IASB/FASB Meeting 16 February 2011

IASB Agenda reference	3H
FASB Agenda reference	58H

Staff Paper

Project	**Insurance contracts**
Topic	**Education session on unbundling**

Objective

1. The purpose of this education session is to understand the effect, costs and benefits of separating insurance contracts into insurance and non-insurance components. This is referred to as 'unbundling'.

2. We have invited Gail Tucker and Sam Gutterman, PwC, and Len Reback, MetLife, to present an education session on unbundling. Their biographies are in paragraphs 23-32.

3. The presentations are intended to provide background to consider when we debate the unbundling of non-insurance components of an insurance contract. In response to the unbundling proposals in the IASB's exposure draft (ED) and FASB's discussion paper (DP), some opposed anything other than minimal unbundling because they believe that unbundling introduces complexities for little or no benefit. (A more comprehensive discussion of the responses received is in paragraphs 12-22.)

4. We have asked the presenters to discuss:

   (a) the effects of unbundling on the measurement and presentation of the unbundled components; and

   (b) the costs and benefits of unbundling.

   We have asked the presenters to walk us through products that they have selected to illustrate the practicalities of unbundling.

5. We are not asking for any decisions at this meeting. We plan to discuss unbundling further in March. However, the final requirements on unbundling will depend upon other decisions to be taken by the boards, in particular on measurement (because it affects the difference in the accounting for the insurance and unbundled components) and on presentation (because some views on what should be unbundled depend partly on how insurers present changes in the insurance liability).

6. The rest of the paper is set out as follows:

   (a) the proposals in the ED/DP (paragraphs 7-10);

   (b) the responses received on the ED/DP proposals (paragraphs 12-22); and

   (c) the presenters' biographies (paragraphs 23-32).

   Further information is provided in the Appendices:

   (d) Appendix A: Relevant extracts from the IASB Exposure Draft; and

   (e) Appendix B: IFRS 4 requirements on unbundling.

Background

Proposals in the exposure draft/discussion paper

7. Insurance contracts are a bundle of rights and obligations that generate a package of mostly interdependent cash inflows and outflows. The ED/DP would require all those cash inflows and outflows to be measured using the proposed building block approach and the boards believe that this approach produces relevant information about the amount, timing and uncertainty of those cash flows.

8. When investment or service components of an insurance contract are not closely related to the insurance coverage, the ED/DP proposes that an insurer would account for those components separately from the insurance component. The ED/DP provides examples of when a non-insurance component is not closely related to the insurance coverage:

   (a) an investment component that reflects an account balance which is credited with an explicit return and the crediting rate is based on the investment performance of the underlying investments;

   (b) an embedded derivative that is required to be separated under IAS 39 *Financial Instruments: Recognition and Measurement* or FASB Topic 815 – *Derivatives and Hedging*; and

   (c) non-insurance services or goods that are not closely related to the insurance coverage but have been combined in a contract with the insurance coverage for reasons that have no commercial substance.

   (Appendix A sets out the relevant requirements from the IASB exposure draft.)

9. The proposal in paragraph 8(b) of the ED carries forward from IFRS 4 *Insurance Contracts* and IAS 39 (and in future IFRS 9 *Financial Instruments)* the requirements to separate specified embedded derivatives from a host insurance contract.

Relevant questions in the exposure draft/discussion paper

10. Question 12 of the ED asked respondents the following:

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

11. Question 6 of the DP asked respondents the following:

Do you support the approach for determining when noninsurance components of contracts should be unbundled? Why or why not?

Responses to the exposure draft/discussion paper

Unbundling

12. Some support the principle that non-insurance components should be unbundled from insurance contracts. Most users agree with the proposals regarding unbundling if unbundling is possible and if investment components or simple (cash-like) elements can be clearly segregated. However, there appeared to be different motivations in the feedback on unbundling:

    (a) Unbundling introduces complexity and involves costs to insurers. Some question whether the benefits justify those costs. In particular, some question whether there would be a material difference after unbundling when the unbundled component would be measured at fair value, rather than at a current value based on fulfilment (as it would be if it were not unbundled). Accordingly, there is widespread preference amongst insurers and actuaries for minimal unbundling.

    (b) Some insurers and auditors suggest unbundling insurance contracts to permit insurers to measure the unbundled investment component of those contracts consistent with the measurement of the assets backing those components without creating an accounting mismatch. Some have expressed this view as an alternative position if the boards proceed with the proposed discount rate.

    (c) Some respondents did not believe unbundling would be appropriate because insurance policies are priced on an integrated basis and are not separately managed. Those respondents believe unbundling would not result in decision-useful information because of the decreased consistency and comparability that would likely result from significant management judgment used to determine whether to unbundle.

Criteria for unbundling

13. Many state that the proposals, in particular the proposed 'not closely related' criterion, in the ED/DP for unbundling are unclear and that different interpretations can be made of these proposals.

