings running-off their whole (previous) business (*full run-off undertakings*);
3) Undertakings with a run-off business model (*specialised run-off undertakings*).

3.2. Partial run-off undertakings are undertakings where only part of the business is discontinued while the rest of its business is in going concern. For the purpose of this Supervisory Statement, partial run-off refers to the cases where a material part of the undertaking's business is stopped[13] (i.e. it excludes the cases where a minority of non-material products/line of business is discontinued).

3.3. Full run-off undertakings are undertakings with legacy portfolios, typically showing a downward trajectory in terms of technical provisions, own funds and Solvency Capital Requirement (SCR)[14]. Not issuing new insurance policies means that the profitability of the business comes only from the management of the existing business[15]. This business model is generally associated with an active management of the technical provisions, cost reduction measures and/or better investment mangement. This could be also done in cooperation with external parties, ranging from consulting to outsourcing activities and to spinning off operating activities.

3.4. Specialised run-off undertakings are undertakings or groups whose business model is to actively acquire legacy portfolios or undertakings in run-off[16]. Besides the measures taken by full run-off undertakings they seek to realise scale efficiencies by maintaining or increasing the size of their run-off book. There are also cases in which specialised run-off undertakings are supporting active (re)insurers underwriting business in a profitable way by providing the (re)insurer with capital relief. Often these transactions operate in

[12] Covering also the cases for undertakings with contracts, which together could be regarded as a portfolio, even if such a portfolio does not constitute an entire line of business.

[13] Covering also cases when premiums can still be paid with new liabilities of the insurer(no contractual guarantee on these future premiums - included or not included in the contract boundaries), such as contracts with flexible premiums or universal life.

[14] Covering also cases when:

- premiums are still paid due to contractual conditions (with contractual guarantees on these future premiums - integrated in the contract boundaries);

- premiums can be paid with new liabilities of the insurer (no contractual guarantee on these future premiums - integrated or not integrated in contract boundaries), such as future premium increases due to salary increases or new premiums of new members in group insurance contracts of the 2nd pension pillar

[15] Run-off undertakings can change the underwriting and/or investment assumptions, initially considered at the inception of the contract (i.e. profit test), if and to the extent that there is margin for keeping the contracts profitable.

[16] In some Member States also a subject of additional regulatory approval.

a partnership and repeat over time working in the same way traditional reinsurance works.

3.5. Cross-border run-off describes the activity conducted by an undertaking which has taken over the run-off business of an undertaking located in another Member State or third - country following a cross-border portfolio transfer or an acquisition. For policyholders, it implies a change of undertaking and of the home supervisory authority.[17]

3.6. This Supervisory Statement addresses risks related to all the three cases above, while recognising at the same time the difference between them.

3.7. Insurance undertakings which are subject to reorganisation measures or winding-up proceedings[18] are not considered in this Supervisory Statement[19].

## 4. Decision to go into run-off

4.1. Undertakings which intend to stop writing any material new business, leading to partial or full run-off undertakings, are expected to notify their supervisory authorities as soon as the decision has been made (as part of the on-going dialogue) by submitting:

- the decision of the administrative, management or supervisory body (AMSB) to run-off their part/whole business including the motivation for putting the business into run-off;
- the description of their strategy to manage their remaining business, if applicable, including how products will be monitored and reviewed, and how adequate customer service will be maintained;
- the financial projections of their assets, technical provisions, own funds and capital requirements, including the description of the underlying assumptions (in particular technical provisions) and – where appropriate – appropriate scenario and stress tests;
- the material reinsurance and outsourcing arrangements expected in the future;
- impact, if any, with regard to key staff retention;
- impact, if any, on costs and charges for existing policyholders belonging to the run-off portfolio.

4.2. The decision to stop writing any material new business might lead to significant change of the risk profile of the undertaking and consequently trigger an ad-hoc/non regular ORSA, the results of which are to be submitted to supervisory authorities. Furthermore, the decision to stop writing any material new business is considered material information and therefore needs to be reflected in the Solvency and Financial Condition

[17] The supervisory statement does not specifically deal with the case of run-off of a cross border business that does not imply a cross-border transaction.

