CONSULTATION PAPER ON SUPERVISORY STATEMENT ON SUPERVISION OF REINSURANCE CONCLUDED WITH THIRD COUNTRY INSURANCE AND REINSURANCE UNDERTAKINGS

EIOPA-BoS-23/145
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European Insurance and Occupational Pensions Authority

RESPONDING TO THIS PAPER

EIOPA welcomes comments on the Consultation paper on Supervisory Statement on supervision of reinsurance concluded with third country insurance and reinsurance undertakings.

Comments are most helpful if they:

- respond to the question stated, where applicable;
- contain a clear rationale; and
- describe any alternatives EIOPA should consider.

Please send your comments to EIOPA, **by Tuesday, 10 October 2023, 23:59 CET** responding to the questions in the survey provided at the following link:

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

Contributions not provided via the EU Survey or after the deadline will not be processed and therefore considered as they were not submitted.

Publication of responses

Your responses will be published on the EIOPA website unless: you request to treat them confidential, or they are unlawful, or they would infringe the rights of any third party. Please, indicate clearly and prominently in your submission any part you do not wish to be publicly disclosed. EIOPA may also publish a summary of the survey input received on its website.

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Data protection

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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[2]. 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 Directive)[3], in particular Articles 134(1), 172(3) and 173 thereof and Commission Delegated Regulation (EU) 2015/35 (Solvency II Delegated Regulation)[4], in particular Articles 211(2)(b) and (c), 213 and 214 thereof.

1.3. This Supervisory Statement is addressed to the competent authorities, as defined in Article 4(2) of Regulation (EU) No 1094/20105.

1.4. The Board of Supervisors has adopted this Supervisory Statement in accordance with Article 2(8) of its Rules of Procedure[6].

2. CONTEXT AND OBJECTIVE

2.1. The Solvency II Directive recognises the fact that the insurance industry is a global industry. As such, to avoid unnecessary duplication of regulation, the European Commission may decide on the equivalence of a third country's (in this context it refers to non-EEA countries) solvency and prudential regime. Particularly for reinsurance, in case of an equivalence decision according to Article 172 of the Solvency II Directive, reinsurance agreements concluded with third-country insurance or reinsurance undertakings (collectively referred to as “third- country reinsurers”) from those countries are treated in the same manner as reinsurance agreements concluded with undertakings authorised in the EU.

2 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).

3 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).

4 Commission 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. 1–797).

5 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.

6 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

2.2. Equivalence decisions are taken by the European Commission on the basis of EIOPA's technical assessment. The list of the assessed countries can be found on EIOPA's and European Commission's websites[7] .

2.3. In case of reinsurers from the United States of America (US) the EU-US Agreement on Insurance and Reinsurance[8] sets conditions to simplify their market access in each other's territory and limits group supervision of (re)insurance groups active in both territories to the level of the parent undertaking in its own jurisdiction.

2.4. Although Solvency II includes some provisions that regulate the conditions for recognising reinsurance with third-country reinsurers, Member States may introduce national provisions, such as requiring notification, prior authorisation or the establishment of a local branch office. In the last years, EIOPA observed some good practices in supervision implemented by some National Competent Authority (NCAs) that are worth considering by the whole supervisory community.

2.5. The aim of this Supervisory Statement is to ensure that a high-quality and convergent supervision is ensured regarding insurance undertakings using reinsurance arrangements with third-country reinsurers both from equivalent and non-equivalent countries. When relevant only to reinsurance arrangements with third country reinsurers from non-equivalent third countries, this is explicitly mentioned in the text.

2.6. Regarding the risk profile of the reinsurance business it should be noted that differences might exist depending on whether the reinsurance arrangements are performed by reinsurance undertakings retroceding their risks (accepted from primary undertakings) or by insurance undertakings mitigating (ceding) their risks. In fact, reinsurance undertakings have a business model based on international placements. Differences might also exist in the strategy, process and procedures in place regarding in particular the choice of the different reinsurance placements and how reinsurance is managed in general. This Supervisory Statement refers mainly to insurance undertakings using reinsurance as risk-mitigation techniques; however, it might be also relevant, following a proportionate and risk-based supervision and considering the specific business models, to reinsurance undertakings retroceding their risks[9].

