
Staff Paper

Topic

Feedback on the Discount Rate decisions

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB working group identified in the header of this paper.

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Feedback on the Discount Rate decisions

The exposure draft proposed that an insurer adjusts the future cash flows for the time value of money using discount rates that:

- are consistent with observable current market data and
- reflect only the characteristics of the liability.

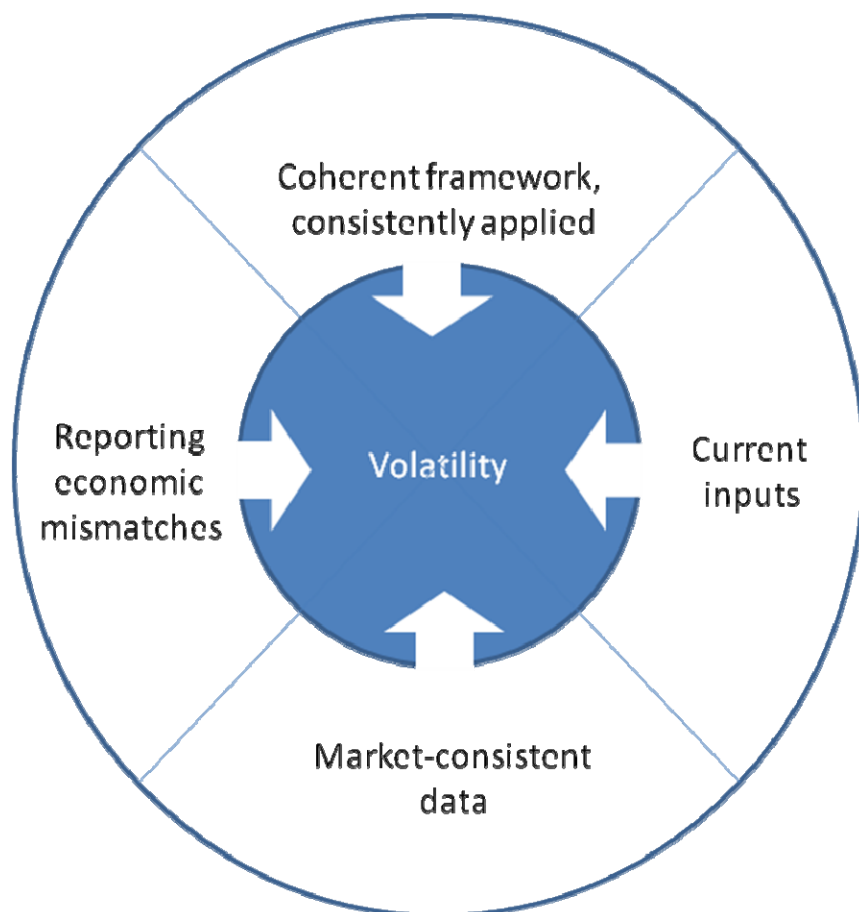
Many respondents to the ED considered the selection of the discount rate as the most significant issue in the proposed measurement model. In particular, there were significant concerns about the volatility in profit or loss that would result from the discount rate proposed in the exposure draft.

Many were concerned that the discount rate proposed in the ED would cause volatility in the financial statements:

- Some insurers state that this volatility results from a failure to reflect the asset-liability management inherent to the insurance business model.
- Some users question whether volatility might mask important information.
- Most believe that this volatility would result in financial statements that will be difficult to explain, lack comparability and be neither relevant nor reliable.

In the pages that follow we outline the more significant matters raised with us and how we responded.

How we analysed the causes of volatility arising from the discount rate



In selecting the discount rate used to measure insurance contracts, we sought an approach that would be consistent with our project axioms:

- An ideal measurement model would report all economic mismatches that exist and would not cause any accounting mismatches.
- An ideal accounting model should reflect both the intrinsic value and time value of options and guarantees embedded in insurance contracts.

An economic mismatch arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions.

An accounting mismatch arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes because different measurement attributes are applied.

Clear reporting of economic mismatches

Proposal in the ED

In developing a measurement model for insurance contracts, we sought an approach that would report all economic mismatches that exist, but that would not cause any accounting mismatches. In that approach, we expected that many insurers would eliminate accounting mismatches by choosing available options to measure investments backing insurance contracts at fair value through profit and loss. In particular, we expected many insurers to measure their financial assets using the fair value option in IFRS 9.

