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The Standard Formula: A Guide to Solvency II

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Chapter 2
Reinsurance and Risk Transfer

The primary function of an insurer is the assumption and management of insurance risk. Very commonly, this will involve an insurer passing (or ceding) risk to other (re) insurers or protection providers in the relevant market. When ceding risk, (re)insurers[65] have a range of motives or objectives in undertaking such a transaction, including:

- The acquisition of capacity to unlock the writing of new business.
- A solution for non-core, difficult or stubborn legacy risks.
- A facility in order to take advantage of future market conditions opportunistically.
- An M&A tool, with the reinsurance constituting either the transaction itself or a precedent step toward an insurance business transfer scheme or even the acquisition of the ceding entity itself.

In each case, the (re)insurer will also aim to achieve regulatory capital credit against the insurance obligations that it has covered with the reinsurance asset. Under Solvency II,[66] (re)insurers are able to lower their capital requirements through the use of risk transfer techniques. This chapter focusses on the regulatory conditions that a (re) insurer must satisfy, and we analyse three key criteria:

- The terms of the risk transfer arrangement.
- The identity, quality and integrity of the reinsurer (protection provider).
- Any collateral that the (re)insurer is able to obtain by way of security for the reinsurer's (protection provider's) obligations.

Following the UK's departure from the European Union on 31 December 2020, the UK has embarked on a managed divergence from EU-derived rules, including a targeted liberalisation of the Solvency II regime. These changes do not, for now, focus on the risk transfer, and we expect the Prudential Regulation Authority (PRA) to continue to follow current Solvency II requirements for the foreseeable future. In this chapter, we summarise the Solvency II position, together with the UK approach (to the extent different or otherwise noteworthy).

1. What Is Risk Mitigation (or Risk Transfer)?

Article 13(36) of the Solvency II Directive defines risk mitigation techniques as "all techniques which enable insurance and insurers to transfer part or all of their risks to another party". These encompass a wide array of techniques, including reinsurance

[65] In this chapter, we refer to a (re)insurer in its capacity as cedant (or acquiror of reinsurance, retrocession, risk mitigation or risk transfer). We distinguish the party on the other side of the transaction, where applicable, as reinsurer (protection provider) regardless of whether the contract is one of reinsurance or retrocession.

[66] Comprising EU Directive 138/2009 (EC) (the Solvency II Directive) and Commission Delegated Regulation (EU) 2015/35 (the Delegated Regulation) as on-shored in the UK by the European Union (Withdrawal) Act 2018 and implemented by reference through the PRA Rulebook.

arrangements, transactions with special purpose vehicles (SPVs) and financial risk mitigation techniques, such as derivatives and guarantees.

Under Solvency II, (re)insurers are subject to specific rules and regulations governing risk mitigation. These rules aim to ensure that any transfer of risk is effective and reliable and creates a structured framework for assessing the eligibility of various risk mitigation techniques. The impact of such a technique on a (re)insurer's balance sheet (discussed further in Section 6 below) will depend on whether or not it calculates its solvency capital position using the standard formula or an internal model.

- **Standard Formula:** Article 101(5) of the Solvency II Directive provides that the calculation of the Solvency Capital Requirement (SCR) can account for the effect of risk mitigation techniques, provided that credit risk and other risks arising from the use of such techniques are properly reflected. The standard formula for calculating SCR involves a set of predefined parameters and calculations.
- **Internal Model:** Article 121(6) of the Solvency II Directive allows an approved internal model to account for the effect of risk mitigation techniques, subject to the same requirement that credit and other risks are properly reflected in the SCR. An internal model offers greater flexibility in applying capital charges associated with risk mitigation techniques. This allows for a more nuanced alignment with specific risks faced. For instance, if a specific instrument triggers a counterparty default risk charge that appears higher than the internal assessment, the internal model will allow for a more accurate evaluation.

In July 2021, the European Insurance and Occupational Pensions Authority (EIOPA) emphasized the need for a holistic approach to risk mitigation.[67] This approach underscores the importance of thorough analysis and assessment of risks being transferred, integrating this analysis into broader solvency considerations to ensure a well-informed decision-making process in line with Solvency II requirements.

Reinsurance

Article 13(7)(a) of the Solvency II Directive defines reinsurance as: "The activity consisting in accepting risks ceded by an insurance undertaking or third-country insurance undertaking, or by another reinsurance undertaking or third-country reinsurance undertaking".

