IFRS

STAFF PAPER

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Project	Insurance Contracts		
Paper topic	Determining discount rates when there is lack of observable data		
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Please note that this paper was reposted to correct editorial errors. Changes from the version posted to the IASB website on 16 May 2013 are marked up and highlighted.

Purpose of paper

1. This paper considers whether the IASB should provide additional application guidance on how an entity should apply the principle in the 2013 Exposure Draft *Insurance Contracts* (the ED) that the discount rates used to adjust the cash flows in an insurance contract for the time value of money should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract.

2. This paper does not reconsider the principle that the discount rates used to measure an insurance contract should be current market-consistent rates that reflect only the characteristics of the cash flows of the insurance contract and exclude the effect of the entity's own non-performance.

Why does the IASB need to address this issue?

3. In April 2014, the IASB agreed that the staff should provide further analysis on whether appropriate application guidance can be provided for determining discount rates when there are few or no observable market rates for assets with similar characteristics and on how to adjust observed asset rates to determine the

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appropriate liability discount rate. The IASB based this decision on evidence in the comment letters that the proposed requirements have been subject to diverse interpretations, and that it could be useful to have additional application guidance on this critical area.

Staff recommendation

4.   The staff recommend that the IASB should confirm the principle that the discount rates used to adjust the cash flows in an insurance contract for the time value of money should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract. The staff recommend that the IASB should provide additional application guidance that, in determining those discount rates, an entity should use judgement to:

(a)   ensure that appropriate adjustments are made to observable inputs to accommodate any differences between observed transactions and the insurance contracts being measured; and

(b)   develop any unobservable inputs using the best information available in the circumstances, while remaining consistent with the objective of reflecting how market participants assess those inputs. Accordingly, any unobservable inputs should not contradict any available and relevant market data.

5.   Appendix A provides relevant extracts from the existing ED, marked up to show how the staff proposes to implement its recommendations. Appendix B sets out relevant extracts from the Basis for Conclusions.

Background

6.   The ED describes a measurement approach for insurance contracts that is based on an 'expected present value' valuation approach.

7.   The measurement of insurance contracts is a current expected value measurement rather than a fair value measurement, because the IASB has previously concluded that the fact that insurance contracts are not traded in active markets means that fair value would not be an appropriate measurement attribute for insurance contracts. Consequently, the valuation approach proposed by the IASB takes into

account the fact that an entity expects to fulfil the contracts, rather than transfer them. That approach differs from fair value measurement in the following main areas:

(a)   It does not reflect the non-performance risk of the entity that issues the insurance contract. In other words, the credit risk of the entity that issues the contract is not reflected in the measurement (paragraph 21 of the ED).

(b)   The risk adjustment reflects the entity's—and not a market participant's—perception of the effects of uncertainty about the amount and timing of cash flows that arise from an insurance contract (paragraph B76 of the ED).

(c)   A contractual service margin is recognised at inception, and allocated after inception (paragraph 32 of the ED), rather than being remeasured in a way that reflects a market participant's viewpoint.

(d)   The measurement of an insurance contract does not have the equivalent of the requirement in paragraph 47 of IFRS 13 *Fair Value Measurement* that the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

8.   Nonetheless, the approach to determining the discount rate in the ED is consistent with IFRS 13. IFRS 13 would require entities to apply a valuation technique to measure the fair value of a liability for which there is no available quoted price for the transfer of an identical or a similar liability and for which the identical asset is not held by another party as an asset (paragraph 40 of IFRS 13). The most significant market variable in the measurement of an insurance contract is the discount rates used to adjust the estimates of future cash flows for the effect of the time value of money (taking into consideration the passage of time and the liquidity characteristics of the insurance contract). The determination of the discount rate in the ED, and the measurement of fair value, are based on the same underlying methodology and that methodology places the same reliance on the use of observable market information.

Feedback from comment letters

9. Some respondents to the ED identified practical difficulties in identifying the appropriate discount rate for insurance contracts, in particular:

    (a) Some respondents seek clarification about the circumstances in which they are permitted to adjust observable rates for assets with similar characteristics but with shorter-term cash flows, to be able to use those rates to derive discount rates suitable for insurance contracts with longer-term cash flows.

    (b) Many respondents commented on the practical difficulties with estimating market consistent discount rates for long-term contracts that extend beyond the periods for which sufficient market data for assets with similar characteristics is observable, perhaps because the market for such contracts is less active. They believe that the final Standard should provide more guidance on how to estimate long-term discount rates for these contracts.

