# Improving the treatment of long-term business

Getting the long-term guarantee (LTG) measures right in Level 2 is essential. Calibrations related to the treatment of long-term business, such as the extrapolation of risk-free interest rates, the volatility adjustment, and the risk margin are important because they will significantly impact whether the Solvency II Review succeeds in safeguarding the insurance long-term business model.

Changes to these aspects of the framework will directly influence the ability of insurers to offer guaranteed products, to invest long-term and to avoid being pushed into otherwise unnecessary procyclical behaviour.

The initial ideas put forward by the European Commission would weaken the agreed high level of political ambition, are not based on strong technical evidence, would not sufficiently reduce capital and volatility. During extreme market environments, the proposals would push insurers towards unnecessary procyclical behaviour.

Unnecessary prudential buffers and unnecessary volatility create barriers to investment, add costs to long-term products and reduce insurers' ability to take risk for the benefit of their policyholders and wider society.

## Volatility adjustment (VA)

The VA is a fundamental part of Solvency II which reflects the important economic connection and interaction between an insurer's assets and liabilities. Without the VA, Solvency II does not work. Making sure the VA is appropriately designed and calibrated is therefore vital.

In their agreement on the Level 1 text of the Solvency II Directive, the co-legislators remedied many of the shortcomings of the current design and calibration of the VA. However, the calibration of the key risk correction parameter - defined by Solvency II as the realistic assessment of expected losses, unexpected credit risk or any other risk – remains to be agreed in Level 2.

The current risk correction approach is already conservative relative to real world data and evidence and has proven to work well. As such, the calibration of the new risk correction methodology should not deviate significantly in terms of outcomes.

The new risk correction parameters should be calibrated using real world data and evidence. The calibration work should focus on an appropriate and technically substantiated calibration of the cap introduced by co-legislators - this limits the procyclicality which could otherwise be introduced by the change in methodology. Once an appropriate cap has been set, the percentages for the three sections should be aligned accordingly.

### Insurance Europe view:

**The following calibrations of the risk correction parameter are evidence based and technically justified.**

- **For corporate bonds:**
  - **A value for the cap% equal to 60% of long-term average spreads (LTAS).**
  - **Percentages for the three tiers to be determined coherently with the cap (for example 30%, 20%, 10%).**
- **For government bonds:**
  - **A value for the cap% equal to 40% of the LTAS.**
  - **Percentages for the three tiers to be determined coherently with the cap (for example 20%, 15%, 5%).**

## Extrapolation of risk-free rates (RFR)

The RFR curve is used to value insurers' future liabilities. Given the very long-term nature of the industry, there are significant liabilities with maturities which exceed the market data available. Therefore, the extrapolation methodology used to extend the RFR is very important.

Stability of the extrapolated part of the RFR curve is paramount to avoid creating barriers for insurers to offer the long-term products which customers need and want and which contribute to insurers' ability and interest to make long-term patient investments.

The calibration for the technical parameters of the new extrapolation methodology which determine the starting point (the First Smoothing Point (FSP)) and the convergence to the Ultimate Forward Rate (the convergence parameter) should be chosen to minimise artificial balance sheet volatility, to avoid incentives for procyclical behaviour and to avoid pushing insurers towards extensive derivative usage.

### Insurance Europe view:

- **The percentage parameter of the Residual Volume Criterion, which is one of the criteria governing the FSP, should be increased to 8%.**
- **The convergence parameter should be calibrated at 15% and 70% for the Swedish Krona.**

## Risk margin

The risk margin is an additional buffer over and above the conservative levels of reserves insurers have to put aside to cover all current and future claims and the comprehensive solvency capital to cover up to 28 different risks.

The current risk margin reduces insurers available capital by €141 bn – and has a very material impact on insurers' capacity to take risk, investment strategies, product design and customer pricing. There are widely acknowledged issues with the design and calibration of the current risk margin. Regions around the world with insurers against whom EU insurers compete, either do not have any risk margin (e.g. USA, Canada) or have significantly lower calibrations (e.g. Japan, UK).

Further explanation and justification for these positions is provided in the following pages.

### Insurance Europe view:

- **A Level 2 calibration of the lambda parameter of 92.5%, without a floor, which would approximately halve the size and volatility of the risk margin is consistent with the technical evidence and political ambition.**
- **There should also be appropriate recognition of diversification of risks at group level.**

# Volatility adjustment (VA)

## Background

Insurers invest significantly in both government and corporate bonds. The bonds are typically chosen by the insurer to match the characteristics of their liabilities, notably their duration and the insurer's risk appetite. In aggregate, the payments from the bonds, i.e. the coupons and redemption proceeds will be used to pay the liabilities as they fall due.

Because insurers can typically manage their overall liabilities and claims at aggregate portfolio level together with their aggregate asset portfolio, short-term fluctuations in the market value of the bonds do not impair their ability to pay the liabilities (as the bonds will still pay the same coupon and redemption payments despite a change in the market price). It is only when a bond defaults that the insurer may be impacted. This ability to manage assets and liabilities together and focus on cashflows rather than temporary market value changes is a core feature of the insurer's long-term business model.

