

Insights

2009 EEV/MCEV

Greater consistency, challenges remain

Following the dislocation in financial markets in 2008, a wide range of approaches was used to set the allowance for risk within 2008 EEV and MCEV reporting.¹ There was more consistency within 2009 EEV and MCEV reporting. In this publication, we describe the areas where the insurance industry has made progress and those where challenges remain.

The last year has seen several developments within market-consistent reporting methodologies in response to the financial crisis, including:

- On 20 October 2009, the CFO Forum published revisions to the European Insurance CFO Forum Market Consistent Embedded Value Principles ©² (MCEV Principles) relating to the use of liquidity premia.³
- On 1 March 2010, a CEIOPS-led task force published its 'Report on the Liquidity Premium', discussing the use of a liquidity premium under Solvency II.⁴
- On 15 April 2010, the European Commission released a draft technical specification for QIS5 and various calibration papers.⁵

These developments should encourage consistency in a number of areas and are discussed in more detail later in this publication.

Table 1 sets out the number of companies reporting under European Embedded Value (EEV) Principles and MCEV Principles as at end 2009 and prior year-ends. A proportionate breakdown of the approach to allow for risk is provided for companies reporting under the EEV Principles.

The 2009 reporting season, up to the end of May 2010, has seen the following:

- new MCEV Principles publications: Himawari Life, Mediolanum, Munich Re, Phoenix Group, Resolution, Swiss Life and Zurich;
- companies which at the previous year-end reported under EEV Principles and for the year-end 2009 reporting season have not published to date under either EEV or MCEV Principles, including: Alleanza, Danica and ING.

1. See our May 2009 Update '2008 EEV/MCEV: Coping with extreme financial conditions'.
2. Copyright © Stichting CFO Forum Foundation 2008.
3. See our October 2009 Update 'Revised MCEV Principles include liquidity premium'.
4. See our March 2010 e-alert 'Report of CEIOPS Task Force on the Illiquidity Premium'.
5. See our April 2010 e-alert 'Draft QIS5 technical specification'.

Table 1. Summary of approach to allowing for risk – companies reporting EEV/MCEV^{i,ii}

	MCEV Principles	Reporting under the EEV Principles ⁱⁱⁱ				
	Total	Total	Top-down	Indirect MCEV	Direct MCEV	Other
End 2009 reporting	14	25	20%	12%	64%	4%
End 2008 reporting	6	30	20%	17%	60%	3%
End 2007 reporting	N/A	34	20%	18%	56%	6%
End 2006 reporting	N/A	35	26%	17%	46%	11%
End 2005 reporting	N/A	21	33%	24%	24%	19%
End 2004 reporting	N/A	5	80%	20%	0%	0%

i. Includes both CFO Forum and non-CFO Forum companies publishing by the end of May.

ii. A list of the 2009 EEV and MCEV publications is provided in the Appendix with further details of the approach used.

iii. For a description of these approaches, see our May 2008 Update '2007 EEV: Stable accounting in volatile markets'.

MCEV developments

In December 2008, the CFO Forum announced that its members were addressing the notion of market-consistency given the prevailing market dislocation at that time. In particular, the areas under consideration were implied option volatilities, calibration of reference rates (including liquidity premia) and the allowance for non hedgeable risks. The revised MCEV Principles published in October 2009 included amendments relating only to the choice of reference rate and liquidity premia.

We comment below on these issues and on industry practice for year-end 2009 reporting. In describing the market practice, we focus on the 14 companies publishing under the MCEV Principles and the 19 companies publishing under the EEV Principles using a ‘market-consistent’ approach at year-end 2009.

Implied option volatilities

MCEV Principle 15 requires the use of end-period derivative prices where possible. However, MCEV guidance 15.3 provides for the possibility of using “less recently observed measures and expert opinion” where “there are concerns over the depth or liquidity of the market or if the market displayed unusual characteristics as at the valuation date.”

