
Staff Paper

Topic

Discount rate for insurance contracts

1. This paper describes how we might implement the boards' tentative decision that it would:
 - (a) confirm the objective of the discount rate is to adjust the future cash flows for the time value of money and reflect the characteristics of the insurance contract liability.
 - (b) not prescribe a method for determining the discount rate.
 - (c) provide guidance that the discount rate should:
 - (i) be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, including in terms of timing, currency and liquidity, but excluding the effect of the insurer's non-performance risk.
 - (ii) exclude 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, such as any investment risk taken by the entity that cannot be passed to the policyholder).
 - (iii) reflect only the effect of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability.
2. The drafting in this paper is indicative only and has not been reviewed by the boards.

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.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Board. Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

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3. Board members noted that the lack of a uniform methodology for determining the discount rate would probably lead to some variation in practice. In view of the likely variation, they indicated that they favour including a requirement to disclose the yield curve used for each major relevant currency. We will consider draft wording for that disclosure when we finalise the disclosure requirements.

Standard

4. A working draft of the wording for the standard is as follows (changes from the ED are marked):

Time value of money

- 30 An insurer shall adjust the future cash flows for the time value of money, using discount rates that reflect the characteristics of the insurance contract liability. Such rates:**
- (a) ~~are shall be~~ 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) exclude 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).
- 31 This IFRS does not prescribe the methodology used to apply the principle in paragraph 30. However, as As a result of the principle in paragraph 30,:**
- (a) if the cash flows of an insurance contract do not depend on the performance of specific assets, the discount rate shall reflect the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, ~~with an adjustment for illiquidity (see paragraph 34). The illiquidity of the cash flows is relevant for the insurance contract liability.~~
 - (b) ~~32 — to the extent that~~ If the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the measurement of the insurance contract shall reflect that dependence. ~~In some circumstances, the most appropriate way to reflect that linkage might be to use a replicating portfolio technique (see paragraphs B45–B47).~~
 - (c) the discount rate shall reflect the illiquidity characteristics of the cash flows.
- 33 Estimates of cash flows and discount rates shall be internally consistent to avoid double-counting or omissions. For example, nominal cash flows (ie those that include the effect of inflation) shall be discounted at rates that include the effect of inflation. Real cash flows (ie those that exclude the effect of inflation) shall be**

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discounted at rates that exclude the effect of inflation. Furthermore, the discount rate should reflect only risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability.

- ~~34 Many insurance liabilities do not have the same liquidity characteristics as assets traded in financial markets. For example, some government bonds are traded in deep and liquid markets and the holder can typically sell them readily at any time without incurring significant costs. In contrast, policyholders cannot liquidate their investment in some insurance contract liabilities without incurring significant costs, and in some cases they have no contractual right to liquidate their holding at all. Thus, in estimating discount rates for an insurance contract, an insurer shall take account of any differences between the liquidity characteristics of the instruments underlying the rates observed in the market and the liquidity characteristics of the insurance contract.~~

Application guidance

5. We propose to add application guidance on determining the discount rate. This section would be inserted between paragraphs B66 and B67 of the ED.

Time value of money (paragraphs 30-34)

- B66A Discount rates that reflect the characteristics of the insurance contract liability may not be directly observable in the market. An insurer adjusts observable market prices of similar instruments to reflect the characteristics of the insurance contract liability. This [Draft] IFRS does not prescribe the methodology for making those adjustments.
- B66B In making the adjustments described in paragraph B66A, an insurer includes only those factors that are relevant for the liability:
- (a) In some cases, an insurer adjusts expected asset returns that are consistent with the market prices of assets. In doing so, the insurer excludes from those rates factors that are not relevant to the insurance contract liability (a 'top-down' approach). Factors that are not relevant to the insurance contract liability include risk premiums for expected and unexpected defaults (unless those risks can be passed to the policyholder).
 - (b) In other case, an insurer adjusts a risk-free rate to include factors that are relevant to the insurance contract liability (a 'bottom-up' approach). Factors that are relevant to the insurance contract liability include differences between the liquidity characteristics of the instruments underlying the rates observed in the market and the liquidity characteristics of the insurance contract. Those differences arise when insurance liabilities do not have the same liquidity characteristics as assets traded in financial markets. For example, some government bonds are traded in deep and liquid markets and the holder can typically sell them readily at any time without incurring significant costs. In contrast, policyholders cannot liquidate their investment in some insurance contract liabilities without incurring significant costs, and in some cases they have no contractual right to liquidate their holding at all.

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[Note for working group participants: we expect to continue to develop the wording in paragraph B66C.]

B66C When observable market variables are not available, an insurer uses estimation techniques to determine the appropriate discount rate. For example, the discount rate applied to cash flows that are expected beyond the period for which observable market data is available would be extrapolated from the current market yield curve. However, long-term expectations or averages (eg long-term average asset returns often used for pricing) shall not substitute existing observable current market variables.

B66D In principle the discount rates used for non-participating insurance contracts will result in the same yield curve for all cash-flows discounted.

[Note for working group participants: the draft wording in paragraph B66E assumes that the boards accept the staff's recommendations on participating contracts. The boards will discuss that topic during the meetings in March.]

B66E Paragraph 31B requires that, to the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the measurement of the insurance contract shall reflect that dependence. Techniques for capturing any such dependence include:

- (a) replicating portfolio techniques as described in paragraph B45.
- (b) for those cash flows dependent on the performance of those assets, using discount rates consistent with current market prices for those assets, adjusted for any asymmetry between the insurer and policyholders in the sharing of those risks associated with those assets.