This definition is clearly recognisable, noting that a reinsurance contact will also need to meet all other relevant tests at law in order to qualify as such. England and Wales have a long-established body of common law, statue and regulatory guidance as to what does (and does not) constitute a contract of (re)insurance. It is important to satisfy these requirements, as well as Solvency II requirements, which in turn leads to complex and nuanced questions as to categorisation — *e.g.*, at what point, for example, does a contract of guarantee, or a derivative, become a contract of (re)insurance? Different categorisations will drive different recognition and effects on the (re)insurer's regulatory balance sheet. Typically such definitions of reinsurance do not focus on the premium due or payable by the (re)insurer to the reinsurer (risk provider), or the adequacy thereof, although some element of consideration is expected.

Reinsurance comes in numerous forms, including quota share, excess of loss, facultative and treaty. Solvency II makes exceptional provision for just one variety of reinsurance, *i.e.*, finite insurance, defined by Article 210(3) of the Solvency II Directive as follows: "Reinsurance under which the explicit maximum loss potential, expressed as the maximum economic risk transferred, arising from both a significant underwriting risk and timing risk transfer, exceeds the premium over the lifetime of the contract by a limited but significant amount, together with at least one of the following features:

i. explicit and material consideration of the time value of money;

ii. contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer".

In the case of finite reinsurance contracts, the regulatory capital benefits accruing to the (re)insurer are key, noting that — in order to distinguish from mere financial engineering — it remains key to evidence a justifiable degree of risk transfer to the reinsurer (protection provider).

Other Risk Mitigation Tools

The Delegated Regulation makes reference to a range of less common risk mitigation tools including:

- **Financial Instruments**, such as derivatives. Derivatives originate their value from an underlying asset or index and can be utilized to hedge against various risks, such as market fluctuations, interest rate changes, duration mismatches or currency fluctuations. Options, for instance, provide the right but not the obligation to buy or sell an asset at a predetermined price, offering a strategic tool for managing volatility, which are subject to further specific requirements detailed in Section 5 below.
- **Contingent Capital/Contingent Convertible Bonds.** The items allow a (re)insurer to draw down capital from a counterparty at a predetermined price on the occurrence of a future event. The status of these items under Solvency II is unclear, and it is important to assess whether such techniques rise to the level of "risk transfer" as distinct from a source of additional capacity. Indeed they appear to have many of the qualities of an item of ancillary own funds. The EIOPA has

[67] European Insurance and Occupational Pensions Authority "Financial Stability Report" — July 2021.

subsequently recommended amending the Delegated Regulation to clarify that such instruments should not be included as risk mitigation techniques to reduce the SCR, either in the standard formula or when using an internal model.

- **Letters of Credit, Guarantees and Similar Instruments.** These tools differ from conventional risk mitigation strategies covered in this chapter in that they provide credit protection rather than transferring risk per se. Article 189(5) of the Delegated Regulation permits the (re)insurer to consider the instrument provider as the counterparty for the purposes of determining the quantity of the related counterparty exposure charge, subject to further specific requirements set out in Section 5 below. A letter of credit may also constitute an item of a (re)insurer's ancillary own funds (see Chapter 1), although Solvency II principles do not permit the (re)insurer to enjoy a double benefit from the instrument.

2. Identity of Reinsurer (Protection Provider)

The identity of the reinsurer (or protection provider) is key to establishing the capital benefits that a (re)insurer may derive from the risk transfer technique in question. When a (re)insurer employs the standard formula, it must meet not only the general eligibility requirements under Articles 209 and 210 of the Delegated Regulation, but also specific requirements defined in Articles 211, 212 and 214. These criteria primarily revolve around which entity stands on the other side of the risk mitigation technique. For instance, a reinsurer (protection provider) that is subject to reinsurance supervision in a European Economic Area (EEA) jurisdiction (and hence subject to Solvency II) will permit maximum credit to be obtained. The same applies in the case of a reinsurer (protection provider) from a jurisdiction that is deemed by the EU Commission to be "equivalent" for the purposes of reinsurance supervision.

Absent Solvency II-grade supervision, a reinsurer (protection provider) must have a minimum rating. Alternatively, a (re) insurer may obtain collateral from the reinsurer (protection provider). Provided this in turn meets eligibility requirements, the (re)insurer may obtain maximum credit for the risk transfer technique. See Section 3 below.

