	Comments Template on Discussion Paper on the review of specific items in the Solvency II Delegated Regulation	**Deadline 3 March 2017 23:59 CET**
Name of Company:	CFO Forum & CRO Forum	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
	Please follow the following instructions for filling in the template: ⇨ Do **not** change the numbering in the column "reference"; if you change numbering, your comment cannot be processed by our IT tool ⇨ Leave the last column empty. ⇨ Please fill in your comment in the relevant row. If you have no comment on a paragraph or a cell, keep the row empty. ⇨ Our IT tool does not allow processing of comments which do not refer to the specific numbers below. **Please send the completed template, in Word Format, to CP-16-008@eiopa.europa.eu** **Our IT tool does not allow processing of any other formats.** The numbering of the questions refers to the discussion paper on the review of specific items in the Solvency II Delegated Regulation.	
Reference	**Comment**	
General Comment	Rather than address all the topics raised in the discussion paper and related questions the Fora has identified priority topics and has focused on these as follows within our response. With regard to the priority topics identified, we would like to highlight the following key issues: *Risk Margin* We believe that the current specification of the Risk Margin is inappropriate, in particular	

for long-term life insurance business. This has been especially evident in the current low interest rate environment, where changes in interest rates have caused excessive balance sheet volatility. Our detailed comments outline our proposals to amend the calculation of the Risk Margin, in particular:

1) A more appropriate (lower) cost of capital rate that recognises that insurance risks should be expected to have a low beta; and,

2) A time dependent scaling factor to the Risk Margin calculation to take account of risk dependence over time.

Loss Absorbing Capacity of Deferred Taxes (LACDT)

In 2016 the CRO Forum formed a working group to produce the Industry Paper "DTA in SCR". This paper developed best practice for recoverability testing of DTA in the SCR and was published on the CROF's website (http://www.thecroforum.org/dta-in-scr/). Our detailed response is based upon the statements published in this paper.
We consider that the calculation of deferred tax liabilities (DTL) and deferred tax assets (DTA) is a straightforward application of the principles contained in IAS 12. The calculation of LACDT needs to reflect the particular circumstances of the relevant entity and the tax rules of the territories in which the entity operates. This reflects the normal on-going management of an entity's tax positon. We do not believe that this introduces any unnecessary subjectivity in the calculation of LACDT and do not consider that any additional regulation, guidance or simplification is required. We consider that the suggested simplifications (in particular the suggestion that LACDT should be limited to the amount of the net deferred tax liability) are wholly inappropriate. They do not reflect the reality of a strong, diverse and resilient European insurance industry that has amply demonstrated its ability to withstand and adapt to substantial stresses (not least in the

recent credit crisis).

USP and GSP on Underwriting Risk

We strongly believe the Solvency II regime should allow for all risk mitigation techniques (re)insurers apply as part of a sound risk management policy. This would be consistent with the SII Directive. While USPs have been introduced to address issues with the recognition of non-life non-proportional reinsurance, we feel the current design of USPs make it complex and burdensome. A greater concern is that USPs currently fail to capture major types of non-proportional reinsurance, such as stop loss, reserve risk, facultative covers or any non-proportional reinsurance with a specific structure. Therefore, we think that alternative options to USPs are needed, which we believe can be achieved in a simple way without adding complexity. We propose a straightforward adjustment to the standard formula that would capture the risk mitigation impact of any non-proportional reinsurance. It would be calculated based on a scenario based approach which is the same to that used for reinsurance under the Life and the Non-Life Cat modules. We consider this would also make the standard formula more consistent.

Volume measure for Premium Risk

We consider there to be two issues with the definition of the volume measure for premium and reserve risk, which make it inconsistent with the rest of the Solvency II framework and less risk sensitive.

1) It fails to identify future premiums correctly (as recognized in the discussion paper). We believe this can only be fixed in a consistent and justified manner if

the same premiums are also considered for the own funds.

2) It does not allow the recognition of reinsurance in the first year because it is based on the larger of the last 12 months and future 12 months of net earned premiums. We believe this was not the intention of the volume measures, and therefore we suggest the Delegated Acts are changed to allow the calculation of the volume measure as though the reinsurance contracts were in place during the last 12 months.

Risk-mitigation techniques

We believe it is important that Solvency II supports all risk-mitigation techniques, independent of the type and form, to avoid creating the wrong incentives and ineffective solutions. We observe increasing interest in solutions designed to mitigate reserving risk, which has become a larger contributor to the overall required risk capital under Solvency II's risk based regime compared to Solvency I. As an example, products such as Adverse Development Cover and Finite Reinsurance (considered by the IAIS to be the most widely used product to provide alternative risk transfer solutions) meet all qualitative requirements of a risk-mitigation technique, as set out in the Delegated Acts. However, they are not currently recognisable under Solvency II.

In addition please find below some additional specific comments on own funds and currency risk in particular.

Own funds

We believe there are fundamental differences between insurance and banking business models that justify some discrepancies in own funds eligibility criteria. We therefore consider for instance the differences in the way the Principal Loss Absorbency Mechanism (PLAM) applies to the two sectors to be justified, and would strongly encourage in the meantime EIOPA, together with key stakeholders, to sort out the write down / conversion mechanism requirement for insurers that does not work as intended.

Notwithstanding differences in business models, it is critical for insurers that there are no unjustified differences in clauses as hybrid debt is a legitimate and necessary source of financing and there is competitive risk that inappropriate restrictions imposed to the insurance sector and not to banks would make the sector unappealing to investors. It holds true in particular for the ban of extraordinary issuer call rights in the first five years post issuance that does not apply to banks.

With regards to your questions on the removal of the 20% limit for restricted Tier 1 own funds, we would not support the removal of the 20% limit and have doubt regarding the ability to define sensible features to make Tier 1 in the form of subordinated debt even more akin to equity. Nevertheless, any pro-cyclical consequences of the regulatory limit provisions should be duly considered and we believe temporary relief from Tiering limits to prevent cliff effects could be envisaged upon supervisory approval.

Currency Risk at Group level

With respect to the topic of currency risk at group level, we would refer you back to the CRO Forum's previous paper (http://www.thecroforum.org/currency-risk-under-solvency-ii/), where we set out the reasons why we consider the current approach to be

	inappropriate and creates the wrong incentives both with respect to risk management and policyholder protection as well as potential improvements that would mitigate these concerns.	
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Q3.11		
Q3.12		
Q4.1	**Longevity solutions** Longevity reinsurance creates benefits for cedants and reinsurers under Solvency II. In fact, longevity is a major risk capital driver under Solvency II, e.g. according to results from QIS 5 it has contributed 36% to the undiversified SCR for life insurance risk. Longevity exposure has also a considerable impact on the Risk Margin. As a reinsurer, we benefit from diversification with mortality exposure which is our major motivation to engage in longevity transactions. Overall, longevity swaps are in our opinion treated in an appropriate way under Solvency II where the risk mitigation impact of the reinsurance may be taken into account under the scenario based approach for longevity risk. **Reserve Risk Covers** Apart from the life solutions as explicitly mentioned by EIOPA, there are also trends affecting non-life reinsurance which is currently not sufficiently considered under the standard formula. For example, we observe increasing interest in solutions mitigating reserving risk which has become a major contributor to the overall required risk capital under Solvency II's risk based regime compared to Solvency I. Companies are particularly interested in Adverse Development Covers (ADC) which are an alternative way of transferring reserving risk; but which allow companies to effective manage the risk while maintaining liquidity and diversification. However, because the risk mitigating impact of an ADC is not recognised under the standard formula and has therefore largely been only implemented by companies using an internal model.	Public
Q4.2	**For each RMT mentioned in the answer to the question above:** 1) Reserve Risk / Adverse Development Covers (ADCs)	Public

o How do you define the RMT? Is there a legal definition?

1) A form of retrospective reinsurance in which the insurer cedes the claims development risk associated with policies from past underwriting periods. The reinsurer assumes the risk that the existing claim liabilities are deficient (i.e., reserve risk).

o How has the situation with respect to the RMT changed in the last years (in other words, what is "recent")?

1) With the introduction of Solvency II non-life reserve risk has become a major risk capital driver, in particular for insurers that write long tail lines of business such as general third party liability. ADCs effectively address companies' reserve risk mitigation needs while maintaining non-life claims reserves on their balance sheets for liquidity and diversification reasons.

o What is the materiality of the RMT for your undertaking/for your country/in Europe (ideally measured based on notional and SII values absolute and relative to all assets)? How has the materiality changed over time?

1) According to EIOPAs report on QIS 5 more than 50% of non-life provisions of non-life undertakings relate to Motor third party liability (MTPL) and General Liability (annex to EIOPA's QIS 5 report), which might after diversification roughly make up around 30% of the SCR for premium & reserve risk SCR. Indeed, these segments typically make up a higher portion for many smaller companies which would largely benefit from proper recognition of ADCs as an effective risk mitigation on reserve risk.

o Why does the RMT not meet the conditions for the recognition of risk-mitigation

techniques for the standard formula calculation (please provide the specific legal provisions)?

1) N/A, because ADCs comply with the qualitative requirements for risk mitigations.

o Why do you consider that the RMT should be recognised despite not meeting all the requirements? Why is the risk from not meeting certain requirements sufficiently low?

1) N/A

o How would the requirements have to be altered to allow recognition of the RMT?

