	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:	Association of British Insurers (ABI)	
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	We welcome the opportunity to respond to EIOPA's consultation paper CP-17-006 on its second set of advice to the European Commission on specific items in the Solvency II Delegated Regulation. We see this review as a timely opportunity to improve upon the regime following its implementation, to achieve a simpler, more workable outcome for insurers. With regard to EIOPA's specific proposals, we have provided feedback on all 20 of the areas included in the consultation. However, we would like to highlight the following:	

Area 3 – Recalibration of mortality and longevity risks

As EIOPA itself highlights, there are numerous limitations to the methodology it has followed for the recalibration exercise on longevity and mortality risks. Given these limitations, we believe that no changes are justified for either the longevity or mortality risk factors.

We note EIOPA's decision not to consider an age-dependent shock, although we would also note that a flat stress is not terribly risk sensitive. However, given EIOPA's decision, we agree that the longevity risk stress should be maintained at 20%.

We do not support the substantial increase in the mortality stress factor from 15 % to 25%. We note that this could have an impact not only on the SCR, but also on firms' ability to apply the Matching Adjustment – EIOPA does not appear to have considered this latter point.

Area 7 Interest rate risk

We acknowledge that the current relative approach is no longer appropriate with low/negative rates. However, none of the options proposed by EIOPA is ideal. Further investigation of these models would be beneficial, as would a more comprehensive consideration of their interaction with other parts of the Solvency II framework.

The shifted approach as proposed by EIOPA does not meet the requirements of the Solvency II framework. However, we believe that there may be alternative calibrations of this, or similar, models which could meet the needs of all stakeholders.

We do not believe that EIOPA's Option A (a symmetric 200 bps shock with a floor) is appropriate, particularly in a low-yield environment. We believe that it would result in a material over-estimation of the interest rate risk. Although it has its own areas of weakness, Option B (combined approach) would be preferable.

We acknowledge that the data needs to adequately capture the 1:200 events that are relevant to periods where current monetary policy was followed. However, the use of daily curves is a disproportionate approach – monthly would generally suffice.

With regard to extrapolation beyond the LLP, we consider this should be carried out subsequent to the application of the shock, to achieve consistency with the valuation methodology, reduce complexity of interest rate risk hedging, and provide a more economically realistic framework.

Area 17 Loss absorbing capacity of deferred taxes (LAC DT)

The European Commission's original Call for Advice of 18 July 2016 asked only for EIOPA to report on the different methods currently applied for calculating LAC DT and their impact. We believe that by submitting this analysis in EIOPA-BoS-17/280, EIOPA has delivered on its mandate.

We acknowledge the desire for greater convergence, and EIOPA's concerns regarding uncertainty, complexity and an uneven playing field. However, we consider that the proposals in this consultation paper take a very conservative view, harmonising to the most prudent approaches possible, and placing some arbitrary limits on projections.

We are disappointed that EIOPA has not chosen to take a more principles-based approach to LAC DT, allowing for supervisory judgement where this is appropriate. Tax rules vary from territory to territory and there is no harmonised corporation tax across Europe. The most appropriate way of dealing with LAC DT would therefore be to allow this to be dealt with primarily by national supervisors.

We believe that EIOPA's 9 key principles introduce a number of undesirable and arbitrary restrictions on the way that firms project their likely future profits. There is also the risk that they produce an unreasonable result when combined, as they result in layers of prudence. For example, a combination of a haircut on future profits together with a restriction on the number of years look forward could lead to an overly prudent outcome. Generally, it would be reasonable to look further ahead if the profits are already restricted to reflect the uncertainty.

We consider that EIOPA's proposed simplified calculation of LAC DT represents a mechanical, formulaic approach, which essentially eliminates any form of judgement, fails to take account of the differing tax rules applicable in individual territories, and adopts all of the most restrictive assumptions set out under the key principles proposed by EIOPA.

Area 18 Risk Margin

Industry has put forward a large amount of evidence demonstrating that the Risk Margin is excessively large, excessively sensitive to interest rates, and inappropriate for certain long-term products. We believe that the current review represents an opportunity for EIOPA to address these weaknesses, which are generally accepted by stakeholders throughout Europe.

Hence we are disappointed that EIOPA has elected to conduct a very narrowly focused review – considering only a single parameter in the Risk Margin calculation (the Cost of Capital rate). We would urge EIOPA to consider broader issues around the Risk Margin framework as soon as possible, rather than remaining wedded to methodologies first derived in 2007-2008.

We are also disappointed that EIOPA does not propose to make any changes to the Cost of Capital rate, despite extensive stakeholder input from across Europe demonstrating that the current 6% rate is too high. We reiterate in this response our evidence that using EIOPA's preferred CAPM approach, a value of 2-3% for the CoC rate is appropriate, yet remains prudent.

Prior to this consultation, stakeholders provided EIOPA with detailed proposals for a number of improvements to the Risk Margin framework. In the consultation paper EIOPA has dismissed these with very brief, high-level comments. It is disappointing that EIOPA has not engaged with these proposals more deeply, and provided more specific and detailed responses to each.

	We would emphasise the purpose of the Risk Margin, as set out in Article 77.3 of the Directive – to reflect the cost of transferring liabilities to a third party. It is unclear what work EIOPA has done to assess the true transfer cost for different lines of business, and whether the Risk Margin genuinely simulates that in a reasonable way across a range of products. EIOPA has a duty to do this work.	
Introduction		
1.1		
1.1.1		
1.2.1		
1.2.2		
1.2.3		
1.2.4		
1.3	***General approach for assessing non-life premium and reserve risk standard deviation –*** We note that EIOPA has maintained the same method as applied in 2011; we would question whether this is still appropriate. The consultation document lacks an assessment as to whether the method used: • is still valid for the various lines of business; and • continues to provide appropriate capital requirements taking into account the applicable legislation and characteristics of the individual markets across Europe, while maintaining a level playing field.	
1.3.1	***Methods applied –*** We believe that the general approach for assessing non-life premium risk should be based around differences between the expected and actual levels aggregate losses in each year rather than a method that assumes variation about a constant level. We are aware this was a much earlier consideration in the development of the standard formula (predating the Joint Working Group’s 2011 work) and recognise there were practical difficulties in the calibration. We would encourage EIOPA to consider other options, including considering year-on-year variation in aggregate loss ratios (for example, the previous year’s loss ratio forms the expectation for the	

	following year). Premium risk method 3 in the GIRO paper in 2012 was not discussed in the CEIOPS CP68/10 2010 paper on the health calibration and CEIOPS CP67/10 2010 paper on the non-life calibrations. All assume a constant loss ratio over the period of analysis (either in the company or across the market). The choice of method was fairly entrenched by the time the JWG started their work in 2011. It appears that the real reason this method did not develop further was because many companies struggled to provide the required information. It is not feasible for undertakings to track through ten or more years of planned ratios to generate a reliable time series of AvEs. In paragraphs 114 and 115 of the JWG's 2011 paper, they acknowledge underwriting cycles which touch on a similar concept (i.e. that loss ratios are not constant year to year), but their comment was that this is not practicable. We would encourage EIOPA to consider further options that allow for firms' loss ratios for the prior year to determine the best estimate for next year's loss ratio.	
1.3.2		
1.3.3	***Portfolio-size heterogeneity –*** We note that when the calibration is done regardless of size of the portfolio (kappa factor), this could generate a bias. It would be expected that a large portfolio would have more diversification effects, and as such outliers would generally have a lower impact. However, in the current approach this effect is disregarded.	
1.3.4	***Deriving a European parameter –*** While we appreciate the simplicity of pan-European factors, it is important to remain conscious that the disproportionate weighting by country in method 2 will mean that the overall calibrations are dominated by a few countries. Differing product designs and local characteristics can influence the underlying risk, and thus the risk is not the same for all countries across Europe. For example, there are significant differences in the delivery of health services between countries and the consequent impact this has on the nature of medical expenses insurance products. We observe in Section 25 (Annex to chapter 1 – Weights used in method 2) for HME premium risk	

	that the exposure is dominated by the Netherlands (47.8%) and France (31.7%). In particular, we note that the JWG’s initial work in 2011 went so far to recognise this heterogeneity, and in paragraphs 104-108 of that work specifically drew out as an example the differences in health systems. Size variations were discussed in the subsequent paragraphs, and in paragraph 109 it is stated that *“the JWG was mandated to derive single factors for each of the individual lines of business”*. While the latter comment is in respect of portfolio size, paragraph 110 talks about the link between country and size, and we believe this is equally applicable to the heterogeneity arising from country differences. It is unclear why there is a single pan-European approach when some parts of the standard formula (catastrophe risk, for example) do allow for regional differences. We encourage EIOPA again to consider the overall method used, and give consideration to country-specific factors or methodologies. The table below highlights the main countries that dominate the exposures of the recalibrated five lines of business	

Lines of business	Premium Risk weighting	Reserve Risk weighting
AS	DK: 17.1 % FR: 27.2 %	DK: 20.9% FR: 29.3%
CS	DE 18.8 % ES: 14.8 % IE: 15.6 % UK: 18.3%	DE: 25.0% FR: 21.0% IE: 16.3%
HME	FR: 31.7 % NL: 47.8%	FR: 18.7% NL:62.8 %
HWC	BE: 30.0 % FI: 20.6 % PT: 21.7 %	BE: 17.2% FI: 14.4 % NO: 31.5 %
LE	AT: 19.3% DE: 43.4% FR: 16.3%	DE: 57.9%

Consequently, we would support country specific rates, if the calibration data used can be shown to be robust enough and there are rational reasons for the differences, i.e. we are not introducing random differentials between countries. If there are real differences, then these should be reflected in the charges applied. There will also need to be appropriate methodologies in place to calibrate for the countries where no data or only 1 submission has been provided. Thus, we would support this as an area of further investigation.

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1.4.1	***Premium reserve risk –*** For the reasons included in our responses to 1.3.1 and 1.3.4, we do not	

	support the updated calibrations. We observe that the overall direction across the lines of business is to increase capital requirements. We question whether this is the desired outcome for all stakeholders, given potential responses of restructuring products and/or increased applications to move away from the standard formula. For credit and suretyship, the premium calibration increases by around 50% (see Sections 24, Annex to Chapter 1). This coincides with a material reduction in volumes used in the 2017 exercise. It would be helpful if EIOPA could provide an explanation of why this has happened, and in particular if there is a material change in the type of products within the class between the periods. We are concerned that the data is not representative of the industry as a whole, and not clear whether there is likely to be significant variation between companies as a result of different mixes of business.	
1.4.2	***Reserve –*** Again, for the reasons set out in 1.3.1 and 1.3.4, we do not support the updated calibrations. For LE and CS, there is an increase in the premium calibration and a reduction in the reserving. However, there is no specific mention of this in the consultation. It would be helpful if EIOPA could provide some rationalisation, e.g. a change in the definition of the data or a change in product mix. Given these offsetting impacts, the net impact is less material.	
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2.4.1	***Paragraph 134 –*** The consultation includes the definition of premium and claims used in the calibration of the risks that are intended to be captured in the Standard Formula, i.e. to capture the volatility in the movement in the balance sheet over the year. Our understanding of the "gap" relates to the volatility in the premium provisions set at year end whilst the current calibration only captures the earned claims volatility over the year. This in isolation would imply an uplift for the calibrations should be appropriate, however, an appropriate method for determining this uplift and thus identifying how material this is has not been provided in the consultation.	

