DeNederlandscheBank
EUROSYSTEEM

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Onderwerp: [Bijlage][Concept] QA asset intensive reinsurance

Q&A on recognition of risk mitigation techniques using reinsurance contracts in the Solvency II Standard Formula

Which aspects are relevant for the recognition of the risk mitigating effect of reinsurance contracts when calculating the Solvency Capital Requirements according to the Standard Formula?

Articles 208 up to 215 of the Solvency II Delegated Regulation 2015/35 set out the general requirements for the recognition of the risk mitigating effect of risk mitigating techniques. This Q&A describes some of the aspects De Nederlandsche Bank (DNB) takes into account when assessing the recognition of reinsurance contracts as risk mitigation techniques for the calculation of the Solvency Capital Requirements (SCR) for undertakings using the Standard Formula (SF). DNB does not prescribe any kind of reinsurance contract, but points out some of the aspects regarding the recognition of such contracts for the SF SCR calculations insurance undertakings have to take into account.

When we refer to an Article we mean an Article of the Solvency II Delegated Regulation 2015/35.

Qualitative criteria and effective transfer of risk: claim amount in case of default, bankruptcy or insolvency (Articles 209 and 210)

For a reinsurance contract to be an effective risk mitigating technique the extent of the cover has to be clearly defined. This includes an assessment of the claim amount on the counterparty of the reinsurance contract in the event of default, insolvency or bankruptcy (or any other credit event set out in the reinsurance contract). This claim amount is also required for the calculation of the loss given default in the counterparty default risk module. Insolvency or bankruptcy regulation in the jurisdiction of the reinsurance undertaking may imply a claim amount for a reinsurance contract in case of insolvency or bankruptcy that differs from the Solvency II best estimate value of the liabilities covered by the contract This may be the case in jurisdictions in scope of the Solvency II regulation as well as in jurisdictions that are declared equivalent to Solvency II. In those circumstances, even when the value of the collateral exceeds the Solvency II value of the best estimate liabilities, the insurance undertaking may be entitled to a claim amount that is significantly lower than the Solvency II value of the best estimate liabilities. If the insurance undertaking is unable to assess the claim amount in case of default, bankruptcy or insolvency then the cover is insufficiently clearly defined and the insurance undertaking cannot recognise the reinsurance contract as a risk mitigation technique in its SCR calculation.

If retrocession by the reinsurance undertaking has a material impact on the effectiveness and related risks of the reinsurance contract, the insurance undertaking ensures that it gets sufficient information to monitor the impact of this retrocession on the effectiveness and related risks on an ongoing basis. This also holds for subsequent retrocessions of the reinsured risks.

If retrocession would result in material basis risks or creates other risk that are not reflected in the calculation of the SF SCR, the reinsurance contract cannot be recognised for the calculation of the SF SCR.

Risk margin

When calculating the risk margin the insurance undertaking assumes that it transfers all its insurance obligations together with its reinsurance contracts to the reference undertaking. As such, reinsurance contracts that are recognised as risk mitigation techniques for the calculation of the SCR lower the risk margin of the insurance undertaking. The reinsurance recoverable on the Solvency II balance sheet does not include a risk margin, but equals the discounted value of the best estimate cash flows after a counterparty default adjustment (see Articles 41 and 42 of the Solvency II Delegated Regulation).

In case of default, bankruptcy or insolvency of the reinsurance undertaking the insurance undertaking becomes exposed again to its obligations which were reinsured by this reinsurance undertaking. The reinsurance contract will then no longer be recognised as a risk mitigation technique for the calculation of the SCR and the SCR will increase. This leads on its turn to an increase of the risk margin, because the risk margin is calculated as the present value of the cost of capital over the future capital requirements the insurance undertaking has to hold. Hence, even if the liquidator of the insurance undertaking would allocate the full claim amount corresponding to the Solvency II best estimate, the undertaking would still suffer a loss of basic own funds equal to this risk margin. At the same time, the undertaking's obligation to pay reinsurance risk premiums to the reinsurance undertaking for the remainder of the contract will end because of the default. This may, partially, offset the loss due to the increase in the risk margin. The total loss in basic own funds depends on the relation between the risk margin and the reinsurance risk premiums payable. If the insurance undertaking would have paid the reinsurance risk premium upfront in full and cannot claim back this amount, then the insurance undertaking would lose the risk margin in full.

