Project **Insurance Contracts**

Topic **Unbundling—Alternative view**

Purpose of this paper

1. An insurance contract may contain insurance, investment (or financial) and service components. This paper discusses an alternative view to the staff recommendations in Agenda Paper 14C (FASB Memorandum 39C). That paper discusses when (if ever) an insurer should recognise and measure those components of a contract as if they were separate contracts (unbundling). For purposes of facilitating the discussion in this paper, references to "the staff" relate to only some of the staff members (that is, those that support the alternative view).

Summary of staff recommendations

2. The staff recommends that:

   (a) the notion of *interdependency* be applied only to situations where the components cannot function independently, that is, only to those situations where a truly symbiotic relationship is necessary for the individual components to function.

   (b) embedded derivatives in an insurance host contract should continue to be subject to existing guidance for derivative instrument accounting and bifurcated when appropriate. There should not be an exception from GAAP for insurance—the general notion in the insurance contracts project should be to address insurance specific issues.

(c) the staff recommends that contracts subject to unbundling should be presented on an unbundled basis on both the balance sheet and income statement.

Structure of the paper

3. The rest of this paper is divided into the following sections:

   (a) When to unbundle (paragraphs 4-11)

   (b) Embedded derivatives (paragraphs 12-13)

   (c) Unbundling for presentation (paragraphs 14-15)

   (d) Variable and unit-linked contracts (paragraphs 16 - 18)

When to unbundle

4. Agenda paper 14C (FASB Memorandum 39C) discusses whether insurance contracts should be unbundled. That paper recommends that an insurer should unbundle a component of an insurance contract if that component is not *interdependent* with other components of that contract. The notion of *interdependency* is described as cash flows from one component affect the cash flows from another component and vice versa. Agenda paper 14A (FASB Memorandum 39A) discusses account-driven contracts. Agenda paper 14B (FASB Memorandum 39B) discusses variable and unit-linked contracts (separate accounts). Those papers recommend that the building-block approach developed in the insurance contracts project be applied to the entire account-driven contract, such a universal life contract or a variable (unit-linked) contract. Based on the combined reading of these papers, the staff believes that the notion of *interdependency* as stated will *lead only to unbundling for the most extreme instances* where two unrelated contracts are bundled into one contract (for example, a contract that provides insurance and fertilizer). The staff disagrees with this approach and the resulting outcome.

5. The staff believes that the most compelling example of contracts that should be unbundled are products with an explicit policyholder account balance (such as universal life-type contracts and variable life contracts) that should be unbundled

into an investment account component (the policyholder account balance measured consistent with other financial instruments of the same nature) and an insurance component (measured consistent with the proposals in this project). The staff believes that these contracts are essentially investment contracts with an insurance rider and agrees with the points raised in paragraph 22 of Agenda Paper 14C (FASB Memorandum 39C); that is, unbundling achieves consistency for the investment component with similar products issued by banks and fund managers and reduces the pressure on the definition of an insurance contract. The staff points out that all premium goes into the policyholder's account. The account is charged for the cost of insurance and other expenses. Thus the insurance contract is fundamentally operating independently from the account balance. The insurance charge to the account balance by the insurer is sometimes based on the net exposure to the general account (life insurance purchased less the account balance). Alternatively the insurance charge can be based on a contract wit a fixed face amount. In either case, the policyholder simply is paying for the amount of insurance purchased. Premiums (less fees charged) are in the investment account component and earn a return over which the insurance entity has discretion (limited by the insurance contract as are the charges for the insurance and expenses). This effectively makes the operation of the investment account component (policyholder account balance) independent from the operation of the insurance component. That is, the insurance component and the investment account component are essentially separate functioning components of both the universal life or other account-driven contracts.

