Solvency II

Technical Specifications for the Preparatory Phase

Comparison between Technical Specifications dated 30 April 2014 and Draft Level 2 Delegated Acts dated14 March 2014

June 2014

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This report was prepared by EY's Global Insurance Risk and Regulatory Taskforce; it provides a comparison between the Technical Specification for the Solvency II Preparatory Phase and the Draft Delegated Acts dated 14 March 2014. Only changes that affect the substance of the calculations are highlighted. Where no change is observed , nothing is mentioned.

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Introduction

Omnibus II was approved in a plenary vote of the European Parliament on 11 March 2014 and by the European Council on 16 April 2014 formalising the agreement reached between the Trialogue parties (the European Parliament, European Council and European Commission) on 13 November 2013. The definitive text was published in the Official Journal of the European Union on 22 May 2014 and is now in force.

Attention has now moved to Level 2 (formed of Delegated Acts and Implementing Technical Standards). The more detailed requirements provided by the Delegated Acts are expected to become stable later in Spring 2014 and be formally proposed by the Commission in Summer 2014 when they will be subject to "3+3" approval/rejection by Council and/or Parliament.

The latest version of the draft Delegated Acts was issued on 14 March 2014. These build on changes introduced in the earlier iteration of draft Delegated Acts of 10 January 2014, which had been issued by the Commission for an initial informal consultation. It is worth noting that the extent of the drafting changes made between January 2014 and March 2014 was significantly smaller than the changes previously seen between October 2011 and January 2014, which suggests that the text is getting close to finalisation.

The draft Delegated Acts are not public documents and, on 30 April 2014, EIOPA issued Technical Specifications for the Preparatory Phase ("the Technical Specifications") to be applied in the EIOPA 2014 stress tests that many companies have been asked to provide by July 2014 and also in the 2015 Solvency II preparatory reporting. These Technical Specifications only cover Valuation, SCR standard formula, Minimum Capital Requirements and Own funds including group consolidation. In general, the Technical Specifications include more detailed explanation of the technical requirements than in the Delegated Acts themselves and include, in places, small refinements to the 14 March 2014 draft Delegated Acts.

This document sets out details of the changes we have identified between the 14 March 2014 draft Delegated Acts and the 30 April 2014 Technical Specifications and provides comments on the possible implications of these changes.

Executive Summary

Key discussion points from 30 April Technical Specification

The Technical Specification provided by EIOPA at 30 April 2014 covers the outcomes of the long-term guarantees package and the transitional arrangements. It also includes some refinement to the 14 March 2014 draft Delegated Acts and provides the calibration for the calculation of technical provisions and standard formula SCR as at 31 December 2013. Important points arising are:

Risk-free interest rate

- Last Liquid Point has been based on EIOPA analysis and varies between different economies (e.g. 7 years in Croatia, 50 years in the UK and US)
- Ultimate Forward Rates have been set at 4.2% pa for all economies, except for Japan, Switzerland and Liechtenstein which use 3.2%pa
- Adjustment for credit risk is based on 50% of the 12 month average difference between the interbank offer rate and the overnight indexed average rate subject to a cap and floor of 35 basis points and 10 basis points respectively. The value as at end 2013 is 10bps (deduction from curve).
- Volatility adjustment is calculated based on 65% of the spread on the reference portfolio, in line with previous information from EIOPA. The Specification confirms that the volatility adjustment is not adjusted in the SCR stresses.
- Details of the Fundamental Spread have been provided by EIOPA for calculating the Matching Adjustment. SCR Interest Rate Shocks will be calculated before applying the matching adjustment, however, the fundamental spread is adjusted in the spread risk submodule.
- The final methodology for all these aspects of the risk-free rate is still under development

Capital during the Preparatory Phase

- Own funds that do not meet Tier 1 or Tier 2 requirements can be included as restricted Tier 1 or Tier 2 under transitional arrangements if these own fund items are currently used under Solvency I. The cap on restricted Tier 1 remains at 20% of total Tier 1 items.
- Firms will need to decide what capital to include in Preparatory Phase. If firms include items of capital by virtue of the transitional arrangements or include items that will require supervisory approval, their inclusion will not influence the subsequent decision by the supervisor.

