ANNEX I TO THE OPINION ON THE USE OF RISK MITIGATION TECHNIQUES BY INSURANCE UNDERTAKINGS: MASS-LAPSE REINSURANCE

EIOPA REGULAR USE
EIOPA-BoS-25/267
15 July 2025

European Insurance and
Occupational Pensions Authority

1. INTRODUCTION

1.1. Reinsurance is an important tool for capital and risk management and it is also used for risk diversification, access to additional underwriting capacity for portfolio expansion, addressing protection gaps and increasing financial stability. It plays a crucial role in the insurance industry's ability to operate and provide coverage to individuals and businesses.

1.2. The transition to a risk-based regime led to an increase of the use of non-traditional risk mitigation techniques, i.e. risk mitigation techniques not frequently used in the past in the European insurance market. Consequently, EIOPA published its Opinion on the use of risk mitigation techniques by insurance undertakings (EIOPA-BoS-21/036)1 on 9 July 2021. This Opinion provides guidance on the assessment of risk mitigation techniques, in particular regarding the consistency between the risk transfer and effects on the Solvency Capital Requirement (SCR). Where the allowance of a risk mitigating effect of the reinsurance treaty in the SCR would lead to a reduction in the SCR that is not commensurate with the extent of the risk transferred or due to an inappropriate treatment within the SCR (e.g. via any new risks that are acquired in the process), insurance and reinsurance undertakings should conclude that the risk-mitigating technique does not provide an effective transfer of risk.

1.3. This Annex aims to extend the guidance provided in the Opinion reflecting on its application to mass-lapse reinsurance. To ensure a comprehensive overview, this Annex will discuss the main elements of mass-lapse reinsurance treaties, addressing Solvency II standard formula SCR calculation, cedant and reinsurer perspective, valuation of reinsurance recoverables and calculation of risk margin as well as supervisory reporting and public disclosures.

[1] https://www.eiopa.europa.eu/publications/opinion-use-risk-mitigation-techniques-insurance-undertakings_en

2. MASS-LAPSE REINSURANCE

2.1. DESCRIPTION OF THE CASE

2.1.1. The lapse risk is part of the life underwriting risk in the standard formula in Directive 2009/138/EC (Solvency II Directive). Article 105(3)(f) of the Solvency II Directive defines it as the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level or volatility of the rates of policy lapses, terminations, renewals and surrenders. While this lapse risk in Commission Delegated Regulation (EU) 2015/35 (DR) covers also health and non-life business, mass-lapse reinsurance is usually seen as mainly relevant risk for life business. Reasons are *inter alia* that, on the one hand, the contract boundaries are often short for non-life, and, on the other hand, as it is higher risk in life business the mass lapse scenario of the standard formula for life leads often to a substantial capital requirement. Furthermore, it sometimes shows a strong dependency on the prevailing economic conditions like the interest rate level. Consequently, this analysis is therefore focused on life lapse risk, even if most considerations might be equally applicable for health and non-life business.

2.1.2. Lapses are considered in best estimate valuation and they depend on policyholder behaviour, which should consider the influence of all relevant factors in accordance with Article 26 of the DR. Therefore, also lapse risk in Solvency II depends on these factors, which even may reinforce each other (see CEIOPS' Advice for Level 2 Implementing Measures on Solvency II (CEIOPS Advice)2. It has been pointed out that the ceteris-paribus approach of the standard formula where one risk factor is changed at a time, does not capture this kind of dependencies.

2.1.3. The standard formula capital requirement for lapse risk in all its manifestations is defined in the life-underwriting risk module according to Article 142 of the DR as the maximum of three scenario-based capital requirements: a permanent increase of lapse rates, a permanent decrease of lapse rates and for mass lapse as combination of instantaneous events. Solvency II requires insurance and reinsurance undertakings to apply a 40% stress for mass lapse risk (70% for management of group pension funds as referred to in Article 2(3)(b)(iii) and (iv) of the Solvency II Directive). In many cases (e.g. when risk-free interest rates are higher than guaranteed rates), the mass lapse scenario is dominant among these three scenarios.

