SLAUGHTER AND MAY

## Slaughter and May Podcast

## Solvency II - Reinsurance and other risk mitigation techniques

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| **Robert Chaplin** | Hello and welcome. I'm Robert Chaplin, one of Slaughter and May's corporate insurance partners. With me is Beth Dobson, our insurance practice support lawyer.<br><br>This is our overview of reinsurance and other risk mitigation techniques under Solvency II. For more information please see chapter 13 of our Solvency II App. If you don't already have the App please email solvency.two@slaughterandmay.com to request access.<br><br>Although the use of insurance SPVs is discussed in chapter 13 we won't cover them today. They will be the subject of a subsequent podcast.<br><br>Insurers use reinsurance and other risk mitigation techniques for a variety of purposes. One use is to improve the regulatory capital position of the insurer. There are a number of ways in which risk mitigation techniques can be used. There are detailed requirements under Solvency II which must be met by the techniques in order for them to be taken into account in the regulatory balance sheet.<br><br>Solvency II recognises two broad categories of risk mitigation techniques – reinsurance on the one hand and financial risk mitigation techniques on the other.<br><br>Let's look first at reinsurance. Reinsurance can be reflected in the regulatory balance sheet both in the Solvency Capital Requirement and in the technical provisions calculation.<br><br>Reinsurance can be used to reduce the SCR. This is because the risk mitigating effects of the reinsurance arrangement can be taken into account when calculating the impact of stress scenarios on the insurer's own funds for the purposes of the capital charge calculation in the relevant risk module. For example, if an annuity reinsurance is entered into by an insurer this would have the effect of reducing the capital charge under the longevity risk sub-module of the SCR. The longevity risk capital charge is based on the expected loss of basic own funds if there were a decrease of 20% in mortality rates. The insurer would be protected against this risk by the annuity reinsurance and there would therefore be a corresponding reduction in the insurer's capital charge for longevity risk.<br><br>The insurer is of course exposed to credit risk in respect of the reinsurer and this must be separately taken into account in the SCR via the counterparty default risk module. |

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| | In the technical provisions calculation, the risk margin component is calculated taking into account any reinsurance arrangements which the insurer has entered into. This has the effect of reducing the risk margin. |
| **Beth Dobson** | Financial risk mitigation techniques can also be used to transfer risk and therefore to reduce the insurer's SCR. Examples of financial risk mitigation techniques include derivatives such as credit default swaps and longevity swaps. Letters of credit and guarantees can be used as risk mitigation techniques but these involve credit protection in respect of a particular counterparty rather than a transfer of risk as such. They are therefore generally relevant to the counterparty default risk module of the SCR only.<br><br>Financial risk mitigation techniques cannot be taken into account in the calculation of the risk margin because the relevant provision of the Level 2 Delegated Regulation only refers to reinsurance contracts and arrangements with SPVs. This is a somewhat anomalous result, particularly in the case of longevity swaps which will generally have the same economic impact as a longevity reinsurance.<br><br>In order to take credit for reinsurance or financial risk mitigation techniques in the SCR calculation, the arrangement must meet certain qualifying requirements. The criteria are different depending on the type of technique being used and on whether the insurer calculates its SCR using the standard formula or an internal model.<br><br>Under the standard formula, all risk mitigation techniques must meet a number of general qualitative criteria. These are:<br><br>• The contractual arrangements and the transfer of risk must be legally effective and enforceable in all relevant jurisdictions<br><br>• The insurer must have taken all appropriate steps to ensure the arrangements' effectiveness and address related risks<br><br>• The insurer must be able to monitor the effectiveness of the arrangement and the related risks on an ongoing basis<br><br>• In the event of an insolvency situation or other credit event the insurer must have a direct claim on the counterparty; and<br><br>• There must be no double counting of risk mitigation effects in own funds and in or within the calculation of the SCR.<br><br>If the arrangement is subject to conditions which could undermine the effective risk transfer and which are outside the control of the insurer this may lead to the arrangement failing to meet the risk transfer requirements. Examples might include termination for change in tax law or change of control or insolvency of the insurer. These are difficult areas as there is no clear guidance on these points and practice |

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| | has tended to vary as to the extent of termination rights given to the reinsurer. Each transaction should therefore be considered on a case by case basis. |
| **Robert Chaplin** | The standard formula also requires counterparty requirements to be met in respect of reinsurance contracts. To take the arrangement into account in the SCR calculation, the reinsurer must be:<br><br>• an undertaking authorised under the Solvency II Directive which complies with its SCR;<br><br>• a third country undertaking in an "equivalent" jurisdiction which complies with its solvency requirements; or<br><br>• a third country undertaking in a non-equivalent jurisdiction with a credit quality step of 3 or better (equivalent to a Fitch rating of BBB+ to BBB-).<br><br>Following the end of the Brexit transition period, the UK will be a third country for the purposes of the Solvency II regime. EU27 countries will be third countries for the purposes of the UK regulatory regime. Whether or not there will be a mutual recognition of equivalence for reinsurance purposes has yet to be decided, as at July 2020.<br><br>For financial risk mitigation techniques, a number of additional criteria also apply under the standard formula. These are:<br><br>• The financial risk mitigation technique must be consistent with the insurer's written policy on risk management;<br><br>• The insurer must be able to value the assets and liabilities which are subject to the financial risk mitigation technique; and<br><br>• either the financial instruments or the counterparty to the risk mitigation technique, depending on the nature of the technique, must have a credit quality step of 3 or better.<br><br>The last requirement raises some potential issues with regard to bespoke derivatives, which may be viewed as financial instruments but do not usually have a credit rating |
| **Beth Dobson** | Reinsurance or financial risk mitigation techniques which do not meet the counterparty or credit rating criteria can still be taken into account in the SCR if either:<br><br>• "qualifying collateral" is put in place covering some or all of the risk exposure; or |

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| | • the risk mitigation technique is accompanied by another risk mitigation technique and in combination the two risk mitigation techniques satisfy the requirements.<br><br>For internal model users, there is more flexibility regarding the recognition of both reinsurance and financial risk mitigation techniques. This is because the model should be capable of capturing all of the insurer's risks, including risks which arise out of the nature of the risk mitigation technique. There are still some requirements stipulated in the Delegated Regulation, however.<br><br>Contractual arrangements must be legally effective and enforceable and the transfer of risk must be clearly defined. If the arrangement is subject to a condition outside of the control of the insurer which could undermine the effective transfer of risk the technique can still be taken into account in the SCR but the SCR calculation must reflect the reduced effectiveness of the technique.<br><br>The insurer must have a direct claim on the counterparty in the event of an insolvency situation or other credit event.<br><br>The transaction documents must clearly define the extent of the cover provided by the risk mitigation technique, and where the cover is only partial the model must take this into account in the SCR calculation. |
| **Robert Chaplin** | As we have seen, there is potential for reinsurance and other risk mitigation techniques to be used to improve insurers' capital positions in a number of ways but it is important to ensure that the detailed requirements of the Solvency II regime have been satisfied in the drafting of the transaction documents.<br><br>This brings us to the end of this podcast but if you have any questions about risk transfer please get in touch with either of us or your usual contact at Slaughter and May. |