

Project **Insurance contracts**

Topic **Practical expedient for the discount rate**

What is this paper about?

1. This paper analyses the feasibility of providing a practical expedient to determining the discount rate for a particular subset of entities.
2. This paper does not discuss:
 - (a) participating contracts in which the amount, timing, and uncertainty of the cash flows arising from the insurance contract are dependent partly or wholly on the performance of specific assets. This topic is discussed as part of Agenda paper 3F/60F.
 - (b) discounting of ultra-long insurance contracts. This topic will be discussed at a future meeting.

Staff recommendation

3. The staff recommend that the boards should not provide a practical expedient for determining the discount rate.
4. If the boards tentatively decide that a practical expedient is appropriate, the staff will ask the boards:
 - (a) to select an option for the practical expedient.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

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 FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in *FASB Action Alert* or in *IASB Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

- (b) to consider the eligibility criteria.

Structure of this paper

5. This paper provides:

- (a) Background, including:
 - (i) a summary of the IASB's proposals and the FASB's preliminary views;
 - (ii) reasons for analyzing the feasibility of providing a practical expedient; and
 - (iii) analogies to be considered as a practical expedient
- (b) Consideration of possible eligibility requirements for applying a practical expedient to determining the discount rate:
 - (i) public vs. non-public entities; and
 - (ii) size of the entity.
- (c) An analysis of possible rates to be used as a practical expedient to determining the appropriate discount rate, including the practical and theoretical problems with each:
 - (i) government rates;
 - (ii) high quality corporate bond rates; and
 - (iii) combination or choice of rates.
- (d) Staff recommendations.
- (e) Consideration of the potential implications of any decisions made by the boards about providing a practical expedient to determining the discount rate on other parts of the project.

Background

Summary of the IASB's proposals and the FASB's preliminary views¹

6. The ED proposes that an insurer adjusts the future cash flows for the time value of money using discount rates that

(a) are 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).

(paragraph 30)

7. Paragraph BC 101(b) of the Basis of Conclusions for the ED states that it would not be appropriate, in a principle-based approach:

To prescribe a discount rate that ignores the liquidity characteristics of the item being measured or uses an arbitrary benchmark (eg high quality corporate bonds) as an attempt to develop a practical proxy for measuring the specific liquidity characteristics of the item being measured.

Reasons for analyzing the feasibility of providing a practical expedient

8. Paragraph 66 of Agenda paper 3D/58D of the February 2011 joint meeting listed two motivations for providing a practical expedient based upon feedback received through comment letters, roundtables, and outreach:
 - (a) Some suggest that an approach based upon the current proposals might theoretically result in an appropriate discount rate, but that a practical

¹ The views expressed in the ED and DP are consistent with respect to the discount rate.

expedient is needed until the boards can examine discounting of all liabilities comprehensively. However, the staff do not see it as a viable option to include a short term solution in a new standard that fundamentally revises the accounting for insurance contracts. To do so would call into question the validity of finalising a standard at this point. However, this does not preclude a practical expedient for other reasons.

- (b) Some suggest that the complexity inherent in determining the discount rate could be reduced if the boards include in the standard a default solution for insurers that is easier to determine than the current proposals while still achieving the objective. This would address the criticisms about the difficulty of determining the discount rate.
9. For this reason, the staff consider below whether a prescribed discount rate could be a practical expedient to determine the discount rate in some circumstances. However, the staff concluded that the options available all have inherent complexities and we are not convinced that these options provide a suitable default solution for insurers that are easier to determine than the current proposals.

Summary of the tentative decisions of the boards to date about the discount rate

10. A summary of the decisions made to date about the discount rate is provided as part of Appendix B of Agenda paper 3/60.

Summary of current IFRS and US GAAP that an entity could analogize to as a practical expedient

11. In this section the staff provides a brief review of the areas within IFRS and US GAAP where the boards have prescribed a benchmark rate for discounting long-term liabilities.
12. Some respondents to the ED and DP suggested that the boards permit or require insurers to approximate the discount rate by prescribing a particular observable market rate or a set of observable market rates. They suggested that the complexity inherent in determining the discount rate could be reduced if the boards include a

default method for determining the discount rate. For these reasons, we consider whether a prescribed discount rate could serve as a practical expedient.