Standard Formula SCR

- The Technical Specification sets the SCR equity stress at 46.5% for type 1 equities and 56.5% for type 2 equities, including the symmetrical adjustment. This is higher than the stresses used under the QIS 5 exercise and those currently resulting in some firms' internal model calculations.
- Clarification that companies that are using different structures for real estate assets or collective real estate investment schemes are subject to a “look-through” approach (unless they are related undertakings). Investment in companies engaged in real estate management and development are treated as equity and are subject to a higher SCR shock.
- Clarification of the treatment of securities lending and repurchase agreements, including the requirement to hold counterparty default risk capital for the lent asset in addition to market risk capital to the lent and / or received asset depending on what is recognised on the balance sheet
- Simplifications for captives have been removed
- The use of undertaking-specific parameters is not permitted during the Preparatory Phase

Pension Schemes

- The Technical Specification advises firms that the effect of all market and counterparty risk scenarios should be properly reflected in the post-shock value of employees' benefits. However underwriting stresses do not apply as employee benefits are not strictly insurance obligations.
- If management of the pension scheme is outsourced, firms will need to look-through to calculate the market risk charge.
- The specification refers only to insurance and reinsurance obligations in defining the requirements for the risk margin calculation, which suggests that any SCR held in respect of pension scheme obligations does not need to be taken into account.

Groups

- Additional guidance relating to the treatment of third country insurance activities over the Preparatory Phase is provided, however an equivalence assessment will still be required
- The adjustment for the loss absorbing capacity of technical provisions and deferred taxes under method 1 uses a relatively simplified approach and should be easy for firms to implement

Technical specifications

Differences against 14 March 2014 Draft Delegated Acts

Overview of the Technical Specifications

The Technical Specifications provided by EIOPA for the Solvency II Preparatory Phase provide the necessary parameters and inputs for calculations to be conducted as at 31 December 2013. In terms of the content, there are limited changes against the draft Delegated Acts of 14 March 2014, although the format of the Technical Specification is very different and direct comparison is not straightforward. Additional guidance is provided in a number of areas (see below) and there are a few areas where requirements from the Delegated Acts are not included, such as the removal of risk factors applying to aspects of concentration and counterparty default calculations.

The specification is provided in two parts and we have reviewed each part for differences against the Delegated Acts of 14 March 2014. Part II is new information and covers the risk-free interest rate term structure and transitional measures on technical provisions. Part I covers the various aspects of the balance sheet and standard formula SCR as follows:

- Section 1 of the Technical Specification covers technical provisions and provides further requirements and guidance relating to the discount rate and in particular the inclusion of the matching adjustment, volatility balancer and credit risk adjustment. This is a significant development area from the 14 March 2014 Delegated Acts. The guidance in these areas requires some interpretation, for example regarding the assets to which the matching adjustment is assumed to apply.
- Section 2 covers the standard formula SCR calculation. Further instruction is provided on the treatment of pension schemes, including the treatment of outsourced or reinsured arrangements relating to the pension scheme. There is also significant further guidance on the allowance for risk mitigation, which clarifies amongst other things the need to segregate the impact of risk mitigation from the additional risk relating to the instruments used for risk mitigation.
- Section 3 of the Technical Specification covers the Minimum Capital Requirement and will have minimal impact on most firms.
- Section 4 covers Own Funds and in particular provides guidance on the transitional arrangements over the Preparatory Phase for own fund items that cannot be classified as Tier 1 or Tier 2 under Solvency II but are currently used to meet solvency requirements under the current regime.
- Section 5 covers Groups and includes guidance on the treatment of undertakings outside the EEA during the Preparatory Phase. As in other areas of the Technical Specification (e.g. transitional arrangements for Own Funds, above) it highlights that any agreement reached with the regulator will apply during the Preparatory Phase only and will not determine how that item is ultimately treated under Solvency II.

In summary, the Technical Specifications provide a very helpful further indication as to the final Solvency II rules. However, firms will still need to apply their own interpretation and judgement in a number of areas and will need to monitor further developments and the evolving industry and regulatory practice in the coming months.