	Paragraph 136 – EIOPA sets out that the calibration does not differentiate between risk types which is as expected, as the risks as defined are not distinctly identifiable in the data requested. However, the proposed approach to allow for this appears to be very simplistic, by aiming for a rate that would be broadly neutral overall. This means that 1-year contracts will increase and multi-year contracts will decrease. Given the points raised above, we do not agree with this approach. We note that for a predominantly 1-year contract business, this would potentially increase the Premium Risk by c5% and the total SCR by c3%.	
2.4.2	***Paragraph 149 –*** It is unclear how the ‘alpha’ is calculated, particularly regarding the proportion of multi-year contracts versus one-year contracts. We note that a recalculation of the SCR in one jurisdiction for the medical expense line of business (with only annual contracts starting insurance cover on 1 January) indicated that the impact would be an increase of the SCR by 15% (€1bn). ***Paragraph 151 –*** For an adjustment factor of 30%, on average the volume measure seems to decrease, however, when considering the impact per line of business, there is an increase in volume measure for 12 out of 15 lines of business. ***Definition of the initial recognition date (Paragraphs 158-164) –*** We do not agree with EIOPA’s proposed clarification and definition of the recognition date – this is taken to be the advance notice date, as per Article 17. The initial recognition date is therefore to be interpreted in the same way as the initial recognition date for technical provision calculation purposes: Article 17 of the Delegated Regulation applies. The initial recognition date is the date at which *“the undertaking becomes a party to the contract that gives rise to the obligation or the date the insurance or reinsurance cover begins, whichever date occurs earlier.”* The proposal states that this is the *“advance notice date”* when a contract *“may renew”*. This is not our interpretation of *“becomes party to a contract”* which, in legal terms, only occurs when an insurance offer/quote or renewal is officially accepted by the policy holder. We accept that the risk and thus premium relating to these policies (for which firms will enter into	

	contracts during the following year, and for which they will be obliged to offer cover starting the following year end) should be incorporated. These policies would impact the balance sheet at t+1 as regards the premium received and premium provisions set up. Thus, in addition to the increased exposure, there is also the booked profit on the t+1 balance sheet in respect of these policies.	
2.4.3	***EIOPA's advice: Definition of $FP_{(future,s)}$*** – We believe that the first option is the most appropriate, i.e. keeping the existing definition to determine premium volume measure. Although the proposed changes to the definition of $FP_{(future,s)}$ in Option 2 would address an inconsistency with recognition of future premium, we do not believe the change should be made, as this would lead to an inappropriate, asymmetric treatment of capital requirements (>1 year time horizon) and future profit recognition (1 year time horizon). We consider that the treatment of both should be the same. A point that has merit is that the movement in the balance sheet over the year includes the impact of profit from future written premiums, i.e. the profit that is realised and booked on the balance sheet when a policy is written. While this may be tempered by the establishment of the Risk Margin, on balance for a stable book, this effect is not expected to be material, i.e. the release in RM broadly offsets the RM from new business. However, the proposed calibrations do not take this into account, i.e. EIOPA is considering adding in the volatility in the premium provisions at t+1 but not considering the expected impact of new business on the balance sheet. Thus, on the assumption that profitable business is being written, the approach does not take into account this expected increase in the Own Funds, which would offset the risk of a fall in Own Funds as estimated by only considering a deviation from the average. Thus, we consider this to be a prudent estimate of the risks faced in writing new business over the year. We agree that when considering the risk sensitivity of premiums, i.e. lower capital charge for lower premiums regardless of the adequacy of the rates, this would add complexity. However, given that EIOPA is proposing to increase the premium measure to include the "gap" (relating to the premium provisions at t+1), it is inconsistent not be including the overall expected increase in own funds as a result of new business. We believe that these 2 factors net	

	off and thus, no change is required. In addition, the consultation does not consider the correlation between the various risk types as defined, i.e. the expected and unexpected (permanent and temporary). The adjustments for future premiums need to consider the relative proportion of risk that each element of the premium is exposed to, as well as how these risks are correlated to each other, i.e. it is not as simple as adding the risk or increasing it pro rata. While this may be the case for unexpected type 1 (permanent) unexpected loss, e.g. claims inflation, type 2 (temporary) unexpected loss is most likely lowly correlated between years and with "type 1" or "expected risk". Thus, the marginal impact of allowing for this risk for the "gap" will benefit from diversification. In summary, we support Option 1, recognising that the gap in premium definition exists, but it is offset by other areas of prudence in the calibration approach, in particular allowance for future profit. If Option 2 is selected, we would not agree with the current proposal for determining the alpha. A more robust approach would be needed, taking into account the differences between classes and between 1-year and multi-year policies, and the relative correlation between year 1 and year 2 exposures.	
3.1	***Recalibration of mortality and longevity risks –*** As EIOPA highlights in paragraph 235, there are numerous limitations to the methodology it followed for the recalibration exercise on longevity and mortality risks. Given these limitations, we believe that no changes are justified for either longevity or mortality risk factors. EIOPA uses an equivalent point, age 60, for both stresses. We consider this to be counter-intuitive as we would assume that mortality exposures would generally be lower for the younger ages than longevity exposures. We note that the proposed increase in the mortality shock (from 15% to 25%) could have an impact not only on the SCR, but also on the Matching Adjustment. Specifically, as noted in article 77b(f) of the Solvency II Directive: *"where the underwriting risk connected to the portfolio of*	

	insurance or reinsurance obligations includes mortality risk, the best estimate of the portfolio of insurance or reinsurance obligations does not increase by more than 5 % under a mortality risk stress that is calibrated in accordance with Article 101(2) to (5)". An increase in the mortality shock could therefore lead to some undertakings no longer fulfilling this condition to apply the Matching Adjustment. EIOPA does not appear to have considered this unintended consequence of its recommendation.	
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3.4.2	***Analysis –*** The correlation between mortality and longevity is not discussed in this section. However, we note that a correlation would potentially differ depending on the similarities and differences in the factors outlined in paragraph 238 on granularity. Given that EIOPA considers both longevity and mortality exposures at the same representative age of 60, then we would expect the correlation to be more inverse (i.e. closer to -1). This is because if firms are exposed to qx rising and falling at the same age on different products, firms 'only' have geographical and socioeconomic considerations to drive behaviours between their books.	
3.4.3	***Mortality and longevity stresses*** – We note EIOPA's decision not to consider an age-dependent shock, although we would also note that a flat stress is not terribly risk sensitive. However, given EIOPA's decision, we agree that the longevity stress should be maintained at 20%. However, we do not support the substantial increase in the mortality stress factor from 15 % to 25%. For the mortality stress, based on the analysis provided in the consultation paper, and given the expectation of a younger average age, it can be seen why a higher stress could be justified. However, we note that mortality is often time bound by the product nature. With that in mind, we consider that some sort of analysis of the flat qx equivalent to the LC/CBD/etc. 99.5% percentile on (for example) a 25-year assurance function from age 40 would be the most useful	

	comparison. It is likely that this would support a lower stress, in that the trend exposure is cumulative over time, and a fixed time bound might therefore require a lower instantaneous shock to achieve the same impact.	
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4.5.2	***Accident concentration risk simplification –*** We reiterate the difficulty undertakings face in identifying their largest concentration risk, as defined in Article 162 of the Delegated Regulations. We believe that both the simplifications considered (but rejected) by EIOPA are appropriate: (1) using the biggest collective contract as a proxy for "largest number of persons" in Article 162.3; and (2) using a major hit to the headquarters of the undertaking as a proxy for "the persons that are working in the same building" in Article 162.3(c). Undertakings should, therefore, be able to use these approximations when determining their largest concentration risk, subject to appropriate assessment and documentation. We believe that supervisors should recognise the challenges inherent in this submodule, and should provide sufficient flexibility for undertakings to make an appropriate judgement of what constitutes a suitable proxy exposure. ***Pandemic risk simplification –*** We agree that a pan-European assessment of drivers of maximal unit claim costs is neither appropriate, nor risk sensitive. We welcome the proposal for supervisors to provide this information at a national level on a non-obligatory basis. Undertakings that are able to make a tailored assessment of their claim costs should not be obliged to use any industry-wide averages.	
4.5.3	***Mass accident risks –*** We support EIOPA's decision to delete the "disability that lasts 10 years" scenario. We welcome the simplification to broadly categorise disabilities into two buckets – namely, less than one year and permanent. However, it will remain challenging to estimate the	

	benefits payable under events, particularly when these benefits are recurring.	
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5.4.1	***Fire risk sub-module –*** The adoption of a Possible Maximum Loss (PML) or Expected Maximum Loss (EML) approach would introduce an inappropriate element of subjectivity to the standard formula calculations. We welcome EIOPA’s decision not to consider these further.	
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5.4.2.3	***Fire risk sub-module –*** The simplification proposed for the fire risk sub-module is a step in the right direction; however, it is likely to be a small reduction in the complexity of the calculation in instances other than where the greatest exposure in a 200m radius is manually processed. The main challenge when calculating the fire risk sub-module lies in determining the 200m radius, often leading to approximations that reduce the risk sensitivity of the calculation. It was disappointing that there was not a wider review into the appropriateness of the existing calibration of the fire risk sub-module, as it appears several respondents hinted at a conservative calculation. We maintain that the fire risk sub-module is not appropriately calibrated. It produces an overly conservative measure of risk, and is not in line with the measures actually used by undertakings in their underwriting processes. It should be emphasised that that the simplified numbers could be substantially lower than the current standard formula approach when insurers have a fairly homogenous set of insured values, such that the “true” highest exposure in a 200m radius is driven by an accumulation of risks, not by the largest individual risks. This is recognised for pure personal line insurers through use of an underpin, but it is worth noting that this also occurs for insurers writing small commercial business, and those writing larger business but relying on per risk policies to level the net loss	

	across risks.	
5.5.1		
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5.5.2.2	***Marine risk sub-module –*** We acknowledge the risk of certain marine exposures falsely resulting in zero modelled claims according to the calculated SCR. However, we would caution against the inclusion of every foreseeable scenario into the standard formula. A balance must be struck between risk sensitivity and complexity. There are other parts of the Solvency II framework (such as the ORSA) that are designed to address the non-uniform nature of risk profiles across the industry.	
5.5.2.3	***Marine risk sub-module –*** We support the replacement of "tanker" with "vessel" in Article 130 of the Delegated Regulations, which will extend the existing scenario to include the risks to other vessels, without introducing a new scenario. This represents a pragmatic approach to resolving the issue which will not unduly penalise firms who have both tanker and other vessel exposures.	
5.6.1	***Motor vehicle liability risk sub-module –*** We support EIOPA's proposal to clarify how this sub-module should be applied through EIOPA's Q&A process.	
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5.7.2.3	***Gross versus net reinsurance –*** We agree with the decision to consider net retained risk when assessing exposure in the marine, aviation and fire risk sub-modules. The revised methodology may be slightly more computationally complex, but we believe this is outweighed by the additional risk sensitivity, especially in instances where there are varied facultative covers in place. We believe that supervisors should adopt a pragmatic approach in supervising this calculation.	
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6.3.2	***Natural catastrophe risk sub-modules simplification –*** We welcome EIOPA's proposal that the	

	final simplification is an optional (not mandatory) simplification under the framework of Article 88 of the Delegated Regulation, rather than a replacement of the current standard formula approach.	
6.3.3.1		
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6.3.3.3	***Unallocated exposures –*** We agree with the decision to select the highest risk zone in a region in instances where the exposure cannot be mapped to an explicit/single CRESTA zone (Option 5). However, in response to paragraph 370, we would support the additional flexibility of being able to limit the area where this highest risk zone is selected to a subset of zones where this information is available. An example is Italy, where CRESTA released additional zones, essentially making the Level 2 text outdated. In this case, it seems more risk sensitive to consider a subset of the zones as opposed to the region as a whole. The geographical location of the exposure is known, it just does not map directly to a CRESTA zone.	
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6.4.3.3	***Recalibrated natural catastrophe scenarios –*** We believe that a number of the recalibration proposals put forward by CAT WS contain excessive and unjustified prudency margins, and do not reflect the scientific data it considered. The proposals in many cases are anchored to existing calibrations that have already been identified by EIOPA as "materially inappropriate".	
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6.5.3.3	***Contractual limits and natural catastrophe risk –*** We do not believe that EIOPA's proposed "ex-post adjustment" to account for restrictive policy conditions (indemnity limits and deductibles) in certain scenarios will have any meaningful impact. For the majority of catastrophe scenarios,	

	severe restrictions would need to apply before any benefit was obtained. However, we do recognise the difficulty in incorporating these into the Solvency II standard formula.	
7.1	***Interest rate risk –*** Consideration of interest rate risk as part of this review has been carried out at EIOPA's own initiative; it was not part of the European Commission's July 2016 Call for Advice.	
7.2		
7.3	***Interest rate risk*** Issues identified with current relative approach We agree that the current relative approach is no longer appropriate with low/negative rates. However, we do not agree that it necessarily leads to an underestimation of interest risk in the low yield environment, as the interest risk exposure may already be exaggerated in the base case. We agree with the comment in paragraph 447 that a minimum downward shock could help to ensure prudence in the low yield environment. Data issues The data need to adequately capture the 1:200 events that are relevant to periods where current monetary policy was followed. However, the use of daily curves is a disproportionate approach, and may give rise to autocorrelation and complicated time-series modelling with temporary aggregation to generate annual stresses. Monthly would generally suffice. With regard to extrapolation beyond the LLP, we consider this should be carried out subsequent to the application of the shock, to achieve consistency with the valuation methodology, reduce complexity of interest rate risk hedging, and provide a more economically realistic framework. Only a correct extrapolation is able to yield the right changes beyond the LLP. If interest rates until the LLP drop significantly, the extrapolation also results in a marked drop of extrapolated rates. Thus, the given example of a 19% decrease as well as any other big or small changes are automatically modelled in the right way.	

