

**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:	Gesamtverband der Deutschen Versicherungswirtschaft e.V. (GDV)	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
<p>Please follow the following instructions for filling in the template:</p> <ul style="list-style-type: none"> ⇒ 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 <u>empty</u>. ⇒ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a paragraph or a cell, keep the row <u>empty</u>. ⇒ Our IT tool does not allow processing of comments which do not refer to the specific numbers below. <p>Please send the completed template, <u>in Word Format</u>, to CP-17-006@eiopa.europa.eu</p> <p>Our IT tool does not allow processing of any other formats.</p> <p><u>The numbering of the reference refers to the sections</u> 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.</p>		
Reference	Comment	
General Comment	<p>GDV supports the review of specific items in the Solvency II Delegated Regulation. We appreciate both the scope and the objectives of the review set by the European Commission:</p> <ul style="list-style-type: none"> - proportionate and simplified application of the requirements, - removal of unintended technical inconsistencies, - removal of unjustified constraints to financing. <p>We also acknowledge EIOPA's work and the proposed improvements in some areas. However, we</p>	

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believe that in other areas the advice has to be considerably enhanced. Thereby the over-all level of prudence set by the legislator must be maintained – requirements must neither be too low and underestimate risks nor be too high and overestimate risks.

This holds in particular for interest rate risk:

- First of all, EIOPA should obey the work programme given by the European Commission which does not include this topic at this point in time for good reason: Interest rate risk is closely interconnected with issues of the upcoming long term guarantees (LTG) review. Thus, there should be no isolated change of the interest rate risk at this point but only in the greater context of the LTG review. When changing interest rate risk, it must in particular be avoided to fortify pro-cyclicality.
- Secondly, any sensible modelling of interest rate risk must obey the empirical fact that interest rate changes are smaller in a low-yield environment. Bigger changes observed in past times of high interest rates must not be blindly transferred into a setting of low or even negative rates. Thus, some kind of relative model should be chosen but not an absolute minimum shock.
- Considering the basic pattern of observed interest rate changes and the given confidence level, both proposals of EIOPA are not appropriate and have to be discarded.
- In contrast, the relative shifted approach is better fitted to the observed data pattern and does not over- or underestimate risk. In particular, EIOPA's finding that the shifted approach did not pass backtesting cannot be replicated. In our in-depth-analyses the relative shifted approach passes the backtesting very well (see below for an explanation what apparently went wrong in EIOPA's calculation). As a consequence, under the three presented approaches only the relative shifted approach is a promising candidate for an appropriate interest rate risk modelling. Thus, the relative shifted approach has to be further analysed and – like the other two approaches – to be tested in the market.

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	<ul style="list-style-type: none"> - In any case, stress factors must only be applied until the last liquid point. Afterwards the shocked curves have to be extrapolated on their own. This is the only way to generate scenarios for the interest rate risk which are in line with the requirements of the Directive concerning the risk free interest rate curve. Only with correctly extrapolated shocked curves the true loss of own funds can be calculated which impends in case of changed market interest rates. According to the Directive, this loss of own funds is decisive for the SCR. In contrast, the proposed "phasing out " massively overstates the shocks in most situations. <p>Please find below our detailed comments on this issues as well as the comments on the other issues.</p>	
Introduction		
1.1	Recalibration of standard parameters of premium and reserve risks	
1.1.1		
1.2.1		
1.2.2		
1.2.3		
1.2.4		
1.3		
1.3.1		
1.3.2		
1.3.3		

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1.3.4		
1.3.5		
1.4	No objections	
1.4.1		
1.4.2	GDV welcomes the outcome of the new calibration for LE which is in line with our calculations.	
2.1	Volume measure for premium risk	
2.2		
2.3		
2.4.1		
2.4.2	<u>151</u> : GDV disagrees with the mentioned numbers. As the usual contracts in motor third party and motor other in Germany last from 01.01. to 31.12. under the new definition two years of premiums have to be taken into account, for all other LoBs 1.5 years. This contradicts the one year time horizon of the current calibration (as mentioned in the consultation paper). The adjustment factor does not at all improve the lack of a proper calibration. Moreover that means that the impact in Germany is not 6 or 5% but about 30% in motor and 15% in other LoBs.	
2.4.3	As the explanation for the adjustment factor 0.3 for FP_{future} in our opinion is not sufficient, we prefer to remain on option 1. If EIOPA decides to change the definition of FP_{future} we propose to introduce an undertaking specific correlation factor to the standard deviation σ instead of using the adjustment factor β for FP_{future}. The former calibration of the risk factors had been based on a 12 month time horizon. If now the time span to derive the volume measure for premium risk is higher than the 12 month period the	

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standard deviation is lower and has to be adjusted appropriately by using an undertaking specific correlation factor as follows:

Considering this the premium risk can be calculated by the following steps:

1. Determine P_s , P_{last_s} , $FP_{existing_s}$ and FP_{future_s} by following the proposed new definition from EIOPA.
2. Calculate as usual

$$V_{prems} = \max(P_s, P_{last_s}) + FP_{existing_s} + FP_{future_s}$$

which is the total premium volume to be considered within the calculation of premium risk.

3. Calculate **the undertaking specific number of years n_s** included in the total premium volume to be considered.

$$n_s = \frac{\max(P_s, P_{last_s}) + FP_{existing_s} + FP_{future_s}}{\max(P_s, P_{last_s})}$$

4. Compute

$$\sigma_{prems,undertaking\ specific} = \sigma_{prems,old} \cdot \frac{\sqrt{1+n_s \cdot r - r}}{\sqrt{n_s}}$$

and use this as standard deviation for premium risk in line of business s

where

$\sigma_{prems,old}$ is the standard deviation for a 12 month period as defined in Annex II of Delegated Regulation 2015/35,

r is the correlation factor between the random variables.

5. Determine r as follows
 - a. Assumed the n_s years are perfectly correlated, which is unrealistic:

$$r=1 \text{ and } \sigma_{prems,undertaking\ specific} = \sigma_{prems,old}$$

This is the current definition.

- b. Assumed the n_s years are uncorrelated:

$$r=0 \text{ and } \sigma_{prems,undertaking\ specific} = \frac{\sigma_{prems,old}}{\sqrt{n_s}}$$

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	<p>Consider two cases:</p> <p>a. One year contracts:</p> <p>Due to the possibility to amend premiums there is no correlation in the combined ratio or change in basic own funds in two subsequent years. So $r=0$.</p> <p>b. Multi-year contracts:</p> <p>If there is the possibility to amend premiums yearly there is no correlation in the combined ratio or change in basic own funds in two subsequent years So $r=0$. If a portfolio contains contracts without the possibility to amend premiums yearly a slightly positive correlation seems reasonable. In this case may be $r=0,25$.</p> <p>6. Follow all the other calculations as described in Delegated Regulation 2015/35 to obtain the premium risk (replacing $\sigma_{prem,s}$ by $\sigma_{prem,s,undertaking\ specific}$). In case of using Article 166 4. use P_s instead of $\max(P_s, P_{last_s})$ and adapt the steps in the obvious way.</p>	
3.1	Recalibration of mortality and longevity risks	
3.2		
3.3		
3.4.1		
3.4.2		
3.4.3	GDV agrees with not increasing the granularity/complexity of mortality and longevity stresses and the arguments given by EIOPA.	
4.1	Health catastrophe risk	

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4.2		
4.3		
4.4		
4.5.1		
4.5.2		
4.5.3	In general we agree in dropping the 10 year scenario. But we think in permanent disability the shift from 1.5% to 3.5% is too high.	
5.1	Man-made catastrophe risk	
5.2		
5.3		
5.4.1		
5.4.2		
5.4.2.1		
5.4.2.2		
5.4.2.3	In general we welcome th simplification. As in some cases the risk may be underestimated there should be a sound consideration in the ORSA.	
5.5.1		
5.5.2.1		
5.5.2.2		
5.5.2.3	In general we agree to the change of « tanker » to « vessel ». But we still don't see any proof that the requirement of Article 101 (3) of the Solvency II Directive is met.	
5.6.1		
5.7.1		

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5.7.2.1		
5.7.2.2		
5.7.2.3	We agree. However, the identification of the largest risk exposures on a net of RI basis in connection with the suggested simplification for man-made Fire might lead to the situation that many risks have the same maximum size. More precise advice regarding this simplification is desirable.	
6.1	Natural catastrophe risk	
6.2		
6.3.1		
6.3.2		
6.3.3.1		
6.3.3.2		
6.3.3.3	The second option is preferable – it can be more risk adequate sometimes and there is no drawback apart from a longer text. But we assume that there is no major impact on the results.	
6.4.1		
6.4.2		
6.4.3.1		
6.4.3.2		
6.4.3.3	We welcome the proposed changes for Germany WS/FL.	
6.5.1		
6.5.2		
6.5.3.1		
6.5.3.2		

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6.5.3.3	This would be a welcome and adequate improvement.	
7.1	<p>Interest rate risk</p> <p>EIOPA should obey the work programme given by the European Commission which does not include this topic at this point in time.</p>	
7.2		
7.3	<p><u>436</u>: Interest rate risk is closely interconnected with issues of the upcoming long term guarantees (LTG) review. Thus, there should be no isolated change of the interest rate risk at this point but only in the greater context of the LTG review.</p> <p><u>438</u>: When changing interest rate risk, it must be avoided to fortify pro-cyclicality. The current provision so far operated in a counter-cyclical manner. A departure from this in the present interest rate situation could have a dangerous pro-cyclical effect. In “bad times”, capital requirement should not be increased but, for stability reasons, rather tend to be lower than in “good times”. It should be acknowledged that the industry already faces a low interest rate environment-stress scenario.</p> <p><u>439</u>: see comment to para 436</p> <p><u>440, 441</u>: Any sensible modelling of interest rate risk must obey the empirical fact that interest rate changes are smaller in a low-yield environment. Bigger changes observed in past times of high interest rates must not be blindly transferred into a setting of low or even negative rates. Thus, some kind of relative model should be chosen but not an absolute (minimum) shock. This would also help to avoid pro-cyclicality.</p> <p>Moreover, in recent years, money and capital markets have been dominated by ECB's extremely loose monetary policy with its unconventional measures (in particular the quantitative easing). As</p>	

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a result, observed interest rates were heavily distorted. Their development hardly reflects market risk but is mainly driven by political decisions in an unparalleled situation. The observations from this special situation should not be used unchanged for the calibration of interest rate market risk in the future. This period of distorted interest rates in the meantime covers a material part of the data basis used for calibration.

442: There should be no minimum shock (see further comments in section 7.4.2).

443: Interest rate down risk decreases in the negative range because more and more market participants would withdraw from such detrimental investments and rather switch to other investments or, e.g., hold cash or cash equivalents. The resulting thinning-out of demand limits any further interest rate decrease. An appropriate modelling of interest rate risk must account for this. This should be done with a **lower interest rate bound**.

446: The shortcomings of the current relative approach in the low interest rate environment can easily be remedied by a **shifted approach** (see further comments in section 7.4.2).

447: There should be no minimum shock (see further comments in section 7.4.2).

452, 455: The stress factors must only be applied until the last liquid point (LLP). Afterwards the shocked curves have to be **extrapolated on their own**.

This is the only way to generate scenarios for the interest rate risk which are in line with the **requirements of the Directive** concerning the risk free interest rate curve: Art. 77a of the Directive requires „[...] *For maturities where the markets for the relevant financial instruments or for bonds are no longer deep, liquid and transparent, the relevant risk-free interest rate term structure shall be extrapolated.* [...]“ So if a shock to market interest rates occurred in reality, the new risk-free interest rate term structure would of course be calculated by extrapolation. The risk free interest curve is the basis for the calculation of technical provisions and, thus, for the calculation of own funds. Consequently, only with correctly extrapolated shocked curves the true

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loss of own funds can be calculated which impends in case of changed market interest rates. According to Art. 101 (3) of the Directive, the Value-at-Risk (VaR) of the loss of basic own funds is decisive for the SCR. Taken together, the SCR for interest rate risk must be deduced from shocked curves which are extrapolated with the same methodology (Smith-Wilson) as the best estimate curve.

Theoretically, the required VaR should be determined on basis of **entire term structures**. However, the quantiles of each maturity are calibrated separately. This means that comonocity is implicitly assumed. Given a particular value of the UFR, comonotonicity of the rates up to the LLP implies comonotonicity of extrapolated rates, too. Then the quantiles of the rates beyond the LLP can be obtained precisely by extrapolating the shocked curves.

In case the legislator would vote for changing the UFR according to a predefined method as currently proposed by EIOPA, the algorithm for annual changes to the UFR can easily be taken into account by extrapolating to the (changed) UFR expected for the next year. Which UFR will result from this algorithm in the next year depends on the current interest rate situation: The UFR can either change in exactly one direction or not change at all. If, however, in the extrapolation it is always assumed that the UFR increases in the up scenario and decreases in the down scenario, the result is already **conservative**.

In contrast, deriving the maturities beyond the LLP of the shocked curves simply from the best estimate curve via **phased out risk factors** is clearly inappropriate and **has to be discarded**. The resulting shock curves

- differ significantly from curves arising from proper extrapolation,
- are an inconsistent, artificial combination of interest rates before and beyond the LLP,
- could never be the basis for the calculation of own funds in the next year,
- are inadequate for calculating the SCR,
- are in violation of the requirement that the SCR should measure a 1 in 200 loss over a 1 year horizon,
- massively overstate interest rate risk in almost all situations.

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EIOPAs **simulations** indicating that the maximum annual change at the 90Y tenor point is 19% are no proper argument for refraining from a separate extrapolation of shocked curves. Actually, only a correct extrapolation is able to **yield the right changes beyond the LLP**. If interest rates until the LLP drop significantly, the extrapolation results in a marked drop of extrapolated rates, too. Thus, the given example of a 19% decrease as well as any other big or small change are automatically modelled in the right way. In contrast, just to apply a factor in the extrapolation area which is based on a maximal change would overstate the risk in almost all situations massively.

Complexity is not at all increased by a proper extrapolation of shocked curves. Exactly the same Smith-Wilson extrapolation algorithm which is already applied to the best estimate curve has just to be applied to another two curves. In addition, this will lead to smooth and realistic yield curves, which is under the proposed method not the case.

From a **legal point**, this is of course possible for EIOPA as EIOPA already calculates and publishes shocked curves. There is neither a further empowerment in the Directive needed for continuing to calculate and publish these shocked curves nor for doing the calculations in a proper manner (according to the requirements of the Directive with respect to the risk free interest rate curve).

We also do not understand EIOPA's counterargument regarding the forward rates: It is exactly the extrapolation of shocked curves which guarantees that changes of the **forward rates of the maturities before the LLP** are fully taken into account. In contrast, to apply risk factors to the spot rate best estimate curve beyond the LLP means not to take properly into account these changes and, thus, to misestimate risk.