Implied equity and swaption volatilities increased dramatically during late 2008. 14 companies reported year-end 2008 results based on implied volatilities observed at dates other than end December 2008. Reasons provided included a lack of deep and liquid options markets, unusual characteristics in the options markets, dislocated financial markets and a practical inability to calibrate to higher volatilities.

For year-end 2009 EEV/MCEV reporting, all companies who disclosed their approach used end-period implied volatilities, with the exception of one company that used a 21 December calibration. Although the 31 December 2009 implied volatilities were lower than those as at 31 December 2008, in many cases they were still higher than those recorded in periods up to end September 2008. For some of the companies which calibrated implied volatilities to periods other than end December in their 2008 EEV and MCEV reporting, the return to using an end December calibration for 2009 reporting has led to an increase in volatility assumptions, and thus negative economic variances in this respect.

Table 2 and Table 4 show market practice for CFO Forum market-consistent publications as at end 2009 and end 2008 respectively.

Table 2. Summary of economic calibration approaches – CFO Forum market-consistent publications only, year-end 2009 EV

Company	EEV or MCEV Principles	Calibration of implied equity option and swaption volatilities	Reference rates
Allianz	MCEV P	End December 2009	Swaps, unadjusted, except Korea where government bond yields are used
Aviva	MCEV P	End December 2009	Swaps, increased for certain contracts. For immediate annuity type contracts an increase of 100 bps in the UK, 30 bps in France and Spain and 15 bps for Delta Lloyd. For US business an increase of 65 bps for immediate annuities and 55 bps for all other contracts
AXA	EEV P	End December 2009	Swaps, increased for general account liabilities by 50 bps in the UK, 30 bps in Eurozone, 50 bps in the US, 30 bps in Switzerland and 20 bps in Japan. No liquidity premium was applied on unit-linked and variable account liabilities
CNP	MCEV P	End December 2009	Swaps, increased by 16 bps for Euros savings and retirement business and annuities. Unadjusted swaps for other business
Fortis	EEV P	End December 2009	Swaps, increased for all business by 20 bps for Euro denominated liabilities and 50 bps for USD and HK\$
Generali	EEV P	End December 2009	Swaps, increased for all business except unit linked liabilities by 20 bps for Euro denominated liabilities (60 bps for Spanish annuity business), 10 bps for Swiss Francs and 30 bps for US Dollar. Government bond yields for Israel and the Czech Republic
Hannover Re	MCEV P	End December 2009	Swaps, unadjusted
Lloyds Banking Group ¹	EEV P	End December 2009	Reference rate set to gilts; for UK annuities set to gilts plus 75 bps
Munich Re	MCEV P	End December 2009	Swaps, unadjusted
Old Mutual	MCEV P	End December 2009	Swaps, increased by 100 bps for US life business and 50 bps for Old Mutual South Africa Retail Affluent immediate annuity business; unadjusted for other business
Prudential	EEV P	Not applicable	MCEV approach used for UK annuities only: reference rate set to swaps plus 104 bps
Standard Life	EEV P	End December 2009	Reference rate set to 4.11% based on gilts; for UK annuities that are level or subject to fixed escalations investment return set to 5.36%
Zurich	MCEV P	End December 2009	Swaps, unadjusted

1. Includes HBOS and Scottish Widows. Scottish Widows is a member of the CFO Forum.

Reference rate and liquidity premium

The original MCEV Principles published on 4 June 2008 set the reference rate to be “the swap yield curve appropriate to the currency of the cash flows” and did not permit the reference rate to be increased to reflect the possibility of a liquidity premium. This approach to setting the reference rate worked well for a number of years up to year-end 2007, but came under pressure following the collapse of Lehman Brothers in September 2008. The deterioration in market conditions in late 2008 led to a number of companies including a liquidity premium adjustment in setting the reference rate at year-end 2008, whether under the original MCEV Principles (noting non-compliance) or using market-consistent techniques within the EEV Principles. However, there was little consistency in the approaches used to calibrate and apply the liquidity premium.

