CONSULTATION PAPER ON SUPERVISORY STATEMENT ON SUPERVISION OF RUN-OFF UNDERTAKINGS

EIOPA-BoS-21/318
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European Insurance and Occupational Pensions Authority

Responding to this paper

EIOPA welcomes comments on the Consultation paper on the Supervisory Statement on supervision of run-off undertakings. Comments are most helpful if they:

a) contain a clear rationale; and

b) describe any alternatives EIOPA should consider.

Please send your comments to EIOPA by 17 October 2021 at 23.59 hrs CET responding to the questions in the survey provided at the following link:

https://ec.europa.eu/eusurvey/runner/Consultation_run_off

Contributions not provided using the survey or submitted after the deadline will not be processed.

Publication of responses

Your responses will be published on the EIOPA website unless: you request to treat them confidential, or they are unlawful, or they would infringe the rights of any third party. Please, indicate clearly and prominently in your submission any part you do not wish to be publicly disclosed. EIOPA may also publish a summary of the survey input received on its website.

Please note that EIOPA is subject to Regulation (EC) No 1049/2001 regarding public access to documents and EIOPA's rules on public access to documents[1].

Declaration by the contributor

By sending your contribution to EIOPA you consent to publication of all information in your contribution in whole/in part – as indicated in your responses, including to the publication of your name/the name of your organisation, and you thereby declare that nothing within your response is unlawful or would infringe the rights of any third party in a manner that would prevent the publication.

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[1] Public Access to Documents

Consultation paper overview and next steps

EIOPA carries out this consultation in accordance with Article 29(2) of Regulation (EU) No 1094/2010.

This Consultation Paper presents the draft Supervisory Statement on supervision of run-off undertakings.

<u>Next steps</u>

EIOPA will consider the feedback received, develop the Impact assessment on the basis of the answers to the questions included in the consultation paper, publish a Final Report on the consultation and submit the Supervisory Statement for adoption by its Board of Supervisors.

Supervisory Statement on supervision of run-off undertakings

1. Legal basis

1.1. The European Insurance and Occupational Pensions Authority (EIOPA) provides this Supervisory Statement on the basis of Article 29(2) of Regulation (EU) No 1094/2010[2]. This Article mandates EIOPA to play an active role in building a common Union supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union.

1.2. EIOPA delivers this Supervisory Statement on the basis of Directive 2009/138/EC (Solvency II)[3].

1.3. This Supervisory Statement is addressed to the competent authorities, as defined in Article 4(2) of Regulation (EU) No 1094/2010[4].

1.4. The Board of Supervisors [has adopted] this Supervisory Statement in accordance with Article 2(7) of its Rules of Procedure[5].

2. Context and objective

2.1. Run-off business model – when properly and fairly managed – can potentially bring benefits to the insurance market, for instance by making possible to use capital to support more profitable business, enabling cost reduction or orderly exit from the market. It can also be a pre-emptive measure to avoid materialisation of risks with impact on new policyholders.

2.2. At the same time, supervision of run-off undertakings/portfolios is particularly challenging because of the specific risk profile, the difficulties of the process and assessment of the change of and the lack of specific regulation on run-off in the Solvency II framework. Understanding the motivation to discontinue the business is also very important.

2.3. The number and size of run-off portfolios are increasing and a growing interest has been observed from investors in acquiring such portfolios.

2.4. The aim of this Supervisory Statement is to ensure that a high quality and convergent supervision is applied to run-off undertakings/portfolios, subject to Solvency II, taking into account their specific nature and risks.[6]

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[2] Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

[3] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (OJ L 335, 17.12.2009, p. 1-155).

[4] Notwithstanding the fact that specific points of this Supervisory Statement describe supervisory expectations for insurance and reinsurance undertakings, they are required to comply with the regulatory and supervisory framework applied by their competent authority based on Union or national law.

[5] Decision adopting the Rules of Procedure of EIOPA's Board of Supervisors, available at: https://www.eiopa.europa.eu/sites/default/files/publications/administrative/bos-rules_of_procedure.pdf

[6] In this context, EIOPA advised European Commission to amend the Solvency II framework with regard to the expenses assumptions considered in the calculation of technical provisions of undertakings not underwriting new business (see section on expenses of the EIOPA's Opinion on the 2020 review of Solvency II).

