The Group of North American Insurance Enterprises

Discussion Paper

Earned/Asset Based Discount Rate for Life Insurance Contracts:

Introduction

This discussion paper has been developed by the GNAIE Accounting Convergence Committee in response to the "Discount Rate" issues raised by the IASB staff in its Insurance Working Group (IWG) papers from July 2004 and January 2006 and as further discussed at the April 1-2 meeting of the Insurance Working Group. In addition, IASB staff asked for any additional information on these topics that might be of assistance to them in progressing the issues.

At the suggestion of certain Board and Staff members of the IASB, this paper has only been provided to those IASB Board members working with the IWG as well as to members of the IWG. Please feel free to circulate these to any others you feel may benefit from the discussion. They will also be posted on the GNAIE Website, along with any other contributions of documents or ideas.

The discussions contained in this paper relate to life insurance only and should not be viewed as appropriate for non-life insurance contracts. Considerations for discounting non-life insurance contracts and the applicable discount rate are outlined in a separate paper.

Summary:

Life insurance contract liabilities should be discounted using an earned discount rate as opposed to using a "risk free rate". The use of an earned rate for discounting life insurance contracts is be consistent with how market participants value and price such contracts, and is consistent with the principle of a "market rate" as currently articulated in the IASB proposals.

General Observations

The current proposals outlined in the IASB Discussion Paper*: Preliminary Views on Insurance Contracts* (the DP) suggest that insurance contracts should be discounted using "current market discount rates that adjust the estimated future cash flows for the time value of money"[1]. This requirement is sometimes interpreted and suggested in IASB staff presentations to result in the use of a "risk-free" or swap discount rate to measure insurance contract liabilities.

As outlined below, the DP proposal to measure life insurance liabilities using a risk-free discount rate when assets held to support these liabilities in the "fair value through profit and loss" category are measured at fair value, will lead to material uneconomic income recognition as well as inappropriate uneconomic earnings volatility. Such volatility will largely be driven by an incorrect measurement emphasis on liquidity that will not typically be realized by a life insurer due to the long-term nature of its obligations. An accounting framework that results in such accounting measurement mismatch will not provide useful, relevant information to users of financial statements.

Appropriate Discount Rate:

Life insurance companies typically have long-term, illiquid obligations, with significant pre-funding of the long-term obligations through ongoing premiums. A life insurer's investment

[1] IASB Insurance Contracts Discussion Paper, paragraph 116(b)

goals are to invest premiums in assets which will generate a sufficient return to permit, at a minimum, the defeasance of its long-term obligations as they come due. A core attribute of a life insurance business is therefore the linkage of assets and liabilities, with an emphasis on long-term cash flow adequacy rather than short-term sensitivity to market movements and market liquidity preferences. A consistent measurement basis for assets and liabilities in a life insurance business is critical to ensure elimination of uneconomical accounting measurement mismatch.

In order to ensure consistent measurement basis for both assets and liabilities, the current market discount rate used to measure a life insurance liability should reflect:

a. the expected coupon, yield and principal payment schedule, based on the asset portfolios typically held to support insurance liabilities; plus

b. the expected investment spreads over government bonds (or sovereign debt) earned on such a portfolio based on historic data (i.e. reflecting expected defaults); less

c. an appropriate margin for risk, (as would be true for all assumptions).

The determination of such discount rate should start with either the expected earnings rate on the existing portfolio (to the extent a portfolio exists) or the expected return on new local investments depending on how the supporting assets are measured. Such measurement should be net of investment expenses and expected defaults, if appropriate, and should reflect a margin for risk and uncertainty. Where reinvestment will be required to settle claim obligations, the liability discount rate should also depend on reinvestment at a reasonably achievable rate of return. The investment risk margin for uncertainty, along with margins on other assumptions, would be calibrated to produce no gain at contract issuance.

An objective framework can be established to determine representative asset portfolios and current market based discount rates for the valuation exercise. For example, for fixed rate assets, the discount rate could be based on the current market yields for either the assets held, or similar reference assets less the expected cost of defaults based on an asset's quality rating. These expected costs could be readily established based on credit default studies. The difference between the net yield and the relevant risk-free yield is the best representation of the expected yield spread over risk-free rates. This approach is supported by existing IFRS guidance (IAS 39.AG72). It permits certain assets and liabilities with off-setting market risks to be considered in tandem for valuation purposes.

Other possible approaches for determining an appropriate discount rate for life insurance liabilities that are non-entity specific yet ensure consistent measurement between assets and liabilities could include the following:

a. Observable corporate 'A' rated bond yield or observable swap curve with relevant risk premium; or

b. Average return of industry asset replicating portfolio

Benefits of using an earned rate to measure life insurance contract liabilities:

While we do not advocate the "current exit value" framework, the use of discount rates that are consistent with expected returns on both assets held and expected reinvestment strategies matches how insurance liabilities are priced, including block sale transactions and is therefore

consistent with a Current Exit Value framework. For situations where asset and liability cash flows are duration matched, the use of discount rates based on the assets held ensures the change in asset and liability fair values will be consistent. This will not be the case if liabilities are valued at discount rates that are inconsistent with the market yields on the assets held.