The October 2009 MCEV Principles permit the use of a liquidity premium for liabilities which are not ‘liquid’. However, the approach to be used for calibration is not prescribed and the definition of ‘liquid’ is open to interpretation. Table 2 and Table 4

Table 3. Reference rate approach for market-consistent publications, year-end 2009 EV

	MCEV Principles	EEV Principles
Swaps	8	5
Swaps / swaps plus liquidity premium ¹	4	3
Swaps plus liquidity premium	0	4
Government bonds	0	3
Government bonds / government bonds plus liquidity premium ^{1,2}	1	2
Other	1	2

1. A liquidity premium is applied for some, but not all, lines of business.

2. One company defines its reference rate, pre-liquidity premium, as government bonds + 10bps.

provide details of the reference rates used for CFO Forum market-consistent publications as at end 2009 and end 2008 respectively. Table 3 summarises the reference rate approaches used by all 33 companies reporting under a market-consistent approach at year-end 2009.

Table 4. Summary of economic calibration approaches – CFO Forum market-consistent publications only, year-end 2008 EV

Company	EEV or MCEV Principles	Calibration of implied equity option and swaption volatilities	Reference rates
Allianz	MCEV P	End September 2008	Swaps, unadjusted, except Korea where government bond yields were used
Aviva	MCEV P	End August 2008	Swaps, increased by 150bps for UK and NL immediate annuities, 300bps for US immediate annuities and 250bps for other US contracts, unadjusted for other businesses
AXA	EEV P	Average during 2008	Swaps, increased by 50bps for European businesses, and 100bps for most non-European businesses
CNP	MCEV P	Average during 2008	Swaps, increased by 70bps for all products
Fortis	EEV P	End December 2008	Swaps, increased by 50bps for European businesses, and 100bps for Hong Kong business
Generali	EEV P	End June 2008	Government bond yields for Italy and Czech Republic; Swaps increased by 50bps for most other European businesses, unadjusted for other businesses
Hannover Re	MCEV P	End November 2008 ¹	Swaps, unadjusted
Scottish Widows	EEV P	End December 2008	Reference rate set to gilts; for UK annuities set to gilts plus 154bp
Munich Re	EEV P	End December 2008	Swaps, unadjusted
Old Mutual	MCEV P	End September 2008 for US\$ swaptions only; end December 2008 for all other calibrations	Swaps, increased by 300bps for US onshore business, unadjusted for other businesses
Prudential	EEV P	Not applicable	MCEV approach used for UK annuities only: reference rate set to gilts plus 252bp for fixed annuities and gilts plus 120bp for inflation-linked annuities
Standard Life	EEV P	End December 2008	Reference rate set to 3.42% based on gilts; for UK annuities that are level or subject to fixed escalations investment return set to 6.44%
Zurich	EEV P	Average during 2008	Swaps, unadjusted

1. Disclosed that end November used for practical reasons and that this was similar to an end December calibration.

The size of the adjustments for liquidity premia at end 2009 has generally decreased significantly compared to end 2008, in line with the significant narrowing of spreads on corporate bonds over swaps. Explanations as to how the liquidity premium was calibrated varied between companies and included:

- basing it on the residual spread observed in the corporate bond and CDS markets;
- taking a proportion of the spread on corporate bond indices; or
- using a collateralised/covered bond approach.

Some companies referred to examining the results of more than one approach when setting their liquidity premium assumption. We can expect such a variety of practice to continue until such time as the CFO Forum issues additional guidance.

Although neither the EEV Principles nor the revised MCEV Principles require the publication of liquidity premium sensitivities, 12 of the 33 market-consistent companies published a sensitivity for year-end 2009. These 12 companies included some which did not include a liquidity premium within their main EEV/MCEV results. The published sensitivity varies with six companies illustrating the impact of removing the liquidity premium entirely while eight companies showed the effect of a 10bps increase in the liquidity premium.