## Solvency balance sheet

The VA is an instrument that was introduced into the Solvency II framework to better reflect the asset-liability matching and risk management practices of insurance companies described above.

As the value of an insurers' bond portfolio changes, impacting the asset side of its balance sheet, the VA provides an offsetting impact on the liability side of its balance sheet. This reflects the economic reality and creates overall stability on the balance sheet by removing some of the "artificial" effects of the short-term volatility that the insurer is not actually exposed to.

## Improving the VA

When developing the VA in 2014, EIOPA took an overly conservative approach by adding in many margins of prudence and limiting the real economic link between assets and liabilities. Insurance Europe has long highlighted the deficiencies in the current approach. These shortcomings were also recognised by EIOPA itself, the Commission and both co-legislators in their proposals to amend the Solvency II Directive.

To address these shortcomings, the Commission proposed a number of improvements which will improve the functioning of the VA and are welcomed and supported by the industry (see annex for more information on these).

**However, the ultimate effectiveness of the new VA will depend on a key parameter called the risk correction.**

In their work on the text of the Directive, the co-legislators' have set the framework for the design of the risk correction. But, its calibration will be defined in Level 2 legislation.

**To deliver on the co-legislators ambitions for the review, it is imperative that the calibration of the risk correction is technically sound, risk-based and does not introduce unnecessary procyclicality.**

## What is the risk correction?

The risk correction adjusts the volatility adjustment for *"a realistic assessment of expected losses or unexpected credit or other risk of the assets"* [1] . In other words, it ensures that the insurer does not assume any income that it is not expected from the bond portfolio. As discussed above, this is the expected losses due to defaults.

The expected default losses can be calculated through an analysis of historical default rates, which are provided by credit rating agencies. The default rates of the individual bonds are aggregated to calculate the total expected default rate for the portfolio.

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[1] Solvency II Directive Article 77d

## Are there any problems with the current risk correction?

The risk correction is currently based on the default approach outlined above with the addition of a Cost of Downgrade to also reflect the impact of ratings migration. There is an additional safeguard that the default risk and cost of downgrade are increased to a minimum of 35% of the long-term average spread, providing an extra prudential buffer.

Neither EIOPA, nor the Commission has provided any robust evidence that the current risk correction does not sufficiently capture the risk. The "evidence" put forward by EIOPA to justify a change to the risk correction was based on BB-rated bonds which represent less than 1% of insurers' investments and focused on changes in credit spreads and not defaults.
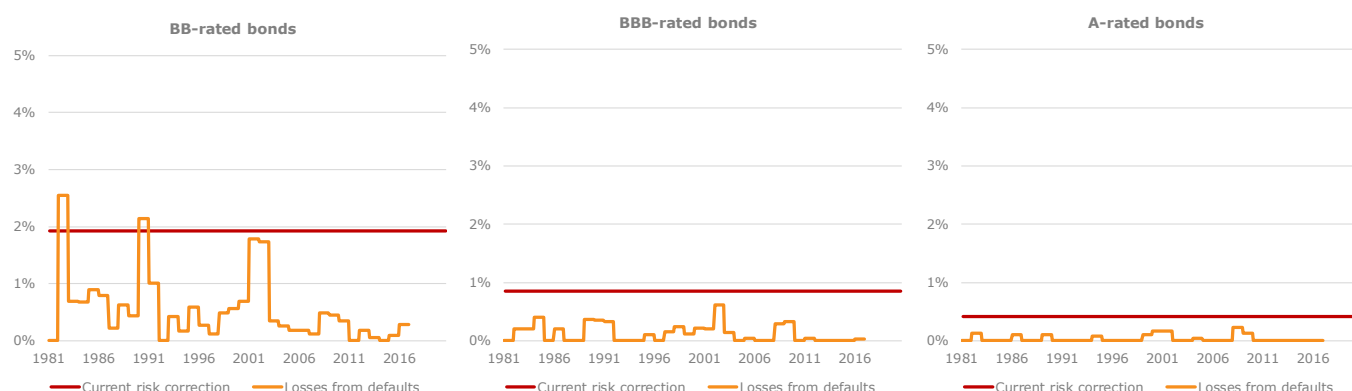


The charts provide a comparison of the current risk correction approach relative to the actual losses from defaults, assessed by credit rating. The charts clearly show

- the actual losses from defaults do not vary as much as some may expect, even during extreme market periods such as the financial crisis and particularly for investment grade bonds that insurers mostly invest in.
- the current risk correction is already calibrated very conservatively and far above the actual defaults.

On the contrary, the current approach has proven to work well to assess downgrade and default risk. EIOPA's own analysis of risk corrections[2] vs incurred losses from default and downgrade in its LTG Reports 2018, 2019, 2020 evidences this.

It is therefore important that the new risk correction methodology is calibrated to deliver broadly consistent outcomes as the current approach.

## The Commission's proposal…

Despite the lack of evidence to justify a change in the risk correction methodology, the Commission proposed to change the methodology to calculate the risk correction using an approach originally proposed by EIOPA.