2.1.4. In the development of the standard formula, the mass lapse scenario was included by CEIOPS to capture non-permanent changes to the lapse rates:

[2] CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Standard formula SCR - Article 109 c Life underwriting risk – CEIOPS-DOC-42-09-L2-Advice-Standard-Formula-Life-underwriting-risk (europa.eu)

2.1.5. "The scenario shocks lapse-shock-up and lapse-shock-down cover the risk of a misestimation or of a permanent change of lapse rates. By contrast, the mass lapse event covers the risk of a temporary and drastic rise of lapse rates. The likeliness that policyholders terminate their policies is increased for a limited span of time." (CEIOPS Advice in 3.150).

2.1.6. The mass-lapse event stands for all non-structural changes in lapse rates. In practice, lapses triggered by an event can manifest over a longer period than a year, for example, due to the lag of the reaction of policyholders. Especially, if the lapses are a reaction to a 1 in 200 event, some of the lapses may not occur within the next 12 months.

2.1.7. For the purposes of this Annex, mass-lapse reinsurance (MLR) is understood as a non-proportional reinsurance treaty designed to cover part of this scenario, where the treaty usually defines an attachment point (lapse rate over assumed best estimate lapse rates) and a detachment point. The cover is usually based on the stress set out in Article 142 (6) (b) of the DR, i.e., 40% lapse rate over assumed best estimate lapse rates. In a straightforward example, a MLR treaty covers all the losses related to an excess of lapses between the so-called attachment point and so-called detachment point.

2.2. SCR TREATMENT

- Based on their own risk profile, undertakings should be able to demonstrate that the treaty provides an effective risk-transfer, which is commensurate with the capital relief, without creating material basis risk as required by Article 210(2) of DR. Where basis risk exists, undertakings should especially assess materiality of the basis risk among others, assessing whether the cover of the MLR treaty closely mirrors the changes in the value of the risk exposure within the range of lapse rates covered (i.e. between the attachment and detachment point) in a comprehensive set of risk scenarios that are consistent with the confidence level set out in Article 101(3) of the Solvency II Directive, including structural changes in the economic environment. The results of this assessment for MLR treaties should be part of the regular supervisory reporting (Articles 306 and 309(5)(a) of the DR).

2.2.1. The potential for lapse risk exposure to change significantly depends on the specific risk profile of the insurance and reinsurance undertaking. This is influenced by a number of factors, including, for example, the business model, the distribution channel, the type of insurance liabilities or the type of customers. Undertakings willing to utilise MLR treaties should have in place a specific risk assessment process concerning surrenders and the discontinuance options that they are more exposed to, in accordance to their materiality.

2.2.2. Some clauses and other features of MLR treaties may reduce the risk-mitigating effect of the treaty or lead to material basis risk (see especially Articles 1(25), 210 and 86 of the DR). Therefore, undertakings should assess whether the MLR treaty leads to a commensurate risk transfer and whether it creates material basis risk. When defining the comprehensive set of scenarios for the assessment, undertakings should include scenarios at confidence level of 99.5%. The results of this assessment should be part of the regular supervisory reporting (Articles 306 and 309(5)(a) of the DR) (see also chapter 3.6 of this document).

2.2.3. Undertakings should consider the EIOPA Guidelines on basis risk and its explanatory text3 in this context. Furthermore, all elements discussed in the subsections of this section should be considered, when applicable, and should be covered by a comprehensive set of scenarios.

- Undertakings that have signed MLR treaties should consider the treaty as risk mitigation technique, when calculating the loss in basic own funds resulting from the events described in Article 142(6) of the DR, only if the risk-mitigating effect can be accurately measured taking into account the specific terms and conditions of the MLR treaty. This requires frequently a detailed analysis of the case and granular considerations.

3. ASSESSMENT OF MASS LAPSE TREATIES IN THE SCR

3.1. INTRODUCTION

3.1.1. This section analyses some of the most relevant elements of MLR treaties to consider when assessing whether the treaty provides an effective transfer of risk that is commensurate to the capital relief or creates material basis risk, as well as for the calculation of its risk-mitigating effect.

3.1.2. In any case, each MLR treaty must be assessed on its own. It is not possible to define one solution to fit all cases, and insurance and reinsurance undertakings are expected to assess the appropriateness of the standard formula to reflect their risk profile and, especially in their ORSA, to analyse the risks related to their own MLR treaties.