	Extrapolation using Smith-Wilson methodology would be inappropriate, as the extrapolated component is often highly correlated to the last point of the curve. EIOPA notes that it does not have the power under the Solvency II Directive to publish stressed extrapolated curves. This is an argument for the interest rate risk submodule to be considered as part of the 2020 review, so that restrictions like this do not artificially constrain the options that EIOPA considers as part of its review of interest rate risk. <u>Mathematical approaches to derive the stressed risk-free curves</u> We welcome EIOPA's view that PCA is an appropriate statistical tool, and the use of PCA in the calibration of the shifted type approaches.	
7.4.1		
7.4.2	***Interest rate risk*** We acknowledge that the current relative approach is no longer appropriate with low/negative rates. However, none of the options proposed by EIOPA is ideal. Further investigation of these models would be beneficial, as would a more comprehensive consideration of their interaction with other parts of the Solvency II framework. <u>Shifted approach</u> The shifted approach as proposed by EIOPA does not meet the requirements of the Solvency II framework. Furthermore, EIOPA's back-testing indicated that the methodology is weak. However, we believe that there may be alternative calibrations of this, or similar, models which could meet the needs of all stakeholders. <u>Proposal A (Symmetric shock with floor)</u> This approach is the most conservative approach discussed – and is overly-conservative when interest rates are low.	

	We do not agree that a 2% minimum shock is appropriate, particularly in a low yield environment. Such an approach would result in a material over-estimation of the interest rate risk. The 2% minimum shock is also unrealistic. In the analysis of Proposal B, EIOPA notes that negative interest rates significantly below -1% have not been observed. As an example, despite the Japanese government bond market experiencing a low interest rate environment for over 20 years, as well as continued aggressive monetary stimulus, this market has never experienced negative rates of the magnitude provided by this model. While we consider that an interest rate floor is necessary for a sensible interest rate model, the floor proposed by EIOPA to mitigate the impact of extreme minimum shocks results in a proposal which is overly-prudent. That the introduction of a considerable minimum shock is overly-prudent is a view also expressed by EIOPA in its assessment of Proposal B in paragraph 488. This is due to the questionable assumptions upon which the interest rate floor is based, in particular the use of the Swiss Franc interest rate curve, where the Swiss Franc market is small compared to the Euro and GBP markets, and has idiosyncrasies that cannot be realistically extrapolated to other, larger markets. Furthermore, applying the downward stress could result in a yield curve that is negative at longer tenors. If it was the case that the yield curve was negative at longer tenors, long term-investors would hold assets in cash rather than continuing to invest in negative-yielding securities. It is unclear why EIOPA considers investors would continue to invest in a way that guaranteed the destruction of their capital. Proposal B (Combined) We consider the combined approach creates a reasonable view of potential interest rate movements, given the level of rates, i.e. weaker stresses when rates are negative or near zero, with the downside stresses being -1% and upside 1.4% (compared to +/-2% under Proposal A) and merges with Proposal A when rates are high enough and multiplicative stresses bite again. We see the key weakness in Proposal B as that it is likely to breach if interest rates suddenly rise	

	by more than 1.4%, and should be adequately stress-tested in alternative environments. It is also more complicated, being the result of attempts to address issues with the existing relative model, the 2% minimum shock proposal, and the affine model.	
7.4.3	***Interest rate risk –*** We agree that the current relative approach is inappropriate to measure interest rate risk in a low yield environment. We consider that Proposal A is overly-prudent, particularly in a low interest rate environment, and would result in a material over-estimation of the interest rate risk. Although it has its own areas of weakness, Option B (combined approach) would be preferable.	
8.1	***Market risk concentration –*** We support the European Commission's call for information on the current assumptions made when calculating the market risk concentration submodule. We appreciate EIOPA's consideration of the specific issue of 'mixed exposures'.	
8.2		
8.3	***Market risk concentration*** Treatment of funds where look-through not possible – as an example, generally the look-through approach is not possible for unit-linked funds which are excluded from the concentration module. Treatment of risk-mitigating techniques – collateral is associated with counterparty risk on derivatives, so generally it would not affect the concentration risk. Definition of exposure at default – we agree with EIOPA's statement that for an asset in the scope of the market risk concentration risk sub-module, the exposure at default should normally equal the value of the asset.	
8.4.1		
8.4.2		
8.4.3	***Market risk concentration –*** We would agree with the proposed approach in paragraph 573 to map any changes to the market risk concentration to Article 199(4) to (7) of the Delegated Regulation.	

9.1	***Currency risk at group level –*** We welcome the EC's request for EIOPA to provide information on currencies chosen by insurance groups to hold their own funds, and to investigate if the approach taken to group currency risk adequately covers the risk to which the group is exposed, taking into account the incentives given to the group's risk management, and suggest modifications where appropriate. However, we suggest that EIOPA has not taken into account the incentives given to the group risk management in its analysis of currency risk.	
9.2		
9.3	***Currency risk at group level*** – We agree with the comments received in response to Discussion Paper CP-16/008 that the current treatment encourages groups to hold capital in the reporting currency, and that the current methodology incentivises hedging currency risk at the group level even though the firm may be backing local liabilities with local currency at the solo level. Neither solo nor group undertakings should be required to hold capital against sensible risk management strategies designed to hedge the surplus position or the SCR ratio against currency risk. Own funds across the group are fungible, and FX translation risk should not impact the assessment of fungible own funds.	
9.4.1	***Currency risk at group level –*** The current treatment encourages groups to hold capital in the reporting currency. This is a poor outcome – as long as subsidiaries can cover their SCR with local surplus, there is no need to move funds between currencies, and firms should therefore not have to hold capital against it. Holding all capital in the reporting currency increases risk, which may remain an issue even when the group's reporting currency is changed (as EIOPA proposes). As noted by EIOPA, a change of reporting currency would only benefit groups with a significant exposure to one particular currency but use a different currency to prepare consolidated financial statements. For the remaining groups with less significant exposure to one particular currency, applying the	

	current standard formula approach continues to result in poor risk management incentives, as well as an excessive level of capital being held due to: a) Translation risk being applied to unstressed own funds – we consider it should be assessed against the residual local Own Funds after the application of other stresses; b) The implied correlations between different FX rates (being 100% correlated in the most onerous direction for each currency); and c) The positive correlations between translation risks and other (market) risks are overstated.	
9.4.2	***Currency risk at group level –*** EIOPA's proposal does not go far enough to address the wider inconsistencies in the currency risk framework. True currency risk arises from the denomination of exposures and not from the reporting currency. We recommend EIOPA reconsiders its advice, to either exclude the translation risk element (only keep local mis-match risk), or only to charge solo Surplus Own Funds for Group aggregation. Regarding paragraph 602, we consider that the current standard formula is not an appropriate trade-off between simplicity of calculation and risk sensitivity. This advice fails to consider the risk management incentives arising from the standard formula. Regarding paragraph 603, we consider the advice to change reporting currency would be ineffective. The example below demonstrates this, and the existing framework results in Groups holding more capital than the sum of its solo parts: • take two separate but near-identical entities A and B, with 100% correlated risks, no FX exposure, except they have different currencies (and all assets and liabilities are localised); • separately these entities A & B would not have to hold FX capital but a Group owning only A & B would have to hold currency capital in addition, irrespective of the choice of "reporting currency".	
10.1	***Unrated debt*** – We welcome the EC's request for advice on possible developments in Solvency II	

	towards the use of alternative credit assessments in the standard formula. However, we suggest that, when asked to provide clear and conclusive criteria for an alternative, EIOPA also considers the ease with which those criteria can be implemented. Unrated debt is not only an important investment asset for the industry, but also a key source of funding for SMEs. Considering the current challenge of unnecessarily high capital requirements for such debt supports the CMU objectives of addressing barriers to long-term financing. While the objective of the current call for advice is to proxy capital charges of unrated debt to those of rated debt, EIOPA should address the key question of whether Solvency II reflects the right risks. Specifically, in the case of debt, where insurers are not exposed to forced sales, risk of default should be measured instead of risk of changes in spreads. This should be addressed thoroughly in the 2020 Solvency II review.	
10.2		
10.3	***Unrated debt*** – While we welcome EIOPA's consideration of a new approach, any alternative approaches for use in the standard formula must not limit insurers' ability to use external credit ratings. Care must also be taken that alternatives do not impose significant costs on insurers. The Commission's proposed ESA regulations require EIOPA, when carrying out its tasks and powers, to take account of the integration of environmental, social and governance related factors, which is indicative of the importance of this topic to the Commission. It is not clear from the consultation paper how such factors have been taken into account when considering unrated debt.	
10.4.1		
10.4.2.1		
10.4.2.2		
10.4.2.3	***Unrated debt*** <u>Financial ratios</u> – EIOPA notes that financial ratios may vary depending on applicable accounting	

rules and policies, and that this introduces an element of judgment. Linked to this is the issue of the ease with which the criteria can be implemented, and the time and resource required to determine which adjustments may be necessary to mitigate differences in accounting rules and policies.

If different criteria are not going to be developed for different industries (paragraph 647), then the ratios and threshold values selected need to reflect that different ratios and thresholds will be relevant/acceptable for different industries.

If it is considered necessary to include financial ratios as part of the regulations, we believe that it would be more appropriate to err on side of "false positives" when setting thresholds as the use of internal ratings will provide a complementary control to filter out loans with a lower CQS.

Overall we support:

- The financial ratios chosen by EIOPA, which align with key financial ratios used by major CRAs in their external rating process, and reflect main drivers of credit risk.
- The qualitative factors, which are generally in line with what financial analysts usually look at in practice.
- Consideration of the average of ratios over several years (as opposed to most current set of financial ratios).
- The calculation of probabilities of default using the Bloomberg function DRSK. However, EIOPA should be mindful of how such an explicit reference to Bloomberg services could generate unavoidable costs for the industry (similarly to the experience with external CRAs).

<u>Yield criterion</u> – We do not believe that a criterion based on comparison of yields of traded rated debt is appropriate. There are several reasons why the yield on a privately traded instrument could differ from that on a publicly-traded bond, including the presence of a premium for illiquidity, or a premium reflecting the borrower's preference for a private transaction. We

	therefore do not believe that the yield alone will provide a good indicator of credit risk. Including such a comparator would be tantamount to regulatory intervention in market pricing and could lead to price distortion. Additional conditions – We consider that the definition of "senior debt" is too simple to cover the wide array of structure types. For example, there may be bi-lateral loans secured against specific assets and the whole company which could be regarded as "more senior". We would suggest replacing the wording with "…senior to substantially all other claims with the exception of an immaterial amount (e.g. less than 5% of senior debt) of other debt that is more senior in the right of payment under certain circumstances". Internal process of the insurer – Overall, we believe it would be more appropriate to allow insurers to define their own internal rating process. EIOPA should not automatically require additional processes to be set up, but should encourage a review of whether existing internal processes and requirements are sufficient. For example, firms' existing processes under their implementation of the prudent person principle should be considered. Furthermore, those firms that follow an internal model approach with approved internal model processes and existing credit assessment systems should be considered to be already fulfilling these requirements.	
10.4.2.4	***Unrated debt –*** We see advantages in utilising the model output to derive the CQS given the availability of the model adequacy and appropriateness, model use and model validation documentation. Since unrated debt is typically bank loans, this method addresses the gap in determining an internal credit assessment. Therefore, we consider that EIOPA should recognise the value of, and accept approved IRB models, for which a mapping to ECAIs should be allowed. For internal model users who already develop an internal credit rating assessment, this should be recognised and accepted with appropriate mapping to CQS in Solvency II.	
10.4.2.5		
10.4.3	***Unrated debt –*** We broadly support EIOPA's proposals for unrated debt, and consider there is value in both the internal assessment approach and the internal banking/insurance risk	

	assessment models. However, under the internal assessment approach, the yield criterion is not appropriate, nor is the definition of 'senior debt' within the additional conditions, which is too simple. The internal process should be determined by the insurer.	
11.1	***Unlisted equity –*** While we welcome consideration of the treatment of unlisted equity, we suggest that, when asked to provide clear and conclusive criteria, EIOPA also considers the ease with which those criteria can be implemented. Looking ahead, we consider that EIOPA needs to address the key question of whether Solvency II focuses on the right risks (as we also note above in relation to unrated debt). In the case of equity, EIOPA should investigate how long-term exposure to equity and absence of forced sales risk impact insurers' actual risks. We welcome in the call for advice the requirement for consideration of the environmental, social and governance aspects, but are disappointed EIOPA does not seem to have considered these aspects in its final advice.	
11.2		
11.3	***Unlisted equity –*** We disagree with EIOPA's assessment that the specificities of different types of equity investment are not relevant for risk measurement under Solvency II. For private equity, it is important to differentiate between buyout investments (i.e. mature companies with solid business models, often EBITDA generating) versus venture capital investments that are young and may not yet have proven business models. This creates a large difference in risk. Default rates for venture capital are much higher, but the return from successful investments can also be high.	
11.4.1		
11.4.2	***Unlisted equity*** <u>Scope</u> – It is unduly restrictive to exclude unlisted equity of companies in non-EU/EEA jurisdictions.	