2.5. This Supervisory Statement sets out supervisory expectations for the supervision of run-off undertakings in the context of portfolio transfers, acquisitions of qualifying holdings and mergers (ownership changes) as well as in the on-going supervision. It addresses some issues that are not exclusive to run-off undertakings/portfolios, however, experience has shown that some issues may lead to stronger and more concerning consequences in that context.

2.6. This Supervisory Statement should be read *inter alia* in conjunction with EIOPA Guidelines on system of governance[7], EIOPA Guidelines on basis risk[8], and Joint Guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the financial sector[9] as well as EIOPA's Approach to the Supervision of Product Oversight and Governance[10].

3. Definition of run-off

3.1. The term "run-off" describes a variety of situations where the insurance undertaking has stopped underwriting new business. The term run-off undertaking may refer to different cases:

1) Undertakings running-off a portfolio of contracts not representing their whole business (*partial run-off undertakings or undertakings with run-off portfolio*);
2) Undertakings running-off their whole (previous) business (*full run-off undertakings*);
3) Undertakings with a run-off business model (*specialised run-off undertakings*).

3.2. Partial run-off undertakings are undertakings where only part of the business is discontinued while the rest of its business is in going concern. For the purpose of this Supervisory Statement, partial run-off refers to the cases where a material part of the undertaking's business is stopped (i.e. it excludes the cases where a minority of non-material products/line of business is discontinued).

3.3. Full run-off undertakings are undertakings with legacy portfolios, typically showing a downward trajectory in terms of technical provisions and the own funds and Solvency Capital Requirement (SCR). Not issuing new insurance policies means that the profitability of the business comes only from the management of the existing business[11]. This business model is generally associated with an active management of the technical provisions, cost reduction measures and/or altering the investment portfolio in a 'search for yield'. This could be also done in cooperation

[7] https://www.eiopa.europa.eu/content/guidelines-system-governance_en
[8] https://www.eiopa.europa.eu/content/guidelines-basis-risk_en
[9] https://esas-joint-committee.europa.eu/Pages/Guidelines/Joint-Guidelines-on-the-prudential-assessment-of-acquisitions-and-increases-of-qualifying-holdings-in-the-banking,-insuranc.aspx
[10] https://www.eiopa.europa.eu/content/eiopa-approach-supervision-product-oversight-and-governance_en
[11] Run-off undertakings can change the underwriting and/or investment assumptions, initially considered at the inception of the contract (i.e. profit test), if and to the extent that there is margin for keeping the contracts profitable.

with external parties, ranging from consulting to outsourcing activities to spinning off operating activities.

3.4. Specialised run-off undertakings are undertakings or groups whose business model is to actively acquire legacy portfolios or undertakings in run-off. Besides the measures taken by full run-off undertakings they seek to realise scale efficiencies by maintaining or increasing the size of their run-off book.

3.5. This Supervisory Statement addresses risks related to all the three cases above, while recognising at the same time the difference between them.

3.6. Insurance undertakings which are subject to reorganisation measures or winding-up proceedings[12] are not considered in this Supervisory Statement.

4. Decision to go into run-off

4.1. Undertakings which intend to stop writing any material new business, leading to partial or full run-off undertakings, are expected to notify their supervisory authorities (as part of the on-going dialogue) by submitting:

- the decision of the administrative, management or supervisory body (AMSB) to run-off their part/whole business including the motivation for putting the business into run-off;
- the description of their strategy to manage their remaining business, if applicable, including how products will be monitored and reviewed, and how adequate customer service will be maintained;
- the financial projections of their assets, technical provisions, own funds and capital requirements, including the description of the underlying assumptions (in particular technical provisions) and – where appropriate – appropriate scenario and stress tests;
- the material reinsurance and outsourcing arrangements expected in the future;
- impact, if any, with regard to key staff retention;
- impact, if any, on costs and charges for existing policyholders belonging to the run-off portfolio.

4.2. The decision to stop writing any material new business is considered material information and therefore needs to be reflected in the Solvency and financial condition report. If taken in between publications, such an event should also be considered a major development affecting significantly the relevance of the information disclosed and should trigger an up-date of the Solvency and financial condition report.

4.3. In case of cross-border run-off, home and host supervisory authorities should cooperate and exchange any information at their disposal which could affect policyholders' rights.

