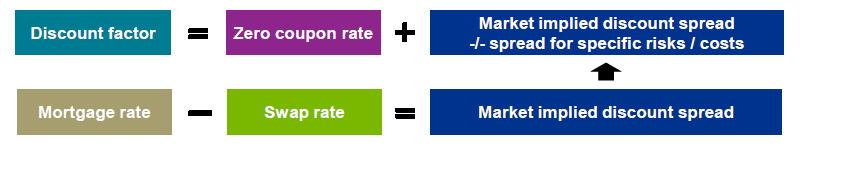
**Volatility Adjustment**

**Paragraph 2.260**

EIOPA explains that it has carried out intensive reviews and the current review has highlighted several deficiencies. However, EIOPA has not assessed the appropriateness of including all possible investments when determining the VA. One asset class which has not been properly included is mortgage loans; In some member states mortgage loans are a significant part of the insurers’ investments backing insurance liabilities. A proper treatment is needed to avoid several of the issues identified by EIOPA in this consultation paper such as the under/overshooting effects (i.e. basis risk) and the negative risk management incentives. Mortgage loans are specific investments which are normally not listed. The counterparties of mortgage loans are individuals, some of which also have a related insurance policy. Mortgage loans are recognized on the economic balance sheet for a longer term; Insurers have no objective to benefit from short-term price fluctuations. Data shows that the default rates on European mortgage loans are very low but mortgage loans are currently being assigned to corporate bonds for the VA calculation.

Proposal for treatment of mortgage loans via a separate index

As mortgage loans neither are traded on an active market, nor are there quoted prices, obtaining an economic value is based on a valuation methodology. The valuation methodology can either be based on a top-down approach or bottom-up approach. The latter involves more entity specific assumptions and possibly expert judgment. For the proposal we refer to the “top-down approach”. Under the top-down approach the spread is derived from market data.



Market rates for comparable mortgage loans can be obtained from the consumer market for mortgage loans. The mortgage rates from providers should be assessed for their quality (no action rates, sufficient cover of the whole market). From this rate the “swap rate” is deducted to calculate the “market implied discount spread”. From the “market implied discount spread” those costs are deducted which are not relevant for the valuation of an existing mortgage loan. These costs include (non-exhaustive list):

Pipeline risk is defined as the interest rate risk which exists for an issuer between the moment of putting forward a proposal to a consumer and the settling of this proposal in a legal manner. In principle the pipeline risk is determined as the cost of buying an interest rate swap in which the fixed leg is the mortgage loan interest rate as put forward and the floating leg is Euribor (or an equivalent benchmark). The IRS is obtained for a similar period for which the pipeline risk exists;

For both “marketing and sales” and “servicing at origination” these expenses reflect the net expenses.

For each Member State this exercise can be performed, based on which the index per Member State can be constructed and included in the determination of the VA.