1) N/A

o What is the effect from not recognising the RMT in absolute terms as well as relative to the overall SCR and the capital requirement for the relevant module or sub-module on the level of your individual undertaking/your country/Europe? When quantifying please follow to the extent possible the standard-formula methodology and explain in detail your methodology.

1) N/A

o Why do you think that the risk-mitigating effect is not adequately reflected?

1) The risk mitigating impact of ADCs cannot be adequately reflected under the structure of the standard formula: The volume measure for reserve risk as defined under Article 116.6 of the Delegated Regulation is understood as the current net best estimate

	reserves (as of last financial year end). Any ADC providing coverage for adverse developments of incurred losses for the upcoming year (and thereafter depending on the contract terms) will not be taken into account. **o What is in your view the effect from this "non-adequate reflection" both in absolute and relative terms to the overall SCR and the capital requirement for the relevant module or sub-module on the level of your individual undertaking/your country/Europe? When quantifying please explain in detail the methodology.** 1) The following example demonstrates the impact of a typical ADC structure covering the MTPL segment. Assumptions and risk mitigation impact are summarised below:	

Net reserves MTPL:	100m
ADC 22m xs 105m, cession to the reinsurer:	70%
Retention:	5
Up-front premium:	15% rate-on-line (15% x 70% x 22m = 2.31m)
Add. premium paid in three years if the reinsurance is not commuted:	10% rate-on-line (10% x 70% x 22m = 1.54m)
Impact on the BOF of reserve risk scenario as defined under the SF:	3 * 9% * 100 = 27m
Impact on BOF reserve risk scenario after ADC:	22m * (100%-70%) + 5 + 1.54m = 13.14m (note: since up-front premium is paid at the inception of the reinsurance agreement, 2.31m would already be subtracted from the insurer's own funds)
Risk mitigation effect of the ADC:	**27-13.14 = 13.86m, i.e., 51% of reserve risk. This is not recognized under the current standard formula.**

O What change(s) would you propose?

1) Our proposed solution under Q 11.5 supports adequate recognition of all types of ADCs. The advantage of this solution is that it can also accommodate other types of

reinsurance that are currently not appropriately considered under the standard formula.

An alternative would be to amend Article 117 just to address the recognition of ADC transactions. For example:

4. For all segments set out in Annex II, the standard deviation for non-life reserve risk of a particular segment shall be equal to the product of the standard deviation for non-life gross reserve risk of the segment set out in Annex II and the adjustment factor for non-proportional reinsurance. For all segments set out in Annex II the reserve risk adjustment factor for non-proportional reinsurance shall be equal to:

NPres = (A – (B – C) x D) / A

- ***A**: Impact on the BOF of reserve risk scenario as defined under the SF = Nominal best estimate net reserves x Standard deviation for non-life gross reserve risk of the segment x 3*
- ***B**: ADC recovery under reserve risk scenario = The lower of the following:*
  - *Nominal best estimate net reserves covered by the reinsurance structure x (1 + 3 x $\sigma_{res,s}$)) – Reinsurance structure attachment point*
  - *Reinsurance structure cover size*
- ***C**: Additional reinsurance premium or the equivalent thereof*
- ***D**: Cession to the reinsurer in %*

2) Recognition of finite reinsurance

	As a framework based on sound economic principles, Solvency II should give priority to substance over form. Finite reinsurance is defined in the Solvency II Directive (article 210) as "reinsurance under which the explicit maximum loss potential, expressed as the maximum economic risk transferred, arising both from a significant underwriting risk and timing risk transfer, exceeds the premium over the lifetime of the contract by a limited but significant amount, together with at least one of the following features: a) explicit and material consideration of the time value of money; b) contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer". Article 208(2) of the Delegated Regulation states that finite reinsurance contracts shall be recognized in the scenario based calculations of the standard formula underwriting risk modules (Non-Life/Life/Health) only to the extent underwriting risk is transferred to the counterparty of the contract. However, finite reinsurance, or similar arrangements, where the lack of effective risk transfer is comparable to that of finite reinsurance, shall not be taken into account for the purposes of determining the volume measures (Article 116 and 147 of the Delegated Regulation) for non-life and NSLT health premium and reserve risk or of calculating (USPs) "in accordance with Section 13"). The concept of risk transfer is not defined in the Directive or the Delegated Regulation (for instance, article 210 of the Delegated Regulation, on "effective risk transfer", does not explain the concept of risk transfer). There is a risk that the appreciation of the reality of risk transfer becomes highly subjective and formal, based on the qualitative analysis of the details and specific features of the contract (e.g. profit sharing arrangements or commissions, multi-year agreements…), instead of considering if the risk exposure of the	

	ceding company will effectively be quantitatively reduced. As stated in the IAIS 2012 report on reinsurance and financial stability, risk transfer transactions, typically known as "finite reinsurance", is "the most widely used product" amongst alternative risk transfer techniques and "supervisors test it for substance over form, requiring a significant amount of risk transfer in conjunction with appropriate disclosure mechanisms". The current Solvency II treatment is not consistent with an appropriate recognition of the potential risk mitigating impact of finite reinsurance contracts. Finite reinsurance should be appropriately treated as a risk mitigation technique. Finite reinsurance contracts should not be systematically excluded from being recognizable in the calculation of the non-life and other risk modules, but allowance should be given to the recognition of that contract to the extent risk is transferred under such transactions. Moreover, structured reinsurance contracts should not be automatically considered as finite reinsurance and disregarded based on formal considerations of the structure of the deal, without consideration of the reality of the risk transfer involved.	
Q5.1	Whilst the proposed changes of the definition of the volume measure addresses an inconsistency with recognition of future premium it does not address inconsistent treatment between the premium being recognized for the SCR calculation with the premium used for the calculation of own funds. Both should be the same. Therefore, we believe that the proposal from EIOPA should be modified in order to provide a consistent vision with regards to risk calibration. Furthermore, we would like to note that the proposal of EIOPA increases the capital requirement for non-life activities whereas it was already the case through the launch of	Public

Solvency II comparing to Solvency I for several non-life insurance activities.

According to the current definition of $FP_{(future,\ s)}$, only the premium earned after 12 months after the inception date should be considered. In our opinion, this part of the definition was motivated by the will to avoid double counting of premium from the new business which is also captured by P_s. However, the way it is articulated, excludes not only the part of the premium that could possibly be double counted by P_s and $FP_{(future,\ s)}$ in the modelled year (marked with *x* on Figure 1), but also additional part, depending on the exact date of the inception (marked with *y* in the example). We cannot see any reason at first sight of excluding this additional part.

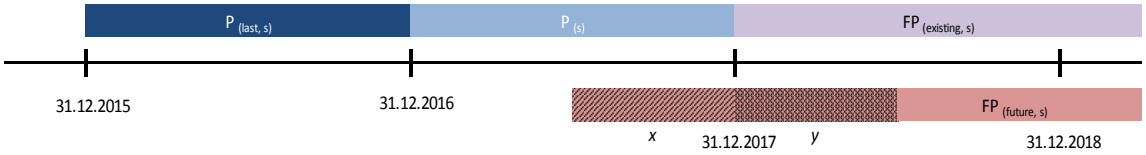

Figure 1: Illustration of the premium risk volume measure (as at calculation date 31.12.2016)

At the same time, we would like to point out that while the corrected definition would fix the current technical problem, it fails to address some more general issues that currently lead to an overstatement of risk:

- There is a mismatch of the treatment of the new business, which is currently included for the risk charge calculation but ignored on the own funds side where the boundaries of contracts do not allow to account for it. More details on this can be found in our answer to question Q5.2.
- Reinsurance may not be taken into account in the first year after inception. We

	include a concrete proposals in our answer to Q 5.5. • Furthermore, the proposal from EIOPA doesn't take into account management actions, in particular, the ability for the insurer to adapt its pricing strategy before accepting new business or renewals. Therefore it overstates the Value-at-Risk over a one-year period as referred to by Article 101.3 of the Solvency II Directive by considering business that might not be written depending on the market development and taking into account additional premium to be earned in the year N+2 (which is currently excluded). Therefore, in particular for changes affecting the premium measure, future premium from 1-year contracts should be excluded, which would be in line with article 101(3) of the Solvency II Directive. • We think that the current definition is also not consistent with Article 105 of the Directive which defines non-life premium and reserve risk as the risk of loss, or of adverse change in the value of insurance liabilities, resulting from fluctuations in the timing, frequency and severity of insured events, and in the timing and amount of claim settlements. However the current definition is based on commercial premium (including profit margins) instead of risk premium and does not take into account the loss absorbing impact of variable commissions. We make concrete proposals as included in our answer to Q 5.5.	
Q5.2	<u>Consistent treatment of future premium for SCR calculation and own funds recognition</u> We think that any solution should ensure that future premium is considered in a consistent manner for the purpose of defining the volume measure for premium risk which is used for the calculation of the SCR and future premiums being recognized for the calculation of own funds according to the application of contract boundaries. Under EIOPA's proposed method, additional premium from future business would be counted	Public

for the premium risk volume measure but will not be included for the calculation of expected profit from future premium (EPIFP).

As long as the definition of the contract boundaries remains unchanged (which does neither consider premium of expected new business nor the real life time of the contracts) an expansion of the definition of future premiums for the volume measure will just increase imbalances. We believe that already the current approach includes an unjustified asymmetric treatment between capital requirements (inclusion of new business expected to be written during the following 12 months) and future profits recognized in the own funds (exclusion of the former), that should be addressed.