3.2. CLEAR AND INCONTROVERTIBLE TERMS AND CONDITIONS

[3] See EIOPA-BoS-14/172: https://www.eiopa.europa.eu/publications/guidelines-basis-risk_en

3.2.1. Undertakings signing a MLR treaties as risk mitigation techniques should ensure that the terms and conditions of the MLR treaty, i.e. the contractual arrangements governing the MLR treaty, are clear and incontrovertible to avoid any legal risk, as a lack of clarity would compromise risk transfer effectiveness. Incomplete or unclear definitions of the claim would lead to limited and non-effective risk transfer (Article 210(1) of the DR).

3.3. LAPSE DEFINITION

3.3.1. Solvency II concept of lapses is particularly comprehensive, as it includes any type of discontinuance (Article 1(14) of the DR):

3.3.2. 'discontinuance' of an insurance policy means surrender, lapse without value, making a contract paid-up, automatic non-forfeiture provisions or exercising other discontinuity options or not exercising continuity options.

3.3.3. In their MLR treaties, undertakings are expected to use a definition of lapse that fits their risk management strategy. However, this should be carefully considered when assessing the risk-mitigating effect as, in cases where the definition of lapse in the MLR treaty is not aligned with the Solvency II definition of discontinuance, the type of discontinuance which most negatively affects the basic own funds of the undertaking might not be the same after entering into the MLR treaty.

3.4. EXCLUSIONS

3.4.1. Exclusions in the treaties are sometimes used to ensure that the MLR treaty responds solely to risks that the parties intended to cover, to reduce the premium to be paid to the reinsurer, to reduce litigation risk by making the treaty clearer, to minimize moral hazard and to align interests between parties.

3.4.2. However, the standard formula mass-lapse scenario does not include any exceptions, i.e. its scope includes all mass-lapse events regardless of the underlying event or events (financial crisis, unemployment, legal changes…). Therefore, exclusions in MLR treaties may create basis risk. While materiality depends on the case, it should be noted that, even if these exclusions might reflect events with very low probability, mass-lapse events are extreme scenarios with very low probability (VaR 99.5%). So, these exclusions may indeed represent a material share of the potential cases leading to the mass-lapse event.

3.4.3. Consequently, when assessing whether a MLR treaty provides an effective risk transfer, exclusions in the terms and conditions may be particularly relevant. Some MLR treaties have been observed to exclude from the cover some events which have been explicitly listed in above-mentioned CEIOPS Advice. Such examples are mass-lapse events due to changes in legislation, including changes in taxation, and due to worsening financial position. Other examples are mass lapse events due to extensive market behaviour (such

as transfer from defined benefit to defined contribution schemes) and due to broker recommendations and due to other third parties but also due to internal switching between the ceding undertaking's products and/or splitting them.

3.4.4. Undertakings are expected to include exclusions in MLR treaties only if they fit their risk management strategy and at the same time ensure proper functioning of the treaty and avoid moral hazard. In particular, exclusions of events which are solely in the control of the ceding undertaking and which voluntarily target to trigger a claim event of the MLR treaty, are still expected to be included in the reinsurance contract and, in principle, are not expected to impair the ability of such contracts to mitigate risks.

3.5. BASIS FOR THE CALCULATION OF THE CLAIM

3.5.1. Claims of MLR treaties, i.e. the claims to be paid by the reinsurer to the ceding undertaking, can be defined on the basis of other concepts than those in Solvency II. Frequently, these definitions have been based on some kind of "economic loss" after the lapses, sometimes referred to as a "loss in Value In Force (VIF)". MLR treaties that define the claims to be paid by the reinsurer by using parameters and concepts different from those used to calculate Solvency II technical provisions may create basis risk.

3.5.2. Undertakings are expected to define the claim of MLR treaties so that it is based on the relevant parameters that fit their risk management strategy. In any case, it should be noted that a consistent use of parameters which define claims, attachment and detachment points avoids unnecessary complexity. In cases where the MLR treaty defines the claim by using non-Solvency II parameters (e.g. discount rates used to calculate the VIF are different from those used to calculate the best-estimate of technical provisions), undertakings are expected to be able to explain the differences between Solvency II losses in the own funds and the claim defined by the MLR treaty, as well as how these differences have been considered in the calculation of the SCR.

3.5.3. It should be noted that the impact of these differences may change across the 1-year time horizon (e.g. the difference between both discount rates may change across the year). Therefore, undertakings should also assess whether these differences create material basis risk.

