University of St.Gallen
Institute of Insurance Economics

GOETHE UNIVERSITÄT FRANKFURT AM MAIN

Summary of the European Life Reinsurance Roundtable

16 February 2023, Frankfurt am Main

Hosted jointly by the International Center for Insurance Regulation, Goethe University and the Institute of Insurance Economics, University of St Gallen

Overview

The Roundtable took place on 16 February 2023 at Goethe University, Frankfurt am Main. The event brought together around 70 participants representing senior delegates from the six largest European insurance supervisors, EIOPA, European Commission, all major reinsurers, and insurers active in the European life (re)insurance market, as well as academics from prominent research institutions in Europe in the field of insurance and regulation. The one-day event consisted of presentations followed by the participants' discussions as well as a longer moderated roundtable discussion.

These notes summarize the speakers' contributions, questions, and views from the audience in conjunction with presentations, and the subsequent discussions at the European Life Reinsurance Roundtable hosted by the International Center for Insurance Regulation, Goethe University Frankfurt, and the Institute of Insurance Economics, University of St. Gallen. As such, the notes will not solely represent the views of each presenter, but also reflect contributions of the interactive and engaging discussions.

Major themes that emerged from the event

The event gave rise to very active exchanges between participants, and the following five themes crystalized across the sessions:

1. The interest in de-risking insurers' balance sheets has been steadily growing in Europe for the past few years. Life insurers have different options to reduce their exposure to guaranteed legacy business; funded reinsurance, along with hedging through derivative contracts, are the options where the insurer remains the ultimate debtor and retains customer contact.
2. Close and continuous dialogue between insurers, reinsurers, and regulators (i.e., transparent dialogue from the beginning of a transaction) is vital to arrive at a suitable transaction.
3. With the purpose of life insurance being to provide policyholders with sound alternatives for their savings and pensions, policyholders must be central in every transaction.
4. Supervisory and regulatory harmonisation across Europe is an important element in achieving a level playing field which benefits policyholders and other stakeholders.
5. We can learn from the U.K. and U.S. reinsurance experience; a common element is that time and effort are required for the industry to accept funded reinsurance as an established tool for insurers.

Session 1
The market backdrop – a view from the outside

The session provided an overview of the public market perspective of the global and European life insurance sector. It illustrated that, over the past decade, life insurers specializing in annuity and guaranteed life business, when compared with other segments of the insurance industry, have underperformed, leading to a "cheaper" valuation that remains and which is driven by an implied high cost of capital in the public market. The U.S., U.K., and now the European insurance industry, have gone through different stages of restructuring and consolidation and in some countries "back book" market is emerging.

Major themes that emerged from the session

- Generally, investors in the stock and debt market have limited appetite for volatile guaranteed life insurance business with heavy capital requirements and lower return on equity (ROE). Consequently, EU life insurers generally underperform in the stock market. It follows that the public market does not easily provide capital to support long dated guaranteed savings and retirement products for the European market.
- Higher market rates are unlikely to change public market sentiment to guaranteed business – preference remains firmly for capital light unit-linked and protection business – therefore one expects continued pressure from investors on life insurers to reduce and divest exposure to annuity and guaranteed life insurance business.
- The stock market seems largely agnostic to the method chosen for divestment from guaranteed business – entity sale, portfolio transfer or reinsurance – and generally welcomes the reduction in volatile asset and capital markets related exposures.
- For life insurers, it ought to be critical to remain relevant to current and future customers and thus the distribution channel, interaction with customers, and product design are key for life insurance industry performance. Question raised: "has the European life insurance industry forgotten the customer and product proposition to savers?"

Session 2
The experience of other mature markets – a glance at the U.S. and the U.K.

Three different presenters shared their perspectives and experiences from executing various funded reinsurance transactions in the more developed U.S. and U.K. markets. These presenters played an instrumental role in the development of the U.S. life reinsurance market after the Global Financial Crisis (GFC) and executed some of the largest funded reinsurance transactions in the U.S. and U.K. market both as a cedent and reinsurer.

Major themes that emerged from the session

- The U.S. life reinsurance market initially developed around flow reinsurance arrangements involving some of the larger insurers looking for product innovation and capital support in the aftermath of the GFC. The ability to meet customer demand for various guaranteed annuity products and enhanced product features by gaining access to reinsurer's capital, data and product development capabilities was a key motivation for cedents. Ultimately, the various life reinsurance arrangements were driven by the desire to improve the value proposition to customers.

