

<b>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</b>		<b>Deadline            5 January 2018            23:59 CET</b>
Name of Company:	Reinsurance Advisory Board (RAB)	
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"> <li>⇒ Do <b>not</b> change the numbering in the column “reference”; if you change numbering, your comment cannot be processed by our IT tool</li> <li>⇒ Leave the last column <u>empty</u>.</li> <li>⇒ 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>.</li> <li>⇒ Our IT tool does not allow processing of comments which do not refer to the specific numbers below.</li> </ul> <p><b>Please send the completed template, in Word Format, to <a href="mailto:CP-17-006@eiopa.europa.eu">CP-17-006@eiopa.europa.eu</a></b></p> <p><b>Our IT tool does not allow processing of any other formats.</b></p> <p><b><u>The numbering of the reference refers to the sections</u></b> 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>		
<b>Reference</b>	<b>Comment</b>	
General Comment	The Reinsurance Advisory Board (RAB) welcomes the opportunity to comment on EIOPA’s draft advice and provide technical input on the various areas under consultation. In the below, the RAB chose to	

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	focus on those areas of the consultation that are specifically relevant for reinsurers and reiterate related key positions covered by EIOPA’s first set of advice.	
Introduction		
1.1	<p>In addition to the standard deviation parameter changes proposed by EIOPA, the RAB would like to point out the importance of a <b><u>risk-based recognition of non-proportional reinsurance</u></b>, as mentioned in the RAB’s comments on EIOPA’s first set of advice:</p> <p>For ceding companies, non-proportional reinsurance is increasingly important as a way of ensuring effective protection. Non-proportional reinsurance is used as the predominant risk mitigation instrument for Non-life, which accounts for more than 50% of total non-life reinsurance premiums in major European markets. It should also be noted that non-proportional reinsurance is particularly effective under extreme loss scenarios such as the 200-year-event.</p> <p>The Solvency II standard formula recognises non-proportional (NP) reinsurance via fixed adjustment factors of 80%, for three business segments only (motor liability, property, and general liability). It is the RAB’s understanding that these have been introduced to adjust the calibration of the standard formula for a market average impact of reinsurance. However, this is not a risk sensitive solution. For the remaining segments, the (standard) adjustment factor is 100%. It should be noted that the Delegated Regulation currently allows the application of the reinsurance fixed adjustment factors regardless of whether reinsurance is applied as a risk mitigation technique.</p> <p>This penalises small and medium sized companies in particular, since they use significant NP reinsurance covers and are less likely to have an approved internal model. This approach fails to incentivise good risk management and wrongly assumes that the impact of NP reinsurance will not be material in general for the majority of segments.</p>	

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	<p>The non-life premium and reserve risk method should be revised to include adjustment factors for premium and reserve risk for NP reinsurance for all lines of business (subject to conditions).</p> <p><b>Therefore, the RAB would propose a straightforward adjustment to the standard formula ("RMother") to address issues with recognition of non-proportional reinsurance.</b> This would capture the risk mitigation impact of <b>any</b> reinsurance that is currently not taken into account in the premium and reserve risk module or anywhere else without increasing the overall complexity. The proposed adjustment would be calculated by the undertaking using a scenario based approach, using the same method as is already applied for the scenario based calculations for Life and the Non-Life Cat module.</p> <p><b>Non-proportional reinsurance should provide the same capital relief as proportional reinsurance if the undertaking can provide evidence that economic risk transfer towards the reinsurer is identical for the scenarios defined under the standard formula.</b></p> <p>The amended formula for the SCR for premium and reserve risk in Art. 116 of the Delegated Regulation would be:</p> $SCR_{nl\ prem\ res} = 3 \sigma_{nl} V_{nl} - RM_{other}$ <p>RM<sub>other</sub> denotes the risk mitigating effect on premium and reserve risk of reinsurance arrangements that meet the requirements of Articles 209, 210, 211 and 213 of the Delegated Regulation but for premium risk excluding reinsurance premiums referred to in Article 116(5) (a) that otherwise have not been reflected in the standard formula. It shall be calculated as the risk mitigating impact of the reinsurance on a change in basic own funds that would result from an instantaneous loss in the amount of <math>3 \sigma_{nl} V_{nl}</math>.</p> <p>The RAB believes that the calculations to be performed for <math>RM_{other}</math> are not more complex than other calculations required under the standard formula which are under the responsibility and governance of the actuarial function (Article 272 of the Delegated Regulation and Article 48(1)(g) of the Solvency</p>	

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	<p>II Directive). This is the case in particular with regard to reinsurance, for which Article 272 (7) of the Delegated Regulation foresees that the actuarial function should analyse the adequacy of the overall reinsurance arrangements, including the expected cover under stress scenarios.</p> <p>The RAB offers to support the development of further details on how to approach the calculation of <i>RM<sub>other</sub></i>.</p> <p>The RAB appreciates EIOPA's decision to analyse the recognition of <b>adverse development covers</b> as set out in in EIOPA's first set of advice as of 30 October 2017. Due to the possible important effect on the ceding company's risk profile, the RAB encourages EIOPA in allowing the recognition of these covers in the calculation of reserve risk within the standard formula.</p>	
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2.3	<p>EIOPA advocates that undertakings should inform the supervisor and demonstrate effectiveness of control about any increase of cession including new reinsurance as a requirement for recognition of the risk-mitigating impact. This will be the consequence if the application of Articles 116(4) or 147 (4) becomes the standard way for the recognition of new reinsurance. The RAB holds the opinion that this is disproportionate and might be not the intention of these Articles.</p> <p>In the RAB's understanding, Articles 116(4) and 147(4) refer to situations where undertakings make a significant change in their business plan. In this case, demonstrating control around the implementation of the business plan and informing the supervisor might make sense, eg to avoid wrong incentives about overly frequent changes to the plan. However, for a reinsurance contract in compliance with Articles 209 and the following of the Delegated Regulation (eg that is effective for the following 12 months) there is no need to demonstrate any additional controls as asked for in Articles 116(4) and 147(4). Additional requirements would further be disproportionate because Solvency II generally does not require undertakings to notify supervisors before concluding reinsurance contracts.</p> <p>The RAB believes the following observations would sufficiently address EIOPA's concern about the RAB proposal to allow undertakings (under certain conditions) to replace last year's NEP figure with a recalculated figure, ie last year's gross earned premium adjusted for the impact of the new</p>	

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	<p>reinsurance structure:</p> <ul style="list-style-type: none"> <li>■ First, the proposal is <i>prudent</i> because it prevents incentives for an overly conservative estimation of earned premiums for the forthcoming years.</li> <li>■ Second, the method is <i>simple</i> and <i>transparent</i>. It can be verified based on gross premium figures and detailed information on each reinsurance contract, as included in SII reporting.</li> </ul>	
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3.4.3	<p>Mortality risk is generally an important driver of reinsurers' SCR. An increase in the factor from 15% to 25% can have a sudden significant (and potentially overburdening) impact on the SCR.</p>	
4.1	<p>Regarding the section '4. <i>Health catastrophe risk</i>' in general, the RAB notes and appreciates that EIOPA has taken up the suggestions of the EIOPA CAT-WS quite consistently in its consultation document for the second set of advice. The RAB would like to highlight that it supports the recommendations which have been agreed and brought forward by the EIOPA CAT-WS.</p>	

