



**IASB/FASB Meeting  
Week commencing 17 January 2011**

IASB  
Agenda  
reference

**3C**

Staff Paper

FASB  
Agenda  
reference

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Project

**Insurance Contracts**

Topic

**Educational Session Discount Rate – Presentation from  
Francesco Nagari and Andrew Smith, Deloitte**

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# Discounting non-participating insurance contracts with a reference asset portfolio discount rate

19 January 2011

Francesco Nagari and Andrew Smith

Deloitte LLP

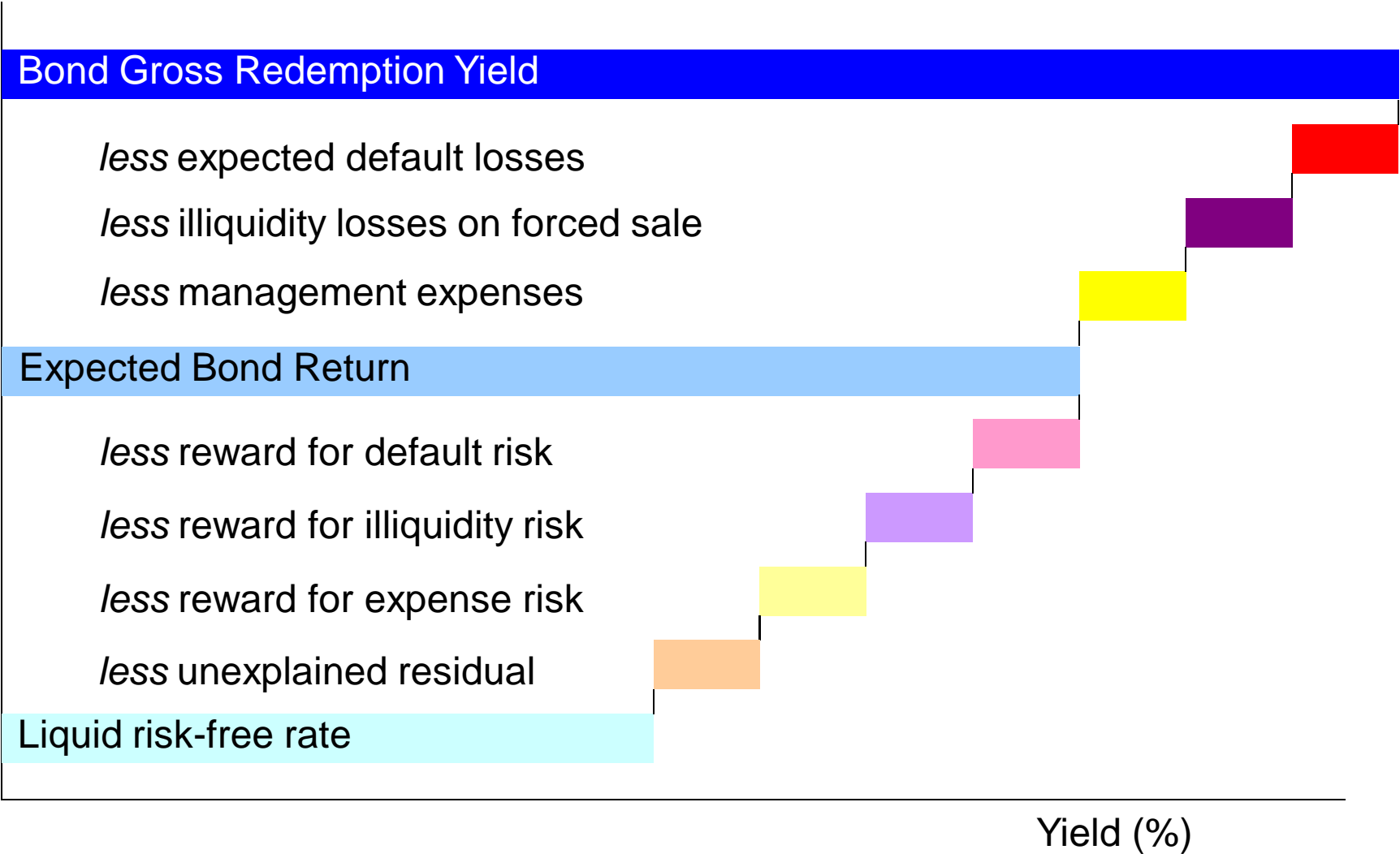
## Deloitte proposal on discount rate using a reference asset portfolio

