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:	CFO Forum and CRO Forum	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
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Reference	**Comment**	
General Comment	**Introductory comments** Thank you for the opportunity to work with you as you develop the methodology for calculating the Ultimate Forward Rate (UFR), which is an important element of the Risk Free Interest Rate (RFR) framework. We fully support the development of a transparent methodology for the calculation of the UFR, and feel that overall the methodology to determine the UFR should be kept straightforward, as the simple sum of long term expectations in real rates and inflation. We also welcome EIOPA's recent workshops with journalists/analysts, and we encourage EIOPA to continue to organise such educational sessions to build understanding of the UFR mechanism, which we	

	consider is often misunderstood. This document reiterates our key concerns on the proposals, as previously shared with you, including at the workshop organized by EIOPA on 14 June. In addition, we have responded to the specific questions posed by EIOPA in the consultation document. **It is premature to change the UFR and methodology** The current UFR rate is an integral part of the Long-Term Guarantee calibration agreed for Omnibus II. We believe that an immediate change to the UFR will undermine the market's perception of the Solvency II basis, raise doubts about its stability, and will lead to market volatility and unintended consequences. Furthermore, Solvency II was developed as a package, and it is inappropriate to single out particular issues. For example, the same conditions of current low interest rates that have given rise to the focus on the UFRs, also have impacts on risk-free rates (RFR) and other elements of Solvency II, such as the risk margin. EIOPA is required to submit to the Commission an opinion on the assessment of the application of the Long-Term Guarantees measures in relation to the availability of long-term guarantees in insurance products, the behaviour of insurance and reinsurance undertakings as long-term investors and, more generally, financial stability. Based on the opinion submitted by EIOPA, the Commission will submit a report to the European Parliament and to the Council by 1 January 2021, or earlier if deemed appropriate. It would be premature to change the UFR before that assessment takes place, and any changes in the methodology should be implemented at the same point in time and in conjunction with the possible changes that might result from the review of Solvency II in 2018 (at the earliest), providing an opportunity for the industry and regulators to gather data and experience during 2016 and 2017. **Unintended consequences of the UFR proposals, including long term investments**	

We believe that lowering the UFR rate would also have unintended consequences for long-term investment. A lower UFR would accentuate pressure on long-term obligations, which insurers would therefore be dis-incentivised to underwrite. However, those features are the main driver of long-term investment needs for insurers, and such a decision would therefore appear to be at odds at a time when the European Union is promoting long-term investment in the real economy, such as in equities or infrastructure.

Inconsistency with the objectives of the UFR in relation to stability

While EIOPA's proposed UFR methodology and the expert judgements may seem reasonable when taken individually, when taken as a whole we believe the methodology is inconsistent with Article 47 of the Delegated Acts, which requires the UFR to be stable and only vary with changes in long-term expectations.

In particular, EIOPA's proposed methodology based on averaging 3 to 6 month term financial instruments, with annual changes to the UFR rate, would not meet this objective. Indeed, as discussed further in our response to question 7 below, the methodology proposed by EIOPA would have led to an unstable UFR in 30 out of the last 36 years, and, should the current market situation last for the coming years, yearly changes would continue. We believe this methodology would therefore fail any stability test.

Supervisory and expert judgement is also important to guarantee that the outcome is consistent with the Regulation's intentions, and provides for good risk management incentives and sufficient financial stability of the sector.

Conclusion

In conclusion, we have strong concerns on the timing, overall impact and implementation of the current proposals, which we believe do not meet the objectives of the UFR, and risk significant unintended consequences. We would encourage EIOPA to continue to engage with the industry on this important issue, and stand ready to participate in further discussions with EIOPA.

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Q1. (pg. 56)	Overall, we believe the methodology to determine the UFR should be kept simple and should be the simple sum of long term expectations in real rates and inflation. Adding an adjustment for convexity would make the methodology and assessment more complex, in particular as expert judgment is needed in this area and the term premium is disregarded in accordance with the Regulation. The methodology for real rates relies on short term instruments whose duration is significantly shorter than 1 year. While we acknowledge that using long term average rates would help ride over the cycle, using short term rates to infer long term expected rates is unlikely to provide for stability of the results.	
Q2. (pg. 56)	Having in mind the overall objective of deriving UFR levels, which is to provide a long-term, stable over time and counter-cyclical convergence point, we believe that the whole sample of historical data should be considered, and expert judgment should be used to remove outliers. Given the long term nature of the UFR, we believe it makes more sense to use historical data instead of current implied market expectations to derive the long term real interest rate. Using market implied long term expected real rates would introduce volatility in the UFR, contrary to the fundamental principles of the UFR. In contrast, the use of historical data acts as a counter-cyclical measure and thus provides an outcome that is better aligned with the purpose of the extrapolation towards a stable UFR.	
Q3. (pg. 56)	Instead of using the geometric weighted average, we believe a simple arithmetic average would serve the goal of stability better and would prevent significant levels of judgement and subjectivity.	
Q4. (pg. 56)	The current methodology derives the long-term expectation on inflation rates based on inflation targets, and on this basis introduces four different buckets. We agree with the current approach as we anticipate the expected inflation rate will remain stable, given central banks target inflation rates tend to move very little. We believe the current approach of differentiating currencies according to the relevant target inflation seems reasonable overall, and has the merit of having been tested and	