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5.1	Regarding the section '5. <i>Man-made catastrophe risk</i> ' in general, the RAB notes and appreciates that EIOPA has taken up the suggestions of the EIOPA CAT-WS quite consistently in its consultation document for the second set of advice. The RAB would like to highlight that it supports the recommendations which have been agreed and brought forward by the EIOPA CAT-WS.	
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5.7.2.3	The RAB welcomes the proposal to identify main exposures on a net of reinsurance basis. This would increase risk sensitivity without increasing complexity much.	
6.1	<p>Regarding the section '6. <i>Natural catastrophe risk</i>' in general, the RAB notes and appreciates that EIOPA has taken up the simplification suggestions of the EIOPA CAT-WS quite consistently in its consultation document for the second set of advice. The RAB would like to highlight that it supports the recommended simplifications which have been agreed and brought forward by the EIOPA CAT-WS.</p> <p>The RAB notes that the CAT-WS' work on the recalibration of various scenarios is ongoing, in particular in the context of the "holistic recalibration" project. The RAB looks forward to providing further input to the continued work of the CAT-WS and comments, as and when concrete recommendations are formed and finalised.</p>	
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6.4.3.3	<p>The RAB would like to comment on EIOPA’s emphasis under 6.4.3.3. (par. 402-410) <i>“that the recalibrations proposed below are highly provisional, due to the outstanding decisions on ways to ensure cross-border consistency”</i>.</p> <p>On the “Cross-border consistency of country risk factors” (paragraphs 397 – 401) a new EIOPA CAT.-WS-process has already been started. In its work, the CAT-WS had already anticipated the requirement that other country factors which are not in the initial mandate of the CAT-WS might need to be recalibrated as well using the latest vendor cat. model versions or other reliable sources.</p> <p>Even though the recalibration process should assure cross-border consistency, the recalibration proposed by the EIOPA CAT-WS for the scenarios included in the mandate might not change at all. The proposed country factors include country-specific modelling assumptions regarding exposures, vulnerabilities, limits, deductibles, coverage types etc (partially included in paragraphs 400, 401). Therefore, it is justified that country factors might look extremely different even for neighbouring countries and for the same peril recalibrated considering cross-border consistency. The RAB does not necessarily expect material changes to the already recalibrated scenarios after considering the proposed “options for addressing potential inconsistencies” set out in paragraphs 398 a and b.</p>	
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9.3	<p><b>In response to the feedback statement on the main comments received to the discussion paper</b> - the RAB does not believe that EIOPA's assessment addresses the main points made by respondents.</p> <p>The Call for Evidence noted that calculation of currency risk within the standard formula may penalise holding own funds to cover a related undertaking's SCR in the currency in which its assets and obligations are denominated. Responses to EIOPA's discussion paper confirmed that in fact it has this</p>	

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	<p>effect. As the RAB’s response to Q15.4 said:</p> <p><i>“The standard formula imposes a 25% capital charge on all foreign capital surpluses, which incentivises firms to hold all excess assets in one currency – namely the local currency – as this does not result in any capital charge. This tends to penalise (re)insurers who reduce their exposure to currency risk by holding foreign currency surpluses and provides a perverse incentive for them to hold surpluses in domestic currency, thereby increasing currency risk.”</i></p> <p>EIOPA’s assessment does not comment on the fundamental issue raised by the Call for Evidence, ie whether the Standard Formula approach is appropriate, in light of the incentives it gives to group risk management. Paragraph 577 notes the key point made by respondents, that a group with exposure to multiple currencies increases its risk if it chooses to hold all its capital in the reporting currency, but EIOPA’s assessment does not respond to this point.</p> <ul style="list-style-type: none"> <li>■ Paragraph 580 says: <i>“...it is not clear that holding assets in the group reporting currency to back local capital requirements and liabilities would reduce the capital because SCRs for the solo undertakings would increase in such cases.”</i></li> </ul> <p>With respect, this is missing the point. As the RAB’s response to Q15.4 of the Discussion Paper points out, (re)insurers hold assets in the currencies in which they are doing business, so groups (and solo entities) usually back local requirements and liabilities in local currency. The problem with the standard formula approach is that they thereby incur a regulatory capital charge under the currency risk sub-module. As this capital requirement does not reflect a real risk to the group’s solvency, Solvency II’s approach, in the words of the Call for Evidence, does not “adequately cover the risk to which the group is exposed”.</p> <ul style="list-style-type: none"> <li>■ Paragraph 581 says: <i>“EIOPA is concerned that the requirements of the Prudent Person Principle may not be satisfied if assets are not held locally.”</i></li> </ul>	

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	<p>This reaffirms the approach of most groups and solo entities, as reflected in responses to the Discussion Paper. But it means that (re)insurers find themselves in a “catch 22 situation”: holding assets locally satisfies the Prudent Person Principle, but means that they incur a currency risk capital obligation; holding assets centrally means that they can avoid the currency risk capital obligation but may be in breach of the Prudent Person Principle.</p> <ul style="list-style-type: none"> <li>■ Paragraph 583 rejects the alternative formula put forward by Insurance Europe. <b>The RAB believes that Insurance Europe’s approach is preferable to that of the existing standard formula.</b> It is not entirely clear on what grounds EIOPA concludes that Insurance Europe’s approach is inappropriate. <b>Furthermore, the RAB does not agree that the proposed formula would result in no capital charge on surplus assets: it would result in a charge if the surplus assets are not matched to the spread of liabilities.</b></li> </ul>	
9.4.1	<p>The Call for Advice asked EIOPA to provide information on currencies chosen by insurance groups to hold their own funds. The account given in paragraphs 584 to 587 is inadequate to determine whether the work carried out by EIOPA is a useful contribution to this issue.</p> <p>In particular, this exercise:</p> <ul style="list-style-type: none"> <li>■ Looks at the assets of groups rather than their own funds;</li> <li>■ Does not focus on groups with foreign exchange exposure. The groups considered apparently included many conducting business in their local currency only (although the details provided are insufficient to confirm this). The exercise should have looked at the currencies in which groups with foreign exchange exposure choose to hold their own funds;</li> <li>■ Does not make any attempt to draw conclusions from the information collected or to relate it to the questions asked by the Call for Evidence.</li> </ul>	

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Paragraph 602 says: *"If the current standard formula seems an appropriate trade-off between simplicity of calculation at group level and risk sensitivity in cases where exposure is not important, this may be different for groups with significant exposure."*

This suggests that the current standard formula is fundamentally flawed. The standard formula approach to currency risk must be assessed by how it affects groups and solo entities with significant exposure to foreign currency risk. As the paragraph notes, for such groups and solo entities it is not appropriate. Firms with unimportant foreign currency exposure are largely unaffected by the currency risk sub-module, so it is bound to appear appropriate to them.

The RAB supports EIOPA’s suggestion, set out in paragraph 603. This would be an improvement on the current approach. As noted before, the problems that the currency risk sub-module create for groups also exist for solo entities. If the standard formula is amended to implement EIOPA’s suggestion for groups, this must also apply to solo entities as well. Otherwise there would be an unnecessary discrepancy in the approach to currency risk.

Nevertheless, it will only enhance the approach to currency risk for groups and solo entities with a particularly large exposure in a currency other than their local currency. Many groups and solo entities are not in that position. EIOPA’s analysis of groups in 9.4.1 does not provide any evidence that there are groups in a situation where EIOPA’s solution will provide an effective alternative approach.