456, 460, 463: In this context, **principal component analysis** (PCA) is not needed in order to reduce the dimensionality of data. Instead, it might be useful to filter some noise in the calibration data set. However, this may result in slightly smaller shocks which do not exactly represent the 99.5% quantil of raw data anymore. Thus, PCA may be one reason that properly calibrated shock factors, e.g. of a simple shifted approach, allegedly do not pass backtesting with

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	the raw data. In order to overcome this problem, PCA might be dropped. This would also reduce complexity of the entire calibration.	
7.4.1	The treatment of interest rate risk in the standard formula without a minimum downward shock has been set as part of the Omnibus II compromise on LTG measures. This political decision of the legislator has to be obeyed at least until the high-level review of the entire LTG package.	
7.4.2	<p><u>Shifted approach</u></p> <p><u>467–473: GDV fully supports EIOPA’s assessment that a shifted approach has many advantages (especially the more simple “relative shifted approach”):</u></p> <ul style="list-style-type: none"> - It considers adequately the main empirical fact that shocks in times of low interest rates are smaller than shocks in times of high interest rates, - works well with low and negative interest rates, - is a simple, transparent approach, - is as close as possible to the previous relative approach, - is easy to calibrate to the 99.5% quantile as required by the Directive, - is quite robust in terms of the shift parameter, - is a simple, transparent, data-driven approach. <p><u>474:</u> In footnote 42 it is asserted that a thorough back testing of the shifted approach is included as an appendix to the discussion (?) paper. This appendix is missing in the consultation paper at hand.</p> <p><u>474–476:</u> We cannot reproduce EIOPA’s finding that the shifted approach yields so many daily breaches in the backtesting. In our in-depth-analyses the relative shifted approach passes the backtesting very well. In fact, when looking at the curves depicted in EIOPAS’s figure 7.3, it seems that EIOPA made a mistake in the calculation of the shifted approach: Up and down curves are both located too high. As a consequence, the down curve has too many breaches</p>	

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whereas the up curve has no breach at all – however, this seems to be an artefact of an inconsistent proceeding. Then, EIOPA’s figures 7.1 and 7.2 are of course incorrect, too.

Possible explanation what went wrong: Over all, interest rates considerably decreased in the observation period (depending on the maturity, data for the euro are available since 1999, 2000 or 2001). In line with this, the relative shifted approach yields risk factors which are larger in the down scenario than in the up scenario. If, however, data were detrended before calculating the shocks, the risk factors would get noticeably bigger in the up scenario and noticeably smaller in the down scenario (in comparison to risk factors derived from original data). It seems that such “detrended shocks” were used to calculate the curves in EIOPA’s figure 7.3. Of course, risk factors which represent movements of detrended data cannot pass the backtesting with original data. A fair backtesting exercise must either apply shocks derived from detrended data to detrended data or apply shocks derived from unmodified data to unmodified data again.

If no detrending is applied and the data period consist of approximately 4,200 data points, the **relative shifted approach** delivers just the 21 breaches which relate to the 99.5% quantile. This result holds for many different calibrations in terms of exact data period and shift parameter as long as no principal component analysis (PCA) is added. If PCA is added, it slightly smoothes the data and delivers slighty smaller shocks. However, the difference in the shock factors is very small. In the backtesting, the number of breaches increases only marginal. Of course, the small estimation error caused by PCA can easily be avoided by dropping PCA which is not compulsory anyway. Independently, we do not see in the least any result with such high numbers of breaches as mentioned in para 475 (probably caused by misleading detrending).

Figure 1 below is a variation of EIOPA’s figure 7.3 that visualises the backtesting for the 10 years maturity. The “Up detrended” and “Down detrended” curves are calculated *with* prior detrending. They correspond to the up and down curves in EIOPA’s figure 7.3 (however, without PCA in the calculation). The light red “Up detrended” curve exhibits 0 breaches and the light green “Down detrended” curve exhibits 241 breaches. In contrast, the additional dark red “Up correct” and dark green “Down correct” curves are calculated *without* prior detrending. They both exhibit

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exactly 21 breaches. This is equal to the 99.5% quantile.

Note that in a calibration on a daily basis, only the number of **daily breaches** is crucial. Due to autocorrelation, these breaches often occur in clusters of subsequent daily breaches. However, the number of such clusters is not relevant and could vary for different maturities. Moreover, all breaches of the calibrated 99.5% stress are very small (only a few basis points).

Thus, it has to be concluded that the relative shifted approach passes backtesting very well and the calibration is sound.

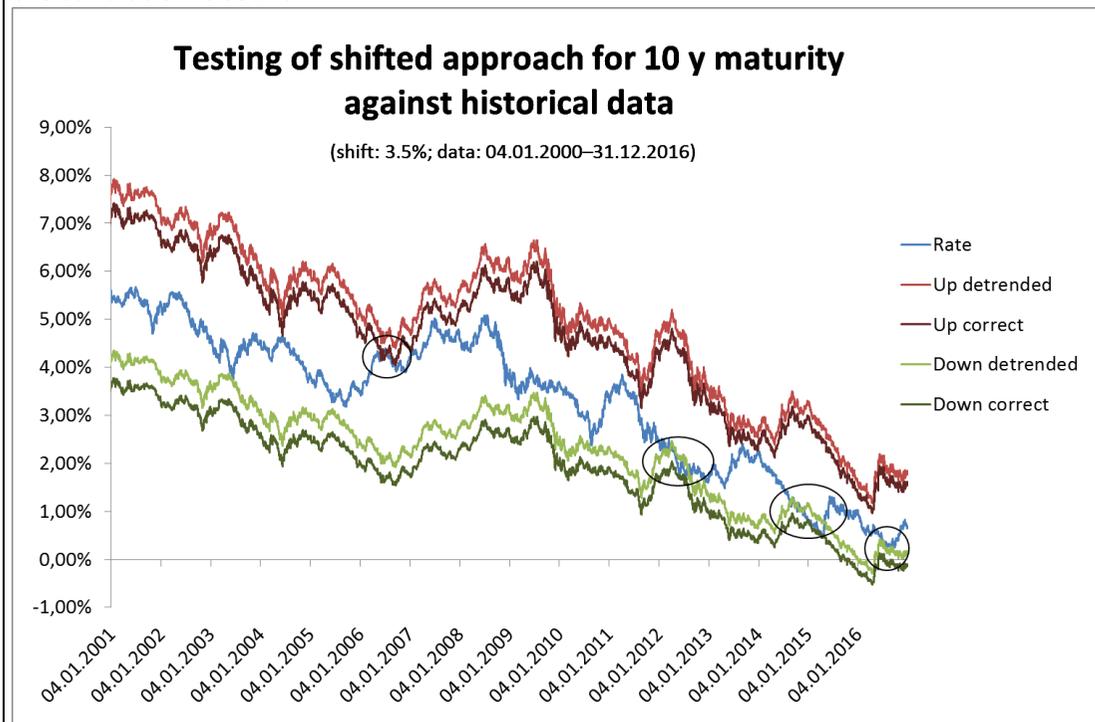


Figure 1: Testing of the relative shifted approach for 10 y maturity against historical data (shift: 3.5%; daily

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data: 04.01.2000–31.12.2016; no PCA)

Of course, the given confidence level is not only met by chance but **by construction**: In case of the relative shift approach without PCA, the 99.5% quantile of annual changes in the data directly determines the shock factors. Thus, if the shock factors are applied to exactly the same data period, they yield the 99.5% quantile again. **Backtesting is always passed.**

For any approach, the **observation period for the calibration** must be determined. If only the maturities used by EIOPA for the calculation of the risk free interest rate term structure (1–10, 12, 15, 20 y) are to be analysed, then beginning the observation period in 1999 seems naturally. The shock factors for the other maturities (with missing data in 1999) can easily be interpolated by the Smith-Wilson algorithm which has to be applied for the extrapolation beyond 20 y in any case (see comments on para 452, 455 in section 7.3). In principle, it is also possible to apply different observation periods for the particular maturities because their risk factors are calibrated independently anyway. However, this may result in implausible differences between risk factors of adjacent maturities.

If the observation period for the calibration is chosen differently, then the risk factors change, too. This is in particular important for the **size of the up shock**: **Figure 2** below is another variation of EIOPA's figure 7.3 that visualises the backtesting of the relative shifted approach for the 10 years maturity to this end. Please note that the two "detrended" curves are not recalculated but still correspond to the up and down curves in EIOPA's Figure 7.3. Only the two additional "correct" curves are now calculated from an extended data set which covers the year 1999, too. In 1999, interest rates strongly increased. The inclusion of this year in the observation period results in a significantly larger up shock than before. As a consequence, the dark red "Up correct" curve is no longer below but rather above the light red "Up detrended" curve located. The "Up correct" and "Down correct" curves now both exhibit 23 breaches, corresponding to the 99.5% quantile of the extended data set. Again, with respect to the confidence level given by the Directive and for this observation period, this is exactly the right number of breaches.

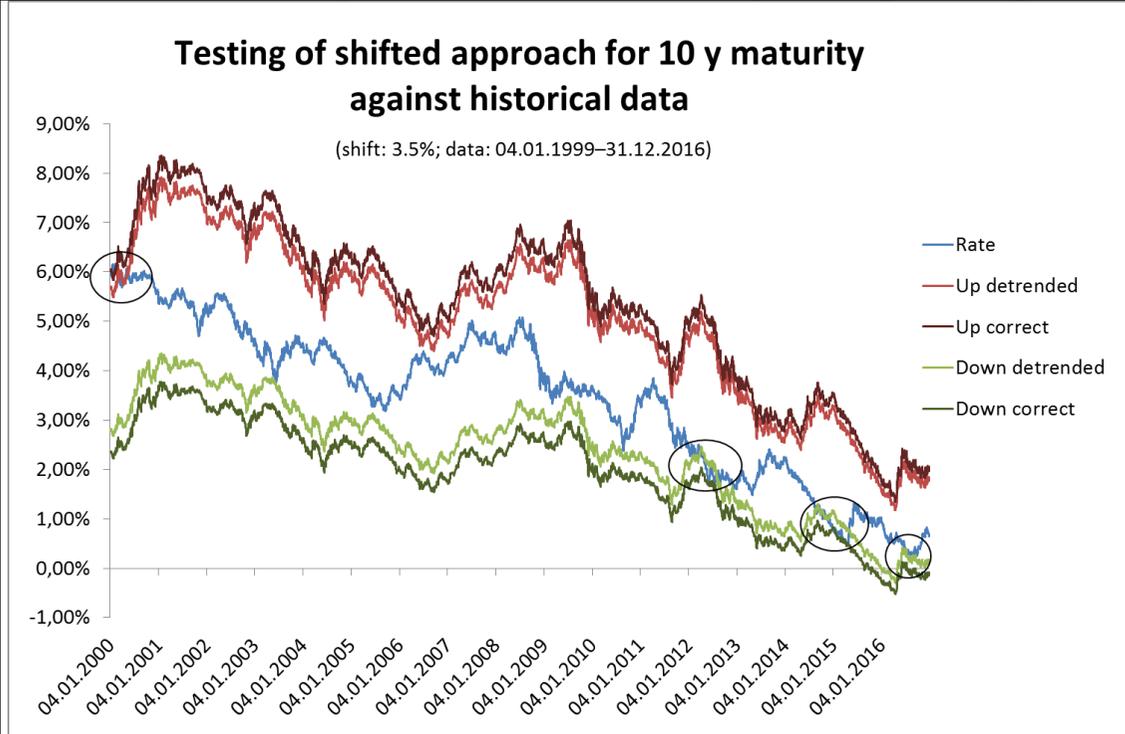


Figure 2: Testing of the relative shifted approach for 10 y maturity against historical data (shift: 3.5%; daily data: 04.01.1999-31.12.2016; no PCA)

Moreover, the observed breaches always relate only to some of the maturities but **never to all maturities simultaneously**. The result is that the combination of the individually calibrated risk factors is **conservative**. **Figure 3** shows for the down curve of the relative shifted approach on a daily basis how often simultaneous breaches of several maturities happened between 2001 and 2016 (since 2001 data for all maturities 1-20 y are available). The empirical probability that for a particular date breaches of nine or more of the twenty maturities happened simultaneously is

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only 0.3%. The empirical probability of simultaneous breaches of all maturities between 1 year and 20 years is in fact zero.

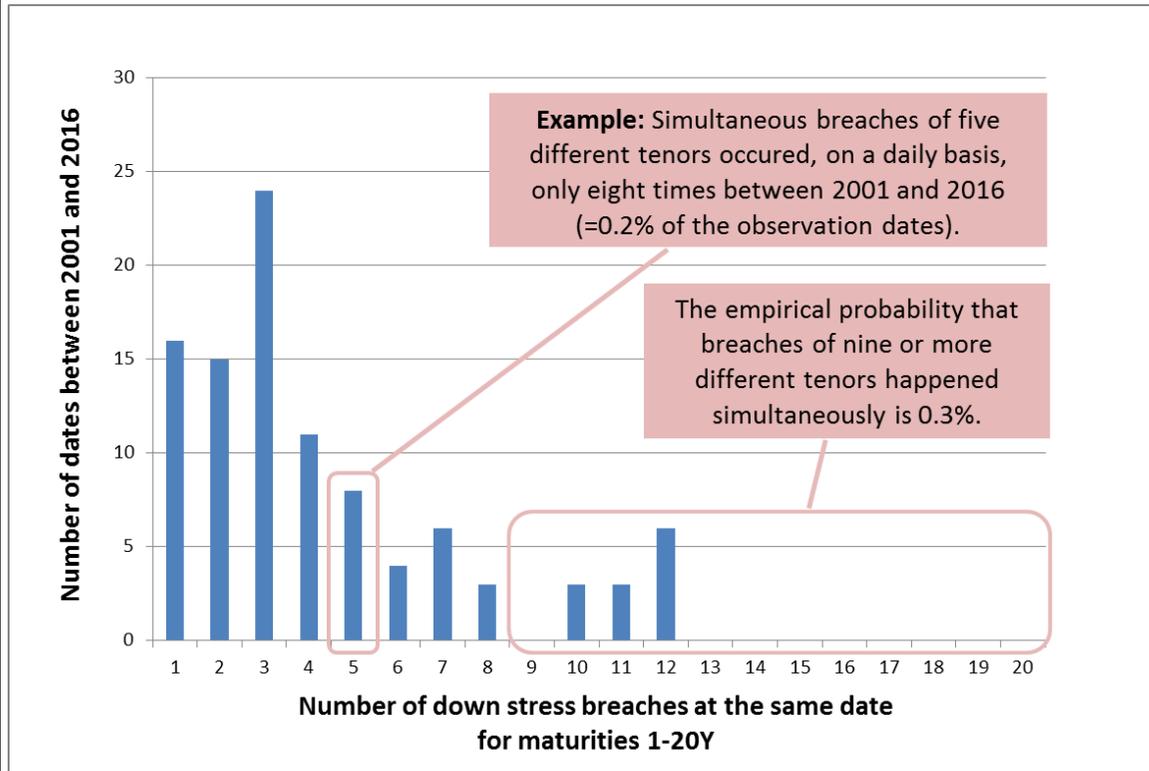


Figure 3: Incidence of simultaneously happening breaches for different maturities in case of the down stress curve of the relative shifted approach (shift: 3%; daily data: 2001–2016; with PCA)

477: Given that the relative shifted approach has so many advantages and also passes the backtesting, it is a promising option for modelling interest rate risk. This holds in particular in

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comparison to the two other options presented by EIOPA which suffer from severe draw backs (see below). Thus, the relative shifted approach has definitely to be further analysed and cannot be excluded from the testing in the market.

