reinsurance
advisory board

Response to EC Better Regulation consultation on its proposal for the Solvency II review

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Introduction

The Insurance Europe Reinsurance Advisory Board (RAB) welcomes the opportunity to contribute to the European Commission's consultation on the Solvency II review proposal.

The RAB strongly supports the Solvency II regime and its risk-based approach. Solvency II is today the most advanced insurance regulatory regime in the world and it has passed the test of the COVID-19 crisis.

Over recent years, the RAB has actively contributed to the review of Solvency II by engaging with EIOPA and the European Commission (see contributions here and here). The review provides the opportunity to address the framework's excessive capital burden and volatility and it should avoid increasing the already very high operational burden the regime places on European (re)insurers. The right set of changes can lay the groundwork for the European reinsurance sector to strengthen its competitiveness, to contribute to reducing protection gaps and to support a sustainable European recovery. These priorities fully align with the Commission's objectives and there should be a common interest in delivering on them.

The RAB welcomes the Commission's intention to **better recognise some reinsurance covers and to reduce the level and volatility of the risk margin for long-term business.** The proposed changes are technically justified and bring more insurance and investment capacity to the EU.

However, the Commission's proposals in areas such as internal models (IM) allow for what the RAB strongly believes would be an **unjustified and significant increase in regulatory requirements and operational and reporting burdens**. In the RAB's view, one of the key drivers of all these challenges is **inappropriate recognition of the specific nature of reinsurance**.

The RAB believes that the review needs to ensure the following:

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- **Standard formula (SF) reporting** — which is not necessarily optimal for capturing all reinsurance risks and diversification between these risks appropriately — **should not be required of reinsurers using an approved IM.**
- Any changes made to **risk mitigation techniques** (RMT) must give fair recognitions to the SF. The RAB welcomes the progress made on the treatment of innovative forms of non-proportional loss-sharing between insurers and their reinsurers (adverse development covers or ADCs) but is concerned by the inclusion of inappropriate new "safeguards" announced in the EC Communication. The RAB urges the EC to base any modification of the delegated act in respect of such safeguards on the latest EIOPA opinion on the topic published in July 2021 rather than the EIOPA advice published in December 2020. EIOPA recognised in its final opinion on RMT that the new "commensurate" criterion would need to be defined by reference to a deviation of the risk profile of the company vis-à-vis the SF assumptions.
- The introduction of **additional "early-intervention" measures** to be applied before the breach of the SCR, during times of exceptional market-wide shocks or via the Insurance Recovery and Resolution Directive (IRRD), should be avoided and not go beyond international standards. These measures would **undermine the credibility of the SCR, while imposing a disproportionate and unreasonable burden on European reinsurers compared to their global competitors.**
- Changes to **Solvency II reporting ITS, which EIOPA initially planned to make applicable for YE2022 closing, are both overly extensive and unnecessary.** The RAB therefore welcomes EIOPA's proposal to postpone the date of application by one year and to consider further postponements of more than one year for certain templates. In a timely manner, the enforcement of the amendments to the QRT-reporting should be aligned with the overall enforcement of the 2020 Review requirements to minimise the implementation burden.
- However, the RAB believes that **the introduction of the IM templates is unnecessary** as they will not bring any significant new insights for supervisors. If the templates are introduced, the RAB strongly recommends including them in the category of templates for which the date of application is delayed by more than one year, due to their complexity and the extensive workload associated with their introduction.
- The **group risk margin calculation should allow for the diversification of risks across the reinsurance group** to reflect the reinsurance business model. The design of the risk margin has implications for the competitiveness of EU reinsurers in non-EU jurisdictions that do not require a risk margin of local (re)insurers.

Detailed comments

- **Internal models**

While the RAB welcomes the fact that Recital 44 of the proposal emphasises the objective of imposing no "limits" on IM as a consequence of SF supervisory reporting, it does not agree with the justification expressed therein that "*partial and full IM make comparisons across companies more difficult and supervisory authorities would therefore benefit from access to the outcome of the calculation of SF capital requirements*". All IM are calibrated to the same level of policyholder protection (99.5% value-at-risk). While there can be significant differences among IM, these reflect the differences in risk profiles and business mix of their users, as intended by the framework.

