

Guidelines on basis risk

Introduction

- 1.1. According to Article 16 of Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (hereinafter "EIOPA Regulation")¹ EIOPA is drafting Guidelines on basis risk.
- 1.2. The Guidelines relate to Article 104 and 105 of 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 (hereinafter "Solvency II")².
- 1.3. These Guidelines are addressed to supervisory authorities under Solvency II.
- 1.4. These Guidelines are aimed at facilitating convergence of practice across Member States and at supporting undertakings in calculating their capital requirement for market risk under Solvency II.
- 1.5. These Guidelines concern undertakings and professionals responsible for the treatment of the risk mitigation techniques in the calculation of the Solvency Capital Requirement with the standard formula.
- 1.6. The aim is to increase consistency and convergence of professional practice relating to the treatment of risk mitigation techniques in the calculation of the Solvency Capital Requirement for all types and sizes of undertakings.
- 1.7. If not defined in these Guidelines the terms have the meaning defined in the legal acts referred to in the introduction.
- 1.8. These Guidelines shall apply from 1 April 2015.

Guideline 1 – Risk-mitigation techniques with no material basis risk

- 1.9. Undertakings should consider that a risk-mitigation technique does not result in material basis risk where the following conditions are met:
 - (a) the exposure covered by the risk-mitigation technique is sufficiently similar in nature to the risk exposure of the undertaking;
 - (b) the changes in value of the exposure covered by the risk-mitigation technique closely mirror the changes in value of the risk exposure of the undertaking under a comprehensive set of risk scenarios, including scenarios that are consistent with the confidence level set out in Article 101(3) of Solvency II.

¹ OJ L 331, 15.12.2010, p. 48–83

² OJ L 335, 17.12.2009, p. 1-155

Guideline 2 - Financial risk-mitigation techniques: assessment criteria of material basis risk

1.10. Before allowing for financial risk-mitigation techniques in the calculation of the Solvency Capital Requirement with the standard formula, undertakings should assess inter alia:

- (a) the materiality of the basis risk with reference to the exposure covered by the risk-mitigation technique and the risk exposure of the undertaking without considering other balance sheet items, unless there is a continuous and consistent connection between other balance sheet items and the risk exposure of the undertaking;
- (b) the similarity of the nature of the exposures referred to in Guideline 1 by taking into account at least the type and terms and conditions of the instruments or arrangements involved and the rules governing the markets where their prices are quoted or which provide the data for their valuation;
- (c) the changes in the value of the exposures under a comprehensive set of risk scenarios referred to in Guideline 1 including all scenarios considered in the relevant modules or sub-modules of the standard formula by at least taking into account:
 - (i) the degree of symmetry among both exposures;
 - (ii) any non-linear dependencies under the scenario;
 - (iii) any relevant asymmetry of the behaviours in case of risk sub-modules where both upward and downward stresses are applied;
 - (iv) the levels of diversification of each respective exposure;
 - (v) any relevant risks not captured explicitly in the standard formula;
 - (vi) the whole distribution of pay-outs applying to the risk-mitigation technique.

1.11. The risk-mitigation technique should be considered to result in material basis risk where the above assessment does not provide sufficient evidence that the changes in value of the exposure covered by the risk-mitigation technique mirrors all material changes in value of the risk exposure of the undertaking.

1.12. Where the terms and conditions of a risk-mitigation technique specify a cap on the maximum loss protection as a proportion of the initial exposure, undertakings should apply the assessment only to the proportion covered by the risk-mitigation technique when determining whether the basis risk is material.

Guideline 3 - Insurance risk-mitigation techniques with no material basis risk

1.13. Before allowing for an insurance risk-mitigation technique in the calculation of the Solvency Capital Requirement with the standard formula, undertakings should identify whether reinsurance or special purpose vehicle arrangements

behave differently than the insurance policies of the undertaking under a comprehensive set of risk scenarios due to differences in terms and conditions.

- 1.14. Undertakings should consider basis risk arising from a currency mismatch to be material where the exposure covered by the insurance risk-mitigation technique is denominated in a different currency than the risk exposure of the undertaking, unless the currencies involved are pegged within a sufficiently narrow corridor or the fixed exchange rate is provided in the reinsurance contract.
- 1.15. If there is material basis risk stemming from a currency mismatch as referred to in paragraph 1.14, undertakings should not allow for the risk-mitigation technique in the calculation of the Solvency Capital Requirement unless the provisions of Article 86 of Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC³ apply.

Compliance and Reporting Rules

- 1.16. This document contains Guidelines issued under Article 16 of the EIOPA Regulation. In accordance with Article 16(3) of the EIOPA Regulation, Competent Authorities and financial institutions shall make every effort to comply with guidelines and recommendations.
- 1.17. Competent authorities that comply or intend to comply with these Guidelines should incorporate them into their regulatory or supervisory framework in an appropriate manner.
- 1.18. Competent authorities shall confirm to EIOPA whether they comply or intend to comply with these Guidelines, with reasons for non-compliance, within two months after the issuance of the translated versions.
- 1.19. In the absence of a response by this deadline, competent authorities will be considered as non-compliant to the reporting and reported as such.

Final Provision on Reviews

- 1.20. The present Guidelines shall be subject to a review by EIOPA.

³ OJ L 12, 17.01.2015, p. 1-797