Project **Insurance Contracts**

Topic **Follow-up on Unbundling-Part 2**

Purpose of this paper

1. At the May 2010 joint meeting, the boards deliberated when to separate components of an insurance contract (unbundling) and requested that the staff perform additional research in developing the concepts behind a principle for when to separate components of insurance contracts. This paper discusses additional means by which to express a principle and the concepts behind such a principle for when to separate (unbundle) insurance contracts.

Summary of staff recommendations

2. The staff recommends retaining the principle for when to unbundle previously discussed by the boards at the May 2010 joint meeting (see paragraph 4 of this memorandum) and using the additional factors for consideration described in paragraph 18 of this memorandum to further explain the notion of significant interdependence

Structure of the memorandum

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

   (a) Background (paragraphs 4 through 8)

   (b) Analysis (paragraphs 9 through 29)

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Background

4. At the May 2010 joint meeting, the boards discussed Agenda Paper 2E (FASB Memorandum No. 45E). In that paper, the staff recommended the following principle for when to unbundled an insurance contract:

   A component of an insurance contract should be unbundled if it functions independently from other components of that contract. A component functions independently if it is not significantly interdependent with other components of that contract.

5. The boards asked the staff to refine the guidance supporting the proposed principle so as to explain more clearly how an insurer would assess whether interdependence is significant. The boards noted that if the refined guidance cannot address this point, the boards may need to review the proposed principle at a future meeting.

6. At that joint meeting, the boards also tentatively decided that account balances of account-driven contracts should be unbundled. For this purpose, the characteristics of these contracts will be defined in accordance with the guidance in US GAAP in ASC Topic 944-20-15. ASC Topic 944-20-15-29 (previously paragraphs 12 and 13 of Statement 97) provides the following characteristics for identifying account balances of account-driven contracts:

   (a) the contract has a stated account balance that is credited with policyholder premiums and interest and against which assessments are made for contract administration, mortality coverage, initiation, or surrender, and any of the amounts assessed or credited are not fixed and guaranteed, or

   (b) the insurer expects that changes in any contract element will be based primarily on changes in interest rates or other market conditions rather than on the experience of a group of similar contracts or the enterprise as a whole.

7. The boards also discussed embedded derivatives at the May joint meeting and reached different tentative decisions. However, as part of the June joint meetings, the IASB changed its tentative decision taken at the May meeting because that decision introduced a redundancy with guidance included in IAS 39. Consequently,

the boards tentatively decided that embedded derivatives should be unbundled using the unbundling principle being developed for insurance contracts.

8. The boards also tentatively decided that unbundling should be prohibited except in cases where it was required.

Analysis

9. Unsurprisingly, the issue about when to unbundle an insurance contract is a difficult and controversial topic. By its nature, separating a single contract into multiple components can increase complexity (and thus make it more difficult for users to understand financial reporting of these contracts) and increase costs (the preparer is forced in some instances to separate intertwined cash flows, measure some cash flows using a different measurement to comply with the accounting, and track those separate cash flows throughout the life of the contract). However, unbundling may be beneficial in instances where it produces useful information at a reasonable cost:

   (a) Transparency: In some instances, unbundling components of an insurance contract provides insight into components included in an insurance contract that do not respond to changes in circumstances in the same manner as components related to insurance risk and affected by changes in insurance risk. Some may even argue that unbundling better reflects the economics of some hybrid contracts when the non-insurance component is significant.

   (b) Comparability: Historically insurers and banks have issued similar contracts but have different accounting in part because under some existing accounting models insurance accounting is industry-specific. The difference in accounting treatment may lead to some concluding that one industry is more sound and prudent than another even though the risks arising from a contract are similar. Requiring similar accounting for similar contracts is important to help users understand the risks undertaken by an entity regardless of the type of business or industry in which the entity resides.

10. The notion of unbundling has been articulated in both Statement 133 and IAS 39. Existing US GAAP guidance is provided by ASC Topic 815-15 and does not require unbundling if the embedded derivative is "clearly and closely related" to the host contract. Under IFRSs, IAS 39 *Financial Instruments: Recognition and Measurement* uses the notion of "closely related".

