Staff Paper

Topic **Unbundling Insurance Contracts**

What is this paper about?

1. We are seeking feedback on the boards' recent tentative decisions on unbundling non-insurance components from insurance components. In particular, we are seeking to understand if any operational issues arise from these tentative decisions.

2. These tentative decisions are described in paragraphs 5-12. At later meetings, the boards will continue to discuss the unbundling issues listed in paragraph 14.

IASB ED/FASB DP

3. Under the proposals in the IASB exposure draft *Insurance Contracts* and the FASB Discussion Paper *Preliminary Views on Insurance Contracts*, an insurer would apply the building block model to all cash flows from the insurance contract. The ED/DP also proposed that specified financial instrument components and specified goods and services components should be unbundled for measurement. In particular, the ED/DP proposed that an insurer should unbundle an investment component, an embedded derivative or a goods and services component that is not closely related to the insurance component. The insurer would account for any unbundled investment components or embedded derivatives using the financial instruments requirements, and any unbundled goods and services components using relevant requirements in IFRSs/US GAAP.

4. Most found the proposals in the ED/DP unclear in the following respects:

   (a) how to apply *the principle of 'closely related'*: the principle and its interaction with the examples in the ED have proved to be confusing to some respondents. The major reason for this confusion is that the example provided in the ED and the current guidance in IAS 39/IFRS 9 on a ‘closely related’ embedded derivative appear to conflict;

(b) whether *account balances that were credited with a market-based interest rate* should be separated (because the proposals referred to unit-linked and index-linked contracts);

(c) whether unbundling applied to *non-variable universal life contracts* for which not all the performance of the general account is passed onto the policyholder; and

(d) how unbundling applied to *goods and services* that are included with insurance contracts for reasons that have commercial substance.

Recent tentative decisions

Embedded derivatives

5. Some believe that the ED’s/DP’s proposals to separate (‘bifurcate’) embedded derivatives produce more understandable information than not separating them, for the following reasons:

   (a) Separation highlights the different risks arising from embedded derivatives and from the insurance contracts that contain them.

   (b) Insurers preparing financial statements under IFRS and US GAAP are accustomed to separating embedded derivatives from insurance contracts under the current requirements—hence, there is little additional cost in continuing to follow current practice.

6. On 20 March 2011, the boards tentatively decided that embedded derivatives in insurance contracts should be separated from host contracts when existing guidance requires this.

Investment components

7. Some believe that the insurance contracts model is appropriate for risk-sharing or risk-assuming functions of the contract, but that all other elements of the contract should be separated and accounted for using the relevant financial reporting standards (revenue recognition or financial instruments). Even when there are no significant measurement differences between those other standards and the insurance contracts model, some would still prefer unbundling, to achieve faithful presentation of the separated insurance and non-insurance components. This is particularly the case if the statement of comprehensive income shows premium information (and not just the summarised margin information proposed in the ED/DP).

8. There is no ‘perfect’ solution. Risk-sharing/assuming and investment functions are present in varying degrees in all long-term insurance contracts. Unbundling only a subset of insurance contracts, as proposed in the ED/DP, reduces comparability of the unbundled contracts with those that are not unbundled. However, requiring unbundling for *all* long-term insurance contracts would be excessively costly, particularly when the investment component is merely implicit and not an explicit account balance.

9. At the 4 May 2011 meeting, the boards tentatively decided that:

   (a) explicit account balances in insurance contracts that meet specified criteria (see paragraph 10) should be unbundled.

   (b) explicit account balances that have been unbundled should be accounted for in accordance with the relevant requirements for financial instruments in IFRS/US GAAP.

10. The specified criteria are adapted from those being developed for identifying separate performance obligations in the revenue recognition project. These criteria are based on the principle that account balances should be separated when they are not integrated with, and have risks distinct from, the insurance component. For insurance contracts, the staff have interpreted the notion of integration as referring to whether the value of the account balance affects the insurer's insurance risk exposure.