[18] See respectively Articles 269-272 and 273-284 of Solvency II.

[19] The cases in which national insurance guarantee schemes are been set up for the purpose of portfolios transfer in winding-up procedures of (re)insurance companies remain out of the scope of this Supervisory Statement.

report (SFCR)[20]. If taken in between publications, such an event should also be considered a major development affecting significantly the relevance of the information disclosed and should trigger an up-date of the SFCR.

4.3. In case of cross-border run-off, home and host supervisory authorities should cooperate and exchange any information at their disposal which could affect policyholders' rights.

4.4. Cross-border transfer of run-off portfolios potentially involves specific risk areas, such as:

- Partial knowledge of the products and market trends of the new country
- Difficult communication between policyholders and their new undertaking, including difficulty to submit claims.

When specific national consumer protection requirements (e.g. ongoing disclosure requirements or complaints handling) are a competence of the host supervisory authorities, they should contribute to the assessment of whether the acquiring/accepting undertaking is compliant with these requirements.

## 5. Specialised run-off undertakings through acquisition of an insurance undertaking or transfer of portfolio

### Early dialogue

5.1. The assessment by the supervisory authority of an acquisition of a run-off undertaking/portfolio or a transfer of a run-off portfolio relies on accurate and timely information from the undertaking concernd.

5.2. The potential acquirer/accepting undertaking is encouraged to have an early dialogue with the supervisory authority before submission of the formal notification on the acquisition of a qualifying holding or on the transfer of portfolio in accordance with Article 57 or with Article 39 of Solvency II respectively. The undertaking intending to acquire a run-off portfolio (for which it is requested the authorisation of the supervisory authorithy in accordance with Article 39 of Solvency II) is encouraged to provide the supervisory authority the information defined in point 4.1 as well as an external actuarial report assessing the adequacy of technical provisions related to the portfolio transfer.

5.3. The financial projection period, including own fund and SCR figures, should be commensurate with the duration of the insurance liabilities. If the technical provisions are of long-term nature, the default projection period of 3 years envisaged in the Joint Guidelines should be extended to an appropriate horizon consistent with the expected duration and uncertainty of technical provisions. If the contract benefits are based on local GAAP, parts of the forecast may follow the same accounting principles (e.g. profit and loss statements, dividends).

[20] The paper does not necessarily imply that the ad-hoc SFCR publication is done before the conclusion of the contracts.

## Identification of the risks of the acquisition / transfer of portfolio

5.4. In order to perform an in-depth analysis of the proposed transaction supervisory authorities are recommended to assess in detail the documentation received as a first step and request the undertaking any further information deemed necessary.

5.5. To perform an in-depth assessment of the risk of the transaction it is vital to assess the financial soundness of the acquiring/accepting entity, the motivation for the aquisition and the impact on policyholders both of the ceding and the acquiring/accepting undertaking. For an appropriate assessment, supervisory authorities need to develop a comprehensive understanding of the business model pursued by the acquiring/accepting undertaking[21] and the expected changes on its risk profile, system of governance – including product oversight and governance – risk management and solvency position (both SCR and own funds) after the acquisition. This is also relevant when the acquirer of the undertaking is identified as an insurance holding company and is subject to group supervision according to Solvency II[22]. The economic situation of the undertaking is usually strongly dependent on the financial strength of the group and its ability to provide support in the event of a loss. For example, when an external run-off is pursued existing intra-group transactions such as outsourcing contracts, profit-and-loss transfer agreements, reinsurance and subordinated loans are usually terminated.

5.6. The protection of policyholders should be one of the main objectives of the assessment and it should not be impaired by the transaction. It is an important issue in case of ownership changes, as the supervisory authority has to assess whether the undertaking will be able to comply with the prudential requirements laid down in Article 59(1)(d) of Solvency II.