Recent Solvency II developments in relation to the liquidity premium may influence future developments of reporting under the MCEV Principles and may encourage greater consistency of practice across

the industry. The CEIOPS-led task force report on the liquidity premium included discussion on two steps that need to be considered when applying a liquidity premium:

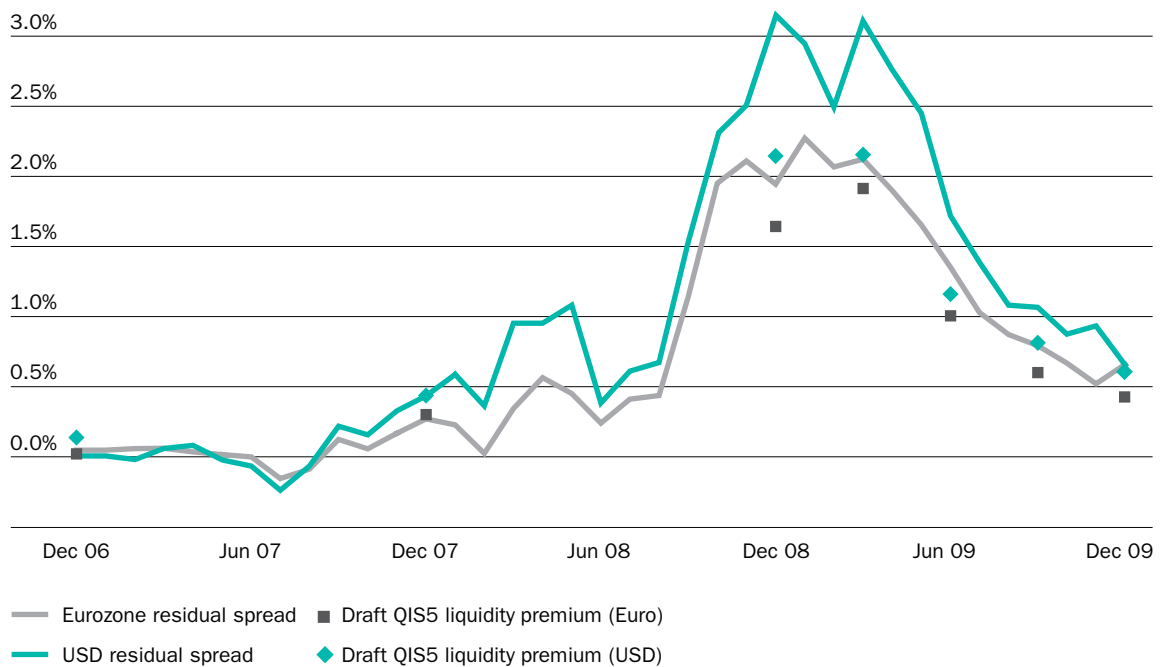
1. Assessing the liquidity risk premium within yields on illiquid assets.
2. Determining for which products a liquidity premium can be included and what proportion of the liquidity premium to apply in a market-consistent valuation.

To calculate the liquidity risk premium component within yields on illiquid assets, industry members of the task force proposed a simplified method and the draft QIS5 technical specification used the following formula, which was originally set out in the task force report, to calculate the liquidity premium for major currencies:

$$\text{Liquidity premium} = \max [0, 50\% * (\text{Spread} - 40 \text{ bps})]$$

The Spread used above is based on corporate bond indices relative to swaps. The draft QIS5 liquidity premium only applies for durations up to a cut-off point, which varies by currency. For the five years after this point, the liquidity premium reduces linearly from the value obtained from the formula above to nil. Figure 1 shows the draft QIS5 liquidity premium compared to illustrative residual spreads (defined as index corporate bonds less index CDS less swap yields, averaged over durations up to ten years) during the period 2007 to 2009.

Figure 1. Eurozone and USD illustrative residual spreads (average up to 10 years) and draft QIS5 liquidity premium relative to swaps



Sources: Towers Watson analysis of Bloomberg and Markit data; April 2010 draft QIS5 technical specification including CFO Forum/CRO Forum paper on risk-free rates

As can be seen from Figure 1, the draft QIS5 liquidity premium provides a reasonable fit to the residual spread at December 2006 and December 2007, but was less than residual spreads from end December 2008.

