**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?*

Insurance undertakings can manage their risks in several ways, and reinsurance contracts can be part of effective measures to manage and mitigate risks. A well-structured reinsurance contract can help protect policyholders as well as other stakeholders of the insurance undertaking. Of course, reinsurance contracts have to meet several requirements in order to be considered as effective risk mitigation techniques. Articles 208 to 215 of the Solvency II Delegated Regulation 2015/35 sets out the general requirements for the recognition of the risk-mitigating effect of risk mitigation 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). The aspects considered in this Q&A are:

1. the recognition of a claim in case of default of the reinsurance undertaking
2. the potential significance of losses related to the risk margin in case of default of the reinsurance undertaking
3. the security that collateral arrangements offer in case of default of the reinsurance undertaking
4. the system of governance the insurance undertaking has in place to monitor and control the effectiveness of the reinsurance contract

The next sections of this Q&A describe these aspects in more detail. For regular, non-complex, reinsurance contracts many of the aspects go without saying, but for less regular, more complex contracts the aspects require additional attention from insurance undertakings.

Reinsurance is not tied to borders and risk sharing at a global level can have its merits. In case of a cross-border reinsurance contract with a reinsurance undertaking in a jurisdiction where Solvency II or another, not necessarily equivalent, regime is applicable, the insurance undertaking not only assesses the applicable supervisory and regulatory regime, but also the applicable bankruptcy regulation.

DNB does not prescribe any kind of reinsurance contract; this Q&A points out some of the aspects insurance undertakings take into account when it comes to the recognition of reinsurance contracts for the SF SCR calculations.

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

## 1. Clearly defined claim in case of default of the reinsurance undertaking (Articles 209 and 210)

For a reinsurance contract to be an effective risk mitigation 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 within the scope of the Solvency II regulation or jurisdictions considered equivalent to Solvency II as well as in jurisdictions that are not 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.

Well-structured and transparent retrocession of the reinsured risks by the reinsurance undertaking can be an effective risk management measure for the reinsurance undertaking. If such retrocession has a significant impact on the effectiveness and risks related to the reinsurance contract between the insurance undertaking and reinsurance undertaking, then the insurance undertaking ensures that it obtains sufficient information to monitor the impact of retrocession on the effectiveness and related risks on an ongoing basis. This may be the case where the reinsured risks are a significant part of the risks of the reinsurance undertaking. This also holds for subsequent significant retrocessions of the reinsured risks.

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

## 2. Potential significance of losses related to the risk margin in case of default of the reinsurance undertaking

In case of default, bankruptcy or insolvency of the reinsurance undertaking (or any other credit event set out in the reinsurance contract), the insurance undertaking becomes exposed again to its obligations which were reinsured by this reinsurance undertaking. Unless, of course, the insurance undertaking immediately enters into a new contract with another 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 therefore increase. This leads in turn to an increase of the risk margin, because the risk margin is calculated as the present value of the cost of capital over future capital requirements[1]. Hence, even if the liquidator of the reinsurance 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

[1] 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).

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 assess the significance with which their risk profile deviates from the SCR. If this risk related to the risk margin and the reinsurance risk premium is material, the risk profile of the insurance undertaking may significantly deviate from the assumptions underlying the SCR.

## 3. Security of collateral arrangements (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 its SCR calculation if the collateral meets the requirements of Article 214(1):

- 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 reinsurance undertaking
- 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 reinsurance undertaking, and the value of the collateral; there is material positive correlation if the collateral constitutes a material part of the risks the reinsurance undertaking is exposed to
- the collateral is not in the form of securities issued by the reinsurance undertaking or a related undertaking of that reinsurance undertaking

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.

## 4. Requirements to the system of governance in case of reinsurance

In case of reinsurance contracts the insurance undertaking has a system of governance to monitor and control the effectiveness of the reinsurance contract.

Specific points of attention are concentration risk and the reinsurance policy as well as the actuarial and risk management functions of the insurance undertaking.

### 4.1 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 that retrocession by the reinsurance undertaking has a significant impact on the effectiveness and risks related to the reinsurance contract between the insurance undertaking and reinsurance undertaking, then this includes an assessment of the impact of this retrocession on this credit risk

A reinsurance contract may give rise to concentration risk. The risk management system of the insurance undertaking has a policy in place for this. 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. The policy also contains actions to analyse possible risks of contagion between concentrated exposures. DNB assesses whether non-compliance with the SCR because of default, bankruptcy or insolvency of a single reinsurance undertaking falls within or outside these risk concentration limits.

### 4.2 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 that retrocession by the reinsurance undertaking has a significant impact on the effectiveness and risks related to the reinsurance contract between the insurance undertaking and reinsurance undertaking, then this opinion 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, if retrocession has a significant impact on the effectiveness and risks related to the reinsurance contract between the insurance undertaking and reinsurance undertaking
- the calculation of the amounts recoverable from the reinsurance contracts

### 4.3 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 on this merger or acquisition.