6. The staff also points out that the policyholder account balance is communicated separately to the policyholder (and therefore is tracked separately by the insurance entity). By measuring contracts with an explicit policyholder account balance using the building-block approach, the fundamental nature and intent of these contracts is not being represented. That is, often the primary function of these contracts to policyholders is that of an investment vehicle that utilizes the tax-deferred build-up of investment income on the investment account. The insurance benefit in many instances is incidental to the investment component (aside from providing the necessary tax treatment) and measuring the entire contract as one contract—an

insurance contract—mischaracterizes the nature of the investment account component (and insurance component).

7. Agenda Paper 14A (FASB Memorandum 39A) states that Statement 97 was issued because Statement 60 was not equal to the task of accounting for the newly developed universal type contracts. That paper goes on to identify several problems with using a Statement 97-like approach to the accounting for universal life-type contracts. The staff acknowledges and does not dispute the impetus behind the reason for issuing Statement 97. However, the staff believes that, just because the thinking at the time was not geared towards expected outcomes, the separation of the accounting for an investment account component and an insurance component is still a valid approach. For example, when a policyholder receives a statement from the insurance entity, the policyholder expects to have access to the stated account balance (less any termination fees).

8. Agenda Paper 14A provides a quote from paragraph 53 of the basis for conclusions of Statement 97 noting that the accounting makes an unusual and unlikely assumption about policyholder behaviour. It states:

> After examining the characteristics of various long-duration insurance contracts, the Board concluded that the balance that accrues to the benefit of individual policyholders represents the minimum measure of an insurance enterprise’s liability that is consistent with the definition [of a liability] above. For many universal life-type contracts, this amount takes the form of an account balance that, absent future action by the policyholder, will continue to fund operation of the contract until exhausted or reduced to a contract minimum.

9. The staff believes that this paragraph is merely discussing the nature of the contract and is not stating that the policyholder will be inert, will not make future contributions to the account balance,and will not die, etc. Further, this paragraph is merely acknowledging that the policyholder account balance is an investment that may be used to fund the insurance component. Further, that liability arises from the demand-like (investment-like) feature of the account balance.

10. In agenda paper 14A (FASB Memorandum 39A) it is explained that the combination of elements in a contract does not behave the same as a synthetic

combination of independent items (that is, the sum of the parts do not equal the whole). That observation presumes that the elements of the contract should be combined for recognition and measurement. The premise behind unbundling is that the elements **should not** be measured on a combined basis and should be measured separately. Therefore, the observation that the sum of the parts will not equal the whole is only valid if you believe the components cannot function independently in the first place. Agenda paper 14C continues this observation and suggests that the ordering of how the unbundled components are measured is important and the amounts may have to be allocated. The staff believes the contracts whose components can function separately should be unbundled first and then measured according to the applicable accounting guidance. Therefore, it would be unnecessary to ever measure the bundled contract.

11. Based on the arguments discussed above, the staff recommends that the notion of interdependency be modified to acknowledge that contracts that function independently should be unbundled for recognition and measurement—most obviously in instances where a contract is principally an investment account (the policyholder account balance). The notion of *interdependency* should be applied only to situations where the components cannot function independently, that is, only to those situations where a truly symbiotic relationship is necessary for the individual components to function. For example, under this approach the investment and insurance components of a universal life or variable insurance contract would be unbundled since the contractually specified investment account and insurance components function independently. The only exchanges between the components are (a) the fees paid by the investment fund to pay for the insurance contract and (b) the credits to the investment fund by the insurer for a discretionary amount of earnings on the insurer's universal life contracts. For a variable contract, the earnings are generated directly by the invested funds which are typically allocated to investments specified by the policyholder. This latter result also can be obtained by wrapping a mutual fund in an insurance contract which further demonstrates the independence of the two components. A contract that can be duplicated using components that can function independently with contractually defined inter-component cash flows that could come from any source should be

unbundled. Certainly, synthetic replications of such contracts would indicate that unbunding is appropriate. The staff also recommends that in instances where unbundling is not required, it should not be permitted (consistent with the staff recommendation in Agenda Paper 14C).