3.6. FIXING A LAPSE PARAMETER

3.6.1. Mass-lapse events are typically not instantaneous events, but when number of lapses grows over a variable period of time and, as the mass-lapse event arises, the expected lapse rate may also increase. In addition, the amount of the reinsurance claim (e.g., the loss in Solvency II own funds) depends directly on expected lapses, as lapses have a direct impact on the profitability of the portfolio of insurance contracts. Therefore, if the MLR treaty

defines the reinsurance claim based on the value of the lapse parameters valid at the date when the mass-lapse event occurs, the real risk-mitigating effect may be lower than initially assessed. So, the risk transfer may not be effective or not commensurate with the capital relief.

3.7. CLIFF-EDGE EFFECT

3.7.1. The standard formula mass-lapse scenario is designed at VaR 99.5%, which means that the capital requirement should also be enough to cover all losses up to the confidence level and thus also less-extreme events. Tailoring the MLR treaty to the standard formula mass-lapse scenario may leave the undertaking vulnerable to other scenarios, therefore creating material basis risk. In particular, the mass-lapse capital requirement should be enough to cover the losses after events not covered by the MLR treaty, i.e. where the lapse rate is below the attachment point.

3.7.2. Most of the observed MLR treaties define the claim as the loss associated to lapses exceeding the attachment point4. For example, for a MLR treaty with an attachment point of 15%5 (over assumed best estimate lapse rate) and detachment point of 40% (over assumed best estimate lapse rate) and in case of real lapses being 35% (over assumed best estimate lapse rate) the treaty would cover the losses associated to lapses between the interval from 15% to 35% (over assumed best estimate lapse rate).

3.7.3. However, some MLR treaties define the claim as the loss associated to all lapses once lapses exceed the attachment point. For example, for a contract with an attachment point of 15% (over assumed best estimate lapse rate) and detachment point of 40% (over assumed best estimate lapse rate), if real lapse rate is 35% (over assumed best estimate lapse rate), the treaty would cover the losses associated to all lapses, i.e., from 0% to 35% (over assumed best estimate lapse rate).

3.7.4. The risk mitigating effect of MLR treaties covering the loss associated to all lapses once lapses exceed the attachment point create material basis risk within the standard formula. The MLR treaty would transfer all losses for scenarios with lapses above the attachment point and no losses for scenarios below the attachment point, creating a sharp cliff-edge effect around the attachment point. Conversely, the real losses derived from the risk exposure constantly increase as lapses increase. Therefore, the value of this risk-mitigation technique would not closely mirror the changes in the exposure for lapse risk, creating material basis risk. Indeed, allowing to consider the risk-mitigating effect of this type of MLR treaties would lead to a non-commensurate SCR reduction as, while the treaty would only transfer losses for scenarios with lapses above the attachment point, the capital relief would be 100% of the mass-lapse capital requirement. Therefore, the risk-mitigating effect

[4] The attachment point is frequently defined as a percentage of lapses in excess of the assumed best estimate lapse rate.
[5] This example is added for illustration purposes and does not reflect supervisory expectations.

of MLR treaties covering the loss associated to all lapses once lapses exceed the attachment point can only be measured through a (partial) internal model.

3.8. ATTACHMENT / DETACHMENT POINTS

3.8.1. Most observed MLR treaties have a detachment point in line with the 40% assumption of the standard formula (or 70% for management of group pension funds) and an attachment point which is lower. This implies that ultimately the net SCR for mass lapse depends on the attachment point.

3.8.2. The undertaking's share of the loss after a mass-lapse event might decrease more or less linearly as the attachment point decreases, but the price of the cover might increase more sharply if the probability of lapses assumed does not behave linearly. This means that, for example, reinsuring the final 10% of lapses (i.e., from 30% to 40% over assumed best estimate lapse rate) is frequently significantly cheaper than reinsuring the first 10% of lapses (i.e. from 0% to 10% over assumed best estimate lapse rate), while the lapse capital relief would be very similar in both cases. In any case, this does not necessarily imply that the risk transfer is not commensurate to the capital requirement relief, as this is driven also by the non-proportional nature of MLR.