We proposed that an insurer's own credit risk should not be considered in determining the discount rate.

The proposal to exclude the insurer's own credit risk is consistent with the deeply held views expressed over many years by most commentators on this project. However, we did acknowledge that its exclusion could lead to an accounting mismatch. This is because the fair value of the assets backing insurance contracts includes changes in credit spreads on those assets, but the measurement model for insurance liabilities does not include changes in credit spreads on those liabilities.

Respondents' comments

Preparers generally welcomed the ability to avoid accounting mismatches. However some respondents argued that insurers would, in effect, be deprived of the ability to measure some financial assets at amortised cost as permitted in IFRS 9.

Some respondents suggested reintroducing the categories of available-for-sale investments in IAS 39, or amending IFRS 9 to permit or require recycling of realised gains on equity investments and losses to profit or loss.

Many insurers suggest that a requirement to report the effect of duration mismatches places them at a disadvantage compared to banks, which compete with insurers in attracting investor capital.

Many view the volatility that arises from credit spreads as relatively unimportant for assets that are typically held to collect principal and interest.

Almost all agree that an insurer's own credit risk should not be considered in determining the discount rate. They note its inclusion would result in a gain when there is a decline in the insurer's credit standing. They believe that result is counterintuitive.

Our response

We think that an ideal measurement model would report all economic mismatches (including duration mismatches) that exist and would not cause any accounting mismatches.

We have no current plans to change the classification and measurement requirements in IFRS 9.

We acknowledge that many see credit spread volatility on assets as relatively unimportant if these assets are held to collect principal and interest, and we are exploring whether there are useful, informative and implementable ways to segregate any volatility arising from credit spread volatility

We confirmed that an entity's own credit risk should not be considered in determining the discount rate.

We will assess throughout the project whether any reported volatility is a faithful representation of the underlying economic phenomena.

Market-based discount rates

Proposal in the ED

The ED proposed to account for insurance contracts from the perspective of the insurer, using inputs that are consistent with observable market data, where available.

In addition, the ED proposed that the discount rate should reflect the illiquidity characteristics of the insurance contract. This would reflect the fact that many insurance contracts can be surrendered or lapsed only on conditions that are unfavourable to the policyholder. Most have interpreted the proposals as requiring insurers to derive the discount rate starting from a risk-free rate and adding on a liquidity premium (a 'bottom-up' approach).

The ED does not provide guidance for extrapolating market data to periods for which there is no observable information. Those difficulties are similar to those in determining fair value when only Level 3 inputs are available.

Respondents' comments

A number of concerns relate to the use of a market-based discount rate.

Determining an illiquidity adjustment

Many are concerned that the calculation of an unobservable illiquidity premium would be complex and difficult to explain to investors.

Many suggest that illiquidity is captured by basing the discount rate on expected asset returns, either on the assets held by the insurer, a reference portfolio, or those contemplated in pricing the contract (a 'top-down' approach).

Some suggest that the boards should permit or require a practical proxy based on an observable market rate.

Losses on day 1

Some insurers believe that the discount rate should reflect the investment income that they earn over time to off-set the cost of the benefits provided. They are concerned that measuring insurance contracts at a risk-free rate plus illiquidity premium could generate significant losses at the inception of contracts expected to be profitable.

Our response

We confirmed that the objective is to use a discount rate that reflects the time value of money and reflects the characteristics of the liability.

We confirmed that we would not prescribe a single method for determining the discount rate. Thus an insurer could use any approach that meets the objective. This would include:

- 'Top-down' approaches based on market-consistent expected asset returns, either on the assets held by the insurer, a reference portfolio, or those contemplated in pricing the contract, adjusted to remove items that relate only to the assets. Any remaining difference between the adjusted rate and the risk-free rate would be regarded as the illiquidity premium.
- 'Bottom-up' approaches based on risk-free rates, adjusted to add an illiquidity premium. We acknowledge that many had interpreted the ED as permitting only the bottom-up approach, but that was not our intention.

Market-based discount rates (continued)

Lack of observable market data at long durations

It is very difficult to determine discount rates for very long duration liabilities because observed market information is rare and the accuracy of the estimate decreases as the duration increases. In addition, small changes in the discount rate can lead to large changes in the measurement of very long duration liabilities.