	known by firms for some years now. In contrast, a methodology whereby as many UFR levels as currencies would be determined seems unrealistic, and would imply a capacity to assess a significant number of parameters, leading to low stability and potential inconsistencies in outcome over time. Since the introduction of target inflation is quite recent, we believe that historical inflation rates, provided a sufficiently long track record is available, could be used as an additional benchmark to provide comfort on the outcome using inflation targets. While keeping in mind the overall objectives of the UFR in terms of stability and counter-cyclicality, we believe expert judgment is particularly relevant in this area.	
Q5. (pg. 56)	There is a general consensus of support across our membership for the proposed limit, although some have suggested that a reduced limit of 10bps would be more appropriate. However, we would like to stress the importance of the fact that the limit cannot be a substitute for a genuinely stable UFR.	
Q6. (pg. 56)	We do not disagree with the suggestion to round the expected real rate component to 5bps.	
Q7. (pg. 56)	Please see the discussion of our key concerns on the implementation of the methodology in the 'General Comment' section above. We have also provided further supporting comments in this section. The Long Term Guarantee measures were adopted to address excessive volatility, arising from the current measurement of assets and liabilities, that would not reflect the insurance business model, i.e. the package of measures was aimed at avoiding pro-cyclicality and its unintended consequences. Beyond investable asset maturity terms, the UFR aims at providing stability for long tail obligations. The Regulation states that the UFR is stable over time, and only changes as a result of changes in long-term expectations. Setting the level of the UFR should hence ride over the economic cycle for the very long run, and changing the 4.2% because of current low environment would contradict the mechanism itself.	

	As mentioned above, the rationale for justifying the 4.2% has been set based on inflation targets from central banks and long term expectations for real rates. The current low interest rate environment for the Euro reflects the monetary policy of the ECB, whose objective is to sustain growth in Europe. The Governing Council of the ECB communicated that it expects the key ECB interest rates to remain at present or lower levels for an extended period of time. ECB medium-term orientation reflects the fact that monetary policy cannot, and should not, attempt to fine-tune developments in prices or inflation over a few weeks or months, but subscribes to a much longer term perspective. The UFR adjusts the interest rates for the very long term, hence referring to the target inflation and looking at long term real rates based on long historical time series is sensible. EIOPA has been charged with providing co-legislators with an annual report on the effectiveness of the Long Term Package until 1 January 2021. EIOPA did carry out some sensitivities testing to the level of UFR in the LTGA report, and co-legislators adopted the Omnibus II agreement based on the 4.2%. The revised methodology as proposed by EIOPA would lead to a decrease in the UFR level of the extant 4.2% to 3.7% over a three year period of time. Should the current market situation last for the coming years, the UFR level would keep decreasing over this period, reaching 3.2% or 3.1% by 2030. The methodology would have led to changes to the UFR in the 3.7% bucket in 30 out of the last 36 years (from the real rates component only), which is not seen as a stable methodology from year to year, and yearly change is likely to continue in the future. EIOPA has estimated that a decrease of the UFR level by 50 bps and 100 bps respectively would decrease capital resources by 5% (€-11 bn) and 10% (€-22 bn). We feel this impact estimate underestimates the likely impact, by not considering the effect on the SCR and the risk margin (the lower the rates, the more in the money the guarantees, increasing the combined effect of low rates and longevity risks), partly offset by deferred taxes absorption.	
Paragraph 1.		

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Paragraph 2.		
Paragraph 3.		
Paragraph 4.		
Paragraph 5.		
Paragraph 6.		
Paragraph 7.		
Paragraph 8.	As noted in our general comments above, we welcome EIOPA's ongoing work to build understanding of the UFR mechanism.	
Paragraph 9.		
Paragraph 10.		
Paragraph 11.		
Paragraph 12.		
Paragraph 13.		
Paragraph 14.		
Paragraph 15.		
Paragraph 16.		
Paragraph 17.		
Paragraph 18.	Please see our general comments above and our response to Question 7, with regards to the implementation and timing of changes to the UFR.	
Paragraph 19.		
Paragraph 20.	Please see our response to Question 5, above.	
Paragraph 21.	We note that inflation will likely be the main trigger for significant changes in the UFR and in the current economic environment, there is the possibility of large inflation changes for several currencies, which may lead to the destabilisation of the UFR.	
Paragraph 22.	Please see our response to Question 3, above, which suggests that a simple arithmetic average would serve the goal of stability better, and would prevent significant levels of judgement and subjectivity. Should a slight geometric weighting to more recent data	

