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:	Gesamtverband der Deutschen Versicherungswirtschaft (GDV)	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
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Reference	**Comment**	
General Comment	GDV appreciates the opportunity to comment on the consultation paper on the methodology to derive the UFR and its implementation. We understand that this methodology has to be clearly specified in order to allow for scenario calculations by insurance and reinsurance undertakings (cf. Article 47 of the Delegated Regulation). **However, even in the given low interest rate environment introducing a new methodology to calculate the UFR right now is neither required nor**	

reasonable. The UFR should **remain at its original level of 4.2%, at least until the upcoming review of the Solvency II standard formula and all LTG measures**:

- Before any changes to the UFR are considered, the relevant stakeholders should gain **sufficient experience with the new supervisory system**.

- The UFR is a crucial component of the quantitative requirements under Solvency II – thus, it **may not be changed in an isolated manner**, but taking this wider context into account.

- A precipitant and isolated change would be in direct contradiction with the **intentions of the European legislators which came to the Omnibus II compromise on basis of an UFR of 4.2%**. With a different UFR level, the long-term guarantee measures would have been designed differently, too.

Although the derivation of the UFR could be more transparent and formalised in the future, for the time being a fixed level of the UFR would clearly enable insurance and reinsurance undertakings to do scenario calculations as required by the Delegated Regulation. Thus, in the short run, there is **no pressure to act**.

In this context, it should also be noted that the UFR is an interest rate which is expected to be effective only far in the future. The UFR is used as a **parameter** for the extrapolation of the risk free interest rate term structure – but it is not used for discounting. The **discount rates** used by the insurance and reinsurance undertakings are **lower by far**. For instance, as of 30 June 2016 the extrapolated interest rate for an obligation due in 60 years amounts to only 2.76 %.

If a new methodology to derive the UFR is introduced at some point in time, **it is of utmost importance that the stability of the UFR is ensured.**

It is inevitable to restrict the maximum changes of the UFR in order to ensure

	stability of the UFR over time and to avoid overly volatile results. The stability of the UFR is prescribed by law. Any methodology to derive the UFR must observe this legal setting. Moreover, a fast changing UFR would lead to severe short term movements in the overall results of the calculations. This would inevitably cast doubt on the validity of the entire quantitative requirements. It is necessary, as proposed in the consultation paper, to restrict the annual changes in both cases when either a new methodology to derive the UFR is introduced or when the inflation target of a central bank changes. **Nevertheless, the proposal of the consultation paper allows for an annual change of the UFR of up to 20 basis points. As a result, the UFR would decline substantially within the next few years.** **This is not in line with the legal requirement of the UFR being stable over time.** Thus, the proposal must be amended. **Any change of the UFR must be phased-in at a slow pace.** To this end, **the UFR level must not be changed by more than 10 basis points within one year.** Besides the phasing-in, the **general approach** to calculate the target value of the UFR as the sum of expected long-term real real interest rate and expected inflation is sensible and in line with the Delegated Regulation. **Expectations of the long-term real real interest rate** should be based on average real interest rates in the past. To this end, it is appropriate to use data since 1960 in a widening window approach as proposed in the consultation paper. **However, data from all points in time should be given equal weight.** Data from different decades have all the same value for the estimation of the long-term expected real interest rate far in the future. In contrast, a higher weight for current data would overestimate the long-run consequences of short or medium term fluctuations. This disadvantage would be especially serious in the current financial market situation which is heavily distorted. This distortions caused by monetary policy might continue	

	for several years. Nevertheless, the crisis measures are of temporary nature and do not change the equilibrium rate in the very long run (60 years, 100 years, or more from now). In addition, by equal weighting arbitrary weighting decisions are avoided and the complexity of the approach is reduced considerably. **In contrast, data from the seven countries considered should be weighted differently.** Geographical weighting would considerably improve the representativeness of the real interest rate component. Besides that, there is no reason to forgo this worthwile improvement because it would neither reduce transparency nor add material complexity to the calculation. For all past years the weights are known already, while the unknown weighting for the current year has very little influence on the overall results. Furthermore, in most cases, the weights change only gradually from one year to the next. **Moreover, to apply 3-months interest rates is overly conservative.** Because the UFR is used as an 1-year-forward rate, it should also be calibrated with 1-year-rates. If appropriate 1-year data are not available, the average of the 3-month data should be scaled at least. **Expectations of inflation rates** should be based on central banks' inflation targets. To this end, it is appropriate to use a bucketing approach as proposed in the consultation paper. **Changes of the UFR in opposite directions** in subsequent years should be avoided. To this end, the target value of the UFR (before phasing-in) should **not be recalculated each year**. In order to ensure a stable UFR, it would be more appropriate, instead, to maintain the target value for several years (e.g. 10 years). Once the target vaulue is recalculated, the new figure is phased-in with annual changes of maximal 10 basis points. Finally, a new methodology to calculate the UFR has to be **sufficiently tested** by the insurance and reinsurance undertakings before it is implemented. It is also not	

