



Exposure Draft

Educational Monograph

Issues Associated with the Determination of Discount Rates for Financial Reporting Purposes

Comments to be received by November 8, 2012

August 10, 2012

This Exposure Draft of an Educational Monograph on “Issues Associated with the Determination of Discount Rates for Financial Reporting Purposes” is being exposed by the International Actuarial Association for comment. Please note that the Exposure Draft may be modified in the light of the comments received before being issued in final form. Comments on the Exposure Draft should be submitted in writing to be received on or before November 8, 2012. Those who respond are requested to forward their comments by email to the IAA addressed to Christian Levac, Manager, IT and Member Services [christian.levac@actuaries.org].

All responses will be forwarded to the IAA Ad hoc Project Oversight Group (APOG) of the Insurance Accounting Committee responsible for the development of this monograph; the APOG is Chaired by David Congram. The responses will also be placed on the public record on the IAA website unless the responder requests confidentiality.

Since this is an Exposure Draft, it may be subject to significant revision. Due to copyright requirements, please do not reproduce or circulate the draft monograph outside your organization. The document can be accessed through the following link:

http://www.actuaries.org/CTTEES_ACTSTD/monograph_review.cfm

You will be prompted to enter a password (the password is supplied on the webpage). You may save the document to your computer. If you have any difficulties accessing the document, please contact Christian Levac, Manager, IT and Member Services [christian.levac@actuaries.org].



Nicole Séguin
Executive Director

Introduction

Why is the International Actuarial Association publishing this Exposure Draft?

An important strategic objective of the International Actuarial Association (IAA) is to facilitate the use and expansion of the scientific knowledge and skills of the actuarial profession.

As many of the contingencies with which actuaries deal with relate to cash flows occurring in the future, the time value of money is significant to the economics and in turn the current value of these cash flows. As a result, the reflection of the time value of money, often in the form of discount rates or discount rate curves applied to expected future cash flows, can be significant. Since discounting these cash flows has been of fundamental importance and actuarial and financial practice has advanced significantly over the last few decades, the discounting process has become more refined.

The primary application considered in the monograph is financial reporting for insurance contracts and for certain employer sponsored pension/employee benefit plans.

While a great deal of material has been published on the topic of interest rates and their application to financial reporting, particularly in actuarial finance and accounting media, there has also been a growing need for a more comprehensive summary of alternative approaches. As a result, the IAA welcomes the opportunity to prepare educational material on concepts and practical methods that can be used in the application of the discounting process for the purpose of financial reporting of insurance companies and certain pension/employee benefit obligations of sponsoring entities.

The comments received will provide essential input to the preparation of the final monograph to be published later this year.

The (IAA) is an association of national actuarial associations. Our 64 Full Member actuarial associations represent more than 95% of all actuaries practicing around the world. The IAA promotes high standards of actuarial professionalism across the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within or likely to have an impact on the areas of expertise of actuaries.

Questions for the respondents

We are seeking both general and specific comments on this draft monograph. We encourage you to cite examples that help illustrate your points. If applicable, please be specific as to the issues and location in the Exposure Draft to which your comments refer.

General Comments

We welcome your overall reactions to the monograph, including your assessment as to the clarity of the material presented and how effectively the concepts are communicated.

Specific Comments

1. **Risk-Free Rates.** A central concept of the Exposure Draft relates to the risk-free rate.
 - a. Is this concept well developed?
 - b. Does the definition of the risk-free rate make sense, especially when considering sovereign and liquidity risks?
 - c. Is there adequate consideration of the practical aspects of the decomposition of observed discount rates?

2. **Discount rates for specific applications.** The Exposure Draft describes the applicability of different discount rate for various applications.
 - a. Is the text clear as to when different definitions of discount rates should be applied?
 - b. Are the techniques for real as well as nominal discount rates sufficiently well described?

3. **Extending the Yield Curve.** The Exposure Draft describes different methods for extending the yield curve beyond the period for which forward rates can be reliably observed in open and liquid markets.
 - a. Are the alternatives described adequately?
 - b. Are there specific additional alternatives that should be included?

4. **Replicating Portfolios.** The monograph describes the replicating portfolio methodology for developing a discount rate.
 - a. Is the presentation of this methodology clear?
 - b. Are the advantages and disadvantages of this methodology adequately described?

5. **Illustrating Specific Methodologies and Alternatives.** In several instances, the Exposure Draft seeks to illustrate specific methodologies. Are there sufficient descriptions and/or illustrations of these specific situations?
 - a. No reliable observed market prices.
 - b. Hyper-inflationary conditions.
 - c. Derivation of sovereign risk.
 - d. Derivation of illiquidity premium.
 - e. Derivation of credit risk.

6. **Pass-through of Investment Earnings.** There are various methods by which insurers (participating or unit-linked/variable insurance contracts are examples) or pension sponsors pass investment earnings through to the benefit of policyholders or members. The monograph describes how the development of an appropriate discount rate should be consistent with the development of the related cash flows. Is the Exposure Draft clear with respect to:
 - a. The different investment earnings methods?
 - b. The development of a consistent discount rate?

7. **General Insurance.** There has been some debate as to whether or not cash flows related to general (non-life or casualty) insurance should be discounted.
 - a. Does the monograph adequately address the considerations in this debate?
 - b. Are there additional considerations, limitations or techniques that should be addressed in the monograph relating to general insurance?

8. **Case Studies.** The Exposure Draft includes fourteen case studies that are designed to expand on and illustrate the concepts presented.
 - a. Do the case studies provide sufficient detail for the reader to replicate the processes illustrated?
 - b. Are there additional techniques that should be illustrated in any of the case studies?