11.4.3	***Unlisted equity –*** While we broadly support the current proposals for identifying unlisted equity that has a similar risk profile to listed equity, and consider that both proposals should be included in the advice to the EC, we note that proposal 2 may be easier to implement. However, we consider that it is unnecessarily restrictive to limit investments to unlisted equity of companies in the EU/EEA area. We also note that, regarding the requirement on PE to have at least 25 fund managers, this does not reflect the current market reality and should be relaxed. The Commission's Call for Advice asks for environmental, social and governance aspects to be taken into account, and the Commission's proposed ESA regulations also require EIOPA, when carrying out its tasks and powers, to take account of the integration of environmental, social and governance related factors. It is disappointing that, despite the mention in 11.4.2, EIOPA's final advice as set out in 11.4.3 is silent on these aspects.	
12.1	***Strategic equity investments –*** We welcome the EC request for information on strategic participations, and on how the related qualifying criteria are applied in practice. However, we consider that EIOPA's advice should extend to what amendments should be made to the criteria for strategic participations to increase the use of this treatment. We consider that the current criteria focus too much on short-term volatility, and not on the actual risks for an insurer, who will take a long-term view of strategic investments.	
12.2		
12.3		
12.3.1	***Strategic equity investments*** – The experience of the NSAs reflects the experience in our jurisdiction – there has been little take-up of the capital treatment for strategic equity investments, primarily because of the unnecessarily restrictive criteria and the difficulties entities face in validating the 'strategic participation' status of the asset. This is particularly difficult when the investment is less traditional and less well-understood by the NSA.	

12.3.2	***Strategic equity investments –*** We agree with the comments of the NSAs that it is difficult to demonstrate that the criteria are met (paragraph 897). We consider that the volatility criterion (Article 171(a)) should be removed. It is very difficult to apply in practice, as the EIOPA analysis shows. It also contradicts the long-term horizon associated with strategic participations and with the criterion of having a clear strategy to hold. We suggest that the minimum ownership and control threshold for an investment to qualify as a strategic participation should be reduced. The requirement for a 'participation' is unnecessarily restrictive, particularly when considered alongside the other Article 171 criteria such as strategy to hold and ability to hold for a long period. We suggest that the requirement should be that the insurer has a 'qualifying holding' instead.	
12.3.3	***Strategic equity investments*** – The statistics provided in this section, as well as the response from the NSAs set out in paragraph 895, show how infrequently the strategic equity participation treatment is applied in practice. Solvency II tends to wrongly treat assets as if they are available for trading, and the strategic equity participation treatment is a necessary alternative to this general treatment. But the criteria for the application of this treatment makes it difficult for insurers to apply this treatment, undermining its usefulness as an incentive to undertake strategic equity investments. Amending the criteria to make this treatment workable in practice would not only help improve identification of strategic participations, but would also help support increasing allocation to such assets, which are linked to long-term holding strategies. EIOPA and the Commission should consider what investment behaviour they are aiming to encourage with this specific treatment and revise the criteria accordingly. We make the following suggestions: • require the investment to be a 'qualifying holding' rather than a 'participation', to reduce the ownership and control requirement.	

	• remove the requirement to show there will be lower volatility for the 12 months after acquisition. • EIOPA could consider a separate sub-module for long-term equity investments.	
13.1		
13.2		
13.3	***Simplification of the counterparty default risk module*** ***Paragraph 940 –*** We support the proposal to introduce an optional simplification to address the difficulties encountered in assessing whether a reinsurance counterparty has more than 60% of its assets pledged as collateral. We believe that the simplification should be based on qualitative factors, such as the credit rating of the reinsurer, rather than effectively assuming all reinsurers have over 60% of their assets pledged as collateral. We would also add that any simplification should be optional, and should not lead to materially lower capital requirements than under a more complex, risk sensitive approach. ***Paragraphs 940-950 –*** We welcome the clarification on the assumptions that should be used in the calculation of the hypothetical SCR and, in particular, how the life, health and non-life sub-modules should be aggregated and whether correlation factors are to be used. ***Paragraphs 951-953 & 1022-1027 –*** We welcome the inclusion of a closed-form optional simplification for the calculation of the risk-mitigating effect of reinsurance arrangements. ***Paragraphs 954-962 –*** The inclusion of an optional simplification to address the issue of the step-change which arises when the standard deviation of type 1 exposures exceeds 7% is welcomed. This would provide continuity in the calculation for undertakings which exhibit standard deviation of type 1 exposures of around 7%. However, to remove the discontinuity, the proposed simplification merely assumes the higher, 5x	

	factor applies to the lower volatility sector (S ≤ 0.07T) as well as the mid-sector (0.2T ≥ S > 0.07T). We note that EIOPA has not provided any justification for choosing the more prudent approach. We believe a reformulation of the calculation would have been preferable to remove the discontinuity. Changes in counterparty exposures, e.g. the implementation of EMIR for derivatives, and the additional information available to EIOPA since the formulation of this sub-module support further investigation of this issue.	
13.4.1		
13.4.2	***Relative significance of the counterparty default risk module*** ***Paragraphs 968-982 –*** EIOPA's analysis shows that the complexity of the counterparty default risk module is not proportionate to the nature, scale and complexity of these risks. The analysis clearly shows that counterparty default risk is not a key driver of the SCR for the majority of undertakings. However, as noted by EIOPA, the counterparty default risk sub-module is considered to be the most burdensome module compared to the level of capital requirements it generates. ***Paragraphs 983-1010 –*** We support EIOPA's proposal to define a "risk-mitigating derivative" as a derivative which is part of a well-defined hedging strategy, because it provides a more accurate representation of economic reality. However, we do not agree that all derivatives should be classified as type 1 exposures within the counterparty default risk submodule. This will result in increasing capital requirements for derivatives which are under the scope of the spread risk submodule. If EIOPA does intend for all derivatives to be in the scope of the counterparty default risk submodule, then we would recommend that it should make very explicit that these are not in the scope of the spread risk or market concentration risk submodules to avoid duplication of capital requirements.	

	Paragraphs 1011-1021 – We agree with EIOPA that the counterparty default risk sub-module should be refined to take into consideration any contractual netting arrangements. The proposal to calculate the loss given default (LGD) and risk-mitigating effect on single name exposures and not on each individual derivative appears to be a sensible approach. Further detail on the specificities of this proposal would be welcomed.	
13.4.3	***EIOPA's Advice*** ***Paragraphs 1030-1034 –*** We note that the complexity of the counterparty default risk submodule is not proportionate to the nature, scale and complexity of the risks. EIOPA's analysis supports this assessment. ***Paragraphs 1042-1043 –*** We do not agree that all derivatives should be classified as Type 1 exposures in the counterparty default risk submodule. This would result in double counting of capital requirements for derivatives within the scope of the spread risk submodule. ***Paragraphs 1044-1056 –*** We welcome EIOPA's proposal to define a financial risk-mitigating technique as a hedging strategy where the hedging strategy as a whole (rather than each individual derivative) meets the requirements of a risk-mitigating technique. ***Paragraphs 1049-1056 –*** We support the recognition of contractual netting arrangements, and the proposal to alter the calculation to reflect their economic reality. ***Paragraph 1057 –*** As EIOPA points out, there is considerable uncertainty on how to calculate the hypothetical SCR – we would welcome clarification. ***Paragraphs 1058-1066 –*** We welcome the proposed simplifications to the counterparty default risk sub-module to reduce the calculation burden, but note that the inclusion of the high margins of prudence inherent in these calculations may discourage their widespread use.	

	Paragraph 1068 – We would welcome additional clarification on the existing simplified calculation, detailed in Article 110 of the Delegated Regulation.	
14.1		
14.2		
14.3		
14.4.1		
14.4.2		
14.4.3	***Treatment of Exposures to CCPs and changes resulting from EMIR*** ***EIOPA's Advice –*** We believe the following key issues should be addressed before EIOPA delivers its final advice to the Commission: • Article 305 of the CRR requires tailoring for the insurance sector to make the framework workable in practice. • EIOPA should investigate whether the current capital requirements for OTC derivatives, used as a starting point for cleared derivatives, are appropriate. We support Option 1, i.e. no changes to the LGD formula, as we consider that Option 2 adds unnecessary complexity to the framework.	
15.1		
15.2		
15.3		
15.4.1		
15.4.2		
15.4.3	***Simplification of the look-through approach –*** We welcome EIOPA's proposal to "carve out" from the 20% limit assets backing unit-linked and index-linked products that: (1) do not significantly contribute to the SCR; or (2) where the change in the value of the underlying assets does not significantly affect the available own funds (due to future profits).	

	We also welcome EIOPA's proposal to amend Article 84(3) of the Delegated Regulation, to allow: (1) the SCR to be calculated on the basis of the last reported asset allocation of collective investment undertakings or funds in cases where the look-through approach cannot be applied; and (2) the use of "groupings" of exposures when the target asset allocation is not available at the level of granularity necessary. However, it should be noted that the last reported asset allocation of the fund may be appropriate for a passive fund vehicle or exchange-traded fund that has little drift in investment strategy, but may not be suitable for hedge funds where exposures and risk can vary materially over a short period of time.	
15.4.4		
16.1	***Call for advice –*** We support EIOPA's proposal to mirror the approach at group level for solo level and vice-versa. Specifically, we agree that if there is a look-through at solo level, then there should be look-through at group level, and where there is no look-through at solo level, then there should be no look-through at group level. While we believe that both options put forward by EIOPA would result in the same approach, we prefer the option of reviewing Article 336 of the Delegated Regulation (Option 2) by specifying that related undertakings should be treated at group level in the same way as they are treated at solo level.	
16.2		
16.3.1		
16.3.2		
16.3.3	***Look-through approach at group level –*** We acknowledge there has been divergent practice in Europe in the way the look-through approach is applied at group level for related collective investment undertakings and other related undertakings. We support EIOPA's suggestion that if there is a look-through at solo level, then there should be look-through at group level, and where there is no look-through at solo level, then there should be no look-through at group level. While we believe that both options put forward by EIOPA would result in the same approach, we prefer Option 2 which is simple and straightforward.	