- In the U.K. where funded reinsurance often is used for immediate risk transfer as a precursor to a Part 7 portfolio transfer[1], there have been cases where policyholders have challenged the subsequent portfolio transfer on the basis that it is in their best interest to remain a customer of the original life insurer.
- From the perspective of execution speed and certainty, sale of legal entity or portfolios would often not be a viable option for the seller or cedent, leaving reinsurance as the only transaction structure that meets all strategic objectives and is considered to be in the interest of the customer.
- Execution of larger funded reinsurance transactions can be intense and challenging due to demanding data requirements and due diligence, stakeholder management (equity and credit investors, regulators, rating agencies, risk functions), and material legal documents encompassing several hundreds of pages.
- An early, regular, and constructive relationship with the respective insurance supervisors was described as a key element in a successful transaction.
- Collateral structure, investment guidelines and counterparty credit profile should be some of the key considerations for the cedent as part of execution, while robust regular (risk) monitoring of the contract and audit & control frameworks post execution are critical. The reinsurance transaction is not "finished" upon execution of the treaty.
- In summary: (i) funded reinsurance transactions are well-established in the U.K. and the U.S. with large double digit billion pound/dollar transactions taking place; (ii) policyholder's interest and preservation of the relationship between the policyholder and cedant is a key motivation for funded reinsurance transactions compared with other alternatives; (iii) analysis of residual credit risk for the cedant in the event of a unlikely reinsurer default is hugely important in the regulatory discussion; and (iv) time and effort is required before a transaction is concluded.

Session 3
Continental European life reinsurance in a historical context

This session focused on the development of the life reinsurance industry in Europe as driven by two forces — product innovation and regulation. Life reinsurance has evolved from finite reinsurance to variable and fixed index annuities, interest rate and financial reinsurance, and non-

[1] A court-sanctioned legal transfer of life insurance policies of one insurer to another.

proportional and stop loss reinsurance. The session highlighted that life reinsurance has been "thematic", and heavily driven by regulatory capital and accounting frameworks.

Major themes that emerged from the session

- Up until the introduction of Solvency II in 2016, most structured reinsurance solutions aimed at formally optimising capital or managing accounting constraints, in many cases without substantial risk transfer.
- Stop loss reinsurance structures, for specific risks - such as lapse or longevity risk, - were fuelled by the introduction of Solvency II. However, some supervisors raise concerns around basis risk and the required level of risk transfer under such transactions.
- There is an expectation that IFRS 17 will bring new demand for life reinsurance solutions and innovation in the ways contracts will be structured.
- Reinsurance of market risk developed as an interesting alternative to capital market hedging with derivatives. The benefit of such reinsurance solutions is that they allow for a superior matching between product risk and obligations towards policyholders, and the risk mitigation effect is closely related to the underlying insurance contracts.
- Solvency II is intended to introduce a consistent and harmonised framework for the use of reinsurance of future claims and liabilities regardless of the type of underlying risk. However, insurers and reinsurers are experiencing different regulatory approaches to assess the level of risk transfer required to allow a recognition of reinsurance as "risk mitigation measure". Also, there are different interpretations of the prudent person principle (PPP) when it comes to asset intense reinsurance.
- For the funded life reinsurance market to further develop in the EU as an effective risk and capital management tool, an improved understanding and a more harmonised regulatory and supervisory treatment across key European markets will be critical.

Session 4

Asset based reinsurance: a helpful tool for European life insurers as part of the ongoing restructuring of balance sheets?

The session focused on the paper "Funded reinsurance as a divestment tool for life insurance books with financial guarantees" prepared for the Roundtable event by Prof. Anastasia Kartasheva (IVW-HSG). The feedback of the participants, including the insurance supervisors, is that the paper provides a comprehensive and balanced assessment of funded reinsurance and raises the key points in the divestment market.

Major themes that emerged from the session

- A decade of low interest rates and the introduction of Solvency II resulted in a material increase in the cost of guaranteed liabilities. Developments in the European life insurance market is leading to increased demand for liability divestment solutions. Historically, divestments in Europe were mostly executed as portfolio transfers and entity sales.