5.7. If the transaction affects the recoverability or amount of the claims, the supervisory authority may request the acquirer to make additional commitments suitable to safeguard the interests of policyholders (e.g. loss transfer agreement). If there are justified doubts about the financial capacity of the acquirer or its credit rating cannot be reliably assessed, the supervisory authority may ask the acquirer to provide collateral to back up the commitment (e.g. bank guarantees).

5.8. It is important to verify if the risk profile of the acquiring/accepting undertaking, after including the new portfolio/undertaking is in line with its risk appetite and does not go beyond the risk tolerance and its risk bearing capacity.

5.9. It is also important to assess whether the acquiring/accepting insurance undertaking's product oversight and governance policy has adequate system and controls aimed at mitigating possible risks which can emerge for the 'acquired'/'accepted' target market,

[21] In case of partial run-off, also the business model of the ceding undertaking should be analysed.

[22] Holding companies whose main business is to acquire and hold participations in subsidiary undertakings which are exclusively or mainly insurance undertakings.

taking into account the product characteristics of the acquired portfolio. If needed, the acquiring/accepting undertaking should have its own product oversight and governance policy adjusted and aligned with the acquired/accepted portfolio. It should also carry out the product monitoring and review as part of the product oversight and governance process for the acquired/accepted portfolio.

5.10. From an operational perspective, supervisory authorities should pay attention to the ability to service the liabilities, in particular the long-term ones, and the capacity of administration of the policies, which usually requires sophisticated contract management systems. In addition, supervisory authorities should assess how the undertaking ensures that claims will be settled in accordance with the contractual terms. Especially for with-profit-business, supervisory authorities should ensure that the policyholders’ share (i.e. future discretionary benefits) will not be unreasonably reduced and are mostly in line with the previous policy of the ceding undertaking and the reasonable policyholder expectations, while considering also external, non-discretionary factors (e.g. market conditions) and country-specific regulations.

5.11. Supervisory authorities should also ensure, in particular for long-term products, that the acquiring/accepting undertaking, throughout the lifetime of the acquired/accepted portfolio - if subjected to product oversight and governance monitoring and review requirements -, has the ability to take remedial measures when it emerges that any circumstances related to the insurance product may adversely affect the customer (e.g. changes in risk coverage or guarantees being materially impacted). In particular, the acquiring/accepting undertaking should be able to take actions to mitigate the situation and prevent further occurance of the detriment.

## Involvement of private equity or similar investment entities

5.12. Private equity or similar investment entities are developing a growing interest in acquiring run-off undertakings. Since their investment horizon is usually shorter than more traditional shareholders, there is a risk that capital is pulled out of the target undertaking with potential negative impact on policyholders protection. To prevent this, supervisory authorities should consider the track record of the involved private equity party and its owners and assess the possible consequences of an early withdrawal from the investment. In the case of undertakings providing financial guarantees, investors should not be privileged with regards to profit and losses in the near future to the detriment of policyholders with longer contractual terms.

5.13. From an operational perspective, private equity tends to increase shareholder returns by making changes to the undertaking’s operations potentially in four main areas:

a. changes in the asset allocation to increase the investment returns;

b. operational changes in order to reduce the cost base of the undertaking;

c. changing the methodology and/or certain underlying assumptions for the valuation of technical provision;

d. changing the methodology and/or certain underlying assumptions for the calculation of capital requirements.

5.14. Private equity investors may seek to increase the return on their investments and thus supervisory authorities should consider the followings:

- if policies with profit-sharing are affected, supervisory authorities should assess if the transaction leads to an unbalanced distribution of risk and reward. To assess whether there is such an imbalance, supervisory authorities can ask the investor to provide expected risk-adjusted return figures of the transaction. In any case, there should be neither erosion of the undertakings' capital position and earning power nor an erosion of policyholders returns for with profit participation business or an increase in any 'undue' costs charged to policyholders with the exception of the consequences of risk reduction;
- if leverage is used to finance the acquisition, the acquirer should show its ability to serve the debt or refinance any remaining amount at maturity even under unfavourable economic conditions (e.g. by reverse stress tests).

