IASB/FASB Meeting
4 May 2011

IASB Agenda reference	**1C**
FASB Agenda reference	**66C**

Staff Paper

Project	**Insurance contracts**
Topic	**Background material on unbundling**

What is this paper about?

1. Agenda paper 1D/66D considers separating (ie unbundling) goods and services from insurance contracts and Agenda paper 1E/66E considers unbundling investment components from insurance contracts.
2. This paper provides supporting material for those papers by setting out:
   (a) The project plan for the unbundling decisions.
   (b) Background, including:
      (i) the proposals on unbundling goods and services and investment components from insurance contracts; and
      (ii) feedback received from comment letters, outreach and field tests on those proposals.
   (c) Context for the boards' decisions at this meeting on unbundling.
3. In addition, this paper contains the following appendices:
   (a) Appendix A: Instruments that some respondents would like the boards to require or permit unbundling
   (b) Appendix B: Relevant tentative decisions on other topics in this project
   (c) Appendix C: Product descriptions

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(d) Appendix D: Comparison of FASB Measurement Methodologies in Insurance Contracts vs Accounting for Financial Instruments

(e) Appendix E: IFRS 4 and SFAS 97 requirements on unbundling

(f) Appendix F: Measurement of Insurance Contract Liability (SFAS 60) vs Deposit Component (SFAS 97)

(g) Appendix G: Unbundling under current US GAAP for contracts issued by insurance entities

4. We are not asking for any decisions in this paper; instead, recommendations are made in agenda paper 1D/66D and agenda paper 1E/66E.

Project plan for the unbundling decisions

5. In previous meetings, we communicated our intention to bring to the boards a series of papers seeking decisions on when and how specific components of insurance contracts should be separated and accounted for using different guidance (ie unbundled). Our plan was to break down the topic of unbundling into four subtopics:

(a) embedded derivatives;

(b) goods and services;

(c) investment (or deposit) components; and

(d) contract riders (eg the provision of additional benefits or limits to the insurer's liability, policy loans).

6. Agenda paper 12G for the 20 March 2011 meeting addressed the unbundling of embedded derivatives in insurance contracts. The boards tentatively decided that embedded derivatives in insurance contracts should be separated from host contracts in accordance with existing guidance.

7. At this meeting, we plan to discuss unbundling goods and services (Agenda paper 1D/66D) and investment components (Agenda paper 1E/66E). We plan to bring unbundling contract riders to later meetings.

8. At the end of this planned series of papers on unbundling, we will consider:

   (a) whether the decisions on unbundling that will have been made separately are operational as a whole, and if additional guidance is needed on separating the specified components.

   (b) whether unbundling (in addition to that required) should be permitted or prohibited.

   (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.

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

   (f) whether there should be requirements to combine contracts. An entity may structure a contract to achieve a predetermined accounting result. The revenue recognition project has developed guidance on when two separate contracts should be combined so that the entity accounts for its present rights and obligations rather than focusing on how the entity structures those contracts. We intend to consider whether the criteria on when to combine contracts can be applied to combining a stand-alone goods or services contract with an insurance contract, or indeed more widely to combining a stand-alone contract (other than a goods and service contract) with an insurance contract.

Background

9. Insurance contracts may provide a number of services alongside insurance coverage. For example:

   (a) Most contracts include claims handling, payment services, and other customer services. Many contracts, including unit-linked and variable-type insurance contracts, also provide for asset management services.

   (b) Some health insurers provide helplines or websites to provide medical advice and/or counselling services.

10. In most long-term insurance contracts, an insurer is subject to both insurance risk and financial risk. In addition, the design of long-term insurance contracts has many variations. Some contracts have an explicit savings-type feature in the form of an account balance. More complex products offer a combination of saving, pension and insurance features, and the policyholder can choose how the premiums paid are allocated between those features from period to period. Most long-term insurance contracts have an implicit or explicit investment component. An implicit 'investment component' is present, even when there is no explicit account balances, for the simple reason that the policyholder is generally required to pay premiums before the period of insurance risk.[1]

11. There is diversity in current practice for certain products that contain a financial instrument component:

    (a) Account for the entire contract as insurance: recognise premiums and an increase in policyholder benefit reserves.

    (b) Account for the entire contract by valuing the liability in each period based on the account balance only, and recognising a daily mortality and expense charge as revenue.

[1] An implicit account balance, for example, can be derived by discounting an explicit maturity value at a rate not explicitly stated in the contract.

