IFRS 17 Discount Rates Working Party

What disclosures are required under IFRS 17 for discount rates?

Under IFRS 17, insurers are required to make disclosures about how the discount rate has been set. Whilst there are some prescriptive requirements, these are limited with the main requirement being that "significant judgements" should be disclosed to allow users of the accounts to understand the insurer's financial position and performance.

This note considers what disclosures might be made by insurers for discount rates. For more about how to set discount rates, the working party has published a series of articles here:

https://www.actuaries.org.uk/practice-areas/life/research-working-parties/ifrs-17-future-discount-rates

Yield Curves (paragraph 120)

One area the standard is prescriptive is that the yield curve used for discounting liabilities should be disclosed.

"An entity shall disclose the yield curve (or range of yield curves) used to discount cash flows that do not vary based on the returns on underlying items, applying paragraph 36 [describes discount rate for IFRS 17]. When an entity provides this disclosure in the aggregate for a number of groups of insurance contracts, it shall provide such disclosures in the form of weighted averages, or relatively narrow ranges."

Insurers will need to consider how to comply with this requirement, with some of the considerations being:

- Many insurers will have many different products, which could have different discount rates so may need to publish more than one discount curve. There's a trade-off between providing too many yield curves that's confusing and providing summarised curves that don't provide any useful information.

  Insurers may well decide to take advantage of the option to use a "relatively narrow range" or a weighted average. This would solve the issue of providing too many curves, but some thought is required as to how this might change in the future. Whilst the discount rates may be in a "narrow range" this year, they may not be in future years, meaning the disclosure could have to change.

- Many companies will model yield curves with many points, potentially monthly or daily tenors. Showing all the tenors might be excessive, but, as the number of tenors is reduced, the amount of information provided is reduced. Insurers might settle on disclosing several key tenors, or alternatively a chart.

  Many insurers may already disclose a yield curve under current accounting standards so this might be a straightforward decision to continue with current practice.

- The yield curve disclosures may be more complex than just the rate, with tables setting out illiquidity premiums or default deductions.

- Do discount rates need to be disclosed by currency? If an insurer has material amounts of liabilities in more than one currency, then more discount curves are likely to be disclosed.

- Are there products which are immaterial so providing a yield curve is irrelevant?

Significant judgements

IFRS 17 also requires the detail behind any "significant judgements" to be disclosed. Paragraph 117 of the standard states "unless impracticable, an entity shall also provide quantitative information".

Wherever there's a decision or judgement to be made when setting the discount rate, there's also a decision over whether to make a disclosure – too little disclosure means users can't understand the insurer's results, too much will swamp the user with too much information to make sense of.

The level of disclosure is likely to depend on how important the discount rate is to calculate the liabilities. For liabilities that are relatively insensitive to the discount rate the disclosures may be limited. For longer term business where the discount rate has a more material impact the disclosures are likely to be more expansive.

The list below sets out many of the significant judgements that insurers may need to consider disclosing, but this is by no means an exhaustive list. Insurers will need to consider whether the disclosures need to be qualitative or quantitative.

It's possible that the level of disclosures could change over time – as external users become more familiar with IFRS 17, companies may be asked to provide further or more comparable information over time.

Bottom up approach
For a "bottom up" approach, the discount rate is set either directly (say, based on the yield on an illiquid asset or an index of illiquid assets) or by taking a liquid "risk-free" rate and adding some form of illiquidity premium. This may result in insurers needing to decide whether to make disclosures for the final curve, or the underlying "risk-free" and "illiquidity" parts of the curve separately. The IFRS 17 discount rates and IFRS 17 General Insurance working party have set some of the considerations around "how" a bottom up discount rate might be set for non-life insurers here. <u>Risk-free rates</u> The disclosure for risk-free rates may be relatively straightforward ("the risk-free curve component of the discount curve has been set by considering the market yields for UK government bonds", say). More disclosures may be required if a more complex methodology is adopted. • Where swap rates are used, there may be different swap markets – for example, "LIBOR" or "SONIA" swaps, where the rates can be materially different. The "LIBOR" market is likely to cease before IFRS 17 is introduced, but this disclosure will wish to avoid any ambiguity if there are different swap markets with different rates. • Where material amounts of long-dated liabilities are valued at points where market yields are unavailable (say, at longer tenors) some assumptions may need to be made about these rates (this is discussed in the article "Imperfect Numbers under IFRS 17" published by the working party). This may lead to a requirement to disclose the methodology setting out how these rates are set where it has a meaningful impact on the liabilities.

- Even when market data is available, it's likely to only be at certain tenors, meaning some form of interpolation is required for the intermediate points. For insurers operating in markets which are deep and liquid, there are likely to be many data points and the method of interpolation is unlikely to be a material judgement. Where markets are less liquid this may be a more important decision where disclosure becomes appropriate.

Illiquidity premium

The risk-free curve may be adjusted for illiquidity (or alternatively, the curve could be set using market data for illiquid assets). Insurers will need to consider how to disclose any illiquidity premium, which will depend on the technique used to set it:

- If an insurer were to set the illiquidity premium using the spread on, say, covered bonds, as a proxy for illiquidity, then the disclosure may be as straightforward as referring to a covered bond index. However, if the insurer is picking individual covered bonds more information may be needed if this is a material assumption.
- Some methods for setting an illiquidity premium may require a reference portfolio – the considerations for a "top down" portfolio will then be relevant.
- An alternative measure might be to take the negative CDS spread, which may require key elements of the methodology to be described.

