Chapter 2

Reinsurance and Risk Transfer

Introduction

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, a (re)insurer has a range of motives or objectives in undertaking such a transaction, including:

- A means of managing the risk that it holds, *i.e.*, laying off risk with third parties.
- The acquisition of capacity to unlock the writing of new business.
- A potential 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 preliminary step towards 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. Pursuant to the Solvency II Directive, (re)insurers are able to lower their capital requirements through the use of risk transfer techniques. This chapter focuses on the regulatory conditions that a (re)insurer must satisfy, through an analysis of 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 Brexit, the UK continues to pursue a managed divergence from EU-derived legislation, including a targeted liberalisation of the Solvency II regime. Presently, such changes do not focus on risk transfer and the PRA is expected to continue to follow current Solvency II requirements for the foreseeable future.

In this chapter, "(re)insurer" takes on a special meaning: where an undertaking is acting in its capacity as cedant (or acquiror of reinsurance, retrocession, risk mitigation or risk transfer). The party on the opposing side of the transaction is distinguished, where applicable, as reinsurer (protection provider) regardless of whether the contract is one of reinsurance or retrocession.

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

Risk mitigation techniques are "all techniques which enable insurance and reinsurance undertakings to transfer part or all of their risks to another party".[81] These encompass a wide array of techniques, including reinsurance arrangements, transactions with special purpose vehicles (SPVs) and financial instruments such as derivatives and guarantees, all of which fall under the category of risk mitigation techniques.

Pursuant to Solvency II, (re)insurers are subject to specific rules and regulations governing risk mitigation. Such rules aim to ensure that any transfer of risk is effective and reliable whilst creating 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 (see Section 6 below) will depend on whether or not it calculates its solvency capital position using the standard formula or an internal model (IM):

[81] Article 13(36) of the Solvency II Directive (transposed in Paragraph 1,2, Conditions Governing Business Part of the PRA Rulebook).

- **Standard Formula:** The calculation of the 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.[82] The standard formula for calculating the SCR involves a set of predefined parameters and calculations.
- **Internal Model:** An approved IM may account for the effect of risk mitigation techniques, subject to the same requirement that credit and other risks are properly reflected in the SCR.[83] IMs offer greater flexibility in applying capital charges associated with risk mitigation techniques which 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 IM will allow for a more accurate evaluation.

In July 2021, the EIOPA emphasised the need for a holistic approach to risk mitigation.[84] This approach underscores the importance of thorough analysis and assessment of the risks being transferred, integrating this analysis into broader solvency considerations to ensure a well-informed decision-making process in line with Solvency II requirements.

What Is Reinsurance?

As a general proposition, there is no statutory definition of reinsurance under English law. However, England and Wales have a long-established body of common law, statute and regulatory guidance as to what does (and does not) constitute a contract of (re)insurance; at times, however, such authorities do not provide a consistent definitional approach. It is generally accepted that under a contract of reinsurance, the reinsured, being the insurer of the original risk pursuant to the underlying insurance contract, cedes part or all of its risk to a reinsurer. In return for the payment of a premium, the reinsurer undertakes to indemnify the reinsured for losses that fall within the scope of the reinsurance contract. However, for Solvency II purposes, reinsurance is: "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".[85]

Notwithstanding this definition, any reinsurance contact will also need to meet all other relevant tests at law in order to qualify as such. 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. For example, at what point 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 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. The Solvency II Directive makes exceptional provision for just one variety of reinsurance: finite insurance. Finite insurance is: "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:

[82] Article 121(6), *ibid* (transposed in Paragraph 11.8(2), Solvency Capital Requirements — Internal Models Part of the PRA Rulebook).
[83] *Ibid*.
[84] The EIOPA, Financial Stability Report, 1 July 2021.
[85] Article 13(7)(a) of the Solvency II Directive (transposed in the PRA Glossary).

(a) explicit and material consideration of the time value of money;

(b) contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer”.[86]

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 vital to evidence a justifiable degree of risk transfer to the reinsurer (protection provider).

