

## **IFRS17 Discount Rate considerations**

### **Introduction**

This article is intended as an overview of some of the key consideration for setting discount rates under IFRS 17. More detailed notes on a number of the areas covered will be produced in due course.

When valuing insurance contracts under IFRS 17 discount rates are required for a number of purposes including discounting the fulfilment cash flows and accumulating interest on the Contractual Service Margin (CSM). The discount rate is also used for unlocking the CSM for changes in future cashflows. For non participating business the original locked in discount rate is used for this purpose. The IFRS 17 discount rates must reflect the liquidity characteristics of the insurance contracts, be consistent with market prices and exclude those factors in market prices which do not affect the insurance cashflows (e.g. credit risk). This is a change of approach from IFRS 4 where the discount rate was focussed on the asset yield rather than the characteristics of the contracts. There are a number of considerations and challenges when setting the IFRS 17 discount rates and this article explores the main ones.

### **Bottom up / Top down**

For setting the discount rate either a bottom up or top down approach can be used. Under a bottom up approach the discount rate is based on a liquid risk-free yield curve and then an addition is made to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts. Under a top down approach the discount rate is based on a yield curve that reflects the current market rates of return of a reference portfolio of assets adjusted to eliminate any factors that are not relevant to the insurance contracts.

When using a top down approach insurers may either use a reference portfolio of their own asset portfolio or of a hypothetical asset portfolio which matches the characteristics of the insurance contracts. IFRS 17 does not specify restrictions on the reference portfolio of assets but fewer adjustments would be required to eliminate factors that are not relevant to the insurance contracts when the reference portfolio of assets has similar characteristics to the insurance contracts.

Insurers will need to consider in particular what reference portfolio to use for new contracts. For example should this be based on a target asset mix or on their actual asset mix relevant to the new business. This is a key consideration for bulk annuities where potentially assets transferred are significantly different to the target asset mix. Consideration will also be needed in respect of how the reference portfolio changes over time, for example if using own assets how a re/derisking of the asset portfolio treated.

Under a top down approach insurers will need to decide a methodology to remove from the market rate of return any element that is in respect of credit risk. They will need to consider the credit risk premia that should be adjusted for as well as credit default and downgrade adjustments. When considering the level of illiquidity premium insurers will also need to consider how assets like equities are treated.

Under the bottom up approach you would first need to derive a risk free rate/ curve and then adjust this for the relative illiquidity of the insurance contracts. The last significant UK industry developments in respect of this approach were during the development of Solvency II. A number of approaches were considered including Covered Bonds, CDS negative basis and Structural Models such as the Bank of England model.

### **Risk-free rate**

Under both the bottom up and top down approach the risk-free rate needs to be considered. Insurers will need to decide how the risk-free curve should be calculated. Insurers could use

the Solvency II risk-free rate provided by EIOPA or could use a different one for example built up from gilt yields.

When firms are using their own discount rate they will need to consider what to do for the ultimate forward rate especially for currencies where the maximum duration gilt or swap rate is less than the insurance contract cash flows. Similar considerations will also apply in respect of how points in the curve after the last liquid point are derived.

### **Term Structure**

Insurers must decide whether to use a single risk-free rate or a curve for the discount rate although to be market consistent arguably only a curve is appropriate. Similarly insurers need to decide whether to apply a single illiquidity premium adjustment or one with a term structure.

### **Products to apply illiquidity premium to**

Insurers need to consider which Insurance products they apply the illiquidity premium to which will potentially be a wider range of products than allowed under the strict requirements under the Solvency II Matching Adjustment. IFRS 17 doesn't restrict which products can be discounted at above risk-free but just highlights that the characteristics of the contracts need to be considered.

Insurers also need to consider if the illiquidity premium should vary by product, e.g. the granularity it is calculated at. For example two annuity portfolios may have quite different characteristics and hence potentially different reference portfolios and discount rates could be used for them both.

### **Disclosures**

Under the current IFRS reporting insurers typically disclose their current discount rate by product for their most material products. Under IFRS 17 insurers need to consider the level of detail they will want to include on their discount rate. This will be both on the methodology used to derive the discount rate and also the discount rates themselves. As a discount rate curve is likely to be used rather than a single rate insurers will need to decide what to disclose on the curve. Also as under IFRS locked in discount rates are used for the CSM then insurers will need to decide if they will disclose the locked in rates as well as the current discount rates used for the fulfilment cashflows.

### **Conclusion**

When developing an IFRS 17 discount rate methodology there are a lot detailed considerations that need to be worked through. There is significant optionality available under IFRS 17 on the discount rate and market practise is still not clear. Insurers need to consider the pros and cons of the different options and the also the different stakeholders including investors including investors who will want to have the methodology clearly disclosed.