- It is not controversial that asset returns contain premiums for many forms of risk, including a premium for illiquidity risk, which compensates investors for potential adverse prices on forced sale
- Econometric estimation of the illiquidity premium has proved challenging, with different methods producing very different results, even at a single point in time. A plausible explanation for the divergence is the difficulty of separating illiquidity premiums from other risk premiums, particularly credit risk.
- The IASB has acknowledged that these difficulties affect the selection from market interest rates of a discount rate to apply to insurance contracts measurement for general financial reporting purposes as the risk of default is not relevant to the insurance contract cash flows
- Deloitte recommended in its comment letter to determine the discount rate for insurance contracts cash flows that do not vary with the value of the assets backing them using a “top down” approach starting with the rate of return on a reference asset portfolio
- The “top down” approach removes the risk of default (based on the insurer’s estimate of expected credit losses carried out in the same way as in IFRS 9) from the rate of return on a reference asset portfolio that matches the duration and currency of the insurance contract cash flows.
- We have attempted to summarise in these slides the basis for our conclusion

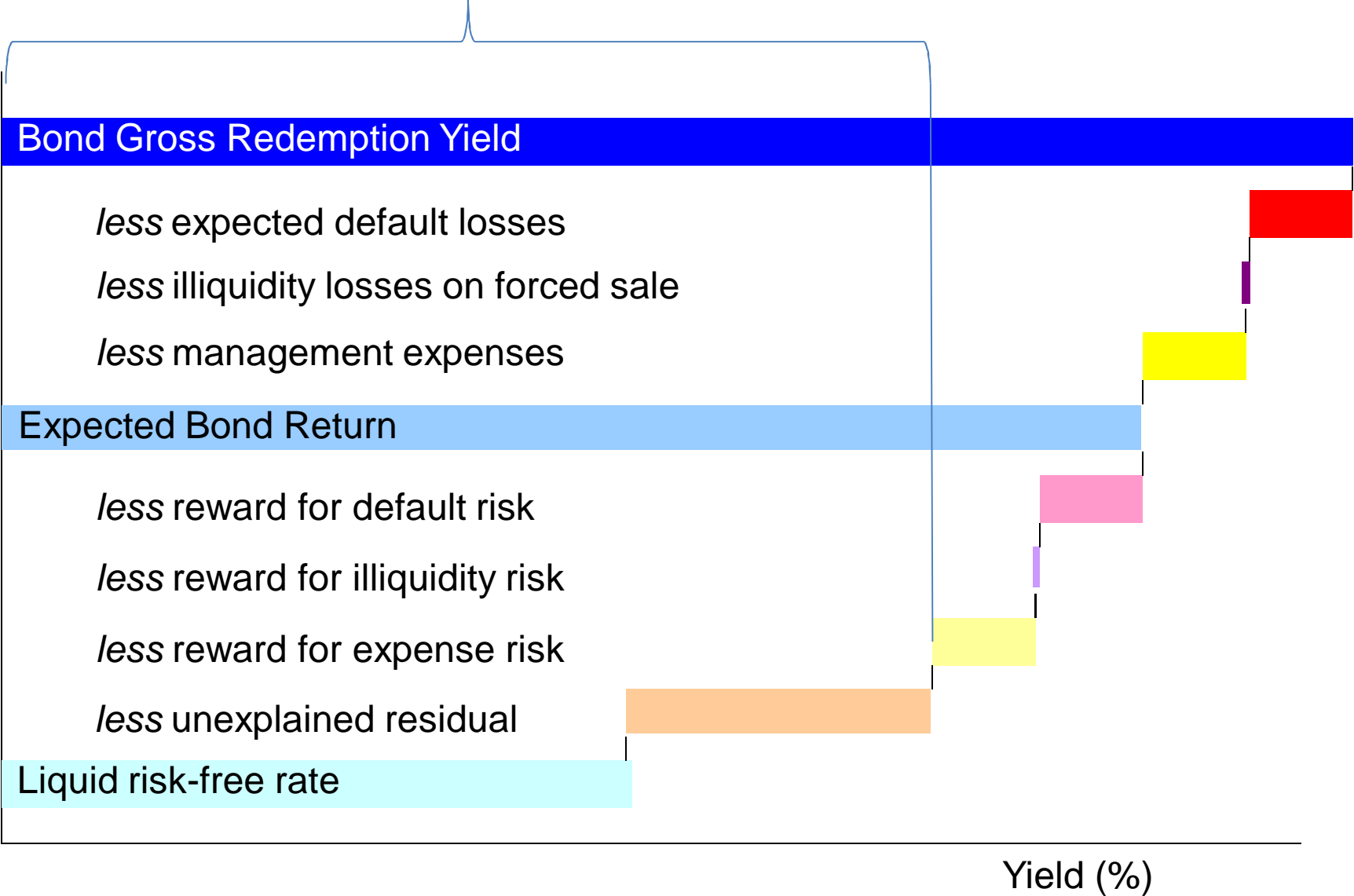
## Deloitte proposal on discount rate using a reference asset portfolio (cont.)