Other Risk Mitigation Tools

The Level 2 Delegated Regulation refers to a range of less common risk mitigation tools including:

- **Financial Instruments** such as derivatives and options. Derivatives originate their value from an underlying asset or index and can be utilised to hedge against various risks, such as market fluctuations, interest rate changes, duration mismatches or currency fluctuations. Options provide the right (but not the obligation) to buy or sell an asset at a predetermined price, offering a strategic tool for managing volatility. Options are subject to further specific requirements detailed in Section 5 below.
- **Contingent Capital/Contingent Convertible Bonds** 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 instruments under the Solvency II Directive is unclear; it is important to assess whether such instruments 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 AOF. The EIOPA has subsequently recommended amending the Level 2 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 IM.
- **Letters of Credit, Guarantees and Similar Instruments** differ from conventional risk mitigation strategies covered in this chapter in that they provide credit protection rather than transferring risk. (Re)insurers are permitted to consider the instrument provider as the counterparty for the purposes of determining the quantity of the related counterparty exposure charge,[87] 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 AOF 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 Level 2 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. 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.

[86] Article 210(3), *ibid* (transposed in the PRA Glossary: “finite insurance”).

[87] Article 189(5) of the Level 2 Delegated Regulation.

The counterparty to an uncollateralised reinsurance contract must be one of the following:

- A (re)insurer authorised under the Solvency II Directive that complies with its SCR.[88]
- A third country (re)insurer, situated in a country whose solvency regime is deemed "equivalent" or "temporarily equivalent" to the Solvency II regime or the UK regime, as applicable, and which complies with the solvency requirements of that third country.[89]
- A third country (re)insurer, situated in a non-equivalent jurisdiction with a credit quality that has been assigned to credit quality step three or better.[90]

Jurisdiction – Equivalence

An insurer can obtain maximum credit in respect of reinsurance to any reinsurer (protection provider) that is also subject to reinsurance supervision in the European Economic Area (EEA) (and hence subject to Solvency II). 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.

"Equivalence" for the purposes of reinsurance supervision entails recognition of the regulatory framework of another jurisdiction as equivalent to the Solvency II regime, facilitating cross-border cooperation in respect of risk mitigation.[91] Predictably, the aim of the "equivalence" regime is to ensure that any such third country upholds standards at least as stringent as those prescribed under Solvency II. Examples of such criteria considered include:

- Whether supervisory authorities in that third country have the power, by law or regulation, to effectively supervise domestic insurance undertakings carrying out reinsurance activities and to impose sanctions or take enforcement action where necessary.[92]
- Whether supervisory authorities in that third country have the necessary means, the relevant expertise, capacities including financial and human resources, and mandate to effectively protect policyholders and beneficiaries regardless of nationality or place of residence.[93]
- Whether supervisory authorities in that third country duly consider the impact of their decisions on the stability of global financial systems.[94]
- Whether supervisory authorities in that third country take into account the potential pro-cyclical effects of their actions where exceptional movements in the financial markets occur.[95]
- Whether the taking-up of business in that third country is subject to prior authorisation conditional on a clear, objective and publicly available set of written standards.[96]

[88] Article 211(2)(a), *ibid.*
[89] Article 211(2)(b), *ibid.*
[90] Equivalent to a BBB rating given by Fitch or S&P and a Baa rating given by Moody's.
[91] Article 172 of the Solvency II Directive.
[92] Article 378(a) of the Level 2 Delegated Regulation.
[93] Article 378(b), *ibid.*
[94] Article 378(c), *ibid.*
[95] Article 378(d), *ibid.*
[96] Article 378(e), *ibid.*

- Whether the solvency regime of that third country requires domestic insurance or reinsurance undertakings carrying out reinsurance to have an effective system of governance in place which provides for sound and prudent management of the business.[97]

For reinsurance purposes, only Switzerland and Bermuda have been named as fully equivalent. Although, there are certain exceptions in place regarding captives and special purpose insurers in Bermuda.

The US is not formally equivalent for reinsurance purposes. However, in practice, credit can be taken by EEA (re)insurers for reinsurance agreements with US reinsurers (and vice versa) if certain conditions are met. A bilateral agreement between the EU and the US signed in 2017 (EU-US Bilateral Agreement)[98] 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.

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 the Solvency II Directive if the UK reinsurer (protection provider) meets the minimum credit rating referred to above, or if there are qualifying collateral arrangements in place. In addition, 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.

The UK regards all EEA States,[99] Switzerland[100] and Bermuda[101] as being fully equivalent for reinsurance purposes.