Under Article 211(2) the counterparty to a reinsurance contract must be any of the following:

- A (re)insurer authorised under the Solvency II Directive that complies with its SCR.
- A third-country (re)insurer, situated in a country whose solvency regime is deemed "equivalent" or "temporarily equivalent" to the Solvency II regime, as applicable, and which complies with the solvency requirements of that third country.
- A third country (re)insurer, situated in a non-equivalent jurisdiction with a credit quality that has been assigned to credit quality step three[68] or better in accordance with Section 2 of Chapter 1 of the Delegated Regulation.

Jurisdiction – Equivalence

Article 172 of the Solvency II Directive establishes the concept of equivalence for reinsurance supervision. This concept entails recognition of the regulatory framework of other jurisdictions as equivalent to the Solvency II regime, facilitating cross-border cooperation in the realm of risk mitigation. Article 378 of the Level 2 Delegated Regulation sets out the criteria that the commission uses in making a determination of equivalence.

The following countries have been found equivalent for Article 172 purposes: Switzerland (fully equivalent), Bermuda (fully equivalent, with exceptions related to rules on captives and special purpose insurers) and Japan (temporarily equivalent).[69]

Although the U.S. is not formally equivalent for reinsurance purposes, in practice, credit can be taken by EEA (re)insurers for reinsurance agreements with U.S. reinsurers (and vice versa) if certain conditions are met. An EU/US Bilateral Agreement signed in 2017 prohibits any requirement for an EEA reinsurer (protection provider) to post collateral before a US (re)insurer may take credit for a reinsurance arrangement, and vice versa. Following Brexit, the UK entered into similar arrangements with the US in 2018, with very similar effects.

Additionally since Brexit, the UK has been considered a "third country" for Solvency II purposes, given it is outside the EEA (even though it is subject to a substantially identical regulatory framework).

Arrangements made between EU (re)insurers and UK reinsurers will only qualify as risk mitigation techniques under Solvency II if the UK reinsurer (protection provider) meets the minimum credit rating referred to above, or if there are qualifying collateral arrangements in place. UK reinsurers (protection providers) no longer have an automatic right to conduct reinsurance activities in the EEA, whether on a freedom of establishment or cross-border services basis.

Special Purpose Vehicles (SPVs)

A (re)insurer may obtain regulatory capital credit by ceding risk to a special purpose vehicle (SPV) that in turn transforms such risks into investment risk — whether debt or otherwise — in which non-insurance investors may participate. Article 13(26) of the Solvency II Directive defines an SPV as follows: "Any undertaking, whether incorporated or not, other than an existing insurance or reinsurance undertaking, which assumes

[68] Equivalent to a BBB rating given by Fitch or S&P and a Baa rating given by Moody's.

[69] The regime for temporary equivalence can be found under Article 172(4) of the Solvency II Directive for a limited period (up to 31 December 2020, with the option of one-year extensions at the commission's option).

risks from insurance or reinsurance undertakings and which fully funds its exposure to such risks through the proceeds of a debt issuance or any other financing mechanism where the repayment rights of the providers of such debt or financing mechanism are subordinated to the reinsurance obligations of such an undertaking".

The sole function of such an SPV is to assume specific risks from (re)insurers. Unlike a traditional reinsurer, an SPV "fully funds" its exposure to the assumed risks through the proceeds of a debt issuance (typically referred to as insurance-linked securities or ILS) or any other financing mechanism. This can be viewed as a variety of collateral, where the debt proceeds are held subject to suitable custody arrangements for the benefit of the (re)insurer. The repayment rights of the providers of such debt or financing mechanism are explicitly subordinated to the reinsurance obligations of the SPV. This subordination ensures that the financial arrangements are designed to prioritize the fulfilment of reinsurance obligations, reinforcing the commitment to risk assumption. In addition, on 19 March 2015, the commission adopted the EIOPA's technical standards on the approval of SPVs (the SPV ITS).

