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1 March 2010

CEIOPS Cover letter to the report of the TF on the Illiquidity Premium

Dear Jorgen,

I am very pleased to submit to you the report of the CEIOPS Task Force on the Illiquidity Premium with technical considerations for the application of a liquidity premium for the valuation of insurance liabilities, principles for extrapolation and considerations on the choice of the reference risk-free rate.

Considering the extremely sensitive nature of the discussion, and the potentially high impact the discounting of technical provisions will have, I am sure you will agree with me that the results achieved by the Task Force are impressive given the very short time available.

The Task Force was set up by CEIOPS following its Members Meeting held on 29 October 2009 where CEIOPS Members agreed to lead further work on the issue of the inclusion of a liquidity premium in the risk-free rate for discounting technical provisions as an additional input for Level 2 implementing measures. The aim of the Task Force was to consider, from a technical point of view, the implications of allowing for a liquidity premium in order to provide Members with the technical background information to advise the political level in this area.

In doing so, the Task Force was to take into account considerations expressed in CEIOPS' advice for Level 2 implementing measures and previous work done by stakeholders. Therefore, CEIOPS decided that a balanced and fully comprehensive composition of the Task Force would ensure that all different viewpoints would be taken on board in the technical discussions, and invited stakeholders to join the Task Force. CRO/CFO Forum, CEA, Groupe Consultatif, AMICE and Prof. Antoon Pelsser from Maastricht University as a representative from an academic perspective were invited to discuss this issue with a small group of CEIOPS Members. Commission services were invited as observers to the discussions, too.

In carrying out the work, the Task Force has taken into account the guidance it received from the Commission, in your letter from 17 November 2009, in which you asked CEIOPS not only to discuss the liquidity premium, but also the extrapolation and the issue of swap vs. government bond rate. The Task Force has met five times since mid-December, with the last meeting held on 24 February.

We are aware of your request made on 11 February 2010 to the industry to provide further input on the calculation method for the liquidity premium and on the adjustments to be made to the swap rate in case this would be chosen as the risk-free rate structure, by 24 February. We are looking forward to receiving your further guidance on this for the purpose of the QIS5 exercise. CEIOPS is continuing, in the Financial Requirements Working Group, to develop a sound calculation method for extrapolating interest rate structure for all currencies in due time for the draft QIS5 Technical Specifications.

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The report was submitted to CEIOPS' Members, in order to allow them to form their opinion on the conclusions of the Task Force. Based on a survey carried out among CEIOPS Members, I would like to point out the following additional observations on behalf of CEIOPS:

1. CEIOPS Members agree that, if a liquidity premium were to be adopted, the principles put forward by the Task Force could constitute an adequate basis for the recognition of the liquidity premium at Level 2.
2. However, CEIOPS' Members are still divided on the question whether a liquidity premium should actually be applied to insurance liabilities, even if limited to the situation of a stressed liquidity position. The main concerns with regard to the addition of the liquidity premium to the risk-free rate can be summarized as follows:
    a. There are concerns on the **theoretical soundness, reliability and appropriate back-testing of the proposed methods** to determine a liquidity premium in the discount rate of cash-flows arising from insurance liabilities based on the degree of liquidity of these liabilities.
    b. If the best estimate is to be reduced through the application of a higher discount rate (risk-free rate plus liquidity premium), the question arises whether this best estimate will be sufficient in order to **transfer the insurance liabilities** in line with Article 76 of the Directive. In short, the inclusion of a liquidity premium may complicate the possibility to move the insurance obligations between companies and limit policyholder protection.

c. The introduction of a liquidity premium is being proposed to eliminate the **mismatch between assets and liabilities**, especially in times of crisis. This purpose is based on the assumption that asset and insurance cash-flows are adequately matched, which is not always the case. Furthermore, during periods of financial stress, some types of liabilities may become more liquid (through the rise in the number and amounts of surrenders for instance) than in normal circumstances. Additionally, by including a liquidity premium in the valuation of the best estimate, undertakings may be obliged to earn this premium on the asset side and therefore increase the risk through the assets held, even unintended.

d. The use of a liquidity premium clearly **introduces additional complexity**, also in the standard formula for calculating capital requirements.

e. Finally, it may be discussed whether in order to reduce artificial volatility on the balance sheet, efforts should be made to exclude unreliable and stressed market inputs for both the valuation of assets and liabilities. Having in mind the discussions held last year on fair value of asset, it could be considered to adjust the **value of assets** which do not meet the definition of active or deep liquid and transparent markets. This would then limit the need to introduce unreliable and stressed market inputs in the risk-free rate.

CEIOPS formally invites the Commission, when drafting its Level 2 implementing measures, to consider all the aforementioned concerns and the challenges they pose.

3. Consistent with the ideas of convergence and harmonization of regulatory and supervisors practices, if a liquidity premium were to be applied to the risk-free interest rate, it is key to ensure a **level playing field concerning the scope of application**. To which liabilities should this premium be applied and should this be applied on a permanent or transitional basis (i.e. to ensure a smooth entry into force of Solvency II)?

   Following the survey of CEIOPS' Members, it can be generally concluded that the scope for applying the premium should be limited to liabilities with the highest possible degree of illiquidity. The premium would then apply or not; a more granular or bucket approach according to the degree of illiquidity of the liability would not be supported.

   If a liquidity premium were to be applied to such liabilities, the majority of CEIOPS' Members would agree to apply this on a permanent basis, with the proviso that if there is no premium to be observed in the market, the liquidity premium would also be set to zero.

4. With regard to the **choice of the reference rate,** CEIOPS' Members are still split on the basis of consistency with a risk-free rate and the accuracy of proposed methods. With further work being carried out by the industry at the

request of the Commission, CEIOPS Members are waiting to see the outcome of such work.

5. With regard to **extrapolation of the reference rate beyond the last available data point**, the principles included in the report are supported by the large majority of CEIOPS' Members. At the same time, Members agree that a practicable and robust solution needs to be found to ensure stability and avoid unnecessary volatility. CEIOPS will continue the work with regard the methodology for the extrapolation rate.

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I am optimistic that the report and the considerations in this letter will allow the Commission to further prepare and discuss its proposals for Level 2 implementing measures with regard to the valuation of technical provisions.

CEIOPS stands ready to further contribute to the discussions on the measures to implement the Solvency II regime in order to ensure that technical provisions will be calculated in a prudent, reliable and objective manner.

Best regards,

Gabriel Bernardino

CEIOPS Chair