Special Purpose Vehicles

(Re)insurers may obtain regulatory capital credit by ceding risk to an SPV, which in turn transforms such risks into investment risk — whether debt or otherwise — in which non-insurance investors may participate. For Solvency II purposes, SPVs are: "any undertaking, whether incorporated or not, other than an existing insurance or reinsurance undertaking, which assumes 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".[102]

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 another 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

[97] Article 378(f), *ibid.*

[98] Bilateral Agreement Between the US and the EU on Prudential Measures Regarding Insurance and Reinsurance.

[99] Solvency 2 Regulations Equivalence Directions 2020.

[100] Paragraph 6, Schedule 2 of the Equivalence Determinations for Financial Services and Miscellaneous Provisions (Amendment etc.) (EU Exit) Regulations 2019.

[101] Paragraph 7, Schedule 2, *ibid.*

[102] Article 13(26) of the Solvency II Directive.

explicitly subordinated to the reinsurance obligations of the SPV. Subordination ensures that the financial arrangements are designed to prioritise the fulfilment of reinsurance obligations, reinforcing the commitment to risk assumption.

The Solvency II Directive demands that eligibility criteria that are adopted in respect of SPVs be followed in a scenario where risk mitigation is transferred to an SPV.[103] Such criteria provide a detailed framework for the authorisation and functioning of SPVs in the context of risk mitigation within the Solvency II regime:

- The SPV must be "fully funded",[104] meaning that:
  - Its assets are to be valued in accordance with the general rules on valuation of assets.[105] Namely, assets and liabilities shall be valued at the amount for which they could be exchanged between parties in an arm's length transaction.[106]
  - Its assets are to be equal to or exceed the aggregate maximum risk exposure (AMRE)[107] and the SPV must be able to pay its debts as they fall due.[108]
  - The proceeds of any debt issuance or financing proceeds must be paid-in in full.[109]
- 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.[110]
- There must be a limitation of rights for debt or financing providers, specifically, the contractual arrangements must:
  - Subordinate the rights of debt or finance providers to the reinsurance obligations.
  - Prevent payments that would leave the SPV in a position where it is not fully funded.
  - Deny any right of recourse to the SPV's assets, and such providers of debt or finance must have no right to apply for the winding-up of the SPV.[111]
- Persons managing the SPV must meet the "fit and proper" requirements specified in the Solvency II Directive. The supervisory authority must be informed of their identity and any changes.[112] Likewise, 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.[113] In addition to the individuals who control the SPV, either on a day-to-day basis or by way of a shareholding, the SPV itself must have an effective system of governance, including written policies, internal controls and risk management systems appropriate to the risks assumed.[114]

[103] Article 211 of the Level 2 Delegated Regulation.
[104] Article 319, *ibid.*
[105] Article 326(1)(a), *ibid.*
[106] Article 75 of the Solvency II Directive (transposed in Paragraph 2.1, Valuation Provisions Part of the PRA Rulebook).
[107] Article 1(44) of the Level 2 Delegated Regulation.
[108] Article 326(1)(b), *ibid.*
[109] Article 326(1)(c), *ibid.*
[110] Article 320, *ibid.*
[111] Article 321, *ibid.*
[112] Article 322, *ibid.*
[113] Article 323, *ibid.*
[114] Article 324, *ibid.*

- SPVs are also subject to specific reporting requirements in addition to those outlined as a general rule for undertakings in Chapter 3: Cross-Border Services and Overseas Branches. SPVs must submit an annual report with specified information to the supervisory authority, including the valuation of its assets and AMRE.[115]
- With respect to the calculation of assets, future payments from existing reinsurance contracts are allowed in the calculation of the SPV's assets provided certain conditions are met.[116] Further, 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.[117]

UK ILS Regime

In 2017, the United Kingdom implemented a new legislative framework that significantly liberalised the PRA's regime for the authorisation and governance of insurance SPVs (ISPVs) and was initially heralded as a sea-change in the UK's approach to alternative risk transfer activities, encompassing corporate, insolvency, regulatory and tax dimensions. To date, however, the UK's ILS industry remains nascent and very few ISPVs have been formed. The ease of setting up such a vehicle (and taxation) remain important factors in a sponsor's decision as to where to domicile an ILS structure and offshore jurisdictions such as Bermuda continue to serve as a first-in-class destination in this field.