In EIOPA's proposal, the risk correction is directly linked to short-term market turbulence. In other words, when markets are volatile, the risk correction is volatile. This is clearly an undesirable quality for a parameter which should provide stability.

Moreover, in our opinion, the academic paper used as a starting point of EIOPA's calibration is unsuitable for the purpose for several reasons.

First, in our view it is very misleading to start the calibration work taking an outdated elaboration as a reference point which does not envisage several elements of the risk correction agreed in the trilogue negotiations, such as a third section and a cap.

Furthermore, the proposed percentages were calibrated starting from the conclusion of Giesecke et al. (2011)[3], a paper unsuitable for several reasons:

- It posited, perhaps correctly, that credit spreads are not reliable predictors of defaults. In fact, authors state that there is no evidence that credit spreads respond to current default rates; this contradicts EIOPA's basic idea that the risk correction should be a proportion of the credit spread.
- It considered only non-financial corporate bonds (including those of a very small amount and not listed) issued in the US from 1866-2008, thus analyzing a portfolio potentially much riskier than the "insurance reference portfolio".

## …and the co-legislators' solution

The risk correction framework agreed by the co-legislators is based on EIOPA's approach. However, very importantly, pushed by European Parliament's concerns about the procyclicality and balance sheet volatility introduced by EIOPA's proposal, the political agreement introduced a cap linked to long term average spreads. This cap acts as a safeguard when market volatility is particularly turbulent.

This agreement is a compromise between what has been considered to represent a too punitive and dangerously procyclical methodology (i.e. EIOPA/EC proposals) and a methodology which was not deemed to be sufficiently conservative (i.e. the current risk correction, depending only on long term average spreads).

## EGBPI non paper proposals

Recently, in a non-paper to the EGBPI, the Commission proposed some initial calibrations of the risk correction which were very concerning and would:

1. significantly overstate the risks,
2. reduce the ability of the VA to protect against short-term volatility
3. introduce unnecessary procyclicality; and
4. be ineffective in crisis situations because the caps would barely be touched.

Furthermore, the Commission's proposed calibrations would also create inconsistency within the Solvency II framework because insurers who use the matching adjustment would have to reserve a different amount for the same risks. For example, a VA-user would have to reserve up to 195% of the LTAS to reflect the default risk of a corporate bond whereas a MA-user would only have to reserve 35% of the LTAS, for the exact same risk.

## How should the risk correction be calibrated?

Contrary to the Commission's approach, we believe that the risk correction parameters should be based on:
- credit spreads from the EIOPA reference portfolio;
- a suitable time series span which includes all relevant crisis event for European insurance companies (element which is not taken into account by the current proposal).

**The EC should calibrate the specific parameters based on a realistic assessment of the risks, keeping in mind how procyclicality should be kept at a minimum, in favor of a stable and well calibrated mechanism which does not influence insurers' investment strategies**.

In particular, the starting point of the calibration work should be to technically substantiate the cap, which will in turn define percentages associated to the three scenarios envisaged by the agreement.

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[2] EIOPA analysis of the fundamental spread for MA portfolios which uses the same method as the current risk correction.

[3] K. Giesecke, F. Longstaff, S. Schaefer, I. Strebulaev, 2011. Corporate Bond Default Risk: A 150-Year Perspective. Journal of Financial Economics, 102(2), 233-250. Here is the summary of the paper: *"We study corporate bond default rates using an extensive new data set spanning the 1866–2008 period. We find that the corporate bond market has repeatedly suffered clustered default events much worse than those experienced during the Great Depression. For example, during the railroad crisis of 1873–1875, total defaults amounted to 36% of the par value of the entire corporate bond market. Using a regime-switching model, we examine the extent to which default rates can be forecast by financial and macroeconomic variables. We find that stock returns, stock return volatility, and changes in GDP are strong predictors of default rates. Surprisingly, however, credit spreads are not. Over the long term, credit spreads are roughly twice as large as default losses, resulting in an average credit risk premium of about 80 basis points. We also find that credit spreads do not adjust in response to realized rates."*

## The industry's proposal for a risk-based and justified calibration

As underlined in the above section, an appropriate calibration of the risk correction and, therefore, of a reasonable cap expressed in terms of long-term averages spreads (LTAS) and consistent percentages associated to the three tiers, should be based on historical evidence and on a "realistic assessment of expected losses, unexpected credit risk or any other risk".

Therefore, taking real world statistics on defaults and rating transitions as a reference, the proposed approach is based on the following inputs:

- time series regarding daily European market spreads and including the most important crisis event related to this market;
- most severe historical probabilities of defaults and rating transitions observed in the last decades;
- use of EIOPA's reference portfolio.

The logic behind the approach is to

**1.** calibrate the percentage of the long-term average spreads acting as a cap (CAP%), based on historical evidence representing a realistic assessment of defaults and rating transitions rates.