Article 211 also extends its scope to risk mitigation techniques involving SPVs, requiring them to be authorised in accordance with the eligibility criteria prescribed in Articles 318 to 327 of the Delegated Regulation. These criteria provide a detailed framework for the authorisation and functioning of SPVs in the context of risk mitigation within the Solvency II regime:

- Article 319: The SPV must be "fully funded", requiring:
  - Assets to be valued in accordance with Article 75 of the Solvency II Directive.
  - Assets to be equal to or exceed the aggregate maximum risk exposure (AMRE).[70]
  - Full payment of debt issuance or financing proceeds.
- Article 326(4): Future payments from existing reinsurance contracts are allowed in the calculation of the SPV's assets provided certain conditions are met.
- Article 320: The contractual arrangements for risk transfer to and from the SPV must be effective in all circumstances, clearly defining and incontrovertibly establishing the extent of the risk transferred. The transfer of risk may be ineffective if undermined by connected transactions.
- Article 321: Limitation of Rights for Debt or Finance Providers: The contractual arrangements must:
  - Subordinate the rights of debt or finance providers to the reinsurance obligations.
  - Prevent payments that would leave the SPV unfunded.
  - Deny any recourse to the SPV's assets.
  - Disapply any rights to wind up the SPV.
- Article 322: Persons managing the SPV must meet the "fit and proper" requirements specified in the Solvency II Directive, and the supervisory authority must be informed of their identity and any changes.
- Article 323: Shareholders with a 10% or more holding must meet fit and proper requirements, assessed based on reputation, financial soundness, level of influence and potential connections with money laundering or terrorist financing.
- Article 324: The SPV must have an effective system of governance, including written policies, internal controls and risk management systems appropriate to the risks assumed.
- Article 325: The SPV must submit an annual report with specified information to the supervisory authority, including the valuation of its assets and AMRE.[71]
- Article 327: The SPV must invest its assets according to detailed requirements, ensuring proper identification, measurement, control of risks, appropriate diversification and avoidance of excessive risk concentration. An SPV may use derivative instruments only insofar as they contribute to a reduction of risks or facilitate efficient portfolio management. It must also keep investments and assets that are not admitted to trading on a regulated financial market to prudent levels.

UK ILS Regime

In 2017, the United Kingdom implemented a new legislative framework that significantly liberalized the PRA's regime for the authorisation and governance of insurance special purpose vehicles (ISPVs). It was thought that this framework, encompassing corporate, insolvency, regulatory and tax dimensions, marked a sea-change in the UK's approach to alternative risk transfer activities. To date, however, the UK's ILS industry remains nascent. The ease of setting up such a vehicle and tax remain important factors in a sponsor's decision as to where to domicile an ILS structure and, for now, offshore jurisdictions such as Bermuda tend to dominate in this field.

The UK regime is contained principally in:

- The Risk Transformation Regulations 2017 (RTR).
- The Risk Transformation (Tax) Regulations 2017 (RTTR).
- The PRA's Supervisory Statement SS8/17 of December 2022.

The RTR:

- Creates a new regulated activity of "insurance risk transformation" under Article 13A of The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

[70] The AMRE is defined in Article 1(44) of the Delegated Regulation as the sum of the maximum payments including expenses that the ISPV may incur (although certain expenses may be excluded).

[71] Articles 13 to 16 of the SPV ITS specify a wide range of quantitative and qualitative contents that must be included in the annual report.

- Introduces a new UK corporate vehicle in the form of a protected cell company or "PCC" comprised of a "core" and "cells", such that each ILS deal can be ascribed to a different cell (ring-fenced from the other cells and the core).
- Permits the establishment of ISPVs, as well as multi-arrangement insurance special purpose vehicles (MISPVs) (an ISPV that assumes risks under more than one separate contractual arrangement from one or more cedants and taking the form of a PCC).[72]
- Makes special provision for the position of an MISPV on insolvency (effectively allowing one cell to "fail" without impacting the solvency of the others).

The RTTR:

- Removes corporation tax in relation to profits arising from the activity of insurance risk transformation (other than in the case of BLAGAB (basic life assurance and general annuity business)).
- Exempts interest payments from ISPVs to investors from withholding tax.
- Denies special tax treatment when UK ISPVs where used as part of a tax avoidance scheme or where there has not been a genuine transfer of risk to an ISPV.

A UK ISPV must be approved by the PRA under Part 4A of the Financial Services and Markets Act 2000 (FSMA). The PRA leads the application process but requires the FCA's consent before granting approval. All UK ISPVs are dual regulated by the PRA and FCA. An ISPV may operate only in accordance with an approved Scope of Permission (SOP) and is otherwise subject to certain limited obligations on an ongoing basis, with the PRA's ongoing assessment being proportionate and risk-based.