Exclusion of profit margin

According to Article 105 of the Directive, we can infer that non-life premium risk could be defined as the risk of loss, or of adverse change in the value of insurance liabilities, resulting from fluctuations in the timing, frequency and severity of insured events which is not adequately reflected under the current definition. We use the following example to demonstrate the impact/

Example: Two companies, A and B, are launching the same product with estimated claims and expenses of 100 m.u. with the same volatilities of claims and expenses. Company A fixes a premium of 200 m.u. for this product while company B requires a premium of 105.

In this example it is evident that the risk that the premium is not sufficient to cover claims and expenses is much higher in B than in A. According to current definition of the volume measures, linked to premiums instead of claims and expenses, A is required to hold almost the double capital requirements than B while the risk is much lower. This is because the

	expected profit margin is included in the volume measure.	
Q5.3	Rough estimations show that the correction of the definition would result in a significant increase of the Non Life and Health NSLT Underwriting risk in the range between 3.5% and 13% (based on an estimation of 7 P&C or composite insurance companies as described below) and around 30% for a company where a large part of the portfolio has tacit renewals on 1st January without any significant difference in the risk born by the company over a 1-year horizon. The increase largely depends on the company and its written business. Generally more affected are companies with higher share of the motor business in their portfolios. In motor business, mostly short term contracts are in force and hence changes within this short contract life time have more significant impact than they would have in lines of business with multiyear contracts. Note: The estimation has been performed by using two alternative versions of the FP(future, s) within the Non-Life and Health NSLT risk modules and comparing their results: 1. From the new contracts expected to be written in the modelled year (2017 in the example) *only half of the premium* to be earned in the next calendar year (2018) is considered. Assumption: the new contracts are incepted on average in the middle of the modelled year (2017). This assumption can overestimate the effect in case the contracts are written earlier than in the middle of the year or underestimate if they are tendentiously written in the second half of the year. This version corresponds to the current definition of the FP(future, s).	Public

	2. From the new contracts expected to be written in the modelled year (2017) *the whole premium* to be earned in the next calendar year (2018) is considered. This version corresponds to the alternative definition of the FP(future, s), suggested by EIOPA in Q5.1. The estimation was based on a sample of 7 P&C or composite insurance companies.	
Q5.4		
Q5.5	<u>Proposal for recognition of Reinsurance in the first year after inception</u> As the standard formula's premium volume measure is based on the larger of the last 12 and future 12 months of net earned premium (NEP), a rigid interpretation would not allow to take into account any new cession or increase in cession, e.g. of quota share reinsurance, in the first year. We do not consider that this disallowance for reinsurance was intended when the volume measure was designed. We would therefore propose a simple change to Article 116(5) to include: "Where P(last, s) is higher than Ps due to the insurance or reinsurance undertaking extending or entering into new reinsurance contracts, P(last, s) should be calculated as though the reinsurance contracts were in place during the last 12 months." <u>Proposal for exclusion of profit margin and consideration of loss absorbing effects</u> The volume measure should exclude the profit margin expected to be earned that is not recognized in the balance sheet. As premium risk covers fluctuations in the timing, frequency and severity of insured	Public

events, only expected claims (cost of insured events) should be included in the volume measure. Following a prudent approach the fluctuations of expenses are also included in the proposal below.
Accordingly, we propose the following definition of the volume measure for premium risk to be incorporated in article 116:

2. For all segments set out in Annex NLUR1, the volume measure for premium risk of a particular segment *s* shall be equal to the following:

$$V_{(prem,s)} = CS_{(esisting,s)} + CS_{(future,s)} + FCS_{(existing,s)} + FCS_{(future,s)},$$

where:

(a) $CS_{(existing,s)}$ denotes an estimate of the claims and expenses corresponding to existing premiums to be earned by the insurance or reinsurance undertaking in the segment s during the following 12 months;

(b) $CS_{(future,s)}$ denotes an estimate of the claims and expenses corresponding to future premiums to be earned by the insurance or reinsurance undertaking in the segment s during the following 12 months;

(c) $FCS_{(existing,s)}$ denotes the expected present value of claims and expenses corresponding to premiums to be earned by the insurance or reinsurance undertaking in the segment *s* after the following 12 months for existing contracts;

(d) $FCS_{(future,s)}$ denotes the expected present value of claims and expenses corresponding to premiums to be earned by the insurance and reinsurance

undertaking in the segment *s* for contracts where the initial recognition date falls in the following 12 months but excluding claims and expenses premiums to be earned during the 12 months after the valuation date.

In addition, in order to appropriately reflect that not all fluctuations cause losses (e.g. due to variable commissions which may absorb the volatility of losses), we propose an amendment of article 115 to include the buffer of profit margin not recognised in the balance sheet. This is in order to consider that Expected Profits in Future Premiums corresponding to future business is not included in the Balance Sheet:

Non-life premium and reserve risk sub-module

The capital requirement for non-life premium and reserve risk shall be equal to the following:

$$SCR_{nl\ premium\ and\ reserve} = 3 \cdot \sigma_{nl} \cdot V_{nl} - \text{PM}_{(\text{future},s)}$$

where:

(a) σ_{nl} denotes the standard deviation for non-life premium and reserve risk determined in accordance with Article NLUR4;

(b) V_{nl} denotes the volume measure for non-life premium and reserve risk determined in accordance with Article NLUR3.

(c) $\text{PM}_{(\text{future},s)}$ denotes the expected profit corresponding to future premiums corresponding.

We recommend that EIOPA should revise the definition of the premium measure for premium risk to address the above mentioned deficiencies. We note that there are various other issues with adequate recognition of future premium which might lead to an overstatement of risk compared to own funds. These should be taken into account for the

	overall calibration of premium risk.	
Q5.6	Recognition of Reinsurance in the first year after inception All standard formula users extending their reinsurance cover might be affected. For example, for a new quota share (proportional) cover the impact can be easily quantified based on the cession rate of the new quota share being applied to the volume measure for any segment covered under the reinsurance.	Public
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Q11.1		
Q11.2	Other standard parameters that could be considered to be replaced by parameters specific to the undertaking are the risk factors Q per peril and region in the Natural Catastrophe sub-module (refer to Annex VI to IX of the Delegated Regulation).	Public

Q11.3		
Q11.4	Rather than modifying the data criteria, a simplification of the USP application process would be welcomed. In particular when following one of the standard methods proposed in Article 220 of the Delegated Regulation. The current application process can be arduous, which in many cases, discourages undertakings to apply for USPs, even if the USPs would be more appropriate for their entities. For instance, a sufficient condition to implement the USPs could be to produce a confirmation from an internal validation team or, more rigorously, from an internal or external audit review that Article 219 is met. This could replace the need of a complete regulatory review upfront.	Public
Q11.5	Non-proportional reinsurance is used as predominant risk mitigation instrument for Non-life, which accounts for more than 50% of total non-life reinsurance premiums in major European markets. Its importance as a risk mitigation instruments becomes even clearer when looking at its impact under the 200 year event, where the risk mitigating impact (relative to the reinsurance premium) of a non-proportional cover is much higher than for a proportional cover. The standard formula doesn't recognize this difference, i.e. the adjustment factors for non-proportional reinsurance as currently implemented which are defined as 80% for only three lines of business are not appropriate in this respect. We support USPs as one way of improving the recognition of non-proportional reinsurance. However, we would like to highlight that these are quite complex and have limitations. Our major concern is that currently proposed methods fail to recognise many types of non-proportional reinsurance that are widely used like Stop Loss, Adverse Development, and Facultative Covers because these are excluded from the scope of "recognisable" excess of loss reinsurance as defiend in DA Art. 218 and the USP method does not work for them. Furthermore, they pose high demands on available data to make them effective, e.g. based on the credibility factor approach, and causes extensive burden	Public

	for the supervisory approval process (which focuses on assessing the data used to calculate the undertaking-specific parameters according to the relevant ITS on USPs). Data issues may be caused if portfolios have not been managed according to Solvency II segments in the past and due to business shifts. Additional assessments and documentation for the purpose of the approval process create effort and make USPs unattractive for companies. While we think that reliance on data could be addressed (within the USP method) by allowing the use of standard parameters for average loss ratios and standard deviations which could be calibrated based on market claims statistics without making it less risk sensitive to the reinsurance cover, the limitations wrt any other type of non-proportional reinsurance would remain and this gap needs to be addressed as well. Given above mentioned shortcomings, we propose an alternative option under the standard formula. This entails a straightforward adjustment to the formula for premium and reserve risk to address issues with recognition of non-proportional reinsurance. The adjustment ("*RM other*") would capture the risk mitigating impact of any non-proportional reinsurance cover that is currently not taken into account in the premium and reserve risk module. The adjustment would be calculated by the undertaking using a scenario based approach, using the same method as is already applied for the scenario based calculations for Life and the Non-Life Cat module. Non-proportional reinsurance should provide the same capital relief as proportional reinsurance if the undertaking can provide evidence that economic risk transfer towards the reinsurer is identical for the scenarios defined under the standard formula. The amended formula for the SCR for premium and reserve risk in Article 116 of the Delegated Regulation would look like:	

