



Top down discount rate

Second 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 papers 6 and 6a. It responds specifically to Agenda Paper 9 (Reporting back on the discount rate) that was prepared for the Insurance Working Group meeting on May 16, 2011.

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

In the documents for the May 16 Insurance Working Group meeting entitled "Reporting back on the discount rate," there is a statement that "in principle the discount rates used for non-participating contracts will result in the same yield curve for all cash-flows discounted." (Application guidance, paragraph B66E) There is also a statement on the first page favoring "a requirement to disclose the yield curve in each major currency," implying that there would be only a single yield curve used for discounting insurance cash flows in any given currency.

We believe that the presumption that there should be – even in theory – a single discount yield curve used for discounting insurance cash flows in ANY given currency is incorrect, since it does not take into account that different types of insurance liabilities have different illiquidity characteristics, which must result in different discount rates, even if the liabilities are in the same currency. This belief has been validated by Solvency II, where different liquidity features indeed lead to different illiquidity premiums, and as a result different yield curves.

Paragraph 30 (a) of the Insurance Contracts exposure draft correctly notes that the time value of money (building block 2) should incorporate characteristics of insurance contract liabilities such as "timing, currency and liquidity." While building block 1, the expected cash flows, incorporates the amount of cash expected to be paid or received in any given period, the discount rate provides the price or value of each expected cash flow. Since liquidity characteristics are generally not a feature of the amount of cash flows, those liquidity characteristics must be included in the discount rate. Therefore, since different non-participating insurance contracts have different liquidity characteristics, they will necessarily use different yield curves to discount their cash flows.

This can be seen clearly by an example using bonds. Assume that a company has issued both publicly traded bonds and private placement bonds. Assume the bonds have equal priority, so the credit risk is the same. Even if the expected cash flow amounts from each bond are identical, and even though the risks are identical, the cash flows from the private placement bond will be discounted at higher interest rates to reflect the relative illiquidity of the private placement bond. Thus the private placement bond will have a lower fair value or price, and generate a higher yield, all else being equal to the publicly traded bond.

The same situation applies to non-participating insurance contracts. For example, a life payout annuity is far less liquid than a non-participating single premium whole life contract that has a cash value, and a whole life contract is less liquid than, say, a publicly traded bond since the policyholder

cannot access cash by selling the contract for fair value in an observable, liquid market, but is rather limited to getting the cash in the amounts and through the mechanisms specified in the contract. In addition, the insurer may have the right to delay payment in certain situations. However, even though there are limits on the liquidity of the whole life contract, the mere fact that the policyholder has access to cash makes the contract far more liquid than the payout annuity, in which the policyholder has no access to the cash buildup in the contract. Thus, even if the two contracts have an expected payment of an identical amount at an identical time, the annuity cash flow would need to be discounted at a higher rate in order to properly reflect the greater illiquidity. For example, if the whole life contract and payout annuity contract each have an expected payment of CU1000 10 years from the valuation date, the annuity cash flow would need to be discounted at a higher rate, and generate a lower value in order to reflect the different liquidity characteristics between the two contracts.

Therefore, in order for the discount rate to reflect the characteristics of the liability, as required by the project principles, different yield curves are necessary for different portfolios of liabilities.