Technical Specification (Part 1)
Differences against 14 March 2014 draft Delegated Acts

1. Valuation and Technical Provisions

Valuation	Valuation and Technical Provisions	Potential Implications
Valuation	**Assets and other liabilities** ▶ A detailed table setting out all relevant IFRS standards is included in the Technical Specification.	▶ Similar tables have been provided in the LTGA and QIS 5 technical specifications. ▶ The impact is limited as it is clear that IFRS can be applied if the requirements in Article 75 of the Solvency II Directive were met.
Valuation	**Discounting (See also slide 12)** ▶ Part II of the Technical Specifications provides details on the basic and relevant risk-free interest rate term structures, the volatility adjustments and application of matching adjustment to be used for the purpose of calculating technical provisions and capital requirements in the Preparatory Phase.	▶ A number of aspects relating to discounting, the volatility adjustment and the application of the matching adjustment still require clarification by the final Delegated Acts.

2a. Overall SCR Structure

Overall SCR Structure	Overall SCR Structure	Potential Implications
Overall SCR Structure	**SCR General remarks** ▶ The Technical Specification clarifies that the SCR is determined as the impact of specified scenarios on the level of basic own funds (BOF), which excludes subordinated liabilities.	▶ Undertakings should review their methodology to ensure that subordinated liabilities are excluded from the impact of SCR stress calculations.
Overall SCR Structure	**SCR General remarks about employee benefits** ▶ In the Technical Specifications there are additional clarifications regarding employee benefits and the assets covering them. ▶ The effect of all market and counterparty risk scenarios should be properly reflected in the post-shock value of employees' benefits ▶ Clarification that SCR stresses do not apply to activities under the IORP Directive. ▶ However underwriting stresses do not apply as employee benefits are not insurance obligations. ▶ In case that the management of the assets representing the employee benefit liabilities have been outsourced, but the insurance undertaking, acting as a sponsor, is liable for any loss of value of these assets, then the outsourcing arrangement should be looked through for the calculation of the market risk capital charge.	▶ In the case of an intercompany reinsured plan, the underlying investments in financial instruments are subject to IAS 39 (future IFRS 9) and only the defined benefit obligation meet the requirements of IAS 19. ▶ In determination of the market and counterparty risk SCR the underlying risks of these employee benefits should be considered. The risks depend on the legal structure and arrangements made. ▶ In case of external reinsured employee benefit plans the risks associated with the counterparty should be assessed ▶ If the employee benefit is internally reinsured, the contract is subject to longevity and expense/inflation risk. The related investments portfolio is subject to market risk.

Technical Specification (Part 1)
Differences against 14 March 2014 draft Delegated Acts

SCR market risk module

2b. SCR Market Risk Module	Potential Implications
Securities lending and repurchases ▶ The capital requirement for securities lending and repurchase agreements is based on the items exchanged on the balance sheet and considers the contractual terms and risks arising from the agreement. ▶ Clarification that a counterparty credit risk charge is required on the lent asset. Relevant market risk charges are applied to the lent and / or received asset depending on whether they are recognised on the insurer's balance sheet.	▶ Undertakings should review the methodology used to calculate the SCR for securities lending and repurchase agreements and ensure it reflects the underlying assets exchanged. ▶ Under some lending arrangements, it would be possible to receive both a market risk charge and a counterparty default risk charge on the lent asset (i.e. if it is still recognised on the undertaking's balance sheet).
Equity Risk ▶ The Technical Specification clarifies that the equity stress should take account of a symmetric adjustment according to Article 106 of Directive 2009/138/EC.	▶ Based on a 31/12/2013 valuation date, the equity stress will be 46.5% for type 1 and 56.5% for type 2 equities for calculations in the Preparatory Phase as at 31 December 2013. This is higher than the stresses used under the QIS 5 exercise.
Property Risk ▶ Investments in companies engaged in real estate management and development are treated as equity. ▶ Companies that are holding structures for real estate assets or collective real estate investment schemes are subject to a "look-through" approach (unless they are related undertakings).	▶ Exposures to companies involved in real estate management and development (rather than direct property holdings) are now subject to a higher risk charge under the equity SCR sub-module.
Spread Risk ▶ In table for exposures to central governments and central banks the Fup factor in credit quality step 3 and duration between 15 and 20 years is 13% + 0%. In the March 2014 Draft Delegated Acts this was 13% + 0.5%.	▶ It is likely that the omission of 0.5% in the Technical Specification is an error.
Concentration Risk ▶ Specification makes no mention of situations where the credit assessment for concentration risk was previously fixed at 64.5% (transitory year and equivalent regimes).	▶ This means that the 73% will apply for concentration risk in the Preparatory Phase instead of the 64.5% risk factor.
SPV notes ▶ The Technical Specifications specify that SPV notes that have the features of fixed interest bonds, have a credit quality step of 3 or better and meet other conditions are subject to spread risk, interest rate risk and concentration SCR sub-modules. Otherwise the SPV notes are subject to the equity risk SCR sub-module.	▶ SPV notes with features of fixed interest bonds may receive a lower capital charge compared to other SPV notes.

