

Insurance Europe views on EIOPA's Holistic Impact Assessment

This paper sets out Insurance Europe's views on EIOPA's Holistic Impact Assessment exercise, undertaken between March and June 2020. Insurance Europe looks forward to continued engagement with the EC, EIOPA and all other stakeholders on the 2020 Review of Solvency II and would welcome the opportunity to discuss the views raised below in more detail.

Key messages

- EIOPA seeks to achieve a "balanced outcome"¹ and has committed to delivering technical advice which, except for the interest rate risk submodule, aims to not increase the aggregate capital requirements for European insurers. However, EIOPA has not provided evidence that a balanced outcome is appropriate, and it should, in any case, achieve its target for a balanced outcome at national as well as European level.
- On the contrary, Insurance Europe considers Solvency II to be unnecessarily conservative and that a net reduction in aggregate capital levels is justified.
- Policy measures not being tested in the HIA, such as those for groups, should be included as part of the balanced outcome. Similarly, the impact of the IBOR transition should also be considered, although such a transition should not have a negative impact in the first place.
- EIOPA's attempt, through the second HIA, to test potential changes under market conditions impacted by COVID-19 is welcome. However, due to the recovery on the financial markets since March this may not, in practice, provide a significantly different data set compared to the previous exercise. In its final recommendations to the EC, EIOPA should ensure that its proposals do indeed work under a wide range of economic conditions, for example by assessing the impact of the proposals under market conditions similar to those experienced in the 2008 or 2011 crises.

Comments on specific proposals:

- **Extrapolation of RFR:** Insurance Europe continues to support the existing extrapolation methodology and parameters. The Matching Criterion and Residual Bond Criterion are key elements of the risk-free rate framework. These two criteria must remain anchor points for any extrapolation approach.
- **Volatility Adjustment:** It is disappointing that EIOPA continues to pursue damaging and uneconomic changes to the VA.
 - There is not sufficient justification to change the risk correction. The existing methodology is already conservative enough to cover any concerns about the level of losses from defaults which may arise after a crisis. EIOPA's small tweak to its original proposal does not address the industry's strong and credible concerns about the risk correction being set as a proportion of the prevailing spread. In addition, this proposal increases procyclicality in the framework.
 - The revised liquidity application ratio criteria remain flawed and therefore strongly opposed by the industry. Liquidity should be dealt with in Pillar II and Pillar III, not Pillar I.
 - However, some of the proposed changes to the VA are welcome as steps in the right direction, as they reflect the industry's positions that the VA is too low and does not sufficiently address artificial balance sheet volatility. This includes the inclusion of a "rescale factor", recognition that the 65% for the GAR is too low and the enhanced country component (Option 7).
- **Risk Margin:** EIOPA's proposal to include a lambda factor is a step in the right direction, yet more work is needed to ensure the calibration of this scalar is appropriate. EIOPA's proposal for the Risk Margin does not go far enough to address its excessive size and volatility; the value of 0.975 for lambda is too high, and the proposed floor of 0.5 has not been adequately justified. EIOPA should improve the Risk Margin by:

¹ See G. Bernardino Key Speech: Insurance and Pension: Leading the Future, 19 November 2019