IM deliver a wide range of benefits to supervisors, undertakings and, ultimately, policyholders[1]:

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[1] Consultation Paper 20, CEIOPS-CP-09/06, 10 November 2006

- Adequate modelling of non-standard, especially non-linear, risks
- In-depth reflection of the underlying risk (also for supervisors) and best-in-class risk management practices
- Financial stability brought to the system by diversity in risk modelling

The RAB believes that the proposed requirement that firms must calculate both IM and SF SCR undermines the credibility of Solvency II, on top of making the framework more onerous. Since IM are typically used in situations where both companies and regulators agree that the SF would not be appropriate, such a requirement would effectively undermine not only IM but also the process underlying their effective management and supervision. IM are currently fully integrated in the decision-making of firms and their risk management, in accordance with the use test prescribed in Article 120 of the Directive. Undermining IM in this way will require the administrative, management or supervisory body (AMSB) to reconsider its strategic and business plans in a way that may limit the provision of reinsurance cover and long-term investment.

- **Fair recognition of reinsurance in the standard formula**

Further recognition of risk-mitigation techniques

The RAB welcomes the fact that, in its Communication on the review of Solvency II, the Commission states it will consider extending the recognition, within the SF, of innovative forms of non-proportional loss-sharing between insurers and their reinsurers, in line with EIOPA's opinion. The RAB welcomes the fact that EIOPA proposed to improve the recognition of RMT in its opinion to the Commission. However, it regrets that it **introduces limitations and therefore fails to completely address the issue**. This is specifically the case for ADCs under the reserve risk sub-module in the SF, for which the requirement to cover only a single line of business is onerous and does not meet the needs of small and medium-sized insurers when engaging in such transactions.

- In particular, the formula proposed by EIOPA should also apply to structures covering multiple lines of business and should not have any limitation in the attachment point. Since the economic effects of the attachment point are already recognised by the formula, there is no risk of underestimation (as is also the Commission's intention in its communication referred to above).
- The RAB encourages the Commission to address this issue, as improved recognition of ADCs could reduce the volatility of small and medium-sized insurance companies, while protecting their back book of historical risks from distortions.
- Therefore, the Commission is called on to **extend the ADCs proposal to multiple lines of business**.

In addition, EIOPA advised introducing in Article 210 of the Delegated Regulation new requirements for allowing SF users to have their reinsurance programme recognised, on top of all the existing safeguards in the regime. EIOPA's advice on the Solvency II review (December 2020) was not based on EIOPA's most recent opinion on the use of RMT (published in July 2021), but instead on a September 2020 consultation document.

This is unfortunate, as EIOPA agreed to review its position on reinsurance recognition after the RAB and other associations strongly opposed the content and tone of the EIOPA consultation document on which the advice is based (please refer to the RAB response to the EIOPA consultation). In particular, EIOPA agreed to clarify that a reinsurance arrangement may not pass the "commensurate" test where it creates "*a significant deviation of the risk profile of the undertaking from the underlying assumptions of the SCR*". In other words, a reinsurance arrangement may not qualify for an SCR reduction if it renders the SF inappropriate for capturing the risk profile of the ceding undertaking.

Therefore, the RAB urges the EC to read EIOPA's advice on the recognition of RMT in conjunction with the final opinion on the matter, as proposed below:

5.32 EIOPA proposes that the following is added to Article 210 of the Delegated Regulation:
"*The undertaking shall prove the extent of an effective transfer of risk in order to ensure that any reduction in the Solvency Capital Requirement or increase in available capital resulting from its risk transfer arrangements is commensurate with the change in risk that the undertaking is exposed to.*
The Solvency Capital Requirement and available capital shall reflect the economic substance of the arrangements that implement the technique. When calculating the Basic Solvency Capital Requirement, insurance or reinsurance undertakings shall only take into account risk-mitigation techniques *as referred to in Article 101(5) of Directive 2009/138/EC where*:
- the reduction in the Solvency Capital Requirements, or increase in the available capital is commensurate with the extent of risk transfer, and
- there is an appropriate treatment within the Solvency Capital Requirement of any corresponding risks that are acquired in the process.
[Insert: ***The reduction in the Solvency Capital Requirement or the increase in available capital is not commensurate with the risk transfer provided by the contractual arrangement if it leads to a significant deviation of the insurance or reinsurance undertaking's risk profile with the assumptions underlying the Solvency Capital Requirement.****] "*