- Funded reinsurance can represent a valid and more robust strategy compared with other divestment strategies. The reasons are (i) funded reinsurance allows insurer to remain the ultimate obligor to the policyholder and maintain the customer relationship; (ii) insurers can continue their trusted relationship with the policyholders; (iii) there is collateralization of the insurer's claim on the reinsurer; and (iv) the operation burden is lower in terms of deal execution and business transition.
- The regulatory focus should be on policyholder protection, consistent and robust framework for collateral management, and ensuring that the cedent/insurer is capable to monitor and manage the relationship with the reinsurer.
- Private ownership of these life insurance liabilities might at times be more suitable as there is a higher ability to hold and absorb short term capital markets volatility. Reinsurance is a widely used as an accepted tool across the European non-life insurance market, but much less common in the life sector.
- Key concerns raised by regulators in conjunction with funded life reinsurance transactions include fair treatment of policyholders, operational preparedness, and capabilities of the parties to manage the transaction, and the cedents' ability to monitor and manage the transaction from a risk perspective.
- Overall, there is demand for European life insurance divestment solutions. Done appropriately, funded reinsurance transactions can represent a valid alternative to outright sale of the liabilities.

Keynote

An integrated and efficient European life insurance market

The keynote address was delivered from a Director at the Directorate General FISMA from the European Commission.

Major themes that emerged from the session

- The European life insurance market operates in the changing environment of climate change, digitalization, geopolitical issues, inflation and rises in commodity prices. Besides providing insurance against biometric risks, it was stressed that life insurance also benefits social security at the age of retirement. The rise in interest rates can provide the relief to the life insurance sector, but there are also risks that can materialize on the back of rising interest rates especially because they increase rapidly. Events that happened in the pension fund sector in the U.K. serve as a good example. Lapse risk is another issue to consider.
- Solvency II started in 2016 and it is now being reviewed after 5 years of positive experience. Solvency II contributed to the safe and resilient insurance sector during the pandemic. Solvency II review needs to balance between existing risks and economic realities that create better incentives for insurers' investments.
- Reinsurance clearly is an important component of a well-functioning insurance market. It is reasonable to elaborate on the question of how reinsurance can contribute to make

life insurance more efficient and resilient. Reinsurance should be available as a potential tool when reinsurance would enhance the options for insurers and outcomes for policyholders.

- The EU Commission aims at creating all-encompassing regulation. There will be no regulatory break. As new items emerge (e.g., digital currency, cyber, etc.) the regulatory momentum will continue, and new regulations will emerge.
- Participants were invited to share any possible regulatory obstacles on executing such (cross-border) reinsurance transaction with the EU Commission.