- Recalibrating the lambda parameter and its proposed floor to better reflect the impact of risk dependence over time.
- Allowing for diversification between life and non-life business within the same entity, or between different entities within a group.
- Lowering the Cost of Capital rate to 3%, in line with evidence provided by the industry.
- **Interest Rate Risk SCR:** EIOPA's proposal is overly punitive and uneconomic. The standard formula interest rate risk requirements must properly reflect the effective lower bound for interest rates and calculate the illiquid part of the stressed curves using the standard extrapolation methodology.
 - The two "optional" configurations on which data is requested are also insufficient to resolve the industry concerns. In particular, the level of the interest rate floor proposed by EIOPA is ineffective and does not reflect the lower bound for interest rates.
- **Dynamic Volatility Adjustment:** Insurance Europe welcomes the recognition of the DVA as a valid tool within internal models and the testing of the standard formula DVA.
 - For internal models, the industry is concerned that the enhancement of the DVA prudency principle could create additional unjustified calculation burden and unstable cliff effects.
 - For the standard formula, the proposed approach is overly conservative and excludes unrated bonds, which would be detrimental in respect of the EC's CMU objectives.
- **Long-term equity (LTE):** EIOPA's revised LTE proposals are not expected to extend the scope of the LTE submodule and therefore are of limited value.
 - For life insurers, the flawed liquidity criteria and excessive duration requirements will restrict the application to only a few long-term pension products.
 - For non-life, the binary application approach and the restricted HQLA assessment will unnecessarily restrict its use.
- **Own funds buffer:** The inclusion of an additional discretionary buffer to be applied when credit spreads are excessively compressed is unnecessary and would effectively create additional capital add-ons to deal with systemic risk. Insurance Europe strongly opposes this.
- **Non-proportional reinsurance:** Insurance Europe welcomes the testing of an alternative approach to recognise non-proportional reinsurance in non-life premium risk. However, several technical challenges remain which need to be overcome to make this a viable solution.

The 2020 review of Solvency II provides a key opportunity for supervisors, regulators and the industry to improve the design and calibration of the framework. Beyond this, the Solvency II review has to be regarded in the context of the broader economic and environmental realities that Europe is facing, and the ambitions for the future that have been set out by the European Union, jointly and individually at member state level.

Europe is currently facing major challenges related to achieving economic growth and technological innovation, global competitiveness and addressing climate change and the aging society. These challenges have been magnified by the ongoing COVID-19 pandemic.

To achieve the objectives and address the challenges above, Europe needs more long-term investment, more insurance products including long-term guarantees and coverage of emerging risks associated with technological innovation and climate change. Insurers, with their long-term business model, are committed and well-placed to play a major role in helping to address these needs.

Capital and other requirements drive the industry's capacity to cover risks, the ability to offer guarantees and the level and type of investments that can be made. They can also have a significant impact on pricing and availability of products for customers. For four years now, European insurers have been subject to the Solvency II regime. Its risk-based approach remains strongly supported and it has been instrumental in widening and deepening the already very high standards of risk management and customer protection across Europe. However, Solvency II does require targeted important improvements and the current review process is necessary and welcome.

Holistic Impact Assessment

In its Call for Advice (CfA), the European Commission requested EIOPA to provide a detailed impact assessment to accompany its technical advice on the 2020 Review.

To inform its technical recommendations and source data for the impact assessment, EIOPA has made two information requests to insurers. The first was made in December 2019 and requested information on the impact of many individual policy proposals which were being considered by EIOPA. The second, the Holistic Impact Assessment (HIA), requests the aggregate impact of several policy options with additional data requested on several other policy options.

While Insurance Europe welcomes the HIA and provides detailed comments on a number of the policy options being tested below, it first highlights the following general considerations which need to be borne in mind as part of the 2020 Review and the accompanying impact assessment:

- EIOPA seeks to achieve a "balanced outcome"² and has committed to delivering technical advice which, except for the interest rate risk submodule, aims to not increase the aggregate capital requirements for European insurers. However, EIOPA has not provided evidence that a balanced outcome is appropriate and should, in any case, achieve its target for a balanced outcome at national as well as European level.
- On the contrary, Insurance Europe considers Solvency II to be unnecessarily conservative and that a net reduction in aggregate capital levels is justified because the current valuation of liabilities can be exaggerated and capital requirements for long-term investments are excessive. The proposed change to the interest rate risk submodule would have an inappropriately large and detrimental impact and exacerbate these issues.
- It is also noted that when assessing the holistic impact (including their own objective for a balanced outcome), EIOPA must incorporate the impact of policy changes which are not included in the HIA, namely any changes to the requirements for insurance groups. The impact of the proposed transition

² See G. Bernardino Key Speech: Insurance and Pension: Leading the Future, 19 November 2019

away from IBOR-based discounting should also be included in the balanced outcome although such a transition should not have a negative impact in the first place.