5.15. Additional guidance with regard to supervision of investments are provided in the sub-section "Assessment of the Investment strategy".

5.16. Private equity investor may be able to reduce fixed costs by realizing some efficiencies in the operational processes, acquiring/accepting other run-off portfolios/undertakings or making extensive use of outsourcing arrangements. The supervisory authority should assess:

- Whether the private equity investor estimates a minimum amount of fixed costs which are needed to running any undertaking (above all when the size of portfolio is small and doesn't allow to spread fixed costs over a large amount of policies);
- The return on investments are higher than costs;
- In case of outsourcing, the private equity investor can demonstrate that they are able to manage and oversee the activity of service provider(s) and the extensive use of outsourcing doesn't lead to new major operational challenges or risks
- Whether the IT infrastructure is appropriate to guarantee a sufficient service level and reliable administration.

5.17. Specific guidance on technical provisions and capital requirements are provided in the relevant sub-sections.

5.18. Furthermore, experience has shown that legacy platforms backed by private equity are often embedded in complex group structures making it difficult for the supervisory authority to gauge the impact of power shifts and changes in the outsourcing environment. In some cases, ownership changes extends to more than one entity, even from other countries or financial sectors, so it may be necessary to consult with several authorities.

5.19. With regard to dividend and coupon payments, the supervisory authority needs to carefully examine the funding structures involved to improve the predicted return on equity (RoE) of the run-off undertaking/portfolio and the time horizon in relation the RoE. Furthermore, the return expectations communicated to the investors need to be realistic.

# 6. On-going supervision

6.1. This section may be also relevant for the assessment described in the previous sections.

## Business model analysis

6.2. In order to perform a proper risk based supervision and in addition to the assessment conducted prior the decision to go into run-off (Section 4) and the business model analysis done in case of acquisition of a run-off undertaking/portfolio (Section 5) supervisory authorities should perform a business model analysis as part of the on-going supervision[23]. In this analysis there should be a specific focus on how the undertaking is expected to remain profitable in the near future, whilst also ensuring the compliance with Solvency II rules relating to technical provisions/SCR and the fair treatment of policyholders. It should be also looked at which are the main sources of current and expected profitability (e.g. the assumption used in the calculation of the technical provisions, the possible change of the investments and reinsurance strategy, the improvement of efficiency of the management of the business through reduction of costs, outsourcing, etc).

6.3. Generally, the focus of a non-life run-off undertaking will be on the claims provisions, by handling the claims in a more ‘efficient and effective’ way to increase the technical profit (underwriting results). Efficiency, however, should not lead to the unfair treatment of policyholders.

6.4. The life run-off undertaking might however try to optimise both underwriting and investments results, by investing in higher yielding (but also riskier or more illiquid) assets.

6.5. From an operational perspective, undertakings might try to save costs through a more effective management in the form of modern IT systems, outsourcing, etc. Supervisory authorities should assess if the methods/approaches used to reduce costs do not raise other risks. By way of example, the migration of insurance contracts to a new IT platform

[23] The ex-post business mode analysis should be conducted following a risk-based approach. For instance, if supervisors had already assessed the business model of the undertaking intending to acquire a run-off undertaking or portfolio, it is not expected to conduct a full business model analysis if the risk profile hasn’t changed.

and other administrative changes can significantly increase operational risks, which should be reflected in the ORSA.

## Assessment of technical provisions

6.6. According to Article 7 of Commission Delegated Regulation (EU) 2015/35[24] (Delegated Regulation) insurance and reinsurance undertakings are required to value assets and liabilities based on the assumption that the undertaking will pursue its business as a going concern. It is important to point out that also undertakings in run-off fall under this rule if they continue to settle their claims. However, the decision to discontinue (parts of) the insurance business may be associated with a change of the financial and non-financial assumptions of technical provisions calculation. If insufficient evidence is shown and the supervisory authority concludes that the technical provisions underestimate the future obligations, the supervisory authority should ultimately consider using the power under Article 85 of Solvency II and require an increase of technical provisions or, in case of deviation of the risk profile, to set a capital add-on in accordance with Article 37 of Solvency II.