Criteria for identifying separate performance obligations as tentatively decided upon at the February 2011 joint meeting on revenue recognition	**Modified criteria for identifying and unbundling account balances**
1. An entity should account for a bundle of promised goods or services as one performance obligation if the entity provides a service of integrating those goods or services into a single item that the entity provides to the customer. (If this criterion is satisfied the entity need not consider the criteria in (2)).	1. An insurer should account for the explicit account balance and insurance component together when the insurer's exposure to insurance risk in the combined contract is integrated with its exposure to the financial risks arising from the account balance. In order to determine whether or not an account balance is integrated with the remainder of the contract, an insurer should assess whether the amount of insurance risk the insurer is exposed to is significantly affected by the investment performance of the account balance. (If this criterion is satisfied the entity need not consider the criteria in (2)).

Criteria for identifying separate performance obligations as tentatively decided upon at the February 2011 joint meeting on revenue recognition	**Modified criteria for identifying and unbundling account balances**
2. An entity should account for a promised good or service as a separate performance obligation if: (a) the pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract, and (b) the good or service has a distinct function.	2. An insurer should account for an explicit account balance separately if: (a) the pattern of exposure to financial risk arising from the account balance is different from the exposure to insurance risk in the contract, and (b) the account balance has a distinct value. (See note below)
3. A good or service has a distinct function if either: (a) the entity regularly sells the good or service separately, or (b) the customer can use the good or service either on its own or together with resources that are readily available to the customer.	3. The account balance has a distinct value if either: (a) the insurer regularly issues separately a financial instrument with the same rights and obligations as the explicit account balance (eg it issues unit-linked/variable contracts with no insurance risk and those contracts credit returns at the same rate as the bundled contract), or (b) the policyholder can benefit from the explicit account balance on its own (eg benefit from investment returns).
Note: The boards may delete criterion 2(a) from the criteria for unbundling investment components (or goods and services) from insurance contracts. Its purpose in revenue recognition is to clarify that performance obligations with distinct functions need not be separated if they are satisfied at the same time.	

Goods and services

11. At the 4 May 2011 meeting, the boards tentatively decided that goods and services should be separated from an insurance contract in accordance with the principles on identifying separate performance obligations in the revenue recognition project (the left hand column of the table in paragraph 10 sets out the boards' tentative decisions).

12. Once separated, those goods and services would be accounted for in accordance with relevant requirements under IFRS and US GAAP.

Examples

13. The appendix to this paper shows our analysis of the application of the above principles to some examples of insurance contracts combined with investment components or goods and services.

Question 1—Useful information
Do you think that it would provide useful information to users of financial statements to unbundle: (a) embedded derivatives when current financial instruments guidance in IFRS and US GAAP would require this; (b) explicit account balances in accordance with the criteria that are based on those developed in revenue recognition for identifying separate performance obligations; and (c) goods and services in accordance with the criteria used for identifying separate performance obligations in the revenue recognition project?

Question 2—Operational issues
Do you see any operational issues with the boards' recent tentative decisions summarised in question 1?

Next steps

14. We plan to discuss the following papers at a future meeting:

    (a) contract riders (eg policy loans).

    (b) whether the decisions on unbundling are operational as a whole, and whether additional guidance is needed on, for example:

        (i) the allocation of charges and fees to the various components, especially when there are cross-subsidies between the insurance component and another component of the contract.

        (ii) the treatment of products with more than one account balance or the option to switch between insurance options.

    (c) whether the unbundling decisions should be applied to investment contracts with discretionary participation features (DPF) if these are within the scope of the forthcoming standard (to be considered at a future date).

    (d) whether unbundling required under the building block model should also apply in the modified measurement model for some short duration contracts.

    (e) whether further unbundling (in addition to that required) should be permitted or prohibited and whether an insurer should be allowed to measure the entire insurance contract under the building block model in specified circumstances.

    (f) whether there should be requirements for combining a stand-alone contract with an insurance contract in some cases. The revenue recognition project has developed guidance in this area.