The risk due to this potential loss of basic own funds related to the risk margin and the reinsurance risk premium in case of default of the reinsurance undertaking is not reflected in the calculation of the SF SCR. The loss given default in the counterparty default risk module is based on the amount recoverable at default which does not include the risk margin. According to Article 45(1c) of the Solvency II Directive 2009/138 insurance undertakings have to assess the significance with which their risk profile deviates from the SCR. If this risk related to the risk margin and reinsurance risk premium is material, the risk profile of the insurance undertaking may significantly deviate from the assumptions underlying the SCR.

Collateral (Article 214)

The reinsurance contract may contain collateral arrangements. This improves the security of the claim in case of a default of the reinsurance undertaking. The insurance undertaking may take account of the collateral in the SCR calculation if the collateral meets the requirements of Article 214:

- the insurance undertaking has the right to liquidate or retain, in a timely manner, the collateral in the event of a default, insolvency or bankruptcy or other credit event of the counterparty
- there is sufficient certainty as to the protection achieved by the collateral because of either of the following:
  - it is of sufficient credit quality, is of sufficient liquidity and is sufficiently stable in value
  - it is guaranteed by a counterparty who has been assigned a risk factor for concentration risk of 0%, other than a counterparty referred to in Article 187(5) and 184(2)
- there is no material positive correlation between the credit quality of the counterparty and the value of the collateral; there is material positive correlation if the collateral forms a material part of the risks the reinsurance undertaking is exposed to
- the collateral is not in the form of securities issued by the counterparty or a related undertaking of that counterparty

Where the collateral arrangement involves collateral being held by a custodian or other third party, the insurance undertaking ensures that all of the criteria in Article 214(2) are also met.

If the collateral does not meet these requirements of Article 214, then the insurance undertaking assumes no collateral in its SCR calculation of the counterparty default risk for this contract. Of course, the risk mitigating effect of the reinsurance contract on the reinsured risks could still be recognised if it meets the requirements of Articles 208, 209, 210, 211 and 213.

Risk management areas: concentration risk and reinsurance (Article 260)
The risk management system of an insurance undertaking shall include policies on, among others, reinsurance and concentration risk management. The risk management policies regarding reinsurance include:

- actions to be taken by the insurance undertaking to ensure the selection of suitable reinsurance
- actions to be taken by the insurance undertaking to assess which types of reinsurance are appropriate according to the nature of the risks assumed and the capabilities of the undertaking to manage and control the risks associated with those types of reinsurance
- the insurance undertaking's own assessment of the credit risk stemming from reinsurance*; in case of retrocession of material parts of the reinsured risks by the reinsurance undertaking this includes the impact of this retrocession on the credit risk*

A reinsurance contract may give rise to concentration risk. The risk management system of the insurance undertaking has a policy for this in place. This policy contains actions to be taken by the insurance undertaking to identify relevant sources of concentration risk to ensure that risk concentrations remain within established limits and actions to analyse possible risks of contagion between concentrated exposures. DNB doubts whether limits that allow for a situation where default, bankruptcy or insolvency of a single reinsurance undertaking results in non-compliance with the SCR, could be considered as appropriate.

Actuarial function (Article 272(7))
The actuarial function shall express an opinion on the adequacy of the reinsurance arrangements and this opinion shall include an analysis of the adequacy of the following:

- the undertaking's risk profile and underwriting policy

- reinsurance providers taking into account their credit standing*; in case of retrocession of material parts of the reinsured risks by the reinsurance undertaking this includes the impact of this retrocession on the creditworthiness of the reinsurance undertaking*
- the expected cover under stress scenarios in relation to the underwriting policy*, including consequences of retrocession of the reinsured risks, if any, by the reinsurance undertaking in such stress scenarios*
- the calculation of the amounts recoverable from the reinsurance contracts

Risk management function and mergers and acquisitions (Article 269(1d))

The risk management function shall advise on risk management matters including strategic affairs such as corporate strategy, mergers and acquisitions and major projects and investments. In case reinsurance plays a material role in a merger or acquisition, the risk management function takes account of the details of the reinsurance contracts in its advice.