IFRS FASB	**IASB/FASB Meeting** **Week commencing 17 January 2011**	IASB Agenda reference	**3B**

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Discount rates using an Economic Default Adjusted Rate ("EDAR")

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What is EDAR?

- EDAR as proposed is a top-down approach to discount rates that begins with actual or estimated asset earnings and then eliminates risk factors that are not related to (are irrelevant to) the underlying insurance contract liability. We believe that in all cases the discount rate used should reflect the characteristics of the insurance contract.

Products and assets are interrelated

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- Policyholders have created demand for products with interest rate guarantees, premium guarantees, participation features, and liquidity features (and probably more)
- Insurers won't tend to sell such products unless they can hedge them (in general overall terms)
- So the product and its common asset backing *tend* to be inter-related

Current and future valuation

- Current valuation for US statutory purposes is effectively a fixed EDAR using a proxy asset class (think IAS19 type idea)
- But consumers demand flexibility in their policies and a simple proxy asset class isn't working
- Insurers *could* invest in Treasuries and discount at risk free … and lose their shirts
- So Insurers have to invest in other assets to offer the products, and we've had to find a more responsive and pragmatic valuation

Principles Based Reserving

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- The NAIC is moving towards Principles Based Reserving (PBR) for life products
- EDAR provides the principles for discounting such products
- EDAR is the short name we have given to the current majority view (Alternative 2) under our exposure draft of chapter 20 of our valuation manual (“VM-20”)

EDAR overarching objectives

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- Default costs for the same or similar assets should be the same across companies
- Companies should not be able to lower reserve by investing in riskier assets beyond some threshold
- In the short term, default costs should reflect current economic conditions and grade into historic conditions over the longer term
- The method should be relatively simple

EDAR characteristics

- EDAR would exclude from the discount rate the following factors:
  - investment expenses
  - credit default spreads
  - investment risk due to mismatch of asset and liability cash-flows (via our requirement for increased reserves in the event of significant cash-flow mismatch)

How complex is EDAR to calculate?

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- Deriving the rate in practice can be as complex or simple depending upon the degree of precision desired. In its simplest form the process for most assets that are commonly traded can be reduced to a table look-up. Items needed for the calculation would be the following for each asset in the portfolio:
  - Investment expense for each asset type
  - Option adjusted spread (OAS) for each asset
  - Weighted Average Life (WAL)
  - ARO (Approved Rating Organization) Rating
  - Current Spreads over Treasuries
  - Historical Spreads over Treasuries

Ok, how do I do it?

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- We have supplied the Board with our training materials on VM-20
- This includes a worked example showing the mechanics of how to derive the default rate for two insurers
- Note that the spreads to Treasuries in the examples (the Option Adjusted Spread) were not real observed rates, so the end result adjustments should not be regarded as fully representative of a real portfolio

Is EDAR generalizable?

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- The descriptions are naturally US-centric: e.g. NAIC ratings, Treasuries
- Nonetheless, we believe that the concepts are capable of being generalized
- Much of the work has been undertaken by the American Academy of Actuaries
- Presumably other international actuarial bodies could derive their ratings, spreads, etc applicable in their jurisdiction

Why EDAR?

- It aligns closely with the business model and the way insurers manage their products
- It is genuinely principles-based (although the application of those principles result in the use in the methodology of a number of parameters)
- It fits well with a fulfillment attribute

Questions?

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