- Solvency II is designed to protect policyholders from extreme events and the framework should function effectively under stressed as well as benign market conditions. While Insurance Europe welcomes EIOPA's attempt, through a second HIA exercise (foreseen between July and September) to capture different economic conditions created by the COVID-19 pandemic, it is not clear if this will provide significantly different data due to the recovery on the financial markets since March. In its final recommendations to the EC, EIOPA should ensure that its proposals work do indeed work under a wide range of economic conditions, for example by assessing the impact of the proposals under market conditions similar to those experienced in the 2008 or 2011 crises.

Regarding the specific policy proposals being assessed, Insurance Europe, together with the CRO and CFO Fora, provided extensive feedback on EIOPA's Consultation Paper on the Opinion on the 2020 Review of Solvency II. Overall, the industry assessed that the proposals would result overall in significant increases in capital requirements, operational burden for insurers and new powers for supervisors. It noted that there was no evidence to justify these increases and such outcomes would in fact reflect a worsening rather than an improvement of the framework.

The HIA proposals reflect a development in EIOPA's thinking across a number of areas of the 2020 Review and partially reflect some of the feedback provided by industry to the consultation.

Certain proposals included in EIOPA's HIA are a step in the right direction. These include the recognition that changes to the current design and calibration of the risk margin are needed to lower it and make it less volatile, acceptance of the Dynamic Volatility Adjustment (DVA) as a valid tool for internal models, testing of a DVA within the standard formula and attempts to improve some of the eligibility criteria for the long-term equity submodule.

However, several of the proposals being tested continue to be unnecessary, overly theoretical, fail to adequately recognise the insurance business model and would make the Solvency II framework less effective. They would also go against rather than contribute to the European Commission's CMU and sustainable finance objectives. These detrimental proposals include, for example, the proposed changes to the VA risk correction, the new and unnecessary additional capital buffers for systemic risk, changes to extrapolation in the risk free-rate methodology and the unduly onerous proposals on interest rate risk.

Detailed comments on technical specifications

Extrapolation of risk-free rate (RFR) curves

Insurance Europe continues to support the existing extrapolation methodology and parameters. EIOPA's concerns with the current approach remain unsubstantiated and do not justify a change to the current approach which would decrease the stability of the framework. Furthermore, a prerequisite of the extrapolation framework is that insurers are able to match cashflows in the "liquid" part of the curve with cashflows from bonds. Therefore, the residual volume and matching criteria must be maintained irrespective of the extrapolation approach.

In the HIA, EIOPA tests the alternative extrapolation methodology which it introduced in its consultation paper. EIOPA's proposal, in its current calibration, will significantly increase capital requirements for long term products. This is further aggravated by the fact that the highest impact is concentrated in a relatively small number of markets and currencies.

EIOPA's preliminary assessment suggested the alternative extrapolation methodology would result in a reduction of the national market SCR ratios of up to 49% points. It represents a significant increase of capital requirements for long-term liabilities and would substantially increase balance sheet volatility.

EIOPA's analysis of the residual volume criterion and the matching criterion demonstrate that market conditions have not changed sufficiently to justify an extension of the LLP or a change in the methodology, neither for the euro nor for any of the non-euro currencies. As such, the implementation of this proposal would require the removal of these criteria which were introduced to ensure that the Solvency II framework was based on practical and real-world, rather than only theoretical considerations. Another example of this theoretical approach is the arbitrary method for compensating for different speeds of convergence, as demonstrated by the choice of mean reversion parameter for the Swedish krona.

Insurance Europe does recognise the potential risk management benefits of the alternative extrapolation approach. However, for such a methodology to be acceptable, it must be calibrated to respect the principle that insurers can match their liquid cashflows with bonds. Therefore, regardless of the extrapolation methodology, the residual volume and matching criteria must be maintained.

