30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **March 2009, London**

Project: **Insurance Contracts**

Subject: **Guidance on cash flows (Agenda paper 11A)**

Purpose of this paper

1. This paper asks the boards for high-level direction on the cash flows that would be included in a measurement of insurance liabilities using either an exit notion or a fulfilment notion.

2. This paper may also assist the boards in analysing the differences between an exit notion and a fulfilment notion. However, this paper does not identify a preferred measurement approach for insurance contracts.

3. It is also beyond the scope of this paper to discuss:

   (a) the guidance on cash flows in detail; this will be part of drafting the Exposure Draft.

   (b) policyholder behaviour and policyholder participation.

   (c) the discount rate.

   (d) non-performance risk.

Features of a measurement approach

4. In its February 2009 meeting, the IASB tentatively decided that, to provide decision-useful information, the measurement of insurance contracts should, among other things use:

   (a) estimates of financial market variables that are as consistent as possible with observable market prices.

   (b) explicit current estimates of the expected cash flows.

5. On February 25 2009, the FASB discussed those two features but did not conclude on them.

6. At those February meetings, both boards discussed whether a measurement approach for insurance contracts should be based on an exit notion or a fulfilment notion. At the IASB, views diverged and no clear consensus emerged. The FASB agreed to explore current fulfilment value rather than fair value. The fulfilment value would be based on entity-specific inputs that generally would not require consideration of market participant views.

7. At both boards' meetings in February, there was considerable discussion about the nature of various inputs into cash flow estimates. This paper is intended to move that discussion forward, using as its starting point material in Appendix E to the discussion paper (DP) *Preliminary Views on Insurance Contracts*. That appendix presented a preliminary draft of guidance on estimating cash flows, in the context of a measurement approach using current exit price[1]. The guidance would apply to all forms of insurance liabilities.

8. The table in the appendix to this paper reproduces most of the draft guidance from appendix E of the DP. It also summarises the staff's view of how that guidance might be amended for a measurement approach based on fulfilment. The staff emphasise that most aspects of that guidance would not require a change merely because of a decision to adopt a fulfilment notion rather than an exit notion.

[1] Current exit value as defined in the DP is similar, probably even identical, to fair value as defined in SFAS 157 *Fair Value Measurements* and expected to be defined in the IASB's forthcoming ED on fair value measurements. Both SFAS 157 and the IASB's fair value measurement project define fair value as current exit price; we therefore proceed with this label for this candidate.

9. The purpose of this table is to illustrate at a high level what cash flows would be included in an exit value and a fulfilment notion. The staff have not yet considered whether changes are needed to the guidance, nor have the staff considered detailed comments received on this material from respondents to the DP.

10. Responses to the DP were mixed on whether this material was at the right level of detail. Also, some respondents questioned whether the guidance struck the right balance between consistency with the underlying principles and practical implementation. Many respondents emphasised the importance of a principles-based approach.

11. The staff believe the material in the table is consistent with IASB's tentative decisions described in paragraph 4 (estimates of financial market variables to be consistent with observable market prices, explicit current estimates of cash flows).

What elements are relevant for guidance on cash flows

12. Appendix E of the DP addressed the following elements related to cash flows:

    (a) Uncertainty and the expected present value approach.

    (b) Consistency with current market prices, distinguishing between:

        (i) Market variables: variables that can be observed in, or derived directly from, markets (eg prices of publicly traded securities and interest rates).

        (ii) Non-market variables: all other variables (eg the frequency and severity of insurance claims and mortality).

    (c) Sources of estimates.

    (d) Using current estimates.

    (e) Future events.

    (f) Which cash flows?

    (g) Entity-specific cash flows.

What data should guidance on cash flows consider?

13. During both the IASB and FASB February meetings, some debate occurred about the use of estimates that are as consistent as possible with observable market prices (paragraph 4(a)). Consistency with observable market prices (to the extent possible) was considered uncontroversial in the context of an exit notion. However, some Board Members questioned whether - or to what extent – observable market prices (or data) should be used for a fulfilment value.

14. Inputs for estimating the future cash flows of an insurance liability can be based on one or both of:

    (a) external data, which can be split into:

        (i) data that can be observed in, or derived directly from, markets; this would typically relate to (financial) market variables, eg prices of publicly traded securities and interest rates.

        (ii) data from population, industry or economy such as national mortality statistics, and inflation rates; this would typically relate to non-market variables, eg expected claims and expenses.

    (b) internal data, which can be split into:

        (i) data that reflects the characteristics of a portfolio of insurance contracts that is being measured such as lapses and mortality; this would typically relate to expected claims.