Symmetric 200 bp minimum shock with static interest rate floor (Proposal A)

479: The depicted (EIOPA's figure 7.4) annual changes as a function of the observed interest rate level clearly show that **interest rate changes are much smaller in times of a low level than in times of a medium or high level**. Thus, absolute amounts of shocks observed at times of much higher rates must not be used to calibrate interest rate in times of very low rates. **Any sensible modeling of interest rate risk must obey this very basic feature**. This can easily be implemented by some kind of relative approach. Due to problems of the previous relative approach with interest rates near to zero and below zero, this should in fact be a shifted relative approach.

480: We do not see **any proper calibration** of the proposed 2% shock. This approach seems not to be a data-driven approach. Thus, it must be assumed that this approach does not comply with the requirement of a 99.5% confidence level given by the Directive. In fact, figure 4 (see below at the comment to para 523 in section 7.4.3) shows that Proposal A clearly fails in the backtesting because it overstates risks by far. For a proper capital requirement it is not sufficient to ensure that the calibration does not underestimate the risk. It is also compulsory not to overestimate the risk. Thus, for both reasons – the approach cuts across the observed data pattern of shrinking risk at time of low rates and it seems not to meet the required confidence level – proposal A is not appropriate and has to be discarded.

481: **Stress factors must only be applied until the last liquid point (LLP)**. Afterwards the shocked curves have to be extrapolated on their own. This is the only way to generate scenarios for the interest rate risk which are in line with the requirements of the Directive concerning the risk free interest rate curve. In case the UFR was changed in the future according to a predefined method as currently proposed by EIOPA, the algorithm for annual changes to the UFR can easily be taken into account by extrapolating to the (changed) UFR expected for the next year.

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In any case, only with correctly extrapolated shocked curves the true loss of own funds can be calculated which impends in case of changed market interest rates. According to the Directive, this loss of own funds is decisive for the SCR. In contrast, the proposed "phasing out " massively overstates the shocks in most situations (see further comments on para 452, 455 in section 7.3).

Of course, this already holds for the **current standard formula**. However, if interest rate risk is recalibrated and shock factors increase, then the effect of the wrong calculation beyond the LLP increases, too. Thus, it gets even more urgent to correct this mistake and to extrapolate the shocked curves on their own.

482: We appreciate that EIOPA wants to take into account the fact that interest rates too far in the negative area have never been observed. However, a shifted approach would be the most natural and simple way to do so.

484: The value of the floor used in Proposal A is doubtful. It is not justified to take a floor obtained from the Swiss franc to the euro. Furthermore the value of -2% seems to be arbitrary since the most negative value observed was -1,22% (and this was even not a market price but highly distorted by the Swiss central bank in order to influence the currency exchange rate). In a Proposal A type approach, the floor for the interest rate should rather be based on the storing costs (for logistics and insurance) of holding cash. Cash is doubtlessly a legally permissible investment class for European insurance companies. Thus, the possibility to avoid investments with significantly negative returns should be taken into account. Analyses indicate that the costs of cash may range about -0,3% to -0,4%, so in a Proposal A type approach, an adequate floor should be significantly smaller than proposed by EIOPA.

485: EIOPA's **backtesting** figure 7.6 indeed exhibits that the proposal seems not to underestimate risk. However, it does *not* show that the proposal performs good or better than an other option but rather that the required 99.5% confidence level is missed. In fact, figure 4 (see below at the comment to para 523 in section 7.4.3) shows that Proposal A clearly fails in the backtesting

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because it overstates risks by far.

486: Conclusion: Proposal A

- is simplistic,
- is not a data-driven approach,
- cuts across the observed data pattern,
- does not comply with the 99.5% quantile as required by the Directive,
- massively overstates risk at time of low rates.

Thus, Proposal A is not appropriate and has to be discarded.

Combined approach (Proposal B)

488: GDV fully supports EIOPA's assessment that **for low or negative interest rates no extreme annual movements have been observed** and that, thus, the minimum shock of Proposal A can be challenged as overly prudent.

489–507: EIOPA's figures confirm that big interest rate changes, in particular big decreases, do not happen in times of low interest rate levels. In fact, the depicted quantiles exhibit a more or **less linear relation between the extent of changes (x-axis) and the lowest level at which these changes occur** (0.05% quantile or min at the y-axis). This is good evidence for a (shifted) relative approach.

510–511: Stress factors must only be applied until the last liquid point (LLP). Afterwards the shocked curves have to be extrapolated on their own. This is the only way to generate scenarios for the interest rate risk which are in line with the requirements of the Directive concerning the risk free interest rate curve. In case the UFR was changed in the future according to a predefined method as currently proposed by EIOPA, the algorithm for annual changes to the UFR can be taken into account by extrapolating to the changed UFR which is expected for the next year.

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In any case, only with correctly extrapolated shocked curves the true loss of own funds can be calculated which impends in case of changed market interest rates. According to the Directive, this loss of own funds is decisive for the SCR. In contrast, the proposed "phasing out" massively overstates the shocks in most situations (see further comments on para 452, 455 in section 7.3).

Of course, this already holds for the current standard formula. However, if interest rate risk is recalibrated and shock factors increase, then the effect of the wrong calculation beyond the LLP increases, too. Thus, it gets even more urgent to correct this mistake and to extrapolate the shocked curves on their own.

512–520: Due to the **high absolute shock components** of +1.4% and –1.0%, Proposal B also fails to sufficiently model the basic data pattern of shrinking interest rate risk in times of low rates. Moreover, Proposal B is obviously more composed than Proposal A and needs more external parameters that are not deduced from market data ("±2%"; "–1%"; "+1,4%"). Being an artificial, compounded approach it is likely that the inherited choices perform poorly when market conditions change. In fact, figure 4 (see below at the comment to para 523 in section 7.4.3) shows that Proposal B already fails in the backtesting. All in all, although Proposal B is less bad than Proposal A, it must be considered as inappropriate, too. The data pattern in times of low interest rates is much better modelled by a shifted relative approach.

521: **Conclusion**: Proposal B

- is quite complex with its combination of several max and min operators,
- does not sufficiently account for the observed data pattern,
- does not to comply with the 99.5% quantile as required by the Directive,
- noticeably overstates in particular the up risk,
- needs a couple of choices and external parameters.

Thus, Proposal B is less bad than Proposal A but still not appropriate. It should also be discarded.

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523: A **shifted approach** has **many advantages** (especially the simple “relative shifted approach”):

- It considers adequately the main empirical fact that shocks in times of low interest rates are smaller than shocks in times of high interest rates,
- works well with low and negative interest rates,
- is a simple, transparent approach,
- is as close as possible to the previous relative approach,
- is easy to calibrate to the 99.5% quantile as required by the Directive,
- is quite robust in terms of the shift parameter,
- is a simple, transparent, data-driven approach.

We cannot reproduce EIOPA’s finding that the shifted approach yields too many breaches in the backtesting. In our in-depth-analyses the shifted approach passes the backtesting very well. In fact, when looking at the curves depicted in EIOPA’s figure 7.3, it seems that EIOPA made a mistake in the calculation of the shifted approach: Up and down curves are both located too high. As a consequence, the down curve has too many breaches whereas the up curve has no breach at all – however, this is just an artefact of an inconsistent proceeding.

Possible explanation what went wrong: Over all, interest rates considerably decreased in the observation period (depending on the maturity, data for the euro are available since 1999, 2000 or 2001). In line with this, the relative shifted approach yields risk factors which are larger in the down scenario than in the up scenario. If, however, data were detrended before calculating the shocks, the risk factors would get noticeably bigger in the up scenario and noticeably smaller in the down scenario (in comparison to risk factors derived from original data). It seems that such “detrended shocks” were used to calculate the curves in EIOPA’s figure 7.3. Of course, risk factors which represent movements of detrended data cannot pass the backtesting with original data. A fair backtesting exercise must either apply shocks derived from detrended data to detrended data or apply shocks derived from unmodified data to unmodified data again.

If no detrending is applied and the data period consist of approximately 4,200 data points, the **relative shifted approach** delivers just the 21 breaches which relate to the 99.5% quantile. This

7.4.3

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result holds for many different calibrations in terms of exact data period and shift parameter as long as no principal component analysis (PCA) is added. If PCA is added, it slightly smoothes the data and delivers slightly smaller shocks. However, the difference in the shock factors is very small. In the backtesting, the number of breaches increases only marginal. Of course, the small estimation error caused by PCA can easily be avoided by dropping PCA which is not compulsory anyway. Independently, we do not see in the least any result with such high numbers of breaches as mentioned in para 475 (probably caused by misleading detrending).

Of course, the given confidence level is not only met by chance but **by construction**: In case of the relative shift approach without PCA, the 99.5% quantile of annual changes in the data directly determines the shock factors. Thus, if the shock factors are applied to exactly the same data period, they yield the 99.5% quantile again. Backtesting is always passed.

Size of the up shock of the relative shifted approach: If the observation period for the calibration is chosen differently, then the risk factors change, too. This is in particular important for the up risk as interest rates strongly increased at the beginning of the possible observation range (see comments on para 474–476 in section 7.4.2).

Given that the relative shifted approach has so many advantages and also passes the backtesting, it is **a good option for modelling interest rate risk**. Additionally, a shifted approach is the common standard approach for modelling interest rate risk within internal models. **In comparison to the two other options presented by EIOPA which suffer from severe draw backs, the shifted approach has to be chosen** (see further comments in section 7.4.2).

Figure 4 summarises this result based on the example of the 10 years maturity:

- **The relative shifted approach is better fitted to the observed data pattern than the other proposals. This holds in particular for Proposal A.**
- **Moreover, the relative shifted approach is the most simple approach without arbitrary case discriminations and kinks. Proposal B suffers especially from this.**
- **Only the relative shifted approach passes the backtesting with historical data. Both of**

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- the other approaches fail in the backtesting (note that a confidence level of 100% contradicts the requirements of the Directive). Proposal A and Proposal B overstate interest rate risk by far.
- **Conclusion: Under the three presented approaches only the relative shifted approach is a promising candidate for modelling interest rate risk which has to be tested, too.**

**Interest rate changes as a function of the interest rate level:
 Comparison of the three approaches and testing against historical data**

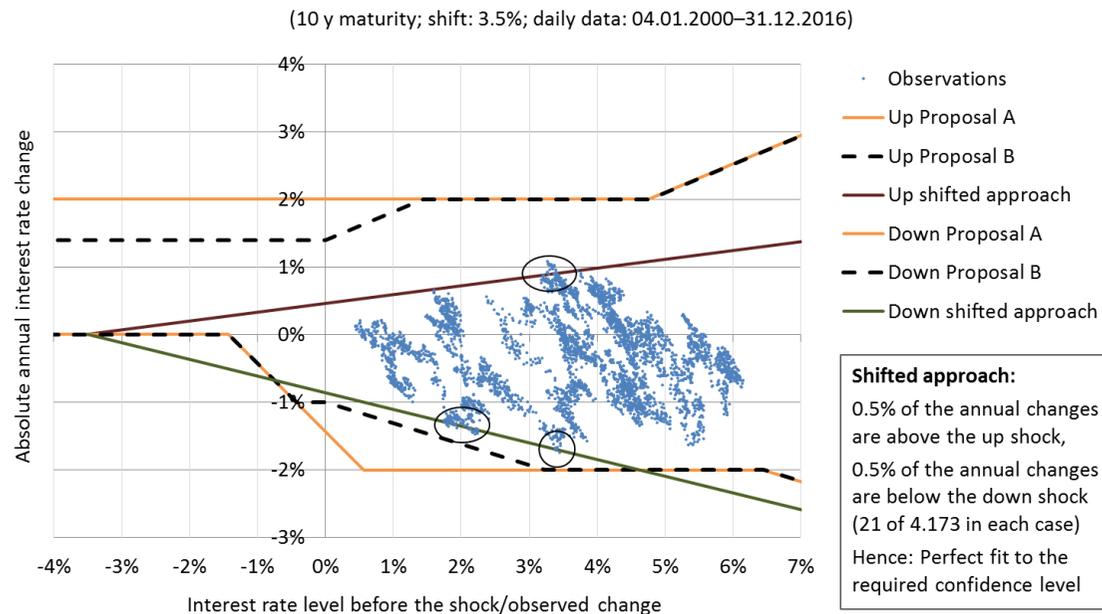


Figure 4: Interest rate changes as a function of the interest rate level: Comparison of the three approaches and testing against historical data (10 y maturity; shift: 3.5%; data: 04.01.2000–31.12.2016)

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524: Proposal A

- is simplistic,
- is not a data-driven approach,
- cuts across the observed data pattern,
- seems not to comply with the 99.5% quantile as required by the Directive,
- massively overstates risk at time of low rates.

Proposal B

- is quite complex with its combination of several max and min operators,
- does not sufficiently account for the observed data pattern,
- noticeably overstates risk at time of low rates,
- needs a couple of choices and external parameters.

Thus, Proposal A is not appropriate and has to be discarded. Proposal B is less bad than Proposal A but still not appropriate. It should also be discarded (see further comments in section 7.4.2).

525: If the current interest rate risk module was changed, two major points have to be regarded:

- **The relative shifted approach should be further analysed and be tested in the market, too.** In contrast, Proposal A and Proposal B are both inappropriate (see further comments in section 7.4.2) and have to be discarded.
- **In any case, stress factors must only be applied until the last liquid point (LLP).** Afterwards the shocked curves have to be extrapolated on their own. This is the only way to generate scenarios for the interest rate risk which are in line with the requirements of the Directive concerning the risk free interest rate curve. Only with correctly extrapolated shocked curves the true loss of own funds can be calculated which impends in case of changed market interest rates. According to the Directive, this loss of own funds is decisive for the SCR. In contrast, the proposed "phasing out " massively overstates the shocks in most situations (see further comments on para 452, 455 in section 7.3).

