IASB/FASB Meeting
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Staff Paper

Project	**Insurance contracts**
Topic	**Unbundling: Overall considerations**

What is this paper about?

1. This paper sets outs the overall considerations for separating insurance contracts into non-insurance components and insurance components. Once separated, non-insurance components are recognised and measured in accordance with the relevant requirements in other IFRSs or US GAAP. This is referred to as 'unbundling'.

2. The discussion in this paper introduces the future papers that consider the separation of specific non-insurance components: services and goods, embedded derivatives and deposit components. We do not ask for decisions. We will ask for decisions in the future papers.

What is 'unbundling'?

3. Unbundling can mean different things. For clarity, there are three types of unbundling:

   (a) Unbundling for measurement - A contract is separated into components and the non-insurance components are **recognised and measured** according to the relevant requirements of another IFRS. For example, embedded derivatives are separated from an insurance contract and once separated, measured under the financial instruments requirements in IAS 39 *Financial Instruments: Recognition and*

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Measurement / IFRS 9 *Financial Instruments* or Topic 815 *Derivatives and Hedging* in the *FASB Accounting Standards Codification*®.

(b) Unbundling for presentation - A contract is separated into components and the components, eg the deposit component in a premium, is **presented separately** in the statement of comprehensive income. Some existing models already use an unbundled model in the performance statement, for example *Financial Services – Insurance Topic* (944) of the FASB Accounting Standards Codification contains such requirements[1] for universal life contracts[2] and some other participating and nonguaranteed-premium contracts.

(c) Unbundling for disaggregation - A contract combining relatively similar components is further separated to provide **disaggregated information**. For example, payments for a mobile phone contract are separated into revenue for the handset and for the network. The contract and the components are measured using the same requirements and the total measurement of the contract equals the sum of the parts.

4. There is a subtle difference between unbundling for measurement (ie approach 3(a)) and unbundling for presentation (ie approach 3(b)). This is best illustrated with an example. A revenue component that is separated from an insurance contract can be measured either:

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[1] These requirements were introduced to US GAAP by SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. Under those requirements, universal life-type policy liabilities are measured under the retrospective deposit method; which is the sum of:

(a) the account balance as at the reporting date;
(b) deferred revenue (acquisition costs);
(c) refundable mounts on termination of the contract; and
(d) any probable loss (onerous contracts test).

Each of the components are measured under the requirements of SFAS 97.

[2] Universal life contracts could be described as a type of permanent life insurance that allows the policyholder, after its initial payment, to pay premiums at any time, in virtually any amount, subject to a specified minimum and maximum. Universal life contracts explicitly unbundle the charges (fees) for mortality and other expenses from other contract elements. A universal life contract also permits the policyholder to reduce or increase the death benefit more easily than under a traditional whole life policy.

(a) under the revenue recognition project (unbundling approach 3(a)); or

(b) under requirements developed specifically to apply to all the separated components of the entire contract (unbundling approach 3(b)).

Sometimes approach 3(b) is necessary because it is not sufficiently clear how the separated component would be treated under the existing relevant standards.

5. We intend to consider only the unbundling described in 3(a) and 3(b). However, we will explore alternative 3(b) only if 3(a) is considered unworkable. We do not intend to discuss unbundling as described in 3(c) because this will be discussed later.

6. This paper provides a general discussion of:

   (a) the background of the unbundling proposals in the ED/DP and the feedback received (7-17);

   (b) the objectives for unbundling (paragraphs 18-28);

   (c) what should be unbundled (paragraphs 29-33); and

   (d) the next steps for considering this issue (paragraphs 34-35).

Background

7. When investment or service components of an insurance contract are not closely related to the insurance coverage, the IASB exposure draft (ED) *Insurance Contracts* and the FASB Discussion Paper (DP) Preliminary Views on *Insurance Contracts* propose that an insurer would account for those components separately from the insurance component. The ED/DP states that the following are the most common examples of non-insurance components that are not closely related to the insurance coverage:

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

(b) an embedded derivative that is required to be separated under financial instruments requirements (IAS 39/IFRS 9 or Topic 815) ; and

(c) non-insurance services or goods that are not closely related to the insurance coverage but that 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.)

