# The Politics of the Discount Rate

Dean Buckner (UK Shareholders)

Corporate Reporting Users Forum, 2 December 2020

# Moi

- Poacher:
  - Off balance sheet trading at US bank
  - Futures trading for hedge fund
  - Derivatives valuation and capital management
- Gamekeeper
  - FSA 1999-2007 (Rogue trading, middle office and valuation)
  - FSA/PRA/Bank of England 2010-2018 (Solvency II implementation)

# Discounting

- Discount rate for future cashflow = rate of return on asset that completely hedges the cashflow
- Rate of return of asset given by market price and its cashflows
- Only a riskfree asset can hedge a future cashflow *without risk*
- Ergo discount rate = riskfree rate (≈ gilt rate)
- Financial economists have known this for more than 60 years
- No one has told the accounting or the actuarial profession!

# 10 out of 10 economists agree

- "While economists are famous for disagreeing with each other on virtually every other conceivable issue, when it comes to this one there is no professional disagreement: *The only appropriate way to calculate the value of a very low-risk liability is to use a very low-risk discount rate*".
  - Donald L. Kohn, "Statement at the National Conference on Public Employee Retirement Systems Annual Conference," New Orleans, LA, May 20, 2008

# Life insurance balance sheets

- Typically long-dated exposures (20 years and more)
- Highly sensitive to assumptions about discount rates.
- (Example - £9bn liabilities discounted at 1% 20 years = about 8bn discounted by 1.5%)

# Creating capital

- Simple
- Increase the discount rate for liabilities
  - decreases present value of reported liabilities
- Capital = net assets = pv assets minus pv liabilities
- Capital goes up (by a lot)

# Two balance sheets better than one?

- The regulatory balance sheet is governed by Solvency II *rules*
  - transposed into UK law
- The statutory balance sheet is governed by IFRS *standards*.
  - For insurers, currently IFRS 4 plus any other relevant standards such as IFRS 9)
- I will (mostly) discuss the statutory balance sheet
  - Beware that statutory reporting tends to mix the two concepts

# Matching Adjustment vs Valuation Interest Rate

- ‘Matching Adjustment’ is the Solvency II term for the excess *spread* used to create capital in the regulatory balance sheet
  - Disclosed in the firm’s Solvency and Financial Condition Report (SFCR)
- ‘Valuation interest rate’ is a term used by many insurers for the *yield* (not the spread) used to create capital in the statutory balance sheet
  - There is little data on the amount of capital created
  - I was told by two senior actuaries that the data should not be disclosed because ‘confusing to investors’

