



Contact(s)	Hans van der Veen	hvanderveen@iasb.org	+44 (0)20 7246 6464
	Mark Trench	metrench@fasb.org	+1 (0)203 956 3455
	Jeffrey Cropsey	jdcropsey@fasb.org	+1 (0)203 956 5305

Project **Insurance Contracts**

Topic **Unbundling**

Purpose of this paper

1. An insurance contract may contain insurance, investment (or financial) and service components. This paper discusses whether an insurer should recognise and measure those components of a contract as if they were separate contracts (unbundling).

Summary of staff recommendations

2. This paper argues that:
 - (a) an insurer should unbundle a contract if its components are not interdependent;
 - (b) the exposure draft should not state whether unbundling is prohibited or permitted in other cases.

Structure of the paper

3. The rest of this paper is divided into the following sections:
 - (a) Background (paragraphs 5-19)
 - (b) Arguments for and against unbundling (paragraphs 20-22)
 - (c) Approaches to unbundling (paragraphs 23-29)

This paper has been prepared by the technical staff of the FAF and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

Staff paper

- (d) If unbundling is not required, should it be permitted or prohibited?
(paragraphs 30-32)
4. It is beyond the purpose of this paper to discuss:
- (a) whether some or all premiums should be treated as deposit receipts rather than revenues. Agenda paper 4B deals with this.
 - (b) whether the measurement model for insurance contracts would include a deposit floor (ie an insurance liability with a demand feature would not be less than the amount payable on demand). Agenda paper 4C deals with this.
 - (c) whether an insurer should recognise items such as the pre-claims liability, the claims liability and future premiums separately items or part of a single net liability or asset. We intend to discuss this with the boards in November.
 - (d) if the investment component is regarded as funds under management, rather than as an asset and liability of the insurer, whether it will be reported off balance sheet. We will ask the boards to discuss that in November, particularly in the context of unit-linked contracts (known in the US as variable contracts).

Background

5. Unbundling, in this paper, 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.
6. The question of unbundling would arise if either:
- (a) the measurement attribute for insurance liabilities differs from the measurement attribute used for financial liabilities, or for performance obligations arising under service contracts, or
 - (b) insurance premiums received are reported as revenue rather than as deposit receipts (we do not discuss this any further in this paper, agenda paper 4B deals with this).

7. The measurement models for the three relevant components (financial liabilities, insurance liabilities, performance obligations) are:
- (a) Insurance component (protection): the insurance measurements selected tentatively by the boards in this project, namely an updated IAS 37 approach for IASB and a current fulfilment value for FASB.
 - (b) Investment component: the measurement models for financial instruments.
 - (c) Service component: the model proposed in the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (the allocated transaction price model)
8. It seems unlikely at this stage that the measurement of financial liabilities, insurance liabilities and performance obligations will be based on the same model. The greater the difference is between measurement models, the greater potential accounting discontinuities will be and the greater the pressure on unbundling becomes.

Investment components

9. The investment component is the component of an insurance contract that is not closely related to the underlying insurance exposure (or other services provided to the policyholder) and reflects the future repayments to the same policyholder who paid the premiums.
10. The investment component would be measured under IAS 39 at either amortised cost or fair value.
- (a) Based on IASB's exposure draft *Financial Instruments: Classification and Measurement*, the financial component would be measured at either¹:

¹ The existing IAS 39 also results in a measurement at either amortised cost or fair value through profit or loss based on the current classification model. In this paper we focus on the classification approach proposed in the IASB's ED *Financial Instruments: Classification and Measurement* because the Board

Staff paper

- (i) amortised cost for those investment components that have basic loan features and are managed on a contractual yield basis (although the insurer still could use the fair value option in some cases).
 - (ii) fair value through profit or loss for all other investment components.
- (b) Based on the latest FASB proposals for the FASB's forthcoming exposure draft on financial instruments, the financial component would be measured at fair value, with changes for some instruments reported through profit or loss and changes for other instruments reported in other comprehensive income.
11. Both fair value and the selected measurements for insurance contracts, an updated IAS 37 approach for IASB and a current fulfilment value for FASB, are current measures. However, the selected measurements for insurance contracts may differ from fair value, for example on features like non-performance risk and a deposit floor. [For FASB, the treatment of acquisition costs could also cause a difference. The FASB decided tentatively to recognise all acquisition costs as incurred and not to recognise revenue to cover those costs. However, for financial instruments the measurement would either include the acquisition costs as part of amortised cost or release to profit or loss the part of the premiums that relate to acquisition costs].
12. The differences between the selected measurement approaches for insurance and amortised cost are likely to be more significant since the insurance models are current approaches as opposed to a locked-in measure.
13. It is likely there will remain some differences between the insurance measurement to be proposed in the exposure draft and the measurement models in the forthcoming standard on financial instruments. However, it is too early to tell how significant that impact of the accounting discontinuity will be; this depends on the final outcome of the boards' discussions on:
- (a) the classification approach to financial instruments;