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8.1	Market risk concentration	
8.2		
8.3		
8.4.1		
8.4.2		
8.4.3		
9.1	Currency risk at group level	
9.2		
9.3	<u>581</u> : The prudent person principle does not require holding all assets locally.	
9.4.1	<u>592–597</u> : We support EIOPA's reasoning in this respect: it can be more realistic to consider currency risk based on the real economic exposure instead of the accounting currency.	
9.4.2	<p><u>602</u>: We believe that the current treatment of currency risk is overly conservative and unrealistic because it prohibits netting out changes on assets and liabilities for each foreign currency. This holds for both the solo and the group level.</p> <p><u>603</u>: We welcome the additional flexibility. It will lead to a more realistic view on the currency risk. Unfortunately, it does not tackle the key problem in the current prohibitions outlined above.</p>	
10.1	<p>Unrated debt</p> <p>General Comments GDV welcomes the inclusion of unrated debt in the Solvency II review. For many mid-sized companies, the source of funding with unrated debt is increasingly important and regulatory provisions as lined out in the second set of advice could expand and diversify their funding base</p>	

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	<p>significantly.</p> <p>GDV welcomes EIOPA's proposal for an internal assessment approach allowing an internal analysis based on key financial ratios in combination with qualitative factors as a lean and not overly complex approach. The financial ratios chosen by EIOPA are generally viewed as adequate and in line with key financial ratios used by major CRAs in their rating process as well as by loan officers and analysts in banks, asset management and insurance companies providing loans. GDV would therefore not expect significant additional costs for obtaining the outlined information. The approach could therefore be applied for direct and indirect investments in corporate debt.</p> <p>Moreover, the qualitative factors are generally in line with what financial analysts usually look at when analysing investment cases for institutional investors. As a result, complexity is not higher as would be for an ordinary internal assessment approach undertaken by a prudent institutional investor. We agree with EIOPA that each insurer investing in unrated debt should have an appropriate internal credit assessment process. Also, the data required for the analysis is easily available through balance sheets and p&l.</p> <p>The proposal is viewed as a very good basis for direct loans granted by insurers to corporates also in markets where currently the focus is more on indirect loan investments via funds. The proposal is viewed as suitable to help achieving some of the major objectives of the Capital Market Union, i.e. better and more diversified financing of the real economy. Also, the proposal is viewed as suitable to improve insurers' overall own credit risk assessment expertise and hence reduce reliance on external credit risk assessments by CRAs.</p>	
10.2		
10.3	<p>Concerning mortgage loans. Mortgage loans are an important asset class in the German market, especially for life insurers. Insurers invest in consumer loans, loans to cooperative housing societies for residential purposes and commercial real estate loans. As far as consumer loans relating to residential property under euro 1 million are concerned they fall under the</p>	

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counterparty default risk module (as long as they meet the further requirements of article 191 para 2 to 13 of the Delegated Regulation (EU) 2015/35). In the spread risk module the following types of mortgage loans may be concerned:

- Mortgage loans beyond euro 1 million;
- Mortgage loans to a natural person, where the property is not occupied or let by the owner;
- Mortgage loans to communal, cooperative or private housing societies;
- Commercial real estate loans.

Mortgage loans, that meet all requirements of article 191 except the threshold of euro 1 million should fall under the counter party default risk module and not under the spread risk module due to the reasons: Whether a loan is granted for euro 900,000 or for e.g. euro 1.2m does not change the general risk or the risk management of the loan. In both cases the same requirements apply to the credit assessment (especially the requirements of the value assessment of the Directive 2014/17/EU) and to the assessment of the property. Also the covenants and the credit hierarchy do not differ (all of these mortgage loans are generally senior loans). Therefore it is justified to delete the threshold of euro 1 million (article 191 para 4) as a characteristic for the classification in the counter party default risk module or the spread risk module. Alternatively the threshold of euro 1 million should at least be increased. Prices for real estate have been constantly rising over time. This leads especially in cases of loans to consumers in agglomeration areas (urban centres) to a different treatment of these loans compared to rural areas. Furthermore, there is an unequal treatment of similar consumer loans (as far as the borrower is financing for example two objects that in sum exceed the threshold of euro 1 million). We therefore consider a rigid threshold for the classification under the spread risk module as not appropriate. Further, the requirement of article 191 para 7 (the risk of the borrower may not materially depend upon the performance of the underlying property) is already met for all consumer mortgage loans due to the requirement of the Directive 2014/17/EU.

Mortgage loans to communal and cooperative housing societies support social goals by Member

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States to provide individuals with adequate and affordable housing. The statutory purpose of communal or cooperative housing societies acting solely on a local basis is to supply the local population / members of the cooperative with reasonably priced housing. The policy is aimed to receive a sustainable yield and not on short term profit maximation. Profits to a large extent are used for maintenance, construction of new buildings or restoration of portfolio buildings. As a consequence, such buildings are usually in a very good condition. Moreover buildings of these housing societies have a solely residential purpose. According to the residential purpose and the fundamental characteristics it is therefore justified to treat loans to communal and cooperative housing societies as residential property occupied or let by the owner. The risk performance of these housing societies is generally very good. According to information from credit agencies (e.g. Creditreform) communal and cooperative housing societies have generally a very strong credit worthiness. This is also the general outcome of the review of the audit reports. Housing societies even possess partially "eligibility for central bank credit" which is awarded by the Deutsche Bundesbank. Credit defaults have not occurred so far. As professional holders of residential building portfolios housing societies pursue a stable and conservative business model. Lenders examine thoroughly the documents concerning the object and the credit worthiness. Loan approval is based on analyses of the annual reports and expert opinions of the financed objects. Regarding the credit risk the business with communal and cooperative housing societies can be classified as secure and low risk. It is therefore justified to classify loans to communal and cooperative housing societies under the counterparty default risk module rather than the spread risk module.

The application of the criteria and methodologies (Financial state of the debtor, Features of instruments, Evidence, Transparency, Availability of data, Creditworthiness assessment, Characteristics of unrated debt, Risk profile, Diversification of portfolio) addressed in the questionnaire of the first set of advice for mortgage loans (to retail customers as well as to communal and cooperative housing societies) justify a classification in the counterparty default risk module. We refer to our statement on the first set of advice. After all, insurers are longterm investors. Also for this reason it is justified to classify these mortgage loans under the counterparty default risk module.

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10.4.1		
	<p>Scope of the analysis GDV supports the objective, that financial ratios should cover all industry sectors for both loans and bonds. GDV is supportive that debt issued by companies from the financial sector should be excluded from the scope, because companies in the financial sector have a completely different risk profile than industrial companies. Also, financial ratios would not fit for companies in the financial sector. GDV also agrees, that the focus should be on senior exposures.</p> <p>For systematic reasons the focus should not be on unrated debt of CQS 2 alone, but also encompass CQS 3 and 4. A high number of unrated debt instruments have CQS 3 and 4.</p>	
10.4.2.1		
	<p>Approaches The suggestion of two approaches, the (1) internal credit assessment approach and the (2) use of results from approved internal banking or insurance models are generally viewed as positive. Many insurers have a long experience with their own internal credit risk assessment processes. GDV also believes that such processes are to a large extent required by the prudent person principle under Solvency II when considering investments in corporate debt. Unfortunately, there has not yet been the opportunity to consider the results of the internal processes in case of high credit quality in the standard formula for the capital requirements.</p> <p>Using internal ratings of banks in a co-investment without an own credit risk assessment should be treated with caution. A bank has different regulatory requirements than insurers. In addition, there could be potentially a moral hazard problem or violation of business secrets.</p>	
10.4.2.2		
	<p>Internal assessment approach In order to qualify unrated debt for the same spread risk charge as rated debt, GDV welcomes EIOPA's approach of general conditions for the internal assessment like</p>	
10.4.2.3		

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- selected financial ratios,
- qualitative factors and additional conditions,
- yield conditions,
- requirements on the internal credit assessment process.

Many insurers in Europe already follow a similar approach of selected financial ratios (financial risk) in combination with a qualitative analysis (business risk) for analyzing the credit risk when deciding on investments in private placements. Also, financial ratios in combination with qualitative factors such as covenants are a key component of the well proven German Kreditleitfaden (guidelines on private placements) that the German Federal Supervisory Authority BaFin uses for insurers' investments in Schuldscheindarlehen of SME corporates. Investments according to these investment guidelines have proven no to very low default rates over many years.

Financial Ratios

The financial ratios chosen by EIOPA are generally viewed as adequate and in line with key financial ratios used by major CRAs in their external rating process as well as by loan officers and analysts in banks, asset management and insurance companies providing loans. Moreover, the qualitative factors are generally in line with what financial analysts usually look at when analysing investment cases. As a result, complexity is adequate and not higher as would be for an ordinary internal assessment approach undertaken by a prudent institutional investor. Generally, the approach should also be applicable by asset management companies at no significant extra costs.

Financial ratios are an essential input for the assessment of credit risk. GDV believes that it does not make sense to apply different ratios to each industry. In practice, some key financial ratios have prevailed, which can be applied with appropriate adjustments for all industries. EIOPA's list of possible financial ratios is very extensive and is seen as adequately reflecting main drivers for credit risk.

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Regarding the strict requirements to meet the financial ratios, it could be reasonable to grant the possibility of taking the average of recent years into account in order to obtain an adequate risk analysis. The reason for this is, that sometimes companies are temporarily unable to comply with certain financial covenants due to seasonal fluctuations or acquisitions while at the same time maintaining an overall sound financial strength and business position. Both average and point-in-time ratios are therefore often looked at in conjunction.

The quick ratio should be reviewed since cash holdings appear to be overly penalized.

Calculating probabilities of default using the Bloomberg function DRSK could be a reasonable proxy for mapping credit quality steps. However, GDV sees the risk of becoming dependent on a single provider such as Bloomberg regarding for example licensing fees. The industry already experiences significant disadvantages and high costs by being dependent on external credit ratings from the oligopoly of the three large CRAs for the purpose of SCR calculation.

German insurers have used since 2006 very successful the financial ratios stated in the guidelines on private placements. The system of financial ratios consisted of three blocks with two ratios each and was introduced in 2006 to make the financing instruments of unrated loans more feasible for companies with high credit quality. From a regulatory perspective adherence to the guidelines on private placements have been a prerequisite for insurers' private placement investments in the scope of coverage assets. Overall default rates of these investments have been none to very low for the industry.

Block I: Cash flow ratios on EBIT(DA) interest coverage

EBIT Interest Coverage (EBIT Int.) > 3.0

EBITDA Interest Coverage (EBITDA Int.) > 4.5

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Block II: Financial ratios on the level of debt

Total Debt / EBITDA („Level of Debt I“, LoD I) < 3.0

Net Debt / EBITDA („Level of Debt II“, LoD II) < 2.5

Block III: Financial ratios on the capital structure

Risk Bearing Capital (RBC) > 27%

Total Debt/Capital (TDC) < 50%

GDV together with stakeholders from the industry currently works on an update to the guidelines for private placements. It is refelcted to add blocks on profitability and cash flow and to divide the creditworthiness of a company / group into five categories from excellent companies to companies with low creditworthiness.

Yield criterion: The Yield criterion is seen as a comprehensible indicator as the yield is usually correlated with the risk and the yields of comparable CQS 2 instruments are pretty similar. The yield criterion is helpful to select appropriate unrated debt instruments. However, it should be considered that illiquidity of unrated debt affects the yield and the comparison to rated debt is difficult (e.g. illiquidity premium). For example there were periods during the last banking crisis in which the yield for unrated debt increased compared to rated debt, without an risk increase of the unrated debt. Therefore, in GDV's view this criterion should be merely seen as an indicator and not be followed too rigid.

Additional conditions: With regard to the prudent person principles insurers are already required to set up their own credit assessment and appropriate internal risk management. Hence we welcome the approach that requirements for internal processes should be built on the already

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	<p>existing processes. Additional processes should not be required automatically. In many instances existing internal processes and requirements may already be enough.</p> <p>GDV agrees with EIOPA that insurers should generally only invest directly in unrated debt, if they have implemented an appropriate internal credit assessment process. In this context it should be clarified, that insurers following an internal model approach with already well proven internal processes and existing functioning credit assessment systems should not be affected by the new regulatory provisions (comment also relevant for 10.4.2.4).</p>	
10.4.2.4	<p>On the approved internal model approach it should be considered to extend the approach also to relationships with companies that are not banks (i.e. asset managers and other financial intermediaries).</p> <p>In the banking industry approved IRB models for quantifying the credit risk are widely used. In Germany there are several providers of BaFin approved IRB models, for example RSU (Rating Service Unit), which provide their services to companies outside the banking industry. Asset managers (in case of indirect investments) or insurance companies (direct investments) should be generally permitted to use IRB models of such providers to determine the credit risk of debt items for which a credit assessment by a nominated ECAI is not available. If the IRB model is approved by the authorities no further requirements should be imposed on asset managers or insurance companies except for the documentation of the understanding of the used IRB model. An own credit view is however important. Using internal ratings of banks in a co-investment without an own credit risk assessment should be therefore treated with caution.</p> <p>The requirements lined out in the proposal are seen as restrictive, in particular the 50% retention rate imposed on banks. A bank has different regulatory requirements than insurers. In addition, GDV believes the high informational requirements for banks could become a barrier for the approach to be realised in practice. Providing such information could mean for some banks to violate business secrets. Also, there could be potentially a moral hazard problem in a co-investment relationship.</p>	

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10.4.2.5	<p>Bonds and loans are some of the most important asset classes for insurers. To improve investment opportunities for unrated debt GDV supports EIOPA's approaches on corporated unrated debt. In particular, the advice on the internal assessment approach is viewed positively (for further comments see 10.4.2.3).</p> <p>For mortgages loans GDV suggests the following approaches:</p> <ul style="list-style-type: none"> • Mortgage loans are an important instrument to finance private housing for families, households and communal and cooperative housing companies in the European Union. As such they complement traditional bank financing and support social goals by Member States to provide individuals with adequate and affordable housing. Providing affordable housing for young families and social housing in larger cities are some of the key challenges for policy makers in many European Member States. • Mortgage loans to retail customers (consumer loans) that meet all of the requirements of article 191 Delegated Regulation (EU) 2015/35 – except the threshold of euro 1 million – should fall under the counter party default risk module and not under the spread risk module. Alternatively the threshold of euro 1 million should at least be increased. <p>Mortgage loans to communal and cooperative housing societies should also fall under the counter party default risk module and not under the spread risk module.</p>	
10.4.3		
11.1	<p>Unlisted equity</p> <p>GDV welcomes the European Commissions request for advice on criteria for identifying unlisted equities which can be treated as type 1 equities. Since excessive capital requirements unnecessarily restrict investment options for insurers, capital treatment based on the real risk allows them to invest in a risk adequate way and to generate additional returns for policyholders and at the same time help stimulate much needed economic growth.</p>	

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	Like the European Commission in its call for technical advice explicitly requests for “clear and conclusive” criteria, we believe, that it is particularly important, that a certain list of criteria is manageable and can be applied in practice without high effort. Overly complex requirements could overshadow potential benefits, if the expenses for handling the criteria outweigh the benefits of a reduced capital requirement.	
11.2		
11.3		
11.4.1		
11.4.2		
11.4.3	In principal GDV welcomes EIOPAs approach to identify qualifying unlisted equities by focusing on the underlying risks of the underlying companies. However the suggested steps to be taken seem to be very complex and challenging in its practical application, so that we believe that the burden and cost of application will not be justified by the limited reduction in capital requirements.	
12.1	Strategic equity investments	
12.2		
12.3	GDV welcomes the extensive presentation of the NSA's feedback on strategic investments.	
12.3.1		
12.3.2	<u>894</u> : The limited application could indicate that the criteria for a participation to qualify as strategic are too complicated. This obviously holds true in particular for the volatility assessment (<u>897</u>). <u>899</u> shows that qualitative criteria may be sufficient and reasonable. <u>911</u> : This is an indicator for a possible general simplification.	

