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NORTH AMERICAN INSURERS URGE USE OF EARNED DISCOUNT RATE FOR LIFE INSURANCE LIABILITIES AS OPPOSED TO RISK- FREE RATE

MUMBAI, INDIA, Feb. 19 – Life insurance contract liabilities should be discounted using an earned discount rate as opposed to a risk-free rate, according to the Group of North American Insurance Enterprises (GNAIE).

The use of an earned rate for discounting life insurance contracts is consistent with how market participants value and price such contracts and is consistent with the principle of a market rate, GNAIE executive director Douglas Barnert told the 12th Global Conference of Actuaries here.

Barnert said that proposals to measure life insurance liabilities using a risk-free discount rate when assets held to support these liabilities in the “fair value through profit and loss” category are measured at fair value, will lead to material uneconomic income recognition as well as inappropriate uneconomic earnings volatility.

“Such volatility will largely be driven by an incorrect measurement emphasis on liquidity that will not typically be realized by a life insurer due to the long-term nature of its obligations,” Barnert said

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To influence the development of international accounting and solvency standards to ensure that they result in robust, high quality standards for insurance enterprises.

“An accounting framework that results in such an accounting measurement mismatch” will not provide relevant information to users of financial statements,” he added.

Barnert explained that a core attribute of a life insurance business is the linkage of assets and liabilities with an emphasis on long-term cash flow adequacy rather than short-term sensitivity to market movements and liquidity preferences.

“A consistent measurement basis for assets and liabilities in a life insurance business is critical to ensure elimination of uneconomical accounting measurement mismatch,” he said.

Barnert told the actuaries that to ensure a consistent measurement basis for both assets and liabilities, the current market discount rate used to measure a life insurance liability should, in part, reflect the expected coupon, yield and principal payment schedule based on asset portfolios typically held to support insurance liabilities.

In addition, the current discount rate should reflect the expected investment spreads over government bonds (or sovereign debt) earned on such a portfolio based on historic data and an appropriate margin for risk.

While GNAIE does not advocate the current exit value framework, he said the use of discount rates that are consistent with expected returns on both assets held and expected reinvestment strategies matches how insurance liabilities are priced, including block sale transactions, and is consistent with a current exit value framework.

For situations where asset and liability cash flows are duration matched, Barnert said the use of discount rates based on assets held ensures the change in asset and liability fair values will be consistent.

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Barnert observed that this will not be the case if liabilities are valued at discount rates that are inconsistent with the market yields on the assets held.

“An earned discount rate will therefore better reflect underlying economics of business and therefore provide more useful information to investors; be consistent with how sale transactions actually occur and, as a result, more reflective of current exit value and reconcile current exit value with a settlement value perspective,” said Barnert.

He also pointed out the shortcomings of using a risk-free discount rate to measure life insurance contract liabilities.

Discounting a life insurance contract at a risk-free rate does not result in a current exit value or fair value because it is not consistent with the value a market participant would be willing to pay to assume the remaining contractual rights and obligations of another entity as evidenced in the pricing of sale transactions of life insurance companies, according to Barnert.

Further, he said, it ignores the interdependence of assets and liabilities which are invariably bundled in life insurance transactions.

“Life insurers expect to earn higher than a risk-free rate of return on invested assets and therefore, factor this in the assumptions used for pricing the product,” said Barnert.

“Using a risk-free rate for discounting such liabilities would result in a reported loss for many contracts at issue.”

He observed that the implications of using a risk-free discount rate to measure long-term obligations is not just a life insurance issue, but could have devastating impacts on other industries, such as defined benefit pension plans.

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“The use of a risk-free discount rate as opposed to an earned rate for pension obligations will increase pension liability and pension expense,” Barnert said.

Such an increase will require additional funding from the plan sponsor for the liability “shortfall” purely based on accounting valuation which bears no relation to the actual economics and/or expected benefit payment to be made under the plan, he said.

The 12th Global Conference of Actuaries was jointly organized by the International Actuarial Association and the Institute of Actuaries of India.

The goal of GNAIE is to influence international accounting standards to ensure that they result in high quality accounting and solvency standards for insurance companies and, to that end, to increase communications between insurers doing business in North America and international regulators and standard setters. GNAIE works to meet its goals through modeling of proposed accounting standards, analysis, comment and coordination with various end users of financial reports.

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