6.7. Supervisory authorities should assess if the going concern assumptions regarding the run-off are reasonable and realistic, including but not limited to administrative expenses, lapse/surrender rates, asset mix and future management actions.

### *Expenses*

6.8. Undertakings writing new business can offset their cost loading per policy through new business[25]. However, this will usually not be possible in case of run-off undertakings because there will be no new business[26]. At the same time, the business reduction might also imply a reduction of some expenses but also the increase of other expenses related to business reduction (e.g. severance payments). The off-setting of cost may be possible for a specialised run-off undertaking that will have new business via portfolio transfers or acquisitions, even if specific assumptions should be required in this case (e.g. consider the possibility that they may not be able to acquire new portfolios). It is important that supervisory authorities make sure that the “non-scalability" is properly addressed in the

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[24] Comission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 12, 17.1.2015, p. 1).

[25] A common practice is to model the (nominal) costs per policy as a fixed percentage of premiums or a fixed percentage of benefits in case of single premiums (as is for instance the case with direct annuities).

[26] Going concern principle does not require to assume new business will be written in the future. Assumptions should always be realistic, which includes the cases where the undertaking is no longer writing new business. For more details, please see EIOPA Q&A 1037. See also Guidelines on valuation of technical provisions (CP), 2021, https://www.eiopa.europa.eu/document-library/consultation/consultation-revision-of-guidelines-valuation-of-technical-provisions_en

calculation of the technical provisions. Furthermore, expenses might be reduced in specific cases (e.g. reduced IT maintenance expenses, outsourcing etc.).

6.9. This may require envisaging future management actions beyond the expenses framework. For example, at a certain point in time it may not be economically viable to continue the business operation any longer with respect to the overwhelming fixed costs. Undertakings need to provide adequate justification on how this is reflected in the calculation of the technical provisions. Whether the projection horizon can be cut off at this point depends on realistic management actions regarding the transfer of the remaining obligations.

### *Lapse*

6.10. While in principle run-off undertakings are expected to have an interest in maintaining their existing contracts[27], certain run-off undertakings may try, as part of their business model, to advise policyholders to lapse or cancel their policy. Supervisory authorities should assess and detect such cases and ensure that undertakings treat their policyholders fairly and are acting in their best interest. In particular, supervisory authorities should ensure that if lapses/switches from one product to another occur, this is done in the best interest of policyholders and not to generate higher fees and/or to shift risks relating to market shocks onto policyholders. In assessing whether policyholders have been treated fairly, supervisory authorities should take into account the risk-reward profile and other relevant characteristics of the 'old' and of the 'new' product, considering that the new product may offer higher returns, and determine whether the run-off undertaking has adequately and sufficiently assessed that the new product towards which policyholders are directed is better aligned with their characteristics, needs, and objectives.

6.11. In making the above assessment, supervisory authorities should take into account the difference between lapses, where the acquiring entity is likely to make a profit, and the lapse has actually triggered an equivalent product and/or a product which is better aligned with the needs, objectives and characteristics of the policyholder.

6.12. Furthermore, supervisory authorities should assess whether the risk of higher surrenders or lapses caused by loss of reputation is reflected in the calculation of technical provisions.

### *Future management actions*

6.13. In case of portfolio transfer, merger or acquiring of qualifying holdings, the new owner might change the executive management, which could react differently to certain developments. The assumptions on future management actions should be reviewed and supervisory authorities should assess if they are in line with the new strategy.

[27] To keep their reputation high, not to lose cost advantages and not to face liquidity outflows.

