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MAJOR CONCERNS REGARDING THE DRAFT SOLVENCY II DELEGATED ACTS FROM REINSURERS' PERSPECTIVE : FOCUS ON STANDARD FORMULA

Reinsurers members of the FFSA are either French reinsurers or foreign reinsurers operating, among others, on the French insurance market. As such, they share similar concerns to those of the European reinsurance community.

Introduction

Reinsurance plays a significant role for insurance and in the real economy as capital and capacity provider and in sustaining the creation of new products, as well as the insurability of major (low frequency/high severity) and/or emerging risks worldwide. "They [reinsurers] contribute to the global diversification of risks, to an efficient allocation of capital and improved risk management on the side of primary insurers" (IAIS Report "Reinsurance and financial stability"). Their scope of activities, generally including a large part of non EEA business and exposures, their management tools and policy, mainly based on diversification in terms of products and of countries, the specifics of the reinsurance contracts, their intensive underwriting processes, the BtoB relationship, are specificities that should be taken into account in the regulatory regime to which reinsurers are subject.

Reinsurance provides support to direct insurers but under Solvency 2 r**einsurance is regulated by the same Directive as direct insurance. However, Solvency II Directive explicitly refers to reinsurance separately from insurance (e.g. in its name itself: "the taking-up and pursuit of the business of** Insurance and **Reinsurance" (and not as accessory to Insurance). In this respect, SII Directive replaces and supersedes the Reinsurance Directive. Reinsurance is specific in various ways and its specificities should be taken into account. Several of the items developed hereunder are of common interest with insurers too but they potentially impact reinsurers in a stronger manner than direct insurers.**

Reinsurers have consistently been strongly supportive of the Solvency 2 Directive as it represents a major regulatory improvement based on key features common with the reinsurance business model : grounding on risk-based and economic view, recognition of diversification effects, emphasis on group dimension.

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While the discussions have remained focused in the past years on issues mostly relevant to direct life insurers (long-term guarantees), **scarce time has been dedicated on other issues which can be highly relevant to other important players of the European insurance and reinsurance market**. **In particular, it is noticeable that the European reinsurance industry which is an industry that is a net exporter of capacity worldwide (in the magnitude of +40G€) has not received much attention so far**.

This memo focuses on reinsurers' **strongest issues** as to the draft Solvency II delegated acts – level 2-. They reflect a market consensus.
There are several other issues which also impact reinsurers but which have not been retained in that list (e.g. currency risk, counterparty default risk -for both of these items which are of particular concern to reinsurers please refer to Insurance Europe position-, reserving risk on capped reserves, please see annex). Besides, beyond standard formula, there are other areas where specificities of reinsurance should also be taken into account (e.g. contract boundaries, reporting of annuities stemming from non-life insurance contracts) but this paper focuses solely on matters relating to the standard formula.

STANDARD FORMULA AND REINSURANCE

- **As it stands, the standard formula does not fit reinsurance portfolios**.
  - ✓ The standard formula is mostly designed to meet the requirements of an average European direct insurer
  - ✓ The risk profiles of global multi-lines reinsurers can differ from the average European insurer, as do their products from primary insurance policies
- However, there is a strong risk that the standard formula will be used as a benchmark for internal models' applications, as well as interim reporting and contingency planning in 2014/2015 according to preparatory guidelines.
- Furthermore, the **standard formula does not fully recognize the impact of reinsurance for insurers**

LEVEL 2 STRONGEST ISSUES FOR REINSURERS

1. Life and Health underwriting

- Contrary to P&C calibration (which was revised following both QIS4 and QIS5) and market risk calibration (which was revised following QIS5 and will be after the LTGA), the calibration of Life and health underwriting has remained unchallenged over the past years.
- This has an impact on both direct insurers and reinsurers but this issue is currently even more relevant for reinsurers since direct insurers are primarily exposed to the financial risk through saving products (QIS5: market risk represents 2/3 of the SCR for life insurers), whilst life reinsurers are predominantly exposed to the biometric risk.
- Given the uncertainties as to the sustainability of the current business model of direct life insurers based predominantly on financial risk taking, the calibration of

biometric risk shall be a rising concern for the whole life and health industry going forward.

- As it stands, the standard formula bias for current direct insurance cannot be corrected through the use of USP for Life and Health

➢ **SUGGESTIONS**

- Allow for USP in Life and Health modules and/or
- Lower factor (e.g. 50%) for values at risk and geographical span and/or
- Allow for potential formula to explicitly calculate geographical and cedants diversification of reinsurers' underwriting in the life insurance module

2. Recognition of Finite Reinsurance

- Risk transfer transactions known as "finite reinsurance" is "the most widely used product" amongst Alternative Risk Transfer techniques and "Supervisors test it for substance over form, **requiring a significant amount of risk transfer in conjunction with appropriate disclosure mechanisms**".(IAIS 2012 Report on reinsurance and financial stability).
- Level 1 Directive (art 210-3) acknowledges that finite reinsurance **transfers** limited but **significant risk to reinsurers**
- In contradiction with Directive wording, level 2 IM exclude finite reinsurance contracts from risk mitigation techniques, thus excluding such contracts from the calculation of BSCR (premium & reserve and CAT risk)
- Being largely used as a risk mitigating tool, this is of main concern to insurers. Moreover these tailored protections are prone to develop, since they aim to fit the specific needs of the reinsured
- draft Level 3 guidelines on finite reinsurance do foresee extensive governance and reporting for this kind of business, which means effective risk transfer will be tightly controlled