        (ii) data that is specific to the entity and potentially goes beyond the characteristics of the portfolio of insurance contracts; this would typically relate to efficiencies and inefficiencies included in expenses that are driven by the insurer's cost structure (ie the costs of administering the contracts).

What may cause differences between an exit notion and a fulfilment notion?

15. Differences in cash flows between two measurement approaches may drive differences between guidance that is required for those approaches.

16. The objective of a measurement approach determines which estimates of cash flows are relevant for that measurement approach. The measurement objective tells us from which perspective to look at the liability (who is **assumed** to hold the liability). For insurance contracts we distinguish between:

    (a) Exit: a market participant that would hold the liability after a (potential) transfer of the liability.

    (b) Fulfilment: the insurer that currently holds the liability and will normally fulfil the obligation with the policyholder over time.

17. Identifying who is assumed to hold the liability tells us which estimates to use and which cash flows to consider:

    (a) Exit: (the insurer's) estimate of the cash flows that would arise for a market participant taking over the liability (market participant view).

    (b) Fulfilment: (the insurer's) estimate of the cash flows that would arise for the insurer that holds the liability when fulfilling the obligation (entity view).

18. Some estimates are based on inputs that can be observed in, or derived directly from, markets (market variables). In terms of a fair value context, these estimates resemble level 1 inputs (eg equity prices) or level 2 inputs (eg interest rates[2]). An exit notion, which is based on the principle of transferring the obligation to a market participant on the balance sheet date, would clearly consider such observable market data (prices); this evidence would override all other forms of evidence. However, it is very likely that this evidence will be persuasive for **any** insurer because the related inputs typically do not depend on any specific characteristics of an insurer or the portfolios it holds. Put differently: for these inputs it **does not** matter who is assumed to hold the liability, the inputs are very likely to be the same to a market participant and an insurer that currently holds the liability.

[2] For some liabilities, interest rates cannot be observed in, or derived directly from, markets; for example when the duration of the liability is significantly beyond the last available market rate. In that case, an insurer needs to develop a level 3 input (interest rate curve) based on the best information available using assumptions that would very likely be similar to those that a market participant would use.

19. Other inputs cannot be observed in, or derived directly from, markets (non-market variables). In terms of a fair value context, these are level 3 inputs. In this case, the entity's internal data would be a natural starting point for determining these inputs. External data might also be considered in the context of an insurer's analysis of the appropriateness of the inputs (reasonableness test), but may have more or less weight than internal data depending on the circumstances. We distinguish between two broad groups of inputs:

    (a) Some unobservable inputs depend solely on the characteristics of the portfolio of insurance contracts that is being measured; examples are lapses and mortality. A market participant might have different underwriting standards, but the estimated mortality rates for an existing portfolio should reflect the characteristics of that portfolio, not the characteristics of a different portfolio that different underwriting standards would have generated. These inputs are therefore portfolio-specific rather that entity-specific; a market participant's estimate would not differ from the estimates of an insurer that intends to fulfil the obligations with the policyholder over time. Put differently: for these inputs it **does not** matter who is assumed to hold the liability, the inputs are very likely to be the same to a market participant and an insurer that currently holds the liability.

    (b) Other unobservable inputs may include characteristics that are specific to the insurer that holds the liability. Such inputs would be consistent with an objective that measures the cash flows that would arise for an insurer if it fulfils the obligations with the policyholder over time. However, if the objective is to measure the cash flows that would arise for a market participant, the inputs should not include any elements that are specific to the insurer and would not arise for other market participants. Put differently: for these inputs it potentially **does** matter who is assumed to hold the liability, the insurer or a market participant.

Next steps

20. At a future meeting, staff intends to address a preferred measurement approach for insurance contracts.

    (a) At its February meeting, the IASB discussed whether a measurement approach for insurance contracts should be based on an exit notion or a fulfilment notion. Views

diverged and no clear consensus emerged. At a future meeting, we will therefore ask the IASB on a tentative decision on the measurement approach.

(b) At its February meeting, the FASB agreed to explore an approach where an insurance contract is measured at a current fulfilment value rather than fair value.

21. Staff intends to prepare the guidance on cash flows in detail as part of drafting the Exposure Draft, taking into account the tentative views of the boards on the preferred measurement approach.