**To that extent, therefore, and in view of EIOPA’s recognition that the current approach is not an appropriate trade-off between simplicity of calculation and risk sensitivity for groups with meaningful currency exposure, the RAB believes that EIOPA’s proposal does not provide an adequate resolution to this issue.**

9.4.2

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13.1	<p>The RAB welcomes the EC’s request for EIOPA to assess if the complexity of the counterparty default risk submodule is proportionate to the nature, scale and complexity of these risks and to develop a simpler structure, where appropriate.</p> <p>However, the RAB would have preferred for EIOPA to have investigated a more fundamental simplification to the overall structure of the submodule. The evidence put forward by EIOPA (eg the extensive use of simplifications, EIOPA’s assertion that “counterparty default risk is not a major risk”) supports thorough simplification. The RAB further believes that changes to the derivatives markets and, in particular, the introduction of EMIR support the proposal for a fundamental evaluation of this submodule.</p>	
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13.3	<p>The RAB welcomes EIOPA’s proposal to introduce an optional simplification to address the difficulties encountered in assessing whether a reinsurance counterparty has more than 60% of its assets pledged as collateral. However, it should be noted that EIOPA has not provided justification for the increased prudency inherent in the proposed simplification due to the change in the LGD factor from 50% to 90%. The simplification should be based on qualitative factors, such as the credit rating of the reinsurer, rather than effectively assuming all reinsurers have over 60% of their assets pledged as collateral.</p>	
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	<p><b>General comments</b></p> <p>The current framework already provides significant guidance on the issue of LAC DT, and any supervisory concerns should be addressed in an appropriate supervisory dialogue, with appropriate knowledge of and respect for undertaking's specific business models. EIOPA should allow and encourage <b>supervisory judgement and dialogue</b>, and not limit it.</p>	
17.1	The RAB appreciates EIOPA's attempt to provide structure to the supervisory dialogue on LAC DT with	



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	<p>the proposed principles. From this perspective, issues such as the role of compliance with the level of capital post-shock, projection of and assumptions for new business, and future management actions are all valid concepts that should be part of the supervisory dialogue. Any arbitrary limitations beyond these guiding principles should be avoided. The RAB therefore believes that <b>the most appropriate way forward is for EIOPA to provide an opinion with guiding principles for the supervisory dialogues</b>. Such an opinion should be based on principles in line with the existing Solvency II framework, and avoid arbitrary limits that would be agnostic to company/jurisdiction-specific circumstances. In fact, in such an opinion EIOPA should not avoid raising criticism on too conservative/unjustified approaches, which are a reality in some member states.</p> <p>The RAB notes that the possibility for a simplified calculation for LAC DT could be helpful but highlights that this should only be applied optionally.</p>	
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17.4.2	<p>The RAB appreciates that the key principles are indeed relevant for the supervisory dialogue on LAC DT. Implementation of the principles should, however, remain part of the supervisory dialogue (see comment above) and appropriately reflect company-specific issues.</p>	
17.4.3	<p><b><u>Key Principle 1: Role of compliance with the MCR and SCR after the shock loss</u></b></p> <p>The RAB generally agrees that the level of capital should play a role in the determination of LAC DT, and should be part of the supervisory dialogue.</p> <ul style="list-style-type: none"> <li>■ However, the assessment of compliance should be made after having taken into account the recovery measures put in place by the undertaking as well as any management action or parental guarantees that would be used in case of such a shock.</li> </ul>	

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	<ul style="list-style-type: none"> <li>■ Additionally, the RAB disagrees with the prescribed formulaic approach as the implementation of this principle, which is an approach agnostic to the importance of company specificities and the value of supervisory dialogue.</li> </ul> <p><b><u>Key Principle 2: Future profits stemming from new business-projection assumptions</u></b></p> <ul style="list-style-type: none"> <li>■ The RAB appreciates EIOPA's intention to base the future profits calculations on economic principles, however, the projection assumptions of future profits stemming from new business should not be more prudent than those of the calculation of technical provisions. The projection assumptions should be consistent with the underlying scenarios causing the shock, in line with the valuation methodology under Solvency II.</li> <li>■ However, future taxable profits should be calculated in line with the local tax regime. Most of the tax regimes are based on statutory accounting, so economic valuation is usually an inappropriate proxy for future taxable profits.</li> <li>■ In line with the comments made under 17.1, arbitrary and automatic cut-offs should not form part of the key principles.</li> </ul> <p><b>The RAB suggests using the local accounting standard instead to be consistent with the tax regime.</b></p> <p><b><u>Key Principle 3: Future profits stemming from new business-projection horizon of taxable profits</u></b></p> <ul style="list-style-type: none"> <li>■ The RAB agrees that a level playing field is needed for the projection period for new business. However, approach 3a seems arbitrary. It is possible that a loss scenario mainly stems one-off losses (eg Nat cat or Investments). In this case it can reasonably be expected that profitability will return to normal levels after the shock. For Nat Cat even an increase in profitability or new business can be expected after an SCR event. <b>The RAB reiterates that no arbitrary or automatic cut-offs should form part of the key principles.</b></li> <li>■ The RAB does not support the provision of limits defined as cut-off points in number of years. <b>Instead, the projection horizon of taxable profits should be an area of discussion in the supervisory review process (SRP).</b></li> </ul>	

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**Key Principle 4: Future profits stemming from new business-projection horizon of new business sales**

As for key principle 3, the RAB is skeptical about using a business plan horizon as a general principle for determining taxable profits. The business plan is intended to aid in managing or steering results on a very granular level. The projection of future taxable profits, however, is intended to project taxable incomes over a longer time horizon. **The horizon should be determined on a case by case basis by the undertaking, and should be an element of discussion between the undertaking and its supervisor in the context of the supervisory review process (SRP).**

**Key Principle 5: Future profits stemming from return on assets**

- **The RAB highlights that limiting returns to the risk-free rate does not make sense in a taxation context and would therefore call for the full recognition of future profits stemming from assets on a realistic basis.**
- As noted for new business, an economic valuation and a reference to the business plan might be a contradiction in itself. Furthermore, if companies have a buy-and-hold strategy and have invested in fixed income securities that pay a coupon in excess of current risk free rates, they should be able to take this extra return into account as it is expected to realise over time even after the shock.
- The RAB considers it inappropriate that no equity market recovery can be considered. The Solvency II framework acknowledges this with the introduction of the symmetric adjustment. The RAB therefore questions why it should not be included in the projection for the LAC DT.
- The RAB generally agrees that calculating various scenarios for future asset returns should be limited to internal models and that the standard formula should be kept simple.

**Key Principle 6: Future profits stemming from return on assets in excess of technical provisions - projection horizon**

As per the comments on key principles 3, 4, and 5, the RAB believes that there should be no arbitrary limit set for the projection horizon of future profits stemming from return on assets in

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	<p>excess of technical provisions. Instead, the features of each tax regime should be taken into account to set the projection limit which is best achieved through a discussion between the company and its supervisor in the context of the supervisory review process (SRP).</p> <p><b><u>Key Principle 7: Future management actions</u></b>            The RAB disagrees with EIOPA’s a priori disqualification of a range of management actions, that can in fact be valuable tools for undertakings to use in case of shock. Future management actions should be allowed, and their relevance and reliability should be part of the supervisory dialogue, and accepted as long as the undertaking can successfully demonstrate to the supervisor their impact on generating future profits.</p> <p><b><u>Key Principle 8: Role of the system of governance</u></b></p> <ul style="list-style-type: none"> <li>■ The RAB generally agrees that there should be a robust system of governance and supports a strong role of the AMSB in the calculation of LAC DT.</li> <li>■ However, implementing an approval of the LAC DT by the AMSB is overly cumbersome. The validation of the assumptions and calculations should further not be specifically assigned to the actuarial function, as this could also be fulfilled by another key function, eg the risk management.</li> <li>■ This represents significantly higher requirements on governance than for all other risk modules. In particular, this is not in line with intention of EIOPA to simplify the Standard Formula calculations.</li> <li>■ LAC DT already forms part of the ORSA. Therefore, there is no evident need for additional requirements. The RAB considers it overly complex to include all the documentation and sensitivity requirements in the ORSA, instead the impacts pre and post-tax should be shown allowing for a more detailed assessment.</li> </ul> <p><b><u>Key Principle 9: Supervisory reporting and disclosure</u></b></p> <ul style="list-style-type: none"> <li>■ The RAB understands that information on the LAC DT should be provided in the RSR. In the SFCR however, this should be avoided as the topic is too complex to be presented appropriately to the audience in such a format. To ensure a level playing field <b>documentation in the RSR should</b></li> </ul>	

