



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

Responding to this paper

EIOPA welcomes comments on the proposal for the Consultation paper on the draft Supervisory Statement on the use of risk mitigation techniques by insurance and reinsurance undertakings.

Comments are most helpful if they:

- a) contain a clear rationale; and
- b) describe any alternatives EIOPA should consider.

Please send your comments to EIOPA by 24 November 2020 at 23.59 hrs CET responding to the questions in the survey provided at the following link:

https://ec.europa.eu/eusurvey/runner/Reinsurance_Statement

Contributions not provided using the survey or submitted after the deadline will not be processed and therefore considered as they were not submitted.

Publication of responses

Contributions received will be published on EIOPA's public website unless you request otherwise in the respective field in the template for comments. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.

Please note that EIOPA is subject to Regulation (EC) No 1049/2001 regarding public access to documents and EIOPA's rules on public access to documents.

Contributions will be made available at the end of the public consultation period.

Data protection

Please note that personal contact details (such as name of individuals, email addresses and phone numbers) will not be published. They will only be used to request clarifications if necessary on the information supplied. EIOPA will process any personal data in line with Regulation (EU) 2018/1725 of the European Parliament and of the Council of 23 October 2018 on the protection of natural persons with regard to the processing of personal data by the Union institutions, bodies, offices and agencies and on the free movement of such data, and repealing Regulation (EC) No 45/2001 and Decision No 1247/2002/EC. More information on data protection can be found at <https://www.eiopa.europa.eu/> under the heading '[Legal notice](#)'.

Consultation paper overview & next steps

EIOPA carries out this consultation in accordance with Article 29(2) of Regulation (EU) No 1094/2010. This Consultation Paper presents the draft Supervisory Statement on the use of risk mitigation techniques by insurance and reinsurance undertakings.

EIOPA will consider the feedback received, publish a Final Report on the consultation and submit the Supervisory Statement for adoption by its Board of Supervisors.

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.
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.
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.
4. This Supervisory Statement raises awareness and ensures that while the insurance sector continues to use risk-mitigation techniques adequate to their risk profile, prudence and effective risk transfer is duly considered when recognising risk mitigation techniques in the SCR calculation.
5. For insurance and reinsurance undertakings it is important to have an appropriate reinsurance policy in place, first of all as a proven concept of mitigating risks that the undertaking is not able to bear on its own, but also as an instrument to expand the current business and alongside to gain knowledge, via the reinsurance undertaking, of the latest developments in emerging markets and risks.
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.
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.
8. Independently from the eligibility criteria for recognising risk mitigation techniques for solvency purposes, insurance and reinsurance undertakings are expected to ensure that risk mitigation is commensurate with the relief in the SCR calculation when introducing new techniques.

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.
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.
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.

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.

Insurance and reinsurance undertakings, when calculating the Basic SCR, should take into account risk-mitigation techniques as referred to in Article 101(5) of the Solvency II Directive and complying with Articles 208-214 of the Delegated Regulation where:

- the reduction in the SCR or the increase in the eligible own funds is commensurate with the extent of the risk transferred, and
- there is an appropriate treatment within the SCR of any new risks that are acquired in the process.

The actuarial function of the undertaking should assess, express an opinion and document the mentioned balance as part of the task to express an opinion on the adequacy of reinsurance arrangement¹. 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.

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).

¹ Article 48(1)(h) of the Solvency II Directive and Article 272(7) of the Delegated Regulation

Insurance and reinsurance undertakings should analyse and assess the risk transferred by the risk mitigation techniques from a holistic perspective. This includes an analysis of the risk profile (not only focussing on the standard formula) of the undertaking, before and after the consideration of the risk mitigation techniques, with special attention to risks like underwriting risk, counterparty default risk, basis risk and concentration risk. This analysis should be integrated in the undertaking's overall solvency needs in the ORSA². 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.

14. Another aspect worth paying attention to is whether the complexity of the reinsurance contract might be hiding the absence of real risk transfer. For example, a simple quota share with a complex commission mechanism can actually conceal the economic reality of a loan. Another example is where a single contract combines two functions: the risk mitigation of a deviation of the best estimate and a loan. These two functions can also be found separately in contracts in the market: a reinsurance of the risk of an adverse development and a loan. When the treatment of the two separate contracts on the balance sheet and on the capital requirements is different from the single combined contract, this indicates that a thorough risk analysis is needed.

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.

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.
16. In case more 'sophisticated/complex' risk mitigation techniques are implemented, supervisory authorities are recommended to engage in an on-

² 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"

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.

Annex: Examples

1. 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.
2. As mentioned in the statement above, every structure should be assessed individually on a 'case by case' basis.

Example 1 'Proportional Quota Share.'

3. 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 premiums³. 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 commissions⁴ 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.

1a with deep sliding scale commissions⁵

4. 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.

1b high overriding commissions

5. 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

³ Article 116(5)(a) of the Delegated Regulation

⁴ 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.

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.

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.

Example 2 Mass lapse reinsurance

6. 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).
7. As such, this part of the standard formula lends itself very well to capital management hedging transactions, since the hedging cost vs. the capital benefit can be very appealing. This holds particularly true if the hedge is structured as a non-proportional reinsurance. As a consequence of the linearity of the Solvency II stresses, the hedging costs for a far out-of-the-money hedge can be substantially lower than the implied capital relief benefits. More specifically, the most common mass lapse covers used an attachment point around 20% (lapse rate over a year, and is approximately half of the mass lapse stress) and a 40% detachment point (the 1:200 stress in the standard formula for mass lapse risk). While the detachment point is simply driven by the lack of capital benefit in hedging further than 40% (i.e. the Solvency II stress), the 20% seems to be a suitable value when a substantial tail risk is to be transferred.
8. 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.

Example 3 'Contract boundary reinsurance'

9. 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.

Example 4 ‘Bifurcated (split) cover for long tail business’

10. 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.
11. Although the reinsurance arrangement is given as one single contract, it actually can be seen to combine two completely independent contracts: an upper layer that transfers real risk but does not come with any significant SCR relief and a lower layer leading to a considerable SCR reduction without mitigating any of the loss development risk. The reduction in the SCR can be materially greater than the risk mitigation of the arrangement. In a situation like this an undertaking may consider the appropriateness of applying the standard formula.

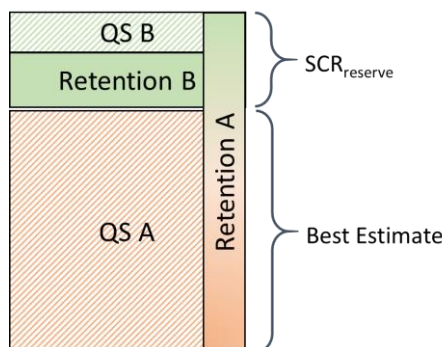


Figure 1 Illustration of an Adverse Development Cover where “QS B” mitigates reserve risk and “QS A” generates recoverables and thus considerably reduces the capital requirement for reserve risk

Example 5 Multi-year stop-loss

12. 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.
13. 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.
14. 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.
15. 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.
16. Lastly, in the case of a single reinsurance undertaking and given the material impact of the reinsurance treaty a concentration risk can arise.