10. Some remain concerned about the volatility that would arise from using observable market data for shorter durations to determine the rates for long-dated cash flows. In this respect, some suggest that the statement in the Basis for Conclusions (paragraph BCA81, see Appendix B), which talks about forecasts of unobservable inputs tending to put more weight on long-term estimates than on short-term fluctuations, provides useful guidance that should be given more prominence.

11. Underlying these comments is a lack of clarity about how to determine discount rates for insurance contracts, in particular for the top-down approach, which starts from the yield curve for assets with similar characteristics. Particular considerations may apply depending on the availability of observable market prices for assets with cash flows at equivalent tenors in different situations, as follows:

    (a) *When markets are active and market prices (including rates of return) for assets are observable.* In this case, an entity applying a top-down approach for determining discount rates would adjust the observable market rates of return for assets to exclude its estimates of the factors

that are not relevant to the insurance contracts. Overall, for periods in which there are active markets and observable rates of return, most respondents accept that changes in current market conditions would typically result in changes to the estimate of liability discount rates.

(b) *When there are observable market prices (including rates of return) for assets, but the markets are less active.* In this case, some are unclear about whether and when it is appropriate to adjust available observable market prices for assets to reflect any effects on those observed market prices that result from markets that are not active or liquid.

(c) *When there is little or no observable market data for determining discount rates to apply to the long-term cash flows.* In such situations, there appears to be agreement with the statement in paragraph BCA81 of the Basis for Conclusions, which states that forecasts of unobservable inputs tend to put more weight on long-term estimates of the relevant rates than on short-term fluctuations (see Appendix B).

12.   In addition:

(a) Some respondents believe that there is an inconsistency between paragraph B70(a), which indicates that when applying the top-down approach entities need not eliminate differences in liquidity (except for those relating to the liquidity risk relating to assets with similar characteristics) and the example in paragraph B74(a) of the ED, which illustrates the elimination of a market premium for illiquidity in the top-down approach.

(b) A few respondents disagree with paragraph B72 of the ED. Paragraph B72 states that discount rates that are not expected to vary with the returns on underlying items will result in the same yield curve for all cash flows, because the different liquidity characteristics of the contracts will be eliminated, thereby resulting in an illiquid risk-free yield curve that eliminates all uncertainty about the amount and timing of cash flows. Those respondents believe that different contracts and different cash flows within one contract might have different degrees of liquidity.

Staff analysis

13.   As described in paragraph 8, both the measurement approach in the ED and the fair value measurement approach in IFRS 13 place the same reliance on observable market information when applying valuation techniques to liabilities not held by other parties as assets. For example, when there are no quoted prices in active markets:

    (a)   Paragraph B44 of the ED states that estimates of market variables used in the measurement of an insurance contract should be consistent with observable market prices at the end of the reporting period. Paragraph B44 further states that an entity should not substitute its own estimates for observed market prices except as described in IFRS 13 and that, in accordance with IFRS 13, if market variables need to be estimated (for example, because no observable market variables exist), they should be as consistent as possible with observable market variables.

    (b)   Paragraph 67 of IFRS 13 similarly states that valuation techniques used to measure fair value should maximise the use of relevant observable inputs and minimise the use of unobservable inputs. Paragraph 69 of IFRS 13 also states that, if there is a quoted price in an active market for an asset or liability, an entity should use that price without adjustment when measuring fair value, except in specified circumstances.

14.   However, observable market prices in active markets would *not* generally be available for insurance contracts. As a result, the staff believe that it is necessary to add application guidance in the *Insurance Contracts* Standard on how to apply the principle that an entity should maximise the use of observable inputs and minimise the use of unobservable inputs in the measurement of insurance contracts.

Applying the principle of market consistency for discount rates used to measure insurance contracts

15.   As described in paragraph 1, the ED proposes that the discount rates for measuring insurance contracts should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract, even though there are generally no quoted

prices or observable yield curves in active markets. As a result, the ED anticipated that most entities would seek to identify the yield curve for assets with similar characteristics and then adjust that yield curve to reflect the characteristics of the liability (adjusting for the effect of the entity's own non-performance). The ED referred to such an approach as a top-down approach.

16. In a top-down approach, an entity would start with a yield curve derived from assets that have similar cash flow characteristics to the insurance contracts being measured and:

(a) extend the yield curve to tenors for which the insurance contracts have expected cash flows, but for which are no observable market asset prices in active markets (paragraph B70(ii) of the ED);

(b) exclude all factors that are not relevant to the insurance contract, or, in other words, exclude the factors that are relevant only to the assets that were used as a starting point (paragraph B70(i) of the ED); and

(c) remove the effect of the risk of the entity's own non-performance (see paragraphs 21 and B70(iii) of the ED).