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12.3.3	<p><u>914</u>: It is unclear what exactly “totals 155 bn in assets”: Is it the value of all participations, the value of those 60% in the EIOPA database or is it the sum of their asset sheets?</p> <p><u>920</u>: According to the figure the number of participations held for more than 10 years seems to be about the same number of participations held for more than 10 years. A figure weighted according to invested amount could be insightful.</p> <p><u>921</u>: The text indicates that there is a contradiction between the period participations had been held so far and the period they are expected to be held. Both results do not necessarily contradict each other, they may be explained e.g. by changes in the group structure, mergers, or more outsourcing activities in last years.</p>	
13.1	Simplification of the counterparty default risk	
13.2		
13.3	<u>952</u> : GDV highly welcomes that EIOPA took our proposal into account.	
13.4.1		
13.4.2	<p><u>999–1010</u>: GDV appreciates EIOPAs suggestions and believes that EIOPA is moving into the right direction: A well-defined definition of risk-mitigating derivatives could solve practical problems occurring when insurers use rolling derivative instruments. It seems in particular important that risk-mitigating strategies can be subsumed under the new definition, with the effect, that not every single derivative contract needs to meet all requirements of a risk-mitigation technique.</p> <p><u>1011</u>: GDV highly appreciates EIOPAs recommendations planned for netting. With regard to other European regulations – in particular EMIR and CRR – the calculation of netted collateral is compliant with international finance legislation standards and therefore the only appropriate solution.</p>	

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	<u>1024</u> : GDV welcomes the possibility to use the simplification. We're fine with EIOPA's slightly change of our proposal.	
13.4.3	In general, the counterparty default module should be simplified much more. The calculations are too laborious given the small impact on the over-all SCR.	
14.1	Treatment of exposures to CCPs and changes resulting from EMIR	
14.2		
14.3		
14.4.1		
14.4.2		
14.4.3	<p>We agree with the approach of EIOPA to calibrate the default risk of CCPs with respect to the framework of Art. 305 (2)–(3) CRR. We prefer option 2 as it presents a transparent and feasible calculation of the default risk and it reflects the system of safeguards in an appropriate manner. Furthermore, option 2 is in line with the Solvency II method of calculating the counterparty default risk.</p> <p>For non-centrally cleared transactions we want to point out that the obligation to exchange initial margin depends on the trading volume of the counterparty and not on the volume of the derivative transaction (see para 1134). Since most insurance companies have a trading volume below 8 bn. EUR, these companies are subject to the exchange of variation margin only. Insurers with a larger trading volume have the obligation to exchange initial margin, and this reduces the counterparty default risk substantially. Thus we prefer option 1 (para 1161) for bilateral transactions, if only the exchange of variation margin is required, and we propose to calculate the LGD with a higher recovery rate for transactions with an exchange of initial margin. For example a recovery rate of 10% corresponding to the factor 90% of the LGD calculation, can be replaced by a recovery rate up to 50%. This reflects comparable levels of collateralisation between transactions with CCPs referred to Art. 305 CRR and transactions with initial margin requirement.</p>	

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	Option 2 (para 1162) is not appropriate in our view, since the calibration of the factors x, y, z in the LGD calculation is crucial and the database mentioned may be insufficient for this calibration.	
15.1	<p>Simplification of the look-through approach</p> <p>GDV welcomes the EC request to EIOPA to review the simplifications for the look-through approach in Art. 84 (3) of the Delegated Regulation (DR) and to suggest refinements to this simplification. We support EIOPA’s considerations to extend the scope of application of the simplified approach of Article 84 (3) DR and to make it less costly and more widely applicable. We welcome EIOPA’s proposals on simplifications, particularly:</p> <ul style="list-style-type: none"> • the proposal to “carve-out” assets for unit/index linked products from the 20% limit, • the possibility to use the last reported asset allocation of the collective investment undertaking or fund to calculate the SCR in cases where the look-through approach cannot be applied, and • the possibility to use “groupings” of exposures also when the target asset allocation is not available in the required granularity. 	
15.2		
15.3		
15.4.1		
15.4.2	<p><u>1200</u>: With regard to the data analysis on investments in “Collective Investment Undertakings” (CIU) based on the annual reporting template QRT S.02.01, GDV would like to point out, that in our opinion S.02.01 underestimates the volume of investments in CIUs of German insurers. In Germany insurers mainly use open-ended special AIF (so called “special funds”) for their fund investments.</p> <p>According to our estimates there is an enormous discrepancy between the investments reported</p>	

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	<p>via QRT S.02.01 as CIUs – as of 31/12/2016 – and the actual investments in CIUs (rather 30% of total assets than 8,7%). It appears, this is because a lot of undertakings in Germany – as of 31/12/2016 – reported such special funds investments, which represent 20% or more of the voting rights or capital of an undertaking) as participation, even though they didn’t fulfill the requirements on Participations as defined in Article 13(20) of Directive 2009/138/EC. This resulted in a significant increase in reported investments in participations for the annual reporting of 31/12/2016. The German supervisory authority Bafin has consequently adapted its reporting-leaflet in April 2017. The clarifications given on that point have already led to a significant shift in the reporting in Q3/2017: According to the figures available so far, the proportion of investments reported as CIUs increased to 21% and the proportion of participations fell accordingly.</p> <p>To avoid any wrong conclusions with regard to the amount and the importance of fund investments for German insurers we recommend to re-evaluate the data from annual reporting templates in 2017 with the data reported from German insurers as of 31/12/2017.</p>	
15.4.3	<p>GDV welcomes EIOPA’s advice for simplifications in Art. 84 (3) DR, like to to “carve out” assets for unit/index linked products from the 20% limit. EIOPA’s data-analysis confirms, that the current threshold might be inappropriate for insurance undertakings – e.g. for undertakings with a strong focus on unit-linked products. The proposal to “carve out” assets for unit/index linked products from the 20% limit, should reduce the burden for insurers when applying the look-through.</p> <p>We also welcome the possibility to use the last reported asset allocation of the collective investment undertaking or fund to calculate the SCR in cases where the look-through approach cannot be applied. Since for some funds it is difficult, if not impossible, to receive all information in the required level of granularity, in these cases insurers can’t take advantage of the current simplifications. The possibility to use the last reported asset allocation to calculate the SCR would be a real relief and at the same time will lead to appropriate results from a risk management perspective.</p> <p>The additional requirement that the underlying assets are managed strictly according to the</p>	

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	<p>(current) target allocation or to the last reported asset allocation, could be difficult to fulfill in its practical application. It should therefore also be sufficient, if it is unlikely to expect, that the allocation will change substantially in the near future and that the allocation is reviewed on a regular basis (at least yearly).</p> <p>The extension of this simplification to groupings of exposures when the target asset allocation is not available in the required granularity is also welcomed by us. It should be sufficient, if the data groupings are applied in an “appropriate” manner instead of a “prudent” manner, like currently required.</p>	
15.4.4	<p>As stated above, in principle we support the proposal for amending article 84 (3) DR. Since it can be challenging to evaluate if the assets are strictly managed according to the target allocation or the last reported asset allocation, we suggest to amend article 84 (3) DR as follows:</p> <p><i>“84 (3) Where the look-through approach cannot be applied to collective investment undertakings or investments packaged as funds, the Solvency Capital Requirement may be calculated on the basis of the target underlying asset allocation or the last reported asset allocation of the collective investment undertaking or fund, provided such a target allocation is available to the undertaking and the underlying assets are managed strictly according to this target allocation or to the last reported asset allocation <u>or it is unlikely to expect that the allocation will change substantially in the near future and that the last reported allocation is reviewed on a regular basis (at least yearly).</u></i></p> <p><i>For the purposes of that calculation, data groupings may be used, provided they permit to calculate all relevant sub-modules and scenarios of the standard formula in an appropriate manner, and that they do not apply to more than 20% of the total value of the assets of the insurance or reinsurance undertaking.”</i></p> <p><i>3b. Notwithstanding Article 84(3), where the look-through approach cannot be applied to investments in collective investment undertakings or investments packaged as funds which back</i></p>	

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	<p><i>unit- and index linked obligations (for which the market risk is borne by policyholders), the Solvency Capital Requirement may be calculated on the basis of the target underlying asset allocation or the last reported asset allocation of the collective investment undertaking or fund, provided such a target allocation is available to the undertaking and the underlying assets are managed strictly according to this target allocation or to the last reported asset allocation <u>or it is unlikely to expect that the allocation will change substantially in the near future and that the last reported allocation is reviewed on a regular basis (at least yearly).</u></i></p> <p><i>For the purposes of that calculation, data groupings may be used, provided they permit to calculate all relevant sub-modules and scenarios of the standard formula in <u>an appropriate manner.</u></i></p>	
16.1	Look-through approach at group level	
16.2		
16.3.1		
16.3.2	<u>1247</u> : It is not obvious that a subsidiary can always share its information with the group, e.g. due to legal constraints.	
16.3.3	GDV favors option b) since it is a simple approach which is also consistent to the procedure at solo level. It avoids additional effort for insurers to prepare data differently on the group and on the solo level. Furthermore, it remains unclear what exactly option a) would mean.	
17.1	<p>Loss-absorbing capacity of deferred taxes</p> <p>EIOPA should obey the work programme given by the European Commission. Regarding the loss absorbing capacity of deferred taxes (LAC DT), EIOPA was only asked for a report about the status quo but not for any proposals on their own. EIOPA has already accomplished the assigned task with its first set of advice (EIOPA-BoS-17/280).</p>	

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	<p><u>1259, 1261</u>: We agree that the variation in LAC DT is partly explained and justified by differences in the tax regime. Of course, such differences must be reflected in Solvency II LAC DT. In particular, in some jurisdictions tax loss carry-forward is possible without a time limit. Thus, when demonstrating the utilisation of notional deferred tax assets (DTA), the projection horizon for future taxable profits must be unlimited, too. A general cap would arbitrarily restrict the recognition of the economic effect of LAC DT provided by the Directive.</p> <p><u>1264</u>: If any changes of the current legal situation regarding the recognition of LAC DT were intended, the legislator has to change the Delegated Regulation. Supervisory convergence tools, such as Guidelines, Opinions or Supervisory Handbooks, can only address proper application of law by supervisors. However, they cannot change the law. Thus, they are legally irrelevant for the undertakings.</p> <p><u>1266</u>: We agree that proportionality should play an important role. This implies, among others, that there should be no disproportionate high requirements on the utilisation of DTA.</p>	
17.2		
17.3		
17.4.1		
17.4.2	<p>Compliance with the minimum capital requirement (MCR) and SCR after the bSCR* shock loss</p> <p><u>1296–1304</u>: Solvency II requires that (re)insurance undertakings have sufficient own funds to survive the 200-year-event of unexpected losses. This is the solvency capital requirement (SCR). The undertaking must still have positive own funds if such a shock would have realised. However, it is of course not required that immediately after the shock the undertaking complies with the SCR again. Otherwise, the undertaking was in fact required to resist two consecutive independent 200-year-events, i.e. a 40,000-year-event would be assumed.</p>	

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If the undertaking is hit by an 200-year-event of unexpected losses and temporarily does not comply with the SCR (or the MCR) anymore, this does not automatically hamper the possibility to utilise post-shock DTA. For example, there may be a rapid de-risking or recapitalisation. Then, the undertaking will comply with the Solvency II requirements again and be able to use tax loss carry-forwards. This is part of the undertaking's assessment of the utilisation of notional DTA. Thus, it would not be appropriate to use a formulaic approach restricting the consideration of future profits subject to post-shock MCR or SCR.

Future profits stemming from new business

1308: It is misguided to demand that assumptions for developments after a shock should be set more prudent than in the calculation of technical provisions. In the calculation of technical provisions, a best estimate is required. In the analysis of a notional post-shock situation which has a 0.5% probability, a best estimate has to be considered, too. That means to assume a conditional best estimate given the occurrence of the shock, but not at all to set a more prudent assumption. Otherwise, the 99.5% confidence level given by the Directive was missed for sure.

1311: We agree that assumptions should be compliant with the Solvency II framework and in particular be consistent with assumptions made in the calculation of technical provisions. When calculating future discretionary benefits, which are part of the technical provisions, live insurers have to project surpluses for many decades. Although uncertainty increases inevitably, they have to calculate a best estimate of payments due in remote future. In order to be consistent with that, projections of future taxable profits must also not be capped arbitrarily and not be distorted by too prudent non-best-estimate assumptions.

1316–1318: It is important that such a threshold is not absolute but can be cleared out by further justifications.

1319–1320: This possible implementation would not be appropriate (see comments on para 1259/1261, 1308 and 1311).

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1321–1325: This possible implementation would not be appropriate (see comments on para 1259/1261, 1308 and 1311).

Future profits from returns on assets

1327: It is misguided to demand that assumptions for developments after a shock should be set “prudent”. In the analysis of a notional post-shock situation which itself has a 0.5% probability, a best estimate has to be considered again. That means to assume a conditional best estimate given the occurrence of the shock, but not to set another prudent assumption. Otherwise, the 99.5% confidence level given by the Directive was missed for sure.

1336: We agree that in the projection of future profits from new business, the liability helps to determine when the projection should stop. This rationale has only to be applied in the section “Future profits stemming from new business”.

1338–1341: This possible implementation would not be appropriate (see comments on para 1259/1261, 1308 and 1311).

Future management actions

1344: We agree that de-risking is at the full discretion of the undertaking.

1349: It is not a valid argument that de-risking should not be recognised because it would make the proposed restriction on new business, which relates to MCR and SCR, less restrictive. The correct argument is: De-risking is possible (see comment to para 1344), so that the undertaking's MCR and SCR may change soon after a shock. Thus, the proposed restriction has to be discarded while de-risking should of course be considered relevant.

