Comments Template on EIOPA-CP-19-006
Consultation paper on the Opinion on the 2020 Review of Solvency II

Stakeholder name:	*Institute and Faculty of Actuaries (IFoA)*
	Disclosure of comments: EIOPA will make all comments available on its website, except where respondents specifically request that their comments remain confidential.
	Please send the completed template to CP-19-006@eiopa.europa.eu, in MSExcel Format, (our IT tool does not allow processing of any other formats).

Questions to stakeholders		Response
	Q2.1	We support the objective approach of measuring the impact of any changes to the derivation of the risk free rate against: - the impact of the underestimation (in the current low interest rate environment) of technical provisions; - risk management incentives; - stability of the solvency position and impact on financial stability weighed up alongside the evidence on DLT assessments. While the proposed alternative method allows for input rates to have varying weights, there are a number of shortcomings; these are the: - discontinuities in forward rates which are likely to cause unwanted volatility in the value of liabilities as they cross over points of discontinuity over time; - inconsistent formulas in the pre-LLP and post-LLP parts of the curve; - the difficulty for firms to replicate the curves; - averaging of forward rates of different terms which creates a bias when the yield curve is not flat. If partial precision of inputs is to be incorporated (whether based on trading volumes or some other measure of precision) we feel there are ways of doing this that are better suited than the proposals in Annex 2.6. The Smith-Wilson objective function could be adapted to incorporate a least squares rather than an exact fit approach to yields whose precision is in question. At the same time, the exact convergence to the UFR at the convergence point can be incorporated as a constraint. This results in a modified series of linear equations to the current Smith-Wilson formula. The IFoA could provide the mathematical derivations on request should this be helpful to EIOPA. In summary we would favour one of Options 3 or 4 to be adopted with a preference for Option 4 with due regard being given to the approach to be taken for those firms that may become technically insolvent as a result.
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	Q2.12	
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	Q3.4	In relation to the MA and VA, we agree that if the reference undertaking is assumed to inherit use of the MA from the insurer, then the risk margin should allow for the associated SCR for credit risk on the backing assets. Nevertheless, this method should be allowed as an alternative. We regard the VA as a proxy for the liquidity risk inherent in liabilities (as noted in the table under paragraph 3.190), and not a function of assets held. We therefore consider that allowing for the VA in both the SCR calculation for the reference undertaking and the discount rate for future costs of capital would be appropriate, and there would be no reason to assume that this required the reference undertaking to hold risky assets and hence a SCR for market or credit risk. *This is Recommendation B in the IFoA Risk Margin Working Party paper described in our comments on paragraphs 3.121-3.137.*

	Q3.5	We believe that the following alternative approaches to the calculation of the risk margin should be considered: **1. Treating longevity risk as hedgeable** There is an active market in reinsuring longevity risk, and we believe that it should be allowed to be treated as hedgeable in the risk margin calculation, as is the case for (most) market risk. Where (re)insurers can validate this assumption, it would be appropriate to replace the longevity risk component of the risk margin calculated with the cost of capital method with the market cost of transferring the risk. This would improve market consistency and reduce distortions. Our research suggests that the cost of longevity reinsurance as a proportion of best estimate liabilities (BEL) is typically insensitive to changes in interest rates. This is in strong contrast to the risk margin where our research shows that the risk margin (as a proportion of BEL) for a typical annuity block rose around 20% in the first 8 months of 2016, simply due to falling interest rates. *This is Recommendation C in the IFoA Risk Margin Working Party paper described in our comments on paragraphs 3.121-3.137.* As a practical alternative, the longevity risk component of the risk margin could be defined as a fixed percentage of BEL for the relevant business. This percentage would be derived on a prudent basis having regard to an analysis of reinsurance costs. This component could either replace the existing method or act as a cap on its result. **2. Use of MOCE as an alternative to risk margin** We recognise that EIOPA’s scope was confined to consideration of the cost-of-capital method, but in our view many of the issues arising from the risk margin, particularly for long duration liabilities, are a function of the method itself, not just its design and parameterisation. International Capital Standards have developed the concept of a Margin Over Current Estimate (MOCE - previously referred to as Percentile-MOCE), and our research suggests that this method has also been more commonly adopted in Asian markets moving to risk-based capital regimes. We would recommend that EIOPA and the Commission consider whether Solvency II should move to this approach, or allow it as an alternative.
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	Q3.7	

