Comments Template on CEIOPS-CP 40 Consultation Paper on the Draft L2 Advice on TP – Risk free interest rate		Deadline 11.09.2009 4 p.m. CET
Name of Company:	**PricewaterhouseCoopers LLP**	
Disclosure of comments:	CEIOPS will make all comments available on its website, except where respondents specifically request that their comments remain confidential. Please indicate if your comments should be treated as confidential:	No

Please follow the following instructions for filling in the template:

- ⇨ Do **not** change the numbering in the column "reference".
- ⇨ Please fill in your comment in the relevant row. If you have no comment on a paragraph, keep the row empty.
- ⇨ Our IT tool does not allow processing of comments which do not refer to the specific paragraph numbers below.
  - If your comment refers to multiple paragraphs, please insert your comment at the first relevant paragraph and mention in your comment to which other paragraphs this also applies.
  - If your comment refers to sub bullets/subparagraphs, please indicate this in the comment itself.

Please send the completed template, in Word Format, to secretariat@ceiops.eu. Our IT tool does not allow processing of any other formats.

The numbering of the paragraphs refers to Consultation Paper No. 40 (CEIOPS-CP-40/09).

Reference	Comment	
General Comment	We have two comments of significant note on this Consultation Paper. The comments relate to the exclusion of an illiquidity premium in determining the discount rate and the definition of the Eurozone risk free rate as the European Central Bank "AAA" rated term structure. Please refer to paragraphs 3.30 and 3.34.	

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3.9.	There may be some question over the level of robustness of the data underlying the term structure given the likely volatility in the current economic environment.	
3.10.	We caution that a "deep, liquid and transparent" market (as defined in Consultation Papers 39 and 41) may not be a realistic option for some currencies and more generally in situations of financial crisis.	
3.11.		
3.12.		

3.13.		
3.14.	We also refer to our comment on paragraph 3.121 of Consultation Paper 39 which states: *"The principles of materiality and proportionality should be applied in the valuation of technical provisions separately by currency. Simplifications should be permitted so that separate currency projections are only required where amounts denominated in secondary currencies are material."*	
3.15.	See comments under 3.14	
3.16.	See comments under 3.14	
3.17.	See comments under 3.14	
3.18.	There may be some degree of subjectivity regarding the ability to show the same degree of risk-freeness in the term structure. See also comments under 3.14	
3.19.		
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3.21.		
3.22.	We agree these are the four main options to derive the risk free interest rate structure.	
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3.24.		
3.25.		
3.26.	We welcome the three stage framework to determine the risk-free interest rate structure and the desired characteristics (3.3 to 3.21) upon which each step is judged. This comment also refers to 3.27 and 3.55.	

3.27.	See comments under 3.26	
3.28.	We agree that a process at Level 3 should be implemented to ensure the risk free rate term structure for non Eurozone currencies is appropriate justified. This comment also refers to 3.57.	
3.29.	See comments under 3.34	
3.30.	**Illiquidity premium** <u>Characteristics of liabilities in the valuation of technical provisions</u> In the valuation of technical provisions, the Level 1 text refers to: *"the amount … to transfer their … obligations immediately to another … undertaking"* (Article 75(2)) and *"the amount … in order to take over and meet … obligations"* (Article 76(3)). This is further elaborated on in Recital (32): *"The amount of technical provisions should reflect the characteristics of the underlying insurance portfolio."* The characteristics of liabilities are therefore an important factor in the valuation of technical provisions. The characteristics of the liabilities would include, for example, their term, currency and liquidity. Term and currency are captured though the use of a term structure for the discount rate in the relevant currency that the liability is denominated. By the liquidity characteristic of liabilities, we are referring to the ability of the policyholder to exit their policy early with a cash payment (e.g. surrender or lapse), for example, a unit linked policy without a surrender penalty would be considered highly liquid as a policyholder can readily convert their investment to cash without penalty. Conversely, liabilities such as UK annuities, defined to have a fixed regular income until death with no surrender value, would possess illiquid characteristics. In addition, there are likely to be products with various	

degrees of illiquidity, for example unit linked policies with surrender penalties.