11. Arguably, that guidance is not significantly different from US GAAP. However, IAS 39 scopes out an embedded derivative that meets the definition of an insurance contract itself; those derivatives are accounted for under IFRS 4. For example, an embedded guarantee of minimum equity returns on surrender and maturity would not be considered closely related to the host insurance contract. But if that embedded derivative is contingent on the life of the policyholder to a significant extent, it would meet the definition of an insurance contract itself and therefore remain within the scope of IFRS 4. In contrast, ASC 944-815-25, by reference to Topic 815-15, requires that such an embedded derivative should be bifurcated because it is not considered to be clearly and closely related to the host insurance contract.

12. Paragraph 60 of Statement 133 provides the basis for the original decisions about bifurcating embedded derivatives stating:

> In discussing whether a hybrid instrument contains an embedded derivative instrument (also simply referred to as an *embedded derivative*) that warrants separate accounting, paragraph 12 focuses on whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. If the host contract encompasses a residual interest in an entity, then its economic characteristics and risks should be considered that of an equity instrument and an embedded derivative would need to possess principally equity characteristics (related to the same entity) to be considered clearly and closely related to the host contract. However, most commonly, a financial instrument host contract will not embody a claim to the residual interest in an entity and, thus, the economic characteristics and risks of the host contract should be considered that of a debt instrument. For example, even though the overall hybrid instrument that provides for repayment of principal may include a return based on the market price (the underlying as defined in this Statement) of XYZ Corporation common stock, the host contract does not involve any existing or potential residual interest rights (that is, rights of ownership) and thus would not be an equity instrument. The host contract would instead be considered a debt instrument, and the embedded derivative that incorporates the equity-based return would not be clearly and closely related to the host contract. If

the embedded derivative is considered *not* to be clearly and closely related to the host contract, the embedded derivative must be separated from the host contract and accounted for as a derivative instrument *by both parties* to the hybrid instrument, except as provided by paragraph 11(a).

13. Acknowledging the numerous Statement 133 Implementation Issues dedicated to explaining when to bifurcate an embedded derivative, the underlying notion in paragraph 60 of Statement 133 is intuitive: that is, there is something embedded within a contract that introduces new or different risks that modifies the cash flows of the host contract and, as a matter of understanding the risks (cash flows) of the contract, bifurcation provides useful information (though bifurcation is the result of the requirement to measure derivative instruments at fair value through profit or loss). Alternatively, cash flows of embedded contracts or instruments that behave in a manner similar to the host contract are not required to be bifurcated. In the case of insurance, the notion could be described as altering the cash flows of the component of the insurance contract that provides insurance protection and is not related to the provision of insurance protection.

What are the choices?

14. Based on the discussions at the May 2010 joint meeting, the staff believes there are two approaches the boards could pursue in resolving this issue:

    (a) Use the principle in paragraph 4 of this memorandum and explain more clearly how an insurer would assess whether interdependence is significant; or

    (b) Seek a principle for when to unbundle components of an insurance contract that might be more robust.

15. Regardless of the approach taken, the staff believes that the invitation to comment should address unbundling specifically and clearly the basis for conclusions will need to discuss this issue.

Explain more clearly how an insurer would assess whether interdependence is significant

16. For reference, the principle for when to unbundle in paragraph 4 of this memorandum is restated:

    A component of an insurance contract should be unbundled if it functions independently from other components of that contract. A component functions independently if it is not significantly interdependent with other components of that contract.

17. The notion of *significance* is used throughout accounting literature. However, in many instances, additional guidance is provided for consideration to explain the meaning of *significance* in a particular context. This guidance ranges from citing a specific percentage (10% of combined revenues in the context of identifying significant activities for oil and gas-producing assets in the Codification) to listing key factors (for example, defining *significant influence* in the context of equity method investments and joint ventures in the Codification). In current insurance accounting, defining significant insurance risk has met many challenges. The FASB spent two years deliberating whether insurance contracts should be bifurcated because of the misapplication of risk transfer criteria focusing on significant insurance risk (even more concerning is that that guidance is actually principles-based). IFRS 4 devoted an appendix and specific implementation guidance to determining when there is significant insurance risk.

