IRSG

INSURANCE AND REINSURANCE STAKEHOLDER GROUP

IRSG RESPONSE TO EIOPA'S CONSULTATION ON MASS-LAPSE REINSURANCE AND REINSURANCE AGREEMENTS' TERMINATION CLAUSES

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European Insurance and Occupational Pensions Authority

General comments

The IRSG calls for caution with respect to overly prescriptive and unbalanced proposals, particularly where such proposals risk unintended effects of making it difficult for an insurer to appropriately manage and mitigate its risks. The IRSG is particularly concerned that some of EIOPA's proposals risk creating undesirable and uneconomic interpretations in respect of Mass Lapse Reinsurance and, by extension, Risk Mitigation Techniques in general.

In the context of the Solvency II framework, it is generally recognised that the design of the standard formula results in an SCR calculation that may not always fully capture either the risk or the Risk Mitigation Techniques in a technically perfect way. Aware of such limitations, The IRSG itself has long argued for a more accurate recognition of non-proportional reinsurance in the standard formula[1].

In The IRSG's view, the consultation proposals, as currently drafted, **take a binary approach to reinsurance contract recognition in the standard formula which**:

- **Risk undermining the Solvency II framework** and the principles on which it is based, notably with respect to the 1-year time horizon. This would create uncertainty for undertakings not only relating to Mass Lapse Reinsurance but also to the future direction of EIOPA's interpretation of Solvency II.
- May fail to **properly recognise the holistic nature of Solvency II** which was designed with the understanding that there are limitations in the standard formula. Doing so may result in an undesirable mismatch between the valuation of inbound risk and the capital recognition merited from the Risk Mitigation Techniques of the same risk.

The IRSG's key recommendations for the finalisation of the EIOPA work on Mass Lapse Reinsurance are as follows:

- Recognize the unavoidable compromises in the Solvency II standard formula and the mechanisms (ORSA, risk management framework) in Solvency II which manage the imperfections of the standard formula, to avoid creating an expectation or precedent that the standard formula should fully capture the specific features of individual non-proportional reinsurance contracts in order for the contract to be recognized.
- Maintain the 1-year horizon measurement period. The IRSG is strongly opposed to the consideration of risks beyond the 1-year time horizon and setting different requirements for mitigating a risk depending on the risk profile, where this is not currently a feature of the SCR.
- The Solvency II binding regulation provides a clear definition of material basis risk, the assessment of which is carried out at the BSCR level. Article 210 (3) of the Delegated Act states that: "*Basis risk is material if it leads to a misstatement of the risk-mitigating effect on the insurance or reinsurance undertaking's Basic Solvency Capital Requirement that could influence the decision-making or judgement of the intended user of that information, including the supervisory authorities*." All references to material basis risk in the Annex should be to the binding regulation and not the description in the guidelines, which if interpreted as applying a granular assessment, goes significantly beyond the binding regulation.
- Recognize that contractual wording, clauses, rights and duties are often necessary and acceptable to ensure an equitable and operational contractual relationship, including exclusions which strengthen the executability of treaties and are in the interests of both cedents and reinsurers and termination clauses which contribute to insulate the treaty from litigation risk between the parties thereby strengthening contract enforceability and the protection offered.

[1] IRSG Advice on the Solvency II 2020 Review

The IRSG would support a redrafting of the Annex wording to better recognise these points and the role of such clauses in reducing possibilities for moral hazard. Restricting such contractual wordings could create a significant risk that reinsurance as a risk management tool becomes unavailable.

- In line with the EC objective to reduce the reporting burden, avoid introducing any new provisions in Annexes to the Opinion which would add to guidelines where existing documentation, including the 2021 Opinion, are sufficient. Examples include: Paras 3.18, 3.21, 3.24, 3.29, 3.45, and Sections 3.3, 3.3.2, 3.3.3, 3.3.4, 3.3.5, 3.3.7, 3.3.10. The 2021 Opinion which in Section 12 describes the role of the actuarial function is already sufficient.