We do not believe a single liquid risk free term structure for each currency captures the characteristics of liabilities as required by the Level 1 text.

Does an "illiquidity premium" exist in asset prices?

An "illiquidity premium" is the extra return that the market might require (over a "liquid" risk-free rate) for a risk-free (that is free from credit risk), illiquid investment. There have been numerous studies of this matter, primarily in relation to corporate bond markets, including:

- Analyses of corporate bond yields;
- Credit default swap spreads;
- Model-based approaches (e.g. regular decomposition of corporate bond spreads by UK Bank of England, Longstaff's comparison of US Treasury and Refcorp bonds etc.); and
- Many others academic studies.

The studies are primarily focused on the major currencies (US dollar, Euros, UK pound sterling). Although these may produce different answers at different times, due to the assumptions, available data and approximations made there is consensus (irrespective of the time period studied) that an illiquidity premium exists in a range of capital markets and specifically corporate bonds markets. Further, the magnitude of the illiquidity premium changes over time and was higher in the last quarter of 2008 and in 2009 than it has often been in the past. In "normal" time, the premium is relatively modest. This is to be expected as investors will require some compensation for the risk that they will not be able to readily realise their investment. In times of high liquidity in the market, any illiquidity premium is likely to be small; currently, with low liquidity in the market, it is likely to have risen.

The default assumption is that an illiquidity premium does exist in certain asset classes and specifically in corporate bond markets.

Illiquidity premium in the valuation of technical provisions

To meet the Level 1 text requirements, the liquidity characteristic of the liabilities should be reflected in

the valuation of technical provisions. This is often expressed (as noted in this paragraph) as an "illiquidity premium" applied to the liquid risk free term structure for certain liabilities which have illiquid characteristics.

We concur with D17 that there is no current best practice to determine the illiquidity premium. However, it is hard, based on the body of evidence from the financial markets (as noted above), to conclude that the answer is zero by default.

We recommend that further research is commissioned to define the liquidity characteristic of liabilities and identify robust methods of estimating the illiquidity premium. It is important that the approach adopted ensures consistency across the insurance industry.

This can then be reflected in Level 2 and Level 3 text as appropriate. For example, Level 2 text could include a definition of the liquidity characteristic of liabilities together with high level principles as to the method of quantifying the illiquidity premium. Further detailed guidance in Level 3 text with full disclosure and independent scrutiny would be important to ensure consistency and greatest harmonisation.

We would be happy to participate in further CEIOPS consultation on this important matter.

Other considerations

We would also like to draw three other considerations to your attention:

- The current views of the UK regulatory authority as expressed by Adair Turner (Chairman of the UK FSA) to the Association of British Insurers (9 June 2009):

  "One important area is the treatment of the annuity business, where the UK is somewhat of an outlier in the extent of private annuity provision and where that provision could become more important as defined benefit pensions continue to decline and defined contribution pensions requiring annuitisation grow in importance. A prudent approach to annuity capital requirements, with adequate recognition of the probability of bond default, is clearly important, but it is also important to recognise that the annuity business in particular is different from the business of banking, not subject to liquidity risk, and specifically focused on matching long-term liabilities with long-term assets. The new Solvency II capital regime therefore needs explicitly to recognise that there is an illiquidity premium in bond yields, while making sure that we do not overstate that illiquidity premium and understate probabilities of default."