8. The proposal in paragraph 7(b) carries forward from IFRS 4 *Insurance Contracts* and IAS 39 the requirements to separate specified embedded derivatives from a host insurance contract. Unbundled non-insurance components are measured under the relevant requirements in IFRS or US GAAP. This is consistent with the unbundling approach described in paragraph 3(a).

9. When the non-insurance components are closely related to the insurance coverage, the ED/DP prohibits unbundling.

Overview of comments on the ED/DP

10. An overview of the comments received on the ED/DP was set out in Agenda paper 3H/58 H dated 16 February 2011. Relevant extracts of that agenda paper are set out in Appendix B for the boards' convenience. The following paragraphs highlight feedback received in relation to the proposed principle 'not closely related'.

Not closely related

11. In developing the proposals in the ED, the boards considered and rejected the following principle to determine whether to use unbundling: unbundle when the components are not interdependent. The boards had decided during the development of the ED that the underlying principle should be that components

would be unbundled if they were 'not closely related' to the insurance coverage. This principle is consistent with the existing bifurcation guidance in IAS 39/IFRS 9 and Topic 815.

12. Paragraph AG33(h) of IAS 39 explains that an embedded derivative in an insurance contract is closely related to the economic characteristics and risks of the host insurance contract only if that derivative and the host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately, ie without considering the host contract.

13. Many respondents did not understand the proposed principle for unbundling for the account balance and services provided as part of the insurance contract. For example, the ED provided account balances as examples of components that are not closely related, but sometimes the account balances are interdependent with the insurance component (for example, unit-linked policies where the sum paid out on death is the higher of the unit-linked account balance and a sum assured). Separating components that are interdependent is inconsistent with the guidance on embedded derivatives that are considered to be closely related (ie paragraph AG33(h) of IAS 39).

14. In addition, some struggle with the application of the principle of 'not closely related' in the context of goods and services that are sometimes provided alongside insurance coverage (eg asset management services). The only example provided in the ED is for goods and services when there is no commercial substance in combining those goods and services with insurance coverage.

15. Respondents are concerned that the three examples of 'not closely related' are rules, in the way that similar examples in IAS 39 have been applied. In contrast, some suggest that the standard should include additional guidance on the meaning of 'not closely related'. Some requested clarity on what should be unbundled from specific products.

Interpreting the feedback received

16. What is the appropriate principle for unbundling? Some respondents base their assessment of the proposed not 'closely related principle' on whether it results in the separation of the appropriate insurance contracts. Standard-setters believe that a 'successful' principle is a clear objective that can be applied consistently and results in relevant and useful information.

17. Because of the mixed feedback received on the unbundling principle proposed in the ED/DP, we would like to ask the boards:

    (i) what is their objective in unbundling components from an insurance contract? This is discussed in paragraphs 18-28.

    (ii) how the objectives for unbundling are applied to determining what should be separated. Possible approaches to doing this are discussed in paragraphs 30-34.

Why unbundle?

18. Insurance contracts are a bundle of rights and obligations that generate a package of mostly interdependent cash inflows and outflows. Under the proposed building block approach, an insurer measures an insurance contract considering all those cash inflows and outflows. The ED/DP stated that the boards believe that this approach produces relevant information about the amount, timing and uncertainty of those cash flows.

Reasons for unbundling

19. Why would unbundling be required under this model? The arguments are:

    (a) Separating non-insurance components from an insurance contract and measuring and recognising these components under the relevant requirements in other IFRSs is a faithful representation of these components and results in useful information (ie like is treated with like).

    (b) Accounting arbitrage opportunities are minimised. An entity might otherwise bundle a contract with some insurance risk to seek some accounting advantage. Although that insurance risk might be significant (otherwise the contract would not meet the definition of an insurance contract), the expected present value of contingent cash flows might still be small.

20. A few believe that insurance contracts should be accounted for under the financial instruments requirements, or under the model developed for revenue recognition and the requirements for uncertain non-financial liabilities. For them, the logical conclusion under the proposed measurement model would be to require the maximum amount of unbundling (except perhaps if the components interact economically in ways that make the whole contract behave differently from the sum of the parts).

21. Some believe that there should be a separate measurement model for insurance contracts, but support unbundling in some instances to resolve some specific concerns.