The PRA will determine authorisation of an ISPV within six months from receipt of a complete application, but will aim for a shorter period in the case of a straightforward and high-quality application. In the case of the addition of cells to an existing MISPV, there is no pre-notification requirement for the establishment of new cells, but a post-notification is required within five working days of the assumption of a new risk (provided always that the MISPV is operating within its SOP).

All individuals who are "effectively running" the ISPV must satisfy the fit and proper criteria set out in the Insurance — Fitness and Propriety Part of the PRA Rulebook.

The PRA will carry out a fit and proper assessment of shareholders or members who have a qualifying holding on the basis that they hold 10% or more of the voting rights in the ISPV, or have significant influence over the management of the ISPV.

[72] A reference in this chapter to an ISPV should be construed as a reference also to an MISPV, unless the context otherwise requires.

As stated above, Solvency II requires all ISPVs to be fully funded. SS8/17 interprets this requirement as follows:

- The assets of the ISPV must be valued in accordance with international financial reporting standards and otherwise in accordance with Solvency II.
- The proceeds of the ISPV's debt issuance or other funding mechanism must be fully paid-in. In other words, the ISPV should have received the proceeds of the debt issuance or other mechanism by which it is financed. Therefore, the PRA expects ISPVs not to include contingent assets for the purposes of satisfying the fully funded requirement. Accordingly, ISPVs should not count legally binding commitments that could be treated as ancillary own funds (or off balance sheer/ callable items) as assets for the purposes of satisfying the fully funded requirement.
- Payments expected to be received from the cedant (*e.g.*, funds withheld) may be recognized as an asset only if all the requirements in Article 326(4) of the Delegated Regulation are met.
- Ihe ISPV must at all times have assets equal in value or exceeding its AMRE such that it is able to pay the amounts it is liable for as they fall due. The PRA considers that the AMRE must be an amount that is determinable at any given point in time, so that ISPVs and the PRA are able to assess whether the fully funded requirement is being met.
- For an SPV, there will be one AMRE that applies in respect of the entire risk exposure of the ISPV. For MISPVs, the AMRE should generally be determined and fully funded at the level of each individual cell (save in the case of a group of cells).
- While the AMRE should be fully funded at all times, the PRA recognises that the AMRE can change over the life of the arrangement. The PRA expects an ISPV to ensure that the contractual provisions should provide for any increase in the AMRE during the life of the arrangement and is only effective if and when the corresponding funds are paid-in. The PRA expects ISPVs to ensure that this is made clear in the contractual provisions.

3. Collateral Arrangements

Article 213 of the Delegated Regulation provides an exception to the specific eligibility criteria outlined in Articles 211 and 212 (See Sections 2 and 5), where a risk mitigation technique is supported by collateral arrangements that meet the criteria of Article 214.

There are numerous ways in which collateral can be structured (*e.g.*, on a funds-withheld or deposit-back basis, or by posting of secured assets by means of security agent/custodian). Article 213(2) specifies that if the value of any compliant collateral arrangement is less than the total risk exposure, the arrangement will only be considered to the extent that the collateral covers the risk exposure.

Article 214 provides that collateral arrangements must align with the general eligibility criteria set out in Articles 209 and 210 (discussed in Section 4 below).

Under Article 214, collateral arrangements are subject to further specific eligibility requirements to ensure their compliance, as follows:

- The (re)insurer must have the right promptly to liquidate or retain collateral in the event of counterparty default, insolvency, bankruptcy or other credit events.
- The collateral must be of sufficient credit quality, liquidity and stability in value (or guarantee from a counterparty) (excluding one that has been assigned a concentration risk factor of 0% for the market risk module of the SCR under Article 184(2) or 187(5) of the Delegated Act).
- There is no material positive correlation between the credit quality of the counterparty and the value of the collateral itself, thus maintaining the independence of the collateral's value from the counterparty's creditworthiness.
- The collateral should not include securities issued by the counterparty or its related entities to prevent potential conflicts of interest and undue influence.
- Where the collateral is held by a third party (such as a custodian or subject to a security arrangement), the relevant third party must keep the assets separate from its own.
- The collateral must be held by a party with a credit quality rating of step three[73] or higher.
- The assets must be individually identifiable and can only be altered or substituted with the explicit consent of the (re) insurer (or trustee).
- The assets must not be used to pay or to provide collateral for any other person other than the cedant (or as directed by the cedant).