For the second HIA exercise, EIOPA has stated its intention to collect more data on the impact of changing the Euro LLP to 30 years. EIOPA has already collected and published data in the 2017, 2018 and 2019 LTG Reports, showing that the proposal to move the Euro LLP to 30 years is inappropriate and damaging to the industry. **Insurance Europe does not consider it necessary to collect further data on this proposal as no alternative conclusions to those already reached by EIOPA and the NSAs are possible.**

Volatility Adjustment

Insurance Europe is disappointed that EIOPA continues to pursue damaging and economically unjustified changes to the VA. The design and calibration of the HIA VA is based on a revised combination of several of the options previously discussed in the consultation paper. There are a few specific elements within the proposals which could help improve the VA but little of the industry feedback has been taken on board by EIOPA. **The resulting overall design that is being tested in the HIA is not appropriate, as it would result in increased procyclicality and make the VA less effective in a crisis.** This has already been evidenced during the first quarter of 2020.

- The risk correction is included in the VA calculation to account for the part of the reference portfolio spread which is needed to cover expected defaults and downgrades losses.

The methodology tested in the HIA derives the risk corrections as a percentage of the prevailing spread and as such it will increase procyclicality and damage the effectiveness of the VA as an anticyclical tool. The theoretical justification for altering the current calibration of the risk correction was challenged extensively by industry in its consultation response and remains unconvincing. While EIOPA has made some changes for the HIA to its original proposals, put forward in its consultation, these are cosmetic tweaks and do little to reduce the additional procyclicality created by the new methodology.

Insurance Europe continues to support the current derivation of the risk corrections based on historical default, downgrade and loss statistics. These already contain sufficient prudence through the long-term average spread (LTAS) underpin.

- EIOPA has maintained an application ratio based on the **illiquidity characteristics of the liabilities**. Its new approach requires insurers to categorise its liabilities into three liquidity buckets which have been assigned a sub-level application ratio (60%, 75% and 100%). The aggregate liquidity application ratio is then calculated by weighting the sub-application ratios by the proportions of liabilities in each bucket.

While this approach is somewhat less complicated relative to the previous approach, it remains flawed. Liquidity cannot be assessed based only the product features and liabilities as EIOPA has proposed. It

must also include assessment of the assets, premiums flow and other sources of liquidity. In addition, no justification is provided for the chosen application ratios. Only very few liabilities will be eligible for the 100% bucket and the allocation of all non-life liabilities to the 60% bucket is overly punitive. The final criterion suggests that non-life insurers are faced with a forced sale of 40% to meet their policyholder liabilities which is a very odd assumption considering the typical cashflow profile of non-life insurers and their continuous premium cash inflows.

Insurance Europe does not support the introduction of liquidity penalties into the VA. Liquidity should be addressed through Pillar 2 and Pillar 3 requirements. Insurers are already required to have a liquidity risk management plan in place and to regularly assess the possible effect of a forced sale of assets in order to apply the VA. A better and more proportionate approach to addressing supervisory concerns about liquidity related to the use of the VA would be to enhance the liquidity monitoring requirements which are already in place, as proposed by EIOPA in its consultation paper.

- The general application ratio (GAR) has been increased from 65% to 85%. **Insurance Europe welcomes EIOPA's recognition that the 65% GAR is too low** in particular when other risks are being addressed through duration ratios. However, in EIOPA's overall proposal for the HIA, this does not provide any significant improvement in the level of the VA for many markets as the positive impact is offset by the liquidity ratio and the cumulative application of all three ratios. It does not provide the improvements to the VA level which are warranted and needed.
- **The inclusion of the Rescale factor is welcome.** This is an effective adjustment to correct the allocations within the reference portfolio. It avoids that the allocation of the nil spread currently allocated to the non-fixed income assets in the reference portfolio dilutes the level of the VA and its ability to offset spread volatility. However, it is important to note that this proposal still means that the discount rate used to value liabilities remains very conservative because it ignores the impact of the much higher long-term average returns that insurers can expect to earn from property and equity assets in the reference portfolio.
- The inclusion of **the enhanced country adjustment, Option 7, is welcome as a replacement to the flawed previous idea of a macroeconomic VA.** The Option 7 mechanism reduces the current cliff-edge effect by enabling a smoother application of the country adjustment. **Option 7 should be further enhanced through improved calibration of the application parameters.**
- To determine corporate bond yield curves for currencies where there is little or no data available, Insurance Europe supports the continued use of Euro corporate bond yield curves adjusted by 1.5 times the difference between the euro RFR and the local currency RFR.
- Further improvements of the VA should focus on 1) increasing the general level of the VA to properly reflect the ability of insurers to earn returns above risk-free rates and 2) avoiding artificial balance sheet volatility. In order to ensure the latter, all proposed VA mechanisms should be tested under stressed conditions.

