The Actuarial Profession
making financial sense of the future

Accounting network evening
Cliff Speed

Discount rate project:
Should discount rates differ?

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Research project on discount rates

- Why commissioned?
  - Discount rates are the heart of many models and therefore of significant public interest
  - Ensure a clear and common understanding of the issues surrounding different rates used today
  - Support the development of future framework for discount rates
- Phase 1
  - Packet 1: Survey of current practices
  - Packet 2: Survey of existing research and debate
  - Packet 3: Develop a common language for communicating current practice on discount rates and risk
- Phase 2
  - Packet 4: developing a common framework
  - Packet 5 : the impact of change

Packet 1: Current Practice

Survey of different discount rates currently used for different purposes in each practice area in the UK

To include

- Historical perspective
- Legislative framework
- Nature of promise
- Impact of government actions on nature of promise

To understand who liabilities are in respect of

- Shareholders
- Policyholders
- Management
- Regulators
- Trustees
- Pension scheme members

Covering following areas of actuarial work:

- Life assurance
- General insurance
- Pensions
- Finance & Investment
- Enterprise Risk Management

UK focus with only a passing reference to international developments where they have a particular bearing on UK practice

Initial findings: Discount Rate project

- Number of different methodologies for setting discount rates
- Principle Drivers
  - Purpose of the calculation and the context (practice area)
- Calculations fall into two broad categories:

Matching calculations

- What are the characteristics of the liability cash flow?
- Are there any traded instruments which *match liability cash flows*?
- Is the market deep, liquid and transparent?

Budgeting calculations

- How is the liability being financed?
- What is the current yield on the investments?
- Is the current yield the same as the total overall return?

Initial findings: Discount Rate project

Matching

- Accounting
  - Current IAS19 (pen)
  - Future IFRS4 (ins)
- Statutory reserves
  - Future (SII)
- Capital requirements (ins)
  - Current ICA
  - Future (SII)
- Shareholder (ins)
  - MCEV
- Risk transfer
  - Section75 (Pen)
  - Hedging (banks, ins)

Budgeting

- Accounting
  - Current (ins)
  - Director's pensions
- Statutory reserves
  - Current (ins)
- Funding (pens)
  - Technical provisions
  - Recovery plans
- Shareholder (ins)
  - **Traditional EV**
- Risk transfer
  - Transfer values (pen)
- Govt STPR
- Fundamental value

Calculations differ in the nature and degree of risk embedded in the discount rate

Initial findings: common language

- Improved language
  - Glossary of terms?
- Disclosure of risk
  - How risk is accommodated in calculations
  - How communicated
  - Are consequences understood?
- Education
  - Long term financing and regular measurement
  - Behavioural consequences
- Should discount rates state a specific purpose?

Should discount rates differ?

- Funding (budgeting exercise)
  - Enable different views on future uncertain events
  - New benefits vs deficit correction
- Valuation /Assessing capital (matching)
  - Is this a least risk assessment?
  - Should it take account of specific circumstances
    - own credit risk or a fulfilment approach
- Do different purposes justify different approaches
  - Market consistent (portfolio replication) or expected return (projected budgeting)?
- Accounting:
    - Is the purpose to provide best possible quantification or to facilitate comparison?
- Who are the end users and what are their purposes?

Differing discount rates: security

- **Does security justify different discount rates**
  - Guaranteed versus discretionary benefits
  - Should the risk of **guarantor** default be considered? If so how measured?
  - Security depends on collateral, amount and quality; should identical pension funds with same funding level but different assets have different discount rates?
  - External protection, PPF, FSCS, other?
  - Should future actions be considered, investment policy, or regulatory, for example removal of Tax advantages on commutation?
  - Does the legal vehicle for delivering the benefits matter? Should insured benefits be discounted differently?
- **Should this be recast as a discussion on capital?**
  - Extra risk = lower security; an expression of capital

Different discount rates: Other considerations

- Should current and future benefits be treated the same?
  - Consider ongoing service and deficit contribution
  - In insurance reinvestment rates are lower to allow for a margin of prudence,
  - should discount rates be higher to reflect greater uncertainty of delivery?
- What is a consistent treatment of demographic risk?
  - Are there a market consistent assumptions?
  - Member options; do assumptions differ for matching and budgeting calculations? Are any demographic assumptions inter-linked with economic assumptions?

Discount Rates: the actuarial profession

- Should the profession address the diversity of approaches to discount rates?
- Should the IAA be leading the work for the IASB, what role should the UK profession play?
- What are the risks to the profession if it:
    i) does not provide direction on discount rates
    ii) advocates a change in approach?
- Can this debate and work be structured to enhance the standing of the profession?