4.4. In case of cross-border run-off, specific areas of potential risk are for example, partial knowledge of the products and market trends, communication with the new insurer or reinsurer, lower power of the

[12] See respectively Articles 269-272 and 273-284 of Solvency II.

customers to submit claims. Moreover, when specific consumer protection obligations (e.g. ongoing disclosure requirements or complaints handling) are a competence of the host supervisory authorities with specific national requirements, the host supervisory authorities should contribute to the assessment of whether the acquiring/accepting undertaking is compliant with these requirements.

5. Specialised run-off undertakings through acquisition of an insurance undertaking or transfer of portfolio

Early dialogue

5.1. The assessment by the supervisory authority of an acquisition of a run-off undertaking/portfolio or a transfer of a run-off portfolio relies on accurate and timely information from the undertaking involved.

5.2. The potential acquirer/accepting undertaking is encouraged to have an early dialogue with the supervisory authority before submission of the formal notification on the acquisition of a qualifying holding or on the transfer of portfolio in accordance with Article 57 or with Article 39 of Solvency II respectively. The undertaking intending to acquire a run-off portfolio is encouraged to provide the supervisory authority the information defined in point 4.1 as well as an external actuarial report assessing the adequacy of technical provisions related to the portfolio transfer.

5.3. The financial projection period, including own fund and SCR figures, should be commensurate with the duration of the insurance liabilities. If the technical provisions are of long-term nature, the default projection period of 3 years envisaged in the above mentioned Joint Guidelines should be extended to an appropriate horizon which can be as much as 15 years or more. If the contract benefits are based on local GAAP parts of the forecast may follow the same accounting principles (e.g. profit and loss statements, dividends).

Identification of the risks of the acquisition / transfer of portfolio

5.4. In order to perform an in-depth analysis of the proposed transaction supervisory authorities are recommended to assess in detail the documentation received as a first step and request the undertaking any further information deemed necessary.

5.5. To perform an in-depth assessment of the risk of the transaction it is vital to assess the financial soundness of the acquiring/accepting entity and the impact on policyholders from both the ceding and the acquiring/accepting undertaking. For an appropriate assessment, supervisory authorities need to develop a comprehensive understanding of the business model pursued by the acquiring/accepting party and the expected changes on its risk profile, system of governance – including product oversight and governance – risk management and solvency position (both SCR and own funds) after the acquisition. This is also relevant when the acquirer of the undertaking is identified as an

insurance holding company and is subject to group supervision according to Solvency II[13]. The economic situation of the undertaking is usually strongly dependent on the financial strength of the group and its ability to provide support in the event of a loss. For example, when an external run-off is pursued existing intra-group transactions such as outsourcing contracts, profit-and-loss transfer agreements, reinsurance and subordinated loans are usually terminated.

5.6. The protection of policyholders should be one of the main objectives of the assessment and it should not be impaired by the transaction. It is an important issue in case of ownership changes, as the supervisory authority has to assess whether the undertaking will be able to comply with the prudential requirements laid down in Article 59(1)(d) of Solvency II.

5.7. If the transaction affects the recoverability or amount of the claims, the supervisory authority may request the acquirer to make additional commitments suitable to safeguard the interests of policyholders (e.g. loss transfer agreement). If there are justified doubts about the financial capacity of the acquirer or its credit rating cannot be reliably assessed, the supervisory authority may ask the acquirer to provide collateral to back up the commitment (e.g. bank guarantees).

5.8. One important assessment is to verify if the risk profile of the acquiring/accepting undertaking, after including the new portfolio/undertaking, is in line with its risk appetite and does not go beyond the risk tolerance and its risk bearing capacity.

5.9. It is also important to assess whether the acquiring/accepting insurance undertaking's product oversight and governance policy has adequate system and controls aimed at mitigating possible risks which can emerge for the 'acquired'/'accepted' target market, taking into account the product characteristics of the acquired portfolio. If needed, the acquiring/accepting undertaking should have its own product oversight and governance policy adjusted and aligned with the acquired/accepted portfolio. It should also carry out the product monitoring and review as part of the product oversight and governance process for the acquired/accepted portfolio.