Technical Specification (Part 1)
Differences against 14 March 2014 draft Delegated Acts

2c.	Other SCR Risk Modules	Potential Implications
Counterparty default risk	**Calculation of capital requirement for type 1 exposures** ► Added additional guidance with respect to exposure to counterparties which belong to the same group. ► Clarification that where a risk mitigation instrument transfers both underwriting risk and market risk, the risk mitigating effect should be calculated by the aggregation between the risk-mitigating effect in relation to underwriting risk and the market risk.	► Undertakings should review the calculation of the risk mitigation effect for instruments that transfer both underwriting and market risks.
Life underwriting	**Waiting period in disability-morbidity risk** ► Additional guidance has been added in relation to the waiting period in the disability / morbidity shock. ► The waiting period should be assessed for each individual policy. If the waiting period has already expired, then the full value of the disability-morbidity shock should be taken into account. If the waiting period is still pending, then the shock would need to be decreased proportionally to the non-expired part of the waiting period.	► It is likely that this approach may already have been in use by the undertaking prior to the new guidance being published.
Captives	**Simplifications for captives** ► Simplifications for spread risk, interest rate risk, market risk concentration and non-life premium and reserve risk SCR modules have been removed. ► Simplifications are permitted in the counterparty default risk SCR module where an undertaking has exposure to a captive.	► Captives should revisit their SCR methodology and investigate the impact of removal of the SCR simplifications. ► Undertakings with exposure to captives should investigate whether they are able to use the simplifications set out in the Technical Specifications.

Technical Specification (Part 1)
Differences against 14 March 2014 draft Delegated Acts

2d. Risk Mitigation

Risk Mitigation		Potential Implications
Risk Mitigation	**Financial and insurance risk mitigation** ▶ The Technical Specifications include significant further guidance on the treatment of financial and insurance risk mitigation. ▶ It clarifies that firms should separate the effects of the reduction in the SCR requirements commensurate with the risk mitigation and the corresponding risk in the use of the risk mitigation technique ▶ The risk mitigation technique should not anticipate shocks used in SCR calculation. The SCR is intended to capture unexpected risks." ▶ There is additional explanation and guidance for determination of material basis risk in BSCR calculations resulting from risk mitigating contracts ▶ For insurance risk mitigations the specification confirms that remote risks should also be considered. ▶ Additional requirements are included in order to benefit from insurance risk mitigation provided by non-EEA SPVs. ▶ There is no reference in the Technical Specification to the partial recognition of the protection given by a reinsurance contract, where the counterparty has ceased to comply with the SCR, but has submitted a realistic recovery plan to the regulator (art. 186 SCRRM3 (2)). ▶ Similarly, there is no reference to the partial recognition of risk-mitigation provided by a SPV that has ceased to be fully funded, but demonstrates that it can restore compliance within three months (art. 186 SCRRM3 (3)).	▶ The additional guidance provides helpful clarification of how risk mitigation should be taken into account in the SCR derivation and is similar to technical specifications released by EIOPA previously. ▶ Any risks embedded in risk mitigating contracts should be examined and taken into account in the calculation of the SCR. ▶ Attention should be paid to basis risk when using risk mitigating techniques as the instrument itself also includes new risks that should be considered. ▶ The omissions relating to counterparties in breach of the SCR, or SPVs that are no longer fully funded, will reduce the benefit gained from risk mitigation via these counterparties.