17.1	***Loss absorbing capacity of deferred taxes (LAC DT) –*** The European Commission's original Call for Advice of 18 July 2016 asked only for EIOPA to report on the different methods currently applied for calculating LAC DT and their impact. We believe that by submitting this analysis in EIOPA-BoS-17/280, EIOPA has delivered on its mandate. ***EIOPA's analysis –*** EIOPA's conclusion from the analysis described in EIOPA-BoS-17/280 is that the supervisory treatment of 75% of the European LAC DT (i.e. that based on net deferred tax liabilities) is harmonised, whereas the remaining 25% (based on future profits) is not. EIOPA has indicated as part of this consultation its intention to *"achieve convergence in the calculation of LAC DT under the standard formula and in particular for the projection of post stress taxable profits …"*, in other words, harmonisation of the remaining 25% described above. ***EIOPA's approach –*** We acknowledge the desire for greater convergence, and EIOPA's concerns regarding uncertainty, complexity and an uneven playing field. However, we consider that the proposals in this consultation paper take a very conservative view, harmonising to the most prudent approaches possible, and placing some arbitrary limits on projections. We are disappointed that EIOPA has not chosen to take a more principles-based approach to LAC DT, allowing for supervisory judgement where this is appropriate. We acknowledge that calculation assumptions should be consistent with Solvency II principles, and welcome EIOPA's statement that "consistency" does not mean requiring the "same" assumptions. However, we find that EIOPA's proposals do essentially follow the "same" assumptions (e.g. requiring the assumption of a risk-free return on assets). ***EIOPA's concerns –*** EIOPA has highlighted 3 main concerns relating to LAC DT: (1) uncertainty about future profits; (2) the complexity of forecasting these future profits; and (3) the impact of an "uneven playing field". The management of an undertaking's tax position (including the use of future table profits) is part of the day to day commercial management of the undertaking's business. Undertakings therefore have the expertise and experience required to do this; EIOPA is overstating the level of complexity involved. EIOPA gives 3 reasons for the "uneven playing field" and only one relates to "unjustifiable" differences in assumptions.	

	Proportionality – EIOPA does recognise that proportionately is important. Tax rules vary from territory to territory and there is no harmonised corporation tax across Europe. The most appropriate way of dealing with LAC DT would therefore be to allow this to be dealt with primarily by national supervisors.	
17.2		
17.3		
17.4.1		
17.4.2	***LAC DT Analysis –*** This section contains the main analysis of the estimation of future profits, covering both profits from new business and future return from net assets (assets over and above technical provisions). It sets out 9 key principles for the projection of likely future profits. Whilst individually many of the proposals seem reasonable on a standalone basis, there is a risk that they produce an unreasonable result when combined, as they result in layers of prudence. For example, a combination of a haircut on future profits together with a restriction on the number of years look forward could lead to an overly prudent outcome. Generally, it would be reasonable to look further ahead if the profits are already restricted to reflect the uncertainty. ***<u>Compliance with MCR/SCR after the shock loss (Key principle 1)</u>*** ***Paragraph 1297 –*** We welcome EIOPA's confirmation that standard formula undertakings are not expected to explicitly determine their compliance with the MCR/SCR after a shock loss – such second order calculations are not a general requirement of the Solvency II standard formula. ***Paragraphs 1298-1299 –*** We believe that EIOPA's position assumes *a priori* that companies will not have a viable recovery plan, which EIOPA cannot pre-judge. With an adequate recovery plan, even if a firm is closed to new business, it may still be possible to make future profits from in-force business. In addition, being close to an MCR breach is totally different from having actual breached the MCR. While a breach will result in no possibility to write new business, being close	

	to a breach will not. ***Paragraph 1300 –*** We reiterate that compliance with the post-shock MCR and SCR should not play a role in the calculation of LAC DT, as these are a given under the going concern assumption. There should be no link between the degree of compliance with the MCR/SCR after a shock loss and the amount of probable future profits. EIOPA's view that there will be no future profits after an MCR shock is not reasonable – firms can recapitalise. ***<u>Future profits stemming from new business (Key principles 2-4)</u>*** ***Paragraph 1310 –*** EIOPA assumes that the calculations of future new business profit should be based on economic profits, whereas most countries (including the UK) do not calculate tax based on economic profits. While profits disclosed in the accounts are based on estimates of the economic profit that will emerge from in-force long-term business, those profits will be adjusted for tax purposes. Hence EIOPA's proposed basis for calculating taxable profits is not appropriate, and demonstrates a fundamental mis-understanding of tax principles. ***Paragraph 1316 –*** We do not support EIOPA's proposal to cap the total future profits stemming from new business after the shock loss as an arbitrary proportion of past profits and profits assumed in the business plan. Instead, the limit should be set based on an assessment of the "credibility" of future profits. A way to mitigate against unreasonable outcomes would be to allow an undertaking to take a different approach to these proposals, while accepting a corresponding increase in the burden of proof and associated governance. This is seen in key principle 3(a), where a cap of 50% is proposed – this could be overridden with appropriate justifications. This approach could also be applied elsewhere. ***Paragraph 1319 –*** We do not agree with EIOPA's proposals for limiting the projection horizon of future profits from new business. The limit should not be set as an arbitrary of number of years,	

but rather as a limitation to the "credibility" of future profits. For example, a long-term business that goes into run-off would continue to earn a return from net assets as the book runs off (and not just for 5 years).

<u>Future profits from returns on assets (Key principles 5 and 6)</u>

Paragraphs 1331-1332 – The Solvency II balance sheet is calculated on a market consistent basis. 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. Therefore, we do not consider that it would be appropriate to limit the expected return to the shocked risk free rates.

Paragraph 1333 – We believe that the reference to Guideline 9 of the EIOPA "Guidelines on the recognition and valuation of assets and liabilities other than technical provisions" is inappropriate in this context, because the LAC DT straddles both the economic world and the fiscal world, and (irrespective of the fact that the economic return on the business is not the basis of taxation) the basis of taxation will always include the real return on assets. Further, as set out above there is no justification in restricting the post-shock returns on assets in excess of technical provisions to the risk-free rate. Therefore, pull-to-par and additional returns from the recovery of equity markets should be allowed.

Further, pull-to-par is in accordance with IAS 12, which states (paragraph 29A) "The estimate of probable future taxable profits may include the recovery of some of an entity's assets for more than their carrying amount if there is sufficient evidence that it is probable that the entity will achieve this".

Paragraph 1338 – We consider that the time horizons used in calculating the LAC DT should be based on the time horizon appropriate to the underlying business in question. If the business is long-term, the time horizon used should reflect the long-term nature of the business. We do not

	consider that it would be appropriate to impose an arbitrary limit on the time horizon used, as this could cause a systematic distortion of the results, contrary to the requirements of the Directive. ***<u>Future management actions (Key principle 7)</u>*** ***Paragraphs 1344, 1346-1347 –*** We do not believe that it is appropriate for EIOPA to limit the use of management actions to the extent it is proposing, and this applies in particular to its assumptions regarding recapitalisation. The European insurance industry would be expected to survive stress losses, as it demonstrated following the 9/11 terrorist attacks and the 2008 financial crisis. We anticipate that European insurance businesses would be able to take appropriate management actions following a shock loss, including if necessary recapitalisation from within the group (which should be relatively straightforward) or from the capital markets. Experience proves that there is almost always a market for insurance debt, even after a shock resulting in a credit rating downgrade. ***Paragraph 1345 –*** We note that the requirements set out in Article 23 of the Delegated Regulation are solely meant for management actions in the calculation of technical provisions. We do not agree that they should also apply to future management actions integrated into the calculation of LAC DT. ***<u>Role of the system of governance in LAC DT calculation (Key principle 8)</u>*** ***Paragraphs 1354 and 1358-1364 –*** We are concerned with the additional governance requirements being proposed, such as the requirement that the calculation of LAC DT should be approved by the Board as part of its ORSA exercise, and the inclusion in the ORSA of a sensitivity analysis to changes in the main assumptions used to estimate DTA and LAC DT. The ORSA is a reflection of a Board's own assessment of its risks, and regulators should pause for thought when requiring additions to the roster of Board activities.	

	Supervisory reporting and public disclosure regarding LAC DT (Key principle 9) ***Paragraph 1368 –*** We are concerned with EIOPA's proposals to strengthen (via the RSR and SFCR respectively) both the supervisory reporting and the public disclosure of the deferred tax assets in the pre-stress balance sheet and the LAC DT calculation, and possibly also include a detailed sensitivity analysis. Such an increase in the reporting burden goes against the expected direction of travel in this respect. ***Possible simplified calculation of LAC DT*** ***Paragraphs 1369-1378 –*** We consider that EIOPA's proposal represents a mechanical, formulaic approach to calculating LAC DT, which essentially eliminates any form of judgement, fails to take account of the differing tax rules applicable in individual territories, and adopts all of the most restrictive assumptions set out under the key principles proposed by EIOPA. These are fundamental to the calculation of LAC DT in the specific circumstances of individual undertakings. Therefore, we consider that National Supervisors should have the main role in reviewing LAC DT.	
17.4.3	***Conclusion on key principles –*** Given the differences in tax regimes, and effect of different regulatory practices or Member state options (including, for example, extent and treatment of transitional measures), diverging practices on the inclusion and level of scrutiny of future profits are to be expected, and should be allowed for. We therefore believe that a principles-based approach is preferable. In particular, we agree that proportionality is an important principle that needs to be applied when considering the calculation of LAC DT. However, we consider that the detailed comments and proposals suggested by EIOPA in applying the key principles do not allow for proportionality, and do not follow a principles-based approach. As stated above, the proposals represent a mechanical, formulaic approach to calculating LAC DT. Convergence in itself should not be the overriding goal, rather the goal should be a convergent principles-based process for assessing LAC DT.	

	We appreciate the desire to apply greater scrutiny and convergence over LAC DT, which forms the basis for these proposals. However, this should not change the current approach to the calculation of deferred tax in the base Solvency II balance sheet, which should continue to be based on the application of IFRS principles. Also, the distinction for new business (in the estimate of future profits) is less relevant to DTA recognition in the base balance sheet than for LAC DT purposes. Reporting, disclosure and governance should be proportionate and not unnecessarily onerous for those firms without LAC DT.	
18.1	***Risk Margin –*** The European Commission's Call for Advice of 18 July 2016 asked EIOPA to *"assess if the methods and assumptions applied in the calculation of the Risk Margin continue to be appropriate, in view of a changed market environment"*. We are disappointed that EIOPA has elected (paragraph 1396) to conduct a very narrowly focused review – considering only a single parameter (the Cost of Capital rate). We would urge EIOPA to consider broader issues around the Risk Margin framework as soon as possible, rather than remaining wedded to methodologies first derived in 2007-2008. In particular, we believe that the current review represents an opportunity for EIOPA to address the excessive level of the Risk Margin, its volatility and the disproportionately large allocation for certain long-term products. These weaknesses in the current Risk Margin framework are generally accepted by stakeholders throughout Europe. We are also disappointed that EIOPA does not propose to make any changes to the Cost of Capital rate, despite extensive stakeholder input demonstrating that the current 6% rate is too high. We reiterate below our evidence that a value of 3% for the CoC rate is appropriate, yet remains prudent. We would emphasise the purpose of the Risk Margin – to reflect the cost of transferring liabilities to a third party. It is unclear what work EIOPA has done to assess the true transfer cost for different lines of business, and whether the Risk Margin genuinely simulates that in a reasonable way across a range of products. EIOPA has a duty to do this work.	
18.2	***Legal basis –*** The key Level 1 requirements for the Risk Margin are given in Article 77 of the Solvency II Directive. In particular:	

- Article 77(3) states that *"The Risk Margin shall be such as to ensure that the value of the technical provisions is equivalent to the amount that insurance and reinsurance undertakings would be expected to require in order to take over and meet the insurance and reinsurance obligations"*.
- Article 77(5) states that *"Where insurance and reinsurance undertakings value the best estimate and the Risk Margin separately, the Risk Margin shall be calculated by determining the cost of providing an amount of eligible own funds equal to the Solvency Capital Requirement necessary to support the insurance and reinsurance obligations over the lifetime thereof"*.

As illustrated in our responses to Section 18.3 (Calculation of the Risk Margin) below, the current approach adopted in calculating the Risk Margin results in insurers holding technical provisions for insurance risks such as annuities and lapses that enable an insurer to raise sufficient capital to withstand a scenario that corresponds to a loss which is greater than the maximum possible ultimate loss (e.g. for annuities in which mortality rates fall to zero over the lifetime of the insurance obligations, or for lapses a lapse rate of more than 100%).

This clearly contravenes Article 77(3), as no insurer would expect this level of protection to take over and meet the insurance obligations. In addition, it runs counter to the financial stability objectives of regulators, as it effectively forces insurers to transfer insurance risks to off-shore jurisdictions and results in the creation of a highly material, artificial, interest rate risk sensitive balance sheet item.

As explained in the analysis below, one of the key reasons the current approach gives rise to a value of technical provisions for insurance risks exceeding that stipulated by Article 77(3) is that it does not take account of risk dependence over time, and therefore overstates the total capital-at-risk.