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	Q12.1	Given the different existing legal frameworks for companies across Europe including (re)insurers, we agree with EIOPA's proposal for minimum harmonised rules at the EU level for recovery and resolution of (re)insurance undertakings. We also agree with EIOPA that the recovery and resolution measures proposed should apply to both insurance and reinsurance undertakings. In addition we would add: - as well as reinsurers, specific consideration needs to be given to the treatment of reinsurance pools; - consideration needs to be given to the direct writers who also have inwards reinsurance, as currently the reinsured policyholders rank below other policyholders in wind-up. Our view is that all material undertakings should develop and maintain recovery plans in a pre-emptive manner but applying a proportionality principle. This would mean that the largest undertakings would be required to have a robust recovery plan; other undertakings would also be required to develop more robust recovery plans if the prospects of those plans being needed increase. In that way, undertakings would not be starting from nothing if their capital resources were to deteriorate; the process of considering recovery plans, including reverse stress testing, should in any case help make significant deterioration less likely as management actions can be taken earlier.
	Q12.2	As for our response to Q12.1, we believe it is appropriate to require the largest undertakings to have a robust resolution plan, and other undertakings being required to have more robust resolution plans if the prospects of those plans being needed increase. We note this is effectively the situation in the UK currently, where PRA Fundamental Rule 8 requires firms to have a resolution plan, but in practice this is only enforced for the largest undertakings or when the prospect of entering resolution is material. We agree that relevant factors are difficult to specify generically, but will depend on an assessment of factors including: the size of the undertaking, extent and materiality of cross-border activity, business model, risk profile, interconnectedness, and substitutability of undertakings. However, we think it is important that NSAs give the insurance industry some idea of the criteria they are using, and individual firms are notified of the reasons why it has been decided that they need to have a formal resolution plan.

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	Q12.3	We agree that early intervention triggers should be judgement-based. For example, the extent and type of intervention will depend on whether an event is idiosyncratic to one firm or is a market-wide issue. In addition, the structure of firms and the business they write, as well as the effectiveness of the firm's risk mitigation (for example reinsurance programmes or approach to hedging), will mean that some firms are more likely to deteriorate quickly than others, and thus intervention may need to be sooner.
	Q12.4	This is inevitably a difficult assessment, particularly if the reason for a viability assessment is systems or data-related; then up-to-date financial statements and projections may not be readily available. However, the supervisor should be requesting and receiving information on the status of a firm as situations develop. The exact nature of the information required will vary from situation to situation. In addition, the supervisor will have some information on a firm's business model and the risks to which it is most exposed; for example, it should have seen the firm's ORSA and the results of (reverse) stress testing exercises. It is likely that the firm will also have been implementing planned management actions and the supervisor should have been kept informed of the impact of those actions, although the extent of the impact may not be immediately apparent.
	General comments	
	Comments on Executive Summary	As with any consultation response from the IFoA, we have considered the issues and proposals within EIOPA's consultation paper from a public interest perspective, rather than consider any impacts from an insurer-specific viewpoint. As such, in our response we have focussed on topics where we believe there is an industry-wide, public interest impact.
Chapter (enter 1, …, 14 or A for Annexes)	**Paragraph** (enter only the second number, e.g. 11 for paragraph 3.11)	**Comment**

2	144	We support the proposal to remove the restriction on diversification benefit between MA portfolios and other business. We agree with the analysis within paragraphs 2.144-2.151: in our view, there is no rationale for a partial limitation of the diversification benefits. We note that in practice firms with MA would expect to be able to extract any surplus within their MA portfolios generated by a stressed event which could be used to offset additional reserve requirements in other parts of the business. The obvious example for MA portfolios is a mortality shock/longevity weakening scenario.
2	164	We support the conclusions of the analysis and the advice to remove the limitations to the diversification benefit as proposed in option 2.
2	180	We note that the proposed new requirements appear to be in line with the UK Prudential Regulation Authority's approach to restructured assets, and equity release mortgages (ERMs) in particular. One key issue is whether any uncertainty in the cash flows is reflected in the Fundamental Spread. A robust credit rating process would be an appropriate mechanism to ensure this occurs. For example, where the credit rating approach reflects stresses relating to prepayment, disinvestment/refinancing or similar risks, the restructured asset should be considered to provide an equivalent level of fixity as for a corporate bond of the same rating, and hence would still be appropriate for MA purposes.
2	183	Applying a look through approach for all restructured assets is likely to be overly burdensome for firms. We therefore suggest that this approach should not apply where holdings are small relative to the overall MA portfolio, or where doing so would be disproportionate to any potential risk exposure.
2	194	We note that the 'yield to worst' callable bond approach has been rejected on the basis that fixed cash flows cannot be ensured. In particular, a proposal to use a reinvestment assumption of current forward risk-free rates is cited as having deficiencies in this regard. We agree that recognising a risk-free reinvestment assumption in respect of assets with a fixed coupon rate is problematic. However, where callable assets have cash flows linked to a floating rate (which can be MA eligible if paired with a float-to-fixed interest rate hedge), this treatment would appear justifiable.
2	196	We suggest EIOPA reconsiders its decision to disregard the inclusion of a 'Yield to Worst' approach on the grounds that the holding of cash is an inappropriate or ineffective asset. Applying the Yield to Worst approach to cash would allow cash to be included as a zero yielding asset. That aside, the regulatory regime would be strengthened by allowing a portfolio to include cash for the benefits of the liquidity it can bring in unexpected circumstances. It was also cited that holding cash is an ineffective asset as it dilutes the MA benefit. This second judgement is a commercial judgement for a firm to make rather than a view to be taken by a regulator on a firm's behalf.