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	<p><b>sufficient.</b></p> <ul style="list-style-type: none"> <li>■ RAB is further concerned that EIOPA’s proposals to strengthen the RSR (and the SFCR) with regards to LAC DT will increase (as opposed to decrease) the reporting burden of undertakings.</li> </ul>	
18.1	<p>The RAB welcomes that the EC call for advice of July 2016 identified the <b>cost of capital (CoC) for the risk margin (RM)</b> as an area to be reviewed. However, EIOPA’s recommendation <i>not</i> to change the CoC rate is highly disappointing. In fact, the current 6% calibration is much higher than necessary and is a major reason why the RM is excessive and difficult to hedge (as it is a fixed factor). EIOPA’s analysis does not take into account the large amount of evidence put forward by stakeholders on the concerns regarding the risk margin, including the excessive size and volatility and the excessive allocation to certain (long-term) products.</p> <p>The excessive size of the RM represents a pan-European issue, of importance to insurance and reinsurance undertakings across EEA jurisdictions. For the entire industry, according to EIOPA figures, the total RM was €210bn in Q3 2016, out of which €150bn stems from life and composite insurance undertakings and represents more than 45% of the life insurance industry SCR. EIOPA’s data for Life business shows very clearly that the RM is higher than 50% of SCR in 4 EEA jurisdictions and between 40-50% in 10 EEA jurisdictions.</p> <p>The amount of RM in absolute and relative terms can be very significant for some (re)insurance groups, representing over 40% or even 50% of their SCR. For certain products - typically long-term - such as funeral insurance, the RM can reach up to 110% of SCR and can sometimes be significant compared to best estimates, in a proportion which was not anticipated in the initial impact assessment from EIOPA.</p> <p>The current methodology for calculating the RM has led to an excessive level and volatility of the RM, as a direct result of a hedgeable risk (interest rates) which the RM is not intending to cover. The excessive level of the RM also tends to incentivise firms to de-risk as interest rates fall.</p>	

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	<p>This trend, as well as the excessive volatility of the RM to interest rates, clearly highlights that the current calibration of the RM is not consistent with economic reality. This is underlined by the economic conditions as reflected in the current low interest environment.</p> <p>The excessive size of the RM and the current inappropriate specification also have a detrimental effect on the volatility of balance sheets. The RAB estimates that a 1% decrease in interest rates can result in an increase in the risk margin of more than 20% for longer duration portfolios. Given the size of the RM, this can represent an extreme change and will impact negatively on firms' solvency ratios. This is not reflective of the behaviour of transfer pricing in the market which takes into account a longer-term view of the risks involved and is much less sensitive to current discount rates.</p> <p>The excessive size and volatility of the RM also creates an un-level playing field between European (re)insurers and (re)insurers domiciled elsewhere and thereby encourages the take-up of reinsurance in non-EEA jurisdictions, outside direct oversight of European policymakers. Furthermore, the level and uncertainty of the RM will lower appetite for the selling of products that suffer most from this (eg long term retirement products), and reduces the capacity to invest in long term finance opportunities. This ultimately harms consumers as it results either in consumers no longer being able to purchase particular insurance products or having to pay too much for insurance cover. It also runs contrary to the EC's aim that the Solvency II framework should ensure that the rules do not unduly discourage long-term investment and sustainable economic growth, and should not give rise to unintended consequences such as regulatory arbitrage.</p>	
18.2	<p>The RAB notes that the legal extracts referred to in the consultation document do not cover all elements of the relevant regulations. The questions posed by the EC do not preclude a review of the elements that are missing. For example, the reference undertaking assumptions are set out in the Delegated Regulations and as such should be in the scope of the current review.</p>	

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	<p>The elements that are not reviewed, as a result, include key elements that may help address the noted issues with regard to the excessive size and volatility of the RM, in particular the highly formalistic non-diversification assumption.</p> <p>Therefore, the RAB believes this section of the consultation paper unduly limits the review and therefore the effectiveness of the advice of EIOPA to address the key issues around the risk margin.</p>	
18.3	<p>The SCR underlying the group RM calculation should allow for full diversification of risks across the group, in line with how those risks are likely to be managed in practice.</p> <ul style="list-style-type: none"> <li>■ <u>According to EIOPA some stakeholders propose to adjust the formula as set out in the consultation paper, where the CoC rate is allowed to vary according to a weighted average of risk-free interest rates for different currencies (paragraph 1395):</u> The RAB does not agree with EIOPA’s assessment, as risk-free rates (RFRs) across terms and currencies are highly correlated. Against this background, the RAB believes that the proposal on varying the CoC with the RFR will therefore inevitably lead to lower volatility compared to the current CoC calibration.</li> <li>■ <u>According to EIOPA some stakeholders argue the reference undertaking should be allowed to use the MA and the VA:</u> The RAB does not agree. The VA and MA are part of the Solvency II framework and should be allowed to be taken into account. Additionally, allowing companies to make use of the MA and VA would avoid additional complexity and problems as the RM and best estimate liability calculations would be based on a consistent valuation basis (see also response to EIOPA-CP-16-008).</li> <li>■ <u>According to EIOPA “some stakeholders propose to use a time scaling factor to reduce SCR projected”:</u> The RAB acknowledges EIOPA’s assessment that it may be difficult to assess the materiality of risk diversification over time, however the RAB deems the impact can be material, and should be accounted for, as by not taking into account risk dependency over time, the</li> </ul>	

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	<p>current approach <b>overstates the ultimate risk and hence overstates the RM</b>. Within the RM the assumption that all future capital funding requirements are independent is not appropriate for long term business.</p> <ul style="list-style-type: none"> <li>■ <b>Capital structure:</b> The use of debt funding will lower the cost of financing, and hence disregarding this will lead to an overestimate of the true weighted average cost of capital.</li> <li>■ <b>Sensitivity of the cost of capital to interest rates</b> <ul style="list-style-type: none"> <li>■ The lack of the CoC rate’s sensitivity to interest rates is a major disadvantage of the current CoC rate because it ignores the fact that in a low interest rate environment, market risk premiums might be expected to reduce as demand for higher yielding assets increases. Such a link between the CoC rate and interest rates is considered and discussed in more detail under the context of frictional market effects in the CRO paper (2008). This report found that the relationship between the CoC rate and the risk-free rate was approximately linear, with the CoC rate for a BBB-rated insurer increasing by 0.3%-0.4% for every 1.0% increase in the risk-free rate.</li> <li>■ Such a relationship is economically justified based on double taxation costs which correspond to the compensation for corporate tax incurred on the base cost of capital. Investors ask for risk free return (RF) plus a spread. When investing in an insurance company, double taxation arises because the companies' return is subject to corporate taxes.</li> <li>■ Therefore, the return should allow for the corporate tax rate for the purpose of determining an appropriate CoC rate. The RAB understands that EIOPA/CEIOPS assumed an average tax rate and calibrated the CoC margin at the prevailing risk free rate in 2007. The RAB believes that under this assumption, the current risk margin should be lowered to adequately reflect changes in the risk free rate since then. This would also address current issues with hedging which are a consequence of the failure of the CoC rate to recognise interest rate sensitivity.</li> </ul> </li> <li>■ <b>Calculation of the RM – allowance for diversification</b> <ul style="list-style-type: none"> <li>■ The separation of obligations for life and non-life obligations is arbitrary and as such the RAB</li> </ul> </li> </ul>	