Embedded derivatives

12. The staff recommends that embedded derivatives in an insurance host contract should continue to be subject to existing guidance for derivative instrument accounting and bifurcated when appropriate (for example, when the embedded derivative is not clearly and closely related to the host insurance contract).

13. As stated in paragraph 42 of Agenda Paper 14C (FASB Memorandum 39C), an embedded derivative in a host insurance contract should continue to be subject to existing guidance about bifurcation because (a) fair value is the most appropriate measure for a derivative instrument, (b) significant pressure will be placed on the definition of an insurance contract if embedded derivatives are not bifurcated, and (c) current practice requires the bifurcation of embedded derivatives. In addition, expanding the proposed insurance measurement to embedded derivatives expands the use of industry-specific guidance. The findings of the Posen Committee noted that industry-specific guidance creates complexity for the user. Ignoring for a moment the fact that the insurance contracts project addresses specialized accounting for those contracts that generally are written by insurance entities, it is problematic to increase not only the population of instruments (in this case embedded in an insurance contract) subject to aunique measurement (for derivatives) but also increases complexity. Further, the discussion paper on preliminary views on insurance contracts suggested a current exit value for all insurance contracts which most acknowledge was fair value (or very close to fair value). Subsequently, both boards tentatively agreed that insurance contracts should not be measured using current exit value because of practical reasons (for example, the difficulties surrounding the ability to observe market information for insurance contracts) but have continued to struggle with the perceived lack of rigor surrounding the proposed measurement for an insurance contract. It seems

contradictory to now suggest that fair value should not be used for embedded derivatives in an insurance host contract (which currently are measured at fair value under existing guidance); we believe this suggestion is beyond the scope of the insurance contracts project.

Unbundling for presentation

14. The staff believes that unbundling for measurement naturally leads to unbundling for presentation for both the balance sheet and income statement. Further, the inclusion of the investment (deposit) component in revenue could be misleading and would not qualify as revenue (either under current accounting or under the proposed accounting in the revenue recognition project). Paragraph 59 in the basis for conclusions in Statement 97 states:

> The Board concluded that it is inappropriate to report total cash inflows (premiums) as revenues from universal life-type contracts. Concepts Statement 6 defines revenues as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations" (paragraph 78). The portion of a premium that accrues directly to the policyholder balance—the advance funding function—does not satisfy that definition of revenue. Similarly, the Board concluded that payments that represent a return of policyholder balances are not expenses.

15. Consistent with the recommendation in this agenda paper about unbundling, the staff recommends that contracts subject to unbundling should be presented on an unbundled basis for both balance sheet and income statement.

Variable and unit-linked contracts

16. As previously noted, the staff recommendation in Agenda Paper 14B is that variable and unit-linked contracts be measured in the same manner as other account-driven contracts (that is, based on a building block approach). Consistent with the recommendations in this paper, the staff recommends that variable and unit linked contracts be unbundled and measured accordingly.

17. In addition, the staff also disagrees with the staff recommendation in Agenda Paper 14B about the presentation of variable and unit-linked contracts. The staff believes that the current practice of presenting the asset and liability as separate line items should continue for the same reasons stated above for unbundling. That is:

    (a) the portion of separate account assets representing contract holder funds are reported in the insurance entity's financial statements as a summary total, with an equivalent summary total reported for related liabilities;

    (b) any liabilities related to minimum guarantees and insurance benefit liabilities under the contracts in excess of the fair value of separate account assets representing contract holder funds should be recognized as general account liabilities.

18. Further, the staff believes that, consistent with current practice, the separate account assets (representing the policyholder accounts) should be measured at fair value with a corresponding liability recognized. Further, the separate account liability and the liability arising from the insurance component should not be combined into a total liability. Rather, the liability arising from the insurance component should be recognized as a general account insurance liability. The staff believes that this approach to variable and unit-linked contracts is consistent with the view in this paper regarding unbundling.