5.10. From an operational perspective, supervisory authorities should pay attention to the ability to service the liabilities, in particular the long-term ones, and the capacity of administration of the policies, which usually requires sophisticated contract management systems. In addition, supervisory authorities should assess how the undertaking ensures that claims will be settled in accordance with the contract terms. Especially for with-profit-business, supervisory authorities should ensure that the policyholders' share (i.e. future discretionary benefits) will not be

[13] Holding companies whose main business is to acquire and hold participations in subsidiary undertakings which are exclusively or mainly insurance undertakings.

unreasonably reduced and are broadly in line with the previous policy of the ceding undertaking and the reasonable policyholder expectations.

5.11. Supervisory authorities should also ensure, in particular for long-term products, that the acquiring/accepting undertaking, throughout the lifetime of the acquired/accepted portfolio, has the ability to take remedial measures when as part of the monitoring process it emerges that a certain product's main features (e.g. risk coverage or guarantees being materially impacted) cause detriment to the policyholders.

<u>Involvement of private equity or similar investment entities</u>

5.12. Private equity or similar investment entities are developing a growing interest in acquiring run-off undertakings. Since their investment horizon is usually shorter than more traditional shareholders, there is a risk that capital is pulled out of the target undertaking with potential negative impact on policyholders protection. To prevent this, supervisory authorities should consider the track record of the involved private equity party and assess the possible consequences of an early withdrawal from the investment. In the case of undertakings providing financial guarantees, investors should not be privileged with regards to profit and losses in the near future to the detriment of policyholders with longer contract terms.

5.13. From an operational perspective, private equity tends to increase shareholder returns by making changes to the undertaking's operations potentially in four main areas:

a. changes in the asset allocation to increase the investment returns;
b. operational changes in order to reduce the cost base of the undertaking;
c. changing the methodology and/or certain underlying assumptions for the valuation of technical provision;
d. changing the methodology and/or certain underlying assumptions for the calculation of capital requirements.

5.14. Private equity investors may seek to increase the return on their investments and thus supervisory authorities should consider the followings:

- if policies with profit-sharing are affected, supervisory authorities should assess if the transaction leads to an unbalanced distribution of risk and reward. To assess whether there is such an imbalance, supervisory authorities can ask the investor to provide expected risk-adjusted return figures of the transaction. In any case, there should be neither erosion of the undertakings' substance and earning power nor an erosion of policyholders returns for with profit participation business or an increase in any 'undue' costs charged to policyholders;
– if leverage is used to finance the acquisition, the acquirer is to show its ability to serve the debt or refinance any remaining amount at

maturity even under unfavourable economic conditions (e.g. by reverse stress tests).

5.15. Additional guidance with regard to supervision of investments are reported in the sub-section "Assessment of the Investment strategy".

5.16. Private equity investor may be able to reduce fixed costs by realizing some efficiencies in the operational processes, acquiring/accepting other run-off portfolios/undertakings or making extensive use of outsourcing arrangements. The supervisory authority should assess:

- Whether the private equity investor estimates a minimum amount of fixed costs which are needed to running any undertaking (above all when the size of portfolio is small and doesn't allow to spread fixed costs over a large amount of policies);
- The return on investments are higher than costs;
- In case of outsourcing, the private equity investor can demonstrate that they are able to manage and oversee the activity of service provider(s) and the extensive use of outsourcing doesn't lead to new major operational challenges or risks.

5.17. Specific guidance on technical provisions and capital requirements are reported in the relevant sub-sections.

5.18. Furthermore, experience has shown that legacy platforms backed by private equity are often embedded in complex group structures making it difficult for the supervisory authority to gauge the impact of power shifts and changes in the outsourcing environment. In some cases, ownership changes extends to more than one entity, even from other countries or financial sectors, so it may be necessary to consult with several authorities.

5.19. With regard to dividend and coupon payments, the supervisory authority needs to carefully examine the funding structures involved to improve the predicted return on equity (RoE) and the time horizon in relation the RoE. Furthermore, the return expectations communicated to the investors need to be realistic.