plans to have the new standard on classification and measurement of financial instruments out by the time the exposure draft on insurance contracts would be published.

(b) the measurement models for financial instruments and insurance contracts.

Performance obligations

14. The service component (if any) in an insurance contract relates to an obligation to provide services (other than risk coverage) under that contract with a customer, for example providing investment management services embedded in an insurance contract. If an entity accounts for such components on a stand-alone basis, the proposed revenue recognition model applies to them.
15. The DP on Revenue proposes an allocated transaction price approach that focuses on reporting about performance under the contracts. Accordingly, it measures performance obligations as the portion of the transaction price allocated at inception to that obligation, and updated for the time value of money (but not updated for other changes in circumstances, unless the contract is onerous). Like the amortised cost approach for financial instruments, this is a locked-in approach.
16. The measurement approach for insurance contracts is selected not only to report performance under the contract but also to report changes in circumstances. Reporting changes in circumstances is necessary because of the long term and inherent uncertainty of many insurance contracts. Such characteristics could still be present in an unbundled service component, for example an investment management component in a long-term life contract.
17. In principle, the outcomes of a current measurement for insurance contracts can differ significantly from the outcomes of the locked-in revenue recognition model. In that case, some may argue that retaining the selected insurance model seems more appropriate than reverting back to the revenue recognition model.
18. Nevertheless, if circumstances do not change significantly, the pattern of margin release ('bottom line') under both the revenue recognition model and the selected insurance approach should be quite similar because for both approaches profit or loss would primarily be driven by performance under the contract.

19. We therefore conclude that, even though the difference between the revenue recognition model and the insurance model can be quite significant in principle, the effect of this accounting discontinuity on net profit is fairly limited in practice:

- (a) In case of significant changes of circumstances for a contract, it does not seem logical to use a locked-in measurement for that contract or a component of that contract.
- (b) But if no changes in circumstances occur, it is likely that the overall margin release is not materially different.

Arguments for and against unbundling

20. Some respondents to the discussion paper *Preliminary Views on Insurance Contracts* (DP) agreed with unbundling when it could be done in a way that is not arbitrary, for conceptual and practical reasons. Arguments for unbundling are:

- (a) an entity accounts in the same way for the investment 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).
- (b) sharp accounting discontinuities can be avoided 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.

21. Others opposed unbundling in all cases. Arguments against unbundling brought forward by respondents are:

- (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

Staff paper

artificial and often require significant and costly systems changes, particularly for contracts that do not have explicitly unbundled charges.

- (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) The level of aggregation for measuring the insurance component might differ from other measurements. This could increase the difficulty of measuring the components separately.

22. The following examples illustrate some of the practical issues of unbundling:

Example A

Background

Insurer A enters into a five-year traditional endowment insurance contract on January 1, 2010. For simplicity, we ignore all expenses other than acquisition costs. We also ignore non-performance risk.

The annual premium is CU100 and is received at the beginning of each year; the contract does not state any explicit charges. Acquisition costs are CU10 and are paid at inception; these acquisition costs are fully incremental. The benefit paid at maturity is CU464, if the policyholder is still alive then. If the policyholder dies before the end of the contract, a death benefit of CU500 is paid. Benefits are paid at the end of each year. For simplicity, we presume that the policyholder cannot surrender the contract.

At inception, the expected mortality rate is 2% for year one, 4% for year 2, 6% for year 3, 8% for year 4 and 10% for year 5. The discount rate for the insurance liability is 5%.

Arguably, this insurance contract includes, at least implicitly, an investment component and an insurance component. If the insurer were to unbundle the contract into its two components, one way forward is a) first to measure the investment element and b) then to measure the insurance coverage as a function of the death coverage and any deposit amounts already accumulated for that contract.