The UK regime is contained principally in three different authorities:

1. The Risk Transformation Regulations 2017

- Created a new regulated activity of "insurance risk transformation".[118]
- Introduced a new UK corporate vehicle in the form of a protected cell company (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).[119]
- Permitted the establishment of ISPVs, as well as multi-arrangement insurance SPVs (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. For the purposes of this chapter, references to an ISPV should be construed as a reference also to an MISPV, unless the context otherwise requires.
- Made special provision for the position of an MISPV on insolvency (effectively allowing one cell to "fail" without impacting the solvency of the others).

[115] Article 325, *ibid.*

[116] Article 326(4), *ibid.*

[117] Article 327, *ibid.*

[118] Article 13A of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

[119] Regulation 12(1) of the Risk Transformation (Tax) Regulations 2017.

2. The Risk Transformation (Tax) Regulations 2017

- Removed corporation tax in relation to profits arising from the activity of insurance risk transformation, other than in the case of a basic life assurance and general annuity business.[120]
- Exempted interest payments from ISPVs to investors from withholding tax.[121]
- Denied special tax treatment when UK ISPVs are used as part of a tax avoidance scheme or where there has not been a genuine transfer of risk to an ISPV.[122]

3. PRA SS8/17 of December 2022

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 Financial Conduct Authority's (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 (the length of time taken, and process complexity, is thought to have been a significant deterrent against the use of the UK ISPV structure, as compared to Bermuda). 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. Such criteria will apply to the ISPV's senior management together with any 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. The PRA requires applicants to nominate "fit and proper" individuals for approval by the PRA including: chief executive, chief financial officer and a chair of the board. While it is expected that a different individual fulfils each of these functions, the PRA may consider an individual with the proper skills to perform a combination of these roles, as assessed on a case-by-case basis.

As mentioned, ISPVs must be fully funded; the PRA interprets this requirement as follows:

- The assets of the ISPV must be valued in accordance with international financial reporting standards (IFRS) and otherwise in accordance with the Solvency II Directive.
- 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 AOF (or off balance sheet/callable items) as assets for the purposes of satisfying the fully funded requirement.

[120] Regulation 4(1), *ibid.*

[121] Regulation 5, *ibid.*

[122] Regulation 6, *ibid.*

- Payments expected to be received from the cedant (*e.g.*, funds withheld) may be recognised as an asset only if all the requirements in Article 326(4) of the Level 2 Delegated Regulation are met (as outlined in Section 2 above).
- The 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 its contractual provisions.

3. General Eligibility Criteria — Standard Formula

There is a comprehensive framework of criteria that risk mitigation techniques must fulfil to be incorporated into the SCR calculation for (re)insurers. The initial set of eligibility criteria focuses on qualitative benchmarks for any risk mitigation technique and are as follows:

- The contractual arrangements and the transfer of risk must be legally effective and enforceable in all relevant jurisdictions.[123] Such 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.[124]
- The (re)insurer must have taken all appropriate steps to ensure the arrangement's effectiveness and address related risks.[125]
- The (re)insurer must be able to monitor the effectiveness of the arrangement and the related risks on an ongoing basis.[126]
- 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 be able to make a direct claim on the counterparty.[127]
- There must be no double counting of risk mitigation effects in own funds and in or within the calculation of the SCR.[128]

[123] Article 209(1)(a) of the Level 2 Delegated Regulation.
[124] Article 210(4), *ibid.*
[125] Article 209(1)(b), *ibid.*
[126] Article 209(1)(c), *ibid.*
[127] Article 209(1)(d), *ibid.*
[128] Article 209(1)(e), *ibid.*

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 on a stand-alone basis or in response to a change in law, regulation, tax treatment or otherwise.

Equally as important is considering 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.

The coverage achieved by the risk mitigation technique (and the corresponding risk transfer) must be "clearly defined and incontrovertible".[129] 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.[130] Such 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.[131] In this context, "basis risk" refers to a significant mismatch between the level of protection provided and the characteristics of the underlying liabilities. Whether or not a risk is "material" is assessed as to whether it leads to a misstatement of the risk-mitigating effect on an undertaking's SCR.[132] This nuanced definition emphasises the importance of avoiding misrepresentations that could influence decision-making or judgement regarding the effectiveness of the risk mitigation technique.