    (a) Paragraph 8 of the ED provides examples of components that are not closely related to insurance coverage. Some insurers believe that it is unclear how these examples are intended to interact with the 'closely related' principle. In other words, if an insurer determined that one of the components described in that paragraph is closely related to the insurance coverage, would it still need to unbundle that component? Most insurers believe that account balances that are closely related should not be unbundled. There is concern that the three examples of 'not closely related' are likely to gain the status of rules, in the way that similar examples in IAS 39 have been applied. Some suggest that the standard should include additional guidance on the meaning of 'not closely related'.

    (b) Some state the intention of the proposal to unbundle account balances is unclear. For example:

        (i) Some claim that universal life contracts would not be unbundled because they do not pass all the investment return to the policyholder, even though such contracts seem to have been the main target of the proposal.

        (ii) The proposal states that an investment component should not be regarded as closely related unless it reflects an account balance for which the crediting rate is based on the investment performance of the underlying investments. Some question the meaning of this condition.

        (iii) Some question whether investment contracts with a discretionary participation feature should be unbundled. Some state that to do so would largely negate the proposal to include these contracts within the scope of the insurance contracts standard, rather than in the financial instruments standards. (The FASB DP proposes that investment contracts with discretionary participation feature should *not* be included within the scope of the insurance contracts guidance).

(iv) Many life contracts contain the option for a loan against the cash value. Some requested clarification on whether those policy loans should be unbundled.

(c) Some find it to be unclear whether unbundling applies to unit-linked contracts.

(d) It is unclear whether asset management services, premium collection and benefit payment services are examples of services that should be unbundled. In addition, some respondents requested clarification on whether these services, when present in a separate contract, should be *bundled* with an insurance contract.

14. Some recommended a different unbundling criterion to the proposed ‘closely related’; for example, they suggest criteria that would result in unbundling:

(a) when practicable;

(b) when the components can be measured and are managed separately;

(c) when components are not interdependent;

(d) when the revenues can be readily identifiable; and

(e) as proposed for separating performance obligations in the exposure draft *Revenue from Contracts from Customers*.

15. Some respondents who supported minimal unbundling recommended that unbundling should be required only when goods and services are combined in a contract with the insurance coverage for reasons that have no commercial substance (Paragraph 8(c) in the IASB ED).

16. Some believe that specific types of insurance products should be unbundled in all circumstances, for example:

(a) universal life contracts;

(b) policy loans;

(c) investment-linked products (eg even when the death benefit is determined by reference to the value of the investment balance); and

(d) a savings-type deposit account combined with insurance coverage.

Permit unbundling

17. Some respondents to the IASB ED/FASB DP recommended that unbundling should be merely permitted, instead of being required, when the non-insurance component can be measured separately. This would be similar to the current requirements in IFRS 4. (Appendix B summarises the current IFRS 4 requirements.) Others believe permitting unbundling would likely result in decreased consistency and comparability in financial reporting.

Further guidance

18. Some request clarification on some details of how the unbundling proposals would be applied, including the allocation of items such as premiums, expected profit and acquisition costs between the insurance component and the unbundled component, and on whether particular components, such as policy loans, should be unbundled.

19. Some respondents questioned how to allocate acquisition costs to different components of a contract if the contract is unbundled as those respondents interpret the proposal in paragraph 9 of the ED that all charges and fees assed against an unbundled account balance should be regarded as belonging to the insurance component or another component of the contract.

20. Some respondents request clarification on fixed-fee service components and how the unbundling principle would apply to insurance contracts with those features. Some respondents also requested clarification regarding the cross subsidy effects noted in paragraph 9 of the IASB ED because it is subject to varying interpretations.

21. Some respondents noted that paragraph 11 of the ED states that an *insurance contract* refers to the components that remain after unbundling components of

an insurance contract. Those respondents suggest clarifying that the classification of a contract as an insurance contract should occur before applying the unbundling principles.

Geography

22. There were geographical differences in the feedback on unbundling, possibly due to different product designs. For example, many in Europe complain that the proposed requirements on unbundling are unclear. Furthermore, in France an issue of prime importance is whether unbundling is required for investment contracts with discretionary participation features. In contrast, some Australian responses support unbundling because they believe that the benefits outweigh the costs of doing so based on their current experience of unbundling. US respondents were generally supportive of unbundling but believe further clarification and implementation guidance is necessary for consistency in the application of the principles and comparability amongst insurers.

Presenters' biographies

Gail Tucker

23. Gail Tucker is a partner in the PwC UK Accounting Consulting Services group where she advises on technical accounting matters generally and leads the UK financial instruments team.

24. Gail specialises in working with insurance companies. She is a member of the firm's UK Insurance Technical Forum and the chairman of the firm's Insurance IFRS UK Technical forum. She also led the firm's global response to the IASB's insurance contracts exposure draft. In addition, she is an active member of the firm's Global Insurance Industry Accounting Group. She chairs the firm's global Virtual Insurance Group that discusses insurance matters with technical and practice partners and with staff in many different territories.

25. Gail is also an audit partner and has been responsible for the audits of a number of insurance companies over the past 14 years, including life, non-life and

mutual insurers as well as other companies within the broader financial services sector.