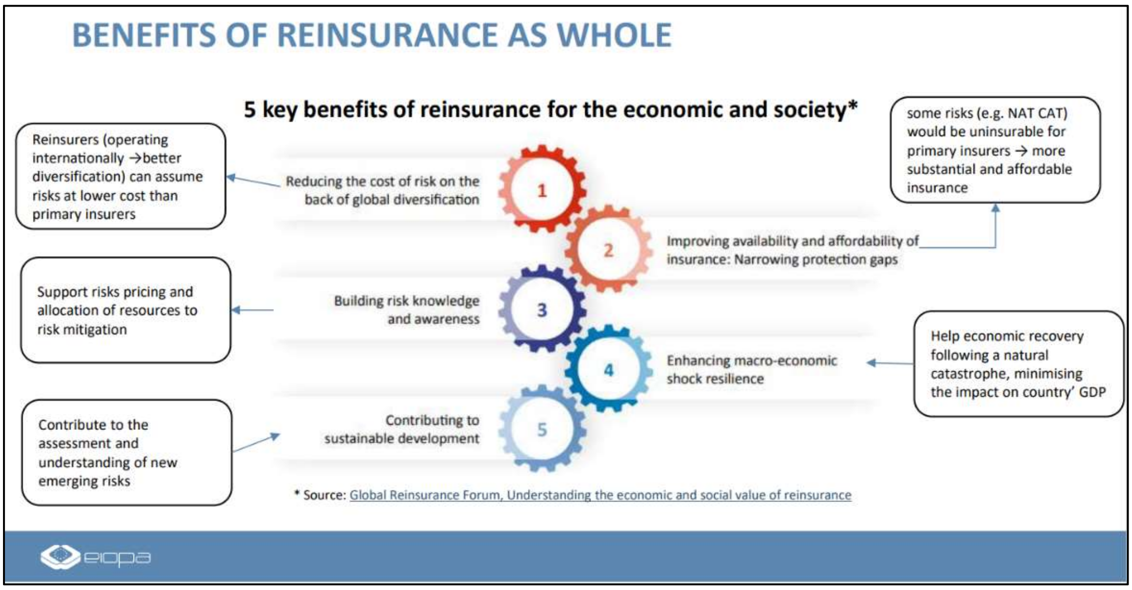
Session 5

The regulatory perspective: the use of reinsurance under Solvency II with a focus on life business – benefits, trends, and challenges

The presentation provided an overview of how reinsurance has been considered in a changing European regulatory landscape and the transition from Solvency I to Solvency II, and subsequently how the use of reinsurance has evolved since 2016. The benefits of reinsurance were highlighted. Finally, the senior representative from EIOPA provided considerations and guidance from EIOPA on the use of reinsurance.

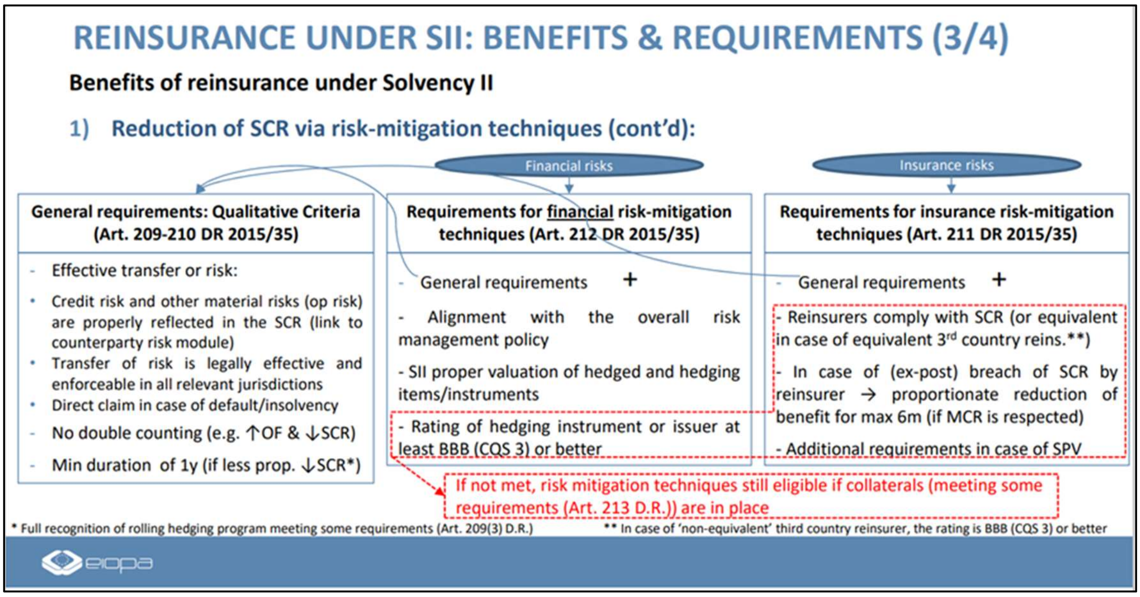
Major themes that emerged from the session

- Solvency II introduced full recognition of reinsurance as an efficient risk mitigating technique. Reinsurance - done appropriately - can have many benefits for the economy and society, as highlighted below:



Source: EIOPA. The chart is included with the permission of the speaker.

- Since the introduction of Solvency II in 2016, the use of reinsurance in European non-life insurance market has steadily increased from 20% to 28% of reserves (19% to 24% of premiums). By contrast, in the European life market, the use of reinsurance has remained stable at 4% of reserves (and 6% of premiums). However, the use of derivatives in life insurance has materially increased to about €3 trillion notional as of year-end 2021.
- Solvency II requires effective risk transfer, proper reflection of reinsurance related risks in the Solvency Capital Requirement (SCR) of relevant parties, the risk transfer is legally effective and enforceable, and generally there should be a substance over form perspective for recognition of reinsurance as a risk mitigating technique.



Source: EIOPA. The chart is included with the permission of the speaker.