	• *SCR_nl_prem_res = 3 * sigma_nl * V_nl – RM_other* • *RM_other* denotes the risk mitigating effect on premium and reserve risk of reinsurance arrangements that meet the requirements of Articles 209, 210, 211 and 213 but for premium risk excluding reinsurance premiums referred to in Article 116(5) (a), and that otherwise have not been reflected in the standard formula. It shall be calculated as the risk mitigating impact of the reinsurance on a change in basic own funds that would result from an instantaneous loss in the amount of 3 * sigma_nl * V_nl. We think that the calculations to be performed for RM_other are not more complex than other calculations as required under the standard formula which are under the governance of the Actuarial Function (DAs Art. 272 and Article 48(1)(g) of the Directive), i.e. in particular with regard to Reinsurance, for which DAs Art. 272 (7) foresees that the Actuarial function should analyse the adequacy of the overall reinsurance arrangements, including the expected cover under stress scenarios. The solution would also effectively address current issue's with Undertaking Specific Parameters caused by the reliance on historic data because under the scenario based approach the risk mitigation impact of the reinsurance will be assessed in the context of the effect of a well defined scenario on a forward-looking basis.	
Q11.6		
Q11.7		
Q11.8		
Q11.9		
Q12.1		
Q12.2		
Q12.3		

Q12.4		
Q12.5		
Q12.6		
Q12.7		
Q13.1		
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Q13.6		
Q14.1		
Q14.2		
Q14.3		
Q14.4		
Q14.5		
Q14.6		
Q14.7		
Q14.8		
Q14.9		
Q14.10		
Q14.11		
Q14.12		
Q15.1	With respect to the topic of currency risk at group level, we would refer you back to the CRO Forum's previous paper (http://www.thecroforum.org/currency-risk-under-solvency-ii/), where we set out the reasons why we consider the current approach to be inappropriate and creates the wrong incentives both with respect to risk management	Public

	and policyholder protection as well as potential improvements that would mitigate these concerns.	
Q15.2		
Q15.3		
Q15.4		
Q16.1		
Q16.2		
Q16.3		
Q16.4		
Q16.5		
Q16.6		
Q16.7		
Q16.8		
Q16.9		
Q17.1		
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Q17.3		
Q17.4		
Q17.5		
Q17.6		
Q17.7		
Q17.8		
Q17.9		
Q17.10		
Q17.11		

Q17.12		
Q17.13		
Q17.14		
Q17.15		
Q17.16		
Q18.1	In 2016 the CRO Forum formed a working group with the motivation to gather experts to share knowledge across the industry and develop a best practice approach for the recoverability testing of DTA in SCR. The working group summarized its outcome in an Industry Paper called "DTA in SCR" that is published on the CROF's website. The comments to Q18.1-Q18.16 are elaborated based on the statements given in the industry paper. The calculation of deferred tax liabilities (DTL) and deferred tax assets (DTA) in the SII balance sheet is a straightforward application of the principles contained in IAS 12. The following topics should be considered for LAC DT calculation: - Automatic reversal of DTA: In case DTA's underlying deductible temporary differences reverse in the future without negatively impacting future taxable income, no taxable income is necessary to prove the recoverability of automatically reversing deductible temporary differences. For example it can be assumed that DTA on Risk Margin or on losses related to HTM assets will reverse automatically with the ending of the insurance contract or with the repayment of the bond at due date. - Sources of taxable income: For DTA recoverability testing all sources of taxable income can be taken into account: o Tax groups or other tax specialties allowing taxable income consolidation and transfer of taxable income between the members of a tax group/consolidation	Public

	vehicle have to be considered when analysing existence of future taxable income. o Taxable income can be sourced by business in force and new business	
Q18.2	The assumptions on the returns on assets and liabilities should be realistic and reasonable. Available market information and experiences from the past should be taken into account when assessing the return on assets. A general assumption that return on assets have to be calculated based on a risk neutral assumptions is not in line with reality.	Public
Q18.3	The uncertainty in the returns of assets in the calculation of the LAC DT is already considered in the market consistent valuation of assets at the calculation date. The return on assets over the duration of the existing business is stable and certain and there is no need to make any adjustment for uncertainty. Over time, economic taxable profits will be realised, which can be used to recover notional deferred taxes. These future profits are expected from earning an investment margin on invested assets over and above the discount rate included in the Solvency II balance sheet and funding costs. We do not consider that it would be appropriate to limit the expected return to the shocked risk free rates.	Public
Q18.4	As a principle, the recoverability testing of DTA has to be based on the future taxable income calculated in compliance with the company's applicable tax code and taking into account the reversals of existing temporary differences. According to IAS 12, the future taxable income has to be adjusted (increased) by deductible temporary differences which reverse and therefore reduce taxable income. Additionally, future taxable income leading to new deductible temporary differences has to be eliminated . In order to assess, which existing deductible temporary differences reverse and which new deductible temporary differences arise assumptions of how tax and economic income will develop in time and impact the reversal of temporary	Public

	differences need to be made. To avoid an assumption based approach it is possible to offset the gross DTA which have to be proven to be recoverable (not the ones which will reverse automatically without impacting taxable income) with existing DTL. This approach would be in line with IAS 12.29a and IAS 12.75 implying that a scheduling of the timing of the reversal of each temporary difference is not required. For the potentially remaining net DTA it is sufficient to take into account as future taxable income the future economic profits from new business adjusted by permanent differences. Additionally, when taking net DTA as a basis and taking future economic benefits as equivalent for future taxable income, it is ensured that future taxable income reflected in DTL MVBS is not taken into account twice. When calculating future taxable economic profits, it is possible to take economic business values instead of economic P&L's. This is in line with the valuation principles and in consequence with the calculation of DT in the MVBS (base case). When calculating the LAC DT itself not all losses from the shock will materialize in tax losses. Depending from the respective local tax regulation, some shock losses will trigger real tax losses, some will only trigger deductible temporary differences. With respect to emerging deductible temporary differences there are some which will trigger real tax losses in the future upon reversal and some which will not trigger real tax losses in the future (e.g. Risk Margin, HTM assets, see point 18.1). Nevertheless, all DTA resulting from the shock loss, either resulting in DTA on tax loss or in DTA on temporary differences result in LAC DT based on the balance sheet approach underlying IAS 12.	
Q18.5	Taxable income stemming from new business, which is not yet reflected in the MVBS/stressed MVBS has to be considered because even after a shock new business and in consequence taxable income will be available based on going concern assumptions. In	Public

	order to reflect the impact of the shock on new business, new business prospects should take into account the impact that the stressed environment has on the sale volume and returns of new products. E.g. the return of P&C products are less affected by interest rate volatility, and there may even be an increase in premium rates and profitability following large P&C loss events. For life business the impact of revised product design on returns need to be assessed at is likely that loss experience will be compensated by the design of new products. In addition, when taking account of new business in the calculation of the LAC DT, a fundamental consideration is the extent to which the relevant business would be able to recoup the shock loss and hence be able to write new business. This requires consideration of the basis on which the business in question can take management actions to improve its capital position (including whether it can be recapitalised). We expect that the European insurance businesses would take appropriate management actions (including if necessary recapitalisation) following a shock loss. We do not consider that it would be appropriate to assume that the whole of the European insurance industry would go into run-off and be unable to write any new business. There is empirical evidence available to demonstrate that following large losses, insurance capacity is reduced resulting in increasing premium rates and hence a recovery in insurance profitability. Some level of new business must therefore be assumed, based on appropriate management actions (including recapitalisation). Consideration of profitability levels post SCR event can be based where possible on historic experience (e.g. industry reaction to past CAT events).	
Q18.6	- New business projections before shock as basis for taxable income - New business projections after shock for taxable income o Going concern assumptions	Public

	○ Impact of shock per risk source ○ Recovery patterns (e.g. premium increases after a loss event, reversal of market shocks) ○ Appropriate Management reactions (product change and corresponding profitability, cost reduction, etc.)	
Q18.7	An arbitrary time limit on the time horizon should not be imposed as this does not reflect reality. In addition, the time horizon must also reflect the local tax regulations in the relevant jurisdiction. For example, in certain jurisdictions losses may expire, but in other jurisdictions the tax deduction arising from a loss may be delayed (for example until payments are required to be made to policyholders).	Public
Q18.8	Please refer to Q18.7.	Public
Q18.9	Although limiting the LAC DT to the amount of net DTL is a conservative and simplified approach, in normal circumstances it would be considered to be inappropriate: 1) It does not comply with current Solvency II and IFRS legislation. Article 207 of Commission delegated regulation (EU) 2015/35 states that (…)The adjustment for the loss-absorbing capacity of deferred taxes shall be equal to the change in the value of deferred taxes of insurance and reinsurance undertakings that would result from an instantaneous loss (…)deferred taxes shall be valued in accordance with Article 15(…). In Article 15 a further reference is made to Article 9 entailing that deferred taxes are to be recognised in accordance with IFRS as adopted by the European Commission. In IAS 12.24 it is stated that (…) a deferred tax assets **shall** be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available (…) (*emphasis added*).This probability assessment is also part of Article 15 and Article 207: (…) deferred tax assets are only to be recognised if the insurer is able to demonstrate that future profits will be available (…). So if and only if it is not probable that taxable profits will be	Public