**2.** calibrate the 3-tier percentages, based on the historical data used to calibrate the cap and on the new definition of risk correction which states that these percentages decrease as spread increases. Moreover, in order for the risk correction formula to be consistent, the percentages should be such that the percentages related to the first two tiers should not be higher than the percentage related to the cap.

**Summary of the methodological approach:**

**Step 1:** estimate, from Jan-2008 to Feb-2024, the risk correction as the portion of the credit spread (based on EIOPA's reference portfolio) attributable to defaults and rating transition rates as a proxy for "expected losses, unexpected credit risk or any other risk" using the frequencies of defaults and rating transitions observed during 2009, following the financial turbulences triggered by the Lehman Brothers bankrupt (which have been identified as the most severe crisis in the last decades). The calculation is performed for each point in time along the whole time series considered.

**Step 2:** calculate the empirical distribution of the portion of LTAS attributable to those risks;

**Step 3:** estimate the CAP% as an appropriate percentile from the distribution of the values obtained in previous step;

**Step 4:** calibrate the three percentages which determine the value of the risk correction coherently with the estimated cap and with the data used in the previous steps.

> ## Insurance Europe view:
>
> According to our analysis, observed data on corporate market spread including the most severe crisis periods experienced by European insurance companies and based on EIOPA's reference portfolios would justify the following calibrations:
>
> For corporate bonds:
> - A value for the CAP% equal to 60%
> - Percentages to be determined coherently with the cap (for example 30%, 20%,10%)
>
> As empirical evidence on transitions matrices for government bonds is limited, historical evidence would suggest applying lower percentages to government bonds:
> - A value for the CAP% equal to 40%
> - Percentages to be determined coherently with the cap (for example 20%, 15%,5%)

The **chart below** shows a historical simulation of the SCR ratio of a simplified insurance company with the risk correction modelled under the Commission's initial proposal and the industry's proposal, outlined above. As it can be seen, the Commission's proposal would have a very negative impact on the solvency position of the simplified company in stress periods, e.g. 2008/2009, 2011, 2020. In contrast, the industry proposal provides sufficient risk sensitivity without exaggerating the solvency risks.

**Simulation of SCR ratio of simplified insurer with risk correction modelled under 1) COM's initial proposal (red line) and 2) industry proposal (green line)**
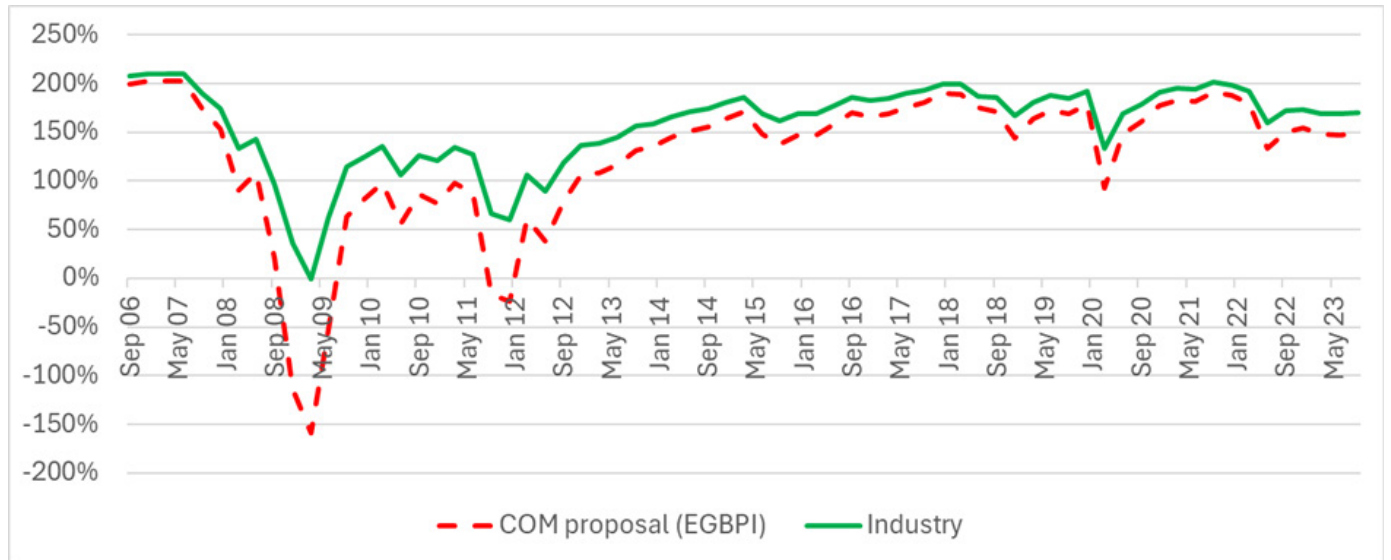