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	<p>would propose that this is removed in order that insurers are able to properly take into account insurance risk diversification effects when calculating their RM (given that investors would be able to do this by providing capital to different reference undertakings).</p> <ul style="list-style-type: none"> <li>■ Additionally, the assumption set out in the Level II text on the need to break up groups prior to sale is not borne out by actual experience, leading to an unnecessarily conservative assumption in the RM calculation for groups. Examples where groups, including all subsidiaries, have been subject to a takeover are Resolution (purchased by Pearl Group), Friends Life Group (purchased by Aviva), Delta Lloyd (merged with NN) and AIA (aborted purchase by Prudential plc).</li> </ul> <p>■ <b>Calculation of the RM – allowance for hedgeability of longevity risk</b></p> <p>In summary, the proposal for allowing for the hedgeability of longevity risk in the RM calculation involves an insurer approving a management action that provides that it would seek reinsurance to cover certain liabilities in specifically defined circumstances, namely when it de-risks its assets – not necessarily that the reference undertaking should apply more (or less) risk-mitigation than the original undertaking, as stated in the EIOPA consultation document. Due to the operation of certain assumptions in the legislation for the calculation of the RM, those defined circumstances would be deemed to occur upon any transfer to a transferee insurer and therefore the transferee insurer can be treated (for the purposes of the RM calculation) as having put in place longevity reinsurance in line with the management action. That management action would be reflected in determining the transferee insurer’s SCR for the purposes of calculating the RM.</p>	
18.4.1	<p>Previous CEIOPS advice states that <i>“In order to account for the fact that a key source of return that exists for going concerns (the so called franchise value related to expected profit from new business) may not be demanded by capital providers in a transfer context, a downward adjustment is needed”,</i> and hence a downward adjustment is applied. However, no explicit allowance seems to have been made for asset risk ie the fact that risky assets are held by the insurer (which are more correlated to the rest of the market).</p>	

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	<p>Moreover, the analysis uses as a starting point the level of the equity risk premium derived from equity price models without the use of an unlevered beta. This is flawed because, as discussed above, this does not take into account the financing structure of insurance firms, which includes cheaper forms of funding in the form of debt. Should EIOPA persist with this particular methodology, it is essential that an unlevered beta is used. Furthermore, the use of a backward-looking equity risk premium is biased upwards due to survivorship bias (ie excludes returns from weaker firms which do not survive).</p> <p>Both these points indicate that previous CEIOPS analysis was flawed and hence resulted in a CoC rate which was overly excessive. Because of this, the RAB believes that after making appropriate yet prudent adjustments for franchise and asset risk (ie the risk inherent in an insurance firm’s business model and the risk from assets held in the balance sheet), a more appropriate range for the CoC rate would be 2%-3%, and so a value of 3% would represent an appropriate yet prudent CoC rate. This is also consistent with previous CRO Forum work on this in 2008 which argued, in response to the original CEIOPS advice, that a range of 2.5%-4.5% would be more appropriate than the CoC rate of 6% recommended by CEIOPS. (see <a href="https://www.thecroforum.org/wp-content/uploads/2012/10/croforummvlpaperjuly2008-2.pdf">https://www.thecroforum.org/wp-content/uploads/2012/10/croforummvlpaperjuly2008-2.pdf</a>)</p>	
18.4.2	<p><b>1. <u>Size of the risk margin (RM)</u></b>  <b>Diverging figures create some uncertainty on the actual total amount of RM in the EEA.</b>            According to EIOPA solo balance sheet statistics, the RM amounted to €179 bn Q3 2016 and to 161 EUR bn at the end of 2016. However, EIOPA’s background note for the 23 of May 2017 roundtable on</p>	

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	<p>SCR review discloses a total of RM of €210bn Q3 2010, which to the RAB's understanding includes groups<sup>1</sup>, and out of which €150bn stems from life and composite insurance undertakings.</p> <ul style="list-style-type: none"> <li>■ <b>The current level of the CoC rate (6%) leads to the unnecessary immobilisation of capital by the industry.</b> This capital could be invested elsewhere to finance the European economy. Besides, the Capital Market Union initiative is intended to make financing cheaper in the European Union (which should reduce the cost of capital in general). The EC 2016 call for evidence on the EU regulatory framework for financial services aimed at ensuring <i>"that the balance is right and that rules do not unduly discourage long-term investment and sustainable economic growth"</i>, focusing in particular on rules <i>"giving rise to unintended consequences such as regulatory arbitrage"</i> and on objectives like maximising the benefits of the financial system to the economy and promoting the competitiveness of the EU economy. <b>Most of the jurisdictions outside the European Union do not require a RM (eg the US), whereas EU groups have to hold a RM even for the business written outside the EU.</b></li> <li>■ <b>The progressive end of the transitional measures will also exacerbate the concerns with the current design of the RM.</b></li> </ul> <p><b>The implementation of Solvency II provides insight in the concrete negative effects of the current calibration of the RM, in a context of a prolonged period of low interest rates. The 2018 review of Solvency II is an opportunity to amend the RM without waiting further.</b></p> <p><b>2. <u>General approach to the review of the CoC rate</u></b></p> <p>The RAB acknowledges the efforts of EIOPA in reviewing the calibration of the CoC rate. However, the information and sources which are presented in the report tend to include an upward bias. The CoC rate is derived from a range based on a conservative choice of parameters and estimates for the</p>	

<sup>1</sup> Part of difference in both figures seems to stem from the difference in UK RM, which equals €28,6bn based on EEA balance sheet figures from Q3 2016 equals whereas EIOPA mentions a total UK RM of EUR 58,9 bn. EIOPA has not yet published group statistics.

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	<p>equity risk premium (ERP). From a methodological perspective, the calibration of the CoC rate should consist in identifying realistic ranges for the different parameters and deriving a central value for these parameters and the resulting CoC rate. The CoC rate has a direct on the RM - considering the amounts at stake, the calibration cannot be based on maximising all inputs instead of determining realistic values for these inputs. The CoC rate is a financial parameter and not a prudence margin in itself.</p> <p><b>a. <u>Cost of debt</u> (paragraphs 1409 to 1412)</b></p> <p>EIOPA refers to CEIOPS’ approach which “assigned 0% to the weight of debt by way of simplification” because “based on QIS 4 results ...debt funding cannot constitute more than 6 – 8% of the capital base”. <i>EIOPA considers that “the situation has not significantly changed since QIS4” and “the weight of debt is ... still assumed to be null”<sup>2</sup>.</i></p> <ul style="list-style-type: none"> <li>■ <b>This approach is flawed as it pretends to use a classic model but truncates this model with regard to the debt financing part, thus ignoring its impact on the CoC rate.</b></li> <li>■ The average share of eligible debt instruments in eligible own funds (EOF) in the EEA is not a relevant indicator for estimating the share of debt financing for deriving the CoC rate with a WACC approach. Indeed, the EEA average reflects a situation which is biased by including all entities, such as insurance mutual companies, which do not really rely on external financing. In addition, important disparities exist between member states in terms of the use of subordinated companies by insurance companies.</li> <li>■ <b>Debt instruments represent a significant share of the eligible own funds of large insurance and reinsurance groups which hold very material amounts of RM.</b> As the WACC derivation of the CoC rate refers to the Cost of equity derived from the CAPM and an average</li> </ul>	

<sup>2</sup> In the feedback statement (18.3), EIOPA considers also that “the universe of investment grade instruments will contain senior debt which does not count as regulatory capital under SII. It therefore may not be appropriate to reflect yields on senior debt when deriving the CoC”.