	feasible to apply the new UFR only three months after its announcement. Insurers should be granted **at least six months to prepare** themselves in order to ensure stability and predictability.	
Q1. (pg. 56)	**Yes**, we agree to maintain the general approach and to calculate the UFR as the **sum of expected long-term real interest rate and expected inflation**. This approach is reasonable and in line with the Delegated Regulation on Solvency II.	
Q2. (pg. 56)	**Yes**, we consider using **data since 1960 in a widening window approach** to be appropriate for averaging past real interest rates. **Long time series of historic data** allow to calculate a long term average. Because no trend is evident in the data, this average can be interpreted as an equilibrium. Hence, this average rate is the **best estimate for the real interest rate far in the future**. In contrast, an **estimation solely based on current market data would be heavily distorted** by the influence of short-run fluctuations which are irrelevant in the long run. Data before World War II or from its direct aftermath should not be applied because the political and economical state of the world at that time was too different from nowadays. As high quality data are available since **1960/61** this seems to be best starting point for the calculation. **In order to get the most reliable and most stable estimates, all available data since that point in time should be applied**. This is achieved by the **widening window approach**. This approach seems to be most suitable to ensure stability of the UFR over time and should be applied. **However**, the **data from the seven countries considered should be weighted differently.** Geographical weighting would considerably **improve the representativeness** of the real interest rate component in comparison to simple equal-weighting. Besides that, there is **no reason to forgo** this worthwile improvement because the geographically weighting discussed on page 32 is	

	transparent, replicable and would not add material complexity to the calculation. In particular, the weights of all past years are known. The unkown weighting for the current year has very little influence on the overall results. Furthermore, in most cases, the weights change only gradually from one year to the next. **Moreover**, to apply **3-months interest rates** is overly conservative. Because the UFR is used as an **1-year-forward rate**, it should also be calibrated with 1-year-rates. If appropriate 1-year data are not available, the average of the 3-month data should be scaled at least.	
Q3. (pg. 56)	We consider **equal weights** to be most appropriate. The real interest rates in the sample exhibit no trend or break but rather some kind of medium range cycle. Thus, **data from different decades have all the same value for the estimation of the long-term expected real interest rate far in the future**. In contrast, **a higher weight for current data would overestimate the long-run consequences of short or medium term fluctuations**. This disadvantage would be especially serious in the current financial market situation which is heavily distorted. This **distortion caused by monetary policy** might continue for several years. Nevertheless, the crisis measures are of **temporary nature** and do not change the equilibrium rate in the very long run (60 years, 100 years, or more from now). Thus, **all data from the time series should be weighted equally** (i.e. beta = 1). This has also the advantage to avoid arbitrary weighting decisions and to reduce the complexity of the approach considerably. However, the **data from the seven countries considered should be weighted differently.** Geographical weighting would considerably **improve the representativeness** of the real interest rate component in comparison to simple equal-weighting. Besides that, there is **no reason to forgo** this worthwile improvement because the geographically weighting discussed on page 32 is	

	transparent, replicable and would not add material complexity to the calculation. In particular, the weights of all past years are known. The unkown weighting for the current year has very little influence on the overall results. Moreover, in most cases, the weights change only gradually from one year to the next.	
Q4. (pg. 56)	**Yes**, we consider both the **bucketing approach** and the **chosen buckets** to be appropriate. Inflation persistently differs by country. Thus, even in the long run, **it would not be sensible to expect the same inflation rate all over the world**. In order to avoid a bulk of slighlty different inflation estimates, it is reasonable to define several **buckets** which pool countries of similar inflation patterns. By adding a high inflation bucket, the few high inflation currencies are appropriately taken into account. The general approach of **considering central banks' inflation targets is reasonable**. In contrast, historic inflation rates would not be suited for the forecast of the future inflation rate. In most countries, inflation patterns have materially changed in the past. The reason is that inflation is not a natural rate but to a high degree subject to policy mesasures. Thus, to apply fixed inflation targets as forecast for future inflation is the most sensible approach. In the euro area, e.g., the ECB adheres to its inflation target and aims to achieve this target at least in the mid run – whatevers it takes. If inflation targets change nevertheless, the UFR would change abruptly. In this situation, a phasing-in with a **limitation of the annual change** is needed in order to ensure the required stability of the UFR and to avoid overly volatile results (see Q5).	
Q5. (pg. 56)	**Yes**, we consider a **limitation of the annual changes of the UFR** as appropriate. **It is inevitable to restrict the maximum changes of the UFR in order to ensure stability of the UFR over time and to avoid overly volatile results.** This holds for both cases – when a new methodology to derive the UFR is introduced and when the inflation target of a central bank changes.	