Source: Insurance Europe calculations

## Annex – Improvements to the VA already agreed as part of the Directive

| Improvement | What is it? | Why does it make sense? |
|---|---|---|
| **Increased GAR** | The general application ratio (GAR) is a prudential buffer to reflect "general" risks not accounted for elsewhere. It is increased from 65% to 85%. | The 65% level was never substantiated and was overly conservative. The new 85% level increases the effectiveness of the VA. |
| **Rescale parameter** | The Rescale parameter better aligns the assumed portfolio composition underlying the VA with insurers' portfolios by removing the equity and property assets. | It increase the size and sensitivity of the VA to make it more effective. |
| **CSSR** | The current VA design can overcompensate some insurers due to the differences in the duration of their liabilities and bond portfolios. The CSSR corrects this overcompensation. | The CSSR can help to avoid creating false solvency signals during periods of market turbulence. |
| **Macro-VA** | The macro-VA is supplemental to the Euro-level VA and provides additional benefit for insurers in specific countries where there are country level developments. | The changes remove unjustified cliff effects and improve the impact of the VA when there are localized issues in the Eurozone. |

# Extrapolation of risk-free rates

## Background

The risk-free interest rate term structure is needed to value insurers' liabilities. For short maturities the data can be sourced directly from the financial markets. However, for longer maturities, it must be extrapolated as there is not enough reliable data available from deep, liquid and transparent markets.

The parametrisation of the extrapolation method is crucial for insurance undertakings as it significantly impacts the level and stability of their solvency position. This was underlined by the impact assessments on the Solvency II Review, in which the new extrapolation method and EIOPA's proposed calibration were the main drivers behind the increased capital requirements.

Based on 2020 market conditions, the negative impact of EIOPA's proposals was estimated to be around €90bn which clearly demonstrates the high potential impact of the proposed changes.

## Industry concerns with Commission proposal

While the current extrapolation methodology has proven to work well over the past 8 years, even during the extended period of extremely low and negative interest rates, EIOPA and the Commission proposed to alter the methodology to facilitate the inclusion of additional market data points, notably for the Euro.

The industry recognises the supervisory desire to include more data for some currencies but is very concerned that the new methodology will unnecessarily increase capital requirements and volatility. These changes are expected to have detrimental consequential impacts on the industry's ability to act in a countercyclical manner and are likely to also affect overall product availability and affordability.

## Proposed reforms

In their agreement on the Solvency II Directive, the co-legislators supported the framework proposed by the Commission but delegated the final key calibrations to the Level 2 discussion.

In Level 2, there are two key parameters which will determine the impact of the new extrapolation methodology.

- The First Smoothing Point
- The convergence parameter

**Both parameters must be chosen to minimise artificial balance sheet volatility, avoid incentives for procyclical behaviour and avoid pushing insurers towards extensive derivative usage.**

## Upholding the agreement regarding the First Smoothing Point for the Euro

The First Smoothing Point (FSP) is a decisive parameter that prescribes the maturity at which extrapolation starts. The Solvency II amending Directive clarifies the criteria for the determination of the FSP. According to Article 77a (1), *the FSP will be the highest maturity:*

- *for which "the markets for financial instruments […] are deep, liquid and transparent" (DLT-criterion) and*
- *which fulfils the so-called "Residual Volume Criterion".*

The residual volume criterion is therefore one of two criteria that determine the FSP of the extrapolation. It states that the market volume of all bonds denominated in a given currency for all maturities greater than or equal to the FSP should be at least a certain percentage of the total market volume (Art 77a (1)b).

The amending Directive does not provide exact criteria for this parameter but requires in Recital 43 that the FSP for the Euro will be set to 20 years at the date of entry into force of the amending Directive. Furthermore, this recital shows the co-legislators' assessment that an FSP of 20 years for the Euro is adequate in the current market conditions. Thus, to avoid contradictory results, **the parameter should be set accordingly to result in an FSP of 20 years** for the Euro in current market conditions.

An FSP of 20 years for the Euro was also a key assumption in all impact assessments that informed the legislative process. These impact assessments already underlined the enormous importance of the extrapolation methodology. Apart from that, the practice of starting to extrapolate risk-free interest rates at a maturity of 20 years for the Euro has been established since the preparation for the introduction of Solvency II. It is important to avoid a significant change of the FSP shortly after the entry into force, which would cancel out the deliberate political commitment at Level 1.
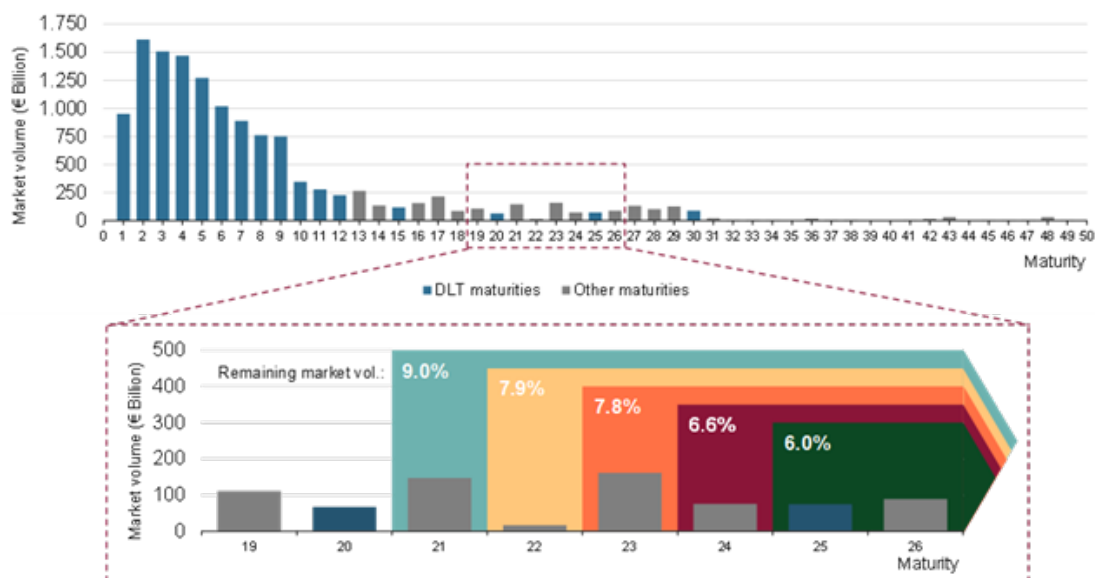