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	<p>beta of listed insurance companies, the share of debt should be assessed on a sample of listed companies. Otherwise, this would lead to overestimate the CoC rate.</p> <ul style="list-style-type: none"> <li>■ The share of eligible debt instruments in the EOFs of larger listed European insurance groups is clearly significant and cannot be considered at all to be null. A quick review of the SFCRs of significant EEA groups shows that the share of debt instruments in EOFs is c. 25%.</li> <li>■ <b>Using the share of debt instruments in total EOFs (and not in the SCR) is conservative when estimating the potential impact of debt financing on the CoC rate for the RM.</b> The RM is indeed the cost of providing capital for covering the SCR and the share of debt financing is a lot higher if expressed as a percentage of the SCR. As far as compliance with the SCR is concerned, insurers are authorised to use subordinated liabilities up to 60% of their SCR, depending on the structure by tiers of their capital.</li> <li>■ <b>The impact of the use of debt financing on reducing the CoC rate depends on the relative cost of debt to the cost of equity and on the benefit of the tax deductibility of interest payments which depends on the tax rate.</b> Significant cost-differences exist between equity and debt funding and tax relief on debt payments contributes to further reducing the effective cost of debt financing compared to equity financing. The average corporate tax rate tended to decrease in the European Union between 2010 and 2017 but continues to be relatively high (around 22%). The cost of debt financing is currently very low (c. 250 bps over the risk free rate) and it is usually materially lower than the cost of equity (for instance, around 200 bps lower or more since 2012).</li> <li>■ <b>No company will leverage its balance sheet when debt financing cost is higher than cost of equity.</b> According to financial theory, the main reason to raise hybrid capital is for insurers to leverage financial resources / capital at a cheaper cost to improve ROE.</li> <li>■ <b>Assuming a 25% weight of debt and an average corporate tax rate of 22%, the WACC cost of capital is materially lower than the CAPM Cost of equity if the Cost of equity is high (eg c. 5% for a CAPM Cost of equity of 6% assuming that the Cost of debt is in this case 200 bps below the Cost of equity).</b></li> </ul> <p><b>b. <u>Equity risk premium (paragraphs 1415 to 1435) – historical return model</u></b></p>	

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	<p>Concerning the equity risk premium (ERP), EIOPA focuses on the historical return model<sup>3</sup> and the dividend discount model, describes the pros and cons of both methods and suggests to use only historic return models to ensure methodological consistency, stronger stability and lower dependence on assumptions.</p> <p><b>In the consultation paper, the table comparing the pros and cons of dividend discount models and the historical return model (backward-looking ERP) is one-sided.</b> The paper “The Cost of Capital: the Swiss Army Knife of Finance” by Damodaran which EIOPA references in paragraph 1422 of the consultation paper articulates the limitations of the historical return approach. This paper states regarding backward looking ERPs: <i>“Not only are they backward looking, by construct, and subject to manipulation, with very different values for the premium based upon what period of history you look at, whether you use T.Bills or T.Bonds as your risk free rate and how you compute averages. Not surprisingly, analysts use this to advantage and pick equity risk premiums that reflect their valuation biases, pushing towards the higher numbers [...], if their bias is towards lower values, and the lower numbers to justify higher values”.</i></p> <ul style="list-style-type: none"> <li>● <b>Historical return models can introduce a strong bias as they are backward-looking and depend strongly on the time period chosen.</b></li> </ul> <p><b>EIOPA considers that the backward-looking ERP is less volatile than the forward-looking one. However, the backward-looking ERP is extremely volatile.</b></p> <p>Even when calculated over very long time horizons, it displays a significant standard deviation: approximately 20%, which is more than double the average value of the backward-looking ERP. (See: Norges Bank (2016) “The Equity Risk Premium”). The Shiller dataset covering 1871-2012 produces a 17.7% standard deviation, while Damodoran’s dataset covering 1928-2015 yields a 20.1% standard</p>	

<sup>3</sup> The historical return model was used in the initial calibration, leading to an ERP estimate of 7.81% derived from the return of US stocks from 1926 to 2006.

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	<p>deviation. There is no evidence that dividend models are more volatile.</p> <p><b>There is considerable scientific evidence that the backward-looking ERP is an upward biased estimate of the true theoretical ERP, which is forward-looking by virtue of the CAPM definition<sup>4</sup>.</b> Ibbotson and Chen (2003) show that after accounting for unexpected capital gains, the ERP for the USA is slashed by 2%. In a similar vein Fama and French (2002) show that the backward-looking ERP over 1951 and 2002 was 2% higher than the forward-looking one.</p> <ul style="list-style-type: none"> <li>● <b>The ERP based on historical return models certainly requires fewer assumptions to be calculated. However, when using a historical return ERP, it is essential to address its upward bias, by making a -2% correction.</b></li> <li>● <b>EIOPA’s backward looking range [7,02% - 8,09%] is too narrow, and based on specific data sets and periods to support it, in particular the Eurostoxx 600 gathering the largest, most successful European listed companies. The RAB considers that an ERP of 7 - 8% is clearly not a central value. Going too far back to calibrate the market risk premium (as when EIOPA used data starting in 1926 for the US case) tends to increase it artificially.</b> EIOPA reasonably underlines in the consultation paper that <i>“the inclusion of the World War II period and the following economic recovery in the US time series may be considered questionable, because that economic situation is not comparable with today”</i>.</li> <li>● Similarly, for the European case, a data set starting more than 40 years ago in 1975 when the economic environment and growth perspective was different from today might also lead to an upward bias (and the forward looking approach, in any case, introduces an upward bias).</li> <li>● <b>The approach of calculating the country risk premiums by adding an adjusted sovereign spread is the most conservative of the options listed in the Damodaran</b></li> </ul>	

<sup>4</sup> The consultation paper further claims that the backward-looking ERP is consistent with beta calculations because the latter are backward-looking too. But the RFR interest rate subtracted from the ERP is also a forward looking variable, describing how much one will get in the future by investing one unit of an asset today.

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	<p><b>paper.</b> The first option in the Damodaran paper is simply to assume that country risk is diversifiable and therefore not deserving of additional risk premia. EIOPA has not considered this further which lends to a one sided presentation of the Damodaran analysis. The result stems from a weighted average of European country ERPs with GDP weights for these 26 countries, which seems overly complex and not reliable as a method of validation. Besides, this validation starts with an excessively high ERP (6%), which introduces a bias in the results.</p> <ul style="list-style-type: none"> <li> <span style="color: yellow;">■</span> <b>A more appropriate validation would be to consider other independent academic views on the equity risk premium.</b> <ul style="list-style-type: none"> <li> <input type="checkbox"/> Dimson, Marsh and Staunton conducted a benchmark study of ERPs in their 2003 paper<sup>5</sup> which analyses historical equity risk premia and concluded that<sup>6</sup> <i>"when developing forecasts for the future, investors and managers should adjust historical risk premiums downward for the impact of these factors. This suggests that a plausible, forward-looking risk premium for the world’s major markets would be in the order of 3% on a geometric mean basis, while the corresponding arithmetic mean risk premium would be around 5%. These estimates are lower than the historical premiums quoted in most textbooks or cited in surveys of finance academics."</i> In a 2011 update<sup>7</sup> the authors <i>"infer that investors expect a long-run equity premium (relative to bills) of around 3%–3½% on a geometric mean basis and, by implication, an arithmetic mean premium for the world index of approximately 4½%–5%. From a long-term historical and global perspective, the equity premium is smaller than was once thought."</i> </li> <li> <input type="checkbox"/> Damodaran shows a range of historic ERPs from 2.3% to 7.96% depending on the choices           </li> </ul> </li> </ul>	

<sup>5</sup> Dimson, Elroy and Marsh, Paul and Staunton, Mike, Global Evidence on the Equity Risk Premium (August 1, 2003). Journal of Applied Corporate Finance, Vol 15, No 4, pages 27–34; <https://ssrn.com/abstract=431901>.