    (a) Unbundling of some non-insurance components results in less accounting mismatch when those non-insurance components are measured at amortised cost in the same way as for the assets backing the entire insurance contract.

(b) Unbundling premiums into deposit and revenue components may make it feasible to develop a presentation model that is more intuitive to some users than the summarised margin presentation.

(c) Some contracts that have traditionally not been treated as insurance contracts would meet the definition of insurance contracts and some believe that the proposed measurement model may not be appropriate for these contracts.

22. Some believe that applying the proposed measurement model to the entire contract is analogous to not requiring separation of the embedded derivatives of a hybrid financial liability that has been measured using the fair value option.

Reasons for not unbundling

23. Some do not support unbundling, perhaps restricted to unbundling only when goods and services are bundled with an insurance contract without commercial substance. Their arguments are:

(a) The model for insurance contracts is based upon the premise that the insurance contract represents a bundle of rights and obligations that generate a package of cash flows. The model faithfully represents this.

(b) Complexity. Additional guidance would need to be developed on when to separate and how to separate. Furthermore, the separated components would be measured under different standards, which is more complex than separating two components under a single standard. The amount of complexity that would be introduced that they believe cannot be overemphasised.

(c) While the objective of unbundling is to faithfully represent the components of the contract, any arbitrariness in splitting some of the cash flows may result in information that is not useful. Furthermore, the amounts attributed to components may be influenced by the order in which components are separated. Also, some question the usefulness of

measuring separate components using different requirements that when added together do not equal the measurement that would apply to the entire contract.

(d) In addition, it would result in a model that is internally inconsistent because any dividing line is imperfect and is likely to result in the separation of some transactions that should not be separated and vice versa (for example, some universal life contracts behave in an economically similar way to some endowment contracts[3]. Less comparable information may result if some of those contracts are separated but others are not).

Are there arbitrage opportunities?

24. Accounting arbitrage opportunities may be created by unbundling. An insurance contract may be split in different ways to achieve a predetermined outcome. For example, a deferred annuity could be seen as:

(a) a loan [measured at amortised cost] and a longevity swap [measured at fair value]; or

(b) a series of prepaid written forward contracts—for each annuity certain payment, and prepaid contingent written forward contracts—for the rest of annuity payments dependent on survival. Derivatives are measured at fair value.

[3] Endowment insurance contracts typically have a term between 10-25 years with a promise to pay out a specified amount (or an amount based on a specified return) at the end of the contract or a death benefit in the event that death occurs before the policy matures.

25. However, some find it hard to envisage how accounting arbitrage opportunities could arise, even if there was little unbundling. Unbundling insurance contracts is *unlikely* to result in significant differences when the financial instrument components are measured at fair value because:

    (a) the model uses an expected-value basis for the cash flows, which is updated in such a way as to be consistent with the expected present value technique used implicitly or explicitly in fair value measurement;

    (b) the model uses market-consistent financial assumptions, consistent with fair value measurement; and

    (c) for embedded derivatives, the model takes into account the intrinsic and time values of those derivatives.

26. Similarly, unbundling insurance contracts is unlikely to result in significant differences in revenue recognition because the residual margin is recognised in profit and loss in a similar manner to the pattern of revenue recognition under the revenue model (ie on the basis of the expected timing of incurred claims and benefits which, in most cases, is assumed to be the passage of time). Consequently, any service components, assuming no changes in assumptions during the life of the contract, are recognised in profit and loss in a similar manner as under the revenue recognition model.

Conclusions

27. We think that the boards' decision on whether to require unbundling is a balance between the benefits (faithful representation of the transaction, in particular on what is recognised in profit or loss) and the costs (further complexity). This balance is difficult to find because there is no natural dividing line for some products.

28. As alluded to in some of the discussions above, the objectives for requiring unbundling are intertwined with the question of which non-insurance components are to be separated from insurance contracts. In addition, the weights of the arguments above differ depending upon the type of non-insurance components that are being considered.

What should be unbundled?

29. In this section we consider how unbundling might be applied in determining what should be separated. To many, unbundling seems intuitive for some contracts, but not for others. We consider the following:

    (a) contracts that most think should almost certainly be unbundled.

    (b) contracts for which there is a wide range of mixed views.

    (c) contracts that most think should not be unbundled.