Question 3—Next steps
Do you have comments on the issues in paragraph 14?

Appendix: Analysis of how the boards' tentative decisions would be applied

Examples	Applying the boards' tentative decisions
Example 1 A unit-linked insurance contract has the following terms: (a) The contract is for a fixed term or until the death of the policyholder, whichever occurs earlier. (b) In the first 2 years, the policyholder is required to pay a fixed premium amount. The premium can be paid annually, quarterly or monthly. (c) After year 2, the policyholder has the flexibility to cease paying the premium amounts or to vary the premium amounts. (d) The premiums purchase a number of units in an investment fund depending on the unit values. The investment fund is a mix of bonds and equity investments.	**Goods and services** *Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?* No, because the stand-ready obligation for the life insurance and the asset management services are unrelated. They are managed separately. *Is the pattern of transfer different? [The boards are considering deleting this test.]* Yes, the mortality risk is higher towards the end of the contract and the asset management services occur evenly during the life of the contract. *Are they distinct?* Yes, the policyholder can benefit from the investment in the fund separately from the life insurance cover. This is because (a) the policyholder benefits from life cover irrespective of the amount invested in the fund; and (b) the policyholder receives a return from being exposed to the investment risk that is unrelated to the life insurance cover.

Examples	**Applying the boards' tentative decisions**
(e) On death, the beneficiaries receive a sum assured of CU100,000 plus the value of the units (without any surrender charges). (f) Monthly charges are deducted from the investment fund to pay for the cost of insurance[1] and expenses (eg asset management expenses). (g) The policyholder can withdraw at any time. An exit fee (calculated as a percentage of the value of the units surrendered) is charged if the policyholder surrenders the contract before the fixed term of two years has finished. On surrender of the whole contract, no surrender value is paid out in relation to the forfeited death benefit component.	**Result:** the asset management fees are separated from the insurance contract. *[Deleting the test in 2(a) would not change the outcome in this example.]* **Explicit account balance** *Is the insurance risk affected by the investment risk arising on the account balance?* No, because the policyholder receives the value of the units in all circumstances (apart from the exit fee in the first two years). The additional amount of CU100,000 paid on death does not depend in any way on the investment performance of the units. *Is the pattern of exposure different? [The boards are considering deleting this test.]* Yes, the mortality risk is higher towards the end of the contract but the investment risks occur evenly during the life of the contract. *Are they distinct benefits?* Yes, the policyholder can benefit from the investment in the fund separately from the life insurance cover because it is receiving investment returns The

[1] Sometimes termed 'mortality and expense risk fees'.

Examples	Applying the boards' tentative decisions
	policyholder's investment return is unrelated to the life insurance cover. In addition, the policyholder benefits from the life cover irrespective of the amount invested in the fund. **Result**: the account balance is unbundled from the insurance contract. *[Deleting the test in 2(a) would not change the outcome in this example.]*

Examples	Applying the boards' tentative decisions
Example 2 The same contract as in example 1 except that for (e), the sum paid out to beneficiaries is the higher of the value of the invested units (without any surrender charges) and CU100,000. Thus, on death, the insurer is on risk for the difference between CU100,000 and the value of the invested units, assuming that the value of the units is below CU100,000. Moreover, for (g), the policyholder receives only the unit value on surrender, even if the unit value is less than CU100,000.	**Goods and services** *Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?* Yes, the facts in this example suggest that the insurer is providing the policyholder with a product that integrates insurance features with investment features. Providing the policyholder with this integrated product is different from providing the customer with a separate insurance contract and investment fund because mortality risk is a factor of both the value of the investment fund and the probability of death. **Result:** the asset management fees are not separated **Explicit account balance** *Is the insurance risk affected by the investment risk arising on account balance?* Yes, the insurer's exposure to insurance risk is affected by the performance of the investment fund. **Under the proposals, no further analysis is necessary.** **Result:** do not separate the account balance.

