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International
Accounting Standards
Board

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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:	**21 February 2007, London**
Project:	**Insurance Contracts (phase II)**
Subject:	**Unbundling (Agenda paper 11A)**

Purpose of this paper

1. This paper asks the Board to reconsider its tentative conclusion on one aspect of unbundling.

Summary of recommendations

2. The staff recommends that:

    (a) the Board should neither require nor prohibit unbundling for the purpose of **recognising and measuring** insurance liabilities. This recommendation would change the preliminary view in paragraph 53 of chapter 5 of the pre-ballot draft of the Discussion Paper (see appendix to this paper).

    (b) the Board should not express a preliminary view on whether **premiums** should be split into revenue, deposit and service components. This recommendation is consistent with the preliminary view in paragraph 29 of chapter 7 of the pre-ballot draft.

Previous discussion

3. The Board's tentative decisions on unbundling so far are as follows:

   (a) The Board should not require insurers to unbundle deposit and service components of insurance contracts for the purpose of recognition and measurement. [April 2006]

   (b) Should an insurer split premiums for some or all insurance contracts into a revenue component and a deposit component? The discussion paper should review the alternatives but not express a preliminary view on this topic. [July 2006]

   (c) Having decided tentatively in April not to require unbundling, the Board discussed whether it should prohibit unbundling in some or all cases. The Board:

      (i) confirmed that an insurer should not unbundle insurance, deposit and service components of insurance contracts if the components are so interdependent that the components can be measured only on an arbitrary basis, but

      (ii) decided tentatively (reversing the April decision) that an insurer should unbundle them if such interdependencies are not present. [September 2006]

Why are we bringing this issue back?

4. Board members suggested in September that the Discussion Paper would need to explain clearly when unbundling would be required and its practical effect. The staff has had some difficulty finding convincing examples, and without them constituents will wonder what the Board has in mind, and what the practical effect will be. Several constituents have already asked us this, and we have been unable to provide useful answers.

5. Interdependencies make unbundling arbitrary in some cases, perhaps many (depending on how 'arbitrary' is defined). In many other cases, unbundling is not likely to make a significant difference to recognition and measurement. Thus, if

the Discussion Paper recommends that unbundling should be required (when not arbitrary), we are likely to confuse constituents, and alarm them through a proposal that may rarely have a significant effect in practice.

When might unbundling arise?

6. Unbundling refers to accounting for the components of a contract as if they were separate contracts. An insurance contract may contain insurance, deposit (or financial) and service components. Relevant extracts from the pre-ballot draft are attached.

7. The question of unbundling would arise if either:

   (a) Insurance premiums received are reported as revenue rather than as deposit receipts. The Board decided that the discussion paper should review the alternatives but not express a preliminary view on this topic. The staff believes that conclusion is still appropriate, given the current status of the project on performance reporting. Therefore, this paper does not discuss that further.

   (b) The measurement attribute for insurance liabilities differs from the measurement attribute used for financial liabilities, or for performance obligations arising under service contracts. Three cases are discussed below:

      (i) Financial liabilities carried at fair value through profit or loss (paragraph 8)

      (ii) Financial liabilities carried at amortised cost (paragraphs 9 and 10)

      (iii) Performance obligations (paragraphs 11 and 12)

Financial liabilities carried at fair value through profit or loss

8. Both fair value and current exit value use current market-consistent estimates. Therefore, if a separately measured deposit component would be carried at fair value through profit or loss, there would be little point in unbundling it from an insurance contract measured at current exit value. Thus, unbundling seems unnecessary in this case (and a prohibition would be redundant).

Financial liabilities carried at amortised cost

9. If a separately measured deposit component would be carried at amortised cost, it would be counter-productive to require unbundling, given that the Board views current exit value as more relevant and reliable than amortised cost. Moreover, even if unbundling were required, an insurer might be able in most cases to use the fair value option for the deposit component, and this would largely negate the measurement consequences of unbundling.

10. For a deposit component that would be carried at amortised cost, there might be some merit in prohibiting unbundling, in order to achieve a measurement (at current exit value) that the Board views as more relevant and reliable. However, insurers and actuaries have repeatedly emphasised to us that unbundling would be arbitrary, artificial and burdensome in most cases. Also, unbundling may make it harder to avoid accounting mismatches. Therefore, it seems unlikely that insurers would choose to unbundle a deposit component in most cases. Thus, prohibiting unbundling would be unnecessary.

Performance obligations

11. Performance obligations would typically be measured under IAS 18 *Revenue* at the unearned portion of the consideration received. This may differ from current exit value if circumstances have changed significantly since inception. However, in many cases, the service components and insurance components may be intertwined in a way that makes unbundling difficult, arbitrary and artificial. In the staff's view, this would make unbundling arbitrary in many (probably most) cases. And when unbundling is not arbitrary, it would not, in the staff's view, result in a demonstrably superior result. Therefore, a requirement to unbundle would not be appropriate.