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2	197	This paragraph states that the proposed approach would not apply to assets already in MA portfolios. It is important, however, that this does not create an uneven playing field and disadvantage or discourage new entrants. Firms who are adding exposure to a particular restructured asset type should be as accountable as those who are seeking investment in the same asset type for the first time.
2	200	We support proposals that both improve and reduce the cost of regulation as suggested in this paragraph.
2	201	The additional eligibility criteria provide added clarity around those assets that can be considered for restructuring and the regulatory expectations around the restructuring of assets. These are helpful. Some asset restructures do not require loss absorbency features, as the restructure is merely splitting an asset into a ‘fixed’ and ‘variable’ cash flow. An example of this would be a long lease property asset, where the lease and residual property are separated via a restructuring process to create two notes. The lease cash flows are simply passed through to the note held in the MA portfolio, and so no loss absorbency is needed. We therefore suggest that Point 2 in the Advice in para 2.201 should have the words ‘where necessary’ added, so that it says: *2. the restructured asset cash flows are supported by loss absorbency features, where necessary, such that those cash flows are sufficiently fixed in term and will remain so even as operating conditions change;* Point 4 in the Advice paragraph 2.201 refers to ‘manage’ the underlying risks. The meaning of this is unclear to us. Within a securitisation there may be features that look to manage risks such as in relation to liquidity, but there may also be risks that are fixed e.g. the assets within the securitisation vehicle may be fixed. Guidance on what is meant by proper management of the underlying risks should be provided to ensure the regulations are interpreted as intended.

2	742	We refer to the text: ‘A more consistent and comprehensive approach to…’. We support the principle of ‘A more … comprehensive approach’, i.e. risk management should consider the impact of variations in each LTG measure that the undertaking uses. Although we also support the principle of ‘A more consistent … approach’, we suggest that the implementation of this principle needs particular care: the various LTG measures (MA, VA, TM) and RFR extrapolation are diverse. These measures all depart from market-consistent valuation of liabilities in different ways and for different reasons, and are based on differing theories. The risk management requirements for each of these measures should be consistent with the risk introduced by that measure, i.e. the market risk, since the measures are grounded in alternatives to market consistent economics. Since the measures are diverse, the risk-management requirements may also need to be diverse. The present proposals do not take into account that the measures are diverse; therefore the proposals would not achieve consistency. *See also comments on paragraph 2.762 below.*
2	755	We support the design of the proposed new stress on RFR extrapolation. **We do not express a view on whether it is appropriately parameterised.** The market risk introduced by RFR extrapolation is that the LLP changes or the UFR reduces, due to any of: - incremental change in input data (such changes have already happened); - step change in input data, i.e. central bank inflation targets; - step change in economic model, i.e. different judgement about LLP, or reliance on something other than an assumed long-term real return. The proposed new stress is a severe but plausible step change scenario, therefore is consistent with the risk. However, taken together with the existing ‘non-application’ tests, this proposal would not deliver the ‘more consistent … approach’ that EIOPA considers necessary. *See also comments on paragraph 2.762 below.*

