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<tr><td></td><td colspan="2">Comments Template on<br>Consultation Paper on EIOPA's first set of advice to the European Commission on specific items in the Solvency II Delegated Regulation</td><td>Deadline<br>31 August 2017<br>23:59 CET</td></tr>
<tr><td>Name of Company:</td><td colspan="3">Reinsurance Advisory Board (RAB)</td></tr>
<tr><td>Disclosure of comments:</td><td colspan="2">Please indicate if your comments should be treated as confidential:</td><td>Public</td></tr>
<tr><td></td><td colspan="3">Please follow the following instructions for filling in the template:<br>⇨ Do not change the numbering in the column "reference"; if you change numbering, your comment cannot be processed by our IT tool<br>⇨ Leave the last column empty.<br>⇨ Please fill in your comment in the relevant row. If you have no comment on a paragraph or a cell, keep the row empty.<br>⇨ Our IT tool does not allow processing of comments which do not refer to the specific numbers below.<br>Please send the completed template, in Word Format, to CP-17-004@eiopa.europa.eu<br>Our IT tool does not allow processing of any other formats.<br>The numbering of the reference refers to the sections of the consultation paper on EIOPA's first set of advice to the European Commission on specific items in the Solvency II Delegated Regulation. Please indicate to which paragraph(s) your comment refers to.</td></tr>
<tr><td>Reference</td><td colspan="3">Comment</td></tr>
<tr><td>General Comment</td><td colspan="2">Alternative methods for non-proportional reinsurance and other risk mitigation techniques<br>RAB continues to support improved recognition of reinsurance under the premium and reserve</td><td></td></tr>
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| | risk module of the standard formula where effective risk transfer can be shown consistent with the Solvency II Directive in Art 101 para 5, ie<br><br>"*When calculating the Solvency Capital Requirement, insurance and reinsurance undertakings shall take account of the effect of risk-mitigation techniques, provided that credit risk and other risks arising from the use of such techniques are properly reflected in the Solvency Capital Requirement.*"<br><br>As stated in previous feedback (to EIOPA's Discussion Paper on the review of specific items in the Solvency II Delegated Regulation), RAB believes that based on evidence undertakings indeed cannot take into account many types of reinsurance, for no valid reason. Simple methods to support better recognition of these risk mitigations that are workable under the current assumptions and calibrations of the standard formula were proposed. It is important that these will be implemented without increasing complexity of the standard formula, eg through one simple adjustment factor *"RM_other"* as specified in previous submissions.<br><br>RAB also highly appreciates that EIOPA has considered the proposed method for Adverse Development Covers (ADCs) in its draft advice and has provided detailed feedback. RAB would like to address some issues that EIOPA has raised in its assessment in the remainder of this response.<br><br>**Risk margin**<br>As was outlined in previous communications, the RAB considers that the magnitude and volatility of the risk margin should be reduced and will join with other companies in Insurance Europe and the CRO Forum to provide concrete suggestions for amending the calculation of the risk margin and the CoC rate. | |

As disclosed in the Solvency and financial condition reports (SFCRs) YE 2016, the amount of risk margin in absolute and relative terms was very significant for some reinsurance groups YE 2016 (total risk margin above 50% of the SCR for large reinsurance groups, and even in the 65%-85% range for 2 groups). In particular, the life risk margin can be very large (above 30% or even above 70%) as a percentage of Life best estimates for reinsurance groups, and especially when excluding Health and Unit-linked/Index-linked (eg above 45% or more). As a comparison, the final CEIOPs advice on the risk margin (October 2009) included an Impact assessment on the cost-of-capital rate for the risk margin (Annex B) which anticipated a ratio of the risk margin (RM) to the best estimate (BE) of 5% for life insurance based on a cost-of-capital rate of 6% (10% for non-life insurance).

The present low interest rate environment has demonstrated that the current specification of the risk margin is inappropriate, in particular for long-term life insurance business, as it has resulted in excessive values of the risk margin and excessive volatility with respect to interest rates. Falling interest rates significantly increase capital costs for long-term insurance products and disadvantage the supply of products offering long-term insurance protection for consumers, relative to products which only protect against market risks.

The RAB considers the cost of capital rate of 6% as too high for pure insurance risks considering their limited correlation with the market. This over-calibration has had significant effects in the current low interest rate environment. CRO Forum studies on the risk margin from 2008 indicate that a range of 2.5% to 4.5% for cost of capital was appropriate, and further suggest that the rate is more likely to have fallen since then in light of low interest rates reducing the return investors require from investments generally.