Examples	Applying the boards' tentative decisions
Example 3 A contract for a sale of a car with 'free' 3-year non-cancellable motor accident insurance	*Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?* No, because the car and the insurance coverage are not interrelated and the entity is not providing a service by integrating the car with the insurance. The sale of the car is not highly interrelated to the provision of the motor accident coverage. The motor accident insurance is a 'sweetener' to promote the sale of the car. *Is the pattern of transfer different? [The boards are considering deleting this test.]* Yes, the control of the car is transferred to the customer on the date of the sale and the entity has a stand-ready obligation over the three years for the motor accident insurance. *Are they distinct?* Yes, because the customer can use the car without the motor accident insurance. Even if the insurance is a legal requirement, the customer could buy the insurance from another provider. Thus, the car is distinct from the insurance. **Result:** The sale of the car is unbundled from the insurance contract. The sale of the car is accounted for under the revenue standard and the insurance coverage is accounted for under the insurance requirements. *[Deleting the test in 2(a) would not change the outcome in this example.]*

Examples	**Applying the boards' tentative decisions**
Example 4 An insurer may sell claims processing services on a stand-alone basis to a customer and might sell those services bundled with a stop-loss insurance contract. Stop-loss insurance is offered by primary insurers to protect employers that self-fund their employee benefit plans. To provide financial protection against catastrophic claims, some self-funding employers purchase stop-loss insurance from insurers. Specific stop-loss insurance is provided to set a limit on the employer's burden for medical expenses for each covered individual. Aggregate stop-loss insurance may also be provided to limit overall annual costs for a self-funded plan by addressing the accumulation of expenses on all individuals. Should the payment processing services be separated from the stop-loss insurance contract when those are part of the same contract? *We will consider in a future paper whether contracts should be combined. We intend to discuss in that*	*Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?* No, because the provision (or non-provision) of the claims processing services that is under the excess amount is unrelated to the provision of stop-loss insurance. While the insurer can minimise its risk by providing the claims processing services, the insurer is primarily providing the claims processing services because it is contracted to do so. The entity is self-insuring for the amount below the amount insured under the stop-loss insurance contract and has contracted the insurer to provide the claims processing service for all claims because the insurer can provide that service more cheaply. *Is the pattern of transfer different? [The boards are considering deleting this test.]* That depends on the type of stop-loss contract issued. The pattern of insurance risk is assessed at the coverage level. If it is an aggregate stop-loss insurance contract (ie when the accumulated claims exceed a specified amount), the risk of that occurring increases more than proportionately over time. This pattern of transfer is different from the provision of the claims processing services, which occurs evenly over the life of the contract. *[Deleting the test in 2(a) would not change the outcome in this example.]*

Examples	Applying the boards' tentative decisions
paper whether a stand-alone claims processing services contract should be bundled together with the stop-loss insurance contract.	If it is a specific stop-loss insurance contract (eg the single instance in which the policyholder's cumulative paid benefits exceed the defined threshold) the risk is likely to occur evenly over the period. In this circumstance, the pattern of transfer of the stand-ready obligation is similar to the pattern of transfer of the provision of the claims processing services. *[Deleting the test in 2(a) may change the outcome in this example.]* *Are they distinct?* Yes. The entity sells stop-loss insurance contracts or payment processing services in stand-alone contracts. ***Result****:* depending upon the type of stop-loss insurance coverage. *[In some cases, deleting the test that refers to the pattern of transfer in 2(a) would mean that these contracts would be unbundled.]*

