

Gabriel Bernardino
Chairman

European Parliament
Mr Roberto Gualtieri
Chair of the Committee on Economic and Monetary Affairs
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EIOPA-17/202
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Solvency II: Methodology to derive the ultimate forward rate

Dear Mr Gualtieri, *Dear Roberto,*

I am referring to your letter dated 15 November 2016 in which you reflect some issues raised by the ECON Committee about EIOPA's work on the methodology to derive the ultimate forward rate (UFR). In my first response letter of 14 March 2017 I promised to inform you about the decision of EIOPA's Board of Supervisors on the UFR methodology.

On 30 March 2017 EIOPA's Board of Supervisors agreed unanimously on a methodology to derive the UFR. By specifying the methodology EIOPA is fulfilling its mandate according to Article 47 of the Delegated Regulation on Solvency II. That provision requires that the methodology to derive the UFR shall be clearly specified in order to ensure the performance of scenario calculations by insurance and reinsurance undertakings. Also the UFR shall be determined in a transparent, prudent, reliable and objective manner that is consistent over time.

Article 47 further provides that the UFR shall be stable over time and shall only change as a result of changes in long-term expectations. The UFR shall take account of expectations of the long-term real interest rate and of expected inflation, provided those expectations can be determined in a reliable manner. The UFR shall not include a term premium to reflect the additional risk of holding long-term investments.

EIOPA has followed a rigorous process for the development of the UFR methodology. EIOPA's work started in May 2015. It included a workshop with stakeholders on the basis of an issues paper in July 2015 and a public consultation on a proposal for the UFR methodology and its implementation from April to July 2016. EIOPA reported about its work on the UFR methodology at the ECON Committee meeting on 31 August 2016. The consultation paper included analysis on the impact of the methodology. After the consultation EIOPA has, in particular at the request of the ECON Committee, carried out further, detailed impact analysis. I outlined the results of the impact analysis in my letter of 14 March 2017. The impact of the envisaged changes to the UFR is very small and manageable by insurance and reinsurance undertakings.

The European Systemic Risk Board has analysed the derivation of the UFR from a macroprudential perspective and reported its view, supportive of changes to the current UFR, to EIOPA at the end of 2016.

I am convinced that EIOPA's methodology strikes the right balance between the stability of the UFR over time and reflecting changes in long term expectations. In response to the comments of the ECON Committee and of stakeholders the stability of the methodology was further increased by the following changes:

- Firstly, the limit to annual changes of the UFR was lowered from 20 to 15 basis points, so that the UFR will change more gradually.
- Secondly, in order to significantly reduce the frequency of UFR changes, the UFR will only be changed when the difference between the calculated UFR and the currently applicable UFR exceeds 15 basis points. Backtesting this approach shows that the UFR would have changed four times since 2000. According to the earlier consultation proposal the UFR would have changed 12 times.
- Thirdly, the average for calculating the real rate component of the UFR will be a simple average instead of a weighted average that puts more weight on recent observations. Also this change will make the UFR move more gradually.

Furthermore, the first application of the UFR methodology is set to the beginning of 2018 in order to provide insurance and reinsurance undertakings more time for their preparations.

In line with the methodology, and reflecting the significant changes in the long-term expectations of interest rates in the recent years, the calculated value of the UFR for the euro is 3.65%. Nevertheless, annual changes will not be higher than 15 basis points. Therefore, in a first step of the phasing-in the current UFR of 4.2% will be lowered in January 2018 to 4.05%.

Please find a description of the methodology in the annex to this letter. EIOPA will announce its decision on the methodology on Wednesday 5 April, together with a report on the calculation of the UFR for 2018 and the results of the further impact analysis.

I remain at your disposal for any questions that you may have on this issue.

Yours sincerely,



cc:

Adolfo BARBERA DEL ROSA, Head of Unit ECON Secretariat.