	be applied, no objections were raised by our members to a factor of 0.99.	
Paragraph 23.	Measuring real rates using a basket of developed nations is consistent with the objective of the UFR as a long-term steady-state scenario. However, whilst the economies chosen represent a high proportion of the insurance exposure in the EU, this choice may not be appropriate for exposures in developing economies (we would not consider the inflation buckets as an offset for this discrepancy).	
Paragraph 24.	Please see our response above to Question 2.	
Paragraph 25.	Please see our response above to Question 2.	
Paragraph 26.	Please see our response above to Question 6.	
Paragraph 27.	Please see our response above to Question 4. We welcome the additional buckets to better match long-term nominal rates in some emerging markets.	
Paragraph 28.		
Paragraph 29.		
Paragraph 30.	Please see our general comments above and our response to Question 7, with regards to the implementation and timing of changes to the UFR.	
Paragraph 31.		
Paragraph 32.		
Paragraph 33.		
Paragraph 34.		
Paragraph 35.		
Paragraph 36.		
Paragraph 37.		
Paragraph 38.	Please see our response above to Question 1.	
Paragraph 39.		
Paragraph 40.		
Paragraph 41.		
Paragraph 42.	Please see our response above to Question 1.	

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Paragraph 43.		
Paragraph 44.		
Paragraph 45.		
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Paragraph 49.		
Paragraph 50.		
Paragraph 51.		
Paragraph 52.		
Paragraph 53.		
Paragraph 54.		
Paragraph 55.		
Paragraph 56.	Please see our response to Question 3, above, which suggests that a simple arithmetic average would serve the goal of stability better, and would prevent significant levels of judgement and subjectivity. Should a slight geometric weighting to more recent data be applied, no objections were raised by our members to a factor of 0.99.	
Paragraph 57.		
Paragraph 58.		
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Paragraph 64.		
Paragraph 65.		

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Paragraph 66.		
Paragraph 67.	Please see our response above to Question 4.	
Paragraph 68.		
Paragraph 69.		
Paragraph 70.		
Paragraph 71.		
Paragraph 72.		
Paragraph 73.		
Paragraph 74.		
Paragraph 75.		
Paragraph 76.		
Paragraph 77.	Please see our comments above on Paragraph 23.	
Paragraph 78.		
Paragraph 79.		
Paragraph 80.		
Paragraph 81.		
Paragraph 82.		
Paragraph 83.		
Paragraph 84.	Please see our response above to Question 2.	
Paragraph 85.	We would suggest that the meaning of ‘short’ and ‘ long’ with respect to the AMECO database be specified.	
Paragraph 86.		
Paragraph 87.		
Paragraph 88.		
Paragraph 89.		
Paragraph 90.	Please see our comments above in response to Question 2.	

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Paragraph 91.		
Paragraph 92.		
Paragraph 93.		
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Paragraph 96.		
Paragraph 97.		
Paragraph 98.		
Paragraph 99.	Please see our comments above in response to Paragraph 49.	
Paragraph 100.	Where EIOPA refers to the 'inflation target' we suggest the text is made more explicit to reference which forecasts/quotes have been used.	
Paragraph 101.		
Paragraph 102.	We would suggest that the inflating target to be applied is clearly specified (e.g. the term of the forecast).	
Paragraph 103.		
Paragraph 104.		
Paragraph 105.		
Paragraph 106.		
Paragraph 107.		
Paragraph 108.	Please see our comments above in response to Question 4.	
Paragraph 109.		
Paragraph 110.		
Paragraph 111.		
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Paragraph 114.		

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Paragraph 115.		
Paragraph 116.	Please see our response above to Question 4, on our comments on Paragraph 23.	
Paragraph 117.		
Paragraph 118.		
Paragraph 119.	Please see our comments above in the General Comments, with regards to the timing and frequency of changes to the UFR rate. We consider an annual change/revision to the UFR to contradict the requirement as stated in Article 47 of the Regulation.	
Paragraph 120.		
Paragraph 121.	Please see our comments above on Paragraph 21.	
Paragraph 122.	Please see our response to Question 5, above.	
Paragraph 123.		
Paragraph 124.		
Paragraph 125.		
Paragraph 126.		
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Paragraph 134.		
Paragraph 135.		
Paragraph 136.	Please see our response to Question 5, above.	
Paragraph 137.		
Paragraph 138.		

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Paragraph 139.		
Paragraph 140.	Please see our general comments above and our response to Question 7, with regards to the implementation and timing of changes to the UFR.	
Paragraph 141.		
Paragraph 142.		
Paragraph 143.		
Paragraph 144.	Please see our general comments above and our response to Question 7, with regards to the implementation and timing of changes to the UFR.	
Paragraph 145.	As noted in our general comments above, we welcome EIOPA's ongoing work to build understanding of the UFR mechanism.	
Paragraph 146.		
Paragraph 147.		
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