17. An entity may use other approaches to estimate the interest curve for the insurance contract, for example using a bottom-up approach (which uses liquid risk-free rates adjusted to reflect the illiquidity of the insurance contract), or using inputs such as interest rates and yield curves that are observable at commonly quoted intervals. Similar considerations to those outlined in this paper would apply when adjusting such inputs to derive an interest curve that reflects the characteristics of the cash flows of the insurance contract. In all cases, the entity adjusts observable market information to reflect the timing, currency and liquidity of the cash flow characteristics of the insurance contract (if required) and to eliminate the risk of the entity's own non-performance, while maximising observable inputs and minimising unobservable inputs.

Extending the yield curve for assets with similar characteristics

18. The cash flows from insurance contracts may occur many years into the future, and the duration of assets with observable prices (including rates of return) in active markets is often shorter than the duration of many insurance contracts.

Accordingly, a yield curve that is derived from assets will often need to be extended beyond the observable term.

19.   In the staff's view, much of the request for clarification relates to what the IASB intended with respect to extending the yield curve for assets with similar characteristics beyond the period for which there are observable market prices in active markets.

20.   Paragraph B44 of the ED proposes that estimates of market variables should be consistent with observable market variables. More specifically, paragraph B71 of the ED states that, when observable market variables are not available, an entity uses estimation techniques to determine appropriate discount rates, taking into account other observable inputs when available. In the staff's view, to be consistent with paragraphs B44 and B71, if an entity determines the yield curve for insurance contracts using the yield curve for assets with similar characteristics as a starting point, that starting point should be consistent with the yield curve implied in the fair value measurement of those assets.

21.   In practice, the process of determining a yield curve for assets differs depending on the extent to which there are quoted prices in active markets for assets with similar characteristics as follows:

(a)   For assets with quoted prices in active markets, such prices should be used without adjustment to measure the fair value of the assets whenever those prices are available, subject to paragraph 79 of IFRS 13 (see paragraph 77 of IFRS 13).

(b)   For assets with quoted prices in markets that are not active, the observable prices may not represent fair value. In such cases, further analysis of the transactions or quoted prices is needed. If an entity determines that a transaction or quoted price does not represent fair value (eg there may transactions that are not orderly), an adjustment to the transactions or quoted prices will be necessary if the entity uses those prices as a basis for measuring fair value. That adjustment may be significant to the fair value measurement in its entirety. Adjustments may also be necessary in other circumstances (eg when a price for a similar asset requires significant adjustment to make it comparable to

the asset being measured or when the price is stale) (paragraph B38 of IFRS 13).

(c)   For assets with no quoted prices in active or inactive markets, there are no relevant observable inputs available. The fair value measurement objective for such assets remains the same, ie an exit price at the measurement date from the perspective of a market participant that holds the asset, and a discount rate reflects the assumptions that market participants would use at the end of the reporting period when pricing the asset. In determining such unobservable inputs, the entity takes into consideration the fact that forecasts of unobservable inputs tend to put more weight on long-term estimates than on short-term fluctuations. Paragraph 89 of IFRS 13 requires an entity to develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data. However those data are adjusted to reflect all information about market participant assumptions that is reasonably available.

22.   The staff believe that it would be useful to clarify that similar considerations apply to insurance contracts, and that an entity should:

(a)   use appropriate adjustments to observable inputs to accommodate any differences between observed transactions and the insurance contracts being measured; and

(b)   develop unobservable inputs using the best information available in the circumstances, while remaining consistent with the objective of reflecting how market participants assess those inputs. Accordingly, any unobservable inputs should not contradict any available and relevant market data.

Adjusting the yield curve for assets with similar characteristics so that it reflects the characteristics of the insurance contract

23.   Paragraph 25(b) of the ED proposes that the yield curve used to discount insurance contract liabilities should exclude any factors that influence observable market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract but that are not relevant to those cash flows.

In a top-down approach, paragraph B70 explains that the entity should exclude, from the observable rates of return that apply to a portfolio of assets, its estimates of the factors that are not relevant to the insurance contract.

24. Those paragraphs are consistent with the principle in paragraph 36 of IFRS 13 that, when an entity uses valuation techniques, such techniques shall maximise the use of *relevant* observable inputs (emphasis added). IFRS 13 focuses on *relevant* observable inputs, because the IASB noted that in some cases the available observable inputs will require an entity to make significant adjustments to them given the characteristics of the asset or liability and the circumstances at the measurement date (eg market conditions). Those considerations apply equally to insurance contracts.