	available, the LAC DT can be limited to the amount of net DTL. 2) It contradicts the idea of a going concern. Setting the LAC DT to the amount of the net DTL effectively assumes that no future returns on assets and liabilities would be earned, and no future new business would be written by the business in question (and by extension the whole of the European/EU industry 3) The net DTL does not necessarily reflect the true future taxable income against which the shock loss can be offset. The net DTL may reflect DTAs that will reverse in the future without negatively impacting future taxable income (e.g. reversal of Risk Margin and spreads). Therefore, to limit the LAC DT to the amount of net DTL would only be appropriate if the net DTL reflects the future taxable profits of a run-off business.	
Q18.10	Please refer to Q18.9. No other issues should be considered.	Public
Q18.11	To calculate a post-shock Solvency II Balance sheet can be insightful in determining the effect of shocks on the carrying amount of assets and liabilities and tiering limits and in showing which part of the LAC DT will result in instantaneous taxable losses and which part is still deferred post-shock. It will help in assessing the recovery measures to be taken (to reach again 100% SCR post-shock) and assessing their effects and in determining the basis for the sources of future taxable results. However, as there are many uncertainties surrounding a post-shock Solvency II Balance sheet (for instance how to determine a post-shock SCR and how to distribute shocks to certain assets and liabilities in internal models) and the insights as described above can also be gathered differently, the creation of a post-shock Solvency II Balance sheet should not be prescribed.	Public
Q18.12	Please refer to Q18.13.	Public
Q18.13	Recapitalization (after breaching SCR or MCR) can be relevant to support future earning	Public

	capacity to support the LACDT. For example through assumptions of excess earnings on assets (recapitalization will generate excess return). Also this should prevent the need of other measures (like derisking) which would undermine the pull to par argument for the (larger part of the) spread shock. The possibility to make use of recapitalization should be in line with the recovery plan. In addition, we would promote an approach that, when planning the profits (post SCR event), there is consideration of the fact that there is potentially a longer period of SCR recovery allowed by the regulator, when it comes to industry wide events (Article 138 of S II Directive). A blended approach to determining the SCR recovery period could be applied taking into account whether company specific events or industry events are driving the SCR.	
Q18.14	No additional regulation, guidance or simplification is required.	Public
Q18.15	We do not promote a number of mandatory simplifications in the required tax modelling across the EEA. As the types of losses incurred will vary across firms and the fiscal regimes are country specific, an overly uniform approach could inevitably lead to unrealistic outcomes. The tax model and assumptions presented by individual firms should take into account such specificities and member state regulators should review if the proposed modelling fits for the individual firm, given its circumstances.	Public
Q18.16	The calculation of the LAC DT introduces significant elements of procyclicality because of the volatility of the differences between market value of assets and liabilities and the corresponding values that are recognized for tax purposes and that are more often linked to historical/acquisition or amortized cost. To limit its effect, it is important to avoid introducing methodologies or requirements characterized by rigidity or artificial	Public

	restrictions that would amplify the procyclical effect.	
Q19.1	We believe that the current specification of the Risk Margin is inappropriate, in particular for long-term life insurance business. This is true in general and has been especially evident in the current low interest rate environment. Please refer to our response to Q19.3 below, where we outline proposals to amend the calculation of the Risk Margin in a way which addresses this.	Public
Q19.2	The current low interest rate environment has resulted in excessive values of the Risk Margin, clearly demonstrating that the current Risk Margin calculation is excessively volatile with respect to interest rates. In our response to Q19.3, we discuss proposals which as well as resulting in a more appropriate Risk Margin for long term insurance business also reduce the sensitivity of the Risk Margin to interest rate movements. However, as well as these proposals, there are additional actions that we would suggest regulators consider taking to ensure the Risk Margin calculation is not pro-cyclical. One option for regulators to consider might be to undertake a formal regular periodic review of the CoC rate applied taking into account changes in the interest rate environment. This is in line with Article 77(5) of the Solvency II Directive which states that the Cost-of-Capital rate "shall be reviewed periodically". Alternatively, another option that we would suggest regulators consider further would be to make the Cost-of-Capital rate a function of the level of interest rates. This would reflect that in a low interest rate environment, we might expect market risk premiums to reduce as demand for higher yielding assets increases. Such a link between the CoC rate and interest rates is also considered and discussed in more detail under the context of frictional market effects in a previous (July 2008) CRO report[1]. This report found that the	Public

[1] See http://www.thecroforum.org/wp-content/uploads/2012/10/croforummvlpaperjuly2008.pdf.

	relationship between the CoC rate and the risk-free rate was approximately linear, with the CoC rate for a BBB-rated insurer increasing by 0.3%-0.4% for every 1.0% increase in the risk-free rate. The function linking interest rates to the CoC rate could either be currency specific or be based on a weighted average of currencies. The second option would be more aligned with letter of Article 77(5) of the Solvency II Directive which states that the Cost-of-Capital rate "shall be the same for all insurance and reinsurance undertakings" but would potentially be less effective at mitigating pro-cyclicality where different currencies' interest rates are not moving in step with each other. Whichever approach is used we would recommend using long term interest rates as a benchmark – e.g. the last liquid point –and that regulators consider the merits of applying a cap and floor on the overall level of the Cost-of-Capital rate to ensure changes in the CoC rate do not end up overcompensating for movements in interest rates. In this context regulators may also want to consider capping how much the CoC rate can change following a review in order that the CoC rate remains relatively stable over time.	
Q19.3	As discussed above, the current low interest rate environment has clearly demonstrated that the current calculation of the Risk Margin is inappropriate, and has introduced excessive balance sheet volatility with respect to interest rates. The excessive level of the Risk Margin also has macro-prudential implications as it encourages the transfer of longevity risk to non-EU jurisdictions which fall outside the remit of Solvency II, and harms consumers firstly by discouraging the provision of certain long-term products and by increasing the cost of provision, resulting in higher premiums. Finally, the excessive volatility with respect to interest rates discourages best practice in the matching of assets and liabilities, since a well-matched balance sheet will still be exposed to interest rate fluctuations via the Risk Margin in a material manner.	Public

In order to overcome these issues, we propose the following solutions:

- Derive a more appropriate (lower) cost of capital rate that recognises that insurance risks should be expected to have a low beta
- Take into account risk dependence over time by introducing time dependent scaling factor to the Cost-of-Capital calculation

These proposals will result in a more appropriate Risk Margin and will reduce the volatility of the Risk Margin to interest rates. We outline each proposal below.

<u>Proposal to take account of the beta value of insurance risk</u>

Investors provide capital to insurers to cover the required risk and will be expected to impose a cost for this in the form of a required spread above risk-free. For simplicity, we consider this in the context of a one-year risk, although this can be generalised to a multi-year context.

For a one-year risk, investors provide the non-hedgeable capital requirement on an insurance risk *i*. In return, they expect to receive the non-hedgeable capital requirement scaled up by the risk-free rate at the end of the one-year period. This however is a risky payment and hence gets discounted at the one-year risk-free rate r_f plus a premium s_i. Due to the higher discount rate applied, the present value of this risky payment will be lower than the SCR capital requirement, and the difference between the two is then the Risk Margin (RM_i):

$$RM_i = SCR_i - \overbrace{SCR_i(1+r_f)(1+r_f+s_i)^{-1}}^{PV(risky\ payment)}$$

[1]

The second term of this equation is essentially the price of a risky asset paying $SCR_i(1+r_f)$ in one year's time. We can see that the higher the discount rate r_f+s_i, the higher will be the RM.

One approach is to consider this equation in the context of the CAPM framework. Under the Capital Asset Pricing Model (CAPM) framework, the discount rate spread s_i will be a function of the market risk premium and the beta β_i of the risky payment:

$$s_i = \beta_i(E[r_m] - r_f)$$

[2]

where $E[r_m]$ is the expected return on the market portfolio.

The current formula for the Risk Margin on a one-year insurance product, as provided in the Delegated Acts, is as follows:

$$RM_i = CoC\frac{SCR_i}{1+r_f}$$

[3]

Putting these equations together, we can derive the cost of capital parameter with formula [4] below, for an insurance risk i:

(Equating [1] to [3])

$$SCR_i - SCR_i(1+r_f)(1+r_f+s_i)^{-1} = CoC\frac{SCR_i}{1+r_f}$$

(Replacing s_i with [2])

$$SCR_i - SCR_i(1+r_f)\left(1+r_f+\beta_i\left(E[r_m]-r_f\right)\right)^{-1} = CoC\frac{SCR_i}{1+r_f}$$

(Solving for CoC)

$$CoC = (1+r_f)\left[1-\frac{1+r_f}{1+r_f+\beta_i\left(E[r_m]-r_f\right)}\right]$$

[4]

For example, we can see that, for an asset with a zero beta, the cost of capital will be zero, and hence the RM will also equate to zero. Conversely, if we were to assume a market beta of 1 for insurance risk, we would recover a cost of capital rate consistent with discounting the risky payment at the full market risk premium.

We consider that a reasonable CoC rate for insurance risk is around 3% rather than the 6% currently used in Solvency II. A CoC rate of 3% can be determined based on assigning a market beta for insurance risk of 0.5, and a market risk premium of 6%:

- In the context of insurance risks, it is difficult to argue for a high beta value given the low systemic nature of insurance risk. For example, a comprehensive study by NYU Stern[2] found an unlevered beta (i.e. the beta of a company without any debt) for insurance companies of c. 0.65. However, this is influenced by the assets held in each insurer and its franchise value, which will have a high market beta – if we

[2] http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/Betas.html

were to consider the beta value of insurance risk only, this would naturally be lower, and likely to be significantly lower[3]. Hence, we consider an assumption of 0.5 for the insurance risk beta to be prudent

- We also need to consider an appropriate value for the global market portfolio risk premium. An appropriate upper level of risk premium for a diversified equity portfolio is likely to lie in the region of 5% - 7%[4], and this can be seen as an upper bound for a global market portfolio which also contains bonds and potentially property. On this basis, we can assume a market risk premium of 6%. We would note that we believe this assumption contains a material degree of prudence – our estimate of the equity risk premium is conservative and in practice, a global diversified market portfolio will contain assets other than equities, which would reduce the risk premium to a lower level.