The draft QIS5 specification provides the current position both on how to assess the liquidity component within asset yields and for which products a liquidity premium can be included. However, further changes can be expected in these areas before the final Solvency II measures are adopted. As shown in Tables 2 and 3, this is also an area where practice within 2009 EEV and MCEV reporting remains varied.

When determining the reference rate for longer durations, the extrapolation of market data beyond durations for which yields are reliably observable is an area where consistent practice has yet to emerge. This issue is less relevant for major currencies where market yield curves are often available to 30 years and beyond. It is more relevant for minor European currencies and those in Africa, Asia, Latin America and the Middle East. Many EEV/MCEV publications do not disclose the extrapolation approach used, but those that do, tend to extrapolate a level forward or spot rate from the longest credible duration. From the duration of the last observed liquid market data point, the draft QIS5 technical specification uses macroeconomic extrapolation techniques which assume a long-term equilibrium interest rate. The aim of this technique is to reflect economic views on how unobservable long-term rates are expected to behave and to improve financial stability.

Non hedgeable risks

The EEV Principles require that sufficient allowance is made for the aggregate risks in the business but do not provide further explicit guidance on the allowance for non hedgeable risks (NHR). In contrast, the allowance for NHR is covered in a number of areas of the MCEV Principles, primarily within Principles 9 (Cost of Residual Non Hedgeable Risks), 3 (Allowance for risk) and 11 (Assessment of Appropriate Non Economic Projection Assumptions). The key elements are described in detail in our June 2008 *Update 'CFO Forum Adopts MCEV'*. We therefore restrict our discussion below to NHR within the context of the MCEV Principles.

MCEV Principle 9 states “An allowance should be made for the cost of non hedgeable risks not already allowed for in the time value of options and guarantees or the PVFP”. It does not prescribe how these ‘residual’ risks should be allocated between components of value. This means that there can be inconsistency between companies in how the overall allowance for NHR is split between the cost of residual NHR (CRNHR) and other components of value, and hence what risks are allowed for within the CRNHR. In addition, practice may vary as to whether the CRNHR includes an allowance for uncertainty, with G9.2 permitting, but not requiring, such an allowance.

Principle 9 requires that sufficient disclosures are provided to enable a comparison to a cost of capital methodology, and G9.4 to G9.8 cover the calculation. For all risks allowed for within the CRNHR, a single average charge should be calculated such that the present value of charges levied on the projected NHR-based capital equates to the CRNHR. The capital determined should be consistent with a 99.5% confidence level over a one-year time horizon to meet the associated risks.

Table 5 provides summary statistics for the equivalent cost of capital charge disclosed in the 14 MCEV Principles publications.

The potential differences in how the allowance for NHR is made in the valuation mean that comparison between companies of the disclosed equivalent cost of NHR capital charge may be misleading. In addition, most MCEV Principles 2009 publications did not describe what proportion of the CRNHR related to residual risks (and which risks) and what proportion related to a charge for uncertainty.

The Solvency II technical provisions include a risk margin in respect of non hedgeable risks, which is based on a cost of capital approach. The pre-tax cost of capital in the draft QIS5 technical specification is set at 6% per annum based on an equity risk premium-related calibration. It should be noted, however, that the Solvency II technical provisions do not require a separate provision for tax and investment expense frictional costs.

Table 5. Equivalent annual cost of capital charge for CRNHR for MCEV Principles publications, year-end 2009 EV

Minimum	Lower quartile	Median	Upper quartile	Maximum
0.0%	2.5%	2.8%	4.4%	7.0%

Additional disclosures

With the recovery of the financial markets over the last year, attention in the 2009 financial reports has shifted from dealing with dislocated markets to explaining the business fundamentals and value creation. This has put particular emphasis around disclosures, including those within the management discussion and analyst presentations, which are intended to help observers understand the business better.