An earned discount rate will therefore:

a. better reflect underlying economics of business and therefore provide more useful information to investors,

b. be consistent with how sale transactions actually occur and therefore more

c. reflective of current exit value and

d. reconcile current exit value with a settlement value perspective

Shortcomings of using a risk-free discount rate to measure life insurance contract liabilities:

Discounting a life insurance contract at a risk-free rate does not result in a "current exit value" or "fair value" as it is not consistent with the value a "market participant" would be willing to pay to assume the remaining contractual rights and obligations of another entity as evidenced in the pricing of sale transactions of life insurance companies. Further, it ignores interdependence of assets and liabilities, which are invariably bundled in life insurance transactions

Life insurers expect to earn higher than a risk-free rate of return on invested assets and therefore factor this in the assumptions used for pricing of the product. Using a risk-free rate for discounting such liabilities would result in a reported loss[2] for many contracts at issue. Life insurance companies have very solid bases for expecting that the assets supporting such contracts will earn more than the risk-free rate even after default costs, and therefore any reported losses at issue will be offset by subsequent inflated profits.

As indicated, life insurance liabilities are typically long-duration liabilities that have limited liquidation risk. Most life contracts have positive cash flows in earlier years and generally aren't expected to be liquidated. The use of current market value for assets supporting life insurance liabilities in combination with a current market risk-free framework for discounting the liabilities will result in an inappropriate liquidation perspective to the balance sheet and income statement of a life insurer.

To illustrate, assume the following fact pattern:

a. A life insurer issues a ten-year single premium endowment product with guaranteed return to policyholder of 5% at the end of ten years. In order to ensure sufficient return under the contract and to cover the guaranteed return to the policy holder at the end of ten years, the life insurer would invest the single premium in a ten year investment grade corporate bond with a fixed interest rate of say 6%. The insurer does not have any

[2] Refer to paragraph 15 of July 2004, Insurance Working Group Meeting – Agenda Paper 3

intention of trading the bond and has essentially locked-in a spread of 1%. Both the asset (corporate bond) and liability (single premium endowment product) will have similar cash flows.

b. The asset would be measured at fair value through profit and loss and would reflect mark-to-market movements based on changes in the bond's fair value due to market liquidity and credit preferences.

c. The endowment liability, if measured using current exit value as proposed in the DP, would be discounted at a risk-free rate. This valuation perspective would assume that liquidity is required and will overstate the true market or current exit value of the liability.

d. The end result is asymmetrical accounting for the asset and liability. Changes in spreads (assets) over risk neutral rates (liabilities) representing market preference for liquidity (as opposed to a changed view on long-term credit costs) will be fully reflected in the balance sheet with subsequent changes reflected in the income statement even where such assets are matched to support relatively illiquid insurance liabilities.

Such "uneconomic earnings volatility" will not be realized and would not produce meaningful information to users of life insurance financial statements. This issue was specifically highlighted by Moody's Investor Services in a May 2008 Special Global Insurance Comment bulletin on Q1 Investment Losses; *"Insurers typically have the ability to hold securities with depressed market valuations until prices recover or until maturity. Their stable liability (long-term and non-callable) and strong liquidity profiles enable them to hold securities for long durations if they believe the investments are economically unimpaired and want to avoid crystallizing unrealized losses (e.g. by selling the securities). While Moody's anticipates an increase in actual impairments and credit losses across most investment classes (rising from historic lows most cases), we believe the current market disruption and valuations of certain securities may be producing bond prices that are somewhat divorced from the ultimate cash flows associated with the securities. For this reason, we anticipate a portion of today's unrealized losses to reverse when markets stabililize.*

Most analysts and users will remove unrealized investment gains/losses from earnings when preparing valuations and assessing the performance of a life insurer, as evidenced by "FAS 115" earnings adjustments in the United States. In a recent survey of insurance industry analysts performed by PricewaterhouseCoopers entitled "Performance statement coming together to shape the future" (PWC, December 2007) when "*Asked how they would define earnings, investment community respondents typically exclude any revaluations of assets or liabilities, both when attempting to understand the underlying earnings of the company and when building forecasts."*

Not just a life insurance issue:

The implications of using a risk-free discount rate to measure long-term obligations are pervasive and could have devastating impacts on other industries including defined benefit pension plans and leasing arrangements. The use of a risk-free discount rate as opposed to an earned rate for pension obligations will increase pension liability and pension expense. Such increase will require additional funding from the plan sponsor for the liability "shortfall" purely

based on accounting valuation which bears no relation to the actual economics and/or expected benefit payments to be made under the plan.

Redington Partners, LLP, a UK based pension-plan advisor, recently completed a study of UK pension plan liabilities which estimated that the impact of substituting a Corporate 'A' discount rate to a UK Government bond discount rate (as is being proposed by the UK Accounting Standards Board) would convert an industry $40bn pension surplus to a $260 billion deficit for UK pension plans. This accounting deficit is required to be funded by plan sponsors (and in certain jurisdictions/plans could include plan participants) despite the fact that it is not an economic deficit as it does not reflect the rate of return actually generated from invested assets and will not impact the defined benefit payment actually received by the plan member. Consequently, pension fund liabilities in the UK are currently being purchased by buyout firms at amounts substantially less than their carrying value.

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