12. As already noted, insurers and actuaries have repeatedly expressed concerns that unbundling would be arbitrary, artificial and burdensome in most cases. Thus, it seems unnecessary to prohibit the unbundling of service components.

Components that are readily separable

13. Paragraphs 10 and 12 argue that unbundling a deposit or service component would be burdensome and possibly arbitrary in many cases, so that an insurer would not generally choose to unbundle them. Should the Board prohibit unbundling if an insurance contract contains components that are easily separable? In the staff's

view, that would achieve little. If the components are easily separable, an insurer could probably avoid any prohibition by issuing two (or more) separate contracts.

Staff recommendation

14. The staff recommends that:

(a) the Board should neither require nor prohibit unbundling for the purpose of **recognising and measuring** insurance liabilities. This recommendation would change the preliminary view in paragraph 53 of chapter 5 of the pre-ballot draft of the Discussion Paper (see appendix to this paper).

(b) the Board should not express a preliminary view on whether **premiums** should be split into revenue, deposit and service components. This recommendation is consistent with the preliminary view in paragraph 29 of chapter 7 of the pre-ballot draft.

Appendix

Extracts from draft Discussion Paper

Chapter 5 Measurement – other issues

Unbundling

45. Because the policyholder must generally pay premiums in advance, virtually all insurance contracts have an implicit or explicit deposit component that would, if it were a separate instrument, be within the scope of IAS 39. Here are some examples of deposit components:

    (a) The surrender value or maturity value of an endowment. These contracts might be viewed as a combination of (i) that deposit component and (ii) an insurance component that pays the difference between the death benefit and the surrender value if the policyholder dies before the contract matures.

    (b) Components for which a policyholder assumes all or most of the investment risks (as with some types of unit-linked (variable) contract).

    (c) An interest-bearing account value, as in some universal life contracts.

    (d) Some experience accounts and similar mechanisms in some reinsurance contracts and some direct insurance contracts for corporate policyholders. IG Example 3 of the *Guidance on Implementing* IFRS 4 illustrates a contract with such a feature.

    (e) 'Excess' premiums pre-paid in the early years of a long-term life insurance or health insurance contract to fund 'excess' benefits in later years.

    (f) Components that are completely separable or have been combined artificially with insurance components that behave economically as separate contracts.

46. Different measurement models co-exist in IFRSs now. Therefore, a deposit component of an insurance contract may not receive the same accounting treatment as a separate deposit contract. Similarly, a separate service contract may not receive the same treatment as a service component of an insurance contract. The relevant measurement models in IFRSs are as follows:

(a) Financial instruments are measured at amortised cost or fair value.

(b) In phase I, rights and obligations under insurance contracts are measured using various bases, mostly inherited from pre-existing national practices. Applying the Board's preliminary views, rights and obligations under insurance contracts would be measured in phase II at current exit value.

(c) Revenue from service contracts is recognised by reference to the stage of completion of the transaction (see IAS 18 *Revenue*).[1] The nominal amount of revenue received in advance is recognised as a liability. The appendix to IAS 18 also gives specific guidance on investment management fees.

47. The Board's preliminary views would reduce the differences between these models, but not eliminate them. Inconsistencies may still remain if:

(a) An insurer does not classify financial instruments as at fair value through profit or loss. In most cases the fair value option in IAS 39 enables an insurer to avoid this inconsistency.

(b) The IAS 18 model is used to recognise revenue from stand-alone service contracts (or from service contracts embedded in long-term savings contracts), but for a servicing component of insurance contracts an insurer reports revenue when service margins are no longer needed.

48. To minimise these inconsistencies, some argue that an insurer should 'unbundle' any deposit component or service component from the insurance component, with some or all of the following consequences:

(a) measurement consequences:

(i) The insurance component is measured as an insurance contract.

(ii) The deposit component is measured under IAS 39 at either amortised cost or fair value. This might or might not differ from the basis used for insurance contracts.

[1] IAS 18, paragraphs 20-28

(iii) An obligation to provide services (eg investment management) is typically measured under IAS 18 at the unearned part of any consideration received in advance. This may differ from current exit value if circumstances have changed significantly since inception.

(iv) For deposit components measured at amortised cost, the related incremental transaction costs are deducted in determining the initial carrying amount, not recognised as an expense.

(b) presentation consequences, discussed in chapter 7:

(i) Premium receipts for the deposit component are presented as changes in the deposit liability, not as revenue. Premium receipts for the insurance element are typically presented as revenue in current practice, but chapter 7 discusses whether this should continue.

(ii) If the deposit component is regarded as third-party funds under management, rather than as a direct obligation of the insurer, the deposit component might be reported off balance sheet. This is how most fund managers account for mutual funds that they manage.