(c) Account for only a portion of the contract; eg in the accumulation phase of a deferred annuity, a liability equal to the account balance is recognised (no premiums or claim benefits are recognised) and charges against the account balance are recognised as fee income to the insurer. When the policyholder annuitises and the contract is in the payout phase, the insurer recognises a liability based on the expected present value of future benefits.

(d) Account for the unit-linked investment component as a financial instrument, for the asset management services as revenue and for the insurance benefits as an insurance contract.

(Appendices E to G provide further background information on the current US GAAP requirements on unbundling.)

12. The boards have tentatively decided to measure an insurance contract, at coverage effective, at the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract. The boards have yet to decide on whether to require a risk adjustment and residual margin, or a composite margin. The insurer would include cash flows from all goods and services and investment components in the measurement of the insurance liability unless those goods and services and investment components are unbundled.

13. Agenda paper 1D/66D considers whether cash flows related to the goods and services should be unbundled from insurance contracts. Agenda paper 1E/66E discusses whether investment components should be separated from insurance contracts. If so, what are the appropriate criteria and how should the separated components be measured?

What is 'unbundling'?

14. It is clear that different people understand different things by the term 'unbundling'. Agenda paper 12F/61F from the meeting on 21 March 2011 described the different types of unbundling. In this series of papers, we will use the distinctions drawn in that paper and discuss two types of unbundling, as follows:

    (a) Unbundling to different standards (sometimes termed 'unbundling for measurement')—an insurance contract is separated into components and the non-insurance components are **recognised and measured** according to the relevant requirements of another IFRSs/ASC Topic. For example, embedded derivatives are separated from an insurance contract and, once separated, are measured under the requirements for financial instruments in IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments,* or Topic 815 *Derivatives and Hedging* in the *FASB Accounting Standards Codification*®.

    (b) Unbundling within a standard (sometimes termed 'unbundling for presentation')—a contract is separated into components (eg the portion of premiums allocated to the investment component) and the components are **presented separately** in the statements of comprehensive income and of financial position. The unbundled component would still be measured in accordance with the insurance contract standard, and therefore those components would not be comparable to similar rights and obligations that are measured in accordance with other relevant guidance. For example: a non-insurance component would be unbundled from an insurance contract and identified in the financial statements as a 'financial instrument', but it would be measured in accordance with the requirement in the insurance contracts standard. The unbundled financial instrument components would not be within the scope of the financial instruments standards and the insurance contracts standard may specify requirements that would apply only to such components.

IASB ED/FASB DP

15. 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 and a goods and service component that are not closely related to the insurance component, and account for the investment component using the financial instruments requirements and the goods and services using relevant requirements in IFRSs/US GAAP.

16. The relevant paragraphs from the IASB ED, which are similar to paragraph 40a in the FASB DP, are as follows:

> 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.

..

(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.

Feedback received from comment letters, outreach activities and field tests

17. The boards have received an overview of comments on unbundling in previous board papers. We wish to highlight the following comments.

Reasons for unbundling

18. Some argue that unbundling enhances users' ability to compare the insurer's risk profile with the risk profile of other insurers and non-insurers. For example, some argue that unbundling would more faithfully represent the insurance and financial risks arising if a banking group issues some unit-linked contracts with insurance coverage, and some without insurance coverage, than if that banking group were to account for the entire contract under the building block model.

19. Respondents generally supported requiring the unbundling of non-insurance goods or services that have been combined with insurance coverage for reasons that have no commercial substance. Some who support minimal unbundling believe that a lack of commercial substance should be the only criterion for separation.

20. Some prefer investment components to be unbundled so that they can be measured on the same basis as some of the assets backing insurance liabilities, ie at amortised cost or fair value (see Appendix D). Some propose this as a means of avoiding mismatches, or as a means of enabling entities to select cost-based measures for particular assets (when so permitted by IFRS and US GAAP) without triggering an account mismatch with the insurance liability.

21. Some support the proposal to unbundle the specified account balances because the proposal would allow a continuation of current unbundling practices.

Arguments against unbundling

22. Some argue against the unbundling of goods and services and investment components from an insurance contract (except when those have been included for reasons other than commercial substance) because:

    (a) insurance contracts are an integrated product and the building block model appropriately measures any goods and services and investment components that are combined with the insurance coverage. Those components cannot be separated from one another in a nonarbitrary manner because the cash flows may be interdependent. Supporters of minimal unbundling believe that further information on those goods and services and investment components can be provided by disclosures.