Question for the boards

22. **Do you have any high-level comments on the material in the appendix? (At this stage, we are seeking general direction rather than specific comment on details).**

Topic	Possible guidance on cash flows for an exit notion (extracted from Appendix E of the DP)	Possible guidance on cash flows for a fulfilment notion
Uncertainty and the expected present value approach	The aim is not to develop a single 'best' estimate of future cash flows, but to identify all possible scenarios and make unbiased estimates of the probability of each scenario. The starting point for an estimate of current exit value is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome, to derive an expected present value. In some cases, relatively simple modelling may give an answer within a tolerable range of precision, without the need for a large number of detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and respond in a highly non-linear fashion to changes in economic conditions, for example if the cash flows reflect a series of inter-related implicit or explicit options. In such cases, more sophisticated stochastic modelling is likely to be needed.	No reason to adopt a different approach for a fulfilment notion.
Consistency with current market prices	*Market variables*: Estimates of market variables should be consistent with the market prices at the end of the reporting period. An insurer should not substitute its own estimate for the observed market prices, even if other evidence causes the insurer to believe that those prices are unrepresentative of conditions at the end of the period. Market prices blend a range of views about possible future outcomes and also reflect the risk preferences of market participants. Therefore, they	No reason to adopt a different approach for a fulfilment notion. Many market variables would be level 1 or level 2 inputs if used in a fair value measurement.

	are not a single point forecast of the future outcome. If the actual outcome differs from the previous market price, this does not mean that the market price was 'wrong'.	
	Non-market variables: Estimates of non-market variables should reflect all available evidence, both external and internal. Market prices over-rule all other forms of evidence. However, non-price external data (eg national mortality statistics) may have more or less weight than internal data (eg internal mortality statistics), depending on the circumstances. For example, a life insurer should not rely solely on national mortality statistics, but should consider all other available internal and external sources of information in developing unbiased estimates of probabilities for mortality scenarios. In developing those probabilities, an insurer should consider all evidence available, giving more weight to evidence that is more persuasive. For instance, internal mortality statistics may be more persuasive than national mortality data if the internal statistics are derived from a large population, the demographic characteristics of the insured population differ significantly from those of the national population and the national statistics are out of date; in that case, an insurer would place more weight on the internal data and less weight on the national statistics. Conversely, if the internal statistics are derived from a small population with characteristics believed to be close to those of the national population, and the national statistics are current, an insurer would place more weight on the national statistics. Estimated probabilities for non-market variables should not contradict observable market variables. For example, estimated probabilities for future inflation rate scenarios should be consistent with probabilities implied by market interest rates.	No reason to adopt a different approach for a fulfilment notion. Non-price external data may be useful as a reasonableness test for a fulfilment notion. Many non- market variables would be level 3 inputs if used in a fair value measurement. Market prices typically will not be available for non-market variables; the statement that market prices over-rule all other forms of evidence is therefore unlikely to be relevant to this type of variables.

	In some cases, an insurer concludes that market variables vary independently of non-market variables. If so, the insurer should prepare scenarios that reflect the range of outcomes for the non-market variables and each scenario should use the same observed value of the market variable. In other cases, market variables and non-market variables may be correlated. For example, there may sometimes be evidence that lapse rates are correlated with interest rates. Similarly, there may be evidence that claim levels for house or car insurance are correlated with economic cycles and hence with interest rates and expense levels. In such cases, an insurer should develop scenarios for each outcome of the variables. The insurer should calibrate the probabilities for the scenarios, and the margins relating to the market variables, so that they are consistent with market prices.	
Source of estimates	An insurer estimates the probabilities associated with future payments under existing contracts on the basis of: a) information about claims already reported by policyholders b) other information about the known or estimated characteristics of the book of insurance contracts c) historical data about the insurer's own experience, supplemented where necessary by historical data from other sources d) if available, recent market prices for transfers of books of insurance contracts, adjusted for known differences between those books and the book being measured and implicit or explicit amounts embedded in those prices that are attributable to future benefits from the relationship with policyholders. e) if available, current reinsurance prices, adjusted for factors that may cause the reinsurance price to differ from the price for a true transfer. Reinsurance prices are not generally true exit prices because reinsurance transactions do not typically extinguish the	Items (a)-(c) reflect the evidence that comes from the characteristics of the portfolio and would also be relevant to a fulfilment notion. Evidence (if any) from items (d)-(f) may be useful as a reasonableness test for a fulfilment notion. [(d) refers to future benefits from the relationship with policyholders. We will discuss this topic when we discuss the whole contract approach and policyholder behaviour. We will **not** discuss this topic at this meeting.]