Calculation of Technical Provisions including the Risk Margin

Insurance Europe **considers the proposal to alter the calculation of the Risk Margin** through the **inclusion of a lambda factor**, a type of approach previously proposed by industry, as **a step in the right direction**.

However, EIOPA's proposed calibration for this scalar does not appropriately reflect the impact of risk dependence over time and will not reduce the level and volatility of the Risk Margin in an economically justified way. This

results in an inappropriately high Risk Margin, which reduces the industry's overall capacity for taking risk, including the capacity for investing in equities. Further, it can affect product design and unnecessarily increase prices for consumers, especially for long term products.

In particular, the lambda factor of 0.975 proposed in the HIA would only result in a limited decrease in the Risk Margin relative to what can be justified. The approach proposed by EIOPA is mathematically equivalent to a progressive decrease in the cost of capital rate from 6% to 3% but it would take 28 years as the lambda factor would start at 0.975 at year 1 and reach its floor of 0.5 in year 28. EIOPA has neither explained its choice for a lambda of 0.975 nor justified the inclusion of a 0.5 floor.

Industry has previously set out detailed evidence that the Risk Margin is too large, too sensitive to movements in interest rates, and inappropriate for long-term business. EIOPA should improve the Risk Margin by:

- Recalibrating the lambda parameter and its proposed floor to better reflect the impact of risk dependence over time.
- Allowing for diversification between life and non-life business within the same entity, or between different entities within a group.
- Lowering the Cost of Capital rate to 3%, in line with evidence provided by the industry.

Interest rate risk

Insurance Europe is disappointed that EIOPA retains its overly theoretical, uneconomic and extremely damaging proposal on the design and calibration of the standard formula interest rate risk submodule.

There are two key deficiencies with EIOPA's proposed formulation; 1) the level of the effective lower bound of interest rates in the model and 2) the use of factor-based stresses for both the liquid and extrapolated parts of the interest rate term structure.

EIOPA's proposal will result in the exaggeration of the capital requirement for interest rate risk. This could negatively impact financial stability and the important role of life insurers not only in the supply of long-term guarantees but also in the long-term financing of the European economy.

Insurance Europe continues to support an approach which properly reflects the effective lower bound for interest rates and calculates the illiquid part of the stressed curves via the extrapolation methodology. It previously provided two alternative proposals which would both result in more realistic capital charges.

As part of the HIA, EIOPA has also requested, on a voluntary basis, information on two alternative interest rate risk formulations.

- The first is the inclusion of an explicit -1.25% floor across all terms. Even if testing a floor is positive in principle, the chosen level of floor has only very marginal impact on the capital requirements at YE2019 and therefore the requested information is of negligible value. An effective floor should reflect that experiences with interest rates changes in times of positive rates cannot be transferred unlimitedly into phases with substantially negatives rates.
- The second alternative formulation replaces some of the shock factors which affect the illiquid parts of the curves for currencies where the first smoothing point (equivalent to the LLP) is less than 15 years. This proposal goes some way to addressing the issues for these currencies caused by applying factor-based stresses to the illiquid part of the curve. However, to fully rectify this issue, the illiquid part of all shocked curves must, as in the industry's proposals in the consultation feedback, be determined using the standard extrapolation methodology and parameters. This is the only way to derive consistent, risk-

sensitive and economically sound stressed risk-free term structures and, thus, to obtain the true loss in basic own funds in the stress scenario.