The investment component has basic loan features and we suppose it is managed on a contractual yield basis. This means that, under the proposals in the IASB's ED on classification and measurement of financial instruments, the investment component will be measured at amortised cost². The yield on a zero bond with similar cash flows and maturity is 5%. Suppose the acquisition costs attributable to the investment component are CU5, the remaining acquisition costs are allocated to the insurance component.

At a crediting rate of 5%, the expected annual deposit payments embedded in the total premium are CU80; the five-year regular payment needed to fund the payment maturity of CU464 at a crediting rate of 5%. Considering the acquisition costs of CU5, the effective interest rate on the investment component is 5.5%. The liability for the investment component will be measured at inception at CU75 (the first deposit payment of CU80 less deferred acquisition costs of CU5).

The insurance component will be measured using current value approach, namely the updated IAS 37 approach for IASB and current fulfilment value for FASB. Because the annual deposit premium is estimated at CU80, the part of the premium related to the insurance coverage is deemed to be CU20 (CU100 less CU80). At inception, this results in future premium inflows with an expected present value of CU91 and death benefits with an expected present value of CU48. (Note that the death benefit needs to be defined as CU500 including the accumulated investment component at the date of death.) Accordingly, the insurer recognises revenue of CU5³ to cover incremental acquisition costs attributable to the insurance component and the overall margin at inception is estimated at CU38 (CU91 less CU48 less CU5). The insurance component therefore results in an asset of CU5 at inception.

Although this case seems reasonably straight-forward, we note that any split of the acquisition costs over the components is likely to be arbitrary [for the purpose of this example, we allocated 50% to the investment component and 50% to the insurance component, determined in no particular way].

Furthermore, we note that the complexity (and arbitrariness) is likely to increase if:

- the insurer considered the expected returns on actual assets in the pricing of the contract; in other words, the insurer passed on some of the return above the risk-free rate by increasing the benefits (or, alternatively, lowering the total annual premium).
- the insurer's expenses are considered, particularly if some efficiency is included in the pricing of the contract.
- the insurance contract could be separated into more than two components.
- the insurance contract contains a surrender value. On surrender, all components would expire and so the expected present value of the surrender value would need to be allocated across the components, affecting their measurement.

² Under the latest FASB proposals on financial instruments, this investment component would be measured at fair value with all changes in fair value recognised in net income.

³ Under the FASB proposals, the insurer would not recognise any revenue to cover the acquisition costs.

Example B

Background

Insurer A enters into a ten-year unit-linked life contract on January 1, 2010. For simplicity, we ignore all acquisition costs, expenses, time value of money and non-performance risk.

The single premium is CU10,000 and is paid at inception. The premium is invested in a pool of assets. At maturity, the policyholder receives the account value (ie the policyholder's proportionate share of the fair value of the assets). If the policyholder dies before the end of the contract, the policyholder receives CU11,000 or, if this is higher, the account value. For simplicity, we assume the policyholder cannot surrender the contract before its maturity.

If the insurer unbundled the contract, it would split it into an investment component and an insurance component. The investment component would be measured at fair value through profit or loss because it does not contain basic loan features. The insurance component will be measured using a current value approach, namely the updated IAS 37 approach for IASB and current fulfilment value for FASB.

The insurance component will be measured at the expected present value of cash outflows relating to that component plus a margin. For this purpose, the insurer needs to consider various scenarios. In some scenarios, policyholders die when the account value is CU11,000 or more, and so no incremental death benefit is payable. In other scenarios, the account value is below CU11,000 and so the shortfall is payable as a death benefit.

Suppose that at the end of year one the account value has increased to CU12,000. The measurement of the investment component will equal the account value. The measurement of the insurance component will be relatively low, because there are relatively few scenarios in which a policyholder's death results in an additional payout.

Suppose that at the end of year two the account value has decreased to CU8,000. The value of the insurance component will be significantly higher now because there are many more scenarios in which a policyholder's death results in an additional payout.

In this example, there is an interdependency between the investment and insurance components. When the account value is low, it is more likely that an additional death benefit will be payable, and it is also more likely that that benefit will be higher. When the account value is higher, additional death benefits become less likely and their likely amount is also lower.

In this simple example, the cash flows from the insurance component depend on the investment component, but because the measurement of the investment component equals the account value, the reverse is not true. However, in many more realistic cases, the contract contains features, such as surrender options, or additional forms of guarantees, that create dependencies that flow in both directions.

