	Comments Template on Consultation Paper on EIOPA's second set of advice to the European Commission on specific items in the Solvency II Delegated Regulation	**Deadline 5 January 2018 23:59 CET**
Name of Company:	Institute and Faculty of Actuaries (IFoA)	
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-17-006@eiopa.europa.eu** **Our IT tool does not allow processing of any other formats.** **The numbering of the reference refers to the sections** of the consultation paper on EIOPA's second set of advice to the European Commission on specific items in the Solvency II Delegated Regulation. Please indicate to which paragraph(s) your comment refers to.	
Reference	**Comment**	
General Comment	The standard formula has become a very complicated calculation. Most of the comments/ suggestions within the consultation consider areas where it can be simplified; however there are also suggestions which could increase the complexity of the standard formula. Proposed changes to aspects of the standard formula where it would increase in complexity need robust justification.	

	Any changes to the standard formula, including any improvements, may give rise to operational issues. Amending parameters (e.g. volatility factors within non-life underwriting risk) may be much easier to amend in calculations than changes to the calculations themselves (e.g. changes of exposure measure). EIOPA’s proposals in relation to the risk margin focus narrowly on whether the cost of capital rate parameter is consistent with market indicators. We believe the advice should be extended to address fundamental questions, including whether: • EIOPA believes that the risk margin in its current form affords policyholders an appropriate level of protection, or whether it is excessive; • EIOPA considers it desirable to incentivise firms to reinsure longevity risk, given the high risk margin that needs to be held if reinsurance is not sought versus the market cost of reinsurance; and • the risk margin incentivises firms to invest in a pro-cyclical manner due to the very high sensitivity to interest rates.	
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2.4.3	It is not clear from the calibration of the variability factors whether these will need to recalibrated to remain in line with any change in the definition of the premium measure. For general insurers with significant long term policies (e.g. extended warranty or creditor business), the current assumption that the variability at t=1 of the closing unearned exposure would be similar to the variability for exposure earned between t=0 and t=1 within the standard formula is potentially unreliable; it is also a significant limitation of the existing standard formula. The proposals to reduce the variability in relation to this exposure would be more representative of entities' capital requirements.	
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15.4.4	In the draft amendment to Article 84(3) 3, we think more clarity is required in what is meant by '...managed strictly according … to the last reported asset allocation'.	

	We suggest the following wording would make this clearer: ‘… managed strictly according … *to the stated objectives of the fund at the time of* the last reported asset allocation”.	
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18.1	The IFoA has considered the risk margin from the points of view of both long-duration life insurance products and general insurers with long tailed liabilities (such as annuity exposures arising from bodily injury awards), for which it is most significant. We note from paragraph 1388 that the scope of the call for advice was very broad, with EIOPA asked to ‘Assess if the methods and assumptions applied in the calculation of the risk margin continue to be appropriate.’ However, EIOPA’s proposed advice to the Commission focuses narrowly on whether the cost of capital rate parameter is consistent with market indicators. We would therefore urge EIOPA to extend the scope of its analysis of the risk margin. This should also include considering recent developments in IFRS financial reporting and the international capital standards being developed by the International Association of Insurance Supervisors: both of which permit a wider range of approaches to calculating the margin above best estimate	

liabilities, which may be more appropriate for long-duration business.

It is important to recognise that the risk margin methodology is a model for the cost of transferring risk to a reference undertaking. As such, it can only ever provide a simplified version of reality. It is therefore important to check whether the answer is sensible.

The proposed advice to the Commission is silent on whether EIOPA believes that the risk margin that results from the calculation affords policyholders an appropriate level of protection, or whether it is excessive. It also does not give EIOPA's view on whether it is desirable to incentivise firms to reinsure longevity risk and to invest in a pro-cyclical manner.

When considering policyholder protection, it is important to recognise that there is no 'correct' answer to the question of how much protection is appropriate. A larger risk margin will, all else being equal, result in greater protection than a smaller one. However, there is a cost to firms of holding the risk margin which will ultimately be passed on to customers in the form of less affordable insurance and savings products. It will inevitably be necessary for EIOPA and the Commission to strike a balance between these two factors.

The IFoA has two significant concerns relating to the risk margin methodology:

1. The requirement to hold a risk margin incentivises firms to reinsure certain underwriting risks to reinsurers outside of the EU. This can be seen in the significant increase in the use of longevity reinsurance since 2015.

   It is not clear that this incentive has been provided intentionally. There may be arguments that this behaviour enhances policyholder protection: for example, the reinsurers may be better placed to manage longevity risk owing to greater expertise, or to the ability to diversify it against mortality risk. However, reinsurance may also increase the risks faced by policyholders, since it means that longevity risk is being managed by entities which are not subject to EU regulation; it also potentially increases the interconnectedness of the

	financial system. A risk margin more consistent with the market price of longevity risk would reduce artificial incentives to transfer risks outside of the EU. We note that taking insurance business outside of the EU reduces the role of insurers in the EU economy as employers, investors and taxpayers. 2. The high sensitivity of the risk margin to changes in interest rates encourages firms to act in a pro-cyclical manner. This sensitivity of the longevity component of the risk margin is arguably artificial, given that is it significantly higher than the corresponding sensitivity of the market cost of reinsurance. Further, hedging creates conflict with both the Standard Formula SCR (where the risk margin is assumed to be fixed) and potentially financial reporting, so firms may not fully hedge this risk. As a result, if interest rates fall, firms' regulatory balance sheets will weaken, encouraging them to de-risk investments in order to reduce their SCR. This hampers insurers' ability to invest through the cycle.	
18.2		
18.3	The IFoA supports EIOPA's proposal to use a 'through the cycle' approach to setting the cost of capital rate. Basing the rate on market conditions at any single point in time runs the risk that market conditions will have changed by the time firms are actually required to raise capital. We would encourage EIOPA to further consider the proposal that the cost of capital rate should be linked to reinsurance pricing. This proposal would provide a more objective measure of the transfer value than the current risk margin methodology - which relies on a number of subjective assumptions. We fully appreciate that there are challenges to obtaining data regarding reinsurance pricing, but	