- Deloitte recommendation attempts to remain within the lines set by the IASB in its ED
  - It measures the time value of money of insurance cash flows in on a current basis;
  - It utilises market interest rates for instruments that match the characteristics of the cash flows; and
  - It removes the attributes of market interest rates that are not relevant to the characteristics as defined in the ED
- We believe that there are advantages from our approach:
  - It does not require to solve the illiquidity premium estimation problem for which an established and practical method does not yet exist;
  - It aligns the IFRS for insurance with concepts that are common to other IFRSs – Impairment of financial assets in IFRS 9;
  - It produces an accounting for time value of money for insurance contracts that is responsive to market fluctuations in a way that is better matching the assets than the ED proposals; and
  - It is neutral towards an asset allocation matching the contracts cash flows barring asset default risk

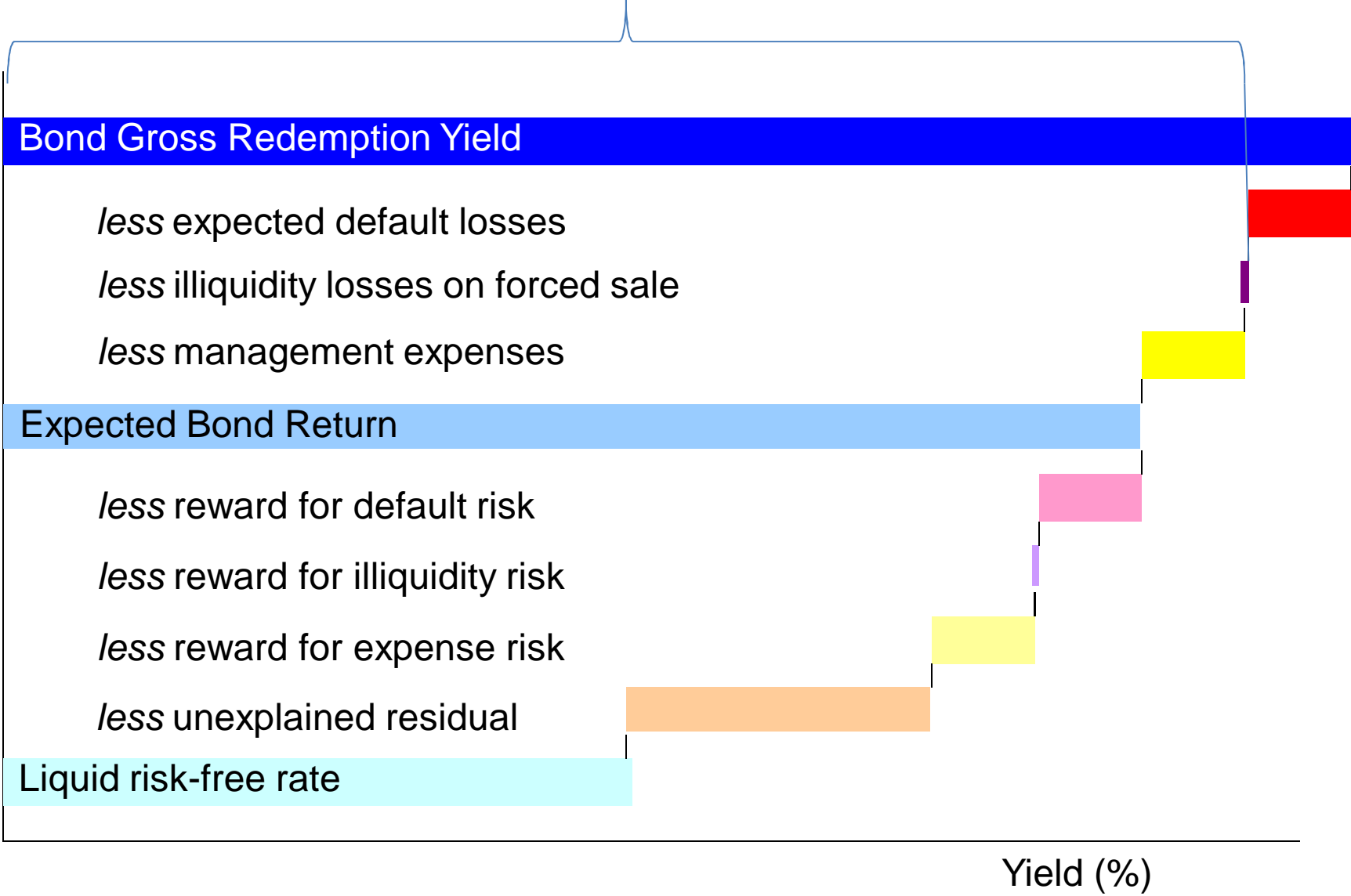
# Elements of Corporate Bond Yields: Illustrative