Almost certainly

30. There are some insurance contracts that most would agree should be unbundled:

    (a) Contracts that are structured with insurance coverage for reasons that have no commercial substance (eg the sale of a fertiliser packaged with insurance coverage, which one Board member raised during the development of the ED);

    (b) Contracts that include an insurance component that has commercial substance but is packaged with it for convenience. Examples are:

        (i) Sometimes a stand-alone savings account, mortgage or pension product is issued at the same time as the life insurance contract is taken out.

        (ii) When a car is sold with motor accident insurance.

Possibly

31. For some insurance contracts, views on whether unbundling should not be applied depend mostly upon past practices in their jurisdictions, the type of features attached to the insurance contracts or how insurers tend to view these products. For example, in Australia and New Zealand, unit-linked insurance contracts are unbundled with the deposit component measured under the financial instruments requirements and the insurance components measured under the insurance requirements. We understands that unbundling is relatively straightforward for many of the products sold in those markets, at least partly because some ring-fencing of the components is required for regulatory purposes.

Probably not

32. There are features of some insurance contracts that many oppose unbundling for, for example:

    (a) additional features attached to life insurance contracts that provide additional benefits or limit the insurer's liability (termed 'riders'). For example, many life contracts contain an option allowing, in specific circumstances, a policyholder to take a loan against the cash value.

    (b) services that are an integral part of the insurance contract (eg asset management services, premium collection and benefit payment services (ie claim adjudication services)).

    We plan to discuss whether the components above should be separated.

33. There are some insurance contracts for which many would oppose the separation of deposit components. This is the case even in those jurisdictions that currently require extensive unbundling. These are: term life, traditional and participating whole life, and endowment type contracts. These contracts cash flows are so intertwined that separating them is likely to produce misleading information. We do not plan to discuss these types of contracts.

Next steps

34. We plan to discuss whether the following should be separated from an insurance contract:

    (a) embedded derivatives. Currently IAS 39/ IFRS 9, IFRS 4 and Topic 815 have guidance on the separation of embedded derivatives from an insurance contract. We will consider whether that guidance should be carried over in the future standard.

    (b) services and goods provided with insurance products. We will consider this in the context of the boards' tentative decisions on separating performance obligations in the project on revenue recognition.

    (c) deposit or investment-type components (eg universal life, unit-linked insurance contracts, investment contracts with discretionary participation features and annuities); and

    (d) riders.

35. We will then consider the boards' decisions as a whole to determine if there are internal inconsistencies that should be eliminated and whether an overall principle or criteria can be developed. At that stage, we plan to also consider whether unbundling should be optional or required. We will also consider whether unbundling non-insurance components, when it is not required, should be prohibited.

Discussion question
What are the boards' objectives for unbundling insurance contracts?

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: Responses to the Exposure Draft/Discussion Paper

Relevant questions in the exposure draft/Discussion Paper

A1. 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?

A2. 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?

Unbundling

A3. 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 in the same way as for the measurement of the assets backing those components, thereby avoiding the creation of 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 that unbundling would be appropriate because insurance policies are priced on an integrated basis and are not separately managed. Those respondents believe that unbundling would not result in useful information because of the decreased consistency and comparability that would be likely to result from the significant management judgment that would need to be used to determine whether to unbundle.

Criteria for unbundling

A4. 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 had determined that one of the components described in that paragraph was 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.

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

(vi) 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.

A5. Some recommended a different unbundling criterion to the proposed criterion of 'closely related'; for example, they suggest criteria that would result in unbundling:

(a) when practicable;

(b) when the components can be measured separately 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 with Customers*.

A6. 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).

A7. 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 from a life contract is determined by reference to the value of the investment balance); and

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

Permit unbundling

A8. Some respondents to the IASB ED/FASB DP recommended that unbundling should be merely permitted, instead of being required, when the non-insurance component could be measured separately. This would be similar to the current

requirements in IFRS 4. (Appendix C summarises the current IFRS 4 requirements.) Others believe that making unbundling optional would be likely to result in decreased consistency and comparability in financial reporting.

Further guidance

A9. 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.

A10. Some respondents questioned how they would allocate acquisition costs.

A11. Some respondents requested clarification on fixed-fee service components and on 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.

A12. 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.

