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Mr Gabriel Bernardino
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Dear Gabriel,

Firstly I would like to take this opportunity to congratulate you on your new role as the chair of CEIOPS and wish you well in this important task.

Secondly, I would like to thank you for your letter of 10 November 2009 and the attached final advice on level 2 implementing measures. The publication of this advice, which represents the majority of CEIOPS' advice on level 2 implementing measures, is a key milestone in the Solvency II project and is fundamental in ensuring that the ambitious timetable that we have set ourselves can be met. With this in mind, I would also like to thank you for the enormous efforts CEIOPS has made over the last few years in producing this advice. Specifically, I would like to emphasise my appreciation for the way in which CEIOPS has reflected in its final advice both comments made by the industry during the consultation process and the comments that the Commission raised in relation to the compatibility of CEIOPS' draft advice with the Solvency II Framework Directive text. I know that you share my view that an open and transparent consultation process is of paramount importance in the effective delivery of Solvency II.

As you are aware, there continue to be a number of difficult technical issues in the area of technical provisions, and specifically on the issue of the illiquidity premium, where CEIOPS has recognised the need for further work. Technical provisions is also a subject on which the industry has voiced its concerns and highlighted during the consultation process the significant financial impact that could result for some insurance and reinsurance undertakings. I fully agree that these technical issues merit further work and it would be beneficial if CEIOPS could start work on this as soon as possible.

In order to carry out this further work, I would like CEIOPS to set up and lead a working party, with a mandate to develop technical solutions on the illiquidity premium and on two further issues set out below, that relate to the discount rate which I think are also important to consider. The working party should be comprised of all key stakeholders, including representatives from CEIOPS, Groupe Consultatif, CRO Forum, CEA, AMICE and from the Commission. I believe that it is important that the technical issues mentioned below are discussed without any preconceived position so that solutions can emerge which are acceptable to all parties involved.

The three technical issues are as follows:

1) Illiquidity premium

The working party should analyse the extent to which the rate used to discount technical provisions should include an illiquidity premium. There has been considerable research to show that an illiquidity premium exists and can be defined as the additional compensation investors require for bearing the risk from an illiquid asset. Consequently, I would suggest that the focus of the working party should be on how to measure the illiquidity premium and incorporate it into the discount rate, in an objective, reliable and consistent way.

CEIOPS has, in its final advice, expressed a preference for limiting the scope of further work on the illiquidity premium to affected business in force. However, in order to allow for a full debate on this issue and to ensure that a range of technical solutions can be considered, I would not propose that the scope is limited in such a way. So, the working party should consider to what extent an illiquidity premium should be included in the discount rate for both existing and new business. The working party should also consider whether any solutions proposed necessitate changes to other parts of CEIOPS' final advice, for example changes to the SCR standard formula.

2) Government bond curve vs. swap curve

In its final advice on the risk-free interest rate term structure, CEIOPS takes as a starting point a AAA government bond curve as the relevant risk-free rate and then provides for adjustments to government bond rates if these do not satisfy the "risk-free rate criteria" set out in the paper. Only where government bonds are either not available or cannot be adjusted, can other financial instruments, such as swaps, be used.

As part of its overall analysis on possible technical solutions to the three issues mentioned in this letter the Commission would like the working party to consider whether the approach to deriving the relevant risk-free interest rate term structure needs to be modified to allow for the use of swap rates or adjusted swap rates in a wider range of circumstances.

3) Extrapolation

CEIOPS' proposals emphasise the need for the risk-free interest rate term structure to be constructed from a finite number of data points of sufficient liquidity on the risk-free curve. This presents a problem for some currencies where government bonds with long maturities either do not exist or are not sufficiently liquid. In such cases, it is necessary to estimate the curve using a process referred to as extrapolation.

I understand that CEIOPS proposes not to prescribe the extrapolation technique in level 2 implementing measures. However, the Commission would like the working party to develop principles for determining appropriate extrapolation techniques. This will then allow for the techniques themselves to be set out in more detail in either Binding Technical Standards or level 3 guidance.

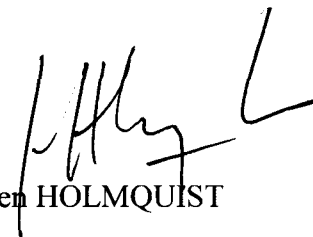
It is recommended that in developing its view on each of these areas the working party has regard to the effects on financial stability of the technical solutions it proposes.

The Commission's intention is to discuss Technical Provisions in the Solvency Expert Group meetings early in 2010. In order to ensure that the outputs of the Technical Provisions working party can be taken into account in this discussion we would need the working party's initial findings to be published no later than 31 January 2010. I appreciate that this represents a very short timeframe for conducting further work on these important issues. However, given the challenging timetable that we have for the preparation of the implementing measures we are unable to allow for more time to complete this work.

In your letter you highlight the treatment of future premiums in the calculation of the best estimate, as an area where CEIOPS has not changed its advice to reflect comments made by the Commission. I acknowledge your request for further guidance from the Commission on the criteria for the treatment of future premiums and confirm that we shall provide this guidance through a technical note that we will send to CEIOPS in the near future.

Finally, I would like to thank you and your colleagues once again for all your excellent work so far on Solvency II. I would be grateful if you could confirm your agreement to the suggested deliverables and timing set out in this letter by the end of November 2009.

Yours sincerely,



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