Dynamic Volatility Adjustment (DVA)

Insurance Europe welcomes EIOPA's acceptance of the DVA as a justified feature of internal models and the testing of a DVA-type approach in the standard formula. The DVA enables insurers to reflect their risk-bearing capacity as long-term liability driven investors on their balance sheet. It therefore creates a more realistic assessment of the credit risks to which they are exposed.

However, Insurance Europe highlights its strong concerns about the proposed approach to the VA, noted above, being transferred and accentuated in the DVA modelling. In particular, the proposed changes to the risk correction moves away from its key purpose as a reflection of the expected cost of defaults and it amplifies procyclicality.

Regarding the proposed enhancement of the DVA prudency principle, Insurance Europe is concerned that DVA users would need to double the internal model's calculations in order to demonstrate that the SCR is at least as high as if:

- using the EIOPA reference portfolio,
- using the undertaking's own asset portfolio.

The use of two different minima can also lead to unstable cliff effects as the effective floor to the calculation can change with differing market conditions. In addition, if implemented, it could diminish the comparability of any year on year results and group level results.

Regarding the proposed formulation of the standard formula DVA, Insurance Europe considers this to be unjustifiably conservative because the impact of the DVA is limited by the inclusion of a reduction factor RF_{CQS} which goes up to 100% for lower credit quality steps.

It is also disappointing that unrated bonds and loans are excluded from the application of the DVA through the application of the 100% reduction factor. This will reduce the attractiveness of these bonds and loans and will inhibit insurers' ability to contribute to the CMU.

Long-term equity (LTE) submodule

The LTE submodule should be an effective tool in aiding the EC's the capital markets union (CMU) objectives of improving the mobilisation of capital in Europe and developing a more diversified financial system. It should not be unnecessarily restrained.

Insurance Europe is sceptical that the changes proposed to Article 171a being tested in the HIA will be broadly effective and does not expect them to have the desired effect of enhancing the scope of this submodule.

Several criteria which govern its application have been removed or replaced. The removal of the requirement to identify the specific portfolio of liabilities (criteria b and c) and the change to the average holding period requirement (criteria e) are welcome changes, since these criteria are in conflict with legal and regulatory requirements in some countries and therefore fundamentally prevent an application of the reduced risk charge.

However, the newly proposed criteria (g) undermines the approach and is a step back to a very conservative approach, similar to the Duration Based Equity Risk submodule, which is applied by one single undertaking in the EU. This criterion should be suppressed as it adds undue complexity and make the LTE inapplicable in most jurisdictions.

The industry's assessment of criteria (g) is summarised as follows:

- For life entities, EIOPA requires liabilities to have "high illiquidity", as measured by its flawed VA illiquidity bucketing and for them to have a duration in excess of 12 years. These are overly restrictive criteria and are expected to result in a very restricted scope comprising mostly of long-duration pension products, similar to the existing Duration-Based Equity submodule (which only has a single user).
- For non-life entities, EIOPA requires insurers to cover all its best estimate liabilities with High-Quality Liquid Assets (HQLA) as defined by banking regulation (i.e. the Liquidity coverage ratio). This is an overly restrictive approach.
 - Firstly, on a going concern basis, an insurer should not be required to cover all its liabilities with liquid assets as a sound ALM shall invest in liquid assets to cover the cash flows of the first years of the liabilities and on more illiquid assets on a longer term.
 - Secondly, the scope of liquid assets is very restricted excluding bonds of financial institutions and listed equity.
 - Thirdly, the binary application (ie if the insurers meets the HQLA test or not) will also likely lead to restricted application.
 - In addition, the HQLA assessment should be specific for insurers. There are fundamental differences between insurers and banks which should be reflected also from this perspective.

Own funds buffer

Insurance Europe considers EIOPA's proposed Own Funds buffer to be unnecessary. The inclusion of an additional discretionary buffer to be applied when credit spreads are excessively compressed would effectively create additional capital add-ons to deal with systemic risk.

In light of the limited systemic risk that the insurance sector poses, and the comprehensive protection provided already by Solvency II, there is no justification for this new measure. The industry recognises that there is now an international framework for addressing systemic risk, and that the EC CfA reflects this framework to a large extent. Therefore, only measures that have been specifically referenced in the CfA should be considered.