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7 https://www.eiopa.europa.eu/browse/regulation-and-policy/international-relations-and-equivalence_en?source=search and List of equivalence Decisions taken by the European Commission - overview-table-equivalence-decisions_en.pdf (europa.eu)

8 EUR-Lex - 4339452 - EN - EUR-Lex (europa.eu) and U.S.-EU Covered Agreement | U.S. Department of the Treasury

9 In the context of reinsurance, please consider as well EIOPA's Opinion on the use of risk mitigation techniques by insurance undertakings (https://www.eiopa.europa.eu/publications/opinion-use-risk-mitigation-techniques-insurance-undertakings_en) including a set of recommendations addressed to supervisory authorities of supervision of risk mitigation techniques including reinsurance.

3. SUPERVISORY EXPECTATIONS

ASSESSMENT OF THE BUSINESS RATIONALE FOR USING THIRD-COUNTRY REINSURANCE AND EARLY SUPERVISORY DIALOGUE

3.1. Reinsurance is an efficient tool for insurance and reinsurance undertakings to manage their risks according to their strategy and capacity. It is also an important tool for capital management improving risk diversification and can be used as an instrument to expand the current business. As like all business strategy, it is the responsibility of the undertakings' administrative, management or supervisory body (AMSB) to define, implement and monitor the reinsurance strategy, considering its advantages (e.g. reduction of capital requirements and volatility of Profit &Loss statement) and disadvantages (e.g. cost of reinsurance, creation of additional risks, such as basis risk or counterparty risk). The actuarial function is also responsible for expressing an opinion on the adequacy of reinsurance arrangements[10].

3.2. Undertakings are expected to properly consider and NCAs to assess the trade-off between reinsurance premiums, additional risks and impact on Solvency Capital Requirement (SCR) as well as other regulatory considerations stemming from third-country reinsurance.

3.3. As indicated in the EIOPA Opinion on the use of risk mitigation techniques by insurance and reinsurance undertakings[11], NCAs are encouraged, considering proportionality, to engage in an on-going supervisory dialogue with the undertaking, as is already common practice in several jurisdictions. For this dialogue to be efficient, it needs to start sufficiently before the conclusion of the reinsurance agreement to allow NCAs to understand the undertakings' reinsurance strategy and its impact on the solvency position. This dialogue is expected to be maintained over time so NCAs are informed in case of any material changes.

3.4. The dialogue is particularly encouraged in cases where a significant level of risk is transferred through reinsurance.

ASSESSMENT OF THE INSURANCE UNDERTAKINGS RISK MANAGEMENT SYSTEM REGARDING THE USE OF THIRD-COUNTRY REINSURERS

3.5. It is the responsibility of the AMSB of the undertakings to ensure that the risk management and internal control systems are adequate and in line with their

10 Reference to Article 48(1)(h) of the Solvency II Directive.

11 https://www.eiopa.europa.eu/publications/opinion-use-risk-mitigation-techniques-insurance-undertakings_en

reinsurance strategy and policy. Insurance undertakings are expected to demonstrate in the Own Risk and Solvency Assessment (ORSA) that risks associated with third-country reinsurance arrangements are appropriately captured by the risk management framework and quantified while also including a list of the most material arrangements.

3.6. As part of the on-going supervision of undertakings' system of governance[12], NCAs following a risk-based supervision perform an assessment of the risk management and internal control systems of the insurance undertakings using material reinsurance arrangements with third-country reinsurers taking the following into consideration:

a) Assess if the strategies, processes, and reporting procedures are adequate to continuously identify, measure, monitor, manage and report on the risks to which the undertaking is or could be exposed taken into account the different domiciles of its third country reinsurers[13], including also retrocession of risks to other third country reinsurers;

b) Assess if the undertaking's assessment of risks arising from reinsurance agreements include identification of any legal/compliance risk arising from the law for the third countries concerned, including for example risks resulting from international sanctions, as well as counterparty risk;

c) Assess if the risk management policies developed by the undertaking cover the principles for the selection of reinsurance counterparties (including the ones from third countries)[14] as well as procedures for assessing and monitoring the creditworthiness and diversification of reinsurance counterparties.

3.7. When performing the assessment under points a) and b) above, NCAs are recommended to evaluate how insurance undertakings assess the different domicile/country of the third country reinsurers to be used. Undertakings are expected to identify the legal consequences arising in case of insolvency, winding-up procedures or recovery and resolution mechanisms, including the power of disavowal with consequently no enforceability of pledged collateral and no direct claim on the counterparty in the third country. Undertakings are also expected to identify how risks arising from such regimes may be mitigated and whether there are special areas to be considered in case of liquidation and bankruptcy of the third country reinsurer.