6. On-going supervision

6.1. This section may be also relevant for the assessment reported on the previous sections.

<u>Business model analysis</u>

6.2. In order to perform a proper risk based supervision and in addition to the assessment conducted prior the decision to go into run-off (section 4) and the business model analysis done in case of acquisition of a run-off undertaking/portfolio (section 5) supervisory authorities should perform a business model analysis as part of the on-going supervision[14]. In this

[14] The ex-post business mode analysis should be conducted following a risk-based approach. For instance, if supervisors had already assessed the business model of the undertaking intending to acquire a run-off undertaking or portfolio, it is not expected to conduct a full business model analysis if the risk profile hasn't changed.

analysis there should be a specific focus on how the undertaking is expected to remain profitable in the near future, whilst also ensuring the compliance with Solvency II rules relating to technical provisions/SCR and the fair treatment of policyholders. It should be also looked at which are the main sources of current and expected profitability (e.g. the assumption used in the calculation of the technical provisions, the possible change of the investments and reinsurance strategy, the improvement of efficiency of the management of the business, through reduction of costs, outsourcing, etc).

6.3. Generally, the focus of a non-life run-off undertaking will be on the claims provisions, by handling the claims in a more 'efficient and effective' way to increase the technical profit (underwriting results). Efficiency, however, should not lead to the unfair treatment of policyholders.

6.4. The life run-off undertaking might however try to optimise both underwriting and investments results, by investing in higher yielding (but also riskier or more illiquid) assets.

6.5. From an operational perspective undertakings might try to save costs through a more effective management in the form of modern IT systems, outsourcing, etc. Supervisory authorities should assess if the methods/approaches used to reduce costs do not raise other risks. By way of example, the migration of insurance contracts to a new IT platform and other administrative changes can significantly increase operational risks, which should be reflected in the ORSA.

Assessment of technical provisions

6.6. According to Article 7 of Commission Delegated Regulation (EU) 2015/35[15] (Delegated Regulation) insurance and reinsurance undertakings are required to value assets and liabilities based on the assumption that the undertaking will pursue its business as a going concern. It is important to point out that also undertakings in run-off fall under this definition if they continue to settle their claims. However, the decision to discontinue (parts of) the insurance business may be associated with a change of the financial and non-financial assumptions of technical provisions calculation. If insufficient evidence is shown and the supervisory authority concludes that the technical provisions underestimate the future obligations, the supervisory authority should ultimately consider using the power under Article 85 of Solvency II and require an increase of technical provisions or, in case of deviation of the risk profile, to set a capital add-on in accordance with Article 37 of Solvency II.

[15] Comission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 12, 17.1.2015, p. 1).

6.7. Supervisory authorities should assess if the going concern assumptions regarding the run-off are reasonable and realistic, including but not limited to administrative expenses, lapse/surrender rates, asset mix and future management actions.

Expenses

6.8. Undertakings writing new business can offset their cost loading per policy through new business[16]. However, this will usually not be possible in case of run-off undertakings because there will be no new business[17]; at the same time, the business reduction might also imply a reduction of some expenses but also the increase of other expenses related to business reduction (e.g. severance payments). The off-setting of cost may be possible for specialised run-off undertaking that will have new business via portfolio transfers or acquisitions, even if specific assumptions should be required in this case (e.g. consider the possibility that they may not be able to acquire new portfolios). It is important that supervisory authorities make sure that the "non-scalability" is properly addressed in the calculation of the technical provisions.

6.9. This may require envisaging future management actions beyond the expenses framework. For example, at a certain point in time it may not be economically viable to continue the business operation any longer with respect to the overwhelming fixed costs. Undertakings need to provide adequate justification on how this is reflected in the calculation of the technical provisions. Whether the projection horizon can be cut off at this point depends on realistic management actions regarding the transfer of the remaining obligations.

Lapse

6.10. While in principle run-off undertakings are expected to have an interest in maintaining their existing contracts[18], certain run-off undertakings may try, as part of their business model, to advise policyholders to lapse or cancel their policy. Supervisory authorities should assess and detect such cases and ensure that undertakings treat their policyholders fairly and are acting in their best interest. In particular, supervisory authorities should ensure that if lapses/switches from one product to another occur, this is done in the best interest of policyholders and not to generate higher fees and/or to shift policyholders from products with guarantees to products where they are more exposed to market shocks. In assessing whether policyholders have been treated fairly, supervisory authorities should examine whether the new product towards which policyholders are directed are aligned with their characteristics, needs, and objectives

[16] A common practice is to model the (nominal) costs per policy as a fixed percentage of premiums or a fixed percentage of benefits in case of single premiums (as is for instance the case with direct annuities).