2	762	The proposed intervention power for NSAs would very significantly and suddenly increase the level of actual SCR coverage that some undertakings need, in order to be sure that they can distribute capital. Therefore it would lead to a corresponding increase in the amount of risk-bearing capital that some undertakings need to hold; and/or it would lead to undertakings reducing their market risk profiles. This could result in lower expected returns, to mitigate the impact of these scenario tests. These impacts, and the incentives that they create, would be stronger when credit spreads are higher, thus the proposed power would have significant pro-cyclical effects. The cost of the additional capital and/or lower expected returns would be reflected, via market forces, in higher product prices. The undertakings affected to a greater extent would experience significant and sudden competitive disadvantages, both in insurance product markets and in capital markets, relative to those less affected. **We therefore do not support** a new intervention power that would increase non-economic capital requirements and would have significant pro-cyclical effects. **We believe that the distorting and pro-cyclical impacts of this proposed power are extremely important**, possibly the most important aspect of the entire 2020 consultation package. In relation to RFR extrapolation, the proposed new test is a severe scenario; see comments on paragraph 2.755 above. So the impact on some undertakings' capital needs would be correspondingly severe. If a new intervention power is to be created, we do not support the proposal to base the power on the existing 'non-application' tests on the LTG measures. In our view these tests are not appropriate risk-management scenarios, because the non-application tests are unrelated to the market risks introduced by the LTG measures. In relation to TM, we believe the proposal is inappropriate because: - the market risk is that the impact of TM reduces faster than expected, either by periodic or ad-hoc recalculation (such changes have already happened); or/for TMTP, by changes in the effect of the financial resources requirements 'cap'; - non-application of TM would not result from any of those causes. Thus, the existing non-application test is not consistent with the risk; - non-application of TM could result from failure to provide an adequate phasing-in plan, when SCR would not be covered without TM. However, the TM regime already requires a phasing-in plan in those circumstances, with annual reports on progress, and NSAs must revoke TM if progress is not sufficient.

3	121	Note that the following comments relate to paragraphs 3.121 -3.137: The IFoA established a research working party in September 2017 to investigate the risk margin. The research was published and presented in September 2019, and is available at: https://www.actuaries.org.uk/system/files/field/document/Risk%20Margin%20Working%20Party%20Research%20Paper%20Final%2008082019_0.pdf. The paper focuses mainly on non-profit annuity business in the UK, which is particularly affected by the size and volatility of the risk margin. Insured annuities are very important to the UK system of retirement provision. Nevertheless, much of the paper is relevant to life insurance business throughout the EEA. We would commend the whole research paper to EIOPA's attention but, in summary, the key findings for UK annuity business are: - the risk margin produces results well in excess of the cost of risk transfer to third parties; - this has been exacerbated as interest rates have fallen, as the risk margin is significantly more sensitive to interest rates than the corresponding market price of risk transfer. This in turn has a number of adverse effects: - the cost of annuities for both individuals, but also corporate pension schemes looking to insure the pensions of their members, is artificially high due to the cost of holding capital to back the risk margin; - there is an artificial incentive to transfer risks outside of the Solvency II regulatory regime either to non-EU reinsurers or to EU entities (such as the new superfunds proposed in the UK) regulated under different regimes; - insurers contribute to pro-cyclicality in long-dated interest rates. The risk margin may not be fully hedged, since the interest rate sensitivity is much higher than IFRS or economic measures of risk; but as interest rates fall, Solvency II becomes a binding constraint, and insurers have been forced to hedge, causing further falls in rates. This behaviour was seen in Q3 2016, and has recently been seen again in Q3 2019. The Working Party's recommendations for potential reforms to the risk margin are to: A. allow for an automatic change in the assumed cost-of-capital rate when risk-free rates change; B. allow a prudent illiquidity premium to be used in the calculations of the projected future SCRs and in the risk-free rate used in discounting the future costs-of-capital; C. allow certain longevity risk to be treated as hedgeable and the relevant part of the risk margin to be replaced by the cost of the

3	152	Note that the following comments relate to paragraphs 3.152 -3.162: We note that EIOPA's analysis of a limited number (24) of transfers of open and closed blocks in the EU did not indicate any systemic mis-calibration of the technical provisions compared to transfer values. However, this considered only transfers of whole blocks of business. For longevity risk associated with UK annuity business, there is a very active market in longevity risk reinsurance transactions, and these transactions are 'purer' transactions, free of many of the issues identified in 3.152 of the consultation (e.g. there is no distortion from new business value or brand). We consider this further in our response to Q3.5.
3	163	We note that EIOPA's analysis focuses entirely on the potential use of the MA and VA in both the SCR calculation for the reference undertaking, and the discounting of the projected costs of capital. We consider this in our response to Q3.4. However, there are other assumptions relevant to the reference undertaking that should be considered. The level of diversification allowed between different risks is particular to the insurer. This means that the risk margin for a given risk can differ between two insurers – one with a concentrated risk (to longevity say) and one with a diverse portfolio of non-market risks. This appears inconsistent with the market-consistency requirement. This feature may also explain why insurers with a significant concentration of longevity risk are incentivised to transfer their risk to the US market, where the (re)insurer may benefit from diversification against senior life insurance risk. An alternative approach would be to perform the risk margin calculation allowing for the marginal contribution to SCR against a diverse portfolio of risks.
3	177	We disagree with the comment that allowing use of the MA 'increases the sensitivity of risk margin to changes in interest rates'; we would expect it to have the opposite effect.