26. Gail is a member of EFRAG Insurance Accounting Working Group and a member of the Institute of Chartered Accountants in England and Wales's (ICAEW) Insurance Committee.

Sam Gutterman

27. Sam Gutterman is a Director and Consulting Actuary for PricewaterhouseCoopers LLP in its Chicago, Illinois office. He has provided actuarial advice to and analysis of the life and health and property and casualty insurance industries and of government agencies for forty years, primarily relating to financial reporting.

28. Sam has been actively involved in the actuarial profession, including service as a former president of the Society of Actuaries and in many capacities in the American Academy of Actuaries, the Casualty Actuarial Society and the International Actuarial Association. He is an FSA, FCAS, MAAA, and HonFIA (UK).

29. He has been active in international accounting and auditing discussions relating to insurance for the past thirteen years. During that period, as chair of the International Actuarial Association's Committee on Insurance Accounting, he has served as the IAA representative on the International Accounting Standards Board's Insurance Working Group and on the Consultative Advisory Group to the International Auditing and Assurance Standards Board. He has also served on the Steering Committee on Discounting of the International Accounting Standards Committee. In addition, he is a member of the PwC Global Insurance Industry Accounting Group, which is responsible for international coordination of worldwide implementation policy and comment letter development relating to insurance aspects of IFRS.

Leonard Reback

30. Leonard Reback has been a Fellow in the Society of Actuaries (FSA) since 1994 and a Member of the American Academy of Actuaries (MAAA) since 1999. He has been active in AAA committees related to financial reporting, and is currently chairman of its Life Financial Reporting Committee. He has authored a number of articles in actuarial publications on emerging US GAAP- and IFRS-related topics.

31. Leonard is a Vice-President and Actuary with MetLife, responsible for MetLife's Deferred Acquisition Costs and similar items. He has been with MetLife for 21 years. During that time, he has led MetLife's adoption of SOP 03-1, SOP 05-1 and the actuarial issues related to FAS 157 and FAS 159.

32. Leonard earned his Bachelor of Science degree in Accounting from Binghamton University in 1987 and his Master of Science degree in Statistics and Operations Research from New York University in 1989.

Appendix A: Relevant extracts from the IASB Exposure Draft

Unbundling

8 Some insurance contracts contain one or more components that would be within the scope of another IFRS if the insurer accounted for those components as if they were separate contracts, for example an investment (financial) component or a service component. If a component is not closely related to the insurance coverage specified in a contract, an insurer shall apply that other IFRS to account for that component as if it were a separate contract (ie shall *unbundle* that component). The following are the most common examples of components that are not closely related to the insurance coverage:

(a) an investment component reflecting an account balance that meets both of the following conditions:

(i) the account balance is credited with an explicit return (ie it is not an implicit account balance, for example derived by discounting an explicit maturity value at a rate not explicitly stated in the contract); and

(ii) the crediting rate for the account balance is based on the investment performance of the underlying investments, namely a specified pool of investments for unit-linked contracts, a notional pool of investments for index-linked contracts or a general account pool of investments for universal life contracts. That crediting rate must pass on to the individual policyholder all investment performance, net of contract fees and assessments. Contracts meeting those criteria can specify conditions under which there may be a minimum guarantee, but not a ceiling, because a ceiling would mean that not all investment performance is passed through to the contract holder.

(b) an embedded derivative that is separated from its host contract in accordance with IAS 39 (see paragraph 12 below).

(c) contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.

9 In unbundling an account balance specified in paragraph 8(a), an insurer shall regard all charges and fees assessed against the account balance, as well as cross-subsidy effects included in the crediting rate, as belonging to either the insurance component or another component, but are not part of the investment component. Thus, the crediting rate used in determining that account balance reflects a crediting rate after eliminating any cross-subsidy between that rate and the charges or fees assessed against the account balance.

10 An insurer shall not unbundle components of a contract that are closely related to the insurance coverage specified in the insurance contract.

11 Throughout this [draft] IFRS, the term *insurance contract* refers to the components of an insurance contract that remain after unbundling any components in accordance with paragraph 8.

Appendix B: IFRS 4 requirements on unbundling

A1. IFRS 4 paragraph 10 requires a deposit and insurance component to be separated (ie unbundled) from a contract when:

(a) the deposit component (including embedded surrender options) can be measured separately (ie without considering the insurance component); and

(b) the insurer's accounting policies do not require it to recognise all obligations and rights arising from the deposit component.

A2. When the insurer's accounting policies requires it to recognise all obligations and rights arising from the deposit component and the deposit component can be measured separately, the insurer is permitted (but not required) to unbundle.

A3. The unbundled deposit component is then measured under IAS 39/IFRS 9.

A4. IFRS 4 paragraph 7 requires derivatives embedded in an insurance contract as required by IAS 39/IFRS 9 except for:

(a) an embedded derivative that itself is an insurance contract; and

(b) a policyholder's option to surrender an insurance contract that does not vary in response to change in a financial variable or a non-financial variable specific to the counterparties.