[17] Going concern principle does not require to assume new business will be written in the future. Assumptions should always be realistic, which includes the cases where the undertaking is no longer writing new business. For more details, please see EIOPA Q&A 1037.

[18] To keep their reputation high, not to lose cost advantages and not to face liquidity outflows.

and assess whether the existing policyholders fit within the target market for the new products.

6.11. Furthermore, supervisory authorities should assess whether the risk of higher surrenders or lapses caused by loss of reputation is reflected in the calculation of technical provisions.

Future management actions

6.12. In case of portfolio transfer, merger or acquiring of qualifying holdings, the new owner might change the executive management, which could react differently to certain developments. The assumptions on future management actions should be reviewed and supervisory authorities should assess if they are in line with the new strategy.

Reinsurance recoverables

6.13. The impact of the cession of some insurance risks to the reinsurer will be accounted for in the Solvency II balance sheet of the ceding undertaking under reinsurance recoverables. It should be ensured by the supervisory authority that the assumptions underlying the recoverables are not overly optimistic and are in line with Article 81 of Solvency II and Articles 41 and 42 of the Delegated Regulation. If both the ceding undertaking and the accepting reinsurer are subject to Solvency II, it is expected that the reinsurance recoverables in the balance sheet of the ceding undertaking (before accounting for expected losses due to default of the counterparty) are broadly in line with the gross technical provisions (referred to the same obligations) in the balance sheet of the accepting reinsurer. It should be noted that the differences can be larger in some cases such as if the ceded business becomes part of a much larger homogeneous risk group e.g. for non-life.

6.14. The reinsurance recoverables typically are based on probability weighted cash flows assuming scenarios with and without the reinsurer's default. The cash flows under the scenario of a reinsurer default will be determined by the insolvency legislation the reinsurer is subject to, which is used to determine the recovery value. In case of a third country reinsurance undertaking, it is possible that the valuation of the recovery value is materially different from a valuation under the insolvency legislation the ceding undertaking is subject to. The assumed credit loss might therefore be lower than the actual loss due to these legal valuation differences before considering economic losses resulting from the defaulted reinsurer not having sufficient funds to reimburse the cedent. The supervisory authority should ensure that this additional credit risk resulting from valuation differences is accounted for in the assumption used to calculate the reinsurance recoverables (e.g. in the Exposure-at-Default and Loss-Given-Default assumptions).

6.15. Typically, the reinsurance recoverable is settled on a recurring basis based on the immediate past financial result or cash flow in a backward-looking manner considering the characteristics of the reinsurance treaty.

In case of material reinsurance, the additional credit risk amongst others resulting from valuation differences can be limited by introducing a clause in the reinsurance treaty which settles the reinsurance recoverable if the position exceeds a predefined threshold. This would be a more forward-looking way of addressing possible credit risks and would ensure that the open position with respect to the reinsurance counterparty never exceeds a certain size.

Assessment of the Investment strategy

6.16. Run-off undertakings typically focus on increasing their investment returns. They can try to achieve this goal by investing in high yielding assets and/or non-listed assets. In this regard, two main investment strategies can be identified:

- shift to a higher risk / return asset mix;
- transfer the current assets of the undertaking to another undertaking (e.g. a special purpose vehicle) that can make higher profits by investing in riskier assets.

6.17. In the first strategy (i.e. shift to a higher risk / return asset mix), acquirers allocate more funds to more profitable and riskier assets, namely (private) equity and private or non-rated credit, which may no longer comply with the prudent person principle. Additionally, it might not always be possible to assess the risks properly because of the complexity of the investment strategy or the complexity of the inter company structure used. The supervisory authority should monitor the changes in the investments and assess if:

- the prudent person principle is still complied with. In case of specialised run-off undertakings, the new acquirers may have more skills to manage a more complex investment portfolio and they are expected to be able to "properly identify, measure, monitor, manage, control and report"[19] investment risks. At the same time, assets should be kept invested in the best interest of policyholders and the higher investment returns should be also passed to policyholders (via the discretionary participation features in case of with-profits contracts) while keeping an adequate level of liquidity to meet insurance obligations. For unit-linked products, considering that risks are entirely borne by policyholders, it is important that the risk/reward profile of assets is aligned with the risk-profile of the policyholders. As it may constitute a significant adaptation of unit-linked products, assets' change should be subject to the entire product oversight and governance process;
- the stress in the standard formula is appropriate to the new investment strategy and the criteria for the categorisation in the market or counterparty default risk module are met.