### *Reinsurance recoverables*

6.14. The impact of the cession of some insurance risks to the reinsurer will be accounted for in the Solvency II balance sheet of the ceding undertaking under reinsurance recoverables. It should be ensured by the supervisory authority that the assumptions underlying the recoverables are not overly optimistic and are in line with Article 81 of Solvency II and Articles 41 and 42 of the Delegated Regulation. If both the ceding undertaking and the accepting reinsurer are subject to Solvency II, it is expected that the reinsurance recoverables in the balance sheet of the ceding undertaking (before accounting for expected losses due to default of the counterparty) are broadly in line with the gross best estimate (referred to the same obligations) in the balance sheet of the accepting reinsurer. It should be noted that the differences can be larger in some cases such as if the ceded business becomes part of a much larger homogeneous risk group e.g. for non-life.

6.15. Article 42 of the Delegated Regulation specifies that adjustments to take into account losses due to default of a counterparty shall be calculated as the expected present value of the change in cash flows underlying the amounts recoverable from that counterparty if the counterparty defaults. The cash flows under the scenario of a reinsurer default will be determined by the insolvency legislation the reinsurer is subject to, which is used to determine the recovery value. In case of a third country reinsurance undertaking, it is possible that the valuation of the recovery value is materially different from a valuation under the insolvency legislation the ceding undertaking is subject to. The expected credit loss therefore would contain two components. A first component would be the expected credit loss as it is traditionally observed resulting from the defaulted reinsurer not having sufficient funds to reimburse the cedent. A second component of the expected credit loss would be due to legal valuation differences which create an additional loss for the ceding undertaking in case of reinsurer default. Dependent on the materiality of the risks ceded the supervisory authority should ensure that this additional expected credit loss resulting from valuation differences is accounted for in the assumption used to calculate the reinsurance recoverables (e.g. in the Exposure-at-Default and Loss-Given-Default assumptions).

## Assessment of the Investment strategy

6.16. One of the common objectives of run-off undertakings usually is to increase their investment returns. They can try to achieve this goal by investing in high yielding assets and/or non-listed assets. In this regard, two main investment strategies can be identified:

- shift to a higher risk / return asset mix;
- transfer the current assets of the undertaking to another undertaking (e.g. a special purpose vehicle) that can make higher profits by investing in riskier assets.

6.17. In the first strategy (i.e. shift to a higher risk / return asset mix), acquirers allocate more funds to more profitable and riskier assets, namely (private) equity and private or non-rated credit, which may no longer comply with the prudent person principle of Solvency II. Additionally, it might not always be possible to assess the risks properly because of the complexity of the investment strategy or the complexity of the inter company structure used. The supervisory authority should monitor the changes in the investments and assess if:

- the prudent person principle is still complied with. In case of specialised run-off undertakings, the new acquirers may have more skills to manage a more complex investment portfolio and they are expected to be able to "properly identify, measure, monitor, manage, control and report"[28] investment risks. At the same time, assets should be kept invested in the best interest of policyholders and the higher investment returns should be also passed to policyholders[29] (via the discretionary participation features in case of with-profits contracts) while keeping an adequate level of liquidity to meet insurance obligations. For unit-linked products, considering that risks are entirely borne by policyholders, it is important that the risk/reward profile of assets is aligned with the risk-profile of the policyholders. As it may constitute a significant adaptation of unit-linked products, assets' change should be subject to the entire product oversight and governance process;
- the stress in the standard formula is appropriate to the new investment strategy and the criteria for the categorisation in the market or counterparty default risk module are met.

6.18. The second strategy is to transfer the current assets of the undertaking to another company (e.g. a special purpose vehicle), belonging to the same group.That company can make higher profits by investing in riskier assets and provide the undertaking with the same cash flows on the same dates as those that would have been obtained from the original assets.

6.19. The effect of such transfer are different at solo and group level, namely:

- solo level: there is no substantial change because, assuming that after the formal transfer/sale there is a substantial retention of risks/rewards stemming from the transferred assets by the ceding undertaking, the latter will continue to recognise the transferred assets in their balance sheet[30] and SCR will be calculated taking into account these (more prudent) assets instead of the riskier ones;

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[28] Article 132 of Solvency II.

