



INSURANCE COMMISSION
OF THE BAHAMAS

GUIDANCE NOTE ON IFRS 17 DISCOUNT RATES

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Section 1: Discount Rates for Life Insurers

Section 1a: Construction of Discount Rates for Cash Flows that Do Not Vary with Underlying Items

The AAR must disclose the following by country and provide the rationale and sufficient information to support the inputs, assumptions and methodologies used:

- The approach(es) used to develop the discount curve (for example top-down, bottom-up, etc.)
- Whether the discount rates are expressed as spot or forward rates and the reason for the choice of presentation.

The Appointed Actuary should disclose the discount curves by country, by currency, by liquidity category and by spot/forward basis. Under special circumstances (such as small, run-off blocks of business) where blocks are immaterial in size and of low risk, the ICB will consider different details for reporting, where appropriate. Please contact the ICB for further discussion of these specific circumstances.

Bottom-Up Approach

If the bottom-up approach is used, the AAR should disclose the following information in detail:

Risk-free rates by currency

- Describe the method(s) used to construct the observable portion of the risk-free curve (use of government bonds, etc.). Disclose the sources of information used to construct the risk-free rates and any adjustment(s) made to the data.
- Describe the approach(es) and rationale supporting the setting of the last observable point.
- Describe any adjustment made for sovereign credit risk.
- Provide the risk-free rates by currency and year for the observable and non-observable period.
- Describe the interpolation method between the last observable point and the ultimate point, and provide the rationale for the selected method.
- Describe the technique(s) used to develop risk-free rates and rationale of the selection beyond the observable period including (but not limited to):
 - I. Timing and level of the ultimate rate as well as sources of information used to set the ultimate rate.
 - II. Definition of ultimate rate (i.e. spot versus forward rate).
 - III. Extrapolation technique from the ultimate rate.

Illiquidity Premium

- List the types of products (Term, Whole Life, etc.) in each liquidity category (i.e. the most liquid, the most illiquid, and other category(ies) in between), and explain how this categorization is determined.

- Describe the considerations used to assess the liquidity characteristics of insurance contracts (for example product features, surrender value, intrinsic value, surrender cost, etc.) for each liquidity category.
- Describe the technique(s) used to derive the illiquidity premium by country and liquidity category.
- If the illiquidity premium is derived from a top-down analysis describe:
 - (a) how the portion of the asset spread that relates to illiquidity (versus credit risk) is derived.
 - (b) the derivation of any further adjustment that is made to reflect the difference between the liquidity of the insurance contract and the asset reference portfolio
 - (c) the asset reference portfolio (following the disclosure requirement as described below in the Top-Down Approach section regarding reference portfolio) by country and liquidity category.

The Appointed Actuary should disclose any additional information pertinent to choices made in implementing the Bottom-Up approach.

Top-Down Approach

If the top-down approach is used, the following information should be disclosed in detail:

- For each liquidity category, describe whether the entity's own asset mix or a hypothetical asset mix is used as a reference portfolio, and explain why the selected reference portfolio is appropriate for the liquidity category. Describe the types of assets that are expected to be included for each liquidity category, and explain the appropriateness of the choice.
- Describe all adjustments to yield curve(s) to eliminate factors that are not relevant to the insurance contracts (i.e. credit risk, market risk and/or other risk adjustments, etc.). Provide details of what factors are eliminated and the methodologies for determining the adjustments by each of the following asset classes:
 - (a) Government bonds
 - (b) Corporate bonds
 - (c) Public equity
 - (d) Non-fixed income assets other than public equity (be specific of the asset classes)
 - (e) Other
- Describe any further adjustments to reflect the differences in liquidity characteristics of insurance contracts and the reference portfolio.
- Describe the technique(s) used to derive the ultimate rate in the unobservable period, including the timing and level of the ultimate rate as well as the sources of information used to set the ultimate rate and the period from which it applies.
- Describe the interpolation method between the last observable point and the ultimate point in the unobservable period, and provide the rationale for the selected method.

The Appointed Actuary should provide any additional details that explain the choices made under the Top-Down approach.

Ultimate Rate for Business in Bahamian Currency

The ultimate risk-free rate and the illiquidity premium used in the reference curve is 5.20% and 0.90% respectively. The Appointed Actuary should explain any differences, compared to entity's ultimate risk free rate and illiquidity premium.

Section 1b: Compare the Entity's Discount Curves to the Reference Curves – Bahamian Business Only

The Appointed Actuary should provide the rationale if the entity's discount curves are the same as the reference curves for the liquid and illiquid categories.

Excluding the cash flows that vary with the returns on the underlying items, a comparison of the present value of the estimates of future cash flows, obtained using the entity's discount curves, to the present value obtained when using the reference curves should be reported.

Section 1c: Construction of Discount Rates for Cash Flows that Vary Based on the Returns on Underlying Items

The Appointed Actuary should discuss how the financial risk is reflected in the valuation per IFRS 17 paragraph B74 (b)(i.e. whether discount rates reflect the effects of financial risk or adjust cash flows for the effect of financial risk or some combination).