Geographical variations

A13. 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 generally supported unbundling but believe that further clarification and implementation guidance is necessary for consistency in the application of the principles and for comparability amongst insurers.

Appendix C: 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 require 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 separation of 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.

A5. The following are paragraphs from the basis for conclusions on IFRS 4 explaining how the IASB reached its decisions on the unbundling requirements.

Unbundling

BC40 The definition of an insurance contact distinguishes insurance contracts within the scope of the IFRS from investments and deposits within the scope of IAS 39.[4] However, many insurance contracts contain a significant deposit component (ie a component that would, if it were a separate instrument, be within the scope of IAS 39). Indeed, virtually all insurance contracts have an implicit or explicit deposit component, because the policyholder is generally required to pay premiums before the period of risk; therefore,

[4] In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

the time value of money is likely to be one factor that insurers consider in pricing contracts.

BC41 To reduce the need for guidance on the definition of an insurance contract, some argue that an insurer should 'unbundle' the deposit component from the insurance component. Unbundling has the following consequences:

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

(b) The deposit component is measured under IAS 39 at either amortised cost or fair value. This might not be consistent with the basis used for insurance contracts.

(c) Premium receipts for the deposit component are recognised not as revenue, but rather as changes in the deposit liability. Premium receipts for the insurance element are typically recognised as revenue.

(d) A portion of the transaction costs incurred at inception is allocated to the deposit component if this allocation has a material effect.

BC42 Supporters of unbundling deposit components argue that:

(a) an entity should account in the same way for the deposit component of an insurance contract as for an otherwise identical financial instrument that does not transfer significant insurance risk.

(b) the tendency in some countries for banks to own insurers (and vice versa) and the similarity of products offered by the insurance and fund management sectors suggest that insurers, banks and fund managers should account for the deposit component in a similar manner.

(c) many groups sell products ranging from pure investments to pure insurance, with all variations in between. Unbundling would avoid sharp discontinuities in the accounting between a product that transfers just enough insurance risk to be an insurance contract, and another product that falls marginally on the other side of the line.

(d) financial statements should make a clear distinction between premium revenue derived from products that transfer significant insurance risk and premium receipts that are, in substance, investment or deposit receipts.

BC43 The Issues Paper published in 1999 proposed that the deposit component should be unbundled if it is either disclosed explicitly to the policyholder or clearly identifiable from the terms of the contract. However, commentators on the Issues Paper generally opposed unbundling, giving the following reasons:

(a) The components are closely interrelated and the value of the bundled product is not necessarily equal to the sum of the individual values of the components.

(b) Unbundling would require significant and costly systems changes.

(c) Contracts of this kind are a single product, regulated as insurance business by insurance supervisors and should be treated in a similar way for financial reporting.

(d) Some users of financial statements would prefer that either all products are unbundled or no products are unbundled, because they regard information about gross premium inflows as important. A consistent use of a single measurement basis might be more useful as an aid to economic decisions than mixing one

measurement basis for the deposit component with another measurement basis for the insurance component.

BC44 In the light of these arguments, the DSOP proposed that an insurer or policyholder should not unbundle these components. However, that was against the background of an assumption that the treatments of the two components would be reasonably similar. This may not be the case in phase I, because phase I permits a wide range of accounting treatments for insurance components. Nevertheless, the Board did not wish to require costly changes in phase I that might be reversed in phase II. Therefore, the Board decided to require unbundling only when it is easiest to perform and the effect is likely to be greatest (paragraphs 10–12 of the IFRS and IG Example 3 in the Implementation Guidance).

BC45 The Board acknowledges that there is no clear conceptual line between the cases when unbundling is required and the cases when unbundling is not required. At one extreme, the Board regards unbundling as appropriate for large customised contracts, such as some financial reinsurance contracts, if a failure to unbundle them could lead to the complete omission from the balance sheet of material contractual rights and obligations. This may be especially important if a contract was deliberately structured to achieve a specific accounting result. Furthermore, the practical problems cited in paragraph BC43 are much less significant for these contracts.

BC46 At the other extreme, unbundling the surrender values in a large portfolio of traditional life insurance contracts would require significant systems changes beyond the intended scope of phase I. Furthermore, failing to unbundle these contracts would affect the measurement of these liabilities, but not lead to their complete omission from the insurer's balance sheet. In addition, a desire to achieve a particular accounting result is much less likely to influence the precise structure of these transactions.