We acknowledge that it may not always be easy for insurers to determine the discount rate and so we intend to consider at the March joint boards meeting whether we should:

- as a practical expedient, permit or require a simplified benchmark for determining the discount rate
- amend the overall approach in any way to reflect the specific problems posed by very long durations, for which there is little or no observable market data.

Current discount rates

Proposal in the ED

The ED proposed that the measurement of insurance contracts should use current inputs, including current discount rates.

This means that the estimates made at contract inception would not be carried forward (ie the model does not lock-in any estimate).

Respondents' comments

Most insurers and users support a current measurement approach because they think it will give them a clearer picture of gains and losses in the reporting period.

Some respondents favour locking in discount rates for some or all insurance contracts. If the discount rate is locked in, those insurer would be able to avoid reporting volatility by carrying loans and bonds backing those liabilities at amortised cost (when so permitted by IFRS 9 *Financial Instruments*).

Respondents who favoured locking in discount rates typically also suggested that:

- A liability adequacy test should be applied to insurance liabilities. The test would increase the measurement of the liability if the expected yield from the related investments is lower than the locked in rate for the liability.
- Derivatives embedded in such contracts should be accounted for separately, as under existing requirements.

Our response

We think that locking in the discount rate would omit information about changes in estimates. This would make the accounting for insurance contracts more complex and less understandable.

A liability adequacy test of the kind suggested by some respondents would be a new approach, not used elsewhere in IFRS. Any such test would need us to consider many details, including when the test is triggered and the level of aggregation for the test (eg per contract, per cohort, per portfolio, per entity, per groups).

Existing requirements for embedded derivatives do not require insurers to separate some significant exposures, such as many guarantees of a minimum interest rate.

We believe it is essential for insurers to report transparently:

- their duration mismatches.
- the intrinsic value and time value of their exposures under options and guarantees embedded in insurance contracts.

We confirmed that discount rates should not be locked in.

A coherent framework, consistently applied

Proposal in the ED

The ED proposed to improve consistency in the reporting of insurance contracts. In particular, the ED proposed a unified approach for accounting for all insurance contracts

Respondents' comments

Many insurers asked the board to consider whether additional considerations should apply to some types of contracts.

Participating contracts

The ED stated that the measurement of an insurance contract should reflect any dependence of the liability on the performance of specific assets held by the insurer. Some interpreted that guidance as implying two different approaches for determining the discount rate:

- An asset-based discount rate for participating contracts.
- A risk-free rate adjusted for illiquidity for non-participating contracts.

Short duration contracts

Many insurers that write mainly non-life contracts believe that discounting for non-life contracts adds complexity for little or no added value because most claims are paid relatively shortly after the incurred date.

Some are concerned that it can be difficult to estimate the timing of expected cash out flows which have greater variability in amount and timing than most other insurance contracts.

Our response

We will consider at the March joint boards meeting whether additional considerations apply in determining the discount rate for insurance contracts that contain participating features.

We confirmed that discounting of insurance liabilities would be required unless the effect of discounting would be immaterial. However, we intend to assess in April whether additional guidance is needed on when discounting a contract with a short-tail claim would be considered immaterial.

Looking ahead: other areas with an impact on volatility

Although our objective is not to minimise volatility, we will consider, throughout our discussions, whether any reported volatility is a faithful representation of the underlying economic phenomena. The boards will consider the possible impact on volatility of the following areas.

Presentation

We will consider how to present information about changes in insurance contract liabilities in a way that is most useful to users of financial statements.

In particular, we will consider whether insurers should report separately:

- changes that provide useful information about the likely amount and timing of future cash flows.
- changes that provide useful information mainly about the uncertainty and risk of future cash flows, rather than about the amount and timing of those cash flows. Some fluctuations arising from market-based inputs might fall into this second category.

Unlocking the residual margin

The ED proposed that the measurement of an insurance liability should include a locked-in residual margin, calibrated as the difference between the present value of the expected cash flows plus a risk adjustment and the expected premium.

Many disagreed that the residual or composite margin should be fixed at inception of the contract and allocated in a systematic way over the coverage period.

Some suggest absorbing changes in market-based estimates in the residual margin.

Unbundling

Some suggest extensive unbundling, allowing deposit components to be measured at amortised cost. This would allow insurers to reduce reporting volatility by carrying loans and bonds backing those components at amortised cost (when so permitted by IFRS 9 *Financial Instruments*).