The Association of Corporate Treasurers

Comments in response to

Consultation Paper on the Draft L2 Advice on TP – Risk free interest rate

Committee of European Insurance and Occupational Pensions Supervisors, 2 July 2009

September 2009

General Comments

	Comments Template on CEIOPS-CP 40 **Consultation Paper on the Draft L2 Advice on TP – Risk free interest rate term structure**	**Deadline** **11.09.2009** **4 p.m. CET**
Name of Company:	The Association of Corporate Treasurers	
	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: Please indicate if your comments should be treated as confidential:	~~Yes /~~ No
Reference	**Comment**	
General Comment	The principal interest of the ACT in relation to the matter of this consultation arises from insurance companies and potentially other regulated persons investing in corporate obligations. The proposals as they stand will, we believe, reduce the willingness of insurance companies and other affected bodies to invest in corporate obligations which will in turn have a negative effect of the real economy and the ability of companies to finance themselves efficiently. We do not think that this impact should be accepted as we do not think the valuation basis is fully justified for the reasons set out below. We recognise that in looking at the return on a bond-like asset, the yield to maturity on acquisition above the real risk free rate available from AAA government bonds at that time can be seen as including varying premiums, conventionally	

- An inflation premium
- A credit risk premium
- A premium to reflect the lower liquidity of the asset
- Possibly a premium related to the maturity of the asset (although this can be seen as part of the inflation premium) and
- An error term.

When comparing to a conventional government bond yield the two major items are the credit risk and liquidity premiums.

We acknowledge that the credit risk premium can be seen the present value of the default risk on the asset. I.e. the expected return on the asset is to that extent diminished.
Taking account of default risk, then, the expected return from the investment, above the government bond yield, is mostly composed of the liquidity premium.

There has been much good work done on understanding liquidity premiums over the years both academically and by central banks, for example the Bank of England has many papers on the subject which are available on their website.

The liquidity of corporate bonds is much lower than that of liquid government bonds because of the smaller total outstandings of a corporate bond – even the largest – and the "buy and hold" propensity of bond investors.

However, such "buy and hold" investors will usually have long-term obligations and do not normally need liquidity at interim stages prior to maturity. This ability to reap the liquidity premium in most or part of their portfolios is, or should be, a key business characteristic of long-term insurers and pension funds.

Accordingly, we believe that the discount rates used in valuing long-term obligations of such firms and funds should recognise this liquidity premium in respect of their long term obligations.

Not to recognise this would open up a volatility in valuations between the long-term holders' assets and liabilities.

We understand from conversations with representatives of such holders that this would materially reduce their ability/ willingness to hold investments other than AAA government bonds. As such holders are major buyers of long-term corporate obligations that is alarming.

With the increased capital requirement of banks and the reduced size of bank balance sheets, non-financial corporates will be increasingly reliant on bond and equity markets for long-term funding over future years. To penalise regulated holders of such obligations would bear on real economy activity levels in an undesirable manner, raising the corporate cost of capital across the board. At a time of hoped-for recovery from the downturn, this would be doubly unfortunate.

	Accordingly we hope that in this fundamental issue, CEIOPS will be deeply thoughtful about the indirect consequences of the valuation methods proposed and recognise that liquidity premiums are a legitimate part of the expectations of investors and of the economy in general and should not be excluded in valuations.	

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

TREASURY, RISK AND FINANCE PROFESSIONALS

The Association of Corporate Treasurers

The ACT is a body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce professional service firms.

Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf .

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