Putting these assumptions together, a market risk premium of 6% and an insurance risk beta of 0.5 yield a cost of capital parameter of 3%, after rounding up[5]. This assumption of 3% is also consistent with the conclusions of previous work by the CRO Forum in 2008[6].

It is important to note that the beta of 0.5 and the CoC rate of 3% relate to the funding of non-hedgeable risk only, in line with Article 38(5) of the Delegated Acts which states that the assets held by the reference undertaking will be selected in such a way that they minimise the SCR for market risk. We also note that, working backwards, the existing

[3] Further background on why the cost of capital for insurance risks is significantly different from the total return required by shareholders is provided in section 3.4 of the CRO forum 2008 paper referred to above

[4] See for example a report by 2008 JP Morgan, available here: https://www.jpmorgan.com/jpmpdf/1320675769380.pdf, or more recently a 2013 report from Ibbotson, available here: http://www.healthinquiry.net/Public%20Submissions/Netcare%20Ex%20GH-. 75%20Ibbotson.pdf, which both support this. This is discussed in appendix D.4 of the 2008 paper.

[5] This holds for all risk-free interest rate assumptions.

[6] See http://www.thecroforum.org/wp-content/uploads/2012/10/croforummvlpaperjuly2008.pdf

Solvency II CoC rate of 6% would imply a beta for insurance risk of 1, which is clearly excessive.

<u>Proposal for the allowance for risk dependence over time</u>

The current approach for calculating the RM treats all future capital funding requirements as independent payments and does not take into account any dependency over time.

Any economic approach to valuing risky payments would have to take into account the dependence of risks over time to avoid inappropriate conclusions and arbitrage opportunities.

In our view, SCR capital requirements are not independent (e.g. a risk may be non-repeatable so if it crystallises in one time period it cannot reoccur, affecting forward SCR capital requirements). This means it is not appropriate to value these as independent payments, which is the assumption implicitly made in the current framework. Instead, when setting the hurdle rate required to finance a liability, an investor will consider the distribution of outcomes at maturity of the liability being financed[7].

In order to take this into account, we propose that the Risk Margin calculation is amended to include a tapering parameter with respect to time. This can be incorporated via an amendment to the Risk Margin formula, provided in Article 37(1) of the Delegated Acts as such:

[7] An alternative way to also think about this is that beta value of an insurance risk will reduce as a function of time, since the standard deviation of the final payment to investors will be lower than the standard deviation of the sum of equivalent independent payments.

	$$RM = CoC \cdot \sum_{t \geq 0} \frac{\lambda^t SCR(t)}{\left(1 + r(t+1)\right)^{t+1}}$$ where 0<λ≤1. In the amended formula, the parameter λ represents the proportion of SCR which is independent so that (1-λ) represents the proportion of the SCR which relates to non-repeatable risk. We consider 0.9 would be an appropriate value to assume for λ. This implies a modest reduction in SCR capital requirements of 10% following a 1-in-200 shock, which we believe is not unreasonable.	
Q19.4	<u>Diversification between business lines at group level</u> The current Solvency II framework does not make sufficient allowance for diversification between risks within an insurance company: - Diversification between life and non-life[8]: When calculating the Risk Margin of technical provisions an assumption is made that the life and non-life insurance obligations are taken over separately by two reference undertakings. This implies that no diversification benefit can be assumed between life and non-life insurance portfolios. We would propose that this arbitrary separation of obligations is removed in order that insurers are able to properly take into account insurance risk diversification effects when calculating their Risk Margin. - Group diversification: The Risk Margin at group level is calculated as the sum of the Risk Margins of the undertakings of the group. This implies that no diversification benefit can be assumed between different entities of a group. We would propose that this arbitrary separation of obligations is removed from the calculation in order that insurers are able to properly take into account group diversification effects when calculating their Risk Margin.	Public

[8] Where the business is managed in accordance with Article 74, of the Solvency II Framework Directive 2009/138/EC

	The above changes would be consistent with the reality of how insurance groups are managed in practice and the SCR treatment of diversification. They are also consistent with the assumption adopted in the most recent ICS specifications that have been tested. The excessive Solvency 2 approach creates unintended incentives for the industry to adapt their organizations in order to enable appropriate diversification and overcome artificial constraints. <u>Allowance for Matching Adjustment and Volatility Adjustment in the estimation of SCR values used in the Risk Margin formula</u> Under the current framework, insurers are required to estimating SCRs in the Risk Margin calculation by discounting liabilities at the basic risk-free rate, without taking into account the Matching Adjustment and Volatility Adjustment. This introduces additional complexity and is operationally burdensome for insurers. We therefore propose that the process of calculating the Risk Margin is simplified by removing this requirement and allowing the Risk Margin calculation to be based on a consistent valuation basis as the best estimate liabilities.	
Q20.1	While the analysis of the different regulatory texts is thorough (nb: *Solvency II Tier 2, page 86 of EIOPA-CP-16/008: "Payment cancellation in case of breach of SCR…". this should be payment deferral rather than cancellation*), it should be put into context of the broader regulation. Hence, the following important aspects should also be noted: ▪ <u>There is a significant risk that, in many jurisdictions, the insurance Principal Loss Absorbency Mechanism ("PLAM") leads to a reduction of the SCR ratio</u>. The insurance PLAM may not cure the trigger breach. In fact, both write-down and conversion can even lead to a **reduction** of the SCR ratio. Please refer to the answer to Q20.4 for a more detailed explanation.	Public

	▪ Bank regulators increasingly understand the importance of the hierarchy of capital: Bank regulators appreciate that not only equity, but also bank Additional Tier 1 ("AT1") are sensitive instruments that signal strength or weakness to investors. While bank regulators want to ensure early loss absorbency, they want to do it constructively by e.g. considering the hierarchy of capital with respect to distributions (AT1 coupons are to be preferred to equity dividends). With this in mind, we believe that a desirable insurance PLAM not only achieves loss absorbency, but respects the hierarchy of capital, and does not worsen the SCR ratio. ▪ Insolvency: The Delegated Regulation ("DR") effectively stipulates significantly tighter insolvency triggers than the Capital Requirements Regulation ("CRR"). For example, the DR requires that all of Restricted Tier 1 ("RT1"), Tier 2 ("T2") and Tier 3 ("T3") contain a mandatory coupon deferral (T2, T3) or cancellation (RT1) trigger as well as a mandatory redemption deferral (or prohibition of early calls) to avoid insolvency due to illiquidity or breach of the asset-liability test (where applicable). The CRR does not require any such triggers for Tier 2 or AT1, and only requires AT1 to be treated as equity for purposes of the asset-liability test. ▪ Absence of a meaningful and systematic definition of "loss": While principal and coupon "loss absorbency" are key requirements for Solvency II own funds instruments, there is no explicit definition of "loss". A "loss" that triggers PLAM, for example, occurs when capital requirements exceed own funds. However, this may occur at a time when no loss in its classical sense (e.g. under local GAAP or IFRS) has occurred. Similarly, it cannot be ruled out that such accounting profits coincide with a breach of the SCR/MCR ratio. Solvency II does not provide for a "market based" profit and loss account (only a Market Value Balance Sheet ("MVBS")), and a "loss" derived from such a profit and loss statement would not be a sufficient "loss" concept either	

	as it only explains a reduction of own funds, while own funds may fall even though the ratio increases (via an over-compensating reduction of the SCR/MCR). Accounting losses do play a role for RT1 coupon cancellation (available distributable items) and the write-up. In case of write-up, there is a clear asymmetry to the write-down which solely depends on a Solvency II ratio breach. We question that a sensible PLAM can be designed in the absence of a clear concept of "loss" – as well as a clear view on what "loss absorbency" really aims to achieve. In this context there should be a clarification that the concept of "loss absorbency" does not refer to accounting losses but undercapitalisation. ▪ <u>Temporary relief from Tiering limits to prevent cliff effects:</u> The current limit of RT1 at 20% of Tier 1 can have adverse amplification effects for insurers which can be meaningful due to the combination of significant investment portfolios and a substantially mark-to-market regulatory regime. Resulting problems can be resolved by explicitly allowing the limit to be breached during periods of elevated market volatility as such periods can impact insurers' own funds, and consequently the RT1 allowance, negatively. This would be in line with recent recommendations from the EBA with respect to the increased market volatility introduced by the new minimum requirements for own funds and liabilities eligible for bail-in (MREL). The comments in the final MREL Report regarding potentially negative consequences of coupon suspension also strongly support our view that the Solvency II coupon suspension trigger should not be raised.	
Q20.2	<u>Regulatory & tax calls</u> The other material and non-justified difference between the banking and insurance sectors is the difference identified on page 85 of EIOPA-CP-16/008. Under CRR, banks have the possibility of special event (tax, regulatory) redemption prior	Public