    (b) Because of the complexities involved, the costs of unbundling would exceed the benefits. For example:

        (i) Sometimes there are significant cross-subsidies between the provision of the goods or services and in question and the insurance coverage. Indeed, sometimes there are no explicit charges for the goods and services provided. When such cross-subsidies exist, it would be necessary to adjust the amounts charged for each component (which may require subjective estimates) or to use the unadjusted amount actually charged (which may mean that the resulting

measurements do not faithfully represent the economics of the transaction, thus contradicting the rationale for unbundling). Moreover, for some contracts, separating those services without an adjustment for cross-subsidies may result in a loss at inception for the insurance component when the entire contract is expected to be profitable.

(ii) Determining the appropriate allocation of the acquisition costs between the right to provide the services or goods in question and the insurance coverage might be difficult and possibly arbitrary.

(iii) Because unbundling would require significant judgement by management, the guidance might be applied inconsistently, thereby lowering comparability between companies.

(iv) the net profits from those components are rarely a significant element of their activities and consequently the respondents who support minimal unbundling see little benefit in separating those components.

23. Others believe that unbundling is entirely unnecessary for investment components, and that contracts that meet the definition of an insurance contract should be accounted for entirely within the insurance contracts model. They argue that that the costs of unbundling outweigh the benefits, because the measurement of the unbundled component would be similar if it were to be measured at fair value, regardless of whether the component is measured as part of an insurance contract or as a financial instrument. This is because the insurance contract model uses market-consistent inputs, and results in a current measurement approach that is similar in this respect to fair value. Any difference arises from the consideration of the entity’s own credit, acquisition costs and, possibly, the deposit floor. In addition, the boards’ tentative decision (reproduced in Appendix B) on the discount rate for insurance contracts where the policyholder participates in the fair value of the assets (eg unit-linked contracts) aligns the measurement of such participation features even more closely with fair value.

24. Some question the benefits of the information produced by unbundling only specified insurance contracts, as proposed in the ED/DP, because an investment component is arguably a feature of most long-term insurance contracts. Consequently, unbundled insurance contracts would not be comparable to bundled insurance contracts.

25. Furthermore, some are concerned that unbundling increases complexity and costs. We wish to stress the following:

    (a) unbundling would be costly for insurers because some do not manage the two components separately or report the two components separately for regulatory or financial reporting purposes. If unbundling is required, these insurers would need to examine their contracts (and some may have many different types) to determine whether investment components should be unbundled, and to construct the systems to measure the two components separately. If unbundling is introduced only for financial reporting purposes (rather than reflecting internal processes or other requirements), some would prefer a higher level of benefits to justify the costs of these changes.

    (b) some insurance contracts have various investment options that the policyholder can switch between during the life of the contract. However, the proposals in the ED would unbundle only some of these options. In those cases, it is unclear how the residual/composite margin would be treated when the policyholder chooses to switch from receiving an investment return using an unbundled investment option to a bundled investment option and vice versa.

Different criteria

26. Some recommended an unbundling criterion that differs from the 'closely related' criterion proposed in the ED and DP, such as:

    (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 are readily identifiable; or

(e) using the criteria for identifying separate performance obligations, as proposed in the exposure draft *Revenue from Contracts with Customers*.

Application to particular contract types

27. Some question how the proposals in the ED/DP would apply to particular contract types, in particular universal life contracts and unit-linked/variable contracts (Appendix C provides generic descriptions of these contracts).

Universal life

28. Some believe that explicit account balances in universal life contracts should be unbundled. However, they claim that universal life contracts that are not unit-linked or linked to a separate account[2] (termed non-variable universal life contracts in the rest of this series of papers) would not be unbundled under the proposals in the ED/DP, because they might not pass the entire investment return to the policyholder. We believe that some of those who believe that explicit account balances in universal life contracts should be unbundled do so because US GAAP currently requires unbundling of account balances. However, we do not think that *all* such respondents understood that the ED/DP proposal for unbundling is different from current US GAAP requirements,[3] in which universal

[2] Variable universal life contracts are a type of universal life contracts. The key feature that differentiates variable universal life contracts is that the return of a segregated pool of assets is credited to the policyholder (minus applicable fees). In the US, the pool of assets is segregated under regulation, and is not subject to the insurer's default risk on bankruptcy (it is called a 'separate account').