However, a current market analysis shows that the previous parameter choice of 6%[4] would result in an FSP of 25 years for the Euro at the end of 2023, as shown in the diagram.

Since EIOPA's assessment considers a wide range of maturities such as 15, 20, 25 or 30 years to be DLT for the Euro (the other criterion besides the residual volume criterion), this would risk an unwarranted jump of the FSP to 25 years under the current market conditions.

In addition, it should be recognised that since the Delegated Regulation 2015/35 came into force, the ECB has withdrawn a huge amount of bonds issued in the Euro area from the market (more than 4,500 bn Euro). These bonds held in the ECB's APP and PEPP portfolios are no longer available for insurers to hedge their liabilities and could impact the outcome of the residual volume criterion. This fact is not reflected in the previous choice of 6%, which further proves that this choice is outdated.

> Insurance Europe view:
>
> To effectively stabilize the agreement regarding the FSP (i.e. a stable Euro FSP of 20 years), it is crucial to accordingly increase the percentage parameter of the Residual Volume Criterion to 8%.

## Calibrating the convergence parameter

The new extrapolation methodology calculates the regulatory risk-free rates by combining market data (known as the Last Liquid Forward Rate or LLFR) with the more stable Ultimate Forward Rate (UFR).

The methodology combines these rates using a new parameter called the convergence parameter which specifies the weight of the LLFR and UFR in the extrapolation. A higher convergence parameter gives the UFR a higher weighting than the LLFR, providing both

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[4] Recital 21 of Delegated Regulation 2015/35

more stability to the illiquid part of the risk-free rate curves and lower capital burden for long term products.

In their agreement, the co-legislators have set a minimum value for the convergence parameter of 10.975% via the technical formulation *"For maturities of at least 40 years past the first smoothing point, the weight of the UFR shall be at least 77.5%"*.

However, a 10.975% calibration would have several undesirable impacts including:

- Adding unnecessary volatility to the SII framework.
- Pushing insurers towards otherwise unnecessary procyclical behaviour.
- Making it harder for insurers to offer long-term guarantees.
- Pushing insurers towards extensive derivative usage
- Overestimating the value of very long-term liabilities when rates are low and underestimating them when rates are high.

## Insurance Europe view:

To avoid these negative impacts, Insurance Europe supports a calibration of the convergence parameter of 15% (and 70% for the Swedish Krona).

While the impact of a lower convergence parameter is lower in more normalised market environments, it will have a significantly detrimental impact in lower interest rate environments.

In addition, EIOPA and the Commission claim that a convergence parameter of 40% for the Swedish krona would be comparable to status quo[5]. However, this is not accurate, especially when interest rates are low. For example, in June 2020 the risk-free interest rate would have been more than 20 basis points lower with a convergence parameter of 40% (see graph below). The difference would be less with a convergence parameter of 70%.

**Difference in the risk-free interest rate for the Swedish krona in June 2020 between the current extrapolation method and with a convergence parameter 40%/70% (in basis points)**



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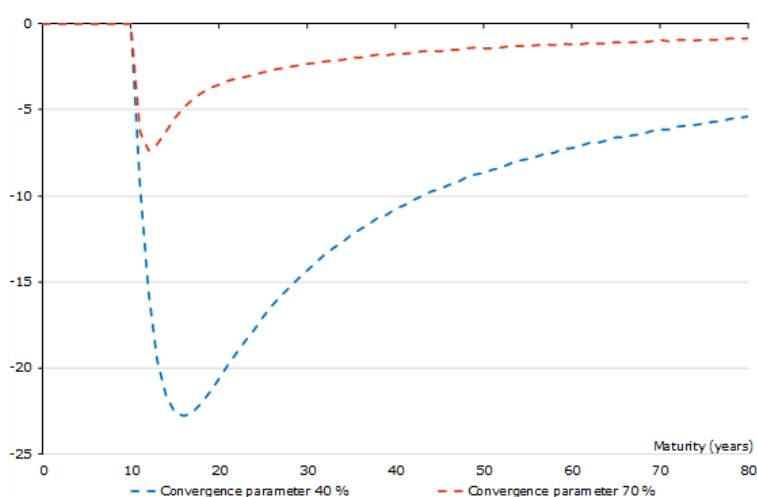
[5] See e.g., EIOPA (2020), Opinion on the 2020 review of Solvency II.