	to year 5, without funding it from the proceeds of the issuance of an own-fund item of at least the same quality, if they can "demonstrate … the own funds would exceed the capital requirement … by a sufficient margin". First call right – appropriate margin (RT1 – DR Art. 71(1)(g)): The CRR does not include a temporary limitation of bank AT1 call rights. Contrary to this, DR Art. 71(1)(g) theoretically foresees such a temporary limitation for RT1 instruments issued less than 10 (but more than 5) years ago. The age of an instrument should be irrelevant for the decision whether or not it is appropriate to call it. Art. 71(1)(g) DR should be replaced with more generally applicable approval EIOPA (Level 3) guidelines for regulators which could reference the respective issuer's level of the solvency ratio as well as its capital policy and plans. Recital on subordination (DR recital 127) *In order to ensure that the policy holders and beneficiaries of insurance and reinsurance undertakings belonging to a group are adequately protected in the case of the winding-up of any undertakings included in the scope of group supervision, own-fund items which are issued by insurance holding companies and mixed financial holding companies in the group should not be considered to be free from encumbrances unless the claims relating to those own-fund items rank after the claims of all policy holders and beneficiaries of the insurance or reinsurance undertakings belonging to the group*. The above recital lacks practical applicability and creates an unjustified unlevel playing field between Groups whose head is an insurance company as opposed to insurance holdings. We believe that recital 127 should be removed from the Regulation.	
Q20.3	Regulatory & tax calls We would suggest providing the same flexibility to Solvency II undertakings as is available	Public

	to banks; not just for changes to applicable tax rules but also for regulatory events. If there is a tax or a regulatory event it will be preferable for the undertaking to redeem the instrument in question. However, the entity may not require the current level of capital if it is already comfortably within the capital risk appetite. Being obliged to replace the redeemed instrument in order to maintain the previous (excessive) capital level would be inefficient, and incur unnecessary cost. It may also be that market conditions are not receptive, and the entity could be forced to issue a non-economically priced replacement instrument in order to remove an inefficient/redundant instrument. Indeed, if conditions were particularly challenging, it would not be able to replace the instrument and so it would not be able to redeem the redundant instrument. If the Solvency II rules were changed to align with those available to banks, any decision as to whether or not a redemption requires prefinancing would be subject to prior supervisory approval, so ensuring a sufficiently high quality of own funds can be maintained. Current Solvency II requirements do not give regulators this authority/flexibility. We reminded below CFO/CRO Forum previous answer to EIOPA-14/036 on Guideline 5 of the Own Funds section (comments #21 & 22). Please note some detailed comments or references may be outdated but main argumentation is still valid: *'We strongly disagree with the prohibition of extraordinary issuer call rights in the first five years post issuance – relevant paragraphs: No. 1.28, No. 1.29, No. 1.61 Explanatory Text for Guideline 18 No. 2.2 (p. 143/175), and Introduction No. 1.10. The wording prohibits call options prior to 5-years from the date of issuance, including for unforeseen changes. This is most likely explicitly set out to include calls for regulatory, rating agency and tax reasons and can be assumed to include accounting calls as well. We strongly disagree with this prohibition.*	

	Extraordinary par call rights can be very important for insurers, and it is not clear what the logic is for preventing an instrument that is deemed not to provide regulatory capital benefit from being efficiently replaced. It must be possible for insurers to redeem or replace instruments that have become inefficient (and thereby potentially disadvantageous) following an unforeseen change (e.g. in tax or regulatory law) that is outside the control of the issuer, and extraordinary call rights are designed to allow issuers to do that: *• Only a call right ensures that you can get rid of 100% of the "inefficient" instrument (exchange offers or tender offers hardly ever get investor participation rates of 100%, unless the price offered to investors is very high).* *• In addition, extraordinary call rights allow the issuer to redeem or to replace such instruments at an attractive price (typically at par) – note that extraordinary call rights represent an option for the issuer, hence such extraordinary call rights are always economically superior to the only other alternative to offload the inefficient instrument, i.e. a repurchase in the open market.* *Provision for regulatory calls is necessary and standard in the banking regulatory environment for example (Regulation N°575/2013 of 26 June 2013), since if for whatever reason (e.g. regulatory change or change in circumstances of the company) a hybrid debt was to be disqualified as regulatory capital, it would bring no advantage compared to senior debt but would continue to have a higher cost than senior debt. From an economic perspective it is therefore rational to call the debt and from a regulatory perspective there is, a priori, no disadvantage created by calling since the instrument no longer contributes to the solvency position.* *From a prudential perspective it would be beneficial to allow an early call of an instrument*	

	on a regulatory non-compliance event, subject to prior replacement with complying capital instrument. Contemplating allowing such a replacement via a liability management exercise, this exposes the issuer to substantial risks and will not create a full replacement, but not to allow a call, moreover increases the risk / costs / inefficiency for the insurers. *Further, extraordinary call rights which are subject to prior regulatory approval do not negatively impact the permanence of an instrument in a meaningful way. All extraordinary call rights (as well as the ordinary issuer call rights after 5 years) are (and should be) subject to prior regulatory approval, and in the large majority of cases, issuers will foresee the prior (or concurrent) replacement or (exchange) of the instrument to be called extraordinarily whenever such a replacement or exchange appears sensible from a medium capital management perspective.* *We can therefore see no sensible reason to generally prohibit extraordinary redemptions without re-placement in the first five years per se. As long as an insurer remains well capitalized after such an extraordinary redemption, the issuer should be allowed to redeem an inefficient instrument without being obliged to replace it with an instrument (such replacement bond would then be outstanding for at least another 8 years). Prohibiting extraordinary call rights primarily serves the interests of investors and forces issuers to maintain inefficient own funds for longer than necessary. Prohibiting extraordinary call rights does not improve the quality of the instruments. Prohibiting extraordinary call rights is an incentive to hold less own funds than without such prohibition.* *We therefore recommend that the Guidelines clarify the L2 text as follows:*	

	• Ordinary call rights that are exercisable solely at the option of the issuer and are not subject to prior changes in circumstances outside the control of the issuer are prohibited in the first five years from issuance. *• Extraordinary call rights for reasons beyond the control of the issuer are possible at all times, subject to prior regulatory approval. Such approval may either (i) not be granted at all, may (ii) be subject to prior or concurrent "equivalent" replacement, or may (iii) be granted without any condition.* *In any case, the extraordinary call together with an equivalent replacement as provided in Level 2 Article 71 (3) (previously Article 59 COF2 (3)) and Level 2 Article 73 (2) (previously Article 61 COF4 (2)) should remain possible.'*	
Q20.4	▪ **PLAM is not required by Basel 3 for equity accounted bank AT1:** While the CRR requires PLAM for European bank AT1, PLAM is not required in many non-European jurisdictions, notably the USA. The original Basel 3 paper only requires PLAM for IFRS debt accounted AT1 instruments (Basel Committee on Banking Supervision, "Strengthening the resilience of the banking sector", No. 89, criterion 11, December 2009). ▪ **The banking and insurance PLA Mechanisms are actually largely identical – and where they differ the insurance PLAM may be more severe:** The bank and insurance PLAM mechanics as defined by the CRR and DR both allow (or do not prohibit) a choice between temporary or permanent write-down and conversion. Both should lead to the same consequences (see Art. 54 No. 1(d) CRR which requires the reduction of (i) distributions, (ii) claim in liquidation and (iii) redemption amount for the banking PLAM). However, in practice, bank and insurance PLAM lead to rather different consequences. ▪ **The consequence of bank and insurance PLAM are different due to a combination of**	Public

factors: Despite identical mechanisms the PLAM impacts bank solvency ratios very differently to insurance ratios. This is mainly due to the following reasons:

- Scope of trigger – justifiable difference, but need to consider consequences for the insurance PLAM therefrom:
  Banking uses a Core Equity Tier 1 ("CET1") trigger (CET1 / Risk Weighted Assets ("RWA")), insurance uses a total capital trigger ((Unrestricted Tier 1 ("UT1") + RT1 + T2 + T3) / SCR). The bank (CET1) trigger ratio will always improve due to the PLAM. In insurance, the PLAM will always increase the amount of UT1 capital, too. In insurance, however, the key regulatory ratio is the SCR (total capital) ratio. Therefore, the insurance PLAM trigger is rightly based on the SCR (total capital) ratio. However, this trigger ratio can either improve, remain unchanged **or even fall** upon application of the PLAM (which we will explain further below). Bank AT1 allows the **mathematical limitation of the write-down** amount to the amount needed to cure the trigger breach. This is not possible in insurance. The need for multiple (group and solo, SCR and MCR) triggers makes it possible that the PLAM does improve one or more of the trigger ratios, but actually leads to the deterioration of one or more of the other trigger ratios at the same time, thus possibly even **leading to an additional trigger breach**.
  The differing scope of triggers in banking and insurance is justified by the different business models and the consequently differing regulatory regimes. However, it cannot be justified that, as a result of applying the bank PLAM without adjustments, the insurance PLAM may not lead to a cure of the trigger ratio, may therefore be unlimited and may even result in the breach of other ratios defined by the trigger.
- Role of DTA – justifiable difference, but need to consider consequences for the insurance PLAM therefrom:

Both known PLAM mechanisms (write-down and conversion) can lead to adverse tax effects, i.e. profits from PLAM can lead to (i) a reduction of DTA (and reduction of UT1/CET1), (ii) an increase of DTL (and reduction of UT1/CET1), or (iii) (least likely) an immediate tax expense (and reduction of UT1/CET1). Bank and insurance regulations require different treatment of deferred tax assets in own funds, and in insurance, net DTA can be added back to own funds as Tier 3, subject to a limit (15% of the SCR).
The MVBS requires that all balance sheet line items are marked-to-market. Consequently, the MVBS is very sensitive to such market changes, and therefore the inclusion of DTA as Tier 3 own funds (up to a limit) is both important and sensible. Assume that a PLAM results in a fall of DTA (and thus in an identical reduction of the insurer's reconciliation reserve). The reduction of the reconciliation reserves that results from tax on PLAM "profits" does not impact the amount of eligible UT1 since the amount of DTA that needs to be deducted from UT1 has also fallen. However, in insurance, a PLAM that reduces DTA may result in a reduction of eligible Tier 3, thus leading to a **fall** of total capital (i..e. eligible own funds) and the SCR (total capital) ratio. To the best of our knowledge such decrease in own funds and/or coverage ratio would not occur for banks. **It cannot be justified that the insurance PLAM can result in unintended consequences for the key Solvency II ratio, whereas the key solvency ratio for banks (CET1) always increases due to the bank PLAM.**

- The differences in how and to what extent DTA is recognised as capital, and what implications this has, including as regards the PLAM, may deserve to be further assessed. As a general point, the *allowance* for DTA as capital *may* be somewhat higher under Solvency II – however it is only admitted within the **lowest quality of capital for insurers whereas it may be recognised as the highest quality of capital for banks**. In contrast, the fundamental *role* for DTAs

is arguably much greater for insurers compared to banks.