[29] Contractual terms and conditions shall be complied with as established, regardless of whether the policy provides for profit-sharing or not.

[30] According to IFRS recognition principles which are used also for Solvency II purposes (see Article 9(1) of Delegated Regulation).

- group level: the effect of the switch to riskier assets emerge only at group level with the consequence that the extra returns are not shared with policyholders of the solo undertaking.

6.20. However, this particular treatment, i.e. keeping the assets sold in the balance sheet, is only allowed within IFRS where no new material risks are created. If a new material risk is created, keeping the assets sold in the balance sheet would lead to a higher risk for policyholders without higher returns and a significant deviation of the risk profile of the undertaking from the underlying assumptions in the standard formula. In particular, one key element of the assessment of these transactions is the counterparty default risk, i.e. whether the new structure keeps the same counterparty default risk as the original assets by setting up additional collaterals that guarantee the payment of the cash flows fixed in the agreement. These collaterals should comply with the requirements of the Delegated Regulation for its inclusion in the Standard Formula.

6.21. Regarding the second strategy, in addition to the guidance applicable to the first strategy, supervisory authorities should consider:

- monitor closely that there is an effective retention of risks and benefits within the undertaking after the asset transfer. In particular, verify that no new risks arise, such as counterparty or liquidity risk, for which the policyholders should be compensated. Particularly, supervisory authorities should ensure that the collaterals provided are enough in quantity to maintain the counterparty risk module, and comply with requirements of the Delegated Regulation.
- supervise that the information in the public disclosure regarding the asset transfer is appropriate and sufficient.

## Assessment of the reinsurance strategy

6.22. After the decision to go into run-off or after the transfer of a portfolio the reinsurance strategy applicable to the portfolio may need to be reconsidered. The instalment of a reinsurance treaty may lead to a material impact on the own funds (due to the reinsurance recoverables) and on the SCR.

6.23. Assuming that the acquiring undertaking reinsures the insurance obligation of (a material part of) the run-off portfolio, the supervisory authorities should assess and discuss the following:

- The probable additional risk of reinsurance concentration: in case of material reinsurance with a high cession rate with respect to a single or few reinsurers, a concentration risk can arise with respect to the reinsurance counterparty. This concentration risk might not be fully reflected in the SCR and as such this possible risk should be highlighted in the ORSA;
- Introducing a collateral as a mitigating power: the counterparty risk could be reduced if collateral would be posted. Risk-based haircuts can be used to incentivise the reinsurer to use high-quality, liquid and short-term assets as

collateral. Lastly, the adjustment of the collateral or the margining should be considered to ensure that this occurs within a sufficiently short delay when needed;

- The possible implications of retrocession: in case of high retrocession the reinsurer is merely fronting and not taking on any risk and the final risk-taker is the retrocessionaire. Specific attention is needed in case the retrocessionaire is not based in the EU. Other legislation with regard to the valuation of the technical provisions or the required solvency margin might be applicable. The ceding insurance undertaking as well as NCAs should ask for information on retrocession in cases where this seems relevant.

6.24. As indicated in EIOPA's Opinion on the use of risk mitigation techniques, insurance and reinsurance undertakings - when calculating the Basic SCR - should take into account risk-mitigation techniques as referred to in Article 101(5) of Solvency II and complying with Articles 208-214 of the Delegated Regulation. Where the reduction in the SCR seems not commensurate with the extent of the risk transferred or there is not an appropriate treatment within the SCR of any material new risks that are acquired in the process, supervisory authorities are recommended to pay attention to avoid material unbalances between the capital relief and the risk mitigation.

6.25. Run-off undertakings with material exposures due to reinsurance treaties with a high cession rate, have material counterparty default and concentration risks as well as possible basis risks due to imperfect margining of the collateral. Due to this idiosyncratic risk profile, it is important to evaluate, in the context of the ORSA, the appropriateness of the standard formula, also considering the possible financial strength of the counterparty.