[19] Article 132 of Solvency II Directive.

6.18. The second strategy is to transfer the current assets of the undertaking to another company (e.g. a special purpose vehicle), belonging to the same group.That company can make higher profits by investing in riskier assets and provide the undertaking with the same cash flows on the same dates as those that would have been obtained from the original assets.

6.19. The effect of such transfer are different at solo and group level, namely:

- solo level: there is no substantial change because, assuming that after the formal transfer/sale there is a substantial retention of risks/rewards stemming from the transferred assets by the ceding undertaking, the latter will continue to recognise the transferred assets in their balance sheet[20] and SCR will be calculated taking into account these (more prudent) assets instead of the riskier ones;
- group level: the effect of the switch to riskier assets emerge only at group level with the consequence that the extra returns are not shared with policyholders of the solo undertaking.

6.20. However, this particular treatment, i.e. keeping the assets sold in the balance sheet, is only allowed within IFRS where no new material risks are created. If a new material risk is created, keeping the assets sold in the balance sheet would lead to a higher risk for policyholders without higher returns and a significant deviation of the risk profile of the undertaking from the underlying assumptions in the standard formula. In particular, one key element of the assessment of these transactions is the counterparty default risk, i.e. whether the new structure keeps the same counterparty default risk as the original assets by setting up additional collaterals that guarantee the payment of the cash flows fixed in the agreement. These collaterals should comply with the requirements of the Delegated Regulation for its inclusion in the Standard Formula.

6.21. Regarding the second strategy, in addition to the guidance applicable to the first strategy, supervisory authorities should consider also the following issues:

- monitor closely that there is an effective retention of risks and benefits within the undertaking after the asset transfer. In particular, verify that no new risks arise, such as counterparty or liquidity risk, for which the policyholders should be compensated. Particularly, supervisory authorities should ensure that the collaterals provided are enough in quantity to maintain the counterparty risk module, and comply with the Delegated Regulation requirements.
- supervise that the information in the public disclosure regarding the asset transfer is appropriate and sufficient.

<u>Assessment of the reinsurance strategy</u>

[20] According to IFRS recognition principles which are used also for Solvency II purposes (see Article 9(1) of Delegated Regulation).

6.22. For both life and non-life insurance portfolios, the use of reinsurance treaties are observed which may lead to a material impact on the own funds (due to the reinsurance recoverables) and the SCR partially compensated by an increase in the SCR counterparty default risk.

6.23. Supervisory authorities should discuss with the undertakings with high cession rates in particular to assess the following:

- reinsurance concentration: in case of material reinsurance with a high cession rate with respect to a single or few reinsurers, a concentration risk can arise with respect to the reinsurance counterparty. This concentration risk might not be fully reflected in the SCR e.g. for the case of a downgrade of the single reinsurer or when financial or underwriting stresses increase the probability of default of the single reinsurer;
- collateral: the counterparty risk could be reduced if collateral would be posted. Risk-based haircuts can be used to incentivise the reinsurer to use high-quality, liquid and short-term assets as collateral. Lastly, the adjustment of the collateral or the margining should be considered to ensure that this occurs within a sufficiently short delay when needed;
- retrocession: in case of high retrocession the reinsurer is merely fronting and not taking on any risk and the final risk-taker is the retrocessionaire. Specific attention is needed in case the retrocessionaire is not based in the EU. Other legislation with regard to the valuation of the technical provisions or the required solvency margin might be applicable. The ceding insurance undertaking as well as NCAs should ask for information on retrocession in cases where this seems relevant.

6.24. As indicated in EIOPA's Opinion on the use of risk mitigation techniques, insurance and reinsurance undertakings - when calculating the Basic SCR - should take into account risk-mitigation techniques as referred to in Article 101(5) of Solvency II and complying with Articles 208-214 of the Delegated Regulation. Where the reduction in the SCR is not commensurate with the extent of the risk transferred or there is not an appropriate treatment within the SCR of any material new risks that are acquired in the process, insurance and reinsurance undertakings should consider that the risk-mitigating technique does not provide an effective transfer of risk.