Under IFRS 17, it is possible to separate the insurance contract cash flows between those that vary with returns on underlying items and those that do not vary, and to use different discount rates to discount different sets of cash flows.

If a separation of cash flows is used, the Appointed Actuary is required to explain in detail the methodology or methodologies used to determine the corresponding discount curves used for cash flows that vary with returns on underlying items, including the underlying assets, and the relationship between the actual yield rates and discount rates.

If the cash flows being valued are not separated, the Appointed Actuary should explain what valuation approach is used and how the discount curve is developed for discounting the cash flows.

Section 2: Discount Rates for General Insurers

The AAR must report the following and provide the rationale and justification for the inputs, assumptions and methodologies used:

- Describe the approach(es) used to develop the discount curve (e.g. top-down, bottom-up, etc.) and the rationale for using the chosen approach.
- The discount rates derived can either be expressed as forward rates or as spot rates. Disclose which form is used and provide rationale for the choice.
- For the effects of financial risk (IFRS 17 Paragraph B74 (b)), if applicable, an insurer can use discount rates that reflect the effects of financial risk or adjust cash flows for the effect of financial risk or some combinations.
 - (a) If the entity uses discount rates that reflect the effect of financial risk, describe how the discount rates are adjusted.
 - (b) If the entity adjusts cash flows that reflect the effect of financial risk, elaborate and identify types of cash flows that are impacted.
- Provide the total discount rates by year by liquidity category. The risk-free rates (spot rates) only need to be provided for the bottom-up approach.
- For contracts measured under the Premium Allocation Approach (hereinafter as “PAA”), the Actuary should disclose any groups of contracts (separately for LIC and LRC) where future cash flows are not adjusted for the time value of money and the effect of financial risk, under the following conditions:
 - (a) Future cash flows relating to LIC are expected to be paid or received in one year or less from the date the claims are incurred, or
 - (b) The time between providing each part of the coverage and the related premium due date is no more than a year for future cash flows relating to LRC.

Bottom-Up Approach

If the bottom-up approach is used, provide the following information in details:

- Risk-free rates
 - (a) Describe the method(s) used to construct the observable portion of the risk-free curve (use government bonds, etc.) Disclose the sources of information used to construct the risk-free rates and any adjustment(s) made to the data.
 - (b) Describe the approach(es) and rationale supporting the length of the observable period.
 - (c) Describe any adjustment made for sovereign credit risk.
 - (d) Provide the risk-free rates by currency and year (if applicable).
- Illiquidity Premium
 - (a) Describe liquidity categories used to categorize insurance contracts/products and incurred claims and the number of liquidity categories used.
 - (b) For Liability for Incurred Claims (LIC) and Liability for Remaining Coverage (LRC) respectively, list the actuarial lines of business (Auto, Property, etc.) to be included in each liquidity category.
 - (c) Provide a rationale for the number of categories deemed necessary and sufficient.

- (d) Describe the considerations used to assess the liquidity characteristics of insurance contracts (e.g. product features, exit cost, etc.).
- (e) Describe the technique(s) used to derive the illiquidity premium by country and liquidity category.
- Replicating portfolio
 - (a) Describe the types of products where a replicating portfolio would be used for valuation including the rationale for choosing a replicating portfolio approach.
 - (b) Describe how the replicating portfolio is constructed – that is how the entity ensures that the replicating portfolio (IFRS 17 Paragraph B46) has the cash flows that exactly match cash flows of the contract liability in amount, timing and uncertainty, for all scenarios.
 - (c) Describe at a high level the types of assets that are expected to be included for each replicating portfolio, along with the rationale for decisions made.

Top-Down Approach

If the top-down approach is used, provide the following information in detail:

- Reference portfolio
 - (a) Describe whether the entity's own assets or a hypothetical mix of assets or both are used, and explain rationale for choosing the particular method. If a hypothetical mix of assets is used, please provide detail on the asset mix, types of assets used, credit rating, etc. and explain the appropriateness of the choice.
 - (b) Describe the types of assets that are expected to be included for each liquidity category of a portfolio. Explain why the selected reference portfolio is appropriate for the liquidity category.
 - (c) Describe any adjustments to yield curve(s) to eliminate factors that are not relevant to the insurance contracts (i.e. credit risk, market risk and/or other risk adjustments, etc.). Provide details of what factors are eliminated and the methodologies of determining the adjustments by each asset class:
 - Government bonds
 - Corporate bonds
 - Public equity
 - Non-fixed income assets other than public equity (be specific of the asset classes)
 - Others
 - (d) Describe any adjustments to reflect the differences in liquidity characteristics of insurance contracts and the reference portfolio.

Reference Curves for Liquid and Illiquid Categories

- If the reference curves are not the same as the entity's discount curves used to calculate the present value of the estimates of future cash flows for financial reporting purposes, the Actuary should explain the choice and describe main factors that cause the differences.
- If the entity's discount curves are higher than the corresponding reference curves at any duration, then the Actuary should compare and report the present value of the estimates of future cash flows obtained using the entity's discount curves to the present value obtained using the reference curves.