13. One area within IFRS and US GAAP that could be analogized to as a practical expedient is employee benefits. The staff analyzed the following guidance:
 - (a) IAS 19 *Employee benefits*;
 - (b) Accounting Standards Codification Topic 715 Compensation – Retirement Benefits, first introduced by FASB Statement No. 87 *Employers' Accounting for Pensions* and FASB Statement No. 106 *Employers' Accounting for Postretirement Benefits Other Than Pensions*.
14. Paragraph 78 of IAS 19 requires:

The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds shall be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.
15. Based on our reading of the Basis for Conclusions for IAS 19, it appears that much of the debate about which discount rate to use for pension liabilities focused on whether the expected return for a given asset portfolio was suitable for discounting liabilities. For many reasons, the IASC (the predecessor to the IASB) decided that an *unadjusted* expected return on an asset portfolio, regardless of the composition, was not appropriate.
16. Accordingly the IASC concluded that there was no clear evidence identified that an expected return on a portfolio of assets could reliably or relevantly measure the risks associated with a defined benefit obligation, nor could such a rate be

determined objectively. Consequently, the IASC determined that the objective of discounting defined benefit obligations should:

- (a) reflect the time value of money without attempting to capture the risks of a defined benefit plan;
 - (b) avoid reflecting the entity's own credit rating.
17. At the time, the IASC concluded the best way to achieve these objectives was through the use of a high quality corporate bond or the yield on government bonds when the corporate market was not sufficiently deep.
18. In August of 2009, the IASB released an exposure draft *Discount Rate for Employee Benefits (proposed amendments to IAS 19)* to address the differences in the options available for the discount rate under IAS 19. The differences in measurement created by the different discount rates was exacerbated during the financial crisis as credit spreads on high quality corporate debt widened. The exposure draft proposed eliminating the use of different rates by deleting the requirement to use market yields on government bonds.
19. From the FASB's perspective, paragraph 715-30-35-43 of Topic 715 states:

Assumed discount rates shall reflect the rates at which the pension benefits could be effectively settled. It is appropriate in estimating those rates to look to available information about rates implicit in current prices of annuity contracts that could be used to effect settlement of the obligation (including information about available annuity rates published by the Pension Benefit Guaranty Corporation). In making those estimates, employers may also look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits. [...]

20. Paragraph 715-30-35-44 of Topic 715 further states:

[...] The objective of selecting assumed discount rates using that method is to measure the single

amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the pension benefits when due. [...]

21. The FASB concluded that the selection of the discount rate should be based upon current prices for settling the pension obligation. They reasoned that the most significant use of the discount rate was to calculate the present value of obligation and service cost component of the net periodic pension cost, and that both of these measures are independent of expected returns on plan assets. They concluded that if two employers had the same obligation, the measurement of that obligation should not be influenced by the fact that one employer expected to obtain a return while the other was unfunded. Thus, the FASB concluded that a current settlement rate best met this objective. Additionally, this measurement was consistent with measuring plan assets at fair value for purposes of disclosing the plan's funded status.
22. Although the objective of setting the discount rate for IAS 19 and Topic 715 differed, the staff provides this background as a reference point for the boards' thinking in prescribing a benchmark rate. The staff will also use this as a point of reference to discuss some of the practical and theoretical issues with prescribing a benchmark rate as a practical expedient.

Staff analysis

Consideration of the eligibility requirements for applying a practical expedient

23. If the boards disagree with the analysis the staff provided, and select one of the options analyzed for a practical expedient, it will be important to decide which entities should be eligible to apply the practical expedient. The staff believe the eligibility requirements will need to be well defined to prevent entities from simply defaulting to the practical expedient rather than making a reasonable effort to apply the building blocks approach as proposed.