3.8.3. However, the risk transfer from MLR should be commensurate to the capital relief. So, to determine the real risk transfer, it is necessary to consider the real risk profile of the reinsured portfolio. It should be noted that the fact that the overall risk profile of the undertaking does not deviate from the underlying assumptions of the standard formula alone is not enough to determine the real risk profile of the reinsured portfolio, which requires additional relevant criteria on portfolio level. For example, if an undertaking reinsures mass-lapse events only for insurance products with low lapse risk, the capital relief may not be commensurate to the real risk transfer if the attachment point is not calibrated based on the risk profile of the reinsured portfolio.

3.8.4. An undertaking's assessment of the adequacy of the standard formula for its risk profile in the ORSA should consider the underlying mass-lapse risk profile of the reinsured portfolio and the mass-lapse reinsurance in place where they are material. The level at which the attachment point is set is relevant for this analysis.

3.9. MEASUREMENT PERIOD

3.9.1. DEFINITION OF MEASUREMENT PERIOD

3.9.1.1. For the purposes of this Annex, the duration or maturity of the treaty should be interpreted as the time until the MLR treaty matures, and the measurement period should be

interpreted as the risk window or cover period, i.e. the timeframe considered to aggregate lapses and potentially trigger a claim in case the attachment point is reached.

3.9.2. MEASUREMENT PERIOD AND RENEWALS

3.9.2.1. Real mass-lapse events are not instantaneous events as in the mass-lapse standard formula, because they span across longer periods of time. Therefore, measurement periods should be adequately defined, as lapses might not arise within a predefined period coinciding with a specific cover period. For example, a 12-month mass-lapse event could start in July and it would not be properly covered by a MLR treaty with fixed cover periods equal to each calendar year. This can be mitigated by defining renewals through rolling measurement periods and a long duration, e.g. every quarter the treaty is rolled over, and three additional months are added to the treaty and a new 12-month measurement period starts.

3.9.2.2. For long-term MLR treaties following a rolling approach on quarterly basis, a 12-month measurement period starts every quarter and, consequently, measurement periods overlap. It is therefore natural that the MLR treaty defines the claim to avoid double counting the same lapses for different measurement periods by, for example, reducing the current claim by lapses that were already accounted for in claims ceded to the reinsurer in the last overlapping6 measurement periods.

3.9.2.3. However, in some observed cases MLR treaties have included “high-water mark” clauses, which require to deduct claims paid in the past within the treaty to calculate current claim for non-overlapping measurement periods (e.g. 24-months high-water mark clause into a MLR treaty with 12-months measurement period). De facto, this type of clauses leads to a permanent increase of the attachment point after each mass-lapse event covered by the MLR treaty. In any case, undertakings should consider the impact of past claims on the cover provided by the MLT treaty in the following 12 months.

3.9.2.4. In exceptional cases, where a specific undertaking's risk profile is such that a material share of lapses would occur after the first 12 months, a rolling 12-month period may endanger the adequacy of the mass lapse risk of the standard formula and therefore a longer measurement period may be appropriate to use (e.g. when policyholders can not surrender the contract at any time but only once per year).

3.10. LIQUIDITY RISK

3.10.1. It should be noted that MLR treaties might not eliminate liquidity risk arising from mass-lapse events, as an undertaking can still be exposed to it because of the time gap between

[6] E.g. the last 3 measurement periods in case of quarterly roll-over and 12-month measurement periods.

lapses and payment of the claim by the reinsurer to the cedent. This might be particularly challenging in cases where a poor definition of the terms of the treaty leads to disagreement between the insurer and the reinsurer. In any case, undertakings should explicitly address this as part of their liquidity risk management system (Article 260 of the DR), considering the specific features of the MLR treaty, including the contractual arrangements and any existing deposits, notably to take into account the potential time gap between lapses and payment of the claim by the reinsurer to the cedent.

3.11. TERMINATION CLAUSES

3.11.1. GENERAL

3.11.1.1. Arguments brought forward to include termination clauses in reinsurance agreements are that these would allow for an equitable and operational contractual relationship which preserves the parties' original commercial intention and economic effect, ensuring its sustainability and stability. They are said to provide safety for reinsurers with regard to the consequences of extraordinary severe events, minimize the risk of anti-selective behaviour and protect cedants from being tied to a reinsurer unable to meet its obligations. Undertakings state that termination clauses can serve as a trigger for renegotiation of the calibration of the treaty in line with the original intent of the parties. On the other hand, termination clauses that can be executed unilaterally from the reinsurer could create basis risk as they in fact restrict the coverage of the reinsurance treaty.