- Level of Trigger – difference not justifiable: Coupon cancellation for bank AT1 is triggered upon breach of the so-called combined buffer, i.e. typically when the CET1 ratio falls below ca. 10%. Even this AT1 coupon cancellation trigger is considered more like a gone-concern trigger (i.e. within the lowest quartile of the buffer). In insurance, the DR foresees cancellation of equity dividends at the same time as cancellation of RT1 coupons (SCR breach), whereas in banking the prioritisation of AT1 coupons is now foreseen by the draft CRR. We also note that bank Tier 2 is non-deferrable at all, whereas insurance Tier 2 requires deferral upon the same trigger level as RT1 coupon cancellation. The bank PLAM trigger is breached when the CET1 ratio falls below 5.125% and is therefore generally considered a "gone concern" trigger. Even before a bank's CET1 capital ratio falls below the trigger ratio, it will be perceived to be non-viable. The corresponding "gone concern" trigger of insurers would arguably be the MCR rather than the SCR. Instead, the insurance PLAM is essentially triggered simultaneously with RT1 coupon cancellation (and even Tier 2 coupon deferral), leaving aside the three months cure period for the PLAM trigger. There is no reason why the insurance PLAM should apply so much earlier than the banking PLAM.

Furthermore, we reminded below CFO/CRO Forum previous answer to EIOPA-14/036 on Guideline 5 of the Own Funds section (comment #30): *'The write-down mechanism is, in our eyes, highly complex as it mixes (i) MVBS and regulatory measures (eligible capital valued in accordance with MVBS principles, SCR) and (ii) local GAAP measures ("distributable" items), and we would therefore suggest deletion from the Guidelines. The two concepts (MVBS, local GAAP) are radically different, much more so than in the banking space, which foresees a similar mix of concepts. It is not clear that this mix of*

	concepts leads to the intended consequences, and no analysis defending the suggested approach has been put forward. An SCR trigger breach can occur at a time when the insurer generates distributable items, and it is not clear why the write-up is limited to distributable items generated after the SCR breach.	
Q20.5	The banking and insurance sectors are very different: <u>Banks:</u> • Very reliant on continued access to liquidity, given that their business model typically uses shorter-term liabilities to finance longer-term assets. It will therefore be important to be seen to swiftly remedy any perceived capital shortfall to prevent any negative impact on liquidity access. • Banks will have a significantly greater amount of financial debt on their balance sheet (both subordinated and unsubordinated) than insurers. Standard leverage measures (ratio of debt to equity) are not a key consideration or constraint, therefore identifying the proportion of higher quality capital (e.g. through the CET1 ratio) is important. Given this necessary differentiation between the various levels of capital, the Principal Loss Absorbency Mechanism (PLAM) has an immediate impact for banks' solvency ratios. <u>Insurance undertakings:</u> • Typically insurance undertakings (particularly Life Cos) will have longer term liabilities (e.g. annuity and pension liabilities) backed by more liquid assets. Even if there is a capital shortfall, the insurance entity is likely to still be able to meet immediate obligations to policy holders. Given liquidity is not as critical a concern as it is for banks, insurers are under less time pressure to be seen to return to the required solvency level immediately, and therefore have time to undertake the necessary management actions to recover, as pre-agreed with their regulators.	Public

- Unlike banks, insurers do not typically have a significant amount of financial debt (subordinated or unsubordinated) on their balance sheets. An insurer's leverage ratio (ratio of debt to equity) is relevant for investors and analysts and there will be negative impacts on ratings and share price if an insurer is considered too highly levered. Insurer subordinated debt issuance is also further constrained by the capacity limits set by regulations – e.g. an insurer cannot flatter the overall solvency cover ratio through issuance of unlimited lower quality capital. These two constraints ensure that an insurer's own funds are of suitable quality. Differentiation between the various levels of capital is not relevant for insurers as this is already controlled through the capacity limits.

Full consistency between insurance and banking regulations is not a goal in itself as differences in business models between insurance and banking exist and should be adequately reflected justifying in our view some differences in respective regulatory regimes.

We understand that some stakeholders prefer a full (100%) write-down or conversion for insurance RT1 even though this is neither required for bank AT1, nor justified by the impact on the Solvency II ratio. While full consistency is not a goal in itself, we think that such a difference between bank and insurance PLAM cannot be justified. The fact that the trigger *level* itself is arguably higher in Solvency II than is the case for AT1 adds to the argument that the triggering *mechanism* (i.e. full vs limited write-down) should not (also) be more conservative. Further, we note that this would maximize the potential reduction of the SCR ratio in many jurisdictions described in our answer to Q20.4 above. Finally, it would turn the hierarchy of capital upside down (PLAM benefits equity investors at the expense of RT1 investors) even though the insurer could still be viewed as "going concern" – in addition to the problems with respect to investor hierarchy already present

	in Solvency II, in isolation as well as relative to AT1. Bank regulation increasingly reflects the importance of maintaining the hierarchy of capital, and insurance regulation should not explicitly disregard the hierarchy of capital either.	
Q20.6	▪ Insurance PLAM applies much earlier and has a much higher risk of worsening a crisis than its bank counterpart. Insurance regulation should avoid the flaws of both the current banking and insurance PLAM. ▪ **We suggest to follow the lead of non-European bank regulators to delete the PLAM requirement altogether while ensuring own funds classified as RT1 still meet highest requirements in terms of loss absorbency (via other means) and subordination. PLAM may well lead to unintended consequences and is not necessary, as even 100% loss absorbency could be achieved without it.** ▪ Designing a sensible PLAM or an alternative to it is very complex, not least because it must work across the relevant European jurisdictions. We would be happy and stand ready to engage in a well-structured, professional dialogue with EIOPA on this issue in order to define workable alternatives to the current PLA mechanism for insurers. The discussion would greatly benefit from an exchange of views with all relevant stakeholders including lawyers and banks with in-depth structuring and market experience. **Importantly though, a short term solution based on the current DR must be found, in addition to potentially more refined long term solutions that may be based on amendments of the DR as the Solvency II review process will take too long to be completed.**	Public
Q20.7	We consider it unjustified and wrong to have a difference between the two sectors in respect of changes to applicable tax rules. Please see the points made in our answer to Q20.3.	Public
Q20.8	This difference in treatment of a change in applicable tax rules is material and is not	Public

	justified by the differences between the two business models. Please see the points made in our answer to Q20.3.	
Q20.9	The differences described in Q20.7 and Q20.8 are not justified, and the Solvency II regulations should be amended to be consistent with those that apply to banks – not just for changes to applicable tax rules but also for regulatory events. The Insurance regulators should be given the same authority/flexibility as bank regulators. Please see the points made in our answer to Q20.3.	Public
Q21.1	We would not support the removal of the restriction on the use of transitional own funds as Tier 1 own funds.	Public
Q21.2		Public
Q21.3	The effect on total own funds coverage ratio would likely be zero for the vast majority of undertakings.	Public
Q21.4	We would not support the removal of the 20% limit. Further, we are skeptical about the ability to define sensible features to make Tier 1 in the form of subordinated debt even more akin to equity – RT1 as currently foreseen is already more risky than equity in several aspects as a consequence of the inversion of the hierarchy of capital. Rather than deleting the 20% limit, it should be maintained, and any pro-cyclical consequences of the regulatory limit provisions should be duly considered and we believe temporary relief from Tiering limits to prevent cliff effects could be envisaged upon supervisory approval (see our answer to Q.20.1).	Public
Q21.5	We would prefer to retain the 20% limit, in this way there is a clearer distinction between the features and pricing of the various forms of own-funds, e.g. Unrestricted Tier 1, Restricted Tier 1 and Tier 2 (and Tier 3). As explained above, the criteria for Restricted Tier 1 should be revised in order to avoid or at least mitigate unintended consequences, *inter alia* with respect to the impact on the Solvency II ratio, to avoid excessively punitive features (in isolation and relative to AT1), and in order to more appropriately respect	Public

	investor hierarchy.	
Q21.6	In terms of a market for such instruments, it is hard to say, given the lack of significant issuance to date.	Public
Q21.7		Public