CFO FORUM

The European Insurance CFO Forum
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Ms. Pauline de Chatillon
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Head of Insurance Unit
European Commission Directorate General for Internal Market and Services

13 July 2009

Dear Ms de Chatillon, Mr Steffen and Mr Van-Hulle,

Solvency II implementing measures: discounting illiquid insurance liabilities

The CFO Forum wishes to convey its support for the views expressed in the CRO Forum letter to CEIOPS dated 12 June 2009 and copied in the appendix to this letter.

The CFO Forum is committed to the market consistent valuation of insurance liabilities and to the need to learn lessons from the current economic crisis. Inconsistent measurement of assets and liabilities tends to promote pro-cyclical behaviours. The CFO Forum recommends that CEIOPS gives full consideration to the recognition of an illiquidity premium in its forthcoming consultation paper and before setting its final level 2 implementing measures for market consistent valuation of insurance liabilities.

The CFO Forum looks forward to communicating regularly with CEIOPS and supporting the development of Solvency II.

Yours sincerely

Philip G Scott
Chairman – European Insurance CFO Forum

Cc: Tom Grondin, Chairman of CRO Forum

Appendix - CRO Forum letter sent to CEIOPS on discounting illiquid insurance liabilities:

12 June 2009

Ms. Pauline de Chatillon
Chair of Financial Requirements Expert Group (FINREG)
CEIOPS
Westhafenplatz 1
Frankfurt
Germany
By email: secretariat@ceiops.eu

Dear Ms de Chatillon,

Solvency II implementing measures: discounting illiquid insurance liabilities

The purpose of this letter is to set out the CRO Forum's initial, high-level thoughts on one aspect of the discounting of illiquid insurance liabilities for solvency purposes.

We understand that this will be one of the key policy issues on which the European Commission is seeking CEIOPS advice in the context of the calculation of the best-estimate of insurance liabilities and that CEIOPS will be consulting on its proposals soon.

As you know the Chief Financial Officer Forum is also considering the need for adjustments for an illiquidity premium in response to the current economic crisis and as part of its review of the MCEV principles.[1]

The CRO Forum starting points are our commitments to market consistent valuation of insurance liabilities and to the need to learn lessons from the current economic crisis. This is to ensure that Solvency II valuations are appropriate in a wide range of economic scenarios and therefore avoid introducing artificial pro-cyclical effects. The dangers of pro-cyclicality are something that CEIOPS has already identified as one of the lessons from the current economic crisis.[2] The CRO Forum has recently expressed an opinion on the reflection of illiquidity premiums in its May 2009 paper on Calibration Principles for the Solvency II standard formula. "The CRO Forum believes that illiquidity spread included in current values should be appropriately reflected in the measurement and hence

[1] CFOF press release dated 22 May, available from www.cfoforum.nl.

[2] CEIOPS, "Lessons learnt from the crisis", 19 March 2009.

in the calibration. Regardless of whether an illiquidity spread is taken into account in liability or asset valuation, the risk that this illiquidity spread widens does not necessarily mean that policyholders are put at increasing risk due to the often illiquid nature of the liabilities and the fact that an (re)insurance company may not be a forced seller of assets."

In practical terms, we start by considering the structural features of the insurance liabilities. One of these features is their illiquid nature and the resulting predictability of the relevant cash flows. We believe that these are factors relevant to the valuation of insurance liabilities. This is the issue usually referred to as the "illiquidity premium".

In addition, we note that the implied risk-free rate of interest that results from the use of the replicating portfolio concept to calculate the market value of the liabilities would include an illiquidity premium as appropriate.

On the asset side, there is a value to liquidity that can be used to measure the value of illiquid liabilities. The existence of an illiquidity premium in financial markets has been widely researched; see for example the references in a research paper on measurement of insurance liabilities from the International Actuarial Association.[3]

Our take on this body of research is that there is a consensus about the existence of an illiquidity premium in asset values. There is a degree of illiquidity in corporate bonds. As a result, these instruments are typically used to identify this illiquidity premium: a component of the spread of corporate bonds. This is usually taken as the excess over the credit risk, which includes expected defaults and a credit risk premium. Although it is recognised that there may be other elements in the observed spread. The research also shows that the illiquidity premium would vary with economic conditions. In particular it increases in times of market dislocation and therefore it reduces the pro-cyclical effect that would otherwise arise if an unadjusted risk-free rate is used for solvency purposes. This has been recognised recently in an EU member state where an illiquidity premium has been explicitly allowed in the light of existing market conditions.[4]

The recognition of an illiquidity premium is consistent with the development of IFRS 'Phase 2'. The discussion paper explicitly recognises that the valuation of insurance liabilities should take account of the illiquid nature of insurance liabilities (amongst other features).[5] This is also an interpretation of the principles in the Solvency II directive requiring valuations to be based on the principle of a transfer value (article 74) and that insurance cashflows are discounted using the "*relevant* risk-free interest rate term structure" (our emphasis).

Once there is clarity about the principles of recognition of an illiquidity premium, the CRO Forum would be happy to work with CEIOPS and other stakeholders on the scope of application of an illiquidity premium and to articulate principles-based approaches to estimate reliably an illiquidity premium that can be applied in a consistent manner across the EU.

We therefore encourage CEIOPS to give full consideration to the recognition of an illiquidity premium in its forthcoming consultation paper and before setting its final advice on the

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3 Pages 55 to 58 in International Actuarial Association, "Measurement of liabilities for insurance contracts: current estimates and risk margins", 15 April 2009.

4 Details of the decision dated 31 October 2008 are available from www.oem.dk. The rationale provided includes "[CEIOPS] has urged national insurance supervisors to exercise flexibility with respect to the limits defined by the supervisors to avoid a pro-cyclical effect".

5 Paragraph 69 of the IFRS discussion paper on valuation of insurance liabilities ("Preliminary views on insurance contracts", May 2007) says: "the objective of the discount rate is to adjust estimated future cash flows for the time value of money in a way that captures the characteristics of the liability […] Therefore the discount rate should be consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability, in terms of, for example, timing currency and liquidity."

implementation of market consistent valuation principles for insurance liabilities. This would enable industry to engage with CEIOPS on the principles and key practical issues set out above. Careful consideration of this issue will ensure that market consistent valuations are resilient and not just “fair-market” consistent valuations and are well understood.

Finally, may we add that without an appropriate recognition of an illiquidity premium it is likely that there would be unnecessary and additional costs to policyholders from Solvency II.

We trust that these comments are of use to you and we would welcome the opportunity to discuss them further. We will send a copy of this letter to Thomas Steffen and Karel van Hulle as well.

Sincerely,

The CRO Forum

Signed by

Tom Grondin
Chairman of the CRO Forum
Chief Risk Officer, AEGON N.V.