3.8. An important part in the assessment of the bankruptcy law is the status of the collateral. In many jurisdictions the collateral is not part of bankruptcy procedures but has a preferential status. In this sense, insurance undertakings should assess whether the third-country law restricts the possibilities to withdraw the collateral and whether it

12 Reference to Article 36(2)(a) of the Solvency II Directive.

13 Insurance undertakings should note, that the risk carrier of the reinsurance agreement is always the signing entity, and that, in certain cases, this entity, may not be the one who carried the negotiations, but another entity, based in another jurisdiction.

14 It is worth reminding that using multiple counterparties has the benefit to reduce the SCR for counterparty default risk and potentially the overall SCR as well.

grants the rehabilitator the authority to disavow active reinsurance agreements to which the undertaking is a party.

3.9. The result of this country/domicile assessment by insurance undertakings should be considered in the undertakings' assessment of compliance with Article 213 and Article 214 of the Solvency II Delegated Regulation. For third-country regimes where the law on liquidation and bankruptcy raises risks of non-compliance with the reinsurance agreement or the supervisory and resolution procedures include the power of disavowal (or similar) of the reinsurance agreement that can completely erase all legal rights and obligations of the parties in relation to pledged collateral, the requirements of Article 214 of Solvency II Delegated Regulation cannot be fulfilled, unless specific measures are available and implemented in that regard.

3.10. One possibility to reduce legal risks for the insurance undertakings or reinsurance undertakings is to include in the reinsurance agreement a specific clause or a contractual provision regarding the choice of the law in the undertaking's state of domicile or the law of another EU Member State. The same applies to a clause or a contractual provision regarding the place of jurisdiction[15] (jurisdiction clause).

3.11. When developing the assessment under point 3.6 c), NCAs are recommended to evaluate how insurance undertakings consider at least the following for the selection of reinsurance counterparties:

- Capital strength, considering the strength/weakness of the capital regime in the country where the counterparty is domiciled;
- Quality of capital of the counterparty (taking into account whatever standards exist in the country);
- Monitoring of the creditworthiness of third country reinsurers, which for SCR purposes must be at least credit quality step 3 in case of use of non-equivalent reinsurance;
- Acting in case creditworthiness deteriorates before arriving to the insolvency, which is a critical situation also for European reinsurance undertakings[16];
- Availability of any other risk mitigants e.g. collateral, ring fencing etc.

3.12. One of the expected procedures in the risk management and internal control of the undertakings using materially third country reinsurers from non-equivalent third country is the assessment of whether they fulfil basic requirements for conducting reinsurance business. This assessment should be performed by the undertakings before entering into the reinsurance agreements and on a regular basis and should cover at least the following areas:

15 See for reinsurance contracts with US reinsurers Article 3(4)(d) of the EU US Bilateral Agreement.

16 However, it is worth reminding that, differently from the case of Solvency II equivalent third-country, the compliance with the local solvency requirements applicable in non-equivalent third-country is not requested by Solvency II as a condition to be met to consider the reinsurance cover as risk-mitigation techniques. In such case, Article 211(2)(c) of the Solvency II Delegated Regulation only requires, in addition to other general requirements in Article 209-2010, a credit quality step 3 or better.

- The third-country reinsurer has a licence to carry out reinsurance business;
- The third-country reinsurer is allowed to carry out reinsurance business in the Member State where the insurance undertaking is domiciled in case there are rules to access the market;
- The experience of the third-country reinsurer with regard to the requested risk transfer solution;
- The existence of any regulatory action taken against the third-country reinsurer.

3.13. A detailed assessment is expected from undertakings when there is a material exposure towards a single third country reinsurer or third country reinsurers belonging to the same group to address concentration and counterparty risk. A detailed assessment is also expected when the type of agreements /risk transfer envisaged is complex.

3.14. Insurance undertakings are expected to use different sources of information e.g., financial checks, review of the website of the third-country regulatory authority to confirm whether any regulatory action has been taken against that third country reinsurer, whether the third country is a member of the International Association of Insurance Supervisors (IAIS), assessments done by the International Monetary Fund and other stakeholders, publications of the third country's regulatory authorities, reports of rating agencies.

3.15. In accordance with Article 44(4a) of the Solvency II Directive, insurance undertakings are required to assess the appropriateness of external credit assessments as part of their risk management by using additional assessments wherever practicably possible in order to avoid any automatic dependence on external assessments. In this context, undertakings are expected to consider the followings regarding the rating of third country reinsurers:

- If a rating exists, who has issued it and assess reports of the rating agencies;
- Any information available from other rating agencies;
- Analysis of the volatility of the rating over the last years;
- Regularly monitor the rating;
- Assess the impact of downgrade risk of third-country reinsurers in the SCR and risk margin.