Question to stakeholders

Q1.1. Do stakeholders see the need for detailed guidance on mass-lapse reinsurance and-or for other reinsurance structures or clauses?

- Options: No / Yes / **Yes, but less detailed (more high-level)**

The IRSG appreciates EIOPA's efforts to provide guidance on assessing the efficiency of risk transfer and the balance between risk mitigation and solvency capital relief. Since the introduction of Solvency II, there has been a substantial pooling (i.e. diversification across the insurance system) of mass lapse risk on reinsurers' balance sheets, which has directly supported the insurance sector and indirectly enhanced both financial stability and policyholder protection. On the other hand, an inappropriate implementation of existing Solvency II regulation by firms entering into mass lapse reinsurance agreements may give rise to policyholder protection issues. In this context, the IRSG welcomes EIOPA's endeavours to support an appropriate and convergent supervision of mass lapse reinsurance to ensure these positive effects continue to benefit the ultimate policyholders.

Beyond this important point, the need for guidance as detailed as these proposals does not come across neatly. In the IRSG's view, the text of the 2021 Opinion is appropriate to address the question of balance between the reduction in the SCR and the reduction of risk transferred in a principle-based manner. In view of making the annex more concise and accessible, EIOPA could have focused its guidance on the expectation that the following para 12 of the Opinion is assessed in the ORSA where material mass lapse reinsurance are in place:
5. Where there is a calculated capital relief, a commensurate risk transfer is also expected. When this is not the case, these reinsurance structures may lead to a significant deviation of the risk profile of the undertaking from the underlying assumptions of the Standard Formula and the result might be an unbalance between risk reduction and capital reduction.

Q2.1. Section 3. Would any of the options have any impact in your case? Please briefly describe the reasons why.

- **The IRSG's view is that both options (24 months and 12 months measurement periods) should be able to coexist if there is a market for them, but for the sake of supervisory convergence, all supervisors should at least allow for the of 12 months measurement period considering that it is sufficient to capture the specific mass lapse risk in line with the Solvency II regulation.**
- Option 1 provides protection for the insurer during situations where policyholders lapse "en masse" over multiple years. This would allow the insurer to handle financial stress during extended crises, potentially making it more stable in the long term. Stability is important to consumers because it helps ensure that their insurance providers remain solvent and can continue to pay claims when needed. At the same time. Option 2 is more aligned with the

Solvency II regulation and therefore EIOPA cannot preclude it. At the very least, all supervisors should converge on Option 2 if EIOPA's convergence objective for this Annex is to be met.

- Besides, an extension of the measurement period beyond 12 months would unnecessarily blur the lines between the instantaneous shock risk (mass lapse) and the long-term trend risk "lapse up" (permanent increase in lapse rates) and create potential double-counting of risks in the SCR. These are two distinct risks which are already appropriately captured and managed in the existing rules, including in both SCR (Delegated Act Article 142) and ORSA where necessary.
- Para 3.5 states that "lapses triggered by an event can manifest over a longer period than a year". There are limited real-world examples which lead to support this.
- The scenario-based calculation for mass lapse is described in Delegated Act article 142(6) as the loss in basic own funds resulting from a combination of instantaneous mass lapse events. the IRSG believes the typical Mass Lapse Reinsurances written to date have appropriately captured sufficient risk coverage to continue qualifying for the calculated capital relief.
- The Solvency II SCR captures the 1 in 200 changes in basic own funds over a 1-year period resulting from a mass-lapse event. The SCR reflects the mass lapse risk crystalizing over a 1-year period. The SCR does not anticipate mass lapse risks which extend beyond that 1-year period. In addition, the design of Solvency II includes both the standard formula as the pillar 1 model for a theoretical average company and pillar 2 aspects to support pillar 1.
- Ultimately, a binary regulatory intervention to disqualify such capital relief would not reflect the economic reality of the transfer of risk occurring under such Mass Lapse Reinsurance as well as potentially conflict with the underlying assumptions of the standard formula in its entirety.