The supervisory authorities should closely monitor and challenge the appropriateness of the standard formula. If sufficient evidence shows that the standard formula underestimate the SCR, supervisory authorities should ultimately consider using their power under Article 37 of Solvency II and require a capital add-on. Where the SCR is calculated with an internal model, this assessment is also part of the model application or model change process.

6.26. In case of material concentration risk or counterparty risk (as eventually indicated in the ORSA report), Supervisory authorities are recommended to start a discussion with the undertaking on how to mitigate this possible risk. Dependent on the materiality of risks ceded and the financial strength of the counterparty the following steps might be considered:

- limit the cession rate to an upper bound. A minimum retention of risks by the undertaking can be considered by the supervisory authority;
- incorporate collateral or a reinsurance deposit consisting of high quality investments with a swift margining mechanism;

- incorporate financial guarantees to ensure that capital will be injected if the solvency ratio drops below a specific threshold.
- Introduce a clause in the treaty to ensure that reinsurance recoverables are settled early when they surpass a specific threshold.

6.27. Supervisory authorities should closely monitor the reinsurance policy and assess if the policy is adequate to the portfolio of technical provisions of the run-off portfolio.

# 7. Conduct of business supervision

7.1. From a conduct of business supervision perspective, specific risks can arise in the case of run-off activities and it is necessary to ensure that the interests of the policyholders remain protected. It includes that the acquiring undertaking has a sufficiently adequate product oversight and governance policy. Moreover, in the case of a cross-border portfolio transfer particular attention should be paid as there may be instances where national requirements may differ, increasing risks for consumers and particular attention should be paid to this.

7.2. In case a Member State has different supervisory authorities for prudential and conduct supervision, EIOPA recommends that the prudential supervisory authority takes advice and involves the relevant conduct supervisor.

7.3. Supervisory authorities should urge the concerned undertakings to foresee and take into account specific risks arising from such transactions having in mind the potential impact of all the circumstances stated in this Supervisory Statement to policyholders and their contracts. This may include the change of parties to the contract, where applicable and the change of applicable insurance guarantee schemes.

7.4. Specifically in case of life business and medium and long-term commitments in run-off, supervisory authorities should assess whether the accepting insurance undertaking has a customer centric business model, including the plan to ensure that customers belonging to the run-off portfolio will be treated fairly throughout the lifecycle of the run-off products. In particular:

- they should assess the product oversight and governance policy of the accepting undertaking to ensure that it is adequately implemented and it is adequate and proportional vis-à-vis the level of complexity of the products concerned in the portfolio transfer and the target market's characteristics.

- they should pay particular attention to how acquiring/accepting undertakings are expected to consistently monitor and regularly review the products within the acquired portfolio and when instances of consumer detriment arise how they plant to take adequate remedial actions.

- they should assess how the acquiring/accepting undertakings would ensure that attention is paid to the policyholders belonging to the run-off portfolio.

7.5. Supervisory authorities should urge the accepting undertakings to ensure transparency towards policyholders in order to ensure that the policyholders receive timely information about the impact of the transactions to their insurance policies. In case the portfolio is transferred to an undertaking in another Member States, they should assess how the acquiring/accepting undertakings plans to comply with specific national requirements.

7.6. Supervisory authorities should also assess how claims and complaints handling requirements will be complied with and whether the acquiring / accepting undertaking will ensure that customers are treated fairly in the complaints handling process. Undertakings should also inform policyholders on changes to claims submission deadlines, about access to the relevant alternative dispute resolution mechanisms and courts, impact on jurisdiction and applicable law etc., which will impact new with profift insurance contracts.

7.7. The level of customer service should not be significantly different to the level of customer service of the transferring undertaking not to cause possisble consumer detriment. This is to be assessed taking into account parameters such as the agility of the communication channels with the client, customer language, response times and other metrics that can influence effective customer service. While procedures and process can vary, it should not be materially more difficult for customers to carry out any activity related to policy servicing, e.g. submitting a claim, assessing information, submitting a complaint.

This Supervisory Statement will be published on EIOPA’s website.

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