	The **stability of the UFR is prescribed by law**. Any methodology to derive the UFR must observe this legal setting. Moreover, a fast changing UFR would lead to **severe short term movements** in the overall results of the calculations. This would inevitably **cast doubt on the validity** of the entire quantitative requirements. **However**, we do not consider the proposed limit to be appropriate. **An annual change of up to 20 basis points is not in line with the legal requirement of a stable UFR and would cause overly volatile results.** Instead, any change of the UFR must be phased-in at a slow pace. To this end, the UFR level **must not be changed by more than 10 basis points** compared to the previously applied level to ensure stability over time. **Moreover**, it should also be avoided that changes in opposite directions occur in subsequent years. To this end, the target value of the UFR (before phasing-in) should not be recalculated each year. In order to ensure a stable UFR, it would be more appropriate, instead, to **maintain the target value for several years** (e.g. 10 years). Once the target value is recalculated, the new figure is phased-in with annual changes of maximal 10 basis points.	
Q6. (pg. 56)	**Yes**, we consider the proposed **rounding** to be appropriate. By means of rounding, many very small changes of the UFR are avoided. Otherwise, meaningless changes of 1 or 2 basis points would occur each year. **However**, it should also be avoided that **changes in opposite directions** occur in subsequent years. To this end, the target value of the UFR (before phasing-in) should not be recalculated each year. In order to ensure a stable UFR, it would be more appropriate, instead, to **maintain the target value for several years** (e.g. 10 years). Once the target vaule is recalculated, the new figure is phased-in with annual changes of maximal 10 basis points.	
Q7. (pg. 56)	**No**, we do not consider the proposed **implementation** to be appropriate. **First and foremost, introducing a new methodology to calculate the UFR right**	

	now is neither required nor reasonable. Before any changes to the UFR are considered, the relevant stakeholders should **gain sufficient experience** with the new supervisory system. The UFR should **remain at its original level of 4.2%, at least until the upcoming review of the Solvency II standard formula and all LTG measures**. The UFR is a crucial component of the quantitative requirements under Solvency II – thus, it may **not be changed in an isolated manner**, but taking this wider context into account. Any other approach would be in direct contradiction with the intentions of the **European legislators** which came to the Omnibus II compromise on basis of a UFR of 4.2%. **Furthermore**, a new methodology to calculate the UFR hat to be **sufficiently tested** by the insurance and reinsurance undertakings before it is implemented. **Moreover**, it is not feasible to apply the new UFR only three months after its announcement. Insurers should be granted **at least six months** to prepare themselves in order to ensure stability and predictability.	
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Paragraph 38.		
Paragraph 39.		
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Paragraph 42.	**We agree** with the conclusion to maintain the general approach and to calculate the UFR as the sum of expected long-term real interest rate and expected inflation. This approach is reasonable and in line with the Delegated Regulation on Solvency II. **However, we disagree** with the conclusion to give current data a higher weight. In fact, we consider equal weights to be most appropriate. The real interest rates in the sample exhibit no trend or break but rather some kind of medium range cycle. Thus, data from different decades have all the same value for the estimation of the long-term expected real interest rate far in the future. In contrast, a higher weight for current data would overestimate the long-run consequences of short or medium term fluctuations. This disadvantage would be especially serious in the current financial market situation which is heavily distorted. This distortions caused by monetary policy might continue for several years. Nevertheless, the crisis measures are of temporary nature and do not change the equilibrium rate in the very long run (60 years, 100 years, or more from now). Thus, all data from the time series should be weighted equally (i.e. beta = 1). This has also the advantage to avoid arbitrary weighting decisions and to reduce the complexity of the approach considerably.	
Paragraph 43.		
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Paragraph 54.		
Paragraph 55.		
Paragraph 56.	**We agree** with the conclusion to apply historic data on real interest rates. Long time series of historic data allow to calculate a long term average. Because no trend is evident in the data, this average can be interpreted as an equilibrium. Hence, this average rate is is the best estimate for the real interest rate far in the future. In contrast, an estimation solely based on current market data would be heavily distorted by the influence of short-run fluctuations which are irrelevant in the long run. **We disagree** with the conclusion to introduce higher weights for more recent data. We consider equal weights to be most appropriate. The real interest rates in the sample exhibit no trend or break but rather some kind of medium range cycle. Thus, data from different decades have all the same value for the estimation of the long-term expected real interest rate far in the future. In contrast, a higher weight for current data would overestimate the long-run consequences of short or medium term fluctuations. This disadvantage would be especially serious in the current financial market situation which is heavily distorted. This distortions caused by monetary policy might continue for several years. Nevertheless, the crisis measures are of temporary nature and do not change the equilibrium rate in the very long run (60 years, 100 years, or more from now). Thus, all data from the time series should be weighted equally (i.e. beta = 1). This has also the advantage to avoid arbitrary weighting decisions and to reduce the complexity of	