[3] For instance, under the ED/DP all the disclosures that apply to financial instruments would also apply to the separated account balances. Under current US GAAP, guidance on financial instruments does not apply to the unbundled account balances (for example SFAS 107 *Disclosure of information about fair value of financial instruments*). More importantly, the account balance would be measured under the current guidance on financial instruments rather than as in the forthcoming IFRS ED/FASB DP.

life contracts are unbundled for presentation purposes and are measured in accordance with that same guidance.

Unit-linked/variable contracts[4]

29. The ED/DP provided, as an example of a component that is not closely related, a specified account balance of a unit-linked insurance contract. This caused some respondents to question their understanding of the proposed ‘not closely related’ principle for unbundling the account balance from insurance contracts.

30. In particular, some were confused about the application of the ‘closely related’ principle to unit-linked contracts when the sum assured is dependent upon the value of the account balances in specified circumstances. In other words, the risk of loss depends on the joint effects of mortality risk and the price of the units. Consequently, some believe that the investment and insurance components would be closely related because this is analogous to an example of a closely related embedded derivative to a host insurance contract in IAS 39/IFRS 9. Paragraph AG33(h) of IAS 39/B4.3.8(h) of IFRS 9 states that an embedded derivative is closely related to a host insurance contract if the embedded derivative and the host contract are so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract).

31. Accordingly, respondents believe that the requirements of IAS 39/IFRS 9 and the proposals in the ED are contradictory.

[4] The IASB ED defined a unit-linked contract as:

“A contract for which some or all of the benefits are determined by the price of units in an internal or external investment fund (ie a specified pool of assets held by the insurer or a third party and operated in a manner similar to a mutual fund). In some jurisdictions referred to as a variable contract[sic].”].

Other long-term insurance contracts

32. Some respondents requested the boards to consider the unbundling of specific long-term insurance contracts, as follows:
    (a) deferred annuities; and
    (b) a plain-vanilla loan on which the outstanding balance is waived on death.

    Both of these contracts are discussed in further detail in Appendix A.

Stop loss contracts

33. Some asked the boards to clarify whether claims handling and payment services should be separated from an insurance contract. They noted that an insurer sometimes sells those services on a stand-alone basis. In addition, some respondents requested clarification on whether these services, when present in a separate contract, should be combined with a related but separate insurance contract.

Geographical differences

34. There were geographical differences in the feedback on unbundling, possibly due to different product designs. For example:
    (a) many in Europe were concerned that the unbundling proposals were too complex, possibly because they currently do not use unbundling for internal, regulatory or financial reporting purposes.
    (b) Some Australian responses support unbundling. We understand that:
        (i) unbundling is relatively straightforward for many of the unit-linked products sold in the Australian market, at least partly because some of the assets are required to be separately managed for regulatory purposes. Feedback indicates that they would prefer to continue that practice, because they see those contracts as being primarily an investment contract with an insurance rider. In the view of those

Australian respondents, unbundling both the asset management fees and the deposit component from those unit-linked insurance contracts provides useful information.

(ii) those unit-linked products are currently separated. The investment component are accounted for as financial instruments under IAS 32 *Financial instruments: Presentation*, IAS 39 and IFRS 7 *Financial Instruments: Disclosures* and the asset management fees are accounted for under IAS 18 *Revenue.*

(c) US respondents generally supported unbundling, but they believe that further clarification and implementation guidance is necessary for consistency in the application of the principles and for comparability among insurers. However, it is unclear whether some understood that the intention of the unbundling proposals in the ED/DP was not to carry over current unbundling requirements (discussed in paragraph 28).

35. Some recommend carrying forward the existing option in IFRS 4 *Insurance Contracts* to separate, in specified circumstances, investment components in specified circumstance so that those who currently unbundle would be allowed to continue to do so. Appendix E sets out the current requirements in IFRS 4 (and SFAS 97).

Context for the boards' decisions on unbundling

The boards' previous discussions

36. At their 21 March 2011 meeting, the boards implicitly rejected minimal unbundling of insurance contracts (ie unbundling components that have been included in the insurance contract for reasons that have no commercial substance) by tentatively deciding to carry forward current guidance to bifurcate embedded derivatives under US GAAP and IFRSs.

37. Some believe that the ED's/DP's proposals to bifurcate embedded derivatives produce more understandable information than not bifurcating them, for the following reasons:

    (a) *Separation adds transparency*. The values, and changes in values, of those embedded derivatives will be included with the insurance liability and in our view this is less transparent. There is signalling information when the carrying values, and changes in those carrying values, are attributed to derivatives. At a minimum, there should be information on the risks borne by the company (ie risks arising from specified derivatives versus insurance contracts).

    (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.