25. Accordingly, depending on the differences between the cash flow characteristics of the assets that are used as a starting point and those of the insurance contact that is being measured, an entity may need to start with the yield curve for assets with similar characteristics that is consistent with available market data, and adjust that yield curve to reflect the characteristics of the cash flows of the insurance contract. Such adjustments include any market risk premiums that are included in the value of the assets, such as those for credit risk and the liquidity risk of the assets. Such adjustments would generally use significant unobservable inputs.

26. In paragraph 12, the staff noted that some respondents believe there to be an inconsistency between paragraph B70(a), which indicates that when applying the top-down approach entities need not eliminate remaining differences in illiquidity, and the example in paragraph B74(a), which illustrates the elimination of a market premium for illiquidity in the top-down approach. The staff note that paragraph B70(a)(i) proposes that an entity should exclude the factors that are not relevant to the insurance contract from the observable rates of return that apply to assets that are used as a starting point Such factors include, to the extent they can be identified. the market risk premiums for credit risk and liquidity risk relating to the assets included in the portfolio,. The entity need not adjust for any illiquidity premium that does not relate to the liquidity risk relating to assets with similar characteristics.

27.   In paragraph 12(b), the staff noted that some respondents disagreed with the statement in paragraph B72 that, in principle, discount rates that are not expected to vary with the returns on underlying items will result in the same yield curve for all cash flows. Those respondents believe that different contracts might have different degrees of illiquidity. However the staff note that discount rates that are not expected to vary with the returns on underlying items would adjust risk-free rates to remove those differing effects of different illiquidity characteristics of the contracts. Accordingly, the discount rates used would result in the same fully illiquid risk-free rate.

Staff recommendations

28.   Taking into account the comments in the comment letters, and the analysis above, the staff believe that it would be useful to provide additional application guidance on how to determine the discount rates for insurance contracts when there is a lack of observable data. In the staff's view, there is evidence that the proposed requirements have been subject to diverse interpretations, and additional application guidance on this critical area could be useful.

29.   In addition to the proposed amendments to the ED's content, the staff are also proposing some drafting changes, which mainly aim to improve the overall structure of the drafting on discount rates proposed in the 2013 ED. These changes have not been reviewed by the IASB and would be subject to the usual drafting and balloting procedures when deliberations are complete.

30.   All the proposed amendments are summarised in Appendix A.

Question: proposed application guidance

Does the IASB agree that it should confirm the proposals in the 2013 ED for the discount rates used to adjust the cash flows in an insurance contract, but clarify how that principle should be applied when there is a lack of observable data?

If yes, does the IASB agree that in determining the discount rates used to reflect the time value of money in the measurement of the insurance contract, an entity should use judgement to:

(a) ensure that appropriate adjustments are made to observable inputs to accommodate any differences between observed transactions and the insurance contracts being measured; and

(b) develop any unobservable inputs using the best information available in the circumstances, while remaining consistent with the objective of reflecting how market participants assess those inputs? Accordingly, any unobservable inputs should not contradict any available and relevant market data.

Appendix A—Relevant extracts from the ED, marked up to show how the staff propose to implement the staff recommendations

Time value of money (paragraphs B69–B75)

25   **An entity shall ~~determine the fulfilment cash flows by~~ adjusting the estimates of future cash flows <u>to reflect the effect of</u> ~~for~~ the time value of money<u>. The</u> ~~, using~~ discount rates <u>applied to the estimates of cash flows described in paragraph 22</u>~~that reflect the characteristics of those cash flows. Such rates~~ shall:**

    (a)   <u>reflect the time value of money, the characteristics of the cash flows and the illiquidity characteristics of the insurance contract;</u>

    (<mark>ab</mark>)   be consistent with <u>any</u> observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract, in terms of, for example, timing, currency and liquidity; ~~and~~

    (c~~b~~)   exclude the effect of any factors that influence the observable market prices but that are not relevant to the cash flows of the insurance contract<u>; and</u>

    (d)   <u>exclude the risk from the entity's own non-performance.</u>

> To clarify that the discount rates reflect the illiquidity characteristics of the contract and exclude the effect of the entity's own non-performance.

26   Estimates of discount rates shall be consistent with other estimates used to measure the insurance contract to avoid double counting or omissions, for example:

    (a)   <u>cash flows that reflect the extent of any dependence of the cash flows</u> ~~to the extent that the amount, timing or uncertainty of the cash flows that arise from an insurance contract depends wholly or partly~~ on the returns on <u>any</u> underlying items~~, the characteristics of the liability reflect that dependence. The discount rate used to measure those cash flows shall therefore~~ shall be discounted using rates that reflect the extent of that dependence.

    (b)   <u>cash flows that do not reflect dependence on the investment risk of the underlying items shall be discounted at rates that do not reflect that dependence.</u>

    (~~b~~c)   nominal cash flows (ie those that include the effect of inflation) shall be discounted at rates that include the effect of inflation.

