	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:	European Insurance CFO Forum	
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. The CFO Forum comments are not confidential.
	Please follow the following instructions for filling in the template: ⇨ <u>Do **not** change the numbering</u> in the column "reference". ⇨ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a paragraph, keep the row <u>empty</u>. ⇨ Our IT tool does not allow processing of comments which do not refer to the specific paragraph numbers below. o 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. o If your comment refers to sub bullets/subparagraphs, please indicate this in the comment itself. **Please send the completed template, <u>in Word Format</u>, to <u>secretariat@ceiops.eu</u>. 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	**The CFO Forum fundamentally disagrees with the proposal to use risk-free interest rates based on AAA government bonds.**	

	See comments in 3.54 **The CFO Forum disagrees with the view that no allowance should be made for illiquidity premia.** See comments in 3.30	
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3.28.	**Guidance to ensure that the relevant risk-free interest rate structures meet the benchmark of risk-free government rates should be provided in Level 2.** CEIOPS propose that a risk-free rate term structure will be defined in Level 3 supervisory guidance. This will be received relatively late in terms of preparing for Solvency II and may result in inconsistency between different regulators.	

	Given the significance of the issue and the importance of harmonisation across Europe, the risk-free rate term structure should be addressed in Level 2.	
3.29.		
3.30.	**The CFO Forum disagrees with the view that no allowance should be made for illiquidity premia.** Currently, no allowance is made for illiquidity despite the fact that many views acknowledge that illiquidity premia exist. The illiquidity premium has become more relevant as it has markedly increased since the widening of spreads during the financial crisis. Solvency II proposals are inconsistent with IFRS Phase II proposals which have suggested a discount rate consistent with the characteristics of the liabilities. Consistency of the discount rate with IFRS Phase II is desirable to the extent that IFRS principles are consistent with sound economic principles. This type of consistency reduces reconciliation differences and the CFO Forum consider the draft IFRS Phase II principles in the Discussion Paper to better reflect the economics of insurance liabilities. The CFO Forum MCEV Workgroup is currently running a project to determine how illiquidity premia could be quantified and to which products it would apply and consistency with this work stream is also desirable as the MCEV framework is also based on economic principles. In addition, the replicating portfolio techniques outlined in CP41 implicitly include an allowance for illiquidity premia.	
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3.37.	**The basis of discounting for non-Euro currencies should be addressed in Level 2.**	

	Treatment of other currencies within and outside of the European Economic Area ('EEA') will not be addressed until Level 3. The basis of discounting for non-Euro currencies should be considered in Level 2 to ensure consistent implementation.	
3.38.	**Detailed guidance is required to explain extrapolation and interpolation techniques.** The CFO Forum believes that the risk free interest rate curve should be based on swap rates plus an illiquidity premium. Swaps provide more data at longer durations than government bonds. Techniques are required to extrapolate and interpolate risk-free interest rate curve at the longer durations for AAA government bond curves. Additional guidance is required from CEIOPS around how to extrapolate and interpolate the risk-free curve to ensure consistency and comparability between companies. We recognise that there are several potential methodologies, including: • Extrapolation using money market rates as a proxy for very short durations. • Extrapolation using spot rates and an appropriate curve fitting methodology, for example: o Applying a long-term limit (with the limit preferably being set at a level which allows the curve and forward rates to run smoothly toward the long-term limit as term increases); o Assuming that either spot or forward rates remain level at the risk-free yield available at the longest term which represents a liquid data point; o Appling the ratio of the swap yield to the government bond yield at the maximum liquid observable term of the swap yield to the government bond yields at longer durations; o Where a relevant government bond yield curve exists which is longer than the swap yield curve, extending the swap yield curve by maintaining a constant margin from the end of the swap curve and assuming it remains level thereafter; o Extension of yield curves beyond the horizon where markets are considered deep and liquid based on convergence to rolling average of last available data points with allowance for non-hedgeable risk for unmatched cash flows that are beyond last liquid point. • There should be no inflection points or turning points in the curve beyond the maximum	

	observable term which represent a liquid data point unless this can be appropriately justified. • In territories where no swap market is available, a curve may need to be bootstrapped from observable government bond data. However, the current draft of IAS 39 provides a methodology on how a proxy rate should be determined without referencing government bond rates. The undertaking should be allowed to select the methodology that they consider to be the most appropriate while taking into account the principle of proportionality and materiality.	
3.39.	Comments in 3.38 are also relevant here.	
3.40.	Comments in 3.38 are also relevant here.	
3.41.	Comments in 3.38 are also relevant here.	
3.42.	Comments in 3.38 are also relevant here.	
3.43.	Comments in 3.38 are also relevant here.	
3.44.	Comments in 3.38 are also relevant here.	
3.45.	Comments in 3.38 are also relevant here.	
3.46.	**The ‘constant spread method’ for extrapolating yield curves for non-Euro currencies has shortcomings which make it unsuitable in practice.** The proposed ‘constant spread method’ does not take into consideration differences in the shapes of yield curves of different currencies prior to the last available liquid data point. For example, if the Euro curve is steep upwards sloping and a non-Euro curve is steep downwards sloping with the last mutually available liquid data point being the point where the two curves cross, then the non-Euro curve will be extrapolated to be steep upwards sloping despite being steep downwards sloping prior to the last available liquid data point. Therefore we do not believe that this method is appropriate. Comments in 3.38 are also relevant here.	
3.47.	Comments in 3.38 are also relevant here.	

3.48.	**To ensure consistency and comparability, the underlying methodology adopted should be consistent with the MCEV framework, when finalised, as this is also based on economic principles.**	
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3.52.	Comments in 3.48 are also relevant here.	
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3.54.	**The CFO Forum fundamentally disagrees with the proposal to use risk-free interest rates based on AAA government bonds.** The key arguments against the use of AAA government bonds are: • Using AAA government bonds would lead to price dislocation given limited liquidity; • A number of jurisdictions do not have AAA government bonds; • Additional guidance would be required in order to choose between multiple government bond curves for currencies other than the Euro. The CFO Forum believes that swaps present a better basis for determining the appropriate interest rate for discounting insurance liabilities for the following reasons: • Swaps have minimal credit risk due to the requirement for collateral and being exchange traded and settled through a clearing bank; • Swaps are margin transactions so there is significant liquidity in the swap market, even when capital markets are constrained. Swap markets are deep and liquid, more so than government bond markets; • The use of swaps is consistent with the measurement of derivatives that are recognised on insurance balance sheets;	

	• Swaps do not suffer from systematic distortions due to supply/demand or regulatory constraints; • Swaps cover a wider spectrum of future durations providing a better model for the yield curve when considering very long term insurance liabilities in some countries; • Swaps are used for MCEV. Consistency with this work stream is also desirable as the MCEV framework is also based on economic principles. Where the liabilities are illiquid, we also believe that the risk-free interest rate should be increased to include an illiquidity premium, as per our comments in paragraph 3.30.	
3.55.	Comments in 3.48 and 3.54 are also relevant here.	
3.56.		
3.57.	Comments in 3.38 are also relevant here. Is this paragraph referring to Level 3 supervisory guidance or “Third stage” as per paragraph 3.55? The CFO Forum highlights that all guidance on interest rate term structures should be set in Level 2 implementing measures.	
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C.31.	The CFO Forum supports the statement that “swaps may be considered to be superior to gilts in respect of some of the other criteria”.	
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