18. Based on the historical evidence of the difficulties surrounding the term *significant* (or in this case *not significant*), the staff believes that providing factors for consideration and examples may be the best approach to assist in understanding when to unbundle a component of an insurance contract. The following factors are intended to be illustrative of potential guidance to be included in the exposure draft and therefore the facts and circumstances of each situation should be taken into consideration:

    (a) A component is not significantly interdependent if the component:

        (i) Exposes the insurer **only** to risks that meet the definition of *financial risk* in IFRS 4. That is, the component has the risk of a possible future change in

one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. (This factor uses the distinction drawn by the definitions of *insurance risk* and *financial risk* to draw out the non-insurance risk component. It would be supplemented by examples of insurance contracts and examples of contracts that are not insurance contracts from Appendix B of IFRS 4 *Insurance Contracts* [an updated version of that guidance as it would appear in the staff draft of the exposure draft is included in Appendix A of this memorandum].

(ii) A separate observable market or market price exists for that component. (This factor covers the more obvious instances where a separate contract is bundled with insurance. However, in this instance, the staff would emphasize that an observable market should not be hypothetical nor should a similar market be used to satisfy this factor. Said differently, extensive efforts should not be made to create or find a similar market for extrapolation (no *search and destroy* needed)).

(iii) Alters the cash flows of the insurance contract in a manner that is not linked to or directionally consistent with the provision of insurance protection. In determining whether cash flows are linked to or directionally consistent with the provision of insurance protection, a qualitative assessment should be done first. If, for example, the cash flows of a component are directionally consistent, consideration should be given as to whether that consistency is coincidental. If after the qualitative assessment it is still unclear, a quantitative assessment should be performed. (This factor originates from the guidance in Statement 133 and IAS 39 related to *clearly and closely related* and *closely related*, respectively. The staff would not recommend using those terms here because of the history attached to those terms but the staff believes the notion is relevant and valid. With respect to the difference between Statement 133 and IAS 39 identified in paragraph 9 of this

memorandum, the staff believes that the IAS 39 conclusion is appropriate in this instance [that is, in the case of a life-contingent embedded derivative, the embedded derivative should not be unbundled because the cash flows would mirror or at least be directionally consistent with those of the insurance component]. In addition, either direct reference to or modification of paragraphs AG 30 through AG 33 of IAS 39 may assist in identifying when to unbundle.

(iv) Represents an account balance in accordance with the characteristics specified in US GAAP in ASC Topic 944-20-15. Account-driven contracts may include either a stated account balance or a feature that functions like a stated account balance. Stated account balances usually include features such as crediting the account balance for premiums and interest and assessing charges for contract administration, mortality coverage, initiation, or surrender, and any of the amounts assessed or credited are not fixed and guaranteed. In instances where there is not a stated account balance, an assessment should be made as to whether the insurer expects that changes in any contract element will be based primarily on changes in interest rates or other market conditions rather than on the experience of a group of similar contracts or the entity as a whole. (This factor uses the guidance in Statement 97 to identify account-driven contracts that should be unbundled. The boards' tentative decision was to unbundle account-driven contracts.)

19. A key underlying aspect of the factors listed above for when to consider unbundling a component of an insurance contract would be that the intention is not to create or require an exhaustive search for components for unbundling. Rather, the point of unbundling those components is to assist users in understanding the different facets of a hybrid contract while achieving some degree of comparability between entities across industries. The overall purpose behind unbundling would not be to identify and separate every insurance contract into components just for the sake of unbundling.

20. A feature which raises questions about significant interdependency of cash flows is a surrender option. Surrender options generally create interdependency between the

cash flows within an insurance contract because surrendering an insurance contract generally leads to cancellation of the entire contract (that would include any embedded derivatives and account balances). For example, the value paid out on surrender (surrender value) is i) a repayment of the deposit component (if any) plus ii) the compensation for forfeiting the right to future insurance coverage less iii) surrender charges (if any). 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.

21. The question is whether a surrender option creates sufficient interdependency between components of an insurance contract to not require those components to be unbundled. Ultimately, the answer is based on the facts and circumstances of each situation. For example, the boards have tentatively decided that embedded derivatives that are not significantly interdependent with the host and policyholder account balances of account-driven contracts should be unbundled. Consequently, in instances where these components are present, a surrender option would not create sufficient interdependence between components of the insurance contract. However, as noted previously, the facts and circumstances of the situation need to be considered carefully and the presence of a surrender option is merely a consideration in the overall assessment of whether to unbundle a component.