24. In this section the staff identified possible alternatives that could be considered to establish requirements for qualifying for the practical expedient. The staff provides these alternatives as preliminary thoughts as to what the requirements could be. However, if the boards disagree with the staff analysis and wish to provide a practical expedient, we would need to return to the boards with a more detailed analysis. The alternatives to consider could be:

- (a) non-public entities;
- (b) size of the entity.

Non-public entities

25. One alternative the boards could consider is to permit all non-public entities that enter into insurance contracts to apply the practical expedient for determining the discount rate.
26. The first issue with this alternative is the different considerations for IFRS and US GAAP. For IFRSs, some jurisdictions require or permit small and medium-sized entities to use the IFRS for SMEs. Small and medium-sized entities are defined under that standard as entities that:
- (a) do not have public accountability, and
 - (b) publish general purpose financial statements for external users.
27. The IFRS for SMEs further states that an entity has public accountability if:
- (a) its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market [...], or
 - (b) it holds assets in a fiduciary capacity for a broad of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.

28. US GAAP does not have separate accounting guidance for small and medium-sized entities. Therefore, given this difference, this alternative will not work for all non-public entities.
29. Furthermore, many would argue that this criteria is much too broad for US GAAP as well because there are insurance entities that are non-public that would fall into this category. This category would provide an opportunity for non-public insurance entities to simply default to the practical expedient thereby eroding comparability across entities with fundamentally the same operations (ie providing insurance coverage). The staff believe that insurance is a sophisticated business regardless of an entity's status as public or non-public and those entities are required under current accounting to have internal modeling capabilities or use external resources.
30. Additionally, the staff has learned through our outreach that non-public insurance entities do not want to be considered separately from public insurance entities because of this fundamental similarity.
31. One possible solution to this problem is to narrow the criteria to non-public entities whose primary business is not providing insurance coverage. This would presumably capture entities that have entered into insurance contracts that meet the scope of the standard but are not sophisticated enough or do not have the requisite resources to adequately apply the model on what some may consider a *one-off* basis (ie they do not match asset and liability durations).
32. Some may argue that all entities (regardless of status as a public entity) should be permitted to apply the practical expedient if their primary business is not providing insurance. The staff believes the intent of the model was to apply to insurance contracts as a whole and not be entity specific. The staff believe that providing a practical expedient for non-public entities is fundamentally different than public entities given the access that investors may have to non-public entity data. Furthermore, the staff believes the population of entities that would meet this criteria would be limited which would be the goal of an exception to the model.
33. The staff believes that non-public entities whose primary business does not include providing insurance may be a viable option for providing a practical expedient for

determining the discount rate under US GAAP. This option will likely not work for IFRSs because non-public entities are not defined.

Size of the entity

34. The boards could also consider to provide a practical expedient to entities of a particular size (ie market capitalization) similar to the United States implementation of the Sarbanes Oxley Act.
35. The staff believe this option would be difficult to justify without appearing to be arbitrary in nature. In the case of Sarbanes Oxley, the concern primarily focused on incremental costs incurred by smaller public entities to implement the act. The staff do not believe the incremental cost savings that would be realized through the use of a practical expedient relative to the costs associated with implementing the entire model would be substantial. Rather, the staff's focus of providing a practical expedient concentrates on the resources and efforts required to build a discount rate relative to the information that is provided to investors. The staff believes the size of the entity should not be the primary reason why an entity is permitted a practical expedient and therefore do not recommend providing practical expedient on this basis.