The applied methodology should be adapted so as to reflect a more appropriate (lower) cost of

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| | capital rate that appropriately recognises the cost of non-hedgable risk in respect of pure insurance risk. Considering the CAPM approach, there is limited correlation between a single insurance risk and the return on the global market portfolio as a whole. Therefore, the specific cost of capital related to pure insurance risk (and hence captured by the cost of capital parameter in the risk margin) is likely to be significantly lower than 6%.<br><br>Appropriate adjustments should be considered if using the CAPM or other approaches to estimate the CoC rate because they are "total return" approaches, and provide an indication of the overall rate of return that might be demanded by an investor. The current level of the CoC rate is excessive because:<br>• No sufficient adjustment is made to reflect the fact that the CAPM is a total return approach whereas the risk margin is based on pure insurance risks; or at least, the adjustment is undermined by the use of a high beta factor for the insurance sector.<br>• It is calibrated based on US data and backward-looking Equity Risk premiums as a substitute for the forward-looking one, which has been recognised by the literature to generate a strong upward bias.<br><br>The RAB also considers that – within the risk margin - the assumption that all future capital funding requirements are independent is not appropriate for long term business.<br><br>Furthermore and importantly, the SCR underlying the group risk margin calculation should allow for **full diversification of risks across the group**, in line with how those risks are likely to be managed in practice. | |
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| 5.3 | **Adverse Development Covers ("ADC")**<br>**General remarks:** The RAB considers Adverse Development Covers (ADCs) a valid and justifiable form of risk mitigation that effectively addresses companies' reserve risk mitigation and that is more and more widely used in the market. It should be appropriately recognised within the Solvency II framework. In the RAB's view the suggested *"RM_other"* in paras 252/253 adequately addresses all reinsurances structures which are not explicitly reflected by the standard formula (ADC, finite reinsurance, complex aggregate covers, etc). Subject to below more detailed input, RAB encourages EIOPA to work further on *"RM_other"* which follows an adequate contract-by-contract approach for ADCs and other types.<br><br>**(250)** ADCs can, for example, effectively cap the impact of the expected loss under a 1 in 200 years event stemming from reserve risk on the undertakings' basic own funds. Currently, only Solvency II internal models (and rating agency models) recognise the risk mitigating impact of ADCs. Hence, the standard formula might provide wrong incentives, eg incentivising undertakings to use less effective cover depending on their situation.<br><br>**(252-253)** In the RAB's opinion, the method *"RM_other"* continues to be the best option for improved recognition of reinsurance under the standard formula. It should be clarified that this method does not require the introduction of a scenario based component under the premium and reserve risk module, but it more generally provides a solution to make the formula | |

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sufficiently flexible to allow for the recognition of risk transfer of effective risk mitigations. Depending on the type of reinsurance, calculations might be more or less complex (albeit, usually not more complex than other calculations under the standard formula, eg for the Cat module). Therefore, in addition to implementing *"RM_other"* in the Delegated Regulation, the complementing guidelines could be helpful for some types of cover to help undertakings and ensure consistent application. Overall, this approach would also be more open to upcoming extensions in the future, eg to accommodate any new types of risk mitigations.

**(256)** RAB highly appreciates that EIOPA considers the proposed method for ADCs in its draft advice and has provided detailed feedback. EIOPA has further identified some issues which RAB would like to address in this note. Firstly, it should be clarified that the proposed standard formula method does not (intend to) achieve the same accuracy level as an internal model but this limitation applies for many other areas of the standard formula as well. It is understood that for this reason, the standard formula generally uses conservative assumptions and the calibration is prudent. RAB would like to demonstrate in its response that the method is consistent with these prerequisites and show some options for amendments so that it will better meet EIOPA's expectations while avoiding complexity to be added to the standard formula.