Minimum guarantee features

22. Many life insurance contracts included minimum guarantees on different aspects of the contract. In some instances, these guarantees are significantly interdependent and in other instances they are not. To provide further clarification on when to unbundle, the staff includes the following illustrative examples of some of the more common minimum guarantees. The staff points out that these are simply examples and not intended to describe all instances or facets of these minimum guarantees.

    (a) Guaranteed minimum death benefit: This benefit provides a guarantee, prior to annuitization, that the beneficiary will receive an amount equal to the higher of the funds paid into an annuity or the value of the contract at the date the

annuitant dies. In this instance, the payout of this benefit is contingent on the death of the annuitant and thus is considered interdependent with the insurance component of the insurance contract.

(b) Guaranteed minimum income benefit: This benefit provides a guarantee, after annuitization, that guarantees the annuitant will receive a minimum value of annuity payments. Accordingly, should markets fall dramatically, the annuitant is guaranteed minimum payments that would not reflect the poor market conditions affect on the annuity (essentially creating a floor for the annuity payments). In this instance, the payout of the benefit is contingent on how long the annuitant lives (longevity risk) and thus is considered interdependent with the insurance component of the insurance contract.

(c) Guaranteed minimum accumulation benefit: This benefit provides a minimum guarantee of the accumulation of funds supporting the annuity payments and generally will either protect the amount invested or could include a guarantee of an additional amount to the amount invested. The question on unbundling is dependent on what is being guaranteed. For example, in instances where the benefit protects the amount invested, an argument can be made that the guarantee is similar to the guaranteed minimum income benefit and the payout is based on how long the annuitant lives (ie it is life-contingent to a significant extent). However, in the instance where there is an additional amount guaranteed above the amount invested, the guarantee is not life-contingent to a significant extent and one could withdraw funds from the annuity and benefit from the guarantee.

(d) Guaranteed minimum withdrawal benefit: This benefit provides a guarantee against downturns in the market. Each year the annuitant has the right to withdraw a stipulated percentage of their investment until the initial investment amount has been recovered. In this instance, the payout is not life-contingent to a significant extent and accordingly would need to be unbundled.

Seek a principle for when to unbundle components of an insurance contract that might be more robust

23. The other approach the boards could consider is to devise a different principle for unbundling than the one in paragraph 4 of this memorandum. The previous discussion in this memorandum provides some possible ideas. Additionally, the factors described in paragraph 18 of this memorandum could be used to clarify the intent of the boards for each of these principles.

Transparency and comparability

24. As described in paragraph 9 of this memorandum, the reasons for unbundling in the first place arise from a desire to provide transparency and comparability between similar contracts or instruments. Therefore, the following principle could be used:

A component of an insurance contract should be unbundled in instances where unbundling improves the understanding of the nature and economics of the overall contract through increased transparency and comparability.

25. The benefit of this principle is that it is a true principle and avoids the use of historically difficult-to-define terms such as *significant*. This principle squarely places the burden of judgment on the preparer and would include the types of instruments or contracts that many believe should be unbundled (embedded derivatives and account-driven contracts). However, a drawback is the vagueness of the principle and the potential for significant diversity in practice due to the overall vagueness. The act of unbundling is deliberate (it is requiring a separation of a single contract that some may view as indivisible and unnatural) and as a consequence the guidance should be more specific as to when to unbundle.

Cash flow variability

26. As described in paragraphs 10 through 13 of this memorandum, the notions of *clearly and closely related* and *closely related* included in Statement 133 and IAS 39, respectively, could be used to develop a principle for unbundling. An example would be:

A component of an insurance contract should be unbundled in instances where the cash flows of that component introduce or can introduce variability in the

overall cash flows of the insurance contract for risks that are not considered part of the provision of insurance protection.

27. The benefit of this approach is that embedded derivatives that are not somehow linked to the provision of insurance protection would be unbundled (similar to IAS 39). Arguably, embedded derivatives would be the types of instruments that many would perceive as likely candidates for unbundling. This principle also appears to work for variable-rate account-driven contracts (the rate of return could vary considerably).

28. A drawback would be how to identify when to unbundle through variability in cash flows. This may lead to the need for running different scenarios to determine whether unbundling is necessary and inevitably leads to questions about significance and materiality. The cost of such a principle may exceed the benefit. However, as noted in paragraph 18(iii) of this memorandum, a qualitative assessment could be done before the need for a quantitative assessment for practical reasons.