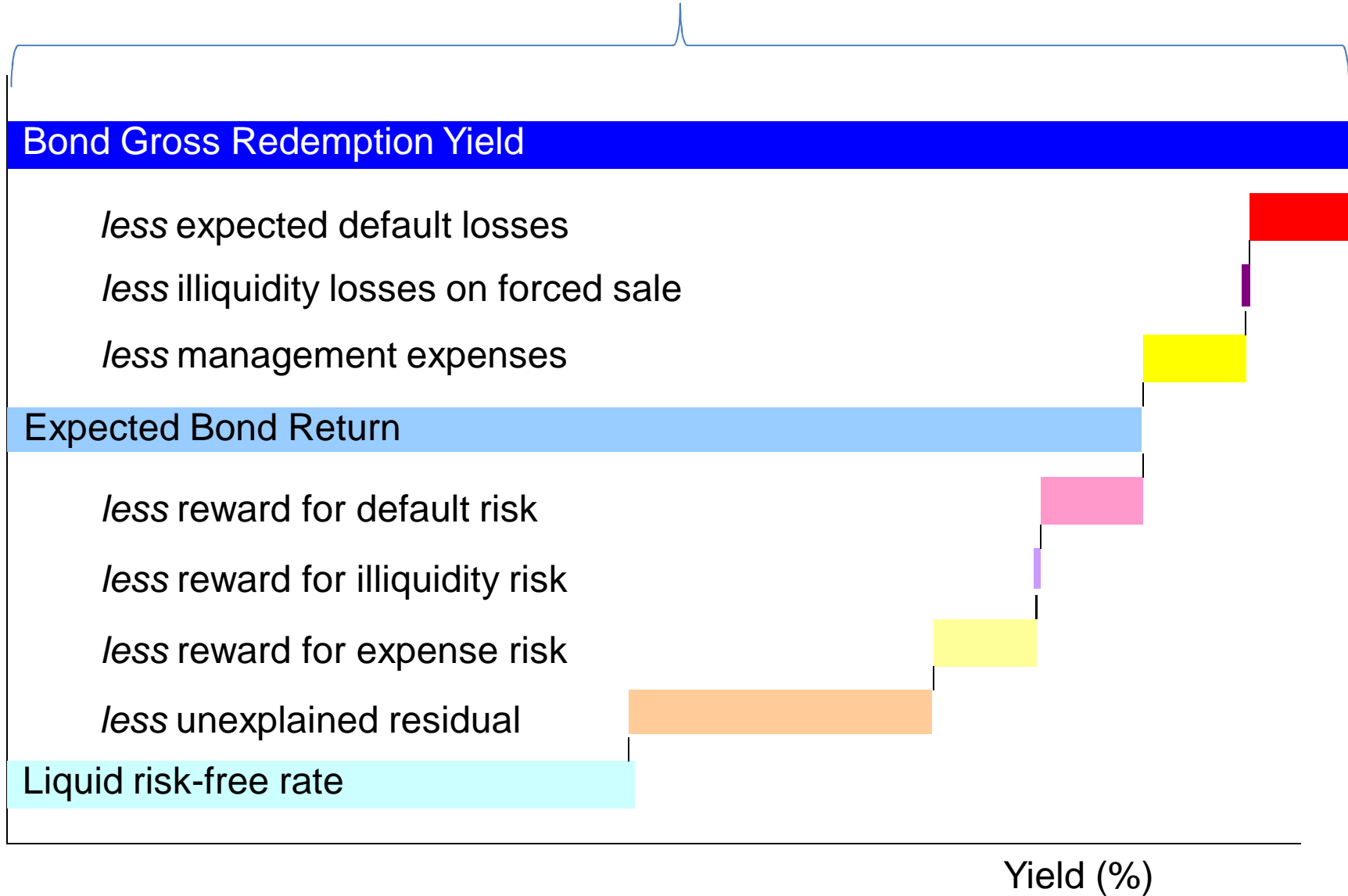
# Illiquid liabilities – theoretical approach



# Illiquid liabilities – pragmatic approach or reference asset portfolio



# IAS 19 approach for pension liabilities





## How complicated is it to derive this rate?

- Identifying candidate assets for replicating portfolios
  - Selection of bonds: we have avoided specifying how to do this
  - Different practical complications will arise for different bonds
- Identifying expected losses
  - Long term data available split by credit grade
  - Assumes rating agencies behave consistently over time
  - More difficult for un-rated instruments or instruments rated differently by different agencies
- Internal rate of return calculation for a given bond is simple in principle but requires detailed knowledge of cash flows and quotation conventions
- Determining liability liquidity
  - Our proposal does not explicitly link liquidity of the replicating portfolio to liability liquidity

## Contact details

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