3	204	EIOPA's findings are consistent with our analysis, namely that for UK annuity business (i.e. business with a high MA exposure), the risk margin as a percentage of BEL increases as interest rates fall, and vice versa. As stated above, we believe this is inconsistent with the actual market price of risk transfer, and furthermore causes pro-cyclicality. Therefore, in the absence of other amendments (e.g. moving away from a cost-of-capital method entirely) we believe the cost-of-capital rate should be reduced as interest rates fall. *This is Recommendation A in the IFoA Risk Margin Working Party paper described in our comments on paragraphs 3.121-3.137.*

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3	208	We note that EIOPA has not identified any reason to change the cost-of-capital rate, as this was reviewed in detail in 2018. Although we propose in our comments under paragraph 3.204 that the cost-of-capital rate should vary with interest rates, the derivation of the rate is important, either in respect of the calibration of the variable rate or in the situation that our proposal for a variable rate is not agreed. The current cost-of-capital rate is based on the equity risk premium, assuming that capital is provided exclusively in the form of equity. Section 6.1 of the Working Party's paper describes the adjustments that should be considered in deriving the rate. We would draw EIOPA's attention to the arguments made by Craig Turnbull, who opened the discussion at the presentation of the Working Party's paper in Edinburgh. In summary, Mr. Turnbull argued that: - the choice of 6% as the cost of capital rate is a significant technical error; - the reference undertaking is nothing like a typical European insurance company or the index of corporations that has been referred to in the EIOPA calibration of the cost of capital parameter, and has a zero-beta balance sheet; - the only compensation required by the shareholders of the reference undertaking is for the frictional costs incurred in tying up their capital on this balance sheet rather than holding it directly; and - estimates of this frictional cost of capital usually vary between 2% and 4.5% (e.g. CRO Forum 2008: https://www.thecroforum.org/wp-content/uploads/2012/10/croforummvlpaperjuly2008-2.pdf) and there are several reasons to believe a well-supervised insurance company in today's environment should have a frictional cost of capital even lower than that of a typical corporation. Mr. Turnbull's full speech can be found at:/https://craigturnbullfia.com/on-the-solvency-ii-risk-margin/
12	98	'Early intervention' refers to supervisory action on an undertaking or a group (together 'a firm') that is not in breach of the SCR or MCR. We believe that some of the proposed powers are disproportionate for a firm in that situation, and are more appropriate to firms in recovery or resolution. Moreover, invoking some of these powers could increase the likelihood of a firm entering recovery or resolution.

12	99	We strongly suggest that: - **NSAs must not disclose publicly** that early intervention powers are being used on a firm. Publishing this fact would itself risk further damage to the firm, including to undertakings not in difficulty that belong to an affected group, and could heighten the risk to policyholders; - for the same reason, any additional or more frequent reporting should also be private between the NSA and the firm; - NSAs should not be given an early intervention power to suspend or limit any contractual right of policyholders, including the right to surrender their contracts, even on a temporary basis. We develop this point in our comments on paragraph 12.100 below.
12	100	We strongly suggest that an early intervention power to suspend the right to surrender should not be created. The creation of this power would, on its own, have significant and systemic adverse effects. We believe those actual detriments would by far outweigh the hypothetical benefit to some policyholders if the power was ever usefully invoked. The adverse effects of creating this power include: - giving customers a reason to ‘rush for the exit’ if they fear, rightly or wrongly, that the power will soon be invoked. Thus, the existence of this power would increase, not reduce, the risk at which it is aimed; - reducing the confidence of current and future policyholders that their contractual rights will be fulfilled; - creating scope for customers to litigate against NSAs for invoking, or for not invoking, the power, regardless of whether the relevant firm continues as viable; - breaking the principle that the firm, not the NSA, runs the business and manages the risks for as long as the firm is viable. This power belongs in resolution, not in early intervention, nor even in recovery. For the limited subset of policy types where this power is a useful risk-management tool, insurance undertakings already commonly include it in contractual conditions. Thus, where the power does not exist contractually, it is unlikely to be useful.