With respect to duration, the standard position is that only those risk mitigation techniques which are in force for a minimum of 12 months and meet the criteria above may be fully taken into account in the calculation of the SCR.[133] Should the duration be shorter, its impact on the SCR will be proportionate to either the total term of the risk exposure or the operational period of the technique.

4. Specific Eligibility Criteria — Standard Formula

There are two specific areas that bring their own eligibility criteria to be compliant with SCR calculations. First, financial risk mitigation techniques must comply with additional qualitative criteria:

- 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.[134]
- The technique's calculations and methodologies should be consistent with the standard formula and other relevant calculation methods used for determining the SCR.[135]

[129] Article 210(1), *ibid.*

[130] Recital 71, *ibid.*

[131] Article 210(2), *ibid.*

[132] Article 210(3), *ibid.*

[133] Article 209(2), *ibid.*

[134] Article 212(2), *ibid.*

[135] Article 212(3), *ibid.*

- Where the risk mitigation technique involves the use of financial instruments, the financial instruments must have a credit quality of step three or higher.[136] Conversely, where it does not involve a financial instrument, the counterparty itself must have a credit quality of step three or higher.[137]

Second, in order for guarantees to be recognised as eligible in calculating the SCR, they must meet the criteria summarised below:

- The credit protection pursuant to the guarantee must be direct.[138]
- The scope of coverage provided by guarantees must be clearly defined and incontrovertible.[139]
- 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.[140]
- On default, insolvency, bankruptcy or other credit event of the counterparty, the (re)insurer must have the right to pursue the guarantor for any monies due without first having to pursue the counterparty.[141]
- The guarantee must be an explicitly documented obligation assumed by the guarantor.[142]
- The guarantee must fully cover all regular payments the counterparty is expected to make.[143]

5. Collateral Arrangements

Notwithstanding the additional qualitative criteria imposed as discussed throughout this chapter in relation to SPVs, there is an exception 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, as set out above in the relevant parts of Sections 2 and 4 above.[144] This exemption is available where a risk mitigation technique is supported by collateral arrangements that meet the relevant criteria as set out below. There are numerous ways in which collateral can be structured, for example: on a funds-withheld or deposit-back basis, or by posting of secured assets by means of security agent or custodian. 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.[145]

[136] Article 212(4), *ibid.*
[137] Article 212(5), *ibid.*
[138] Article 215(a), *ibid.*
[139] Article 215(b), *ibid.*
[140] Article 215(c), *ibid.*
[141] Article 215(d), *ibid.*
[142] Article 215(e), *ibid.*
[143] Article 215(f), *ibid.*
[144] Article 213, *ibid.*
[145] Article 213(2), *ibid.*

Collateral arrangements must align with the general eligibility criteria set out in Articles 209 and 210 (as analysed in Section 3 above).[146] As with other qualitative specific requirements, collateral arrangements are subject to further specific eligibility requirements to ensure their compliance:

- 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.[147]
- The collateral must be of sufficient credit quality, liquidity and stability in value or is guaranteed by a counterparty (excluding certain counterparties that have been given a concentration risk factor of 0%;[148] such examples include, amongst others, counterparties whose exposure is covered by a state government).
- 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[149] 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).

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 SCR and technical provisions.

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.[150] 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.[151] The (re)insurer will also need to reflect the credit and counterparty impacts of entering into the arrangement, in 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).

[146] Article 214, *ibid.*

[147] Article 214(1)(a), *ibid.*

[148] Pursuant to Article 184(2) or Article 187(5), *ibid.*

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

[150] Article 101(5) of the Solvency II Directive (transposed in Paragraph 3.5, Solvency Capital Requirement — General Provisions Part of the PRA Rulebook).

[151] Article 83(4) of the Level 2 Delegated Regulation.

Where the (re)insurer uses an IM, 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.[152]

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 counter-party. Articles 41 and 42 of the Level 2 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 layer of prudence on top of a (re)insurer's best estimate of liabilities (BEL) and forms part of its 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.[153] Accordingly, the risk margin is also reduced to the extent of an eligible risk mitigation technique.

[152] Article 121(6) of the Solvency II Directive (transposed in Paragraph 11.8, Solvency Capital Requirement — Internal Models Provisions Part of the PRA Rulebook).

[153] Article 38(1)(c) of the Level 2 Delegated Regulation.