Project	**Insurance Contracts**
Topic	**Discount rate: Asset-based rates and liquidity adjustments**

The purpose of this paper

1. This paper discusses the comments we have heard on the discount rate proposed in the Exposure Draft *Insurance Contracts* (ED) and asks working group members for their feedback and their input for possible solutions.

2. The paper does not address:

    (a) the discount rate for participating insurance contracts, ie insurance contracts for which the amount, timing and uncertainty of cash flows depend wholly or partly on the performance of specific assets.

    (b) adjustments for insurance risk.

    (c) whether, or how, the measurement of insurance contract should reflect their credit characteristics.

    (d) whether the discount rate should be locked-in or updated. Agenda paper 3B discusses that issue.

The proposals in the Exposure Draft *Insurance Contracts*

3. The ED proposes a current measurement model for insurance contracts, based on the notion of the 'present value of the fulfilment cash flows'. Discounting the future cash flows to their present value reflects the time value of money.

4. The ED proposes using a discount rate that:

    (a) is consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, in terms of, for example, timing, currency and liquidity.

(b)   excludes any factors that influence the observed rates but are not relevant to the insurance contract liability (eg risks not present in the liability but present in the instrument for which the market prices are observed).

5.   We have heard three main criticisms of the discount rate proposed in the ED:

(a)   It introduces volatility to the measurement of an insurance contract that, in some people's eyes, does not reflect the economics of the contract

(b)   It could result in recognition of a loss at the inception of an insurance contract that is expected to be profitable and is priced to reflect the returns the insurer expects to make from the assets backing the insurance contract. That loss arises because the discount rate is lower than those expected returns.

(c)   It could lead to a lack of comparability because there is insufficient guidance on how to apply the requirement to make an illiquidity adjustment.

Asset-based rates

6.   Some people believe that use of asset-based rates for insurance liabilities could address the criticisms in paragraphs 5(a) and 5(b).

Volatility

7.   Some people think that a discount rate as described in paragraph 4 introduces volatility to the measurement of an insurance contract, which does not, from an economic point of view, stem from a volatile business. That volatility arises from two factors:

(a)   using a current rate. The ED proposes the discount rate be updated at the end of every reporting period. Agenda paper 3B discusses whether the discount rate should be locked-in or updated.

(b)   using a rate that reflects only the characteristics of the insurance contract. Because the discount rate for the insurance contract is determined independently from the assets backing the insurance contracts, the measurement of the insurance liability would not reflect

interest rate changes that only occur on the asset side (eg due to changes in credit spreads). This is the case for non-participating insurance contracts.

8. The major concern is that using a rate that is determined independently from the assets de-links the liability-side from the asset-side and results in volatility that, in some people's view, does not reflect the economics of the contract. Insurers aim to match the expected future cash flows of the insurance contracts with the expected future cash flows of their portfolio of assets. For some contract types, the matching of the cash flows might be relatively easy to achieve. However, particularly for very long-term insurance contracts, it is not possible to match the cash flows in regard to, for example, the duration or the risk characteristics of the instruments.

9. The cash flows of the underlying asset portfolio might bear risks that are not reflected in the insurance contract, even though those risks are priced in the expected return on those assets and in their interest rate. Typically, this would include the credit risk of the issuer of the financial instrument, which is clearly not part of the inherent risk of a non-participating insurance contract. A change in the credit spreads on assets or in the expected returns on assets would not be reflected in the measurement of the insurance contracts as proposed in the ED.

Losses at inception

10. Some people state that a discount rate as described in paragraph 4 could result in the recognition of losses at inception of insurance contracts that are expected to be profitable over the life of the contract, especially investment-intensive products. Those losses would be the result of the discrepancy between the discount rate at which the insurer prices the insurance contract and the discount rate proposed by the ED. The insurer would often price the insurance contract based on the return it expects to make on the assets backing the insurance contract. However for a non-participating insurance contract, the discount rate proposed by the ED would be a (credit) risk-free rate with an adjustment for illiquidity. Although these differences between the pricing rate and the discount rate as proposed by the ED may be small, they could have a large impact on very

long-term insurance contracts, which may run over 30, 40 or even 50 years, and could result in significant losses at inception.

11.   Some respondents believe that asset-based rates reflect the economics behind an insurance contract better than risk-free rates. An asset-based rate would, in their view, reflect the relationship in the business model between the expected insurance contracts payments and the expected cash flows from investments.

12.   Others believe that cash flows from assets backing an insurance liability are irrelevant for a decision-useful measurement of that liability (unless the cash flows from those assets affect the cash flows arising from that liability) and that the discount rate should reflect the characteristics of the insurance contract. It should not capture characteristics of assets actually held to back the insurance liability, unless the liability shares those characteristics.

> **Q1: Using a rate based on expected asset returns**
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> Should the discount rate reflect the expected returns of assets even if the insurance contract does not share those characteristics?

Adjustment for illiquidity

13.   Many insurance contracts, for example long-term annuity contracts, are illiquid. Annuity contracts in the payout phase generally do not permit the policyholder to withdraw cash, ie they cannot lead to early payments, and are therefore relatively illiquid. Typically, the policyholder has little or no ability to sell its contracts (claims) to others.

14.   A highly liquid asset (eg a government bond traded in an active market) contains a feature for the holder (the ability to sell or cash in the asset at any time without any substantial discounts) that is not present in a liability that is not highly liquid. Accordingly, in determining the discount rate for that liability, it would be necessary, in principle, to adjust the observed market rate on highly-liquid assets for illiquidity of the liability.

15.   Furthermore, some state it is consistent with a fulfilment notion to exclude any liquidity features that are implicit in market rates for highly liquid financial assets, such as government bonds traded in deep and liquid markets from the measurement of the insurance liability. However, many others acknowledge that

it might be conceptually correct to adjust the discount rate to exclude the liquidity discount, but believe it would be impractical or not feasible to calculate the adjustment. Therefore, those with this view believe that the reference to an illiquidity adjustment would lead to lack of comparability because it does not give sufficient guidance on how to measure the liquidity premium or how to adjust the discount rate for the insurance liability to reflect liquidity characteristics of the liability.

Q2: Adjustment for illiquidity
Do you think that illiquidity is a characteristic of an insurance contract?
If so, do you also think that it is a relevant characteristic if measured under the assumption of fulfilling the contract?
Are you concerned that the illiquidity adjustment is not measurable? If so, should, based on those concerns, the adjustment not be permitted?