- Insurers must have a proper understanding of the reinsurance treaty, and the treaty must be aligned with the overall risk management policy and business strategy (including on a forward-looking basis) of the cedent, and there needs to be a thorough understating of any related counterparty risk.
- Early dialogue between the industry and supervisors are encouraged when new or material reinsurance transactions are contemplated.
- It is acknowledged that Supervisory convergence and ensuring a level playing field in Europe is needed.

Session 6

The consumer perspective: the attraction of reinsurance for the counterpart and ultimately consumer

In this session, a former representative from a large European consumer association expressed the needs and desires of the current and future policyholders, and highlighted relevance and implications for the life reinsurance market.

Major themes that emerged from the session

- The needs and wishes of consumers (with a specific German perspective): i) financial security in retirement; ii) investment guarantees; iii) liquidity; iv) "value for money"; v) flexibility; and vi) transparency. Insurer's role is to assume risks and provide attractive products, not push all risk on to the consumer.
- Life insurers should focus more on advice, product development and product availability - to provide tangible "value for money" for consumers.
- Reinsurers can help support the insurance industry and to organize these needs by aggregating risks, driving financial and operational scale, delivering guarantees to primary insurers, or otherwise focusing on core activities of the value chain, thereby supporting primary insurers with product innovation and pricing power.
- It is equally important for consumers and consumer advocates to acknowledge that delivering both attractive guarantees, optionality, liquidity, and attractive returns is a difficult, if not impossible, ask for the insurance industry, as all of the aforementioned come at a price.
- Digitalisation is a future challenge and increasingly demanded by consumers – how can the (re)insurance industry evolve to meet consumer demands?
- Strong regulation is required and much welcome to ensure that consumers participate in the value creation of the (re)insurance industry and are provided appropriate "value for money".

Asset Backed Reinsurance Roundtable

The afternoon Roundtable Discussion – moderated by Prof. Dr. Christian Thimann – allowed for an open and constructive discussion among 14 participants from all domains of the insurance industry, including supervisors. Current and former supervisors, academics, representatives from European reinsurers and insurers, industry associations and other market participants all displayed different perspectives and views on funded reinsurance. There was broad agreement that the life reinsurance market, and funded reinsurance specifically, will continue to develop if approached appropriately by all stakeholders involved.

Major themes that emerged from the session

- The Solvency II framework has led insurance companies to be conservative regarding asset risk, e.g., invest in government bonds at very low yields, which in the end is not always beneficial for policyholders.
- Funded reinsurance is seen as a new structure in the EU, and it is challenging for insurers because there is (i) fear of something new; (ii) fear of complexity; (iii) fear of not obtaining regulatory approval; and (iv) the need to make it function over the long term and virtually under all circumstances. Such funded reinsurance took quite a while to become established in the U.S. hence there is no need to be defensive about the slow pace of development in Europe. Europe can take inspiration from the U.S. but not necessarily imitate the U.S. as insurance markets differ.
- P&C is fundamentally different than life so that one cannot translate solutions from one area to the other, tail risk, duration, etc., are all different.
- There is a strong case for addressing market risk, for which funded reinsurance is an option, because such market risk is the largest risk insurers face with guaranteed products. Life insurers continue to offer life products with guarantees because it meets policyholders' needs.
- Funded reinsurance contracts are complex and require a vast array of considerations and scenarios, but insurance leaders are there to deal with complexity. Practically everything that is done in insurance, and requires actuarial & legal work, is complex; reinsurance is no exception.
- Insurance companies report having detected differences in treatment of reinsurance solutions among European supervisors. These issues should be discussed transparently and be analysed and addressed. There is a case to be made that funded reinsurance will develop by creating a common understanding and a level playing field.
- Reinsures need to develop more specific products, educate all the stakeholders and work with select group of strong insurers to complete transactions. Academics can help by strengthening the analytical understanding of reinsurance of financial market risk.

Conclusion

The Roundtable provided an opportunity to reflect and discuss life reinsurance and in particular funded reinsurance as a valid risk management tool to support the restructuring of the European life insurance industry to the advantage of the stakeholders. Speakers and discussants presented the market perspective and experiences both inside and outside Europe. Further, they discussed funded reinsurance, its main drivers, and modelling details. The Roundtable increased the awareness of what funded reinsurance can provide. Also, it improved the understanding of the pros and cons of other solutions like entity sales, portfolio transfers and internal run-offs.

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