Approaches to unbundling

23. The boards could consider the following approaches to unbundling⁴:

- (a) Do not require unbundling at all
- (b) Require unbundling in all cases
- (c) Require unbundling if there is no interdependency⁵ between the components.

24. Option (a) would be problematic in terms of consistency, particularly if unbundling can be done in a straightforward way. It seems natural to account for two components separately if those components can be determined in a reliable way. Furthermore, not considering unbundling for any case could result in structuring (combing two or more components in one single contract for reasons other than economic).

25. Option (b) is not a feasible option; in some cases, an insurer cannot identify evidence to decide what to allocate to each of the components (in other words; separating the components goes beyond requiring the insurer's judgment and becomes arbitrary). In such a case, unbundling would probably be costly and burdensome and, more importantly, not result in useful information.

26. Option (c) combines the rationale behind both options (a) and (b); unbundle if it is likely that it can be done in a clear way, but not require it if it can only be done in a way that is unlikely to produce useful information and is probably costly .

⁴ The DP considered another option: if the components are interdependent but can be measured separately on a basis that is not arbitrary, IAS 39 should apply to the deposit component. The whole contract would be measured by applying the phase II standard. Consequently, the insurance component would be measured as the difference between the measurement of the whole contract and the measurement of the deposit component. Respondents generally disagreed with this option. They noted the resulting measurement of the insurance component as a residual would not be a faithful representation and would not provide useful information to users. They also said that splitting the measurement in this way would be costly.

⁵ Similarly, in their project on revenue recognition, the boards use the term 'interdependent' as a basis for deciding when two or more contracts with the same customer should be combined into one single contract position.

27. Staff recommends, for recognising and measuring insurance liabilities, to select approach (c) requiring unbundling if the components are not interdependent because:
- (a) Some differences between the measurement models that would be applied to difference components will probably remain, which seem particularly relevant for investment components. For straightforward cases, accounting discontinuities would be eliminated. This approach would also mean that if components are combined into a single contract without a logical, economic reason, those components will be accounted for separately.
 - (b) However, this approach would not require the insurer to separate contracts into components when splitting those components would potentially be arbitrary and costly (ie cost-benefit test will not be passed).
28. In the previous paragraph we argued for an approach that requires unbundling components of a contract only if they are not interdependent with the rest of the contract. If such an approach is selected, the exposure draft should give a number of factors that may indicate when the components of a contract are subject to interdependencies, for example:
- (a) the cash flows from one component affect the cash flows from another component.
 - (b) for some or all elements that need to be considered when separating the components, the insurer cannot identify evidence to decide what to allocate to each of the components; the allocation would require an arbitrary split.
 - (c) the contract is priced as a package, no components were negotiated separately and the whole contract has a single commercial objective.
 - (d) the components involve interrelated activities, services and costs, etc.

Question for the boards

Do you agree with staff recommendation in paragraph 27 to require unbundling if the components are not interdependent?

If not, what approach should the exposure draft take to unbundling and why?

If you agree with staff recommendation, do you have any comments on the factors in paragraph 28 that may indicate that an interdependency exists?

29. Staff wants to use this approach as a working premise when developing the ED.

While developing the ED, we will continue analysing the differences between the insurance measure on one hand and the measures for financial instruments and performance obligations on the other hand in more details. As the boards further develop their proposals for financial instruments and revenue recognition, the relevance of unbundling could increase or decrease, depending on the comparison to the insurance measurement.

If unbundling is not required, should it be permitted or prohibited?

30. In the previous sections we discussed the circumstances under which an insurer is required to unbundle. In addition, if the boards select an approach that requires unbundling only if the components are not interdependent, we need to consider whether unbundling should be (a) prohibited or (b) permitted in other cases (ie components are interdependent).

31. Respondents have repeatedly emphasised that unbundling would be arbitrary, artificial and burdensome in most cases. This means in our view that:

(a) if components are easily separable, an insurer could easily avoid any prohibition by issuing two (or more) separate contracts.

(b) insurers are unlikely to opt for unbundling if components are interdependent.

Staff paper

32. We therefore believe that, if unbundling is required only when components are not interdependent, prohibiting or permitting it in other cases would achieve little. Staff therefore recommends that the exposure draft should not state whether unbundling is prohibited or permitted in other cases.

Question for the boards

Do you agree with staff recommendation in paragraph 31 that, if unbundling is required only when components are not interdependent, the exposure draft should not state whether unbundling is prohibited or permitted in other cases?