Where the illiquidity premium has been based on assets with different characteristics to the liabilities, further adjustments might be made to reflect this. Insurers will need to consider whether and how to disclose how these adjustments have been made.

Top down approach

A top down approach will require disclosures to explain how the discount rate is being set, including which assets are being used to determine the rate (the reference portfolio) and any adjustments made (for example, credit risk).

For more about how to set discount rates, the working party has published a case study on the top-down approach.

Reference portfolio

IFRS 17 has no specific requirements for the reference portfolio if they have characteristics like the liabilities. It could be based on actual assets held by the company or on a theoretical portfolio of assets. However, the better the reference portfolio reflects the characteristics (e.g. liquidity) of the cash flows for which the discount rate is being developed, the fewer adjustments are likely to needed. Where these adjustments are significant, insurers may need to make an appropriate disclosure.

Insurers will need to consider the disclosures that need to be made for the reference portfolio, which could potentially include description of the assets used. For insurers using their own assets, it may be as straightforward to highlight the relevant disclosures under IFRS 9.

Some insurers may use a reference portfolio based on assets in a credit index, which may also make any disclosures straightforward, as this can be referred to directly. Where it isn't possible for investors to see how the reference portfolio has been set, insurers may need to consider publishing further information.

Credit risk

Where the adjustments for credit risk are material, insurers will need to consider what an appropriate level of disclosure is and may be a mixture of quantitative ad qualitative. For example, an insurer using historic defaults to set the adjustment for credit risk might describe the disclosure as, say:

"The liability discount rate has been reduced to remove the effect of credit risk. This adjustment has been based on historic default rate statistics, increased to reflect the compensation an investor would require for taking credit risk. At the end of 20XX, this adjustment was ZZ basis points."

Other adjustments

Further adjustments may be made where the assets and liabilities are mismatched or have a different duration. Where these adjustments are large and have a material impact, further disclosures might be considered.

Impact of changes in the Reference Portfolio

The September 2018 TRG paper discussed further disclosures that may be required for insurers using a top down approach. Where liabilities are measured using a top down approach, the liabilities can be sensitive to both changes in the market value of the reference portfolio, and changes in the composition of the portfolio. Changes in the reference portfolio will occur as insurers trade assets (say, to reduce credit risk) or optimise matching.

The TRG recommended that insurers should consider further disclosures to allow investors to understand how changes in the composition of the reference portfolio have affected profitability. This could describe changes to the discount rate or changes to the value of liabilities.

This is a new disclosure which insurers have not had to consider in the past, and it's not clear how market practices might develop. There are several potential ways this disclosure could be developed:

- Insurers could disclose how the asset mix has changed over the period together with the impact on the discount rate. Whilst easy to show, this may not provide enough information to allow on the impacts on the discount rate from market movements to be separated from changes in the reference portfolio.

- Alternatively, insurers could calculate the value of the liabilities using the same reference portfolio at the start and end of the reporting period, and contrast this with the liabilities at the end of the period with the new reference portfolio, disclosing the change. The insurer would need to consider how to deal with issues such as assets in the starting portfolio having, say, matured or defaulted over the period.

- It may be possible to track and model individual trades separately to identify the impact on the reference portfolio – for example, calculating a "before" and "after" discount rate and liability value as each trade is carried out. This is only likely to be practical where trading is infrequent.

- Alternatively, insurers could use transaction data to develop systems that track the change in liability discount rates as assets are bought and sold. This would allow the discount rate to be tracked more accurately but given the complexity of this approach this may only be justified where the liability discount rate is critical to the valuation of liabilities.

Depending on how insurers set their discount rates, there could be further complexity if, say, adjustments for credit risk aren't set at the level of each individual asset.

The reference portfolio will also change for reasons other than sales and purchases of assets, adding further complexity to this disclosure.

- As new business is written, new assets will be added to the reference portfolio. These may have different characteristics, making analysis harder.

- The reference portfolio will need to be updated when, say, demographic assumptions are updated, presenting similar problems to new business as the reference portfolio changes.

Stochastic discount rates

Where insurers use a stochastic model to value business with options and guarantees (for example, with-profits business in the UK), there are already extensive disclosures under IFRS 4, covering risk-free discount rates, option volatility and so on.

Insurers will need to consider whether their current disclosures continue to meet the requirements of IFRS 17, allowing investors to determine how the liabilities are calculated.

Where insurers allow for an illiquidity premium for stochastic discount rates, there may be additional disclosures setting out the level of illiquidity assumed and how it's been set.

Locked-in discount rates

There's no explicit requirement to disclose locked-in rates, but it may be challenging to explain profits without some explanation setting out the level of locked-in discount rates compared to current rates.

For the General Measurement Model, where an insurer makes changes to the assumptions underlying the best estimate liability cash flows, the value of the fulfilment cash flows will change, using current rates. This will be offset by a change in the Contractual Service Margin (CSM) but using historic "locked" discount rates. Where the rates are the same there will be no impact on profits, but where rates have changed there will be an impact on profits. Where rates have fallen since the business was written there will be a smaller change in the CSM than the value of the fulfilment cash flows, and vice versa where rates have risen.

This effect will be apparent in any published sensitivities for demographic or expense disclosures, and insurers may consider what disclosure is required to enable investors to understand the potential impacts. This could be a simple explanation describing why profits or losses occur, or, where critical to understanding, a disclosure of the locked-in curves may be needed.