The EEV and MCEV Principles prescribe certain minimum disclosure requirements and the latter has standardised some of the disclosures to facilitate comparison between companies. Companies are free to disclose additional information.

Disclosures include the balance sheet, the analysis of earnings (or movement), the value of new business (VNB), and sensitivities. This set of information can help provide the basis for indicating the components of value, understanding a company's risk exposures, determining capital requirements, understanding capital flows and assessing risk-adjusted targets and performance. Users typically consider all these components when analysing results.

The MCEV Principles prescribe the format for presenting the analysis of earnings in Appendices A and B of that document. Appendix A requires that the MCEV movement is split between free surplus, required capital and value of in-force business. Appendix B, the Group MCEV analysis of earnings, requires a combined analysis of covered business MCEV and non-covered business IFRS results to be shown.

At year-end 2009, 13 of 14 MCEV Principles publications included an Appendix A analysis of MCEV earnings (five of six in 2008). At year-end 2009, eight of these publications also included an Appendix B analysis of Group MCEV earnings (two of six in 2008). There were nine EEV Principles publications at year-end 2009 which included information similar to the Appendix A analysis of earnings.

The recent financial crisis and, in particular, the significant negative economic variances during 2008, have had a significant impact on the balance sheets of some companies. Observers are now showing interest in how the companies are recovering and focus has shifted to the analysis of movement. Historically, a breakdown of the components of economic variances has not been published in the reports. However, for year-end 2009, one company published additional disclosures with a split of its MCEV economic variances on long-term business for 2008 and 2009.

The number of companies publishing credit spread sensitivities is unchanged from year-end 2008 with seven companies publishing at year-end 2009. Most of these companies calculate a 50 bps credit spread sensitivity.

At year-end 2009, ten companies voluntarily published an indication of the timing of the emergence of future statutory (regulatory) cash flows on which the value of in-force business is based, an increase of two companies compared to year-end 2008. One company published similar information for the VNB.

Thirteen companies published metrics related to new business, including the internal rate of return (the discount rate which reproduces a zero VNB) and the payback period needed to repay initial new business strains.

Related accounting developments

The International Accounting Standards Board (IASB) is planning to publish its exposure draft on accounting for insurance contracts in the summer of 2010, with the objective of issuing the final standard in the first half of 2011. The measurement approach is expected to use the following building blocks: the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation; incorporation of the time value of money using a 'risk-free plus liquidity premium' discount rate; and a margin. It is also likely that an accounting profit will not be permitted at the point of sale of new business and that the margin will include an amount that eliminates any gain at inception.

The IASB published IFRS 9 Financial Instruments in November 2009. This new standard for financial instruments, which so far contains new classification and measurement rules for financial assets with other elements to follow, will replace IAS 39, the previous standard. It allows fair value and amortised cost measurement models for financial assets, where an entity's business model and the contractual terms of its assets determine classification. Subject to successful adoption procedures in the European Union and other jurisdictions, these rules will become mandatory for reporting periods beginning 1 January 2013, with the possibility of early adoption.

The IASB Fair Value Measurement project aims to clarify the definition of fair value and establish a single source of guidance for all fair value measurements. The core principle of the proposed standard is that the fair value is the price in an orderly transaction between market participants. The IASB is currently re-exposing specific areas of the exposure draft and expects to issue the final standard sometime in 2010. Amendments may include allowing mid prices to be used under certain conditions.