Examples	Applying the boards' tentative decisions
Example 5—fully-insured health insurance contract with variable claim pattern An insurer contracts with a government agency (the 'policyholder') to provide specified benefits to a prescribed population of individuals. Based on the benefit design (structured as initial coverage with a limit, then a gap in coverage, and then catastrophic coverage limits) the expected pattern of claim varies throughout the year with higher claims expected early in the year, lower in the middle, and higher again at the end of the year. Although the contract is with the policyholder on a group basis, coverage levels are based on individual claim occurrences. In addition to the provision of insurance coverage, the contract stipulates that the insurer will provide administrative services to the policyholder, including claims processing and adjudication services.[2] Similar administrative services are sold separately; however, the insurer does not sell this insurance coverage without the related administrative services. Service components are generally provided ratably (ie evenly)	*Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?* No, for the following reasons: (a) The risks involved in providing the administrative services (eg the number of claims might be excessive and therefore costly) are entirely different from the risks involved in providing the insurance coverage (ie participants may submit claims for amounts in excess of those that the insurer anticipated). (b) The provision of claims processing services that falls during the period during which the policyholder is responsible for payment is unrelated to the provision of insurance coverage. While the insurer can minimise its insurance risk by managing the contract and providing the claims processing services, the insurer is primarily providing the claims processing services because it is contracted to do so. *Is the pattern of transfer different? [The boards are considering deleting this test.]* No, provision of the administrative services and the insurance coverage are both transferred to the policyholder evenly over the length of the contract. The

[2] Claims adjudication is the determination of the insurer's payment or financial responsibility, after the member's insurance benefits are applied to a medical claim.

Examples	Applying the boards' tentative decisions
throughout the year.	pattern of insurance risk is assessed at the level of the individual because the coverage is at the individual level. Despite the fact that individual participants are forced to pay out of pocket during the gap in coverage, the insurer is at no point relieved of its insurance risk. Even during the gap period, a single large claim could trigger an obligation to resume funding claims. *Are the goods and services distinct?* Yes, the insurer sells administrative services as a stand-alone product. **Result:** Do not unbundle. *[Deleting the test that refers to the pattern of transfer in 2(a) would mean that these contracts would be unbundled.]*

Examples	Applying the boards' tentative decisions
Example 6—high-excess/deductible health insurance plan Contracts are sold both to individuals and to groups, generally with an annual term (assume this to be the calendar year). Under the contracts, the policyholder is responsible for 100 per cent of the costs at the beginning of the contract period up to a defined threshold (eg a CU2,000 excess/deductible). For high-excess plans sold as part of a group contract, the individual policyholders often have a choice of what coverage and what excess they can select. After the excess is met, the contract converts into a regular co-insurance arrangement whereby the insurer is responsible for 80 per cent and the policyholder is responsible for 20 per cent until the policyholder reaches an annual out-of-pocket maximum of CU6,000, at which point the insurer is responsible for 100 per cent. The insurer also provides administrative services to the policyholder for the entire duration of the contract, which includes claims processing services and network access. These services are generally provided evenly throughout the year.	*Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?* No, for same reasons as those noted in example 5. *Is the pattern of transfer different? [The boards are considering deleting this test.]* No, provision of the administrative services and the insurance coverage are both transferred to the policyholder evenly over the length of the contract. The pattern of insurance risk is assessed at the level of the individual because the coverage is at the individual level. Despite the fact that individual policyholders are forced to pay out of pocket prior to meeting the amount of their excess/deductible, the insurer is at no point relieved of most of its insurance risk. Even during the period before policyholders meet the amount of their excess, a single large claim could trigger an obligation to resume funding claims. *Are the goods and services distinct?* Yes, the insurer sells administrative services as a stand-alone product. **Result:** Do not unbundle. *[Deleting the test that refers to the pattern of transfer in 2(a) would mean that these contracts would be unbundled.]*

Examples	**Applying the boards' tentative decisions**
Example 7 An insurer issues a term life insurance contract for a single premium of CU300 for a period of 5 years. If the policyholder dies during that period, the beneficiary receives a death benefit of CU25,000. An insurer has a claims processing department to process of the claims received and a team of asset managers to manage its investments.	*Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?* The claims processing services and asset management are part of the normal operating activities or internal process of an insurer. The contract promises a benefit on death. The process that the insurer follows to make that payment is an internal process/activity and not a service to the policyholder. Because of that the insurer does not need to consider whether the claims processing services or its asset management is a separate performance obligation. **Result:** Do not unbundle any goods and services. *Is there an explicit account balance?* No there is no explicit account balance. **Result:** Do not unbundle the investment component.