



**IASB
Insurance Contracts Project**

Field Testing Questionnaire: Discount Rate

Date: Sept 2009

Field Testing – Round 1

In Round 1 of the targeted field test we ask you to submit information on specific topics prior to the publication of an exposure draft (ED) in December 2009. The questions we would like you to answer are detailed below. The questionnaire is supported by background information, including the most recent decisions made by the IASB and FASB boards.

We shall treat any information that you provide to us in the strictest confidence.

Discount rate

In this questionnaire we focus on the discount rate for non-participating contracts; the discount rate for participating contracts will be part of a future questionnaire. Furthermore, this questionnaire does not consider the risk of non-performance by the insurer ('own credit risk'). In providing information please provide, where appropriate, information on the line of business and whether the liability relates to new or existing business.

Question 1

Please specify which discount rate you use under your current accounting model for **non-participating** liabilities (in other words, the expected benefit payments are not linked to asset performance)? Please specify the rate for each line of business (where appropriate) stating your reasons for doing so. How (if relevant) does your answer differ between different business lines?

Description	Life	Non Life	Health
No discounting			
Original rate implied in expected cash flows at inception			
Current risk free rate			
Risk free rate at inception			
Expected yield at inception on investments backing insurance liabilities			
Current yield on investments backing insurance liabilities			
Derived using a replicating portfolio			
Other (please specify)			

Some insurers suggest that discounting should be prohibited, or at least not required, for some insurance liabilities for which all claims will arise within one year. They maintain that the effects of discounting are not likely to be material for these liabilities. Some believe that a one year cut-off is more practical and cost-effective.

Question 2

Have you applied discounting to all your cash flow estimates, or only beyond a particular cut-off point? If you used a cut-off point, what was it and why did you select it?

Question 3

What are the practical implications of moving to discounting all insurance liabilities, where this represents a departure from current practice (including cost / benefit considerations)?

The IASB decided tentatively that the discount rate for an insurance liability should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability rather than using a discount rate based on expected returns on actual assets backing those liabilities (unless the cash flows from those assets affect the cash flows arising from that liability, ie participating contracts). The IASB also specified

- that the measurement should use estimates of financial market variables, including discount rates, that are as consistent as possible with observable market prices, and
- that the discount rate should be updated each reporting period.

The FASB has yet to discuss whether what discount rate(s) should be used and whether some liabilities should not be discounted (particularly claims liabilities arising from non-life contracts). The staff will send field test participants an update, and any necessary follow-up requests, when the FASB concludes tentatively on these issues.

Question 4

Which approach did you use for determining the discount rate for the Board's proposal? More specifically:

a) What observable market rate did you use?

b) What factors did you consider in determining a discount rate that reflects the characteristics of the **insurance liability** being measured? Factors to be considered are for example currency, timing and liquidity.

(We note that the IASB decision implies that the discount rate for insurance liabilities should exclude any premium for default risk of the issuer included in the observable market rate. The premium to be excluded includes two elements: the premium for expected credit losses and the premium for bearing the risk that those actual credit losses may differ from the expected credit losses.

c) How did you adjust that observable rate for the factors mentioned under b) to arrive at the discount rate for insurance liabilities? Please specify any methods for estimating those factors. [Question 8 asks for additional information about liquidity].

Question 5

Did you identify any (practical) issues in determining the discount rate, such as a lack of observable market rates? Please provide details.

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The IASB has also decided tentatively that the exposure draft should not give detailed guidance on how to determine the specific discount rate in practice. Instead, the exposure draft should provide a cross-reference to the guidance on fair value measurement. That is because determining the current market yield on an instrument with specified cash flows is essentially the same task as determining the current market yield of the fair value of that instrument.

The IASB's guidance on determining the fair value of financial instruments is currently in IAS 39 *Financial Instruments Recognition and Measurement* and is expected to be replaced in due course by guidance in a standard resulting from the exposure draft *Fair Value Measurement*.

Question 6

Does the cross-reference to the guidance on fair value measurement provide sufficient guidance for estimating the discount rate for insurance liabilities? If not, what additional guidance would the exposure draft in your view require? Please provide details.

Question 7

How does the discount rate under the proposals for the forthcoming exposure draft on Insurance Contracts compare with the discount rate(s) you use for your current accounting model? If achievable, please give an indication of the impact on the measurement of the insurance liability and an analysis of that impact. If considered relevant, you may also provide a comparison with the rate used for supplementary information such as embedded value or economic capital.

Some insurance contracts are priced using an expected return on assets that exceeds the risk-free rate. Some have argued that a highly liquid asset (eg a government bond traded in an active market) contains a feature that is not present in a liability that is not highly liquid. This view implies that a loss that is not an economic loss could arise at inception in some cases if an illiquid (or non-puttable) liability is discounted using the discount rate for a highly-liquid instrument. Accordingly, in determining the discount rate for that liability, it would be necessary, in principle, to adjust the expected return on such an instrument (asset). (It would not be appropriate to increase the discount rate for a liability by including the premium that investors require for bearing risks associated with assets they hold).

Question 8

a) In addition to your comments under Question 7, in applying the discount rate under the proposals for the exposure draft did you observe any losses at inception for some types of contracts? If any, please provide an analysis of these losses, including their impact on profit or loss.

b) In addition to your comments under Question 4, does the discount rate include a component that reflects the liquidity characteristics for some types of contracts? If it does, how did you determine this liquidity component?

Please give an indication of the size of the liquidity premium compared to the total discount rate. Could you also describe your approach to estimating the liquidity factor (if any).

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c) If you had not included the liquidity component described in b), would the measurement of the liability have resulted in a loss at inception? If so, please give an estimate of the impact of these losses.

Please submit your results to Jane Jordan (jjordan@iasb.org) by 23rd October.

Background Information.

Why discount cash flows?

The second building block used in measuring an insurance liability relates to the time value of money. In the DP it was argued that discounting represents faithfully the economic fact that money has a time value. The DP proposed to reflect the time value of money by using a discount rate that is consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability. These characteristics include, for example, timing, currency and liquidity. Discounting is also consistent with rational pricing decisions, which typically reflect the time value of money and the risk inherent in the contract.

Where are the boards?

IASB

At its February 2009 meeting, the Board tentatively decided that the measurement of insurance liabilities should conceptually reflect the time value of money. This approach is consistent with other IFRSs that require discounting for other comparable items, such as long-term provisions, employee benefit obligations and finance leases.

Some existing accounting approaches for insurance liabilities use a discount rate based on expected returns on the actual assets held. The IASB decided tentatively that the discount rate for an insurance liability should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability rather than using a discount rate based on expected returns on actual assets backing those liabilities.

The discount rate should be consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability as closely as possible for factors such as:

- timing
- currency
- liquidity

FASB

At its July meeting, the FASB reaffirmed its tentative decision that discounting should be included in the measurement of an insurance liability because it reflects the passage of time and faithfully represents that an obligation payable today is not equal to an obligation payable at a future date (although the FASB will discuss at a future meeting whether claims liabilities arising from non-life contracts could be measured by using undiscounted cash flows (with no margin)). In addition, FASB also agreed that the discount rate used should be updated at each reporting period because an updated discount rate would best reflect the current market conditions and provide users with the most accurate measurement of the insurance liability.

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The FASB will discuss at a future meeting the discount rate that should be used.

Other sources of information

- IASB Discussion paper *Preliminary Views on Insurance Contracts* (paragraphs 63 – 70).
- **Agenda Papers**
 - [IWG Paper 8 Discount rates and day one losses \(June 09\)](#)
 - [IASB Board Paper 17D \(September 2009\)](#)