Furthermore, the Own Funds buffer would conflict with the principles of Pillar II which require an insurer to formulate a risk appetite, prepare a risk appetite statement and set its desired level of capital considering this assessment of risk appetite. The Own Funds buffer is unlikely to have an effect on the insurer's risk appetite and therefore is not expected to materially change capital levels across Europe.

The proposed formulation of the buffer also raises several issues which require further consideration.

- The application of the measure would alter the agreed 1-in-200 confidence level of the Solvency II framework.
- Application and de-application would further create cliff-edge effects and could potentially introduce volatility into insurers' balance sheets.
- This proposal is based on work by the ESRB, in which it assesses the changes in credit spreads in isolation. It is very likely in an environment of compressed spreads that other market prices, including the risk-free rate, will move at the same time and that the company's excess capital will not, as argued by the ESRB³, increase. This effect could also arise due to the flaw that the buffer does not take into account the interaction between assets and liabilities for life insurance contracts with policyholder profit participation. In such cases this buffer could lead to unwarranted consequences.
- Different interpretation of bond markets by NSAs could distort the level-playing field across Europe.

Additional specification on the recognition of risk-mitigation techniques in the standard formula

³ See ESRB (2020), *Enhancing the macroprudential dimension of Solvency II*.

The industry opposes the additional specification on the recognition of risk-mitigation techniques in the standard formula. The existing regulatory framework offers sufficient instruments and measures to address issues as mentioned in EIOPA's consultation paper.

For example, according to EIOPA, the current regulations do not specify that the capital savings needs to be commensurate with the amount of risk transferred (section 5.8.6.5. in EIOPA-BoS-19/465). However, the actuarial function is an instrument which expresses an opinion on the adequacy of reinsurance arrangements. The risk of medium to large stresses that are less severe than the 1-in-200 event of the standard formula is captured. Similarly, these should be evidenced through the ORSA process.

The requirement of additional evidence of the effective risk mitigation brings the calculation close to an internal model which is not the intention of the standard formula. EIOPA should look for approximations instead. Further, this amendment could un-intentionally lead to less recognition of traditional risk mitigation techniques and therefore lead to the risk of undesirable effects.

Non-proportional reinsurance

Insurance Europe welcomes the inclusion of the testing of an alternative approach to recognising non-proportional reinsurance in non-life premium risk. However, a balance will have to be struck between risk-sensitivity, complexity, and prudence. The industry is conscious that the architecture of the standard formula places limitations on what is practically achievable. Expanded recognition can be a solution to handle shortcomings of the current approach without jeopardizing simplicity and prudence.

On a technical level, the approach has several shortcomings which need further consideration:

- There is no possibility given to account for proportional reinsurance in the approach, since the computation is based on the gross premium V .
- Due to the double counting requirements, most reinsurance contracts cannot be counted for risk mitigation purposes for the premium and reserve risk sub-module. In particular, reinsurance contracts can only be recognized, if they are not in the scope of non-life catastrophe risks or lapse. It is not understandable why a reinsurance contract cannot be considered for catastrophe risks and premium risk. Lapse risk and premium risk are completely uncorrelated for the SCR calculation. Catastrophe risk and premium and reserve risk correlate only to a factor of 25% for the SCR calculation. It makes sense to handle the reinsurance recognition accordingly.
- The requirement for covers corresponding unconditionally to a layer of the possible losses leads to binary treatment of non-proportional reinsurance contracts where a contract only has a non-zero contribution to risk mitigation if it provides cover in every possible (1:200) event. This neglects the risk mitigating effect of conventional covers that would only provide cover in most but not all possible (1:200) events.
- The average number and amount of losses within the last 5 years is needed to determine the retention (if specified per risk). However, in many cases there are no losses within that period of time for a given reinsurance contract.
- The cap of the expected payout seems to be computed inappropriately. The parameter sigma is calibrated on the basis of a diversified np portfolio. However, the payout with an np contract can be multiple of the premium.
- The recognition of adverse development covers is not possible in the proposed approach.