	the approach considerably.	
Paragraph 57.		
Paragraph 58.		
Paragraph 59.		
Paragraph 60.		
Paragraph 61.	**We agree** with the conclusion to change the source of data in favour of the EU AMECO and OECD MEI databases **only if** the average of the 3-month data from the AMECO database is scaled in order to get a proper estimation for a 1-year real interest rate.	
Paragraph 62.		
Paragraph 63.		
Paragraph 64.		
Paragraph 65.		
Paragraph 66.		
Paragraph 67.	**We agree** with the conclusion to estimate the UFR based on a single average for the real interest rates in all countries.	
Paragraph 68.		
Paragraph 69.		
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Paragraph 72.		
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Paragraph 74.		
Paragraph 75.		
Paragraph 76.		
Paragraph 77.	**We agree** with the conclusion to base the real rate component on historic data from Belgium, France, Germany, Italy, the Netherlands, the United Kingdom and the United	

	States. **However, we disagree** with the conclusion not to apply different geographical weights. Geographical weighting would considerably improve the representativeness of the real interest rate component in comparison to simple equal-weighting. Besides that, there is no reason to forgo this worthwile improvement because the geographically weighting discussed on page 32 is transparent, replicable and would not add material complexity to the calculation. In particular, the weights of all past years are known. The unkown weighting for the current year has very little influence on the overall results. Furthermore, in most cases, the weights change only gradually from one year to the next.	
Paragraph 78.		
Paragraph 79.		
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Paragraph 82.		
Paragraph 83.		
Paragraph 84.		
Paragraph 85.	**We disagree** with the conclusion to apply 3-months interest rates from the AMECO database without subsequent adjustment. To apply 3-months interest rates is overly conservative. Because the UFR is used as an 1-year-forward rate, it should also be calibrated with 1-year-rates. If appropriate 1-year data are not available, the average of the 3-month data should be scaled at least.	
Paragraph 86.		
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Paragraph 99.	**We agree** with the conclusion to use a widening window approach starting in 1960 to average the real rate component. Long time series of historic data allow to calculate a long term average. Because no trend is evident in the data, this average can be interpreted as an equilibrium. Hence, this average rate is the best estimate for the real interest rate far in the future. In contrast, an estimation solely based on current market data would be heavily distorted by the influence of short-run fluctuations which are irrelevant in the long run. Data before World War II or from its direct aftermath should not be applied because the political and economical state of the world at that time was too different from nowadays. As high quality data are available since 1960/61 this seems to be best starting point for the calculation. In order to get the most reliable and most stable estimates, all available data since that point in time should be applied. This is achieved by the widening window approach. This approach seems to be most suitable to ensure stability of the UFR over time and should be applied.	
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Paragraph 112.		
Paragraph 113.		
Paragraph 114.		
Paragraph 115.		
Paragraph 116.		
Paragraph 117.	**We agree** with both the conclusions to retain a bucketing approach and to add a high inflation bucket. Inflation persistently differs by country. Thus, even in the long run, it would not be sensible to expect the same inflation rate all over the world. In order to avoid a bulk of slightly different inflation estimates, it is reasonable to define several buckets which pool countries of similar inflation patterns. By adding a high inflation bucket, the few high inflation currencies are appropriately taken into account. The general approach of considering central banks' inflation targets is reasonable. In contrast, historic inflation rates would not be suited for the forecast of the future inflation rate. In most countries, inflation patterns have materially changed in the past. The reason is that inflation is not a natural rate but to a high degree subject to policy mesasures. Thus, to apply fixed inflation targets as forecast for future inflation is the most sensible approach. In the euro area, e.g., the ECB adheres to its inflation target and aims to achieve this target at least in the mid run – whatevers it takes.	