    (~~c~~d)   real cash flows (ie those that exclude the effect of inflation) shall be discounted at rates that exclude the effect of inflation.

> To clarify that the discount rates for asset-dependent cash need to reflect the way the asset dependence is reflected in the cash flows.

Market variables and non-market variables (paragraph 22(b))

B43   This application guidance identifies two types of variables:

    (a)   market variables—variables that can be observed in, or derived directly from, markets (for example, prices of publicly traded securities and interest rates); and

    (b)   non-market variables—all other variables (for example, the frequency and severity of insurance claims and mortality).

Market variables (paragraph 22(b))

B44   Estimates of market variables shall be consistent with observable market prices at the end of the reporting period. An entity shall not substitute its

own estimates for observed market prices except as described in paragraph 79 of IFRS 13. ~~In accordance~~Consistently with IFRS 13, if market variables need to be estimated (for example, because no observable market variables exist), they shall be as consistent as possible with observable market variables.

B45   Market prices blend a range of views about possible future outcomes and also reflect the risk preferences of market participants. Consequently, they 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'.

B46   An important application of market variables is the notion of a replicating asset or a replicating portfolio of assets. A replicating asset is one whose cash flows *exactly* match the contractual cash flows in amount, timing and uncertainty. In some cases, a replicating asset may exist for some of the cash flows that arise from an insurance contract. The fair value of that asset both reflects the expected present value of the cash flows from the asset and the risk associated with those cash flows. If a replicating portfolio of assets exists for some or all of the cash flows that arise from an insurance contract liability, the entity can, for those contractual cash flows, use the fair value of those assets for the relevant fulfillment cash flows <u>(adjusted to reflect the effect of the entity's own non-performance)</u> instead of explicitly estimating the expected present value of those particular cash flows and the associated risk adjustment. For cash flows that are not measured by a replicating portfolio of assets, and entity shall explicitly estimate the expected present value of those particular cash flows and associated risk adjustment.

Time value of money (paragraphs 25–26)

B68A   <u>This [draft] Standard does not prescribe a particular estimation technique for determining the discount rates that reflect the characteristics of the insurance contract. However, such rates should:</u>

    (a)   <u>include only factors that are relevant for the insurance contract, including;</u>

       (i)   <u>the liquidity characteristics of the insurance contract; and</u>

       (ii)   <u>the extent of any dependence of the cash outflows from the insurance contract on the returns from underlying items. Such factors are relevant for the insurance contract regardless of whether that dependence arises as a result of the contractual terms or through the entity exercising discretion, and regardless of whether the entity holds the underlying items; and</u>

    (b)   <u>exclude the risk from the entity's own non-performance.</u>

From paragraphs B69, B70 and B73

B69   Discount rates that reflect the characteristics of the cash flows of an insurance contract may not be directly observable in the market. ~~An entity shall maximise the use of current observable market prices of instruments with similar cash flows, but shall adjust those prices to reflect the differences between those cash flows and the cash flows of the insurance contract in terms of timing, currency and liquidity. This [draft] Standard does not prescribe the method for making those adjustments.~~

B71, and redrafted below

<u>When observable market rates for an instrument with the same characteristics are not available, or observable market rates for similar instruments are available, but do not separately identify the relevant factors that distinguish the instrument from the insurance contract, an entity estimates the appropriate rates using an estimation technique. In applying such an estimation technique, an entity shall:</u>

    (a)   <u>maximise the use of current, relevant observable inputs and minimise the use of ==un==observable inputs.</u>

Staff recommendation

(b)   reflect all available evidence, both external and internal, concerning non-market variables (see paragraph B49) as well as observable market data. In particular, the discount rates used should not contradict any available and relevant market data, and any non-market variables used shall not contradict observable market variables.

(c)   reflect current market conditions from the perspective of a market participant.

(d)   exercise judgement to assess the degree of similarity between the rates for the insurance contract being determined and the instrument for which observable market prices are available and adjust those prices to reflect the differences between them.