- **Basis risk**

The RAB is of the view that clarification and improvement of the current rules on basis risk in the context of RMT in the SF would be welcome. Indeed, the current approach takes an "all or nothing" view of material basis risk, which creates significant uncertainty for both insurers and reinsurers and is not consistent with a risk-based approach.

EIOPA ignored all the industry's feedback and proposals on basis risk and advised transforming EIOPA Guidelines 1, 2 and 3 on basis risk into legislation in the Delegated Regulation. The RAB believes that this would only exacerbate the issues currently faced and encourages the Commission not to incorporate these in the Delegated Regulation. These points would be better addressed in a future review of the Guidelines.

- **Early-intervention measures**

With regards to the proposed supervisory measures during times of exceptional market-wide shocks, the RAB strongly opposes the introduction of additional "early-intervention" measures which could be applied before the breach of the SCR. Solvency II already provides for an appropriate set of measures for supervisors to intervene in cases of deteriorating financial conditions and the breach of the SCR is a clear threshold for supervisory intervention, which is why the introduction of any additional measures would only undermine the credibility of the SCR. Not only is it unclear how these measures would further improve policyholder protection, but the proposed changes also place a disproportionate and unreasonable burden on European reinsurers compared to their international competitors.

- **Risk margin**

The RAB is very supportive of the intention expressed in the Commission's communication to reduce the cost of capital parameters and to introduce a new parameter "lambda" (without a floor). These, in combination, will contribute to correcting the flaws of the risk margin for long-term business.

Although further reductions are justified, the RAB recognises that the proposed changes would support the competitiveness of the sector, as most jurisdictions in which RAB companies operate do not require a risk margin.

However, for global reinsurers such as the RAB members, the absence of recognition of diversification in the risk margin at group level (although allowed at solo entity level) is uneconomic and fails to recognise the reinsurance business model which is based on diversification. Just as diversification is recognised in the group SCR, the Delegated Regulation should allow for its recognition within the group risk margin.

- **Mitigation of artificial solvency volatility**

The RAB supports the EC's stated objective to mitigate short-term volatility in solvency positions and notes that the EC has made a number of proposals intended to achieve this objective.

However, the RAB is concerned that the proposed changes to the extrapolation of the risk-free rate (RFR) and the proposed changes to the risk correction in the volatility adjustment (VA) could undermine the positive impact of other proposals, especially during periods of market turbulence when they are most needed.

- The RAB considers that a speed of convergence parameter, which is used in the EC's proposed RFR extrapolation, significantly above the 10% proposed by EIOPA is needed to maintain the anticyclical qualities of the extrapolation and to avoid a significant and unnecessary decrease in capital resources.
- In addition, Article 77a of the Directive should be amended to specify the convergence parameter (ie, the exact value), the deep, liquid and transparent (DLT) determination method and the residual volume criterion (ie, the percentage value of 6%).
- The RAB also supports the retention of the current risk correction methodology for the VA or, alternatively, improvement of the calibration of the methodology proposed by EIOPA and brought forward by the Commission.

- **Group supervision**

In Art.1(72)(b) and (c), the Commission proposed a significant improvement to the calculation of the minimum consolidated group SCR to prevent the trigger inversion issue (where the minimum would be hit before breaching the SCR, leading to the same consequences as breaching an MCR at solo level).
While the RAB supports this modification, the wording of the new paragraphs 2 and 3 of Art. 230 in the proposal now says that the previous minimum should continue to exist in addition to the new one. A quick fix would be to adjust the second subparagraph of paragraph 2 to read "*For the purpose of the calculation in paragraph 3, point (b), of this Article, the participating insurance and reinsurance undertakings ~~consolidated group Solvency Capital Requirement~~ shall ~~have~~ use ~~as a minimum~~ the sum of the following: (…)*". The RAB believes this is sufficient to address the trigger inversion issue while still ensuring that the minimum reflects the full scope of undertakings in the group.