<sup>6</sup> "More fundamentally, however, we have argued that **past returns have been advantaged** by a re-rating due to a general decline in the risk faced by investors as the scope for diversification has increased. We have illustrated one approach that can be used to obtain an estimate of the amount by which the required rate of return has fallen. In addition, we have argued that **past returns have also been inflated by the impact of good luck**. Since the middle of the last century, equity cash flows have almost certainly exceeded expectations. Stock markets have therefore risen for reasons that are unlikely to be repeated."

<sup>7</sup> Dimson, Elroy and Marsh, Paul and Staunton, Mike, Equity Premia Around the World (October 7, 2011). <https://ssrn.com/abstract=1940165>.



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	<p>made (table 4) and a range for Europe of 3.1% to 5.1% and 3.2% to 5.6% for the world (table 6)<sup>8</sup>. The consultation is therefore very selective when retaining a figure of 6.05% based on table 1 on page 11. The Norges bank notes <i>"The equity risk premium" (2016) concludes that "The average World ERP based on data from 1970 to 2015 is 6.4 percent. Adjusting the average for repricing over the period lowers the average to 3.9 percent"</i>.</p> <ul style="list-style-type: none"> <li> <span style="color: yellow;">●</span> <b>A realistic range for the backward looking ERP is rather [5%-7%], which translates into a [4%-6%] range when adjusting the bias of a backward looking measure. The RAB considers 5% as a central value for the ERP.</b> </li> </ul> <p><b>c. <u>Equity risk premium (paragraphs 1415 to 1435) – dividend discount model (DDM)</u></b></p> <p>Although EIOPA does not deny that DDMs tend to a lower ERP in general, correcting the bias linked to historic models, it does not retain any adjustment when using the historical return model. EIOPA obtains an ERP smoothed estimate of 6% derived using the Damodaran method<sup>9</sup> over a ten-year period, based on the Eurostoxx 600 index (share price) with a dividend growth of 5.5% for the first five years of the projection and at the risk free rate after the first 5 years; share buy-backs are included with an uplift factor of 143% to dividends<sup>10</sup>.</p> <p><b>EIOPA indicates that the retained ten years includes a period where the ERP increases abnormally because of the latest financial crisis</b> (The drop in share prices will tend to mechanically inflate the ERP if expected cash flows do not decrease similarly). The period is not well chosen and the impact of the crisis should be accounted for, resulting the ERP to be lower.</p> <p><b>The 5,5% dividend growth assumption is not appropriate when calculating a rolling ERP</b></p>	

<sup>8</sup> Damodaran, Aswath, "Equity Risk Premiums (ERP): Determinants, Estimation and Implication"s – The 2017 Edition (March 27, 2017). <https://ssrn.com/abstract=2947861>.

<sup>9</sup> The Damodaran method projects future compensation, and derives the ERP from the discount rate that gives these future cash flows a present value equal to the current share price (Damodaran, The Cost of Capital: The Swiss Army Knife of Finance, 2016).

<sup>10</sup> The % corresponds to 1/(1-0.3) as share buy backs represented c30% of shareholders’ total remuneration over the last ten years.

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	<p>(the average dividend growth rate of the Eurostoxx 600 over the last five years was c5% but was c0% over the last 10 years). The ERP for a given year should be based on analyst estimates of earnings growth, rather than historic figures. This assumption has a strong impact on the result. It is likely too optimistic if including also a significant uplift factor applied to dividends.</p> <p>In its report (pages 83 onwards), Damodaran derives the forward looking equity risk premia based on the S&amp;P 500 from 2008 to 2017, including the contribution of share buy-backs (S&amp;P figures are used by EIOPA for deriving the historical return ERP so that it is consistent to use it also to derive the forward looking ERP). The average of the ERPs calculated for this 10 year period is c 5%.</p> <ul style="list-style-type: none"> <li> <span style="color: yellow;">■</span> The Norges bank notes <i>"The equity risk premium" (2016) indicates that "The average World ERP estimate from various dividend discount models is 5.9 percent. These estimates may be affected by recent data bias. Cash flow growth has been exceptionally large since the end of the Global Financial Crisis in 2009, which in turn may bias upward expectations of future cash flow growth when extrapolated from historical data. In a below-average cash flow growth scenario, the estimated World ERP is 3.7 percent. Estimates of the expected ERP are also affected by the choice of proxy for the future risk-free rate. The current near-zero short-term interest rates may be a poor proxy for future short-term rates if the market expects rate increases in the future. <u>The expected World ERP from the discount models may be closer to 4 percent if expectations of interest rate normalisation are taken into account. Estimates from cross-sectional and time-series models also suggest an expected World ERP of 3 to 4 percent.</u>"</i> </li> <li> <span style="color: yellow;">■</span> <b>The RAB considers that the realistic range for the forward looking World ERP is between 4 and 6%. The expected ERP, which is theoretically the most appropriate for the CAPM, is lower than the historical ERP. It is necessary to correct the upward bias of backward looking ERPs if using the latter to derive the Cost of capital rate.</b> </li> </ul> <p><b>d. Beta factor (paragraphs 1436 to 1440)</b>            EIOPA indicates that <i>"it is not useful to derive separate beta factors for life and non-life undertakings because the Solvency II Directive stipulates that the same CoC rate is applied for all undertakings. It</i></p>	

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	<p><i>is therefore more appropriate to directly derive a beta for an average undertaking</i><sup>11</sup>. <b>This significant change of approach shows that the initial range derived by CEIOPS for the CoC, which was corresponding to different beta values for Life and Non Life business, was artificial. The beta used to derive the upper bound of the CoC rate was too high, as not reflecting a beta for an average undertaking.</b></p> <p><b>EIOPA uses a “levered beta”, ie “the capital structure of insurance companies, reflecting equity and debt, was taken into account” but using a levered beta is not at all consistent with an approach where “the weight of debt is [...] still assumed to be null”.</b> If a company is considered as holding no debt, it is unclear how its beta factor can be considered to be levered. The use of a levered beta necessarily implies to account for the impact of debt financing in the WACC approach (in particular if the derived Cost of equity is high). Otherwise, the unlevered beta should be used, which is generally considered as more adequately reflecting the correlation of a company to the market. The unlevered beta is by nature materially lower than the levered beta<sup>12</sup>.</p> <p>EIOPA derives the beta factor on the basis of a weighted average of the betas for the 66 listed EEA insurance and reinsurance companies and groups, regressed against the Eurostoxx 600. This is not theoretically correct: the beta should be calculated with respect to the global market, simply because the marginal investor can diversify away European-specific risks by investing outside of the EU market. This is especially true today with globalised portfolios and capital flows.</p> <p>Besides, the insurance beta as calculated by Damodaran is significantly higher in Europe (1,12)</p>	

<sup>11</sup> CEIOPS’ advice was based on a derivation of the beta factor that compared the performance of US stocks with European insurance stocks over a period of nine years. The calculation provided separate beta factors of 1.28 for life insurance and 0.94 for non-life insurance. For the revision of the beta factor the returns of European insurance undertakings are compared with the returns of the European stock market “because the beta factors will be applied to an ERP for the European stock market”.