**(257)** <u>Potential double counting because the standard formula's parameter for reserve risk are net of reinsurance and the effect has been already taken into account in the Reported But Not Settled ("RBNS") and Incurred But Not Reported ("IBNR") provisions and the claims paid</u>

While the overall number of ADCs in the market is low, ADCs are usually classified as a "large and material transaction" by companies for their portfolio based on the volume of reserves that is covered. Even where the impact of ADCs has been considered for the calibration of the standard formula parameters (based on few companies in the sample that have used ADCs) the impact on

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| | the market average is negligible (close to 0). In other words, if a company applies an ADC, the risk transfer from this transaction is almost entirely in excess of the market average utilisation of reserve risk covers. Furthermore, at the times the standard variations were calibrated, ADC was not that common thus the potential risk-reducing effect is inadequately reflected in the standard deviation parameters. The double counting effect is therefore in RAB's opinion neglectable.<br><br>RAB would like to note that for a similar reason, adjustment factors for the impact of non-proportional reinsurance on premium risk (ie 80% for three lines of business) have been introduced. As another option to improve recognition of ADCs, EIOPA might propose to introduce similar (fixed) adjustment factors also for reserve risk. However, introducing such a factor would create the same issue with risk sensitiveness as currently exists for the premium factor, which is fixed and therefore not risk sensitive. The approach that RAB is proposing is rather simple to implement given that it is a single calculation with only four variables.<br><br>**(258-262)** Potential overestimation of the risk mitigation impact because of modification of the underlying distribution of claims development results and ignorance of alternative equivalent scenarios (derived with the Euler method). EIOPA uses a quantitative example to show the impact.<br><br>RAB understand EIOPA's concern and the limitations that are inherent to the factor based formula. Under the equivalent scenario as used by EIOPA **the ADC results in a 1,358 loss in basic own funds whereas RAB's suggested approach results in a 1,343 loss in absolute terms.** It should be highlighted that, if the ADC attachment used in EIOPA's example was changed to less than 2,100, the methodology proposed would actually result in a higher SCR for reserving risk than the equivalent scenario methodology. From experience, the gap between best estimate reserves and the ADC attachment point rarely exceeds 5% in capital management driven structures due to | |

capital efficiency (ie the cedent would not be provided with a sufficiently significant capital benefit if the gap between reserves and the ADC attachment point exceeds 5% of best estimate reserves).

Below is the table that shows the sensitivity of the difference between the SCR for reserving risk calculated with the methodology that RAB is proposing and the equivalent scenario using the Euler method:

| ADC exit \ ADC attachment | 2,000 | 2,050 | 2,100 | 2,150 | 2,200 | 2,250 | 2,300 | 2,350 | 2,400 |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 2,400 | 1.9% | 1.6% | 1.3% | 1.0% | 0.8% | 0.5% | 0.3% | 0.2% | 0.0% |
| 2,450 | 2.2% | 1.9% | 1.6% | 1.3% | 1.0% | 0.8% | 0.5% | 0.3% | 0.2% |
| 2,500 | 2.6% | 2.2% | 1.9% | 1.6% | 1.3% | 1.0% | 0.8% | 0.5% | 0.3% |
| 2,550 | 3.1% | 2.6% | 2.2% | 1.9% | 1.6% | 1.3% | 1.0% | 0.8% | 0.5% |
| 2,600 | 3.6% | 3.1% | 2.6% | 2.2% | 1.9% | 1.6% | 1.3% | 1.0% | 0.8% |
| 2,660 | 0.8% | 0.4% | 0.0% | -0.3% | -0.6% | -0.9% | -1.1% | -1.4% | -1.6% |
| Delta reserves - ADC attachment (% nominal reserves) | 0.0% | 2.4% | 4.8% | 7.0% | 9.1% | 11.1% | 13.0% | 14.9% | 16.7% |

**RAB therefore believes that the proposed methodology is more conservative than the equivalent scenario methodology for most structures. RAB would be glad to share the spreadsheet used in this calculation.**

**(263)** <u>Other issues with the appropriateness of the simple method, ie impact of some dependencies on the effectiveness of the cover</u>:

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| | • **Attachment point**: RAB agrees that the attachment point has an impact on the level of risk transfer; this issue can be addressed by stipulating a maximum attachment point level (ADC attachment should not be too far out of the money) and an exit level of: BE reserves x (1 + 3 x reserving risk factor). This would also ensure that the methodology always results in a more conservative SCR than the equivalent scenario methodology.<br><br>• **Percentage of reserves under the cover**: Typically, the volume of reserves that is covered under an ADC is not less than 50% - 70%. Therefore, the effectiveness of the cover in this respect is not an issue.<br><br>• **Diversification/business mix of the undertaking**: RAB proposes to apply the cover pre-diversification, so the formula considers the impact of the diversification according to the assumptions of the standard formula. In this respect, the proposed method is not different from existing standard formula methods for other types of reinsurance, eg prospective XL treaties.<br><br>**(264)** Most ADCs with an attachment point above the BE reserves will not be adequately reflected, for example an ADC that would cap the expected loss under an adverse development that is expected to happen with a frequency of less than 1 in 10 years at the level of the impact that a 1 in 10 years event would have.<br><br>**Finite reinsurance**<br>RAB appreciates that EIOPA considers previous comments shared on the so-called "finite reinsurance" and would like to reiterate that the classification of a contract as finite reinsurance should not be based solely on formal criteria. The RAB would consider this to be a non-feasible objective. Instead, the substance of the contract should be the crucial factor, in line with the | |