Alternatives for a practical expedient

36. In this section the staff provides our analysis of the practical and theoretical difficulties of prescribing a benchmark rate as a practical expedient. We have considered some of the recent difficulties encountered by the IASB as part of its project *Post-employment Benefits (including pensions)*, in particular in its 2009 exposure draft *Discount Rate for Employee Benefits*, as part of this analysis.
37. The staff analyzed the following alternatives as possible solutions to a practical expedient:
 - (a) Government rates;
 - (b) High quality corporate bond rates;

- (c) Option to select (a) or (b) (similar to IAS 19).
- 38. The staff based our selection of alternatives on what exists under current IFRS or US GAAP today. Therefore, the staff believed examining a host of benchmark alternatives that are not in practice today could have unintended consequences as well as not achieve the goal of providing a suitable default solution for insurers that is easier to determine than the current proposals.
- 39. We presumed that a practical expedient would be applied by smaller, less sophisticated entities, lacking the appropriate resources to implement the tentative decisions made to date in a cost effective manner. We presumed this because, aside from providing what some have referred to as a “temporary fix” until a comprehensive project can be undertaken to address discounting, the other primary motivation is the complexity inherent in deriving a rate. Therefore, the staff believed it was safe to assume that the boards would target these types of entities if it were to provide a practical expedient.

Government rate

- 40. There are practical issues in implementing as a practical expedient a benchmark such as a government rate. Some refer to a government rate as a risk-free rate. These issues include:
 - (a) emerging markets without stable governments;
 - (b) comparability concerns.
- 41. Many of the discussions about using government rates contemplate usage in jurisdictions with stable governments with investment grade ratings. In those jurisdictions, the government rate approximates a risk-free rate. This of course highlights the first area of concern when establishing a government rate as a benchmark for prescribing a practical expedient: what to do for those entities that meet the criteria for using a practical expedient, but operate in a jurisdiction without investment grade government ratings.

42. This question will likely need to be answered because entities that operate in jurisdictions with government rates that reflect credit risks and high inflation could potentially benefit (ie have a lower liability) simply by virtue of operating in an unstable jurisdiction. The staff do not believe that the inflation and credit risks of the government are reflective of the characteristics of the insurance liability nor does the rate represent risk-free.
43. A potential answer to this dilemma would be to allow the entity in an unstable jurisdiction to use as a proxy for the benchmark a government rate for a neighboring, more stable jurisdiction. However, if we think of the construct of any discount rate as a collection of risks², even a risk-free government rate would reflect at least the currency and macroeconomic environment of the proxy jurisdiction. Therefore in order to use the government rate from any other jurisdiction as a proxy, the entity in the unstable environment would, at a minimum, need to compare the macroeconomic environment and currency of the proxy jurisdiction to that of its own jurisdiction. It would then have to adjust the discount rate accordingly to meet the objective of discounting insurance contract liabilities.
44. This of course raises concerns about the subjectivity of the adjustments made, the jurisdiction selected as the proxy, and the definition of what constitutes a *stable* jurisdiction.
45. Thus, such a practical expedient would result in the entity making subjective adjustments to an observable rate. The costs of making those adjustments are likely to be similar to those of constructing a discount rate in accordance with the boards' tentative decisions. Thus, if subjective adjustments are needed, the proxy would not accomplish the goal of providing a suitable default solution for insurers that is easier to determine than the current proposals. Further, the staff believe it is likely that the boards would have to provide guidance on the adjustments that would need to be made or what would be considered an acceptable proxy in order for these entities to meet the objective of the discount rate.

² See Agenda Paper 3B from the February 2011 joint meeting for a discussion of risks potentially included as part of the discount rate.

46. Additionally, due to the long-term nature of the insurance contracts, the entity will likely need to use extrapolation techniques to project the yield curve to match the duration of the insurance contract. Therefore, using a government rate as a practical expedient will not alleviate all the complications of discounting even for those entities in stable jurisdictions with investment grade government securities.
47. Notwithstanding the issues discussed above, using a government rate for discounting can create comparability issues with those entities calculating a rate under the current proposals.
48. We learned through the comment letters that some respondents believed the calculation of the discount rate as a risk-free rate plus liquidity did not reflect the characteristics of the liability. Many of these concerns stemmed from respondents' belief that the discount rate proposed was too low (ie the liability was overstated) primarily because they could not properly calculate the liquidity premium. If this is the case, using a government rate would result in two entities measuring the same obligation differently when one applies this practical expedient and the other does not. This is because a government rate may be potentially much lower than the rate that reflects the characteristics of the liability. This will, in effect, penalize entities for using a practical expedient that was designed to provide a cost benefit relief.
49. For these reasons, the staff believes that a government rate will not work as a practical expedient in all jurisdictions and therefore do not recommend this approach.