There is, however, nothing in the legal text that prevents insurers taking account of risk

	dependence over time when calculating a set of SCR(t)s in Article 37(1) and (2) of the Level 2 Delegated Acts so long as they do not contravene Level 1 requirements. As described below, we consider that the best way to determine a set of projected SCRs that fully meet the Level 1 requirements is to ensure that they are consistent with an extreme but plausible lifetime shock. For standard formula firms, we believe that it could also be possible to find reasonable approximations and simplifications for longevity risk, which would allow them also to take risk dependency over time into account, while remaining compliant with the Level 1 and Level 2 requirements. We anticipate that the approaches described would result in a more realistic run off profile for future capital requirements, and a more realistic calculation of their NPV as a consequence. We believe that this NPV value (and hence the Risk Margin itself) could be materially reduced while remaining reasonable and prudent.	
18.3	***Feedback statement on the main comments received to the discussion paper –*** this section covers EIOPA's analysis of the various stakeholder proposals. ***<u>Level of the cost of capital</u>*** The current level of the CoC rate is excessively high, and its impact is exacerbated in the current interest rate environment. This leads to a Risk Margin which does not reflect the realities of the transfer market and is unduly sensitive to changes in interest rates. This harms consumers by inappropriately increasing premiums and reducing access to insurance products. ***<u>Calculation of the Risk Margin</u>*** *The proposals below are the subject of detailed papers prepared by industry during the course of 2017. While they are summarised here at a high level, we stand ready to provide greater detail on*	

each should EIOPA require it.

a) The reference undertaking should be allowed to use the VA and MA.

We are disappointed that EIOPA has chosen to delay consideration of this proposal until its 2020 review of the long-term guarantee package. The exclusion of the Matching Adjustment in the Risk Margin appears to go beyond the requirements of the Solvency II Directive and Delegated Regulations in so far as the reference undertaking, to whom the liabilities are transferred, could also benefit from both a Matching Adjustment and a Volatility Adjustment. The MA and VA are core, permanent parts of the Solvency II framework and should be allowed to be taken into account.

We believe that this proposal is consistent with other assumptions made about the reference undertaking having similar characteristics to the transferring insurer, as well as the assumption that the best estimate does not change.

We propose that firms with Matching Adjustment and/or Volatility Adjustment approval use the respective measure in the calculation of the Non-Hedgeable Solvency Capital Requirement only. Inclusion of the Matching Adjustment in the rate used to then discount the Non-Hedgeable SCR would require a change to Article 37(1) of the Delegated Regulations.

b) Allowing for more diversification in the reference undertaking.

We do not agree with EIOPA's assertion that the current Solvency II framework makes sufficient allowance for diversification between risks within insurance companies.

When calculating the Risk Margin, an assumption is made that the life and non-life insurance obligations are taken over by two separate 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, such that insurers are able to properly take into account insurance risk diversification effects when calculating their Risk Margin.

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, such that insurers are able to properly take into account group diversification effects when calculating their Risk Margin.

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 by IAIS in the most recent ICS specifications that have been tested. The excessively onerous Solvency II approach creates unintended incentives for the industry to restructure their organisations in order to enable appropriate diversification and overcome artificial constraints.

c) Allowing for hedgeability of longevity risk (including the Management Action Solution).

For annuity providers, the longevity risk SCR generated by the annuity business is likely to be the most significant non-hedgeable risk in the Risk Margin calculation, particularly at long durations where the annuity business is still in force but the other lines of business have entirely run-off. The level of longevity risk will also be particularly sensitive to changes in the level of interest rates.

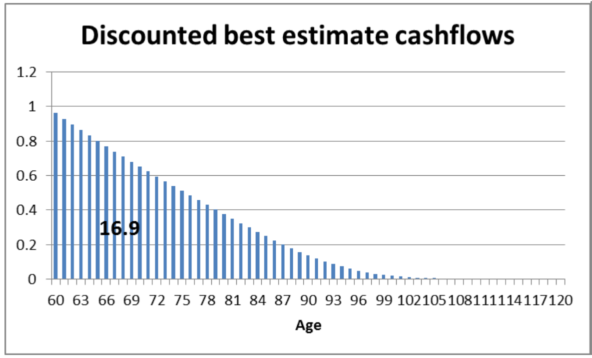
Research compiled by specialist news service Artemis (www.artemis.bm/library/longevity_swaps_risk_transfers.html) demonstrates that since 2015, longevity risk transfers and longevity reinsurance deals have totalled close to £50bn. These figures present compelling evidence that a strong market in longevity hedging (primarily via longevity swaps but also via reinsurance structures) has developed in the years since the Solvency II text was agreed.

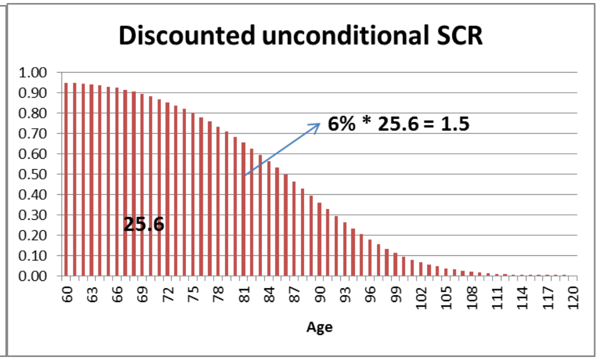
Given this, our view is that it is now unreasonable to assume no longevity risk can be transferred

	throughout the period of run-off. Instead, we propose that the Risk Margin should be able to use longevity reinsurance to price the transfer value of the risk. Firms should assess how much longevity exposure they believe could be traded out and at what cost; the net exposure could then be used in the SCR calculation for Risk Margin purposes. The "Management Action Solution" is a specific proposal developed by industry that takes advantage of this new market in longevity hedging. In summary, this involves an insurer approving a management action that provides that it would seek reinsurance to cover certain liabilities in specifically defined circumstances, namely when it de-risks its assets. Due to the operation of certain assumptions in the legislation for the calculation of the Risk Margin, those defined circumstances would be deemed to occur upon any transfer to a transferee insurer and therefore the transferee insurer can be treated (for the purposes of the Risk Margin calculation) as having put in place longevity reinsurance in line with the management action. That management action would be reflected in determining the transferee insurer's SCR for the purposes of calculating the Risk Margin. There is a case to consider further what "hedgeable" means. The argument that longevity risk should be considered hedgeable is one which we support, but similarly, it could be argued that both lapse risk and mortality risk are hedgeable through reinsurance and financing arrangements etc., and catastrophe risk is hedgeable via extreme mortality bonds (in addition to XOL reinsurance). There is a case to be made that operational and expense risks are the only truly non-hedgeable risks. Consistent with this, Insurance Europe previously issued a Solvency II dictionary defining a hedgeable risk as *"a risk associated with an asset or an obligation that can be effectively neutralised by buying or selling a market instrument (or engaging in a contract with a third party in an arm's length transaction under normal business conditions), whose value is expected to change in such a way as to offset the change in value of the asset or liability caused by the presence of the risk".*	

	d) Use a time scaling factor to reduce the projected SCR. This proposal is the subject of a detailed ABI paper *"Addressing the Size and Volatility of the Solvency II Risk Margin Using a Tapering Approach"*. The contents of this paper are summarised here. The current approach for calculating the Risk Margin treats all future capital funding requirements as independent payments (i.e. based on future unconditional SCRs) and does not take into account any dependency over time. However, any economic approach to valuing risky payments would have to take into account the dependence of risks over time to avoid inappropriate conclusions – such as, in the case of annuity products, implausibly low mortality rates and the implication that more capital is at risk than the worst case scenario of policyholders living forever. In our view, SCR capital requirements are not independent – some non-hedgeable risks (such as mortality/longevity risk and lapse risk) may be non-repeatable, so if they crystallise in one time period they cannot reoccur. This will have a downward impact on the calculation of forward SCR capital requirements. We make the following proposal on such a basis, and acknowledge further consideration may be required to confirm for which risks there is a negative correlation over time due such non-repeatability. The non-repeatability means it is not appropriate to value the projected SCRs in the Risk Margin calculation as independent payments, which is the presumption implicitly made when applying the formula currently specified in Article 37(1) of the Delegated Regulation. Instead, when setting the compensation required to finance a liability (i.e. the level of payment required, in the form of a Risk Margin, to take on that risk), an investor will consider the distribution of outcomes at maturity of the liability being financed. In other words, when providing this capital an investor will necessarily consider the <u>ultimate</u> risk when assessing the compensation required to provide that capital. The impact of such risk dependency is to limit the ultimate loss that an investor can experience on any particular risk – if a risk cannot occur twice, it should not be charged twice.	

Current Risk Margin funds too much capital – Consider a simple illustrative annuity example – a policyholder aged 60 with the IML00 base mortality table, a constant mortality improvement assumption of 1.8%, and a constant interest rate of 3%. This produces a best estimate annuity value of 16.9 (arbitrary units) and a Risk Margin of 1.5 (assuming Standard Formula stresses):





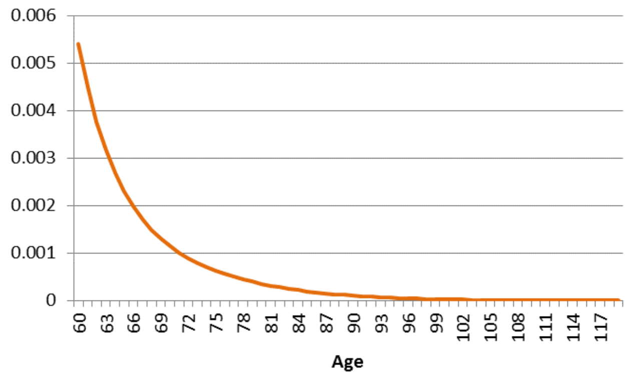
The current approach for calculating the Risk Margin implies total capital required over the lifetime of this policyholder of 25.6 (i.e. sum of discounted unconditional SCRs). However, if this policyholder were to live forever, the total cost would be 33.3 (i.e. a perpetual bond whose value is 1/0.03 = 33.3), implying a loss in this case of 16.4. This means that the current Risk Margin would require firms to fund more notional capital than even the worst case scenario of this policyholder living forever, which is clearly wrong. In fact, the worst possible case for the investor corresponds to a 1-in-200 shock in each and every year, which yields a lower loss than 16.4. Therefore, any capital raised above this level the investor will receive back *with certainty* – and hence will not charge a premium above risk-free for this (i.e. this component of the total capital raised requires a corresponding Risk Margin of zero).

The same reasoning can also be applied to other insurance risks. In the case of lapses, the current application of the Risk Margin formula will result in total lapse rates of greater than 100% (for example, for a five-year product with constant exposure, applying the Standard Formula stress of

40% each year implies that the Risk Margin should fund enough capital corresponding to a total lapse rate of 200%, or every policyholder lapsing twice).

In fact, it is possible to show that the way that the Risk Margin formula is currently applied leads to arbitrage opportunities, and so can in no way be justified by any economic theory. The ABI paper *"Addressing the Size and Volatility of the Solvency II Risk Margin Using a Tapering Approach"* contains two detailed examples (from a simple catastrophe insurance product and via an illustration based on the annuity above) how such arbitrage opportunities can arise.