	▪ We understand that the IASB is considering whether an allowance for an illiquidity premium should be made in the IFRS Phase II standards. Though this maybe a different conceptual framework, consistency with this developing standard should be a consideration. We refer to the IASB staff paper tabled at the Insurance Working Group in November 2008 which gives initial consideration to this matter. ▪ In certain markets, the exclusion of an illiquidity premium is likely to result in significant policyholder detriment through additional unnecessary cost in purchasing certain contracts, for example, UK annuity contracts. This comment refers to D.17 and D.18.	
3.31.	See comments under 3.34	
3.32.	See comments under 3.34	
3.33.	See comments under 3.34	
3.34.	Risk free interest rate for Eurozone The risk free interest rate for the Eurozone is defined as the European Central Bank "AAA" rated government bond yield curve. We believe this should not be defined in Level 2 text which will be a binding European Union regulation. A definition in Level 2 text may not be sufficiently flexible to allow for changes in future circumstances. Paragraph 3.29 notes a requirement for regular review due to potential changes in circumstances; however, it is not clear how this would be achieved in Level 2 text. This comment also refers to 3.29, 3.31-3, 3.50 and 3.58.	
3.35.	See comments under 3.37	
3.36.	See comments under 3.37 A degree of judgement is required in assessing the characteristics described in 3.1.1, particularly given	

	the current economic environment, leading to a high level of subjectivity in this area.	
3.37.	Risk free interest rate for non-Eurozone The risk free rate for other currencies will be a significant area of judgement in the technical provisions. We accept that this is an evolving area where further research and analysis will be required to determine the treatment (as evidenced in the Annexes to CP40). In addition, the approach adopted by each Member State is likely to evolve over time as economic conditions change. As such, we agree that Level 3 text is the most appropriate medium to address the treatment. This comment also refers to 3.35-6.	
3.38.		
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3.45.	Extrapolation methods There will inevitably be significant judgement in the extrapolation from the last liquid data point. Given this, transparency (through disclosure) and point in time consistency will be important. We acknowledge the advantages of the CEIOPS aim for a single specified method for extrapolating the interest rate structure. However, we caution: ▪ A single approach may not be appropriate for all currencies and all future time periods where the	

	shape of the curve and depth of liquidity may significantly differ. ▪ This is likely to be an area where best practice evolves over time. Consequently, it may be better to define the features of an appropriate extrapolation method in Level 2 text rather than prescribing a single method. Assuming a single method is prescribed, we welcome the suggestion of a "comply or explain" procedure which would allow Member State supervisors to choose the application of a different extrapolation technique in their own currency area. To ensure harmonisation under the "comply or explain" procedure, it will be necessary for further guidance over its application to be specified in Level 2 or Level 3 text. We would also like to draw two other considerations to your attention: ▪ There has been significant research into the extrapolation of interest rate term structures which should be considered. For example, the recent work by Barrie & Hibbert, see: "A framework for estimating and extrapolating the term structure of interest rates" - September 2008. ▪ There is no mention of extrapolation at the short-end where money market rates should be considered as well. This comment also refers to 3.47 and 3.59.	
3.46.	<u>Constant spread method of extrapolation</u> The "constant spread" method described in this paragraph is not appropriate as it does not take account of the shape of the curve before the last available liquid data point. Consider the plausible situation where the Eurozone curve is downward sloping at all data points and the UK pound sterling curve is upward slope up to last liquid data point. The "constant spread" method would introduce a point of inflexion at the last liquid data point where after the UK pound sterling curve would be downwards sloping. That is to say that the extrapolation method would result in a "humped" shape curve for UK pound sterling. This is not an appropriate extrapolation method.	

	This comment also refers to 3.59.	
3.47.	See comments under 3.45	
3.48.	See comments under 3.14	
3.49.		
3.50.	See comments under 3.34	
3.51.		
3.52.		
3.53.		
3.54.		
3.55.	See comments under 3.26	
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3.57.	See comments under 3.28	
3.58.	See comments under 3.34	
3.59.	See comments under 3.45 and 3.46	

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C.33.	The conclusion in Annex C is that the liquid risk free term structure for UK pound sterling is the swap curve less an adjustment for credit risk. The method to derive the adjustment is deferred to a later stage. This will be essential to determine the appropriateness of the term structure. It would be helpful to have clarity as to the timeframe for determining the adjustment and the relevant external consultation period.	
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D.17.	See comments under 3.30	
D.18.	See comments under 3.30	
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