Appendix: 2009 EEV and MCEV Principles publications

Company	Allowance for risk classification ¹	RDR approach	Options and guarantees ¹	Cost of capital ²
Year-end 2009 publications under the MCEV Principles				
Allianz	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Aviva	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
CNP	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Delta Lloyd Group	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Hannover Re	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Himawari Life ³	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Mediolanum	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Munich Re	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Old Mutual	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Phoenix Group	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Resolution ⁴	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Sony Life ³	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Swiss Life	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Zurich	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Year-end 2009 publications under the EEV Principles				
AEGON	Top-down WACC	Top-down	Real-world	Traditional
AXA	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Chesnara	Direct market-consistent	Bottom-up	Not material	Frictional costs
Dai-ichi ³	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Eureko	Top-down WACC	Top-down	Both are used	Traditional
Fortis ⁵	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Generali	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Groupama	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Hansard Global	Direct market-consistent	Bottom-up	Not material	Frictional costs
IL&P	Indirect market-consistent	Bottom-up	Market-consistent	Traditional
KBC	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Legal & General	Top-down WACC	Top-down	Real-world	Traditional
Lloyds Banking Group	Direct market-consistent	Bottom-up	Market-consistent	Not disclosed
Mitsui Life ³	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Prudential ⁶	Other	Bottom-up	Both are used	Traditional
Royal London	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
SCOR	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
SJP	Indirect market-consistent	Bottom-up	Not material	Not disclosed
SNS REAAL	Top-down WACC	Top-down	Real-world	Not disclosed
Standard Life ⁷	Indirect market-consistent	Bottom-up	Market-consistent	Traditional
Storebrand	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
T&D Holdings ³	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
UNIQA	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Vienna Insurance	Direct market-consistent	Bottom-up	Market-consistent	Frictional costs
Vital	Top-down WACC	Top-down	Real-world	Traditional

1. At year-end 2009 a number of different 'market-consistent' approaches were used in EEV and MCEV to set the reference rate and to adjust for illiquidity. For a summary of CFO Forum company approaches see Table 2.

2. Traditional cost of capital is the difference between the top-down risk discount rate and the net earned rate. Frictional costs were almost always defined as tax and investment expenses.

3. Financial year end is 31 March 2010.

4. In 2009, Resolution acquired Friends Provident, which previously reported under the EEV Principles using a direct market-consistent approach.

5. Renamed Ageas in April 2010.

6. Prudential used a bottom-up product specific beta approach, except for UK annuities where it used an Indirect MCEV approach with a risk-free rate of swaps plus a liquidity premium adjustment.

7. Standard Life used an indirect MCEV approach which separately calibrated the allowance for risk by in-force business / new business and by region.

Towers Watson opinion

Market-consistency is expected to form a key element of future IFRS, US GAAP and Solvency II reporting measures, although these measures will almost certainly include additional margins. The level of prudence or optimism in such margins can only be understood once the remaining technical challenges with market-consistency are addressed in a credible and consistent manner. While the recent reporting season has seen considerable progress compared with year-end 2008, several technical inconsistencies and areas of further work remain.

We welcome the work of the Solvency II liquidity premium task force in developing a position on the level of liquidity risk premia in illiquid assets. We hope that a consensus and credible position quickly develops as to how much liquidity premium should be capitalised in a market-consistent valuation, bearing in mind the type of liabilities for which the use of a liquidity premium in the valuation is appropriate and the ability of insurance companies to capture liquidity premia in varying investment conditions and at different durations.

Other areas where further work remains include the valuation of financial instruments in illiquid markets, the extrapolation of the reference rate where calibration markets are not deep and liquid, the calibration of stochastic models used to value options and guarantees, and the allowance for non hedgeable risks.

In addressing these technical challenges, we advocate the following as guiding principles:

- **There should be consistency in the valuation of assets and liabilities.** Where the market in the calibration instruments is judged not to be deep and liquid, the methods used to determine the fair value of illiquid assets should be consistent with the methods used to determine the reference rate (including liquidity premium) and the valuation of options and guarantees;
- **The market-consistent balance sheet should avoid prudential margins.** Prudence should affect the capital requirements.

Insurance companies face practical challenges in improving the predictability of MCEV results (for a given set of economic conditions) and improving the explanation of the analysis of movement. Development by the industry of an enhanced set of sensitivities and a standardised breakdown of the economic and non-economic variances would help to address these challenges.

These remaining areas of development represent significant challenges. However, such developments and enhancements will deliver invaluable supplementary financial information that responds coherently in varying investment conditions, provides key insights into the performance of the business and supports valid comparisons of performance across the industry.

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