

The future of discount rates - Draft Terms of Reference

Background

There are two key catalysts to rethinking discount rates, particularly for annuity business, which requires some immediate thought.

- 1) IFRS 17 doesn't prescribe a discount rate mechanism for annuity business (in particular). Instead, it implies that a discount rate which references a theoretical basket of assets could be used or it could utilise the asset backing the insurance liabilities.
- 2) As the UK leaves the EU, one of the obvious areas of consideration for PRA will be the setting of the discount rate under a "new Solvency II" regime.

For IFRS 17, the rules are now sufficiently clear that there is value in the actuarial profession developing some thought leadership to consider how the different discount rate mechanisms may operate.

For "new Solvency II", there is value in the profession leading the debate with some sound arguments in advance of PRA pronouncements. In particular, there is value in considering the theoretical soundness of a "fundamental spread" style deduction for credit risk compared to a "percentage of spread" version as well as benefit in some new research on defaults, downgrades and spread behaviour.

Purpose

The purpose of the working party is to:

- Compile and review current literature in the life insurance arenas to ensure access to up to date information.
- Consider, for IFRS 17, the benefit and theoretical soundness of two discount rate mechanisms;
 - A notional basket of assets
 - Actual backing assets
- Consider, for IFRS 17, the profit profile and sensitivity of a notional basket of annuity liabilities using different discount rate approaches.
- Consider, for "new Solvency II", different approaches for calculating discount rates and the merits of each.
- Provoke thought leadership and innovation within the industry through presentations and forums to gain wider input.

Approach

This working party is formed under the sponsorship of the Life Research Sub-committee (LRC) to take this work forwards. The working party works closely alongside the IFRS 17 and the IFRS 17 - CSM working parties.

Composition of working party

We recommend a working party of at least ten members of the actuarial profession working within life insurance to perform this research. We recommend that members cover consulting, pricing, financial reporting and investment experience.

Specific goals and areas to be investigated

- A summary of existing research material performed by the actuarial profession, European bodies, regulators and consultants on the topic.
- Modelling work covering different methods of deriving discount rates, including, but not limited to:
 - Notional basket of assets

- Actual backing assets
- And, for the calculation of credit deductions, considering, but not being limited to the following
 - Percentage of spread
 - Fundamental spread based approach
 - Historical empirically observed default deductions and transitions
- The working party is also expected to liaise with regulators and lobbying bodies (e.g. ABI) where possible.

Research methods

The working party will perform a literature review to avoid reinventing prior thought. The expectation is that the body of the work will focus on two areas:

- 1) Some qualitative analysis and technical analysis of the robustness of different mechanisms
- 2) Developing some interesting modelling studies on the impact of the different approaches and presenting the analysis of the modelling.

Output

Informal material will be developed to provoke thought and generate input over the course of the working party. The ultimate aim will be to develop a sessional paper presenting the results of the work.

Recommendations

The working party is expected to recommend the advantages and disadvantages of different discount rate approaches.

Potential timetable

- Working party to be created - July 2018
- First meeting and finalisation of scope – July 2018
- Literature review and summary – September 2018
- Initial analysis and provocative output – short notes on social media or Actuary article – Autumn 2019 (**note that this date is very important as this working party needs to make progress quickly to be of use to the industry for IFRS 17**).
- Collation of analysis and feedback – Summer 2019
- Presentation of sessional paper – Autumn/Winter 2019

Funding

No expectation of external funding.