3.11.1.2. For the purposes of this Annex, discretionary termination clauses are clauses that, without any prior condition, allow a party of an MLR to unilaterally terminate the agreement before its end or bring an open-ended agreement to an end.

3.11.1.3. For the purposes of this Annex, conditional termination clauses are clauses that, subject to a special prior condition, allow a party of an MLR to unilaterally terminate the agreement before its end or bring an open-ended agreement to an end.

3.11.1.4. While termination clauses exist generally in favour of both parties, this Annex focuses on the termination rights of the reinsurer, as these are the ones that may create basis risk.

3.11.2. DISCRETIONARY TERMINATION CLAUSES

3.11.2.1. Discretionary termination clauses allowing the reinsurer to unilaterally terminate the contract without any prior condition are expected to endanger an effective risk transfer, as the reinsurer could terminate the contract once lapses are getting close to the attachment point. Therefore, contractual arrangements providing the reinsurer the

option to unilaterally terminate the contract early without any prior conditions, are expected to be considered not eligible as RMT to reduce the SCR, unless it can be demonstrated that the residual measurement period7 and the residual duration of the treaty is sufficient to ensure an effective risk transfer.

3.11.3. CONDITIONAL TERMINATION CLAUSES

3.11.3.1. Some MLR treaties includes special termination clauses that allow the reinsurer to terminate the contract under special circumstances. Such examples include situations in which the insurer is unable to maintain a sufficient service level to retain policyholders or cases of a regulatory authority decision to restrict the (re)insurance business or adoption of supervisory measurers concerning the insurer. Such cases also include termination if the cedent's solvency ratio under Solvency II is below a certain level.

3.11.3.2. Some of these events may trigger a mass-lapse event or be triggered by an ongoing mass-lapse event. If the reinsurer has the right to terminate the treaty on short notice, i.e. the residual measurement period and the residual duration of the treaty are not sufficient to ensure an effective risk transfer, some mass-lapse events could be indirectly excluded from the MLR treaty. Therefore, special termination clauses with a short notice period in MLR treaties are expected to create basis risk.

3.11.3.3. In any case, undertakings may include special termination clauses in MLR treaties if these fit to their risk management strategy, ensure the proper functioning of the treaty and avoid moral hazard. In particular, special termination clauses that only apply when events have been solely in the control of the cedant are not expected to create material basis risk and thus should not impair the ability of such contracts to mitigate risks.

3.12. REINSURER'S PERSPECTIVE

- Reinsurance undertakings applying the standard formula accepting mass-lapse risk should calculate the mass-lapse capital requirement applying the mass-lapse scenario of the underlying direct insurance contracts.

3.12.1. The party accepting the risk in a MLR treaty is also exposed to life/health SLT mass-lapse risk, as in case of a mass-lapse event affects all undertakings, the MLR treaties would be triggered. The standard formula appropriately supports this, as according to the second

[7] The residual measurement period should be understood as the time until the end of the last measurement period still covered by the MLR treaty.

subparagraph of Articles 142(6)8 and 159(6) of the DR, for reinsurance treaties mass-lapse capital requirement should be assessed based on the underlying insurance contracts in the life/health SLT underwriting risk module.

3.12.2. In some observed cases, the party accepting the risk from a MLR treaty has classified it as a non-life risk and has not calculated any life mass lapse capital requirement. This approach fails to recognise the real economic nature of the underlying risk and is against Solvency II principles, which leads to a material underestimation of the SCR. This would allow arbitrage in application of Solvency II regulation. The cedant would materially decrease the SCR, while the increase in the SCR of the reinsurer would be significantly lower than the reduction for the cedant (e.g., only 5–10%)".

3.13. BALANCE SHEET

- Undertakings projecting MLR renewals for risk margin calculation should consistently project the cost of MLR renewals when valuating reinsurance recoverables.
- However, undertakings should only project renewals for calculation of the risk margin and valuation of reinsurance recoverables when they can (1) clearly justify that the risk that the MLR treaty cannot be replaced due to an absence of liquidity in the market is not material and (2) accurately estimate the risk that the cost of replacing existing reinsurance arrangements may increase. Undertakings should take into consideration that the degree of uncertainty of assumptions for (1) and (2) increases as the projection horizon becomes longer.