Q2.2. Which additional pros, cons or additional considerations (if any) would you like to highlight for one or both options?

- In principle, Option 1 provides greater protection against unexpected mass lapses over periods of time longer than 12 months, leading to a more stable insurer. This would increase confidence that the insurer will remain solvent and be able to cover claims during crises. Longer protection would likely reduce the risk of insurers needing to raise premiums drastically to cover mass-lapse losses.
- However as noted by EIOPA in para 3.13, there is no functioning Mass Lapse Reinsurance market for Option 1 and existing ML treaties would not align with Option 1. Standard reinsurance agreements are usually on a 12-months rolling basis. Given that there does not exist Mass Lapse Reinsurance with measurement periods longer than 12 months, implementing a requirement to adjust the minimum period would require a change to all existing reinsurance agreements, resulting in a change in solvency calculations. If reinsurance companies do not have the appetite to provide capacity for longer measurement periods (if required by regulation), a significant number of insurance companies could be negatively impacted and unable to reinsure this risk as part of their risk management approach. In addition, the IRSG considers that longer than 12 months measurements periods would also have negative consequences on the timeliness of reinsurance claim payments, as reinsurers would need additional best estimate lapse rates to be calculated.
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- The IRSG believes that Option 1 is less aligned with the Solvency II regulation than Option 2. Option 1 singles out reinsurance and undermines the principles and practical application of the standard formula for one specific circumstance. In so doing it risks creating significant regulatory uncertainty for the insurance industry regarding the future direction and interpretation of the standard formula, beyond the specific point under consideration in this paper. The application of the standard formula must be consistent with existing regulations.
  Conversely Option 2 appears more aligned with the standard formula framework under Solvency II, as the 12-month rolling periods preserve the 1-year time horizon used for risk calculations.

Moreover, these rolling periods ensure that mass-lapse shocks are treated as instantaneous events, as outlined in Article 142(6) of the Delegated Regulation, thereby avoiding confusion with the permanent lapse-up risk also described in the same Article, which falls outside the scope of MLR treaties.

- Furthermore, option 2 may be easier for consumers to understand, as it aligns with the one-year time horizon commonly used in many insurance policies. Additionally, it may be more affordable for insurers in the short term, which could prevent sharp premium increases.
- Furthermore, the MLR treaty structure proposed under Option 2 effectively addresses the issue of mass-lapse events lasting less than 12 months but spanning two different calendar years. This approach enhances the coverage of MLR treaties, aligning with the definition of the underlying risk while also increasing the flexibility of existing contractual arrangements.
- Therefore, since firms are required to manage their risk on an annual basis under Solvency II to reduce their SCR, Supervisory Authorities should permit insurance firms to lower their SCR even during the final year of a multi-year MLR treaty, when the remaining coverage period is less than 12 months. While a measurement period of at least 12 months on a rolling basis may be expected, it should be recognised that article 209(3) of the DA continues to apply in respect of MLR as per other RMTs and that where the outstanding duration of the reinsurance treaty is less than 12 months treaty renewal can be assumed where the criteria specified in article 209(3) of the DA are satisfied. Consequently, the requirements specified in paragraphs 3.14–3.15 for "at least 12 rolling months" should be revised accordingly.
- Overall, Option 1 may offer better protection against extended lapse events (part of it being due to double-counting of mass lapse SCR and Lapse Up SCR) but Option 2 is simpler, potentially cheaper for the consumers and more aligned with the Solvency II regulation.

