



cutting through complexity™

Risk Free Rate Workshop

SAM Pillar One Technical Provisions

November 2012

Chair: David Kirk

Plan for the Day

- We have assembled a panel of key individuals with balanced experience across a range of areas.
- The chair will provide an overview of some of the key issues to place the discussion in context
- Some of the panel members will briefly introduce their thoughts on the issues
- We will then have a brief discussion amongst panel members followed by questions and comments from the broader audience
- We will aim to conclude on issues or derive specific follow up actions to conclude on key issues that cannot be resolved during the workshop.
- Tea / coffee break at 11:00am till 11:15am
- Lunch is planned for around 1pm “Under the Oaks”

Panel Members

David Kirk

Ian Marshall

Philip Harrison

Brian Kipps

Lance Osburn

Lindy Schmaman

Louis Scheepers

The panel members have kindly volunteered to give their views and support the discussion and debate. The views presented today are not necessarily those of their employers.

Background

Why we're discussing Risk Free Rates

- SAM is a wide-ranging review of the insurance regulatory environment in South Africa
- Part of that covers the quantitative measures of assets, liabilities and capital
 - Pillar One of SAM
- An important part of liability measurement is the discount rate applied
 - Technical Provisions Task Group
- To date, little discussion outside of the Technical Provisions Task Group has occurred, although we know there are strong views in the wider industry

Official SAM process

- Risk-free rate working group prepares a Discussion Document
- Technical Provisions Task Group reviews and approves for submission to Pillar One Subcommittee
- Pillar One Subcommittee recommends this to the SAM Steering Committee
- SAM Steering Committee approves for publication for comment as a Draft Discussion Document
- Public comments are collated and changes made if appropriate
- Process continues to the publication of a Final Discussion Document and again to a Position Paper
- The FSB / Parliament will ultimately determine what the regulations say

So what has happened to the discussion on risk-free rates?

Current Practice

- Current treatment (per SAP104) is principles based
 - Different practices exist across insurers and within insurers
 - Not currently (nor likely to be in the future) a major issue for short term insurers
- IFRS4 Phase 2 currently proposing a principles based approach
- MCEV reference rate is a swap curve

Discussion Document and QIS2 status

- Prescribed Swap Curve
- Some allowance for illiquidity for certain products

The issues

- Principles vs prescriptive
- Should the rate be specified exactly, a guiding reference rate specified or broad discretion with disclosure be provided?

The issues

- Swaps vs bonds
 - Which is more reliable
 - Market depth, breadth and liquidity
 - Most appropriate for insurance liabilities
 - Illiquidity / funding risk through use of swaps
 - How much does it matter?

The issues

- Technical yield curve construction
 - What instruments to include?
 - Removing credit spreads
 - Removing Expected Default Losses and Credit Risk Premia
 - Adjusting for illiquidity in the underlying investments
 - Fitting algorithms
 - Extrapolation approaches

The issues

- Liquidity Risk
- Illiquidity Risk, Matching Adjustment
- What is the appropriate rate for illiquid liabilities?
- How to measure liquidity of liabilities?
- Is this a material issue for the industry and/or particular insurers and/or potential future insurers
- Top-down versus bottom-up

The issues

- Real and nominal
 - Do we need similar methodologies for real and nominal rates?
 - Which is more important, coherent inflation with derived real yield curve or market consistent real yield curve and derived inflation?
 - How big, how variable is the Inflation Risk Premium?

The issues

■ Practicalities

- Consistency with Solvency II, IAIS' ICPs, IFRS4 Phase 2, MCEV and the tax basis
- Who provides the curve, how frequently?
- Is a universal methodology available? Can a tool be developed to produce yield curves on demand?
- SAM curves for Europe
- SAM curves for rest of the world (including emerging markets with limited swap and/or bond markets)

The issues

- Capital Requirements
- Should backing liabilities with the instruments used to derive the risk-free curve attract a capital requirement?

The issues

- Matching
 - Economic Impact
 - Regulatory Arbitrage
- Will the choice of curve impact matching strategies?
 - Is basis risk a major problem?
 - What is the likely impact on the capital markets of the chosen approach?
 - Will increased use of swaps lead to greater systemic risk for insurers, banks and the combined financial services sector?
 - Will Banks under Basel II/III hold more/less capital against the same matching / basis risk?

The issues

- Other

Rest of the Programme

- Panel members will add their thoughts
- General Discussion
- Concluding thoughts and summary
- Lunch