- **Supervision of cross-border (re)insurance business**

The RAB welcomes the Commission's objective of strengthening the cooperation between home and host national supervisory authorities (NSAs) on the activities of businesses operating cross-border through the freedoms of services and establishment (FOS/FOE). However, this should not result in overburdening or even discriminating against (re)insurers whose business model integrates the opportunities created by the single market. It is important not to lose track of the actual problem that these new provisions aim to address — which are ultimately related to supervisory failures in very specific business circumstances and models. The solutions should be

tailored to the actual problems and not create new rules and requirements for a wider spectrum of companies, for which new measures are not needed.

The new Article 159a significantly increases the powers of the host NSA, thereby potentially undermining the home member state principle. The process and timeline it sets out do not necessarily seem adequate given the urgency that is likely to be needed in cases where an undertaking will not meet the MCR. Furthermore, the RAB notes that this provision should not apply and is, in fact, not needed, in cases where a supervisory college exists. The Commission's proposal could end up undermining supervisory convergence in the case of groups with established colleges by creating the possibility of having different supervisory approaches for groups with different business structures.

Similarly, Article 159a should not apply to reinsurance. The inclusion of reinsurance undertakings within the scope of these new requirements is incompatible with the nature of reinsurance business. The Solvency II Directive defines reinsurance as the activity consisting in accepting risks ceded by an insurance undertaking or third-country insurance undertaking, or by another reinsurance undertaking or third-country reinsurance undertaking. By nature, reinsurance is a business-to-business activity that is intrinsically cross-border. It should therefore be excluded from the scope of Article 159a, which fails to recognise the specific characteristics of reinsurers' business models. This is also supported by EIOPA's recent report on "Failures and near misses", which does not identify any case related to reinsurance.

- **Macroprudential concerns in the own risk and solvency assessment (ORSA) (Art. 45)**

It is unclear what the EC's expectation is regarding the requirement to consider and analyse the activities of the undertaking that may affect macroeconomic and financial market developments that have the potential to turn into sources of systemic risk (proposed Art 45, 1 (e)).

The proposed requirement to have an outward assessment of systemic risk for each insurance company has the potential to be very far-reaching and goes beyond the recommendations made by EIOPA. It is unclear how it could work in practice. Given the very limited contribution of individual (re)insurers' behaviour to systemic risk and the diverse range of strategies employed across Europe, the potential benefits of this requirement seem small and do not justify the substantial costs involved.

- **Macroprudential concerns in the prudent person principle (PPP) (Art. 132)**

It is unclear what the EC's expectation is regarding the requirement to assess the extent to which the undertaking's investment strategy may affect macroeconomic and financial market developments and have the potential to turn into sources of systemic risk (proposed Art 132, para 6), since historically there is very limited, if any, evidence that investments by insurers have created systemic risk. This lack of clarity may lead to reinsurers avoiding certain investments that would have benefited the policyholders and contributed to a conversion to a green economy. To reduce the lack of clarity, reinsurers should only have to take this into consideration in their investments strategy if the supervisory authorities can clearly demonstrate that certain investments are a source of systemic risk.

- **Liquidity risk management plans (LRMPs)– Article 144a**

The requirement for all (re)insurers, except those classified as low-risk profile undertaking, to submit LRMPs is overly burdensome. A much more proportionate scope should be foreseen or, at a minimum, the frequency for submitting a reduced LRMP for those insurers that have low liquidity risk should be limited to every three to five years.

The liquidity risk plan and indicators should be designed and reflect (re)insurers' own assessment of their liquidity position, included under stress. Company-specific plans and indicators ensure that they result in useful and practical risk management tools rather than arbitrary metrics.

Therefore, the RAB suggests removing EIOPA's empowerment to standardise the content of the plans (delete article 144a (6)). Article 144a (2) is sufficiently clear as to what is expected is the plan.

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