Current Risk Margin implies implausible mortality – The current approach assumes that the future SCR being funded is based on unconditional 1-in-200 shocks. However, a significant proportion of insurance risks are non-repeatable – this is the case for longevity risk (e.g. cancer can only be cured once). Considering longevity risk further, ignoring such risk dependency over time results in implausible mortality rates – for example, for the 60 year-old policyholder, if we apply the Standard Formula stress of a 20% reduction in mortality rates every year, this results in mortality rates which are effectively zero after the age of 90:



	Historically, mortality rates have always increased with age. Therefore, the resulting mortality rates from applying the same unconditional shock year after year are completely implausible when viewed from a historic context and clearly not realistic – this is something that the use of a conditional stress (i.e. allowing for time dependency) would address. ***Proposal –*** We propose that internal model firms are allowed to model risk dependence over time in their SCR projections in the Risk Margin calculation. The simplest way to do this would be for firms to use a tapering parameter λ^t to derive the projected SCR in the Risk Margin formula provided in Article 37(1) of the Delegated Act, i.e.: $$RM = CoC \sum_{t \geq 0} \frac{SCR(t)}{\left(1 + r(t+1)\right)^{t+1}}$$ where $SCR(t) = \lambda^t SCR'(t)$ and $SCR'(t)$ denotes the unconditional SCR at time t. In this context, λ represents an estimate of the degree to which the ultimate risk reduces relative to a series of independent risks, and is linked to the reduction in size of future 1-in-200 risks following a 1-in-200 loss in previous periods. This could be based on targeting an appropriate extreme lifetime shock to mortality rates. For example, for annuities, if we target an ultimate mortality rate of 5% at age 100, in this example this would result in a λ of 0.84. The diagram below demonstrates the impact on best estimate cash flows and notional SCR for the simple annuity product discussed above for (from left to right): (1) capital funded under the current Risk Margin (λ = 1); (2) capital required to fund a perpetual bond (λ = 0.97); (3) capital required to fund a standard formula shock every year (λ = 0.92); and (4) capital required to fund a reasonable lifetime shock (λ = 0.84):	

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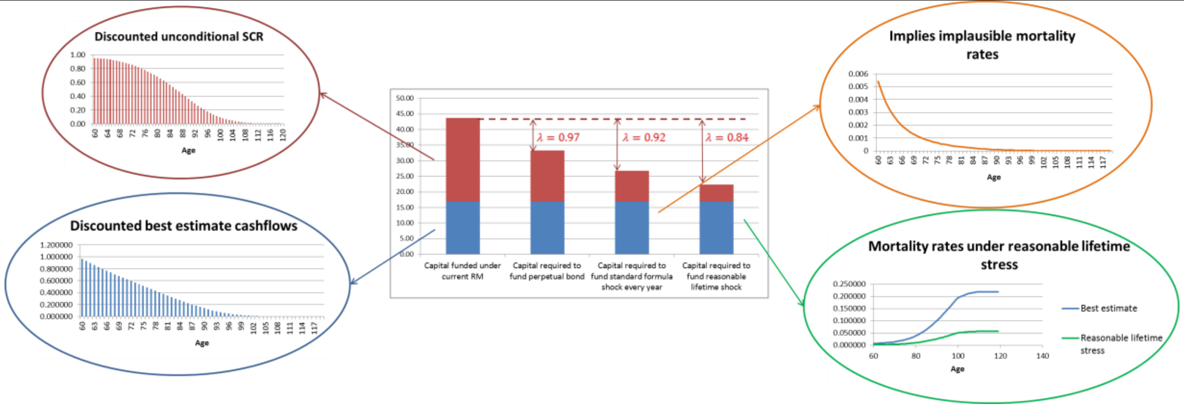
<tr><td></td><td>

It is important to note that the tapering approach is one possible way to implement the main proposal – which is to allow for risk dependence over time and hence take into account the ultimate risk to the investor. Alternatively, firms could be allowed to use their internal models to achieve this by projecting forward SCRs using their internal model in a way that is consistent with their own view of the ultimate risk.</td><td></td></tr>
<tr><td>18.4.1</td><td>Previous advice – Previous CEIOPS advice stated that "In order to account for the fact that a key source of return that exists for going concerns (the so called franchise value related to expected profit from new business) may not be demanded by capital providers in a transfer context, a downward adjustment is needed", and hence a downward adjustment is applied. However, no explicit allowance seems to have been made for asset risk i.e. the fact that risky assets are held by the insurer (which are more correlated to the rest of the market).

Moreover, the analysis uses as a starting point the level of the equity risk premium derived from equity price models without the use of an unlevered beta. This is flawed because, as discussed above, this does not take into account the financing structure of insurance firms, which includes cheaper forms of funding in the form of debt. Should EIOPA persist with this particular methodology, it is essential that an unlevered beta is used. Furthermore, the use of a backward-</td><td></td></tr>
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	looking equity risk premium is biased upwards due to survivorship bias (i.e. excludes returns from weaker firms which do not survive). Both these points mean that the previous CEIOPS analysis was flawed, and hence resulted in a CoC rate which was excessive. Due to this, we consider that after making appropriate yet prudent adjustments for franchise and asset risk (i.e. the risk inherent in an insurance firm's business model and the risk from assets held in the balance sheet), a more appropriate range for the CoC rate would be 2%-3%, and so a value of 3% would represent an appropriate yet prudent CoC rate.	
18.4.2	***Analysis –*** this section contains EIOPA's analysis of the current size of the Risk Margin, and the process used to derive the Cost of Capital rate. ***<u>Size of the Risk Margin</u>*** As a new and theoretical concept, a methodology and calibrations for the Risk Margin had to be invented during the development of Solvency II. The Risk Margin was never expected to have a very significant impact on a life insurer's balance sheet, but its current level is unexpectedly extremely high. For the entire European industry, according to EIOPA figures, the total RM was €210bn in Q3 2016, out of which €150bn stemmed from life and composite insurance undertakings, representing more than 45% of the life insurance industry SCR. For certain long-term products the RM can be especially extreme; such products include pensions paid out in lifelong annuities, whole life insurance and funeral insurance products. The figure of €210bn represents an enormous amount of capital consumed by the Risk Margin and locked out of productive use. Such excessive levels result in a waste of scarce capital and limit the capacity of insurers to take risks and grow. The excessive Risk Margin will also (to the detriment of policyholders) have a major impact on the costs and availability of certain products, particularly long-term products such as annuities. Since 2014, seven UK firms have withdrawn completely from the UK open annuity market, citing in part the capital requirements and risk management challenges of Solvency II.	

The excessive size of the Risk Margin represents a pan-European issue, of importance to (re)insurance undertakings across EEA jurisdictions. For example, EIOPA's Q3 2016 data for Life business shows very clearly that the Risk Margin is higher than 50% of SCR in 4 EEA jurisdictions (Czech Republic, Germany, Netherlands and Norway) and between 40-50% in 10 EEA jurisdictions (Estonia, Greece, Ireland, Liechtenstein, Lithuania, Luxembourg, Poland, Slovakia, Spain and UK).

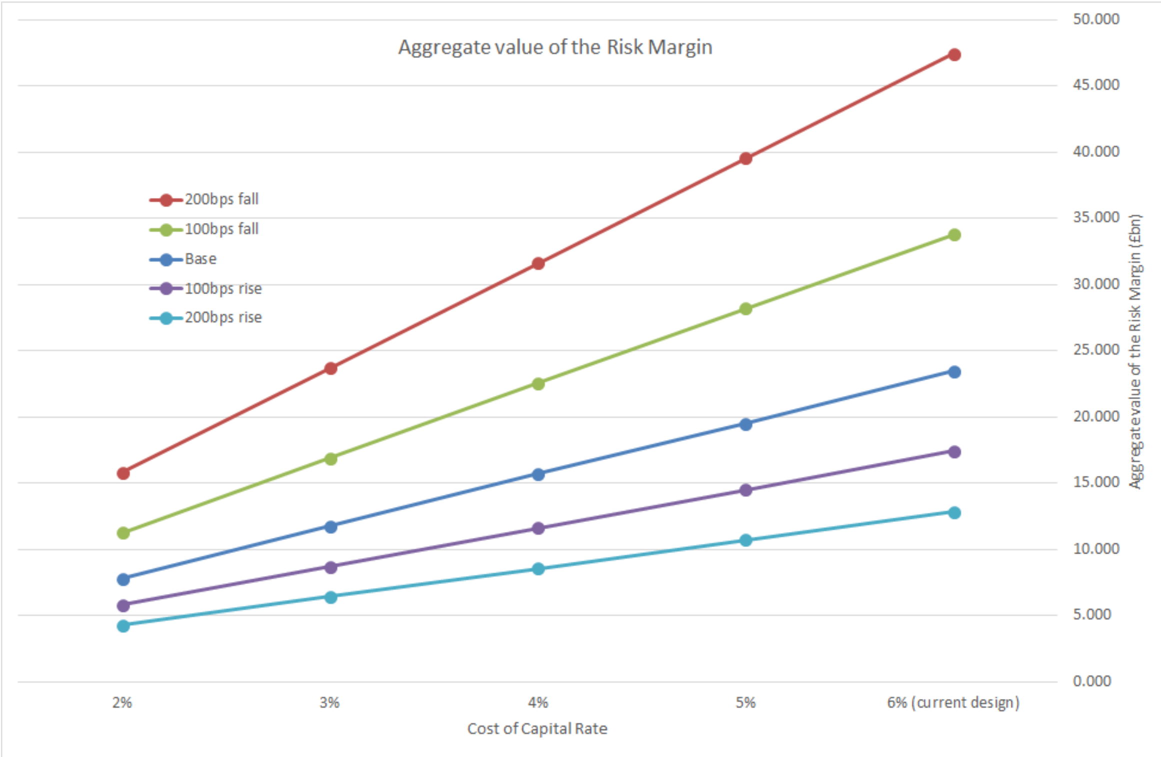
Empirical evidence provided by a large annuity writer demonstrates that there are significant incentives for firms to reinsure longevity risk away to non-EU jurisdictions that fall outside the remit of Solvency II rather than retain it, and this is chiefly driven by the impact of the Risk Margin. In current market conditions, the Risk Margin would need to reduce by 75-85% for annuity writers to be economically neutral between retaining and externally reinsuring longevity risk, and make decisions based solely on their stated risk appetites. This demonstrates how far the Risk Margin is from an economically sound, risk-neutral approach.

Sensitivity of the Risk Margin to interest rates

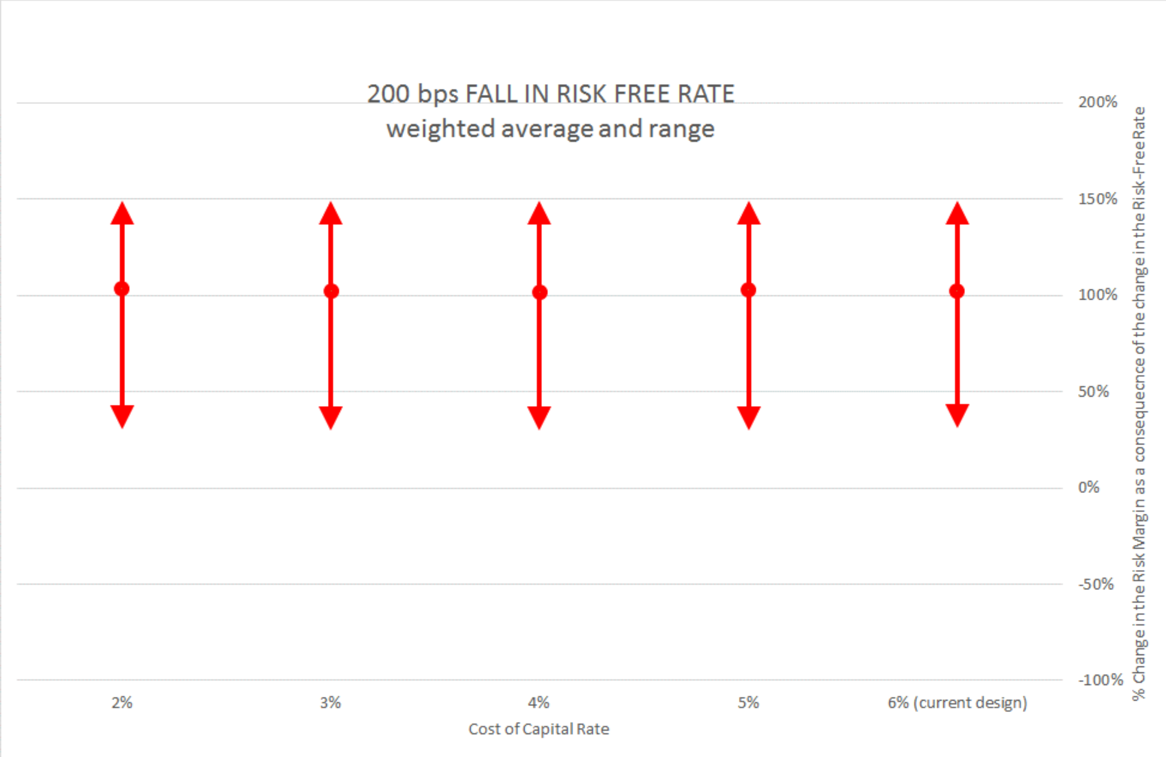
The Risk Margin methodology was never tested for current low interest rate conditions, and has proved to be overly sensitive to changes in interest rates. A recent sensitivity analysis on 14 UK firms representing 75% of the aggregate UK Life Risk Margin (a total of £26.6bn at YE2016) demonstrated that:

- A 100 bps fall in the risk-free rate would cause the Risk Margin to increase by more than 40% (i.e. by c £11bn in aggregate with a 6% CoC rate for the 14 firms in this survey).
- A 200 bps fall in the risk-free rate would cause the Risk Margin to more than double (i.e. increase by c £27bn with a 6% CoC rate).