B69A If the cash flows of an insurance contract do not depend on the performance of underlying items, the discount rate reflects the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, adjusted to reflect that the insurance contract does not have the same liquidity characteristics as assets traded in financial markets. For example, some government bonds are traded in active markets and the holder can typically sell them readily at any time without incurring significant costs. In contrast, policyholders cannot liquidate their investment in some insurance contracts without incurring significant costs, and in some cases they have no contractual right to liquidate their holding at all.	From B70(b)
B69B In some cases, the entity determines such discount rates by adjusting a liquid risk-free yield curve to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contract (a bottom-up approach).	From B70(b)
~~B70 In making the adjustments described in paragraph B69, an entity shall include in the discount rates for the insurance contract only those factors that are relevant for the insurance contract, as follows:~~	To B68A
~~(a) in some~~ In other cases, the entity determines the appropriate discount rates ~~yield curve~~ for the insurance contract based on a yield curve that reflects the current market rates of returns ~~either~~ for ~~the~~ a reference ~~actual~~ portfolio of assets, adjusted to exclude the market rates of return for the assets included in the reference portfolio that are not relevant to the insurance contract (a top-down approach). An entity estimates the yield curve that reflects the current market rates of return for the fair value measurement of a reference portfolio of assets and then adjusts that yield curve to eliminate any factors that are not relevant to the insurance contract. In estimating that yield curve:	Staff recommendation

(a)   where there are observable market prices in active markets for assets in the reference portfolio, an entity must use those prices to estimate fair value (consistent with paragraph 69[1] of IFRS 13).

(b)   where market become less active, an entity adjusts observable market prices for similar assets to make them comparable to the assets being measured (consistent with paragraph 83[2] of IFRS 13).

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[1]An entity shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability (see paragraphs 11 and 12). In some cases those characteristics result in the application of an adjustment, such as a premium or discount (eg a control premium or non-controlling interest discount). However, a fair value measurement shall not incorporate a premium or discount that is inconsistent with the unit of account in the IFRS that requires or permits the fair value measurement (see paragraphs 13 and 14). Premiums or discounts that reflect size as a characteristic of the entity's holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity, as described in paragraph 80) rather than as a characteristic of the asset or liability (eg a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement. In all cases, if there is a quoted price in an active market (ie a *Level 1 input*) for an asset or a liability, an entity shall use that price without adjustment when measuring fair value, except as specified in paragraph 79.

(c)   where there is no market for assets in the reference portfolio, an entity applies an estimation technique which is consistent with fair value. For such assets, consistently with paragraph 89[3] of IFRS 13, an entity:

     (i)   develops unobservable inputs using the best information available in the circumstances, which might include the entity's own data;

     (ii)   adjusts those data to reflect all information about market participant assumptions that is reasonably available; and

     (iii)   places more weight on long-term estimates than on short-term fluctuations.

B70D   An entity uses judgement to adjust observed market rates of return so that they are relevant to the insurance contract. For example, an entity adjusts market rates observed in recent transactions in instruments with similar characteristics for movements in market factors since the transaction date, or adjusts market rates observed to reflect the degree of similarity between the instrument being measured and the instrument for which observable transaction prices are available. To the extent that the cash flows of the insurance contract do not depend on the cash flows of the assets in the reference portfolio, such adjustments include: — Staff recommendation

~~that the entity holds or for a reference portfolio of assets as a starting point. The rates of return for the portfolio include market risk premiums for credit risk and liquidity risk. In a 'top-down' approach, an entity:~~ — Redrafted below

     ~~(i)   excludes, from the observable rates of return that apply to a portfolio of assets, its estimates of the factors that are not relevant to the insurance contract. Such factors include market risk premiums for assets included in the portfolio that are being used as a starting point.~~

(a~~ii~~)   ~~adjusts for~~ differences between the timing of the cash flows of the assets in the portfolio and the timing of the cash flows of the insurance contract; and ~~This ensures that the duration of the assets is matched to the duration of the liability.~~

     (b)   market risk premiums for credit risk and liquidity risk relevant to the assets included in the reference portfolio. An entity need not adjust to reflect any ~~(iii)   does not include, in accordance with paragraph 21, the risk of the entity's own non-performance.~~

~~While there may be~~ remaining differences between the liquidity characteristics of the insurance contract and the liquidity characteristics of the assets in the portfolio, other than those — From B72

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[2] Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the following:

    (a)   the condition or location of the asset;

    (b)   the extent to which inputs relate to items that are comparable to the asset or liability (including those factors described in paragraph 39); and

    (c)   the volume or level of activity in the markets within which the inputs are observed.