High quality corporate bond rates

50. High quality corporate bond rates present unique issues to consider while also replicating some of the challenges noted with government rates. These issues include:
 - (a) the meaning of high quality;

- (b) what to do in jurisdictions where a deep corporate bond market does not exist.
51. Past practice has often equated the characteristics of a high quality corporate bond to a particular rating in the market (ie AA rating). However, this rating assumes a deep market exists for corporate bonds. This has not been an issue in the United States and therefore Topic 715 does not tend to create many problems in application. Therefore this option would likely work in the United States and other jurisdictions with deep corporate markets.
52. However, this option could create practical problems in determining a discount rate in other jurisdictions. Under IAS 19 the issue is somewhat different, because if the corporate market is not deep, the entity defaults to using government bonds. Therefore, if the boards conclude that the benchmark for a practical expedient should be a high quality corporate bond without a government rate default, this will likely shift the pressure from determining if a market is deep to how entities interpret 'high quality'.
53. The IASB learned through its exposure of *Discount Rate for Employee Benefits (proposed amendments to IAS 19)* that there was opposition to eliminating the government bond option in IAS 19 in those jurisdictions that used the government bond rate option. Although the change to IAS 19 was proposed for reasons particular to that standard, some of the opposition to the change is relevant for this discussion.
54. The relevant opposition stemmed from the lack of guidance for how to determine the characteristics of a high quality corporate bond. Entities were concerned about determining if a bond is of high quality when traded in a jurisdiction experiencing high inflation and currency risk. Specifically, respondents wanted to know:
- (a) could a bond be considered 'high quality' in this environment,
 - (b) should the judgment of 'high quality' be made from a local or international perspective, and finally

- (c) if the bond is considered ‘high quality’ would the entity include in the discount rate the inflation and currency risk for purposes of discounting.

The staff believes it is reasonable to assume that these same concerns and requests for guidance would arise as part this project if the boards chose a high quality corporate bond rate as a benchmark for a practical expedient.

55. Aside from the issue of how to determine ‘high quality’ there is also an issue of what to do in jurisdictions without deep corporate markets. As expressed above this has not been an issue in the United States under Topic 715. However, without a default mechanism such as government bonds (as currently provided for under IAS 19) there are jurisdictions in which the corporate bond market is not sufficiently deep to determine a discount rate by reference to a high quality corporate bond. Therefore, the boards will likely have to develop another mechanism for determining the discount rate using corporate bonds.
56. Potential solutions to this problem could be:
- (a) to use an observable corporate rate in a neighboring jurisdiction with a deep corporate market;
 - (b) to use a government rate (if available) in the same currency while adjusting that rate for corporate credit spreads observable in a neighboring jurisdiction;
 - (c) to use a build-up approach using the principles provided for fair value currently under IAS 39 *Financial Instruments: Recognition and Measurement* or ASC Topic 820 Fair Value Measurement.
57. Options (a) and (b) each have the same issues as government rates determined in neighboring jurisdictions and discussed above. Option (c) is similar to the current proposal for a bottom-up approach and the staff see no benefit in having to apply this approach.
58. Given the complications discussed above, the staff believe that using a high quality corporate bond as a benchmark for a practical expedient is not a viable option in all jurisdictions and therefore does not recommend this approach.