The chart below shows the aggregate size of the Risk Margin at YE2016 as a function of the CoC rate. The size following changes of ±100 bps and ±200 bps in the RFR are also shown. The linear relationship between CoC rate and Risk Margin is clearly demonstrated. Also clear is the significant increase in aggregate Risk Margin that would follow a fall in interest rates:



The same survey demonstrated that the Risk Margin volatility can vary significantly from firm to firm. The chart below shows the weighted average and range of the estimated change in Risk Margin that would occur as a consequence of a 200 bps fall in the risk-free rate. Note that a c 150% increase in the Risk Margin is possible following this shock. These results demonstrate that a change in the Cost of Capital rate would not address the significant volatility associated with the Risk Margin:



General approach to the review of the CoC rate

EIOPA starts with a basic formula for the Cost of Capital (CoC):

CoC = (cost of equity)*(weight of equity) + (cost of debt)*(weight of debt)

Based on the original CEIOPS analysis, the weight of debt is assumed to be nil, and therefore the formula above simplifies to the following (however, note our comments below that we regard this as an oversimplification, given that insurers are not funded 100% with equity – and so the use of an unlevered beta is required as discussed below):

$$\text{CoC} = \text{cost of equity}$$

EIOPA remains focused on a capital asset pricing model (CAPM) for deriving the cost of equity. However, as pointed out in previous CRO Forum papers, alternative methods exist that are equally valid (e.g. the frictional cost of capital approach or the weighted average cost of capital approach).

In the CAPM approach, the cost of a particular equity above the risk-free return (the Equity Risk Premium, ERP) is equal to its beta (β, a measure of the volatility of a sector in comparison to the risk of the market as a whole) multiplied by the market return over risk-free (the Market Risk Premium, MRP):

$$\text{Equity Risk Premium (ERP)} = \text{cost of equity} - \text{RFR} = \beta * \text{MRP}$$

Previous CRO Forum papers have demonstrated that the cost of capital is not equivalent to the total return required by shareholders; the impact of franchise risk should be removed, as well as the contribution resulting from the possession of risky assets. Therefore an adjustment (x) to the beta value should be made to reflect the fact that CAPM is a "total return" approach, and allow for economic aspects not reflected in the CAPM model.

From the above, the formula for deriving the Solvency II CoC rate can be expressed as:

$$\text{CoC rate} = (1-x) * \beta * \text{MRP}$$

We consider each of the parameters x, β and MRP in the sections below.

Equity risk premium

The Equity Risk Premium (ERP) represents the extra return that investors demand above a risk-free rate to invest in an equity class. EIOPA has retained the use of historical return models to derive the ERP; it has done this for reasons of methodological consistency, and also because it believes that it ensures stronger stability of the CoC rate over time and less dependence on assumptions.

We consider that the only theoretically correct risk premium to be used in the CAPM model is the expected or **forward-looking** MRP. However, most of the time a backward-looking MRP is used instead, essentially for practical reasons. In these cases, appropriate adjustments need to be considered.

Industry studies indicate that a backward looking assessment of the risk premium for a diversified world equity portfolio would support a value of around 5%-7%. However, this does not take into account that a global diversified portfolio, required to derive the MRP, contains assets other than equities (in particular bonds which have lower risk premiums), and does not account for the fact that backward-looking risk premiums contain a strong survivorship bias. Studies support at least a 2% downward adjustment to take account of both these effects.

Following this, we can derive a prudent estimate for the market risk premium of 4% (due to the fact that the market risk premium should also be based on lower-yielding assets other than equities), which we can extend to a prudent range of **4% - 5%**. This is consistent with average estimates of forward-looking ERPs found on Thomson Reuters' data stream.

Beta factor

We do not accept that the beta factor used in the CAPM calculation should be as high as 1.20, as proposed by EIOPA in paragraph 1440. The beta used in the CoC calculation should be the pure, unlevered beta of the insurance sector. This is consistent with CEIOPS' assumption that firms are 100% funded by equity, which will tend to add a layer of prudence in the calibration of the CoC rate. In practice, the use of debt funding will tend to lower the cost of financing, and hence disregarding this will lead to an overestimate of the true weighted average cost of capital. Therefore, not using an unlevered beta in this context would result in an inappropriately high CoC rate.

A comprehensive study by NYU Stern (http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/Betas.html) found an unlevered beta for insurance companies of c 0.65. Adding a margin for prudence, we consider **0.65 – 0.8** a prudent but reasonable range for an unlevered beta for insurers.

Further adjustments

We consider that the 20% value proposed by EIOPA in paragraph 1442 to be too low. Instead, a value for x of **30% - 35%** may be derived from conservative estimates of the impact of franchise risk, and the impact due to risky assets held by insurers. This level of adjustment is consistent with the downward adjustment assumed by CEIOPS in its 2009 final advice on the Risk Margin.

CoC rate

From the above, the formula for deriving the Solvency II CoC rate can be expressed as:

$$\text{CoC rate} = (1-x)*\beta*\text{MRP}$$

As demonstrated in the sections below, we consider that the following parameter estimates are reasonable:

- MRP = 4% -5%
- β = 0.65 – 0.8

	• x = 30% -35% This would give an estimated CoC rate of between 2% and 3%. Thus a value of 3% for the CoC rate is appropriate, yet remains prudent.	
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19.4.1		
19.4.2	***Operation of the Principal Loss Absorbency Mechanism (PLAM) –*** The insurance PLAM can be triggered at going concern SCR levels and simultaneously with mandatory deferral on T2 (and in the case of trigger inversion even simultaneously with mandatory deferral on T3). Whereas the bank PLAM is triggered at gone concern and bank T2 does not require deferral. We consider the differences in the banking and insurance business models justify the differences in the way the PLAM applies to the two sectors, and we welcome EIOPA's view that there is a strong case not to align with the banking regime in this regard. Such alignment could have unintended consequences, such as worsening a crisis situation. However, we believe that there is no reason for the insurance PLAM to be triggered earlier than the banking PLAM.	
19.4.3	***Amendments to Article 71 of the Delegated Regulation unrelated to any alignment with the banking regime –*** EIOPA intends to recommend that even if it is decided not to align the PLAM with the banking regime, changes should be made to the Delegated Regulations to further specify	

	the operation of the PLAM. These changes include: • When and how partial write down should be permissible. We welcome the introduction of a permission for partial write-down when the mandatory trigger of 3 months SCR breach is reached, but only so long as the 75% SCR breach and MCR breach thresholds have not also been triggered. • Considering the need for further write-down – recalculation of the SCR. We agree with EIOPA's proposals for undertakings to recalculate their SCR coverage and perform further write-down every 3 months if necessary, until compliance with the SCR is restored. • How write-down subsequent to the initial write-down should be calculated. • Whether partial conversion of rT1 instruments should be permissible. We believe that partial conversion of rT1 instruments on breach of a mandatory trigger event should be allowed.	
19.4.4		
19.5.1	***Tax effect of restricted Tier 1 (rT1) which writes down on trigger –*** We note that EIOPA proposes not to align with the banking regime, and instead to continue to allow for full recognition of the principal amount of rT1 instruments on issuance.	
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19.6.3	***Paragraph 1504 –*** This paragraph is not necessarily correct with regard to regulatory calls. If a regulatory call is exercised because an instrument is no longer recognised as regulatory capital, the exercise of the call does not reduce regulatory capital.	
19.6.4		
19.7	***EIOPA's advice –*** We welcome EIOPA's proposals for a partial write-down under certain conditions, and its proposals to provide supervisory authorities with the ability to consider an exceptional waiver on write-down, in cases where the solvency position of the issuer would most	

	likely be significantly weakened as a consequence of the write-down. We maintain that trigger inversion should be avoided. Trigger inversion implies that the PLAM can be triggered when the group is still in a going concern state and thus while own funds are still sufficient to withstand another 1-in-200-year event.	
20.1	***Capital instruments only eligible as tier 1 up to 20% of total tier 1 –*** We welcome EIOPA's assessment that the status quo should be preserved in this area, as the strengthening of the related criteria would prevent most insurers from issuing Tier 1 instruments in the form of subordinated debt.	
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20.4.1	***Analysis: strengthening of the features required of rT1 instruments –*** The improvement in the capital quality of rT1 instruments through a longer first call date is questionable. Any redemption is already subject to regulatory approval, which should ensure that the capital position of the issuer is maintained at an appropriate level. An extension of the first call date would restrict the financial flexibility of the issuer. The fact that <u>5-year call dates do not reduce the permanence of capital</u> instruments without step-ups is demonstrated by the <u>actual history</u> of numerous perpetual instruments with 5-year call dates ("perpNC5") issued into the USD markets, for which perpNC5 is the standard format, particularly for non-domestic USD. No behavioural expectation attaches to the 5-year first call dates, and many of these instruments have remained outstanding many years beyond their first call dates without any market reaction. Whilst rT1 would not be suitable for all current investors in this market, it would be suitable for a sufficient part of the investor base (current buyers of bank AT1 which permits 5-year calls) to make this market a very interesting potential source of rT1 capital. Therefore, in the event Option 2 were chosen, we disagree with the proposal to lengthen the	

	minimum period of the first call from 5 to 10 years. Not only would this take away option value and financial flexibility from the issuer, it would also risk the loss of an investor base which consists of willing buyers of truly perpetual but callable instruments. We also disagree with the proposal in Option 2 not to permit any call dates. There are no legal mechanisms to eliminate this capital (unlike equity), so a perpetual instrument without call rights would reduce the issuer's financial flexibility to an unacceptable extent.	
20.4.2	***Analysis*** ***Paragraph 1531 –*** We agree with EIOPA that that no strengthening of the features required for restricted Tier 1 instruments would mitigate the effect on Tier 1 own funds of removing the 20% limit. In fact, restricted Tier 1 instruments as currently anticipated are already riskier than equity in several aspects because mandatory conversion can lead to an inversion of the hierarchy of capital (i.e. holders losing before equity), which makes instruments expensive. Any strengthening of criteria or addition to the requirements will render them even less attractive, making it impossible for all but the strongest insurers to issue Tier 1 in the form of subordinated debt in the capital market. ***Paragraph 1538 –*** We welcome EIOPA not recommending a blanket measure to withdraw altogether the ability for hybrid instruments to be recognised as Tier 1 capital.	
20.4.3	***EIOPA's advice*** We support EIOPA's Option 1 recommendation, which keeps the status quo (retaining the 20% limit). If Option 1 were not to be accepted, grandfathering arrangements would be essential. We do not support Option 2. As noted above, the extension of the first call date would restrict the financial flexibility of the insurer and eliminate a good source of rT1 capital as 5-year first calls are standard (particularly in the non-domestic USD market) for perpetual instruments. Although no behavioural expectations attach to these call dates, and numerous perpetual instruments have	

	remained outstanding for many years beyond their first call dates without any adverse market reaction, we consider that a deviation from the standard terms would impair the marketability of rT1 instruments – long-standing practice has a strong influence in these markets. In Option 2, EIOPA proposes to change the mandatory triggers. We are concerned by these proposals and note the following: • The SCR coverage ratio is likely to be very volatile, but it is currently unclear how volatile, so it is impossible to calibrate the trigger to a sensible level. To be meaningful, there would possibly need to be differences for differing sectors of the insurance industry. • The SCR already includes a substantial buffer over the MCR to cover a "1 in 200 year" shock. Raising the trigger materially above the current level would make a breach proportionally more likely, at a level of capitalisation which might still be comfortable. We note that as at H1 2016, the range of published SCR ratios was very wide, from 126% to 196%. We are also concerned about the suggestion in Option 2 that rT1 should not have any call dates. The legal framework for bonds is different from that of ordinary shares, and there would be no possibility ever to eliminate perpetual instruments without call rights if – for example – the regulatory requirements for own funds items changed in the future, or the circumstances of the issuer changed. In our view, such a requirement would restrict the financial flexibility of the issuer to an unacceptable degree, and would be a serious disincentive for the issue of rT1.	
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