1351: It is plausible that undertakings will perform some management actions increasing

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	<p>profitability only after a shock-loss has occurred. An obvious example would be to cut future discretionary benefits. Before the shock, these benefits might have been higher than prescribed by law/contract because they are used as a marketing instrument. After a 200-year-event of unexpected losses, they may be cut overproportional in order to improve the financial situation.</p> <p>Possible simplified calculation of LAC DT</p> <p><u>1369</u>: In general, we would appreciate if a simplified calculation for LAC DT was introduced. However, the definite drafting is crucial.</p> <p><u>1370–1377</u>: If <i>TaxableEconomicProfits</i> are adequately calculated, no further reduction factor <i>PF</i> is needed.</p> <p><u>1378</u>: In the end, nothing is simplified if undertakings nevertheless have to demonstrate that fiscal profits will be available at the right time for the utilisation of the post-shock DTA*.</p>	
17.4.3	<p>The Directive requires to recognise the economic effect of the loss absorbing capacity of deferred taxes (LAC DT) in the SCR calculation. This is appropriate and must not be devaluated at the technical level. If projections are arbitrarily capped or assumptions are too prudent, then the calculation has a one-sided deviation leading to distorted results. The 99.5% confidence level required by the Directive cannot be met this way.</p>	
18.1	<p>Risk margin</p> <p>We welcome the review of the calculation of the risk margin because its current value is much higher than necessary.</p>	
18.2		
18.3		

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18.4.1		
18.4.2	We think as well that EIOPA's estimation for the beta is too high. The CoC rate for the risk margin should reflect the low dependence between underwriting risk and general equity risk. Therefore the covariance of pure insurance risks with market returns should be used for the calculation. To apply a beta factor which refers to equity prices of listed insurers is not appropriate.	
18.4.3	We think that 3% is a prudent estimate for the CoC rate.	
19.1	<p style="background-color: yellow;">Comparison of own funds in insurance and banking sectors</p> <p>GDV welcomes the Commission's request for EIOPA to investigate the appropriateness of own funds regulation in insurance and banking sectors. For the majority of European insurance companies which are either not listed on a stock exchange and/or are organized as mutual, cooperative or public sector companies, RT1 instruments are the only means to raise Tier 1 own funds externally. Since these insurers do not have the opportunity to increase own funds by capital increases, RT1 instruments have a high significance for the industry. Moreover, also for listed insurers these instruments are important.</p> <p>GDV welcomes EIOPA's clarification that a partial write down instead of a full write down is permissible under certain conditions. Also, we welcome EIOPA's proposal to provide supervisory authorities with the ability to consider an exceptional waiver on write down, if the solvency position of the issuer would most likely be significantly weakened as a consequence of the write down. We acknowledge EIOPA's efforts in finding a practicable solution for issuance of RT1 instruments. However, given the complexity of the functioning of these instruments in different jurisdictions and under certain stressed conditions we would like to explain potential challenges that could derive from the current proposal and highlight a number of additional concerns.</p>	
19.2		
19.2.1	SCR is a <i>going concern</i> solvency level – Bank AT1 PLAM is effectively applicable in gone concern	

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- The ***going concern nature*** of the SCR is well documented by Solvency II Directive Art 138:
 - If own funds fall below the SCR, insurers must restore compliance with the SCR within **6 months** (or 9 months if such extension is considered appropriate by the regulator)
 - In case of an industry wide crisis, time to SCR restoration can be extended to **7 years**.
 - If own funds are lower than the SCR, the insurer can continue as a ***going concern*** (subject to a sufficiently high MCR coverage).
 - EIOPA’s analysis for bank versus insurance should appreciate that bank regulation does not know a differentiation of SCR (going concern) and MCR (gone concern).
 - Originally, bank AT1 PLAM was intended as a going concern loss absorbency trigger – just like RT1. However, bank regulation has moved on, and the bank AT1 trigger levels of 5.125% (or, where applicable 7%) are no longer considered going concern triggers – investors expect that bail-in will apply at much higher CET1 ratios and thus way ahead of PLAM.
 - Bank PLAM is therefore considered a ***gone concern*** trigger by many market participants.
- On group level, the MCR can be breached while the Group SCR ratio still exceeds 100%**
- In this paper, we use the term “**Group MCR**” to describe the “minimum consolidated Group SCR” (Solvency II Directive Art. 230(2)).
 - The Group MCR is the simple ***sum of solo MCRs***, the MCR Tiering Limits (min 80% T1, max 20% T2, no T3, no ancillary own funds) also apply to the Group MCR (Solvency II Directive Art. 230(2) refers to Art. 98(4) of the same Directive; see also the EIOPA Guideline 16 on Group Supervision (No. 1.47(c)).
 - The solo MCRs are factor based charges based on technical provisions, premiums and capital at risk, subject to an absolute EUR amount floor.
 - Adding up solo MCRs ignores diversification between subsidiaries. The Group MCR is higher for the more complex group with many subsidiaries than for another group with only few large operating entities.
 - As mentioned above, there are stricter Tiering limit rules for the SCR than the MCR (both on solo and group level).
 - On solo level, the regulatory ladder of intervention ensures that the SCR is always breached ahead of the MCR. The reason is that T1 must exceed 50% of the SCR, whereas the MCR is

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- capped at max. 45% of the SCR. Despite the stricter Tiering limits for SCR-coverage, a MCR ratio of less than 100% must always coincide with an SCR ratio of below 100%.
- On group level, there is no cap for the Group MCR relative to the Group SCR. In fact, there are several cases where the Group MCR exceeds 80% of the Group SCR. **As a consequence, the Group MCR can be breached even though the Group SCR is still above 100%.**
 - In this paper, we refer to a Group MCR breach with the Group SCR above 75% as “**trigger inversion**”. We use “trigger inversion” both for cases where the Group MCR trigger is breached, and the Group SCR Ratio is between 100% and 75% (i.e. the Group MCR PLAM trigger is breached ahead of the 75% SCR trigger), but also for the even more critical case where the Group MCR is breached, but the Group SCR is still above 100%.

This unintended issue of trigger inversion is a realistic risk for many large insurance groups, observed on the basis of an analysis of 15 large Solvency II-regulated groups that together are responsible for a large proportion of currently outstanding group *externally* placed subordinated debt. We have calculated the pro forma group SCR ratios (scope includes entities included via internal model or standard formula as well as Other Financial Sector (“OFS”) entites and D&A (equivalent) insurers) after a shock to UT1 has been applied that reduces the Group MCR coverage for *each* insurance group to 100%. The scope of the Group MCR ratio only includes entities included via internal model or standard formula.

On average, the Group SCR is ca. 96% when Group MCR is just about to be breached (this average would increase to 107% if one assumes that in such a shock, DTA (T3) would increase and fully use the actual remaining T3 headroom of those issuers as per year end 2016). For 5 groups, the resulting pro forma Group SCR ratios would still be above 100% (trigger inversion for all three triggers, i.e. cancellation/deferral, redemption and PLAM; 8 groups would be affected if you allow for the full use of the remaining T3 headroom). The resulting pro forma Group SCR is lower than 75% at Group MCR breach for only two of the 15 groups, and it is only for these two groups where PLAM would be triggered by the 75% SCR trigger rather than the Group MCR trigger. **To avoid confusion, please be aware that the analysis is based on a crucial “all else equal” assumption: only the UT1 capital of the group of insurance entities included via internal model or standard**

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formula is assumed to fall, i.e. despite the significant shock to UT1 required to breach the Group MCR, the group SCR (and group MCR) were simply left unchanged. Also, other parts of the groups (D&A, OFS), if any, such as the other financial sectors and the D&A entities were left unchanged, since they are not included in the scope of the Group MCR. In practice, this shock – as any other assumed shock scenario – is of course unlikely to materialise in this way. Depending on the shock, the group SCR can increase or decrease. The point here is “only” to point out that trigger inversion is possible, and that the risk of this happening is actually non-negligible in our eyes. We are not aware of a better approach to demonstrate this other than by this simple “shock assumption” that is then consistently applied to all groups.

Why trigger inversion should be avoided

- **Trigger inversion is an issue that also extends to any discussion around resolution and/or bail-in for insurers:**
 - More important than its effects for a functioning framework for RT1, T2 and T3 that we explain below, trigger inversion is highly relevant in the context of resolution and/or bail-in for insurers.
 - A logically consistent system with a regulatory ladder of intervention should ensure that the Group SCR (100%) is always breached ahead of the Group MCR.
- **RT1:** The consequences of trigger inversion for PLAM (RT1) are as follows:
 - DR Art. 71(8) specifies that PLAM should apply upon a “*significant non-compliance with the SCR*”. Instead, on group level, PLAM would typically apply with full force (e.g. 100% write-off) when the group SCR is only marginally breached – or possibly not even breached at all.
 - The 75% SCR ratio trigger would be meaningless for most of the large groups.
 - There would be no 3-months cure period for many of the big groups even though the Group SCR ratio would still exceed 90%.
 - In effect, trigger inversion would imply that “partial” loss absorbency or the waiver for PLAM suggested by EIOPA to avoid adverse tax effects is unlikely to apply in practice.
 - Effectively, trigger inversion implies that PLAM can be triggered when the group is still very much a going concern state, i.e. **potentially while** own funds are still sufficient to

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	<p>withstand <i>another</i> "1-in-200 year event".</p> <ul style="list-style-type: none"> ▪ T2, T3: The consequences for T2 and T3 are also unintentional, in our eyes: <ul style="list-style-type: none"> ○ The coupon deferral triggers for T2 can apply simultaneously with RT1 PLAM and RT1 coupon cancellation, and even T3 deferral may apply at the same time, too (depending on the trigger inversion issue). ▪ Contrary to this, bank regulation foresees a clear logical hierarchy of capital: <ul style="list-style-type: none"> ○ First step: RT1 coupon cancellation <i>may</i> apply (breach of MDA buffer, CET1 ratio >= 10%), although banks may be able to prioritise AT1 coupons while "inside" the buffer. ○ Second step: PLAM at a CET1 ratio <= 5.125%, in several cases <= 7%. ○ Last step: T2 is not subject to any triggers for coupons or principal. It is only subject to the ultimate risk of bail-in. ▪ Importantly, in today's market, trigger inversion is only marginally meaningful for the marketability and pricing of <i>RT1 (or T2, T3) at issuance</i>. RT1 can only be sold to investors when investors view a trigger breach as highly unlikely at issuance. Trigger inversion does matter in crisis, however, when regulatory capital instruments should function as intended and when any additional (unintended) negative surprises for investors should be avoided. <p>What could be done to avoid trigger inversion?</p> <ul style="list-style-type: none"> ▪ A systematic re-design of the Group MCR would require changes to the Solvency II Directive. ▪ A potential "quick-fix" would be to amend the Group Supervision Guideline 16 No. 1.47(d) so as to allow the Group MCR to be met with 50% T2 and 50% T1 (i.e. the maximum T2 tolerance that we believe is allowable according to the Solvency II Directive). ▪ <i>In the absence of any changes to the Group MCR concept, PLAM as well as the cancellation / deferral triggers for T2 and T3 deferral should not reference the Group MCR to avoid unintended consequences. As a minimum, the proposed waiver for PLAM (write-down) should also be possible in case of a Group MCR breach.</i> 	
19.2.2		
19.2.3	Legal certainty is also required for write-up	

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	<ul style="list-style-type: none"> ▪ PLAM for Bank AT1 is both partial and temporary. Write-up provisions are reasonably clearly defined (although complicated). ▪ We strongly support the possibility of a write-up, unless PLAM truly only applies in winding up (gone concern) of the group. ▪ We would therefore welcome EIOPA to make a transparent statement on write-up and clarify what exactly EIOPA would deem as a hindrance to recapitalisation. ▪ Without write-up, conversion instruments could be significantly less costly for issuers as investors could at least profit from the upside in the shares held post conversion – in the case of fixed price conversion (e.g. RSA's instruments issued in 2017), there is a non-negligible chance of RT1 investors even making profits upon conversion. In case of permanent write-down, investor losses from write-down would be permanent, the entire nominal could be written-off potentially at rather high group SCR ratios. It is not clear why write-down instruments should be disadvantaged in this way. ▪ If no legal certainty is achieved on write up, the non-listed insurers would find it difficult to issue RT1 instruments at reasonable prices. Conversion instruments are not available for non-listed insurers. In particular insurers in the legal form of a mutual, cooperative or public sector company are dependent on the marketability of a write down instrument for RT1 issuance. 	
19.2.4		
19.2.5		
19.2.6		
19.3	<p>The differences between PLAM for bank AT1 and insurance RT1 are substantial – even when considering the suggested EIOPA changes. Even though we acknowledge that certain differences between bank and insurance instruments make perfect sense, as highlighted in the introductory comments, we do note the following:</p> <ul style="list-style-type: none"> ▪ Bank PLAM is triggered in <i>gone concern</i>. Insurance PLAM is potentially triggered at <i>going concern</i> SCR levels – and it can be triggered simultaneously with mandatory deferral on T2 (and in case of trigger inversion even simultaneously with mandatory deferral on T3), whereas bank T2 does not require deferral at all. 	

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	<ul style="list-style-type: none"> ▪ Bank PLAM via W/D can be <i>temporary</i>. Write-up is explicitly allowed for bank AT1. EIOPA so far has not commented on write-up, there seems to be a risk that regulators would prefer write-down to be permanent. ▪ Bank PLAM via W/D can be <i>partial</i> – insurance PLAM is likely to be full, potentially even where the Group SCR is not or only marginally breached(trigger inversion). ▪ <i>We recommend</i> that insurance PLAM should also apply only in a gone concern to align at least in a logical sense with the manner PLAM works within banking regulations, which in tun should be defined by regulators rather than by an automatic reference to the group MCR (avoiding the identified trigger inversion risk in the current regulations). <p>Another important difference between bank and insurance own funds regulation includes limit system:</p> <ul style="list-style-type: none"> ○ In some jurisdictions, we understand that there is a “cliff effect” on eligible capital once T1 falls to less than 50% of the SCR, as exisiting T2 and T3 then no longer counts as eligible own funds. In these jurisdictions, the SCR ratio could fall from 101% (with T1 at 51%) to 49% due to a 2% reduction of T1 to 49%. In such a case, EIOPA’s suggested linear approach to write-down is not applicable. We are not aware of any similar effects in banking. ○ There is also a “cliff effect” related to RT1, since its limit is implicitly based on UT1 (the RT1 limit of 20% of total Tier 1 implies that RT1 is limited to 25% of UT1). If UT1 falls by 100, the maximum eligible amount of RT1 falls by 25. If the T2/T3 headroom is fully exhausted, a loss of 100 reduces total eligible own funds by 125 altogether. There is no such cliff effect with respect to bank AT1. ○ PLAM in insurance can only lead to an improvement of the key regulatory metric (SCR ratio) if it leads to a reversal of a prior cliff effect. In banking, PLAM always increases the key regulatory metric, the CET1 ratio. 	
19.4.1	<p>1454 and 1456: The very high quality of RT1 should not be underestimated for the following reasons:</p> <ul style="list-style-type: none"> a) The quality of RT1 is <i>formally</i> at least as good as that of equity. 	