Option to select government or high quality corporate bond rate

59. It may be possible to solve some of the issues discussed above by providing a practical expedient with an option similar to the rate required by IAS 19. An entity would use a high quality corporate bond rate in jurisdictions where the market for corporate bonds is deep. For those jurisdictions in which there is no deep corporate bond market, the entity would use the government bond rate.
60. This option could solve the issues with jurisdictions that do not have deep corporate bond markets. However, this option introduces additional complications that the IASB recently attempted to address through an exposure draft *Discount Rate for Employee Benefits (proposed amendments to IAS 19)*.
61. That exposure draft attempted to address the disparity between the rates used in jurisdictions that have deep corporate bond markets and those that default to a government rate under IAS 19. The recent financial crisis caused credit spreads to widen significantly over a government or risk-free rate. This caused concern that those jurisdictions using a corporate bond rate were reporting pension liabilities at an artificially low amount as compared to those using a government rate. The staff think there is no reason to believe that this situation could not happen again if the boards chose this option to provide a benchmark for a practical expedient.
62. One solution to this problem could be to require an entity to evaluate the credit spreads over government rates and have the entity adjust corporate rates for credit spreads that do not reflect the characteristics of the insurance contract liability. This methodology could bring the corporate bond rates in line with the government rates used in other jurisdictions.
63. The staff find two potential issues with this solution:
 - (a) how to determine the risk-free portion of a government rate in an unstable jurisdiction;
 - (b) determining the adjustments to the government rate have the same difficulties as determining the adjustments for the discount rate in the current proposal the boards tentatively decided on.

64. The staff are concerned that entities will have difficulty determining the amount of inflation or credit risk that is added to the risk-free component of the government rate for unstable jurisdictions. Moreover, this could become particularly difficult in jurisdictions where the government effectively increases the money supply to cover outstanding debts thereby masking what portions of the overall rate are attributable to risk-free, inflation, credit, etc. If entities do not know the true risk-free portion of the government rate they will likely find it difficult to determine the portion of the credit spread that is truly credit risk of the entity, rather than a function of the macroeconomic environment. This would increase the likelihood that the rate used will not reflect the characteristics of the insurance liability.
65. Furthermore the staff believe the judgment required to make the adjustments to the corporate bond rate are similar to the judgment required to determine a discount rate that adjusts the future cash flows for the time value of money and reflects the characteristics of the insurance contract liability under the tentative decisions. Therefore, the staff are not convinced this option provides a practical expedient but rather provides a less precise measure with all the same steps. For this reason, the staff do not view this option as a practical expedient.

Staff recommendation

66. The staff analyzed the alternatives for providing a benchmark rate for a practical expedient and determined none of the options achieves the goal of providing a suitable default solution for insurers that is easier to determine than the current proposals while still accomplishing the objective of reflecting the characteristics of the liability.
67. Therefore, the staff recommend that the boards should not provide a practical expedient for determining the discount rate.

Questions for the boards
<ol style="list-style-type: none">1) Do the boards agree with the staff recommendation that the boards should not provide a practical expedient for determining the discount rate? If not, why not?2) If the boards tentatively decide that a practical expedient is appropriate, which option do the boards select?3) If the boards select a practical expedient: Do the boards agree with the eligibility criteria provided? Are there any other criteria the staff should consider and bring to the boards at a future meeting?

Potential Implications of Discount Rate Decisions for the Rest of the Model

68. Any discount rate that differs from the rate described in the ED and DP would have implications for most parts of the model. For example differences in the discount rate would affect:
- (a) the size of the residual/composite margin. A higher discount rate would result in a lower liability and therefore a higher residual or composite margin
 - (b) the difference between the measurement result of the building blocks and measurement at fair value. Using a government or high quality corporate bond rate increases the difference between the measurement result of the building blocks and fair value, and would have implications for:
 - (i) *unbundling*: when the measurement of the liability is not close to fair value, entities will likely want to unbundle those pieces of the contract that may not be closely related to minimize accounting mismatches. The same is true for the question of embedded derivatives, such as minimum interest guarantees and others, especially if the risks from these embedded derivatives are hedged through purchased financial derivatives.
 - (ii) *risk adjustment*: a higher discount rate would result in a lower liability and therefore a higher residual margin. This

may decrease the significance of the risk adjustment, relative to the residual margin.

- (iii) *scope*: some may be reluctant to apply the building block approach to contracts that have similarities to financial instruments (eg investment contracts with discretionary participation features) if the differences in measurement are increased.