Section 3.3: SCR Treatment

- **The IRSG does not support the use of the "mirroring" approach as the key test for recognising Mass Lapse Reinsurance as a Risk Mitigation Techniques in the standard formula.**
- This "mirroring" approach considers that to avoid basis risk, the change in the value of the Risk Mitigation Techniques closely mirrors the change in the value of the risk exposure in different scenarios - it may be appropriate in the context of proportional reinsurance but is inappropriate in the context of non-proportional reinsurance. A non-proportional treaty **responds to the claims when they attach**. The fact that the Mass Lapse Reinsurance cover does not mirror the risk exposure in all scenarios is by design and therefore should not be a reason for disqualifying a Mass Lapse Reinsurance as an Risk Mitigation Techniques. Indeed, what matters is whether the standard formula continues to reflect the risk profile of the undertaking after the implementation of the Risk Mitigation Techniques.
- The IRSG would suggest that EIOPA relies on the test elaborated in the Opinion on Risk Mitigation Techniques. This would have the added benefit of internal consistency. The test in the Opinion is whether a particular treaty would cause the calculated SCR to deviate significantly from the underlying assumptions of the standard formula in such manner that it would no longer reflect the risk profile of the cedant. This test has also the benefit of being consistent with the actual definition of material basis risk per article 210 (3): "*Basis risk is material if it leads to a misstatement of the risk-mitigating effect on the insurance or reinsurance undertaking's Basic Solvency Capital Requirement that could influence the decision-making or judgement of the intended user of that information, including the supervisory authorities*."

Q8.1. Section 3.3.3: Exclusions

- The IRSG believes that any guidance on contractual language should be balanced, reflecting the valid and essential purpose that contractual language achieves, including in ensuring the risk meets the usual criteria for being (re)insurable by the reinsurer. It is not realistic to expect a contractual relationship to contain no rights or protections for one party. Where guidance is necessary, we would expect that, rather than implying a wide-ranging objection to such contractual language through examples, a broad description of what is appropriate is included.
- While insurance companies should have specific risk management assessment, the IRSG disagrees with the blanket statement that exclusions create *per se* basis risk. This simplistic assessment fails to consider the purpose of exclusions, i.e. to ensure that the treaty responds solely to risks that the parties intended to cover (and the reinsurer price), to reduce litigation risk by making the treaty clearer, and, crucially, to align interests between parties. Exclusions strengthen the executability of treaties and are in the interests of both cedents and reinsurers.
- In general, the IRSG supports reinsurance agreements whereby moral hazard is minimised and alignment of interests between the insurer and the reinsurer is supported. Many of the standard agreements in place today are a result of many years of reinsurance supporting the operation of the insurance sector. Where the proposed guidance acts to create possibilities for moral hazard, there is a significant risk that reinsurance as a risk management tool becomes unavailable. A clear distinction should be made between what is within the cedent company's control. There should be a strong preference for exclusions to only apply because of actions within the control of the insurance company or their partners, which result in a misalignment of risk.
- In addition, such guidance can create a damaging precedent that could affect other forms of reinsurance agreements. As in every synallagmatic contract, the obligations of each party to a reinsurance contract necessarily depend on the obligations of the other.
- Specifically in relation to the examples presented in the consultation paper:
    - It is not clear how a reinsurance, or any other contract, can continue to function if the insurer is unable to maintain its operations.
    - It would be inappropriate for an insurer to benefit from its own actions in recommending lapsation, including via third parties it contracted with.
    - It would be inappropriate and likely unnecessary for an insurer to claim on the Mass Lapse Reinsurance in the event policyholders are retained under an alternative product not in scope of the Mass Lapse Reinsurance (switching), as such an exclusion should not create any (material) basis risk. An explicit exclusion that clearly reflects the intention of the party is better than no written exclusions in terms of predictability and executability of the treaty (cf. EIOPA's liquidity risk considerations stemming from poor wording in paragraph 3.50).

Q12.1. Section 3.3.7: Attachment / Detachment point.