4. General Eligibility Criteria — Standard Formula

The Delegated Regulation establishes a comprehensive framework of criteria that risk mitigation techniques must fulfill to be incorporated into the Solvency Capital Requirement (SCR) calculation for (re)insurers.

Article 209: Qualitative Criteria

The initial set of eligibility criteria, outlined in Article 209(1) (a) to (e), focuses on qualitative benchmarks for any risk mitigation technique. These criteria are as follows:

- The contractual arrangements and the transfer of risk must be legally effective and enforceable in all relevant jurisdictions. Article 210(4) states that this determination must consider whether:
  - The arrangement is subject to any condition that could undermine the effective transfer of risk, the fulfilment of which is outside the direct control of the cedant.
  - There are any connected transactions that could undermine the effective transfer of risk.
- The (re)insurer must have taken all appropriate steps to ensure the arrangement's effectiveness and address related risks.
- The (re)insurer must be able to monitor the effectiveness of the arrangement and the related risks on an ongoing basis.
- In the event of a default, insolvency or bankruptcy of a counterparty or some other credit event set out in the transaction documentation, the (re)insurer must have a direct claim on the counterparty.
- There must be no double counting of risk mitigation effects in own funds and in or within the calculation of the SCR.

These criteria require an assessment of the legal effectiveness and enforceability of contractual arrangements across all relevant jurisdictions. Effective risk transfer in particular must be closely guarded in the course of negotiating a reinsurance arrangement, if the cedant is to achieve full regulatory capital benefit. Accordingly, attempts by the reinsurer to introduce optionality around termination of the agreement (or even around initiation of a consultation between the parties on the future shape or duration of the agreement) must generally be resisted or appropriately moderated, whether this is on a standalone basis or in response to a change in law, regulation, tax treatment or otherwise.

It is also important to consider what termination events (or other contractual triggers) may be viewed as outside the direct control of the undertaking. Externalities, such as a change in law, a change in control of the (re)insurer or even the insolvency of the (re)insurer will all need to be carefully considered from this perspective.

Article 210(1): Clearly Defined and Incontrovertible Coverage

Article 210(1) provides that the coverage achieved by the risk mitigation technique (and the corresponding risk transfer) must be "clearly defined and incontrovertible".

Recital 71 to the Delegated Regulation clarifies that the remote nature of the amount or timing of payments by the reinsurer (protection provider) should not, by itself, undermine the recognition that the reinsurer (protection provider) has assumed risk.

Article 210(2): Material Basis Risk and Other Risks

Article 210(2) requires that arrangements must not result in a material basis risk or the creation of additional risks, unless these risks are duly considered in the calculation of the undertaking's SCR. Basis risk, in this context, refers to a significant mismatch between the level of protection provided and the characteristics of the underlying liabilities.

[73] Equivalent to a BBB rating given by Fitch or S&P and a Baa rating given by Moody's.

Article 210(3) further defines basis risk as "material" when it leads to a misstatement of the risk-mitigating effect on an undertaking's SCR. This nuanced definition emphasizes the importance of avoiding misrepresentations that could influence decision-making or judgement regarding the effectiveness of the risk mitigation technique.

Term

Article 209(2) provides that the risk mitigation technique must be effective for a minimum of 12 months. Should its duration be shorter, its impact on the Solvency Capital Requirement will be proportionate to either the total term of the risk exposure or the operational period of the technique.

5. Specific Eligibility Criteria — Standard Formula

Article 212: Financial Risk Mitigation Techniques

Financial risk mitigation techniques must comply with the criteria outlined in Articles 212(2) to (5) for inclusion in the SCR calculation. These additional criteria are as follows:

- Article 212(2): Financial risk mitigation techniques must have a clearly defined methodology for calculating their risk mitigation effect. This involves a quantitative assessment of how the technique contributes to reducing the overall risk exposure of the (re)insurer.
- Article 212(3): The technique's calculations and methodologies should be consistent with the standard formula and other relevant calculation methods used for determining the solvency capital requirement.
- Article 212(4): Financial risk mitigation techniques must recognise and appropriately account for the diversification effects within the (re)insurer's risk profile.
- Article 212(5): The financial risk mitigation technique should effectively address and mitigate counterparty credit risk. This involves assessing the creditworthiness of counterparties involved in the risk mitigation process and implementing measures to minimise the impact of credit risk on the (re)insurer.