3.13.1. Mass-lapse reinsurance has also been associated with long-term contracts which may last significantly longer than the reinsurance treaty. When projecting future SCRs associated with long-term contracts, insurance and reinsurance undertakings need to make assumptions on potential replacements of reinsurance contracts, including mass-lapse treaties. This can have a material impact on the calculation of risk margin and valuation of reinsurance recoverables.

3.13.2. Article 209(3) of the DR, subject to some conditions, allows for the renewal or replacement of reinsurance to be considered in the projection of the SCR as a future management action. Article 209(3) of the DR is limited to a 12-month future period in line with the time horizon of the SCR. However, according to Article 38(1)(l) of the DR when calculating the risk margin

[8] *It should be noted that, while Article 159(6) is clear on the need to assess mass-lapse capital requirement based on the underlying direct insurance contracts in all cases, Article 142(6) inconsistently requires this only for group risk. However, there are no economic reasons to justify such a difference* and all risks assumed by the party accepting the MLR treaty should be assessed based on the underlying direct insurance contracts.

the reference undertaking should adopt future management actions that are consistent with the assumed future management actions of the original undertaking. According to this article, these future management actions should satisfy the requirements of Article 23 of the DR. Paragraph 156(g) of Guideline 78 of EIOPA Guidelines on valuation of technical provisions (EIOPA-BoS-22/217)9 clarifies further that future management actions include projecting future reinsurance arrangements provided the relevant criteria are met, which means that the risk margin should also consider them if the criteria are met.

3.13.3. Article 41(1) of the DR stipulates that the contract boundaries of the reinsurance recoverables should be consistent with the insurance contracts to which they relate. Guideline 78 clarifies further that, as consequence, the undertaking should recognise future cash-flows relating to future reinsurance purchasing and renewals in the reinsurance reoverables of MLR treaties for as long as for the underlying obligations, provided some conditions are met.

3.13.4. Requirements in Guideline 78 and Article 209(3) of the DR to consider future reinsurance are equivalent. Therefore, consideration of future reinsurance purchasing and renewals for calculations of risk margin and valuation of reinsurance recoverables should be consistent.

3.13.5. However, mass-lapse reinsurance is still a niche market compared to other reinsurance treaties. So, justifying that the risk that the risk-mitigation technique cannot be replaced due to an absence of liquidity in the market is not material as required by Article 209(3)(e) and Guideline 78(e) may be challenging considering the long projection horizon of some products covered by MLR.

3.13.6. Similarly, Article 209(3)(f) of the DR and Guidelines 78(f) require undertakings to consider the risk that the cost of replacing existing reinsurance arrangements may increase, which will usually be particularly challenging considering that MLR is a niche market and the usually long projection period of the obligations reinsured10.

3.13.7. Therefore, undertakings should only project renewals for calculation of risk margin and valuation of reinsurance recoverables when, for their specific case, they can (1) clearly justify that the risk that the MLR treaty cannot be replaced due to an absence of liquidity in the market is not material and (2) accurately estimate the risk that the cost of replacing existing reinsurance arrangements may increase. Undertakings should take into consideration that the degree of uncertainty of assumptions for (1) and (2) increases as the projection horizon becomes longer.

3.13.8. It should be noted that approximating future SCRs for risk margin calculation based on future net best estimates (Method 2 of Guideline 61 – Methods to calculate the risk margin) usually implicitly assumes renewal of reinsurance contracts.

[9] See: https://www.eiopa.europa.eu/publications/guidelines-valuation-technical-provisions_en

[10] In addition, it should be noted that the proposal to amend the Solvency II Directive states that "*the calculation of the risk margin should account for the time dependency of risks*".

3.14. SUPERVISORY REPORTING AND PUBLIC DISCLOSURE OF MASS LAPSE REINSURANCE TREATIES

3.14.1. It is recalled that, in accordance with Articles 295(4), 306 and 309(5)(a) of the DR, undertakings that have entered into a mass lapse reinsurance treaty are required to include, within the supervisory reporting and public disclosure, detailed qualitative and quantitative information relating to such treaty.