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- b) PLAM does *not* increase the quality of own funds in a meaningful way.
 - c) PLAM may even reduce the quality of RT1 as it can have adverse effects on the *financial stability* of the undertaking.
 - d) Even without PLAM, RT1 is formally more risky for investors than T2 or T3.
- a) *The quality of RT1 is formally at least as good as that of equity***
- Permanence: RT1 is as good as equity
 - RT1 is perpetual. Since incentives to redeem are prohibited, market participants regard RT1 as so-called “True Perpetuals”.
 - In contrast, perpetuals with a coupon step-up (incentive to redeem) are expected to be called at the step-up date, unless the issuer is in a severe crisis.
 - For True Perpetuals like RT1, investors expect a call only when it makes economic sense for the issuer to do so, i.e. when the old bond can be replaced at lower cost (or when RT1 exceeds the 20% limit). **Importantly, we refer to our comment on EIOPA's observations in No. 20.3 (item 1525).** Market data does demonstrate that investors price True Perpetuals like bank AT1 and RT1 to the next *expected* call date. Given the considerable spread tightening in recent months, the expected call date for many True Perpetuals is actually the next call date. However, this is only true because investors assume that the issuer can, and will, call the old AT1 bond and issue a new ***cheaper cost replacement AT1***. For those bonds where it is not economically attractive to call, investors price the bonds on a “to-perpetuity” basis, i.e. assuming that the instrument will never be called (at least not in the near future).
 - From a regulatory perspective, the quality (permanence) of RT1 is additionally protected as calls are always subject to prior regulatory approval. Note that we understand that a repurchase of equity is not subject to prior regulatory approval in some EEA jurisdictions.
 - **Consequently, in terms of permanence, the quality of RT1 is as at least as good as equity.**
 - Loss absorbency with respect to distributions: RT1 is of higher quality than equity

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- RT1 distributions (coupons) are fully discretionary. In particular, dividend pushers and dividend stoppers are prohibited by EIOPA Guidelines.
- ***As a result, RT1 investors can be subordinated (!) to equity investors:***
 - An issuer can decide to cancel all RT1 coupons in eternity, irrespective of the issuer's financial health (solvency). The issuer can nonetheless continue to pay equity dividends, or even do share buybacks etc. Solvency II allows issuers to subordinate RT1 investors to equity investors – note that PLAM is not required for this.
 - Importantly though, equity dividends can be seen as effectively ***cumulative***, whereas RT1 distributions are explicitly ***non-cumulative*** (without compensation or other “upside”). Equity dividends can be cancelled, but equity investors can be compensated with higher dividends in the future, and/or recovery/future upside in the shares.
- ***In terms of loss absorbency via cancellation of distributions, RT1 is of higher quality than equity.***
- The same is true for bank AT1. Both bank AT1 and insurance RT1 are high-risk products for investors – only where issuers have an incentive to treat RT1/AT1 investors fairly – and not worse than equity investors – will investors be prepared to invest in such products (the need of an issuer to access the RT1/AT1 bond market in the future is such an incentive to treat RT1/AT1 investors fairly today).
- The current demand for RT1/AT1 is strong despite these risks for RT1 investors. Note that many market observers are not sure whether this favourable demand situation will also prevail in a more normal yield environment.
- Loss absorbency (and subordination) with respect to the principal: RT1 is at least as good as equity
 - Both equity and RT1 add to the stack of capital that does not count as a liability in insolvency – they both count as (anti-insolvency) “equity” for purposes of the asset-liability test.
 - The sum of RT1 and equity (“anti-insolvency equity”) helps an issuer to withstand

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- unexpected losses as it helps to avoid insolvency due to over-indebtedness.
- Ignoring PLAM, losses do not reduce the accounting value of RT1, only that of equity. While the absence of a reduction of its accounting value does not signal that RT1 is of higher quality than equity, it certainly does not mean that RT1 is any weaker either.
 - PLAM does *not* change the relative quality of equity and RT1 from a ***policyholder perspective*** either, as it leaves the stack of “anti-insolvency equity” unchanged – any increase in equity due to write-down or conversion is compensated by a fall in RT1 (ignoring any potentially adverse tax effect of PLAM).
 - Insurance PLAM occurs before equity is “wiped out”, leaving future upside for equity investors, including reduced future RT1 coupon expenses for the benefit of shareholders in a going concern scenario.
 - RT1 can contractually rank senior to equity in insolvency. However, when liabilities exceed assets, the providers of “anti-insolvency equity” cannot receive a liquidation consideration – i.e. effectively, RT1 and equity investors rank pari passu in liquidation.
 - ***In terms of loss absorbency (and subordination) via the principal amount, RT1 can indeed be junior to equity in circumstances that are not entirely unrealistic, causing a “value transfer” from (supposedly) more senior to (supposedly) more junior claimants.***
- Consequently, RT1 investors are - formally - exposed to more risk than equity investors in realistic scenarios.
- b) PLAM does not increase the quality of own funds in a meaningful way***
- PLAM does increase UT1, but only at the expense of falling RT1. PLAM therefore does not increase the amount of capital. Moreover, it also does not *formally* increase the quality of capital:
 - Both UT1 and RT1 allow cancelation of distributions.
 - Both UT1 and RT1 are truly perpetual (maximum permanence).
 - Both UT1 and RT1 add to “anti-insolvency” equity, which for purposes of the asset-liability test does not count as a liability.
 - There is no meaningful benefit from PLAM for policyholders, *formally* RT1 is of equal or even

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higher quality than equity.

- It is true that RT1 creates different investor expectations than equity. RT1 can only be sold to investors if there is a reasonable certainty that RT1 investors will not be subordinated to equity investors. Rather, in practice RT1 investors expect to be treated preferentially to equity investors ***unless the issuer experiences a severe crisis***.
 - To understand what this means for the relative quality of equity and RT1, note that reputational issues and signalling considerations can also impact the “quality” of equity as well. Some insurers may pay equity dividends in order to signal strength, even though prudence would suggest otherwise. However, please also note that insurers are typically much less dependent on capital markets financing than banks are – reputational pressures that may prohibit issuers from cancelling RT1 coupons (or equity dividends) are significantly lower than for banks, where short term refinancing requirements are substantial.
 - At the margin, it is still to be expected that cash flows to RT1 investors in forms of distributions will be stopped at a later stage than equity dividends.
 - Therefore, and despite the formally very high quality of RT1, we agree with EIOPA that RT1 should be limited (more reasons to limit RT1 are provided in our comment on **20.4.3** below).
 - The important point to note here is, however, that – ***once a crisis is indeed severe***, i.e. most definitely at times of a PLAM trigger breach – RT1 gives issuers (and, indirectly, regulators) a lot of power to impose losses on investors (through coupon cancellation, potentially in perpetuity) and maintain all funds within the insurer for as long as is deemed necessary. In times of crisis, the quality of RT1 is at least pari passu to equity (if not better as coupons are cancelled vs. dividends that are effectively only deferred (cumulative)).
- c) PLAM may even reduce the quality of RT1 as it can have adverse effects on the financial stability of the undertaking**
- No. 1456 states that the primary objective of PLAM is to support **financial stability** at times of stress. We think that there is a risk that PLAM will rather harm financial stability than support it:
 - Financial stability is not supported when PLAM results in the issuance of a potentially large number of shares without increasing own funds by a single Euro. Since the

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- market value of conversion RT1 can be expected to match the value of the delivery shares at the time of conversion, there is – in theory – at least an offset to the share issuance in the sense that liabilities of equal market value are cancelled via conversion. However, to restore a healthy SCR coverage, an additional large scale capital increase may be required, and any additional supply of shares resulting from PLAM is not helpful for this additional capital raising. We are convinced that RT1 offers all necessary rights to impose extensive losses on RT1 investors without share issuance – and thus without this potential challenge to recapitalisation.
- As outlined above, PLAM is a contractual subordination of RT1 investors to equity investors. At issuance, RT1 investors effectively ignore this subordination risk as a trigger event is deemed extremely remote. However, when a PLAM trigger event becomes more likely, the inversion of the hierarchy of capital will manifest itself, and investors in conversion RT1 may try to short-sell shares in anticipation of the imminent trigger breach. Such uncoordinated sales will certainly not contribute to orderly trading in the issuer’s shares and thus potentially complicate a recapitalization effort.
 - Financial stability may be harmed in the worst-case scenario where eligible own funds could even fall in case of adverse tax effects from PLAM in a severe crisis.
- d) Even without PLAM, RT1 would be much more risky for investors than T2 or T3**
- The combination of true perpetuity and discretionary cancellation makes RT1 significantly more risky than T2 (dated, not even discretionary *deferral*, let alone cancellation).
 - Even without PLAM, RT1 allows the insurer to stop all cash flows to RT1 investors and effectively wipe out the investors’ claims – while being able to pay equity dividends at the same time.
 - RT1 contains “vulture fund risk” – if a “vulture fund” were to own a small insurer with no need to re-access the capital markets for additional RT1, the vulture fund could stop all payments to RT1 investors in eternity.
 - T2 and T3 do not pose anywhere near comparable risks for investors.

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Some regulators (like APRA) do not require going concern insurance PLAM

We note that Australian (APRA) rules for subordinated insurance Tier 1 require PLAM (conversion) only at Point Of Non-Viability (“PONV”). At PONV the relevant insurer has become a ***gone concern***. To our knowledge, PONV is not defined by a particular solvency ratio, but is rather determined by the relevant regulatory bodies. Depending on when PONV occurs, PLAM may of course be justifiable and sensible. Importantly, PLAM at PONV does not have unintended consequences, assuming that both equity and insurance RT1 are “wiped-out” simultaneously (or shareholders before RT1-holders – but not in the inverse sequence). We note further that Basel 3 rules do not require PLAM for equity accounted bank AT1. While European regulation nevertheless requires PLAM for any European bank AT1, other important regulators (e.g. US-regulation) do not – none of the US bank AT1 has been issued with PLAM. APRA does require PLAM for Australian bank AT1 at the earlier of PONV (i.e. as determined by the relevant regulatory body) and a CET1 ratio of 5.125%, whereas insurance AT1 requires PLAM only at PONV (and not at a specific solvency ratio). At the time of drafting bank AT1 rules, a CET1 ratio of 5.125% was viewed as a going concern trigger level (the Basel 3 Pillar 1 minimum for CET1 is 4.5%). Today, however, PONV is generally expected to be reached at much higher CET1 ratios, and consequently the PLAM of European bank AT1 is generally expected to be triggered only in a gone concern situation.

1455: It is conceivable that PLAM leads to an increase in the SCR ratio

- A trigger breach most likely coincides with a significant fall of UT1.
- Assuming meaningful issuance of RT1, the fall in UT1 can lead to “**cliff effects**” (see our comment on 19.3 above). “Cliff effects” imply that certain capital items are available, but not eligible due to Tiering limit restrictions.
- PLAM increases UT1, which in turn can reverse a prior cliff effect. As a consequence, PLAM may potentially lead to an increase in *eligible* own funds.
- However, there is no guarantee that this happens. Of course, the currently envisaged criteria do – at the margin – incentivize high levels of T2/T3 as well as RT1, with lower UT1 levels as a likely consequence. This cannot be intended, in our eyes. Also, these instruments are of perpetual nature. Scenarios that may seem remote today might become very real in the

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	potentially very long life of the instruments.	
19.4.2	<p>We support the EIOPA position that there is a strong case not to align the Principal Loss Absorption Mechanism with the banking regime.</p> <p>We note that a UT1 trigger would not solve the fundamental weakness of the insurance PLAM, which is that it typically does not lead to an increase – and may even lead to a decrease – of the key solvency metric for insurers, the SCR ratio. Insurance PLAM also does not increase the quality of capital in crisis, because of the very high quality of RT1 (as outlined extensively in our comment on section 19.4.1). Note that in crisis, the high quality of RT1 will come to full force (ability to terminate all cash flows to investors indefinitely) independent of PLAM.</p>	
19.4.3	<p>Clarity regarding write-up would be welcomed.</p> <p>The suggested waiver for write-down (“W/D”) would be welcomed</p> <ul style="list-style-type: none"> ▪ The waiver can help to avoid the most glaring of the unintended consequences that PLAM may have, namely a reduction of the SCR ratio. However, the way it is currently worded limits its applicability in practice ▪ Given the risk of trigger inversion (see our comment on section 19.2.1), there is a reasonable chance that the Group MCR will be breached even though the Group SCR is not. The waiver must not be granted if the group MCR is breached. It can be shown that in this case, the W/D may cure the breach of the Group MCR, but may at the same time result in a breach of the Group SCR. This cannot be an intended consequence of insurance PLAM, in our eyes. Ideally, the concept of the Group MCR would be amended, but this would require changes to the Solvency II Directive. In the meantime, a breach of the Group MCR in case of trigger inversion should not trigger PLAM. We therefore believe the waiver should be amended accordingly. ▪ In some jurisdictions, conversion can equally lead to taxable profits and a fall in the SCR ratio (via a reduction in T3 (DTA) or via an increase in tax liabilities and a fall in UT1). A waiver should therefore equally be possible for conversion or alternative PLAMs. 	

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Recalculation of SCR and calculation of subsequent write-downs

- Because of its adverse impact on investors, the application of PLAM requires legal certainty. The same is true for mandatory cancellation of RT1 coupons, albeit to a lesser extent, since the overriding risk for investors is the contractual right to cancel coupons on a fully discretionary and non-cumulative basis.
- For PLAM, to avoid litigation risk all trigger ratios (group and/or solo SCR/MCR) must be properly calculated, which requires a fully consolidated MVBS to determine own funds to be used as a basis for the SCR/MCR calculation.
- Even the for large insurance groups, the consolidated MVBS is only established on a quarterly basis, and typically audited only annually. Small and medium sized insurers may prepare a fully fledged MVBS only once a year, suggesting more flexible re-calculation periods may be sensible.
- ***In practice, a trigger breach can therefore be “determined” at best on a quarterly basis in a legally sound way.*** In addition, the result will typically be known only 3-5 weeks after the quarter-end date. More frequent assessments are good approximations only, but arguably not reliable enough from a legal perspective to effect PLAM thereon.
- ***Since all cash flows can be stopped on RT1 at any time, there is no particular need for a fast PLAM anyway.***
- Most importantly, this means that a meaningful three months cure period as foreseen by DR Art. 71(8)(c) would need to work as follows:
 - E.g. the issuer announces in May 2027 that the SCR ratio as per Q1-2027 has fallen to, say, 90%.
 - From this date on, the issuer knows with certainty that a capital increase is required within a short time frame (3 months) – this could be very little time left in case an equity prospectus needs to be prepared for said capital increase, and given any holiday season or black-out periods (no issuance window).
 - Assume the issuer is fast and raises capital in July 2027. This will only impact the SCR ratio as per Q3-2027, the ratio as per Q2-2027 may still be insufficient.
 - **In order for the 3-months cure period to be appropriate, a breach of the SCR should**

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	<p>be possible for the 6 months period between the two relevant accounting dates (from Q1-2027 to Q3-2027).</p> <ul style="list-style-type: none"> ○ Other than the original 6 months period, we see no reason why further write-downs should not be assessed on a quarter-by-quarter basis thereafter. However, any capital increase that occurs after the relevant accounting date, but before the figures for the last quarter have been established and published, should reduce (or eliminate) the need for such subsequent write-downs. 	
19.4.4	<ul style="list-style-type: none"> ▪ The proposed L2 Art. 71 5bis(a) requires write-down in full rather than allowing partial write-down when the Group MCR is breached <ul style="list-style-type: none"> ○ Breach of the Group MCR is arguably intended to reflect an extreme situation where the group may need to be wound down. In such (supposedly) severe circumstances, equity investors should have been effectively wiped out, and RT1 investors should arguably sustain a maximum loss, too (100% “loss absorbency” from an investor perspective). ○ Given the possibility of trigger inversion, the intuitive sounding prohibition of partial write-down at breach of the Group MCR may not make sense, however. Own funds may still be sufficient to cover a “1-in-200” year event, i.e. equity would still be valuable, and wiping-out RT1 bondholders would inverse the hierarchy of capital. ○ In case of trigger inversion, it is also possible that a 100% write-down may cure the Group MCR breach, but e.g. because of a reduction of T3 (DTA) may simultaneously lead to a breach of the Group SCR (waiver in Art. 70bis must not be granted if the Group MCR is breached). We believe that this cannot be intended either. ○ <i>We therefore recommend to allow a PLAM waiver also in case of a group MCR breach, which requires that L2 Art. 5 bis should be changed to read “trigger event listed in paragraph 8(a)-(c)”</i> ▪ The proposed Art. 71 5bis(a) prohibits a limitation of write-down when Group SCR falls below 75% <ul style="list-style-type: none"> ○ Similarly, for large insurance groups that are expected to issue the majority of total outstanding RT1, the 75% SCR trigger level is likely to be breached long after the 	