BC47 The option for the policyholder to surrender a traditional life insurance contract at an amount that differs significantly from its carrying amount is an embedded derivative and IAS 39[5] would require the insurer to separate it and measure it at fair value. That treatment would have the same disadvantages, described in the previous paragraph, as unbundling the surrender value. Therefore, paragraph 8 of the IFRS exempts an insurer from applying this requirement to some surrender options embedded in insurance contracts. However, the Board saw no conceptual or practical reason to create such an exemption for surrender options in non-insurance financial instruments issued by insurers or by others.

BC48 Some respondents opposed unbundling in phase I on the following grounds, in addition to the reasons given in paragraph BC43:

(a) Insurance contracts are, in general, designed, priced and managed as packages of benefits. Furthermore, the insurer cannot unilaterally terminate the agreement or sell parts of it. In consequence, any unbundling required solely for accounting would be artificial. Insurance contracts should not be unbundled unless the structure of the contract is clearly artificial.

(b) Unbundling may require extensive systems changes that would increase the administrative burden for 2005 and not be needed for phase II.

[5] In November 2009 and October 2010 the IASB amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.

(c) There would be no need to require unbundling if the Board strengthened the liability adequacy test, defined significant insurance risk more narrowly and confirmed that contracts combined artificially are separate contracts.

(d) The unbundling conditions in ED 5 were vague and did not explain the underlying principle.

(e) Because ED 5 did not propose recognition criteria, insurers would use local GAAP to judge whether assets and liabilities were omitted. This would defeat the stated reason for unbundling.

(f) If a contract is unbundled, the premium for the deposit component is recognised not as premium revenue but as a balance sheet movement (ie as a deposit receipt). Requiring this would be premature before the Board completes its project on reporting comprehensive income.

BC49 Some suggested other criteria for unbundling:

(a) All contracts should be unbundled, or unbundling should always be permitted at least. Unbundling is required in Australia and New Zealand.

(b) All non-insurance components (for example, service components) should be unbundled, not only deposit components.

(c) Unbundling should be required only when the components are completely separable, or when there is an account in the name of the policyholder.

(d) Unbundling could affect the presentation of revenue more than it affects liability recognition. Therefore, unbundling should also be required if it would have a significant effect on reported revenue and is easy to perform.

BC50 Some respondents argued that the test for unbundling should be two-sided (ie the cash flows of the insurance component and the investment component do not interact) rather than the one-sided test proposed in ED 5 (ie the cash flows from the insurance component do not affect the cash flows from the deposit component). Here is an example where this might make a difference: in some life insurance contracts, the death benefit is the difference between (a) a fixed amount and (b) the value of a deposit component (for example, a unit-linked investment). The deposit component can be measured independently, but the death benefit depends on the unit value so the insurance component cannot be measured independently.

BC51 The Board decided that phase I should not require insurers to set up systems to unbundle the products described in the previous paragraph. However, the Board decided to rely on the condition that provides an exemption from unbundling if all the rights and obligations under the deposit component are recognised. If this condition is not met, unbundling is appropriate.

BC52 Some argued that it is irrelevant whether the insurance component affects the deposit component. They suggested that a deposit component exists if the policyholder will receive a minimum fixed amount of future cash flows in the form of either a return of premium (if no insured event occurs) or an insurance recovery (if an insured event occurs). However, the Board noted that this focus on a single cash flow would not result in unbundling if a financial instrument and an insurance contract are combined artificially into a single contract and the cash flows from one component offset cash flows from the other component. The Board regarded that result as inappropriate and open to abuse.

BC53 In summary, the Board retained the approach broadly as in ED 5. This requires unbundling if that is needed to ensure the recognition of rights and obligations arising from the deposit component and those rights and obligations can be measured separately. If only the second of these conditions is met, the IFRS permits unbundling, but does not require it.

BC54 Some respondents suggested that if a contract has been artificially separated through the use of side letters, the separate components of the contract should be considered together. The Board did not address this because it is a wider issue for the Board's possible future work on linkage (ie accounting for separate transactions that are connected in some way). The footnote to paragraph B25 refers to simultaneous contracts with the same counterparty.