<sup>12</sup> Levered beta = Unlevered beta \* (1 + (1 - tax rate) \* (Debt/Equity)). EIOPA notes in a footnote that Damodaran derives an unlevered beta of 0.9. Actually, Damodaran derives an insurance unlevered beta of 0.79 for Europe (and 0.51 globally).

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	<p>compared to the global (0,71) and US-specific (0,9) insurance betas. This difference comes from higher life insurance betas in Europe than globally and in the US. But the life insurance betas in general are likely related to asset risks that are correlated to the market, which is not relevant when deriving the CoC rate for pure insurance risks (for instance, the standard formula assumes a correlation of only 25% of Non Life and Life insurance risks with pure market risks). Otherwise, a significant adjustment would be needed when using the CAPM to derive the RM (this adjustment should also reflect that the RM is not held in relation to new business).</p> <p>The global insurance beta is also more in line with the increasingly global insurance market and the specific margin of the RM. There is no reason why European insurance risks would have a higher correlation with the market than global insurance risks, and too much attention should not be placed on the European figures.</p> <p>On <b>paragraph 1438</b> in particular, it is not clear what EIOPA's estimation is based on ("<i>sufficient to transfer half of the insurance liabilities in the market</i>") and EIOPA has not shared its data and calculations, so that it is not possible to replicate its analysis. The weighted average approach based on market capitalisation is not justified: it creates a distortion insofar as big caps can have a larger correlation with the market and a larger financial component whereas the RM will finance the capital for the run off of pure insurance risks which are not correlated with the market.</p> <p>The CoC rate calibration is proportional to the beta factor so that the calibration will be highly sensitive to different assumptions on this factor. EIOPA provides a range of 0.9 to 1.25 for the beta, but selects 1.2 for its recommendation, which is clearly an upper bound - the 1,25 figure is derived based on a reference (Eurostoxx) which is biased towards the largest and most successful companies. A realistic range for the levered insurance beta of European companies is [0,9-1,2] which would lead to consider a levered beta of 1.05 as very prudent. This figure seems however to be biased by the contribution of asset risk exposures of Life insurers. In practice, the run-off situation reflected by the RM could attract international investors for which the levered beta is far below this figure.</p>	

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	<p><b>The RAB considers that a levered beta of 0,85 represents the central value of a [0,7%-1%] realistic range for the global beta.</b></p> <p><b>e. Further adjustments</b></p> <p>EIOPA derives a range of 6,7% - 7,8% after taking into account a 20% adjustment<sup>13</sup> which leads to "results of the CoC calculations in the range from 6% to 8%" and the recommendation to maintain the currently applicable CoC rate of 6%.</p> <p><b>CEIOPS’ and EIOPA’s recommendations are based on beta and ERPs parameters which are at the top of the ranges, coupled paradoxically with a limited adjustment and the absence of allowing for any impact of the cost of debt (despite retaining inconsistently a levered beta). The resulting CoC rate is materially too high and would already be materially reduced by considering the impact of the cost of debt according to the allegedly endorsed WACC approach.</b></p> <p>Although it is complex to quantify precisely the impact, retaining an adjustment of only 20% of the CAPM results is clearly marginal, which would put into question the legitimacy of using the CAPM framework for this purpose, whereas the specific nature of the RM which is related to pure insurance risks and excludes new business should lead to a material adjustment. This is confirmed by the fact that CEIOPS and EIOPA implicitly apply another adjustment to derive the 6% figure, but this second adjustment is not made explicit and it is just presented as taking the lower bound of the derived range. Presenting the 6% figure as the lower bound of the realistic range of the CoC rate is artificial. The suggested range presents an upward bias linked to the chosen ERP and Beta and the absence of a material adjustment.</p> <p><b>A 20% adjustment appears especially insufficient if the beta retained is too much</b></p>	

<sup>13</sup> This is based on an ERP of 8,09% based on the historical return model on European stocks and 7.02% on US stocks and country factors, with a beta factor of 1,2.

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	<p><b>dependent on the impact of asset risks linked to life insurance and is consequently very high</b>, whereas the RM is supposed to reflect only the run off of pure insurance risks. Vice versa, it is possible to consider a more limited adjustment (mostly limited to the impact of new business) if the retained beta is corrected to account for the bias linked to asset risk. <b>The RAB considers that for a central value of the beta, an adjustment of c 30% is reasonable.</b></p> <p><b>The derivation of the CoC rate should be rather based on consensus-based central values of the ERP and the beta and apply an adjustment which is material enough in relation to the beta estimate. This approach which leads to a WACC CoC rate of 3% max is the only way to ensure that the CAPM is legitimate for the purpose of deriving the CoC rate.</b></p> <p>Even with parameters which deviate from the central values of realistic ranges, the WACC CoC rate stays in a range which is far below 6%.</p>																													
	<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th></th> <th colspan="4" style="text-align: center;">Cost of equity calibration*</th> <th colspan="2" style="text-align: center;">WACC CoC rate**</th> </tr> <tr> <th></th> <th style="text-align: center;">Beta</th> <th style="text-align: center;">ERP</th> <th style="text-align: center;">Beta *ERP</th> <th style="text-align: center;">Adjustment</th> <th style="text-align: center;">Range post adjustment</th> <th style="text-align: center;">Cost of debt</th> <th style="text-align: center;">WACC CoC rate</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">Central values</td> <td style="text-align: center;">0,85</td> <td style="text-align: center;">5%</td> <td style="text-align: center;">4,3%</td> <td style="text-align: center;">30%</td> <td style="text-align: center;">3,0%</td> <td style="text-align: center;">2,5%</td> <td style="text-align: center;">2,7%</td> </tr> </tbody> </table>						Cost of equity calibration*				WACC CoC rate**			Beta	ERP	Beta *ERP	Adjustment	Range post adjustment	Cost of debt	WACC CoC rate	Central values	0,85	5%	4,3%	30%	3,0%	2,5%	2,7%		
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	<p>* <i>Cost of equity = beta*ERP *(1-Adjustement)</i></p> <p>** <i>WACC CoC rate = 75%*Cost of equity + 25%*(1-22%)*Cost of debt, assuming a 22% tax rate</i></p>																													
18.4.3	<p>The RAB does not agree with EIOPA’s conclusion that the CoC would be in the range from 6% to 8%. The RAB believes that, <b>under the current interest rate environment, a lower CoC rate</b>, based on the arguments and analysis set out above, <b>would be adequate</b>. The weighted average CoC rate cannot be calculated based on the assumption that “the cost of capital is equal to the cost of equity”.</p>																													

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	<p>In summary, the current 6% level of the Solvency II cost of capital rate is excessive because:</p> <ul style="list-style-type: none"> <li>● It was calibrated based on backward-looking equity risk premiums, rather than forward looking market risk premium, which introduces a strong upward bias;</li> <li>● It was calibrated based on a 100% equity funding assumption but with the use of a levered beta (which is completely inconsistent), and without adjusting the beta for the run off of pure insurance risks.</li> <li>● It does not consider the sensitivity to interest rates.</li> </ul> <p>This leads to a level of the Risk Margin which is too volatile and does not seem reasonable within the Solvency II framework.</p>	
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