



# Top down discount rate

## *Addendum to the technical position of the HUB Group on Insurance Contracts*

This paper provides additional detail on the top down discount rate that was presented in the HUB Group’s paper 6 on top down discount rate. It responds specifically to IASB/FASB Agenda Paper Reference 5A/63A for the April 12, 2011 IASB/FASB meeting.

As with all our documents, comments from the public are welcome.

### **I. Comment**

Per the IASB insurance contracts exposure draft, the objective for insurance contract liability discount rates are rates that “are consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability” and which “exclude any factors that influence the observed rates but are not relevant to the insurance contract liability.”<sup>1</sup> Since insurance contracts are not traded in liquid, observable secondary markets, interest rates that are consistent with characteristics of an in force insurance liability must necessarily be estimated.<sup>2</sup> In order to appropriately estimate such an interest rate, it is necessary to use techniques consistent with the manner that credited rates on insurance contracts sold to customers are determined.<sup>3</sup> Since rates determined using such techniques result in arms length transactions of insurance contracts between insurance companies and customers, such rates generally reflect the characteristics of the liability.<sup>4</sup>

### **II. Deductions from the earned rate**

Credited rates on insurance contracts are typically determined by starting with the interest rates the insurance company expects to be able to earn on a portfolio of high quality assets whose cash flows match closely to the expected cash flows of the insurance contract. This rate is then typically reduced for investment expenses and default losses the insurer expects to incur. The rate is also typically reduced by some additional amount to cover the risk that default losses are greater than expected, and any other risks inherent in the asset portfolio, such as risks related to any duration mismatch or to equity returns. All such deductions are determined based on the insurer’s expected experience and the insurer’s own assumptions and risk tolerance. A rate thus determined would reflect the characteristics of an insurance liability.

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<sup>1</sup> IASB Insurance Contracts Exposure Draft, paragraph 30

<sup>2</sup> A possible exception is the interest rate for a contract that has just been sold, since the interest rate included in the entry price will generally provide an appropriate rate consistent with the characteristics of that liability.

<sup>3</sup> Such credited rates may be explicit, as in the case of a universal life contract, or implicit in the premium and or dividends for the contract.

<sup>4</sup> The HUB technical paper 6 on determining top down discount rates identifies situations where such rates may not be appropriate without adjustment, but these are exceptions rather than the rule.

Even though such rates are often determined only at inception of a contract, such estimation techniques are valid for in force contracts as well. That can be seen from situations where credited typically determined in a similar manner. Similarly, reinsurance prices for in force blocks of business are typically determined in a similar manner.

The main fallacy with the application of the top down approach to determining discount rates described in agenda paper 5A/63A for the 12 April 2011 IASB/FASB meeting is that the deductions to the asset yield are based on the market risk premium for the asset credited risk. This produces an estimated liquidity premium for the assets, not for the liabilities. As a result, the discount rate would be consistent with the liquidity and other characteristics of the assets, not the characteristics of the liability. In particular, insurance liabilities are generally far less liquid than the assets that back the liabilities, even if the expected cash flows match. This is obviously the case for publicly traded bonds, with deep liquid secondary markets, but even private placement bonds and other assets are more liquid than almost all insurance contract liabilities. The IASB insurance contracts exposure draft recognizes that this is the case: “Many insurance liabilities do not have the same liquidity characteristics as assets traded in financial markets...”<sup>5</sup> Hence, the appropriate illiquidity adjustment for an insurance liability discount rate is greater than the illiquidity premium inherent in the assets backing the liability. Thus, the approach described in the agenda paper is not appropriate for determining the illiquidity premium and discount rate for an insurance contract liability. Rather, the approach described in the HUB paper 6 on top down discount rates is the appropriate manner in which to estimate a discount rate that genuinely reflects the characteristics of the insurance contract liability.<sup>6</sup>

Supporting this point is that what appears to be defined as the market risk premium for the asset credit risk in agenda paper 5A/63A includes not only the expected defaults plus a risk premium for unexpected defaults, but also the impact of supply and demand for spread instruments in the financial markets. However, this latter amount is relevant to the characteristics of the liability, and thus should not be deducted from the discount rate. To the extent that the market risk premium for credit risk on financial instruments widens due to supply and demand pressures, as opposed to changes in actual or perceived default risk, the amounts credited on new and renewal insurance contracts increase in order to attract business. And to the extent that the market risk premium for credit risk narrows due to supply and demand pressures, interest rates credited on new and renewal insurance contracts decrease. Since these impacts are reflected in the credited rates and prices of new and renewal insurance contracts, they must represent a characteristic of the insurance liability. To the extent that the application of the top down approach to determining discount rates described in agenda paper 5A/63A excludes this element from the insurance contract discount rate, the resulting discount rate fails to account for the characteristics of the insurance contract liability. Although there is no way to explicitly measure the illiquidity premium or the impact of supply and demand pressures, the approach described in the HUB paper 6 on top down discount rates reflects the characteristics of the insurance contract appropriately by backing out the elements that can be measured.

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<sup>5</sup> IASB Insurance Contract Exposure Draft paragraph 24

<sup>6</sup> Effectively, the HUB approach generates a rational, appropriate estimate of the type 3 adjustment discussed in agenda paper 5A/63A.

### III. Book value versus market value

An additional issue with the application of the top down approach to determining discount rates described in agenda paper 5A/63A is that it requires starting with a market rate. In implementing a top-down approach to determining the discount rate for measuring the liability for Insurance Contracts, it is essential that the starting rate be consistent with the basis that assets are held on the balance sheet. If assets are held at market value with changes in market value recorded through net income, then the starting rate of return should be based on the market rate of return of the assets. If, however, the asset is held at a different value (e.g. amortized cost or depreciated book value) or if changes in market value are not recorded through net income, then the return should be measured based on that value. Any other measurement would introduce volatility to the income statement that would not reflect true economic results.

In order to avoid this volatility which would distort information to investors we would, at a minimum, be forced to change our management practices. However, even if it were appropriate to change historically sound management practices to avoid unrepresentative accounting results, this may not always even be possible. For example, for many participating and interest sensitive contracts, credited rates must be based on asset amortized cost values due to regulatory constraints or to meet policyholder expectations. And in many cases, non-participating contracts share the same administrative systems with participating or interest sensitive contracts, making it unduly burdensome to require differing accounting treatment.

The application of the top down approach described in the HUB paper would permit insurers to discount insurance contracts at a rate that reflects the characteristics of the liabilities, as demonstrated by long term insurance pricing and management practices. As such, the approach described in the HUB paper 6 on top down discount rates should be permitted under a new insurance accounting standard.