Article 215: Specific Eligibility Criteria for Guarantees

Guarantees must comply with criteria outlined in Article 215(a) to (f) of the Delegated Regulation for inclusion in the SCR, as follows:

- Article 215(a): Provides that the credit protection under the guarantee must be direct.
- Article 215(b): Provides that the scope of coverage provided by guarantees must be clearly defined and incontrovertible.
- Article 215(c): States the guarantee must not contain any clause, the fulfilment of which is outside the direct control of the undertaking, that could:
  - Allow the guarantor to cancel the protection unilaterally.
  - Increase the effective cost of the protection as a result of a deterioration in the credit quality of the underlying liabilities.
  - Prevent the guarantor from being obliged to pay out in a timely manner if the original obligor fails to make any payments due.
  - Allow the maturity of the guarantee to be reduced by the guarantor.
- Article 215(d): On the default or insolvency of the counterparty, states the undertaking must have the right to pursue the guarantor for any monies due without first having to pursue the counterparty.
- Article 215(e): States the guarantee must be an explicitly documented obligation assumed by the guarantor.
- Article 215(f): States the guarantee must fully cover all regular payments the counterparty is expected to make.

Combinations of Risk Mitigation Techniques

Article 213 provides an exception to the specific eligibility criteria outlined in Article 211 where a risk mitigation technique is coupled with another risk mitigation technique, and the combination of the two satisfies the outstanding specific eligibility requirements under Article 211 or 212, respectively. To qualify, the counterparties to the second risk mitigation technique must adhere to the relevant counterparty requirements outlined in Article 211 or 212.

6. Impact of Risk Mitigation on Capital Requirements

A risk mitigation technique will, to the extent effective and eligible, operate to reduce the (re)insurer's capital requirements, in particular its Solvency Capital Requirement and technical provisions. We briefly discuss this below, with further details of a (re)insurer's capital requirements to follow in subsequent chapters.

Solvency Capital Requirement

The calculation of the SCR may account for a risk mitigation technique, provided that credit risk and other risks arising from the use of such techniques are properly reflected.[74] Under the standard formula, the SCR aggregates capital charges arising from the various constituent risk modules. The capital charge for a given module reflects the impact a prescribed (adverse) scenario on the (re)insurer's own funds. An eligible risk mitigation instrument may be taken into account (*i.e.*, the capital charge will be reduced) if it has the effect of lessening the impact on own funds.[75] The (re)insurer will also need to reflect the credit and counterparty impacts of entering into the arrangement, in

[74] Article 101(5) of the Solvency II Directive.

[75] Article 83(4) of the Delegated Regulation.

particular with regard to the reinsurer (protection provider). Such exposure is, however, reduced to the extent that eligible collateral is provided (see Section 3 above).

Where the (re)insurer uses an internal model, a similar assessment is required based on the more calibrated and bespoke procedure that the (re)insurer has agreed with its regulator as part of the model, and remains subject to the same requirement that credit and other risks are properly reflected in the SCR.[76]

Technical Provisions

Technical provisions correspond to the current amount a (re) insurer would have to transfer to another (re)insurer to accept its insurance and reinsurance obligations. In calculating technical provisions, amounts recoverable from reinsurance contracts may be taken into account. Given that assets held against technical provisions usually represent the majority of a (re)insurer's assets, it follows that an eligible risk transfer instrument delivers the majority of its capital benefit in this area. Such recoverables must be calculated separately in accordance with Article 81 of the Solvency II Directive to take account of any lag between recoveries and direct payments and reduction in recoveries due to default of the counterparty.

Articles 41 and 42 of the Delegated Regulation provide further rules around how amounts recoverable from reinsurance contracts and SPVs should be calculated, and how such amounts should be adjusted to account for expected losses due to counterparty default.

Risk Margin

The "risk margin" is a further layer of prudence on top of (and with reference to) a (re)insurer's technical provisions. The notional transfer of liabilities assumed as part of the assessment of technical provisions would also involve the notional transfer of reinsurance assets relating to the "transferring" book.[77] Accordingly, the risk margin is also reduced to the extent of an eligible risk mitigation technique.

[76] Article 121(6) of the Solvency II Directive

[77] Article 38(1)(c) of the Delegated Regulation.