Staff recommendation

29. The staff recommends retaining the principle for when to unbundle previously discussed by the boards and using the additional factors for consideration described in paragraph 18 of this memorandum to further explain the notion of significant interdependence.

Question 1 for the boards
Do the boards agree with the staff recommendation? What additional guidance or further clarification should be provided to assist in the understanding of the unbundling principle?

Appendix B
Excerpt of Application Guidance from Staff Draft of Exposure Draft

Appendix A

Examples of insurance contracts

B18 The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:

(a) insurance against theft or damage to property.

(b) insurance against product liability, professional liability, civil liability or legal expenses.

(c) life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance).

(d) life-contingent annuities and pensions (ie contracts that provide compensation for the uncertain future event—the survival of the annuitant or pensioner—to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival).

(e) disability and medical cover.

(f) surety bonds, fidelity bonds, performance bonds and bid bonds (ie contracts that provide compensation if another party fails to perform a contractual obligation, for example an obligation to construct a building).

(g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument.

(h) product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of this IFRS. However, product warranties issued directly by a manufacturer, dealer or retailer are within the scope of IAS 18 because they either:

  (i) do not meet the definition of an insurance contract (warranties intended to provide a customer with coverage for latent defects in the product); or

  (ii) meet the definition of an insurance contract but are outside the scope of this [draft] IFRS (warranties intended to provide a customer with coverage for faults that arise after the product is transferred to the customer).

(i) title insurance (ie insurance against the discovery of defects in title to land that were not apparent when the insurance contract was written). In this case, the insured event is the discovery of a defect in the title, not the defect itself.

(j) travel assistance (ie compensation in cash or in kind to policyholders for losses suffered while they are travelling).

(k) catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or foreign exchange rate).

(l) insurance swaps and other contracts that require a payment based on changes in climatic, geological or other physical variables that are specific to a party to the contract.

(m) reinsurance contracts.

B19 The following are examples of items that are not insurance contracts:

(a) investment contracts that have the legal form of an insurance contract but do not expose the insurer to significant insurance risk, for example life insurance contracts in which the insurer bears no significant mortality risk (such contracts are non-insurance financial instruments or service contracts, see paragraphs B20 and B21).

(b) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example some financial reinsurance contracts or some group contracts (such contracts are normally non-insurance financial instruments or service contracts, see paragraphs B20 and B21).

(c) self-insurance, in other words retaining a risk that could have been covered by insurance (there is no insurance contract because there is no agreement with another party).

(d) contracts (such as gambling contracts) that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, that the event adversely affects the policyholder. However, this does not preclude the specification of a predetermined payout to quantify the loss caused by a specified event such as death or an accident (see also paragraph B13).

(e) derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment based solely on changes in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (see IAS 39).

(f) a credit-related guarantee (or letter of credit, credit derivative default contract or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (see IAS 39).

(g) contracts that require a payment based on a climatic, geological or other physical variable that is not specific to a party to the contract (commonly described as weather derivatives).

(h) catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological or other physical variable that is not specific to a party to the contract.

B20 If the contracts described in paragraph B19 create financial assets or financial liabilities, they are within the scope of IAS 39. Among other things, this means that the parties to the contract use what is sometimes called deposit accounting, which involves the following:

(a) one party recognises the consideration received as a financial liability, rather than as revenue.

(b) the other party recognises the consideration paid as a financial asset, rather than as an expense.

B21 If the contracts described in paragraph B19 do not create financial assets or financial liabilities, IAS 18 applies. Under IAS 18, revenue associated with a transaction involving the rendering of services is recognised as an entity satisfies its performance obligation to by providing the services to the customer.

B22 The credit insurance discussed in paragraph B18(g) and the credit-related guarantees discussed in paragraph B19(f) can have various legal forms, such as that of a guarantee, some types of letter of credit, a credit default contract or an insurance contract. If these contracts require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument, they are insurance contracts, and within the scope of this [draft] IFRS. IAS 39 applies to other contracts of this kind, for example contracts that pay out:

(a) regardless of whether the counterparty holds the underlying debt instrument.

(b) on a change in credit rating or change in credit index, rather than on the failure of a specified debtor to make payments when due.