[3] An entity shall develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, an entity may begin with its own data, but it shall adjust those data if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (eg an entity-specific synergy). An entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, an entity shall take into account all information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described above are considered market participant assumptions and meet the objective of a fair value measurement.

	included in the market risk premiums. As a result, although in principle there should be a single illiquid risk-free yield curve that eliminates all uncertainty about the amount and timing of cash flows, different yield curves may result in practice, even in the same currency. ~~an entity applying the top-down approach need not make adjustments to eliminate those differences.~~	
	~~(b) in other cases, the entity adjusts a risk-free yield curve to include its estimates of the factors that are relevant to the insurance contract (a 'bottom-up' approach). Factors that are relevant to the insurance contract include differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contract. For example, some government bonds are traded in deep and liquid markets and the holder can typically sell them readily at any time without incurring significant transaction costs such as bid-ask spreads. In contrast, insurance contract liabilities cannot generally be traded, and it may not be possible to cancel the contract before it matures.~~	To B69A and B69B
~~B71~~	~~When observable market variables are not available, or do not separately identify the relevant factors, an entity uses estimation techniques to determine the appropriate discount rate, taking into account other observable inputs when available. For example, the entity may need to determine the discount rates applied to cash flows that are expected beyond the period for which observable market data is available using the current, observable market yield curve for shorter durations. Another example would be the estimate of the credit risk premium that is included in the spread of a debt instrument using a credit derivative as a reference point. An entity assesses the extent to which the market prices for credit derivatives includes factors that are not relevant to determining the credit risk component of the market rate of return so that the credit risk component of the overall asset spread can be determined.~~	To B69, B74
~~B72~~	~~In principle, the discount rates that are not expected to vary with returns on underlying items will result in the same yield curve for all cash flows because the different liquidity characteristics of the contracts will be eliminated to result in an illiquid risk-free yield curve that eliminates all uncertainty about the amount and timing of cash flows. However, applying paragraph B70(a) may result in different yield curves in practice, even in the same currency.~~	To B70D
~~B73~~	~~To the extent that the amount, timing or uncertainty of the cash flows that arise from an insurance contract depends on the returns on underlying items, paragraph 26(a) requires the characteristics of the liability to reflect that dependence. The discount rates used to measure those cash flows shall therefore reflect the extent of that dependence. This is the case regardless of whether that dependence arises as a result of contractual terms or through the entity exercising discretion, and regardless of whether the entity holds the underlying items.~~	To B68A
B74	The [draft] Standard does not specify restrictions on the portfolio of assets used to determine the discount rates in applying paragraph B70B~~(a)~~. However, fewer adjustments would be required to eliminate ~~those~~ factors that are not relevant to the ~~liability~~ insurance contract when the reference portfolio of assets has similar characteristics to those of the insurance contract liabilities. ~~Accordingly~~ For example, if the cash flows from the insurance contract do not depend on the performance of underlying items:	From B71
	(a) for debt instruments, the objective is to eliminate from the total bond yield the ~~factors that are not relevant for the insurance contract. Those factors include the~~ effects of expected credit losses, the market risk premium for credit and a market premium for liquidity, and other factors that are not relevant to the insurance contract. If an entity estimates the discount rates for insurance contracts using a debt instrument as a starting point, the entity would need to adjust the observed transaction price of	

the debt instrument to eliminate the credit risk premium that is included in the spread of the debt instrument. One way to estimate that credit risk premium is to use a credit derivative as a reference point, and adjust the market prices for credit derivatives to exclude factors that are not relevant to determining the credit risk component of the market rate of return so that the credit risk component of the overall asset spread can be determined.

(b)   for equity investments, ~~an entity would make~~ more significant adjustments ~~are required~~ to eliminate ~~the factors that are not relevant to the insurance contract. This is because there are greater differences between the cash flow characteristics of equity investments and the cash flow characteristics of insurance contracts. In particular, the objective is to eliminate from the portfolio rate the part of~~ the expected return for bearing investment risk~~, including~~ ~~. Those investment risks include the~~ market risk and any other variability in the amount and timing of the cash flows from the assets.

~~B75~~   ~~In some circumstances, the most appropriate way to reflect any dependence of the cash flows that arise from an insurance contract on specified assets might be to use a replicating portfolio technique (see paragraphs B46–B48). In other cases, an entity might use discount rates that are consistent with the measurement of those assets, and that have been adjusted for any asymmetry between the entity and the policyholders in the sharing of the risks arising from those assets.~~   Deleted because of overlap with paragraphs B46-B48

Appendix B—Relevant extracts from the Basis for Conclusions

Estimates that do not contradict available market information (paragraphs B43–B54)

BCA29 The IASB believes that measurements are more relevant and reliable if they are as consistent as possible with observed market prices, because such measurements:

(a)   involve less subjectivity than measurements that use the entity's own estimates;

(b)   reflect all evidence that is available to market participants; and

(c)   are developed using a common and publicly accessible benchmark that users of financial statements can understand more easily than information developed using a private, internal benchmark.