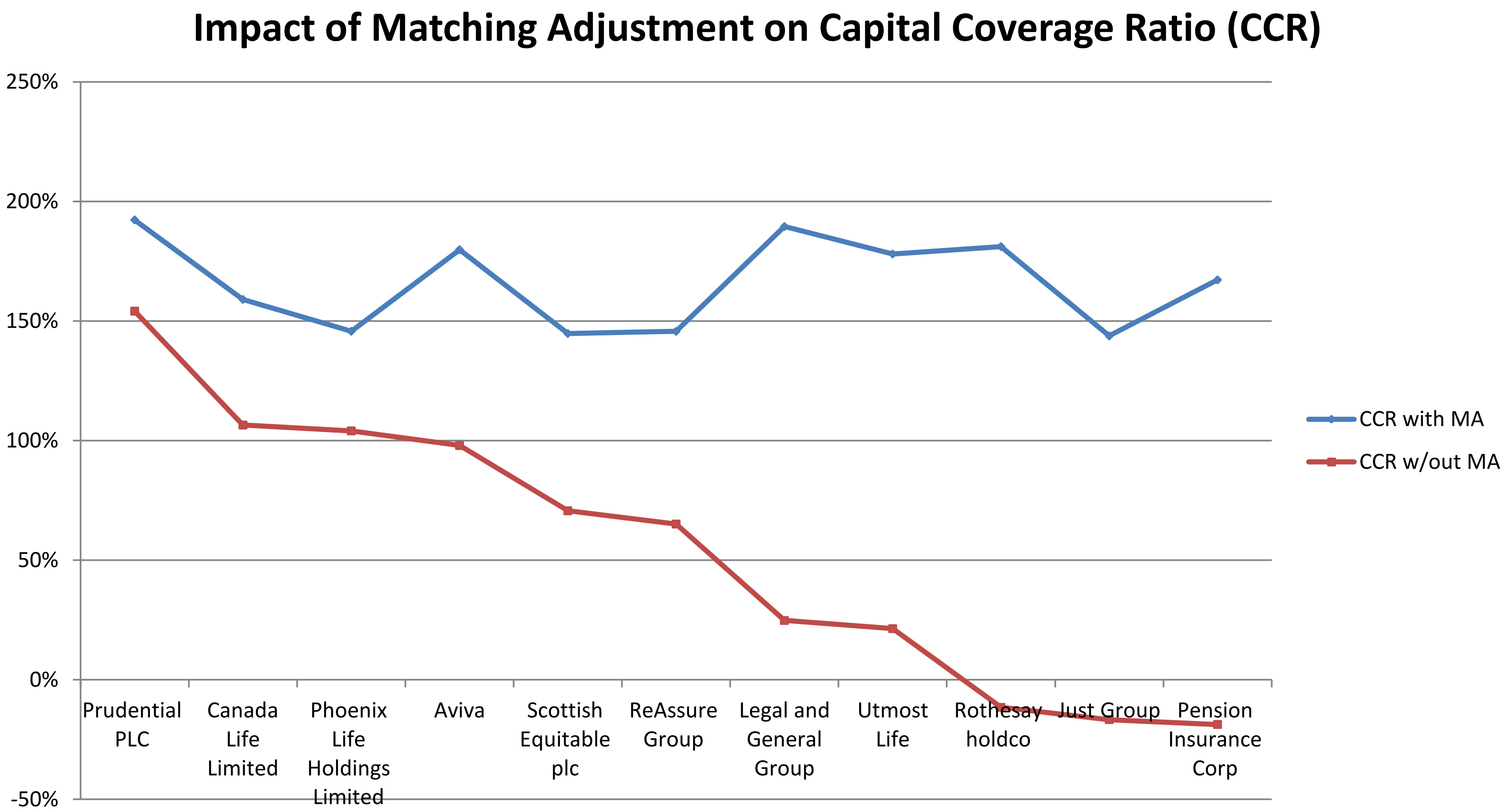
# Cui bono

- Existing shareholders benefit
  - Every time you acquire pension liabilities, you are paid at close to the riskfree rate.
  - substitute the safe assets for less safe, and discount at higher rate to create equity capital.
  - distribute equity, or build balance sheet to sell on to other investors.
- Prospective shareholders less so
  - New investors have overpaid by exactly the amount they have paid, and can only make a profit on further buyouts. Once scope for buyouts ends, game over

# Existing shareholders

- Pension Insurance Corp
  – Abu Dhabi Investment Authority (sovereign wealth), Reinet (‘specialised investment fund’), CVC Capital Partners (private equity)
- Rothesay Life
  – GIC (global investment firm), MassMutual (mutual life)
- Utmost Life
  – Oaktree capital (distressed securities)

# Dependency on MA capital



# Amount of created capital

- Hard to say, as insurers don’t disclose capital created on *statutory* book
- But is likely to be similar to amount of capital created on *regulatory* book
  - Estimates of around £60bn (Bank of England)

# Ongoing consultations

- Technical Advisory Group on endorsement of IFRS 17 (statutory reporting)
- HMT consultation on use of Matching Adjustment (regulatory reporting)
- (Legal) Part VII transfer of policyholders from Prudential to Rothesay Life

# IFRS 17

- Original version of IFRS 17 mandated a riskfree discount rate, in line with standard financial theory
  - After lobbying by industry, the ‘illiquidity premium’ was introduced
  - Allows firms to discount by more than riskfree rate if liabilities are illiquid
  - (Makes absolutely no sense)

# Questions

- Should insurers report the amount of capital created on statutory balance sheet?
  - ("confusing to investors"?)
- What other information should users of financial reports be asking for?
- Should insurers be creating capital at all?
- Why hasn't this issue been aired at CRUF before now?