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Paragraph 134.		
Paragraph 135.		
Paragraph 136.	**We agree** with the conclusion to apply mechanisms to limit both the frequency and the magnitiude of annual changes of the UFR. It is inevitable to restrict the maximum changes of the UFR in order to ensure stability of the UFR over time and to avoid overly volatile results. To restrict annual changes is necessary in both cases when a new methodology to derive the UFR is introduced and when the inflation target of a central bank changes. The stability of the UFR is prescribed by law. Any methodology to derive the UFR must	

	observe this legal setting. Moreover, a fast changing UFR would lead to severe short term movements in the overall results of the calculations. This would inevitably cast doubt on the validity of the entire quantitative Solvency II requirements. **However, we disagree** with the conclusion to limit the annual changes with a cap of 20 basis points. An annual change of up to 20 basis points is not in line with the legal requirement of a stable UFR and would cause overly volatile results. Instead, any change of the UFR must be phased-in at a slow pace. To this end, the UFR level must not be changed by more than 10 basis points compared to the previously applied level to ensure stability over time. Moreover, it should also be avoided that changes in opposite directions occur in subsequent years. To this end, the target value of the UFR (before phasing-in) should not be recalculated each year. In order to ensure a stable UFR, it would be more appropriate, instead, to maintain the target value for several years (e.g. 10 years). Once the target vaule is recalculated, the new figure is phased-in with annual changes of maximal 10 basis points.	
Paragraph 137.		
Paragraph 138.		
Paragraph 139.		
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Paragraph 141.		
Paragraph 142.		
Paragraph 143.		
Paragraph 144.	**We agree** with the proposal to apply a mechanism to limit the magnitiude of annual changes of the UFR during the initial implementation of the revised methodology to calculate the UFR. It is inevitable to restrict the maximum changes of the UFR in order to ensure stability of the UFR over time and to avoid overly volatile results. To restrict annual changes is	

	necessary in both cases when a new methodology to derive the UFR is introduced and when the inflation target of a central bank changes. The stability of the UFR is prescribed by law. Any methodology to derive the UFR must observe this legal setting. Moreover, a fast changing UFR would lead to severe short term movements in the overall results of the calculations. This would inevitably cast doubt on the validity of the entire quantitative requirements. **However, we disagree** with the proposal to limit the annual changes with a cap of 20 basis points. An annual change of up to 20 basis points is not in line with the legal requirement of a stable UFR and would cause overly volatile results. Instead, any change of the UFR must be phased-in at a slow pace. To this end, the UFR level must not be changed by more than 10 basis points compared to the previously applied level to ensure stability over time. Moreover, it should also be avoided that changes in opposite directions occur in subsequent years. To this end, the target value of the UFR (before phasing-in) should not be recalculated each year. In order to ensure a stable UFR, it would be more appropriate, instead, to maintain the target value for several years (e.g. 10 years). Once the target vaule is recalculated, the new figure is phased-in with annual changes of maximal 10 basis points. **In addition, we disagree** with the proposed implementation in general. First and foremost, introducing a new methodology to calculate the UFR right now is neither required nor reasonable. Before any changes to the UFR are considered, the relevant stakeholders should gain sufficient experience with the new supervisory system. The UFR should remain at its original level of 4.2%, at least until the upcoming review of the Solvency II standard formula and all LTG measures. The UFR is a crucial component of the quantitative requirements under Solvency II – thus, it may not be changed in an isolated manner, but taking this wider context into account. Any other approach would be in direct contradiction with the intentions of the	

	European legislators which came to the Omnibus II compromise on basis of an UFR of 4.2%. Furthermore, a new methodology to calculate the UFR hat to be sufficiently tested by the insurance and reinsurance undertakings before it is implemented. Moreover, it is not feasible to apply the new UFR only three months after its announcement. Insurers should be granted at least six months to prepare themselves in order to ensure stability and predictability.	
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