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| | principle of prominence of substance over form in the accounting standards. Auditors and regulators have been following the "substance over form" rules now already for years and therefore an undertaking's subjective assessment is counterbalanced this way. As a framework based on sound principles, Solvency II should give priority to this approach.<br><br>Solvency II should not prevent the recognition of state-of-the-art financial solutions and innovation based on a general suspicion over the form of transactions. While it is perfectly reasonable to prevent any benefit from reinsurance for a transaction deprived of any characteristic of effective risk transfer, the "lack of effective risk transfer" has to be assessed for each transaction and it should not be assumed that the presence of a financial component does necessarily impede the possibility of a risk transfer and of determining the part of premiums and reserves that is attributable to the risk transfer component. Indeed, a concrete suggestion on how premiums and reserves could be separated was not proposed because a contract-by-contract approach is considered as the most appropriate solution. RAB considers the approaches presented in paras 252/253 helpful for identifying the risk-mitigating effect. | |
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| 5.4.3 | **Article 211(3) of the Delegated Regulation EU 2015/35 ("realistic recovery plan")**<br>The RAB companies highly appreciate that EIOPA considers their comments on Article 211(3) of the Delegated Regulation, provided detailed feedback and suggests how to strike a balance between different considerations.<br><br>Under Solvency II (re)insurers are required to be capitalised to meet their SCRs. In a stress event | |

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| | when the reinsurer has to meet higher obligations corresponding to the stress event, the SCR coverage may fall below 100%. In such a case, the risk margin provides for recapitalisation or transfer of the insurance liabilities and restoration of 100% solvency coverage. In this way Solvency II by design provides for continuation of 100% SCR coverage, apart from the temporary period after the stress event at which point recapitalisation/transfer occurs. Currently under Article 211 a reinsurer needs to be pre-stress capitalised at a level to ensure full solvency coverage post stress, with no credit taken for the risk margin in facilitating recapitalisation after the event, in order to provide full solvency credit for the ceding company post the stress event. RAB believes this is not appropriate as Solvency II was not designed to require SCR coverage significantly above 100%, and that credit for the performance of the reinsurance protection in stress should only be partially reduced where the future protection afforded by the reinsurance contract proves not to be temporary following the stress event (ie when a realistic recovery plan is not submitted or it fails to restore solvency).<br><br>Article 138 (3) of the Solvency II Directive foresees the possibility for the supervisory authority to extend the six months period by 3 months and Article 138 (4) even allows an extension to up to seven years in exceptional circumstances – if the supervisory authority takes this decision, it is logical that recognition should also continue to be allowed for 3 months or longer as appropriate. Generally, the RAB believes that supervisors should retain sufficient discretion to extend the timelines regarding the credit which can be taken for reinsurance to ensure that insurers or reinsurers are not forced into unnecessary and potentially counter-productive actions where recovery of the reinsurer remains realistic.<br><br>In paragraph 312 EIOPA suggests that the period for recognition should be shortened accordingly in case the reinsurance undertaking discloses the date of the SCR breach and this date lies before the disclosure date. There is a high probability that the SCR will be restored in the prescribed time | |

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| | period after non-compliance so that shortening the period for a partial recognition appears not to be necessary.<br><br>EIOPA considers that "There should be no recognition in case of a breach of the MCR". The Delegated Regulation is silent about this case and it is not necessary to give this precision because a breach of the SCR will precede any breach of the MCR and be resolved before such extreme situation. On the other hand, the consequences of a breach of the MCR will be rapid and significant if this extreme situation cannot be resolved. It is also necessary to avoid any ambiguity on the fact that the Delegated Regulation does not prevent the recognition of reinsurance if compliance with the MCR has been restored, without prejudice to compliance with the SCR. | |
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