3.16. NCAs are recommended to assess if/how insurance undertakings monitor the relevant third country reinsurers and have in place procedures on actions to be followed in case:

- The recognition in the SCR of the bespoke risk mitigation contract ceases or is only partial, e.g. as a consequence of a rating downgrade of the third country reinsurer from non-equivalent third country or in case the NCA is of the view that the reinsurance agreement provides none or only partial risk transfer;

- In case, the third country reinsurer (in an equivalent solvency regime breaches its national solvency requirements[17].

ASSESSMENT OF THE REINSURANCE AGREEMENT

3.17. Another important aspect of the undertakings' reinsurance risk management is to assess if the reinsurance agreement is in compliance with Articles 209-211 of the Solvency II Delegated Regulation. Such an assessment should take into consideration whether the agreement is an intragroup or non-intragroup reinsurance, short or long-term reinsurance, reinsurance of primary insurance or retrocession.

3.18. In such an assessment insurance undertakings should consider at least:

- Whether there are further retrocessions, their conditions and agreements as well as soundness and location of the retrocessions;
- Whether there are side letter agreements with the third country reinsurer (which introduce additional conditions and requirements to the existing reinsurance agreement);
- Whether the reinsurance agreement includes a 'termination clause', providing the insurance undertaking with the right to terminate the agreement in case certain conditions occur, such as the breach of the local solvency requirement or a material deterioration of the financial situation of the third country reinsurer (including its downgrade), if the third country reinsurer is put on any form of administration by a competent regulatory authority or court;
- Whether the third country reinsurer can unilaterally terminate the agreement under certain conditions and what are those conditions ;
- Clearly established claims' hierarchy in case of default that does not depend on the third-country accounting principles, third-country (bankruptcy) legislation or receiver/rehabilitator assessment and mandate;
- If applicable, collateral arrangements ensuring collateral quality and liquidity so that collateral is completely and readily available in the event of third country reinsurer's bankruptcy, default, rehabilitation or other conditions of financial distress;

3.19. If any of the points above are assessed as jeopardising the effective transfer of the risk and/or legality of contractual clauses, the insurance undertaking need to provide evidence to the NCA justifying the recognition of the contract as a risk-mitigation techniques in the calculation of the SCR.

3.20. Insurance undertakings should document their assessment of the reinsurance agreement, including, where applicable, how the above-mentioned aspects were

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17 In case the reinsurance undertaking is from a non-equivalent solvency regime, the assessment should focus on the monitoring of the the creditworthiness of the reinsurance undertaking. See 3.11, third point.

considered, and how it was concluded in compliance with Articles 209-211 of the Solvency II Delegated Regulation.

TOOLS TO MITIGATE ANY ADDITIONAL RISKS

3.21. If resulting from the assessments of the country, third country reinsurer and reinsurance agreement referred to above, the insurance undertaking has concerns or has identified increased material risks, the following different tools could be considered (or be requested by the NCA):

- Pre-emptively limit exposures on certain third-country reinsurers, through a careful diversification of the reinsurance panels, as far as assigned shares to third-countries reinsurers are concerned, particularly in case of a single or relatively few counterparties, for long tail lines of business and/or types of reinsurance treaties which may generate large recoverable amounts;
- Mitigate counterparty default risk of the third country reinsurer with collateral agreements[18]/pledge assets/premium and reserve deposits in cash or securities, but taking the adequate precautions to prevent situations where the collateral might not be enough or available entirely in case of a bankruptcy, through for example the assessment of the quality of collateral, negotiation of the localisation of the collateralised assets in the jurisdiction where the undertaking is located;
- Make sure that undertakings have in the event of a default, insolvency or bankruptcy of a counterparty or other credit event set out in the reinsurance agreement , a direct claim on that counterparty;
- Include in the agreements with third-country reinsurers clauses for regular commutations or exposure threshold-initiated execution of a commutation agreement[19].

18 Examples of type of collateral which may be used include: letter of credit, funds withheld, cash, securities, etc.

19 A commutation agreement is “an agreement between a ceding insurer and the reinsurer that provides for the valuation, payment, and complete discharge of all obligations between the parties under a particular reinsurance contract”. It can be used for the final settlement of best estimates for outstanding claims in case the cedent and/or the reinsurer desires to end the contract. A commutation agreement can also be added to long duration reinsurance contracts to avoid the build-up of large best estimate exposures. In such cases the commutation agreement specifies the frequency for best estimate account settlement and reset or defines a specific reinsurance recoverables threshold trigger for the commutation.

Done at Frankfurt am Main, on 28 June 2023.

[signed]

For the Board of Supervisors

Petra Hielkema

Chairperson