6.25. Run-off undertakings with material exposures e.g. due to reinsurance treaties with a high cession rate, have material counterparty default and concentration risks as well as possible basis risks due to imperfect margining of the collateral. Due to this idiosyncratic risk profile, it is important to evaluate, in the context of the ORSA, the appropriateness of the standard formula. The supervisory authorities should closely monitor and challenge the appropriateness of the standard formula. If insufficient evidence shows that the standard formula underestimate the

SCR, supervisory authorities should ultimately consider using their power under Article 37 of Solvency II and require a capital add-on. Where the SCR is calculated with an internal model, this assessment is also part of the model application or model change process.

6.26. The decision to go into a partial/full run-off in many instances represents a material change in the risk profile and should trigger an ad-hoc ORSA,in accordance with Article 45(5) of Solvency II.

6.27. If the material reinsurance counterparty default and concentration risk is not fully captured by the SCR as demonstrated within the ORSA, and to make sure that the solvency position of the cedent remains guaranteed, the supervisory authority can request the undertaking to:

- limit the cession rate to an upper bound. A minimum retention of risks by the undertaking ca be required by the supervisory authority;
- incorporate collateral or a reinsurance deposit consisting of high quality investments with a swift margining mechanism;
- incorporate financial guarantees to ensure that capital will be injected if the solvency ratio drops below a specific threshold.

6.28. Supervisory authorities should closely monitor the reinsurance policy and assess if the policy is adequate to the portfolio of technical provisions of the run-off portfolio.

7. Conduct of business supervision

7.1. From a conduct of business supervision perspective, specific risks can arise in the case of run-off activities and it is necessary to ensure that the interests of the policyholders remain protected.

7.2. In case a Member State has different supervisory authorities for prudential and conduct supervision, EIOPA recommends that the prudential supervisory authority takes advice and involves the relevant conduct supervisor.

7.3. Supervisory authorities should urge the concerned undertakings to foresee and take into account specific risks arising from such transactions having in mind the potential impact of all the circumstances stated in this Supervisory Statement to policyholders and their contracts, including the change of parties to the contract, where applicable and for example, applicable insurance guarantee schemes.

7.4. Specifically in case of life business and medium and long-term commitments in run-off, supervisory authorities should assess whether the accepting insurance undertaking has a customer centric business model, including the plant to ensure that customers belonging to the run-off portfolio will be treated fairly throughout the lifecycle of the run-off products. In particular:

- they should assess the product oversight and governance policy of the accepting undertaking to ensure that it is adequately implemented and that it is adequate and proportional vis-à-vis the

level of complexity of the products concerned in the portfolio transfer and the target market's characteristics.

- they should pay particular attention to how acquiring/accepting undertakings are expected to consistently monitor and regularly review the products within the acquired portfolio and when instances of consumer detriment arise how they plant to take adequate remedial actions.

7.5. Supervisory authorities should urge the accepting undertakings to ensure transparency towards policyholders in order to ensure that the policyholders receive timely information about the impact of the transactions to their insurance policies. In case the portfolio is transferred to an undertaking in another Member States, they should assess how the acquiring/accepting undertakings plans to comply with specific national requirements.

7.6. Supervisory authorities should also assess how complaints handling requirements will be complied with and whether the acquiring / accepting undertaking will ensure customers are treated fairly in the complaints handling process. Undertakings should also inform policyholders on any changes to their status. For example, about access to the relevant alternative dispute resolution mechanisms and courts, impact on jurisdiction and applicable law, ceasing to effect new insurance contracts in a with-profits fund.

7.7. The level of customer service should not be significantly different to the level of customer service of the transferring undertaking as to cause possisble consumer detriment. This is to be assessed taking into account parameters such as the agility of the communication channels with the client, customer language, response times and other metrics that can influence the perception and effective customer service. While procedures and process can vary, it should not be materially more difficult for customers to carry out any activity related to policy servicing, e.g. submitting a claim, assessing information, submitting a complaint. The supervisory authority may require additional reporting on the service level.

This Supervisory Statement will be published on EIOPA's website.

Done at Frankfurt am Main, on 8 July 2021.