➢ **SUGGESTIONS**

- Change of Level 2 drafting for conformity with level 1
- Effective risk transfer to be recognized
- Proposed change to the level 2 wording :
  "**Finite reinsurance, or similar arrangements where the effective risk transfer is comparable to that of Finite reinsurance, shall be recognized in the calculation of the BSCR only to the extent risk is assumed by the reinsurer."(art 186 SCRRM3 (5))**[1]

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[1] *Current drafting : "finite reinsurance, as defined in Article 210(3) of Directive 2009/138/EC, **or similar arrangements, where the lack of effective risk transfer is comparable to that of finite reinsurance**, shall not be deemed to meet the requirements in Articles SCRRM1 and SCRRM2 and shall not be recognised in the calculation of the Basic Solvency Capital Requirement"..*

3. Non-life non-proportional reinsurance

3.1 Risk mitigating effect of Non-life non-proportional reinsurance

- Standard formula currently recognizes non-proportional reinsurance via fixed adjustment factors of 80% for the sole lines of business Motor Liability, Property and General Liability. No capital relief for the remaining lines of business.
- **Non Proportional Reinsurance is key** to Non Life, limitation to three LOB and flat calibration of 80% are not adequate to reflect reinsurance actual exposure and capital relief. This is a major issue for both insurers and the efficiency of reinsurance capital relief.
- Existing USP framework for adjustment factors (Level III guideline Draft proposal for Implementing Technical Standard on Undertaking Specific Parameters: Methods, December 2011) are a positive point but the framework should be more flexible and allow for simplifications.

➢ **SUGGESTIONS**

- As an alternative method based on market parameters for the average gross claim and volatility per lob (e.g. taken from claims statistics), a **flexible USP framework with simplifications**[2]. Calibration of such market parameters would facilitate a sufficiently risk sensitive consideration of non-proportional reinsurance, which can be assessed consistently due to the ORSA requirements
- Proportional, CAT and aggregate **Multi-lines and multi perils covers** which are more and more frequently purchased to be mapped onto the different lines of business to better reflect actual relief

3.2 . Calibration of Non-life non-proportional reinsurance for reinsurers

- Current calibration leads to implausible high requirements for non-proportional lines of business which overstate the risk profile of the reinsurers' portfolios
- In view of limits within Non Proportional Reinsurance contracts, current calibration is inappropriate to reflect the riskiness of non-proportional non-life reinsurance portfolios
- No possible geographical diversification for Non Proportional, not acknowledging that these types of cover are particularly driven by geographically disconnected events

➢ **SUGGESTIONS**

- Allow for an adequate reflection of the geographical diversification benefit in the standard formula with a cap of at least 50%.
- Reflections on a more suitable calibration for these lobs.

[2] *See RAB/IE letter to the EU Commission, May 27, 2013 – (RAB-13-004)*

4. Catastrophe risk module

- Number of limitations for insurers and reinsurers in this module
- This module is not fit for reinsurers :
  - Risk factors applied to sums insured, no loss or event limit taken into account
  - No differentiation between type of reinsurance covers (proportional/non proportional) and accessorily type of properties (residential, commercial, industrial)
  - No method for non-EEA exposure ensuring consistency with EEA exposures
  - Data requested not available to a significant extent to reinsurers who have no access to primary policies detailed information. This is particularly true for man-made catastrophes, and for Marine, Aviation Transport i.e. "moving elements", where details of sum insured per Country and Cresta zone cannot be available

➢ **SUGGESTIONS**

- Nat Cat : non EEA risk exposures consistently compared with EEA exposures. Number of scenarios need to be enhanced to cover at least the most relevant of non EEA exposures. In order to better reflect non-proportional reinsurance structures the windstorm module should serve as a role model as it makes use of combined scenarios.
- A further possible solution would be the usage of generic scenarios similar to the life underwriting risk or market risk module. Possible to work with scenarios based on the maximum exposure for specific events
- Man-made exposures should be reflected via reinsurers models

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Annex relative to other items

Reserving risk on capped reserves

The capital requirement for reserve risk in the standard formula is calculated by applying for each line of business a volatility factor to the overall net claim reserves (SCR9.2). However, for reinsurance, some parts of those reserves have absolutely no risk of adverse deviation/volatility due either to the conditions of the retrocession/reinsurance contract, or to the conditions of the contract with the cedants:

- when the attachment point on a retro recovery has been reached
- when the reinsurer participate in an XS layer which has been reserved in full
- when an annual aggregate limit on the contract has been reached

Reinsures propose as **more economically justified to exclude those capped reserves from the reserve volume in the calculation of the non-life and Non-SLT Health underwriting risk.**