- **The IRSG strongly recommends the Annex does not specify arbitrary higher requirements to recognize the impact of the Risk Mitigation Techniques depending on the assessed riskiness of the cover.** The mass lapse SCR stress is applied equally for all portfolios (other than group business). EIOPA should revise Para 3.3.7 to make it risk-based and proportionate rather than binary with the level of analysis expected increasing with the level of exposure to mass lapse risks.
- It is not clear to the IRSG why there is any need for regulatory oversight of the AP, which is already considered for any assessment of risk transfer and associated capital relief. If the inbound risk is to be quantified at 40% in the context of the standard formula SCR then any Attachment Point below 40% is reducing the risk of the insurer, as defined by Solvency II standard formula, and as such should qualify as capital relief.

- The overall impact of the underlying lapse risk and the Mass Lapse Reinsurance on the standard formula result and whether this result adequately reflects the firms overall risk profile can be assessed as part of the standard formula adequacy assessment in the ORSA. This IRSG believes that this point needs emphasis in this section. Otherwise, **the IRSG supports the removal of this section.**
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Q15.2. Section 3.3.9: Early termination clauses

- The IRSG disagrees with the EIOPA's description of early termination clauses. Early termination clauses usually allow reinsurers and cedants to benefit from the same protections. They ensure a balance of contractual rights and obligations in specific pre-agreed situations. An insurer may for example be able to terminate a mass lapse reinsurance contract early if it decides to discontinue the reinsured line of business. Early termination rights often come with financial penalties or unwind costs to compensate for the early cessation of risk transfer to ensure contractual fairness between the parties. Some triggers could be aimed at a renegotiation of calibration of the treaty in a way that preserves the parties' original commercial intention and economic effect in relation to this treaty. Therefore, the goal is not to impede the execution of the transfer of risks but to ensure it happens as originally intended.

Section 3.3.10: Special termination clauses.

The IRSG recommends that EIOPA removes or significantly amends section 3.3.10.

- The purpose of special termination clauses is to ensure that the treaty transfers risks as intended by the parties, and not any other risks. EIOPA should avoid singling out special termination clauses where it is within the control of the cedant to not trigger the clause and where the clause ensures ongoing alignment of interests with the reinsurer.
- Special termination rights provide safety for insurers and reinsurers regarding the consequences of extraordinary severe events or breaches while also protecting cedants from being tied to a reinsurer unable to meet its obligations. The purpose of the termination clause is aligning interests of the insurer and (re)insurer, minimizing the risk of anti-selective behavior e.g. service standards or a cedent's obligation of full disclosure to the reinsurer of all information and data that are material to the risks being assumed by the Reinsurer. They ensure the sustainability of the contract and safeguard the interests of both parties against unforeseen circumstances, contributing to the contract's stability and risk-sharing effectiveness.
- In addition, the assessment of the materiality of the impact of special termination clauses on risk transfer needs to be carried out on a case-by-case basis.
- In practice, special termination clauses serve primarily as a trigger for renegotiation of the calibration of the treaty in line with the original intent of the parties. This is a lever to ensure that the treaty stays fit-for-purpose over time. For example, special termination in case of material changes in regulation and/or applicable laws are particularly important to trigger the review of the treaty terms and find a solution which preserves the parties' original commercial intention and economic effect in the new environment.
- On termination clauses for insolvency, EIOPA could note that the Mass Lapse Reinsurance provides effective protection against mass lapse events and therefore a failure of the cedent would not stem from the mass lapse event which is covered. The failure would come from the manifestation of other risks which the treaty is not intended to cover (e.g., breach of contract, fraud or misinterpretation, deterioration of the financial standing of the other party). The intended purpose

of Mass Lapse Reinsurance is to protect against financial rather than regulatory risks. Termination clauses help to insulate the treaty from litigation risk between the parties, by making clear that only the mass lapse risk is covered and are therefore a must-have in effective contractual arrangements.

- The insolvency event clause would be triggered by the liquidation of the cedent on a gone-concern basis whereas Article 101(2) of the Solvency II directive sets out that "*The Solvency Capital Requirement shall be calculated on the presumption that the undertaking will pursue its business as a going concern*". Therefore, the credit for reinsurance in the standard formula cannot be challenged by the existence of a clause to be applied outside of the scope of the standard formula.