BCA30 This view has the following consequences:

(a)   an entity would use observable current market variables, such as interest rates, as direct inputs without adjustment; and

(b)   in principle, consistency with observed market prices implies that estimates of cash flows should be consistent with the estimates that other market participants would make. However, many variables cannot be observed in, or derived directly from, market prices. Examples of such variables are mortality and the frequency and severity of insurance claims. When developing estimates of these variables, an entity would need to consider all of the available data, external and internal. However, the estimates should not contradict current market variables. For example, estimated probabilities for inflation scenarios should not contradict probabilities implied by market interest rates.

Current, market-consistent estimates of the time value of money

BCA74 Paragraphs BCA26–BCA30 describe the IASB's reasoning for using current, market-consistent estimates of cash flows. Those reasons also apply to the discount rate applied to those cash flows. Accordingly, this Exposure Draft proposes that entities should discount cash flows using current, market-consistent discount rates.

Reflecting liquidity factors in the discount rate

BCA75 Discussions of the time value of money often use the notion of risk-free rates. Many use highly liquid, high-quality bonds as a proxy for risk-free rates. However, the holder can often sell such bonds in the market at short notice without incurring significant costs or affecting the market price. This means that the holder of such bonds acquires two things:

(a)   a holding in an underlying non-tradable investment, paying a return that is higher than the observed return on the traded bond; and

(b)   an embedded option to sell the investment, for which the holder pays an implicit premium through a reduction in the overall return.

In contrast, for many insurance contracts, the policyholder cannot sell the contract to a third party but is also unable to put it back to the entity, or perhaps can do so, but only by paying a significant penalty.

BCA76 The IASB concluded that, in principle, the discount rate for an insurance contract should reflect the liquidity characteristics of the item being measured. Thus, the discount rate should equal the return on the underlying non-tradable investment, because the holder cannot sell or put the liability without significant cost. There should be no deduction for the premium on the embedded put option, because no such put option is present in the liability.

BCA77 The IASB considered input from preparers of financial statements, academics and regulators on how to measure the liquidity premiums for an insurance contract. Their feedback suggested that there is not yet a consensus on how best to measure those effects, for example, how to separate liquidity effects from credit effects. The divergence in views became greater during the financial crisis of recent years, during which asset spreads widened dramatically.

BCA78 The IASB believes that it would not be appropriate, in a principle-based approach:

(a)   to prescribe a discount rate that ignores the liquidity characteristics of the item being measured, or that uses an arbitrary benchmark (for example, high quality corporate bonds) as an attempt to develop a practical proxy for measuring the specific liquidity characteristics of the item being measured; or

(b)   to provide detailed guidance on how to estimate liquidity adjustments.

BA79   However, the IASB observed that in estimating liquidity adjustments, an entity could apply either:

(a)   a 'bottom-up' approach that would be based on risk-free rates, adjusted to include a liquidity premium; or

(b)   a 'top-down' approach that would be based on the expected returns of a reference portfolio, adjusted to eliminate factors that were not relevant to the liability.

BCA80   This Exposure Draft confirms the proposal in the 2010 Exposure Draft that an entity should not consider its own credit risk when calculating the discount rate. This proposal is consistent with the view of many that own credit is not relevant to the measurement of a liability that must be fulfilled by the issuer. In developing this Exposure Draft, the IASB considered concerns that excluding own credit risk could lead to accounting mismatches, because the fair value of the assets backing insurance contracts includes changes in credit risk on those assets, while the measurement of the insurance contract would not include changes in credit risk on the liability. In the IASB's view, such mismatches would be partially economic, because the credit risk associated with the insurance contract differs from the credit risk of the assets held by the entity. Nonetheless, the IASB noted that an entity using a top-down approach to calculate the discount rate assumes that any part of the observed credit spreads that cannot be identified as relating to credit risk relates to liquidity and thus would not eliminate that unidentified risk from the reference discount rate. As a result, the discount rate for the liability would in part respond to changes in credit spreads and the effects of the mismatches might be reduced.

BCA81   The IASB noted that if there are no observable inputs for determining the discount rate, the entity should use an estimate that is consistent with the IASB's guidance on fair value measurement, in particular fair value measurements categorised within Level 3 of the fair value hierarchy. When applying that guidance, an entity would adjust an observable input that relates to an instrument whose characteristics differ from the characteristics of the liability being measured. Furthermore, because forecasts of unobservable inputs tend to put more weight on long term estimates than on short-term fluctuations, this counteracts concerns that current-period fluctuations in discount rates exaggerate the volatility of very long-dated liabilities.

BCA82   The IASB decided that it would not prescribe a default discount rate as a simpler alternative for calculating the appropriate discount rate to apply. In the IASB's view, it is not possible to simplify the implementation of the proposals by prescribing a rate while still achieving the objective of reflecting the characteristics of the liability.