

Comments Template on the Consultation Paper on the methodology to derive the UFR and its implementation		Deadline 18 July 2016 23:59 CET
Name of Company:	Institute and Faculty of Actuaries	
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, in Word Format, to CP-16-003@eiopa.europa.eu</p> <p>Our IT tool does not allow processing of any other formats.</p> <p>The numbering of the paragraphs refers to on the Consultation Paper on the methodology to derive the UFR and its implementation.</p>		
Reference	Comment	
General Comment	<p><i>Single real rate estimate used for all countries</i></p> <p>The estimation basis assumes that all currencies / countries will converge to the same long-run real rate of return or real economic output. There is perhaps an argument for this where countries are close trading partners, e.g. in the Eurozone, but this is not necessarily true for different countries across the globe, reflected in very different yield curves prior to the last liquid point (LLP). We therefore feel that estimated real rates should reflect country-specific information where relevant.</p>	

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	<p><i>Real rates estimated using historic time series</i></p> <p>The assumption that a long-run historic time series can be used to estimate future rates relies on real rates being stationary and converging to a mean value. There is however very little evidence of this, with the ARMA model fitted in the consultation paper not achieving a close statistical fit.</p> <p>The use of very long forward rates would seem more credible for this purpose, perhaps supplemented by historic data where forward rates are not available, although as a consequence, the derived Ultimate Forward Rate (UFR) will be less stable.</p> <p>We note that there have been a number of step changes in rates of return over the past 40 years. The model assumes a degree of historic continuity which may not exist in reality.</p>	
Q1. (pg. 56)	We agree with the approach. As noted in the consultation, the approach is theoretically sound and consistent with the Solvency II Delegated Regulation.	
Q2. (pg. 56)	We agree that in order to obtain a stable estimate of long-run real rates of return, a significant period of historical data is required, with rates going back to 1960 achieving this purpose. However we do not believe that the historic averaging approach is appropriate; refer to comments made in the general comments section above.	
Q3. (pg. 56)	We agree that a geometric weighting scheme is appropriate; it favours most recent data and therefore allows more recent trends in real rates of return to influence the long-run estimate. As above, we do not however believe that the historic averaging approach is appropriate; refer to comments made in the general comments section above.	
Q4. (pg. 56)	We do not agree with the proposed approach. It is difficult to see why the 'four buckets' approach is used to allow for inflation expectations, rather than a 'pure inflation target'. The rationale given in the consultation paper is that it leads to the same UFRs for all European countries. However, this ignores the fact that certain central banks in Europe have higher long-run inflation targets and are intentionally differentiating monetary policy from that of countries with lower inflation targets.	

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	Actual inflation targets should therefore be used to ensure that yield curves reflect available economic information for each country.	
Q5. (pg. 56)	<p>We do not agree with the proposed approach. As a consequence of the way in which real rates of return are estimated, significant changes in the UFR are likely to result from changes to central bank inflation targets. This should then feed through to the methodology used to determine the yield curve so that it reflects current information and is market consistent.</p> <p>If a 20 bps limit is used, but with the true UFR a significantly different value, then companies may come under pressure to disclose the impact of the ultimate level of the UFR in addition to the 'limited' rate.</p>	
Q6. (pg. 56)	We agree with the proposed approach. Rounding changes in rates to 5 bps is preferable as this ensures that spurious annual changes are smoothed out and do not create unnecessary noise. However, we would suggest that further rounding may also be possible (to 25 bps?).	
Q7. (pg. 56)	<p>We agree with the proposed approach. The application of a phased-in change to UFRs from the existing basis to the updated methodology will be less disruptive to companies that are making hedging and investment decisions based on the level of UFRs.</p> <p>The implementation method is however likely to be thought of as a type of transitional measure or phased-in adjustment where companies would be under pressure to disclose the impact of the ultimate level of the UFR in addition to the 'limited' rate.</p>	
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