Section 4: Reinsurance agreements' termination clauses

- It should be made clear that this section (similar to the rest of the paper), only applies to standard formula users, recognizing internal model users capacity to model specific treaty features where appropriate and as provided for in Article 235 of the Solvency II Delegated Acts.
- The IRSG agrees with EIOPA that if a reinsurer can unilaterally terminate a contract and avoid paying legitimate claims (especially due to insolvency or regulatory actions), this could directly harm policyholders. It could leave the ceding insurance company unable to fulfil claims, potentially leaving consumers without coverage when they need it most.
- The IRSG also agrees with EIOPA that the effectiveness of reinsurance agreements relies on the clear and binding transfer of risk. If termination clauses allow reinsurers to walk away from legitimate claims or retain assets without fulfilling obligations, it undermines the primary purpose of reinsurance, which is to protect both the insurance company and policyholders.
- The document suggests that supervisory bodies should intervene if reinsurers withhold premiums or assets without fulfilling their contractual obligations. This underscores the important role of supervisors in safeguarding consumers and ensuring the insurance industry remains solvent and reliable.
- However the IRSG is concerned about the potential scope of this section. It is the understanding of the IRSG that EIOPA wants to set guidance on a very specific and rare termination clauses where the reinsurer is released of its obligation to pay "legitimate" claims upon the occurrence of predefined events. Because this concept of "legitimate claims" can be misinterpreted or misconstrued, the IRSG urges EIOPA to add in para 4.2, 4.3, 4.8 and 4.9 the following clarification: "termination clauses that stipulate that premiums, claims, expenses and fees (as applicable) related to the period prior the occurrence of the event are to be settled at the point of the event, per the reinsurance arrangements, are considered to be in line with the conditions in the delegated regulation regarding the effective transfer of risk."
- Notwithstanding the previous preliminary remarks, the IRSG notes that overly strict limitations are not needed and could conflict with standard business practices that have been established over decades to ensure contractual balance and fairness between the parties. Termination clauses help to address unforeseen circumstances and ensure contract stability. For instance, clauses allowing termination under certain conditions, like material breaches or changes in regulatory circumstances, are vital for managing operational and credit risks. EIOPA should acknowledge that termination clauses contribute to insulate the treaty from litigation risk between the parties and to help manage their risk exposure in line with their risk appetite and system of limits.
- There are concerns that the proposals considered could reduce the ability to tailor reinsurance contracts to specific business needs. Such restrictions might drive up costs or limit availability.
- The IRSG considers that termination clauses that release reinsurers from paying claims, in case of insolvency could directly impact consumers by affecting the stability of their coverage and the insurer's ability to meet claims.
- However, the IRSG does not agree that termination clauses for insolvency events may compromise the "effective transfer of risk for the purposes of the SCR calculation" when the treaty stipulates

that incurred claims prior to insolvency claims would continue to be paid after insolvency. Furthermore, the existence of insolvency event clauses in treaties do not invalidate the fact that risk transfers are effectively happening in most scenarios including the 1-200 scenarios of the Solvency II frameworks. It is reminded that the effective transfer of risk should be assessed on a going concern basis for the SCR calculation (article 101 of the Solvency II Directive). Reinsurance should be recognized in the SCR when risks are transferred effectively in the scenarios of the standard formula.

- EIOPA is mentioning that the "the contractual arrangements and transfer of risk [must be] legally effective and enforceable in all relevant jurisdictions" (article 209 (1.a), i.e. that the arrangement is not "subject to any condition which could undermine the effective transfer of risk, the fulfilment of which is outside the direct control of the insurance or reinsurance undertaking" (article 210 (4)). The IRSG does not agree that termination clauses will compromise enforceability and the effective transfer of risk for the purpose of the SCR calculation. Legal effectivity and enforceability of a contract is distinct from the scope of the risks transferred by a contract. What matters is that the conditions of a legally effective contract are compatible with the purpose of the treaty to transfer risk.

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