	cedant's obligation to the policyholder. Also, reinsurance often covers only part of the cedant's liability. In addition, the price for reinsurance may be affected by the relationship between the cedant and the reinsurer f) if available, current prices for instruments (if any) covering similar risks such as catastrophe bonds and weather derivatives, adjusted for differences between the risk covered by these instruments and the risk covered by the insurance contracts.	
Using current estimates	In estimating the probability of each cash flow scenario relating to non-market variables, an insurer should use all available current information about conditions at the end of the reporting period. An insurer should review its estimates of probabilities at the end of the reporting period and update them if evidence indicates that previous estimates are no longer valid. Current estimates of expected cash flows are not necessarily identical to the most recent actual experience. An insurer should investigate the reasons for the change in experience and develop new probability estimates for each possible outcome, in the light of the most recent experience, earlier experience and other information.	No reason to adopt a different approach for a fulfilment notion.
Future events	If future events may affect the net cash flows arising from an existing insurance liability, the insurer should develop cash flow scenarios that reflect those future events, as well as unbiased estimates of the probability weightings for each scenario. In contrast, the insurer should not develop cash flow scenarios reflecting future events that create new obligations (or change or discharge existing obligations). For example, an insurer should not develop scenarios reflecting possible new legislation that would create, change or discharge the obligation itself. Estimates of non-market variables consider not just current information about the current level of insured events, but also information about trends. For example, mortality rates have declined consistently over long	No reason to adopt a different approach for a fulfilment notion.

	periods in many countries. In developing cash flow scenarios, an insurer should assign probabilities to each possible trend scenario in the light of all available evidence. Similarly, if contractual cash flows are sensitive to inflation, cash flow scenarios should reflect possible future inflation rates. Because inflation rates are likely to be correlated with interest rates, an insurer should calibrate the probabilities for each inflation scenario so that they are consistent with probabilities implied by market interest rates. Probability weightings should reflect conditions at the end of the reporting period. For example, there may be a 20 per cent probability at the balance sheet date that a major storm will strike during the remaining six months of an insurance contract. After the balance sheet date and before the financial statements are authorised for issue, a storm may actually strike. The measurement of the liability under that contract does not reflect the storm that, with hindsight, is known to have occurred. Instead, the measurement reflects the 20 per cent probability that was apparent at the balance sheet date (with an appropriate risk margin that reflects conditions at the end of the reporting period, and appropriate disclosure that a non-adjusting event occurred after the end of the reporting period). The scenarios developed should include unbiased estimates of the probability of catastrophic losses under existing contracts. For example, if there is a 5 per cent probability that an earthquake during the remaining term of an existing contract will cause losses with a present value of CU1,000,000, the expected present value of the cash outflows includes CU50,000 (1,000,000 @5 per cent) for those catastrophe losses (with an appropriate risk margin for the possibility that existing contracts may generate greater losses). However, the scenarios exclude possible claims under possible future contracts.	

Which cash flows?	Estimates of cash flows in a scenario should include all cash flows arising in that scenario from the contractual rights and contractual obligations associated with the existing insurance contracts, and no others. The relevant cash flows include: a) payments to (or on behalf of) policyholders under existing contracts, including claims that have already been reported but not yet paid (reported claims), claims that have already been incurred but not yet reported (IBNR), and all future claims and other benefits under existing contracts. b) claim handling expenses (expenses that the insurer will incur in processing and resolving claims under existing contracts, including legal and adjuster's fees and internal costs of processing claim payments). c) the direct and indirect costs that market participants would incur in providing contractual benefits that are paid in kind. d) net cash outflows resulting from policyholder behaviour that is unfavourable to the insurer (for example, selective lapsation by policyholders who present lower risks). e) enforceable cash inflows (eg enforceable premium adjustments and enforceable instalment premiums) from policyholders under existing contracts. f) premiums that the policyholder must pay to retain guaranteed insurability, and additional policyholder benefits resulting from those premiums. Guaranteed insurability is a right that permits continued coverage without reconfirmation of the policyholder's risk profile, at a price that is contractually constrained. g) cash flows that will result in the scenario from options and guarantees embedded in the contract. When contracts contain embedded options or guarantees, it is particularly important to consider the full range of scenarios. h) policy administration and maintenance costs, including all direct and indirect costs that market participants would consider in	Most items would probably not be different for a fulfilment notion because they would not depend on whether the insurer or a market participant holds the liability. However, items (b), (c) and (h) would refer to costs that the insurer would incur rather than the costs a market participant would incur. We intend to ask the boards to discuss some items on this list at future meetings.