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	<p>Group MCR has been breached (see trigger inversion comments in 19.2.1. above). This significantly reduces the applicability of the linear write-down mechanism.</p> <ul style="list-style-type: none"> ○ Please see also our comments on cliff effects under section 19.3 "Limit system" that are not known to exist in banking. They are also relevant to this section. ○ <u>We therefore recommend</u> to allow a PLAM waiver also in case of a group MCR breach. ▪ The three months time frame in Art. 71 5ter may need to be extended to a longer period in order to allow it to be meaningful in practice. ▪ Please clarify the timing of subsequent write-down in view of our comments in 19.4.3. (Recalculation of SCR and calculation of subsequent write-downs). 	
19.5.1	<p>Clarification: PLAM can reduce own funds not only because it creates a tax liability, but also because it can lead to a reduction of DTA (T3): in case of a trigger breach, the issuer may be subject to high tax losses carried forward, which in turn can be mirrored in a DTA (T3). The profit from PLAM can reduce T3 own funds, or result in a tax liability thereby reducing UT1.</p>	
19.5.2	<p>1485: It is not just an assumption that Bank AT1 PLAM is indeed triggered at a very low (gone concern) level and thus later than insurance PLAM. As explained in our comment on 19.2.1 above, AT1 PLAM is triggered at a level that – for all practical purposes – must be considered gone concern. RT1, however, is triggered at a level that – within the Solvency II framework – must be considered a going concern level.</p> <p>1489: We are not aware of a single EEA jurisdiction where the amount of bank AT1 has actually been subjected to a haircut for potential tax effects in the EEA. We therefore strongly support the currently envisaged EIOPA approach to foresee exceptional waivers instead.</p>	
19.5.3	<ul style="list-style-type: none"> ▪ There is no experience with waivers of this kind, and we therefore recommend not to prescribe specific deadlines today. In case a waiver were to become relevant, the respective regulator would need to decide in 	

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	reasonably short time to avoid market uncertainty.	
19.5.4	<ul style="list-style-type: none"> ▪ The waiver as worded in Art. 70bis is not excluded for the cases of 75% SCR mandatory nor MCR breach. We think this is sensible, as we cannot see any level of the SCR where it is in any sense beneficial to policyholders if the SCR ratio is reduced further. However, the drafting of Art. 70bis (in para 1496) is not in line with the EIOPA's clear statement in para 1495. ▪ The waiver should also be granted for conversion where necessary (depending on tax jurisdiction). ▪ A waiver should also be possible if the the SCR ratio is less than 75% (or less than 100% for longer than three months), and, given trigger inversion, also when the Group MCR is breached. We can see no level of the SCR where it is in any sense beneficial to policyholders if the SCR ratio is reduced further. ▪ <i>We therefore recommend to allow a PLAM waiver also in case of a group MCR breach.</i> ▪ Importantly, the SCR ratio may decrease because of a reduction of DTA (via lower tax losses carried forward). The wording of Art. 70bis (b)(i) only refers to tax liabilities and is too narrow in our eyes. 	
19.6.1		
19.6.2		
19.6.3		
19.6.4	<p>New wording for tax and regulatory calls</p> <ul style="list-style-type: none"> ▪ We appreciate that tax and regulatory calls may no longer <i>automatically</i> require equivalent replacement irrespective of the issuer's solvency ratio. ▪ Regulators are expected to approve a call without replacement <i>only</i> if the post call solvency ratio is sufficiently high, i.e. if there is an "appropriate margin" between the post-call solvency and 100% SCR/MCR. For this, it is irrelevant how old the instrument is – the same regulatory decision is expected for a tax call after three years, or an ordinary call after 15 years – post-call solvency ratios always matter. 	

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	<ul style="list-style-type: none"> ▪ At the same time, it is not clear why only tax and regulatory calls should be possible without replacement in the first five years if the issuer’s solvency is strong. ▪ To summarize, all calls are subject to prior approval, and approval to call without replacement can always (including 10+ years post issuance) only be granted if the post call solvency is sufficiently high (i.e. appropriate margin <i>concept</i> should apply at all times). At the same time, <i>all</i> extraordinary calls should be possible without replacement at any times as long as solvency remains sufficiently high after a call. ▪ It should be ensured that necessary grandfathering rules are implemented to further allow considering outstanding SII RT1 / T2 bonds as own funds. 	
19.7	<p><u>1509-1511</u>: Please refer to our comments on section 19.2.1 on trigger inversion, why it should be avoided, and what could be done about it.</p> <p><u>1513</u>: Please refer to our comments on section 19.4.3 (sub-header: Recalculation of SCR and calculation of subsequent write-downs).</p> <p>1514: We are sceptical about “partial conversion”</p> <ul style="list-style-type: none"> ▪ Partial conversion does make intuitive sense when it is sufficient to restore of the SCR. ▪ Please note that the impact of conversion on the SCR ratio may well be better (or less bad) with partial instead of full conversion – the same is true for write-down. The “optimal write-down or conversion amount” can be lower than 100%, depending on the tax jurisdiction and tiering limit effects. ▪ However, partial conversion is complex, and there is very little (if any) experience with partial conversion in practice. ▪ Instead of adding even more complexity (and room for contractual errors) via partial conversion, <i>we think the waiver for W/D should be broadened to conversion to avoid the worst case outcome from conversion – a further reduction of solvency ratios.</i> <p><u>1516</u>: Please refer to comments on section 19.4.3. The waiver should also be applicable for conversion instruments, as well in case of a Group MCR breach.</p>	

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	Write-up: Please see comments on section 19.2.3.	
20.1	Capital instruments only eligible as tier 1 up to 20% of total tier 1	
20.2		
20.3	<p>1525: Concerns around para 1525, which is believed to not give a fair reflection A higher coupon does not automatically imply lower “permanence”</p> <p>Consider two instruments, both with a term of five years and no call rights. By definition, the permanence of the two instruments is identical. Assume that the only difference is that instrument A has a fixed rate coupon, and instrument B has a floating rate coupon (3-months Euribor plus spread). If – as is typically the case – Euribor (fixed for 3-months) is lower than the risk free rate (fixed for 5 years), the initial coupon of instrument B will be lower than that of instrument A. However, arbitrage ensures that the expected present value of both instruments is identical – the 3-months Euribor is expected to increase over time, which would increase the future coupon of instrument B after the initial 3-months period for which Euribor was fixed. Some market participants will call instrument A “more expensive” than instrument B nonetheless, after all, the initial coupon of the fixed rate bond will be higher, and an issuer may have a different expectation with respect to the expected future Euribor rates than the market. Importantly, though the “permanence” of both instruments is identical by assumption, namely 5 years.</p> <p>Analysing market data – AT1 and RT1 trade to the <u>expected</u> call date, which can be “never” (true perpetuity), but may be the <u>next</u> call date</p> <p>We are not sure based on what market data EIOPA concludes that investors tend to price instruments to the “next call” date. EIOPA’s conclusion is only correct for instruments with step-up (incentive to redeem) which cannot qualify as RT1. For True Perpetuals like AT1 and RT1, it is only correct to extent that investors are convinced that issuing replacement AT1 at the next call date would be <u>cheaper</u> for the relevant issuer than leaving the existing AT1 bond outstanding instead.</p>	

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We view permanence as a quality criterion for capital as meaningful only to the extent it protects the issuers’ solvency. Where a issuer call right only enables the issuer to save money by calling and replacing an instrument with an equivalent lower cost instrument, permanence is not negatively impacted. Permanence requires that there is no need for the issuer to call an instrument even though it would be very expensive or impossible to issue a replacement instrument. Given the impressive tightening of AT1 spreads in recent quarters, the reset coupons of existing AT1 (= risk free rate plus original credit spread) look high compared to the new coupon that the same issuers would have to pay today for a replacement AT1 (risk free rate plus lower current spread). Many AT1 bonds will therefore trade on a “to-call” basis, but only because a call and replacement allows the issuer to save money. **Importantly though, if credit spreads were to increase significantly from today, many of these bonds will start trade on a “to-perpetuity basis” instead of a “to-next-call” basis, i.e. investors would no longer expect the bonds to be called at the next call date.**

Market observation – simultaneously launched dual-tranche AT1 trades

The vast majority of bank AT1 and RT1 are issued with a so-called fixed/fixed reset coupon structure which works as in the following example:

- Perpetual bond with issuer call rights every 7 years (“PerpNC7”; “NC7” means not callable for the first seven 7 years).
- Coupon
 - Until first first call date / first seven years: fixed at the 7-year risk free rate at issuance plus “original” credit spread.
 - Thereafter: reset every 7 years to the then-prevailing 7-year risk free rate plus “original” credit spread.
- Note the following difference:
 - The interest rate risk is limited to 7 years, because the “risk free rate” component of the bond will be readjusted to the market rate every 7 years.
 - The credit spread is not re-adjusted. It is effectively a premium for “perpetual credit risk”.

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It is challenging to determine whether a particular existing AT1 with fixed/fixed reset coupon is likely to be called at the next call date, or not. You need to know the fixed credit spread of the existing AT1 bond (this spread is generally available), and you must compare it with the "current market spread" that the same issuer would have to pay today if it wanted to issue an equivalent new AT1 (not directly observable). If the current market spread is lower than the existing spread, the issuer will be expected to call the instrument at the next possible call date. If not, the assumption is that the bond is "truly perpetual" and will not be called.

An easier way to test whether bonds are truly priced to expected call rather than always priced to the first/next call is to compare the credit spread of two otherwise identical AT1 trades issued by the same issuer on the same date, where only the time to first call differs. A "perpetual" credit spread would imply that the spreads are identical or not materially different for a non-call period of, say, 10 years and a non-call period of, say, 5 years. If, instead, it can be deemed very likely that issuers will always call the bond at the first call date, the spread should be lower in case of shorter non-call periods.

From the table below, you can see that credit spreads are broadly identical for simultaneously launched tranches, irrespective of the non-call period. The spread for a shorter non-call period can be even higher than that of a longer one, because the option to call is an "issuer option", and having call rights from year 5 on (rather than only from year 10) puts investors at greater risk (issuer call when the old bond's spread is higher than the market spread, so the issuer takes away upside from investors).

USDAT1

Issue Date	Issuer	Curr	Amount	Maturity	Call Date	Structure	Coupon until first call	Coupon thereafter	PLAM type	ISIN
23/09/2014	NORDEA BANK AB	USD	1,000	Perpetual	23/09/2019	PerpNC5	5.500	Swap +356.3bps	TWD	US65557DAM39
23/09/2014	NORDEA BANK AB	USD	500	Perpetual	23/09/2024	PerpNC10	6.125	Swap +338.8bps	TWD	US65557DAL55
17/09/2014	HSBC HOLDINGS PLC	USD	1,500	Perpetual	17/01/2020	PerpNC6	5.625	Swap +362.6bps	EC	US404280AR04
17/09/2014	HSBC HOLDINGS PLC	USD	2,250	Perpetual	17/09/2024	PerpNC10	6.375	Swap +370.5bps	EC	US404280AS86
16/04/2015	ING GROEP NV	USD	1,000	Perpetual	16/04/2020	PerpNC5	6.000	Swap +444.5bps	EC	US456837AE31
16/04/2015	ING GROEP NV	USD	1,250	Perpetual	16/04/2025	PerpNC10	6.500	Swap + 444.6bps	EC	US456837AF06
10/08/2015	ROYALBK SCOTLND GRP PLC	USD	2,000	Perpetual	10/08/2020	PerpNC5	7.500	Swap +580bps	EC	US780099CJ48
10/08/2015	ROYALBK SCOTLND GRP PLC	USD	1,150	Perpetual	10/08/2025	PerpNC10	8.000	Swap +57.2bps	EC	US780099CK11

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Market observation – insurance bonds

Very few RT1 bonds have been issued to date. However, you may want to look into the trading performance of the Tier 2 style US\$ denominated True Perpetuals issued by several insurers in Q3-2016 (Allianz- ISIN: XS1485742438; Axa - ISIN: XS1489814340; Prudential- ISIN XS1488414464) and Zurich - ISIN: XS1449950663). These bonds were issued in fixed-for-life coupon format, a small niche market that is only rarely accessible. These bonds are very sensitive to changes in interest rates, given the absence of a reset. When US\$ interest rates increased significantly from mid-September 2016 on, the prices of these bonds fell dramatically because it “suddenly” looked highly *unlikely* to investors that these bonds would be called. It can be shown that these bonds where then traded on a “yield-to-perpetuity” basis, and not on a yield-to-call” basis any longer.

The trading performance of these bonds is strong evidence for the “truly perpetual” nature of these bonds – investors did no longer expect that these bonds will be called on their first call date.

1522/1526: The transitional arrangements in Art. 308b of the S2 Directive apply to instruments issued prior to the publication of the DR (January 2015). For the RT1 instruments issued in 2016 and thereafter (e.g. Gjensidige, Protector Forsikring, RSA, a.s.r., or the currently marketed TopDanmark RT1), and for any further transactions issued between today and the implementation date of changes to RT1 criteria (e.g. higher trigger levels), **transitional arrangements are required for these instruments to continue to qualify as intended** (risk of relegation into T2 or disqualification from own funds). This is also true in case the contemplated changes to the DR with respect to early calls would lead to a disqualification (not expected), in which case transitional arrangements would be warranted, in our eyes, too.

20.4.1

20.4.2

Our comment on section 20.4.3 explains why we strongly oppose the removal of a limit for RT1.
Increasing the 75% SCR trigger to 80% does not improve the quality of RT1.

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	<p>Our extensive comments on section 19.4.1. explain why current RT1 instruments are at least the same quality as equity. It also explains that, in practice, insurers will treat RT1 investors senior to equity investors as long as the insurer is healthy, and hence payments to RT1 investors will stop at a later stage than payments to equity investors. While this is a voluntary decision by issuers, which can be prohibited by regulators, we think that RT1 should be limited.</p> <p><i>The following reasons support limiting RT1 despite its very high quality</i></p> <ul style="list-style-type: none"> ▪ Equity investors are the owners of the insurer, only equity investors have voting rights. In case of a crisis, existing equity investors typically play a crucial role in a recapitalisation exercise. Contrary to this, RT1 investors are passive providers of capital. They take no part in decision making and invest on the premise that the risk of a crisis is highly remote. It is unlikely that RT1 investors would play the same role as equity investors in any recapitalisation – irrespective of whether or not they become equity investors via PLAM. ▪ Equity benefits from a well established statutory legal framework, whereas RT1 and bank AT1 are largely contractually defined. ▪ Equity is tried and tested in crises. Contrary to this, there is only limited experience with bank AT1 and insurance RT1 yet. In their current form, these instruments have only been issued during the last 5-6 years, and absent Banco Popular, no real “test in crisis” has been made with respect to a write-off or conversion of publically placed benchmark AT1. <p><i>With regard to the alternative provided by option 2, i.e. strengthening of the quality of Restricted Tier 1 should the 20% limit be changed we note the following:</i></p> <ul style="list-style-type: none"> ▪ In the comment on 19.4.1, it is explained that the quality of RT1 capital is formally at least as good as that of equity. The benefit and justifiability of trying to further strengthen the quality of RT1 is questioned. There is seen an increased risk of unintended consequences. ▪ 	
20.4.3		
20.4.4		
21.1	Draft Impact Assessment	

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