# Risk Margin

## Background

The risk margin is part of an insurer's liabilities (known as "technical provisions") on the Solvency II balance sheet. It is an additional buffer held by insurers, above the best estimate which is expected to be required to pay all customers' claims and benefits, including administration costs.

Its theoretical prudential purpose is to ensure that, in the rare event of an insurer's failure, sufficient funds are available to transfer the insurer's liabilities to a third party, such as another insurer, thereby enabling an orderly run-off of the portfolio.

## Issues with the current risk margin approach

The issues with the risk margin are:

- it is very excessively calibrated,
- it penalises long-term products and
- it introduces excessive volatility.

The risk margin, amounting to €141[6] Bn for the industry, is significantly higher than necessary. This is because the risk margin, and in particular the Cost of Capital parameter, were not correctly calibrated when the Solvency II Directive was being developed.
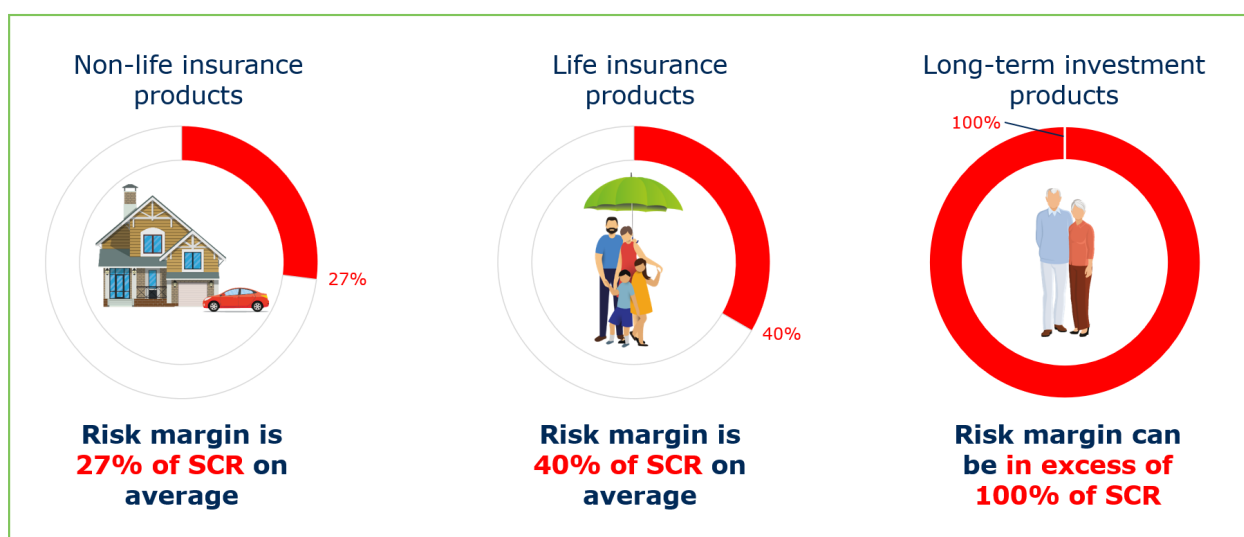


The current methodology also introduces unnecessary volatility to solvency positions by placing too much emphasis on the very long-term projections.

This excessive level and additional volatility introduced reduce insurers' own funds and limits their risk taking and investment capacity.

## Proposed reforms

In their agreed revisions to the Solvency II Directive, the co-legislators recognised the issues outlined above and noted their intention to reduce the burden of the risk margin.

To address these issues, the co-legislators agreed to set the Cost of Capital rate at 4.75%. This is a key change, fully supported by industry, that alleviates some of the excessive capital requirements.

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[6] EIOPA Annual Solo statistics 2022

The co-legislators also strongly supported changes to design of the risk margin to address the punitive treatment of long-term business and to address the excessive volatility. This is noted in recital 33a which states that:

*"In addition, the calculation of the risk margin should account for the time dependency of risks and reduce the amount of the risk margin in particular for long-term liabilities. This would reduce the sensitivity of the risk margin to interest rate changes. An exponential and time dependent element should be introduced to implement this adjustment"*

To achieve the co-legislators' stated intentions and deliver the necessary improvements, the calibration of the exponential and time-dependent element (known as the lambda parameter) is critical and crucial.

## Calibrating the lambda parameter

Insurance Europe has previously evidenced why a reduction in the risk margin of at least 50% is justified (see here).

As such, Insurance Europe fully supports setting the lambda parameter to a level which would reduce, in conjunction with the 4.75% Cost of Capital rate, the size and volatility of the risk margin by around 50% from current levels.