	assessing the acceptability of a price for taking over the contractual rights and contractual obligations. i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or can be attributed to them on a reasonable and consistent basis j) potential recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts. and, to the extent they do not qualify for recognition as separate assets, potential recoveries on past claims. k) payments to policyholders to satisfy existing obligations to pay participating benefits, to the extent those obligations qualify for recognition as a liability l) interest that the insurer expects to credit to policyholder accounts to satisfy a legal or constructive obligation in a universal life contract	
	The following cash flows are not relevant in estimating the current exit value of existing insurance liabilities: a) investment returns. The investments are recognised, measured and presented separately, unless the liability cash flows depend on the investment returns. b) payments to and from reinsurers. Reinsurance assets are recognised, measured and presented separately c) net cash inflows resulting from policyholder behaviour other than the payment of premiums to retain guaranteed insurability d) cash flows that may arise from future insurance contracts. Nevertheless, estimates of cash flows from existing contracts are not performed on a run-off basis. In other words, those estimates do not incorporate the changes that could occur to cash flows from existing contracts if the insurer stopped issuing new	Most items would probably not be different for a fulfilment notion because they would not depend on whether the insurer or a market participant holds the liability. However, a fulfilment notion would not exclude entity-specific cash flows (item (h)). We intend to ask the boards to discuss some items on this list at future meetings.

	contracts e) income tax payments and receipts (recognised, measured and presented separately under IAS 12 *Income Taxes)* f) cash flows between different components of the reporting entity, such as between policyholder funds and shareholder funds. An example of such cash flows is when a policyholder fund owns an office building that is rented to the insurer at an arms' length rent for use in the insurer's own operations g) transaction costs that the insurer would incur in negotiating and implementing a transfer of its contractual rights and obligations to a third party. These costs are not relevant until the insurer is obliged to incur them h) cash flows that would not arise for other market participants if they held the current insurer's rights and obligations under the insurance contract (entity-specific cash flows) No pricing or measurement model can guarantee to identify in advance all events that might cause insured losses. In determining an acceptable price for taking over insurance liabilities, market participants would consider the possibility of such unidentified events. Because insurance contracts provide asymmetric pay-offs, such unidentified events tend to result in more large losses than large gains. Therefore, they tend to increase the expected present value of future net cash outflows. However, to deal with the possibility of unidentified events insured by existing contracts, it may sometimes be more practical to increase the risk margin, rather than include additional scenarios.	Although a fulfilment notion would look at this from the perspective of the insurer fulfilling the obligations over time, the basic principle would probably be the same. Unidentified events may lead to a higher required risk margin for the insurer [we come back at risk margins at a future meeting].
Entity-specific cash flows	The objective is to estimate the current exit value of the rights and obligations associated with the insurance contracts themselves, without considering cash flows attributable to other assets and liabilities or to goodwill. It follows that cash flow scenarios exclude cash flows that other market participants would not generate (or suffer) if they held the contracts. Examples might include:	A fulfilment notion will capture entity-specific cash flows.

	a) the presence of superior claims management skills, managerial skills or distribution network, an unusually effective system for detecting fraud, actions that limit lapse rates, a monopolistic market position, special tax circumstances that affect only the insurer and would not affect other market participants, or synergies with the insurer's other assets or liabilities b) an intention to settle insurance liabilities differently from the way that other market participants would settle them. For example, an insurer may decide to use its own garages to service motor claims, whereas other market participants might prefer to pay third parties and so incur the costs incurred by those third parties. However, if the insurance contract requires the insurer to settle the liability in a particular way, the measurement of the liability must reflect that requirement, because the objective is to measure the liability that exists in fact, rather than a hypothetical liability with different terms c) unusually efficient, or unusually inefficient, administration systems. Estimates of servicing costs need to reflect the characteristics of the contracts being measured, including the level of service provided to policyholders and the approach to claims management. Those characteristics affect the future cash flows that market participants would consider. For example, aggressive, but expensive, claims management will lead to low claims but high expenses. Similarly, the level and type of service might affect the degree of adverse selection. That would occur if the level and type of service affect lapse rates more for some classes of policyholders than for others. If other insurers incur higher or lower servicing costs, an insurer would need to assess whether the difference arises from the characteristics of the contracts or from differences in efficiency.	

	Estimates of non-market variables should reflect the characteristics of the existing insurance contracts, not a hypothetical portfolio of standardised liabilities. For example, unbiased mortality estimates should reflect, as far as possible, the demographics of the portfolio being measured. Although these estimates are portfolio-specific, they are not necessarily entity-specific. In other words, they are not necessarily inconsistent with estimates that other knowledgeable market participants would make about that portfolio. Moreover, there will rarely be persuasive evidence that the insurer's estimates differ from estimates that other market participants would make.	Estimates of non-market variables that reflect the characteristics of the existing insurance contracts are portfolio-specific rather than entity-specific; as a result, any guidance on these variables is relevant also for a fulfilment value.