| | there may be scope for EIOPA to perform more detailed analysis to better investigate the feasibility of this. For example, EIOPA could issue a data request to firms asking them to provide details of reinsurance contracts that they have entered into – including how the price depended on metrics such as the best estimate liabilities and the SCR for various risk modules. The data could then be anonymised prior to publication, with it then forming the basis for the risk margin calibration.

EIOPA has stated that there is no clear economic justification for a proposal to link the cost of capital rate to the risk-free rate. This appears to be true according to the data that EIOPA has presented. However, the economic justification for the current approach of using a fixed cost of capital does not appear to be any stronger – i.e. there is no clear economic justification for either approach. Given this, it is important to focus on the question of whether the end result is appropriate – in terms of both policyholder protection and preventing pro-cyclical behaviour – as well as the narrow theoretical aspects.

EIOPA notes that 'Changes to the scope of application of long-term guarantee measures should be assessed in the ongoing review of the long-term guarantee measures and measures on equity risk.' We hope that EIOPA will include the risk margin in its review of the long-term guarantee (LTG) measures. A key objective of the LTG measures is to reduce incentives for pro-cyclical investment behaviour: the behaviour of the risk margin is one such incentive.

One proposal considered is that longevity risk could be deemed to be hedgeable. It is not clear from EIOPA's response whether it is stating that longevity risk is or is not hedgeable or whether this is a matter for national regulators or firms themselves. EIOPA has noted that if longevity risk were to be deemed hedgeable, then the cost of hedging would need to be reflected in the risk margin. This is true, but it does not in itself justify the assumption that longevity risk is not hedgeable, and indeed allowing for the cost of hedging could be a valid alternative approach as noted above.

We believe that EIOPA should clarify that firms or national regulators are permitted, if they can | |

	produce sufficient evidence, to treat longevity risk as hedgable. EIOPA also notes that 'It is not clear why the reference undertaking should apply more (or less) risk mitigation than the original undertaking.' However, the risk margin methodology already assumes that the reference undertaking will hedge its exposure to market risk and a consistent approach should be considered for longevity risk. We agree with EIOPA that – given its current structure – there is no reason for the risk margin to be capped at the level of the SCR. The current approach is consistent with the objectives of not only giving the insurer a 99.5% probability of surviving the next year but also giving the reference undertaking a 99.5% probability of surviving the second year, and indeed all subsequent years. We suggest EIOPA should consider the level of policyholder protection which is appropriate – and this ultimately is a political question. If the level of policyholder protection is considered excessive, then a pragmatic solution might be to impose a cap on the size of the risk margin, which could be proportional to the size of the SCR or the MCR. We note that EIOPA has rejected the idea of allowing the risk margin to change in the scenario-based calculations of the SCR standard formula, on the grounds that it would increase complexity. Whilst we accept that it would be complex, it is clearly more appropriate to stress the risk margin, and we see no reason to prevent an insurer which wishes to deal with the complexity from doing so. We suggest that the Standard Formula should include stresses to the risk margin, and permit excluding these as a simplified method.	
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18.4.2	The data presented on the size of the risk margin suggests that it was relatively stable between Q1 2016 and Q3 2016. We find this surprising: the Executive Director of Insurance Supervision at the Bank of England noted (21 February 2017) that the risk margin for major UK life insurance firms had increased from c.£30bn to c.£44bn between January/ September 2016. He also noted	

	that a 100 basis point fall in interest rates would increase the risk margin by 27% for these firms. These statistics do not appear consistent with those EIOPA has presented. It may be that EIOPA's figures reflect the increased tendency of firms to transfer risks impacted by the risk margin outside of the Solvency II regime. Although EIOPA has clearly carried out detailed analysis on the economic justifications for the cost of capital rate, we are unsure whether this has focussed primarily on this input to the model, rather than also assessing whether the resulting risk margin is appropriate. Such wider assessment might include a comparison of the risk margin: relative to the cost of reinsurance; relative to the premium on previous transfers of business; and against the level of protection afforded to policyholders e.g. determine X such that the risk margin broadly equates to a X% one-year VaR in basic own funds. EIOPA's proposed advice to the Commission appears to us to be incomplete without any statement on whether EIOPA believes that the risk margin, as currently constructed, leads to an appropriate level of policyholder protection.	
18.4.3	EIOPA's proposed advice to the Commission focuses narrowly on whether the cost of capital rate parameter is consistent with market indicators. We believe the advice should be extended to address fundamental questions, including whether: • EIOPA believes that the risk margin in its current form affords policyholders an appropriate level of protection, or whether it is excessive; • EIOPA considers it desirable to incentivise firms to reinsure longevity risk; and • the risk margin incentivises firms to invest in a pro-cyclical manner. It is particularly important that EIOPA considers these fundamental questions given the results of its own analysis, demonstrating there is material uncertainty around some of the parameters. There is therefore significant value in 'sense checking' the resulting risk margin that ultimately	

	emerges from the calibration.	
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