3. Minimum Capital Requirement

Minimum Capital Requirement		Potential Implications
Minimum Capital Requirement	**Absolute floor AMCR** ▶ The values of the absolute floor AMCR have increased for all insurance undertaking types and is now consistent with Omnibus II (Directive 2014/51/EU).	▶ The change will have an impact only on the undertakings for which the value of combined MCR is lower than AMCR. For these companies, the change will result in higher MCR.
Minimum Capital Requirement	**Linear formula component for life insurance and reinsurance obligations** ▶ The function used to calculate linear life MCR has been changed: technical provisions in relation to future discretionary benefits are included in Delegated Act with a plus sign and in Technical Specifications with a minus sign .	▶ We believe this is a drafting error in the March 2014 Draft Delegated Acts. The deduction of technical provisions related to future discretionary benefits in the MCR formula is consistent with previous versions of the Draft Delegated Acts, October 2011 Draft Level 2 Implementing Measures and the LTGA Technical Specifications.

Technical Specification (Part 1)
Differences against 14 March 2014 draft Delegated Acts

4. Own Funds | Potential Implications

Own Funds	Potential Implications
Transitional arrangements ▶ Own funds that do not meet Tier 1 or Tier 2 requirements can be included as restricted Tier 1 or Tier 2 under transitional arrangements if these own fund items are used to meet up to 50% of the solvency margin under the current regime (restricted Tier 1) or 25% of the solvency margin (Tier 2). ▶ The cap on restricted Tier 1 remains at 20% of total Tier 1 items. ▶ The use of transitional arrangements is not to be considered as a pre-approval of the item.	▶ Undertakings should consider whether transitional arrangements on own funds is beneficial and apply for supervisory approval from their regulator. ▶ Undertakings should consider whether current own fund items that don't qualify under the transitional arrangements should be replaced before 1/1/2016.
OF Tier 1 /2 /3 Own Funds ▶ The reconciliation reserve does not include a reduction for items that are not classified as basic Tier 1 but been approved by the supervisory authority. ▶ Foreseeable dividends or distribution – A dividend or distribution shall be foreseeable at the latest when it is declared or approved by the administrative, management or supervisory body of the insurance or reinsurance undertaking and the other persons who effectively run the undertaking, regardless of any requirement for formal approval at the annual general meeting. ▶ Own shares held by the undertaking shall include direct and indirect holdings. ▶ The definition of an undated basic own fund item is confirmed to be where the first contractual opportunity to repay or redeem the basic own-fund item does not occur before 5 years from the date of issuance. However contractual terms providing for a call option prior to 5 years from the date of issuance in case of unforeseen changes, outside the control of the undertaking, may be permitted with prior supervisory approval. ▶ Cancellation of distributions in case of non-compliance with the SCR - the inclusion of an 'alternative coupon satisfaction mechanism' as part of the contractual agreement is conditional on meeting specific requirements.	▶ These items should only be deducted if these are included in the Tier 1 own fund items from a select list. However items requiring supervisory approval are not in scope of the Preparatory Phase. ▶ In our view, under IFRS dividends should be presented as equity until formally approved by the general meeting of shareholders, when the dividend becomes a legal liability. SII would deviate from IFRS rules in this respect. ▶ This clarification of the treatment of own shares is in line with expectations. ▶ Firms should investigate the terms of the call options that it has written. ▶ The specific requirements, including whether the distribution can be settled by means of issuance of ordinary share capital, should be investigated for putting this mechanism into place.
OF Tier 2 and 3 Ancillary Own Funds ▶ Own fund items which currently exist but which do not count towards the available solvency margin may in the future be approved as Tier 2 or Tier 3 ancillary own funds. However these cannot be included in own funds during the Preparatory Phase.	▶ There is a possibility for current own fund items that do not meet basic own fund requirements to be classified as ancillary own funds.

Technical Specification (Part 1)
Differences against 14 March 2014 draft Delegated Acts

5. Groups

Potential Implications

Groups

Equivalence

- Additional guidance relating to the treatment of third country insurance activities during the Preparatory Phase
  - EEA groups that have a related third country (re)insurance undertaking
  - Third country groups that have an EEA subgroup
  - Third country reinsurers that reinsure EEA undertakings
  - Swiss participating groups can apply the Swiss Solvency Test if they participate at the ultimate group level in Switzerland

Potential implications:

- Although for the purposes of the Preparatory Phase, equivalence may be assumed (and so third country undertakings can be consolidated on local rules etc), third country insurance activities will still ultimately be subject to an equivalence assessment as set out in the Directive and the assumptions used in the Preparatory Phase may not be valid for full implementation.