**Concretely, this means <u>the lambda parameter should be set to 92.5% without a floor.</u>**
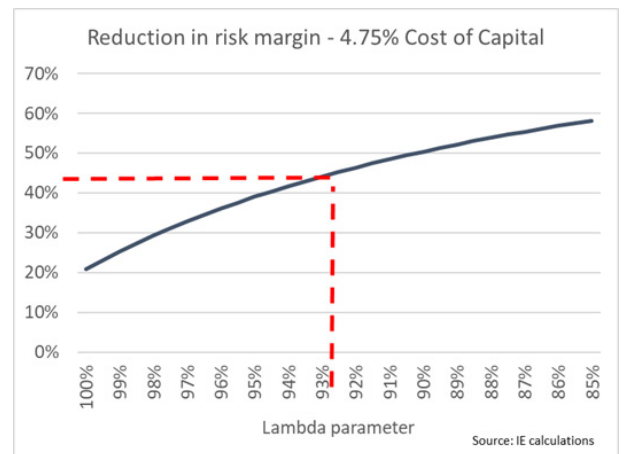


It is worthwhile highlighting that other prudential regimes either do not apply a risk margin (USA, Japan, China) or have a significantly lower risk margin than that in Solvency II. For example, in the UK, the PRA has provided support to the 70% reduction of the risk margin for long-term business through a reduced cost of capital rate and a 0.9 lambda. The necessary reduction of the risk margin, also to take EU's insurers competitiveness into account, can only be achieved by a decline of the Cost of Capital rate to 4.75% and by setting the lambda to 92.5% without a floor.

## Risk Margin Comparison



| | | | | |
|---|---|---|---|---|
| Cost of captal: | 4,75% | 3,00% | 4,00% | n/a |
| Lambda: | ? | n/a | 0,90 | n/a |
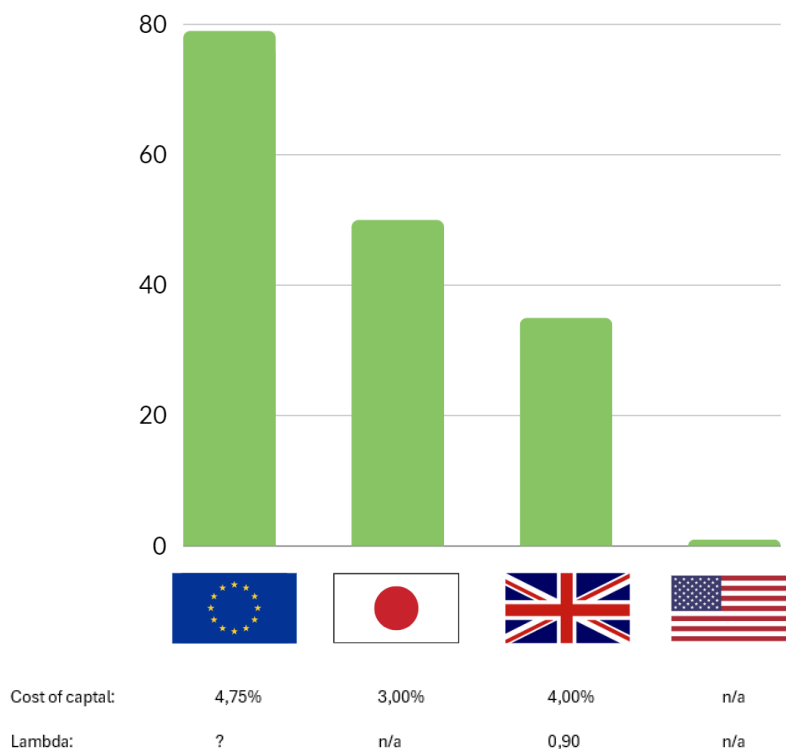
## Other improvements

In addition, counter-intuitively, diversification between risks at group level is not permitted when calculating the risk margin. This contrasts with other areas of the Solvency II regulation (SCR, risk margin at solo level) and practical experience – where there are many examples where groups have transferred policies as a whole.

By not allowing for diversification between different entities within a group, the current approach to calculating the risk margin has the effect of artificially increasing the projected SCRs at group-level and hence leads to an overinflated risk margin.

To address this shortcoming, the arbitrary separation of obligations should be removed, and the risk margin methodology should be amended to allow for diversification between all risks and legal entities at group level, for example by changing the Delegated Regulation as set out in the annex.

The replacement of Art. 340 of the DA in the proposed manner would lead solely to a change in the calculation technique for the risk margin on Group level but have no consequences (e.g. in terms of reallocation) to the calculation on legal entity level, thus ensuring the same level of policyholder protection at entity level.

## Annex – proposed amendments needed to address the diversification

Replace Art. 340 of the DA with: Method 1: Risk Margin

*The consolidated risk margin of technical provisions on the basis of the consolidated data shall be calculated on the basis of consolidated data referred to in Article 335(1)(a), (b) and (c) of this Regulation following the rules laid down in articles 37 to 39 of this Regulation.*

*For the purposes of this calculation, Art. 38.1(b) should not apply.*