49. IFRS 4 requires an insurer to unbundle an insurance contract if the rights and obligations arising from the deposit component (a) can be measured separately and (b) would not otherwise be recognised. If only the first of these conditions is met, IFRS 4 permits unbundling, but does not require it.[2] The Board's objective was to require unbundling only when it is easiest to perform and the effect is likely to be greatest (eg for some large customised financial reinsurance contracts).[3] Also, the Board did not wish to require unbundling in cases where phase II might not require it.

Arguments for unbundling

50. Supporters argue that unbundling of deposit components would:

(a) mean that an entity accounts in the same way for the deposit component of an insurance contract as the issuer of a separate, but otherwise identical, financial instrument (eg one issued by a bank or a fund manager).

[2] IFRS 4, paragraphs 10-12 and *Guidance on Implementing IFRS 4*, paragraph IG5 and IG example 3.
[3] *Basis for Conclusions on IFRS 4*, paragraphs BC40–BC54.

(b) avoid sharp discontinuities in the accounting between a contract that transfers just enough insurance risk to be an insurance contract, and another contract that falls marginally on the other side of the line. This would reduce the pressure on the definition of insurance contract.

(c) distinguish between premium revenue earned for accepting insurance risk and premium receipts that are, in substance, investment or deposit receipts.

Arguments against unbundling

51. Opponents of unbundling give the following arguments:

(a) The components are closely interrelated and the value of the bundled product may differ from the sum of the individual values of the components.

(b) Insurance contracts are designed, priced, managed and regulated as packages of benefits. Furthermore, the insurer cannot unilaterally terminate the agreement or sell parts of it. Any unbundling required solely for accounting would be artificial and often require significant and costly systems changes.

(c) Surrender options may cause interdependencies between the components. In principle, the deposit component does not include the part of the surrender value needed to compensate the policyholder for forfeiting the right to future insurance coverage. However, it may not be straightforward to identify that part. Thus, the measurement of the deposit component might be arbitrary in some cases.

(d) Some users want information about gross premium inflows, as an indicator of new business activity. They would prefer that either all products are unbundled or no products are unbundled.

52. Some favour unbundling for some types of deposit component, but not for all types.

The Board's preliminary view on unbundling

53. In the Board's view, an insurer should unbundle insurance, deposit and service components of insurance contracts for measurement, unless the components are so interdependent that the components can be measured only on an arbitrary basis.

In addition, chapter 7 discusses whether an insurer should split premium receipts into a revenue part and a deposit part for presentation in the income statement.

Chapter 7 Changes in Insurance Liabilities

26. Another way to avoid the disadvantages of possibly arbitrary definitional boundaries is to unbundle all premiums into a deposit receipt and a revenue component. This would provide consistency between stand-alone components and similar components embedded in a larger contract. However, unbundling could be costly to perform, and perhaps arbitrary if there are significant interdependencies between components.

27. To minimise the disadvantages of unbundling, the Board could require unbundling only in specified cases when the benefits of unbundling are most likely to exceed the costs. For example, the Board could require an insurer to unbundle any deposit component that is not closely related to the underlying insurance exposure and has been inserted artificially to meet an accounting objective rather than a commercial objective. When the Board assesses whether it should propose unbundling, it will consider responses to the FASB's *Invitation to Comment on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*, published in May 2006. In December 2006, the FASB discussed the comment letters and directed the FASB staff to focus on:

    (a) editorial changes to clarify the minimum level of insurance risk transfer required for a contract to be accounted for as reinsurance under SFAS 113 *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.

    (b) improved insurance and reinsurance disclosure requirements.

    (c) clarifying that non-insurance company policyholders must use criteria like those for reinsurance contracts in SFAS 113 to evaluate whether the insurance contracts they hold transfer significant insurance risk.

Preliminary view

28. Does it matter whether an insurer treats premiums as revenue or deposits? The Board believes it does. Many insurers emphasise total premium revenue as a

headline indicator of the size of their business. Some have expressed concerns that using insurance or reinsurance accounting for significant deposit components distorts changes in performance metrics such as combined ratios or the ratio of liabilities to premiums. Moreover, some insurers provide supplementary measures that they view as more comprehensive than the premium revenue reported in their income statements. For example:

(a) Some life insurers report 'annual premium equivalent'. This is often defined as the premium revenue for the year from recurring premium contracts plus 10% of the premium from single premium contract. The aim is to provide greater comparability between insurers with different ratios of single premium business to recurring premium business.

(b) Some life insurers report performance metrics that combine (i) premium revenue for insurance contracts with (ii) non-revenue inflows (such as deposit receipts) for products such as mutual funds, long-term savings products and universal life contracts.

29. This suggests that insurers, and probably also users, view reported revenue and expense as important. So it would seem important to distinguish revenue from deposits. However, the Board has not yet formed a preliminary view on the treatment of premiums and would welcome input from respondents. In reaching a conclusion, the Board will also consider developments in the FASB's project on insurance risk transfer.