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Frequently Asked Questions & Answers

THE ULTIMATE FORWARD RATE

Legislation requires the Ultimate Forward Rate (UFR) to be stable over time. Why is EIOPA suggesting changing it?

- ✓ Legislation also requires the UFR to be derived using a clearly specified methodology. That is what EIOPA has provided.
- ✓ Change to the UFR is prudent if long-term expectations change.
- ✓ And long-term expectations have changed significantly in recent years.
- ✓ Moreover, the European Systemic Risk Board analysed the derivation of the UFR from a macro-prudential perspective and supported the review of the UFR methodology.

The UFR of 4.2% was part of the political settlement which finalised Solvency II. Why is EIOPA reopening this?

- ✓ The legislators specified the need for a UFR methodology in the Solvency II legislation.
- ✓ The legislators specified conditions for the methodology which include that it should change as a result of changes in long-term expectations.

What were the steps EIOPA took to derive the methodology?

- ✓ EIOPA followed a rigorous process for the development of the UFR methodology.
- ✓ EIOPA's work started in May 2015.

- ✓ A workshop was organised with stakeholders in July 2015.
- ✓ A public consultation on a proposal for the UFR methodology from April 2016 to July 2016 was conducted.
- ✓ On 31 August 2016 EIOPA reported about its work on the UFR methodology at the meeting of the European Parliament’s Committee on Economic and Monetary Affairs.

What are the results of EIOPA’s full impact assessment?

- ✓ EIOPA collected information from 336 European insurance and reinsurance undertakings on the impact of changes of the UFR on their solvency position.
- ✓ The impact of UFR changes is small.
- ✓ The average Solvency Capital Ratio changes from 203% to 201% if the UFR is changed by 20 basis points.
- ✓ Insurance and reinsurance undertakings comply with the capital requirements when their Solvency Capital Ratio is above 100%.

Why conducting the review of the Ultimate Forward Rate methodology now and why not waiting for the review of the Solvency Capital Requirement in 2018?

- ✓ The legal requirement for a clearly specified methodology applies now.
- ✓ The implementation of the review of the Solvency Capital Requirement (SCR) will be unlikely to materialise before 2019.
- ✓ It would not be sound and prudent to wait especially when the changes in long-term expectations are significant.
- ✓ The SCR determines capital needs of an insurer based on the risks it faces in the next year. The UFR is one component in the valuation of liabilities.

If the justification for changing the Ultimate Forward Rate is that expectations of long-term interest rates have fallen, why are you not prepared to change the cost of capital of 6% for calculation of technical provisions, which likewise was set when rates were higher?

- ✓ Unlike the Ultimate Forward Rate, the 6% value for the cost of capital is fixed in legislation.
- ✓ The 6% cost-of-capital rate is not an interest rate. It is a spread above the risk-free interest rate measuring in particular the credit risk of counterparties.
- ✓ The European Commission has asked EIOPA to include the risk margin in its advice on the review of the Solvency Capital Requirement.

What are the next steps?

- ✓ EIOPA will publish the consultation report including responses to the stakeholder comments by the beginning of May 2017.
- ✓ The first change of the UFR, for the euro from 4.2% to 4.05%, will be implemented at the beginning of 2018, in the calculation of the risk-free interest rates for January 2018, which will be published in February 2018.
- ✓ The European Commission may adopt and consequently publish implementing acts which set out the technical information for each relevant currency.

Why did EIOPA propose the Ultimate Forward Rate of 4.05% for the euro and on which basis?

- ✓ EIOPA decided **<u>not</u>** on a value for the UFR, but on a methodology to derive the UFR on an ongoing basis.
- ✓ According to the methodology changes of the UFR are phased-in.
- ✓ In line with the methodology, and reflecting the significant changes in the long-term expectations of interest rates in recent years, the calculated value of the UFR for the euro is 3.65%.
- ✓ Annual changes to the UFR will not be higher than 15 basis points.

- ✓ In a first step of the phasing-in the current UFR of 4.2% for the euro will be lowered in January 2018 to 4.05%.

How is the calculated UFR of 3.65% derived?

- ✓ The calculated UFR is the sum of an expected real rate and an expected inflation rate.
- ✓ The expected real rate is derived as a long-term average of past real rates since 1961. Currently that average is 1.65%.
- ✓ The expected inflation rate is derived from the inflation targets of central banks. For the euro the expected inflation rate is currently 2%.
- ✓ Both components sum up to 3.65%.

How does the new rate impact the European insurers? Could you provide details according to countries?

- ✓ EIOPA collected information from 336 European insurance and reinsurance undertakings on the impact of changes of the UFR on their solvency position.
- ✓ The impact of UFR changes is small.
- ✓ The average Solvency Capital Ratio changes from 203% to 201% if the UFR is changed by 20 basis points.
- ✓ Insurance and reinsurance undertakings comply with the capital requirements when their Solvency Capital Ratio is above 100%.
- ✓ The analysis shows that impact of the UFR changes is manageable in all national markets.
- ✓ EIOPA published the results of the impact analysis together with the UFR methodology.

When will the new rate be applied?

- ✓ The first change of the UFR, for the euro from 4.2% to 4.05%, will be implemented at the beginning of 2018, in the calculation of the risk-free interest rates for January 2018, which will be published in February 2018.

How often does EIOPA plan to review the rate, regularly or according to the development of the economic and financial cycle?

- ✓ EIOPA will apply the methodology on an annual basis.
- ✓ Changes to the UFR will only be made if the calculated UFR differs from the currently applied UFR by at least 15 basis points.
- ✓ Not every recalculation will therefore result in a change of the UFR.
- ✓ EIOPA will also not change the UFR by more than 15 basis points per year.

What are the changes that EIOPA made to the consultation proposal?

- ✓ EIOPA made three changes to the consultation proposal in order to improve the stability of the UFR:
  1. The limit to annual changes to the UFR was changed from 20 basis points to 15 basis points. As a result the UFR will change more slowly.
  2. The UFR will not change if the difference between calculated UFR and currently applied UFR is less than 15 basis points. That implies in particular that the UFR will change less often.
  3. The expected real interest rate is derived from a simple average of past real interest rates instead of a weighted average. This will make the calculated UFR more stable over time.
- ✓ The first application of the UFR methodology was set for the beginning of 2018 in order to provide insurance and reinsurance undertakings sufficient time to prepare.