Deduction and aggregation method for consolidation

- During the Preparatory Phase, groups that elect to use the deduction and aggregation method or a combination of methods should discuss it with their group supervisors.

Potential implications:

- Any decision of the group supervisor taken in this regard is relevant only during the Preparatory Phase and it cannot be regarded as approval on the choice of the calculation for Solvency II.

Treatment of related collective investment undertakings under method 1

- Related collective investment undertakings are treated as participations and are to be valued using the “equity method”

Potential implications:

- “Look through” requirements are likely to remain applicable to related collective investment undertakings in calculating the market risk SCR.
- If the related collective investment undertaking is a strategic participation then a reduced equity stress of 22% is applicable

Group technical provisions

- The Specification clarifies that the calculation of the technical provisions within the group should include any long term guarantee measure applied at a solo level.

Potential implications:

- The impact on the Group calculation will be minimal if these results are available at solo level.

Group consolidation

- Under method 1, the adjustment for the loss absorbing capacity of technical provisions and deferred tax is based on the solo loss absorbing capacity calculations and the solo and consolidated SCR
- Clarification on removal of restricted own funds in the Group own funds, including ring-fenced funds and matching adjustment portfolios.

Potential implications:

- The adjustment for the loss absorbing capacity of technical provisions and deferred taxes under method 1 uses a relatively simplified approach and should be easy for firms to implement

Technical Specification (Part 2)
Differences against 14 March 2014 draft Delegated Acts

Risk-Free Interest Rate

Determination of the Risk-Free Interest Rate Term Structure	Potential Implications
Basic risk-free interest rate structure - overview ► Part II of the Specification describes how basic risk free term structure has been derived and is applied in the Preparatory Phase. ► Final methodology is still under development but the Technical Specification also describes how the transitional arrangements should be applied.	► Specification sets out the risk free rates as at 31 December 2013. EIOPA will also specify rates at 31/12/2014 and 30/09/2015. ► Matching adjustments and the application of the transitional arrangements are company specific.
Last Liquid Point ("LLP") ► Basic risk-free interest rates have been derived from swap rates in most countries. Government bond rates used where the swap market is not deep, liquid and transparent. ► LLP based on EIOPA analysis of swap and government bond curves and varies significantly between different economies (e.g. 7 yrs in Croatia and 50 yrs in UK and US)	► EIOPA has supplied a risk-free curve taking into account the last liquid point, the adjustment for credit risk and the ultimate forward rate (see below).
Deduction from risk-free curve for credit risk ► The adjustment for credit risk is based on 50% of the 12 month average difference between the interbank offer rate and the overnight indexed average rate subject to a cap and floor of 35 basis points and 10 basis points respectively. ► The value as at end 2013 is a fixed deduction of 10basis points across the curve.	► The deduction is currently 10 basis points but would have been 35 basis points during 2009. ► For currencies pegged to the Euro (Denmark, Bulgaria) there is a further credit risk adjustment to make.
Ultimate Forward Rate ► For the Stress Test Ultimate Forward Rates have been set at 4.2% pa for all economies, except for Japan, Switzerland and Liechtenstein which use 3.2%pa.	► The UFR has been used by EIOPA in the extrapolation of the risk free curve beyond the last liquid point. The speed of convergence parameter (provided) determines the path of the extrapolation.
Volatility Adjustment ► The volatility adjustment is calculated using the reference portfolios, formulae and fundamental spread provided. ► It is based on 65% of the calculated spread on the reference portfolio.	► The volatility adjustment is applied to the liquid curve and doesn't impact the ultimate forward rate. ► The volatility adjustment is not applied alongside the matching
Matching Adjustment ► The criteria for the use of the matching adjustment are set out within the specification. ► Details of the Fundamental Spread have been provided by EIOPA for calculating the matching adjustment.	► The SCR interest rate shock will be calculated before applying the matching adjustment. However, the fundamental spread is adjusted in the spread risk submodule.
Transitional measures on risk free rate ► Formulae provided for calculation of the transitional discount curve over 16 year transitional period.	► In the Preparatory Phase firms assume they are at start of transitional process. ► Transitional measure cannot be applied alongside matching adjustment.

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