38. At that meeting, some board members expressed the view that the insurance 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 appropriate financial reporting standards (revenue recognition or financial instruments). Some are less likely to unbundle insurance contracts if there are no significant differences in measurement of the unbundled component under the building block model and the relevant guidance in IFRS and US GAAP in accordance with which the unbundled component is accounted for. When there are no significant measurement differences, some would still prefer unbundling, to achieve the objective of faithful presentation of the separated insurance and non-insurance components. This is particularly the case if gross premiums are recognised in the statements of comprehensive income.

39. We believe that 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, proposed in the ED/DP, reduces comparability of the unbundled contracts with those that are not unbundled. However, in our view, requiring unbundling for *all* long-term insurance contracts would be excessively costly, particularly when the investment component is implicit.

40. Some are also concerned that any unbundling criteria creates further opportunities for accounting arbitrage. A contract could be structured to achieve a desired outcome.

41. In addition, unbundling investment components raises the issue of cross-subsidies between the asset management services and insurance coverage, as discussed in paragraph 22(b)(i).

42. In contrast, *not* requiring unbundling of the investment and goods and services components may reduce the comparability of the financial information between insurers and non-insurers. We believe that the objective of unbundling is to increase comparability of financial information between insurers and non-insurers. Indeed, some may argue that this is the main driver for developing requirements for insurance contracts instead of for insurance entities. Consequently, we explored alternatives that would require the unbundling of investment and goods and services components' from some insurance contracts.

43. One alternative that was considered and rejected was confirming the ED/DP proposals. We note that 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 (as described in paragraphs 29-31);

(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 it 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 it applied to goods and services that are included with insurance contracts that have commercial substance.

44. One way of addressing the concerns in paragraph 43 is to provide guidance on when the economic characteristics and risks of the insurance component are not ‘closely related’ to the investment component. We do not recommend this because it would add to complexity by creating another interpretation of ‘closely related’, which would be located in a different place than for financial instruments. An alternative is to specify which types of insurance contracts should be unbundled, which we believe suffers from the same shortcomings.

45. The alternatives discussed in agenda papers 1D/66D and 1E/66E have differing advantages and flaws. We think that our recommendation in those papers result in the least amount of flaws of all the alternatives discussed.

Appendix A: Instruments that some respondents would like the boards to require or permit unbundling

Annuity Contracts

A1. Some respondents suggested that the proposals in the ED/DP would result in an accounting mismatch for some annuity contracts because the measurement of the insurance contract liability would change from period to period in a way that does not reflect the predictability of the cash flows.

A2. Under US GAAP, the accounting for annuity contracts is affected by the type of annuity contract, the premium payment terms, and the current status of the contract (i.e. accumulation phase vs. payout phase). The following section illustrates the difference between specific contract types and highlights feedback received on each:

(a) Immediate annuity contracts: An immediate annuity contract is a contract in which the policyholders pays a one-off premium at inception that ensures a guaranteed stream of payments over a specified period. For example, a policyholder might purchase an immediate annuity contract for CU 10,000 that guarantees that either he/she or his/her dependents will receive payments of CU 500 annually for the longer of (a) the policyholder's remaining life or (b) a period of 10 years from the inception of the contract. Under current guidance, premiums for this type of contract should be recorded as revenues, and a liability should be recorded at the amount approximating the present value of future annuity payments and expenses based on mortality, costs, and interest assumptions. Some respondents believe that the guaranteed annuity cash flows (i.e. for the minimum contractual payout period of 10 years) should be unbundled and measured at amortised cost.

(b) Deferred annuity contracts: The lifecycle of a deferred annuity contract is made up of two phases. Current accounting for the contract depends on where it stands in its lifecycle:

  (1) Accumulation phase: The accumulation phase is the period of time prior to the policyholder taking the necessary actions to trigger commencement of the cash outflows from the insurer to the policyholder as described in the annuity contract. This process is often referred to as annuitisation. The primary risk during this phase is that the insurer's investments will not generate a sufficient return to match the interest rate guaranteed to the policyholder in the contract (i.e. a financial risk). During this phase, an annuity is accounted for as an investment contract, meaning that premiums received are recorded as deposits (i.e. liabilities) and total accrued account balances are presented separate from the insurance liability.

  (2) Payout phase: This phase is sometimes referred to as the liquidation phase, and can be broadly defined as the period during which the policyholder receives benefits from the contract (i.e. the period post-annuitisation). At the point when the contract enters the payout phase, an element of mortality risk is introduced into the contract. That is, once annuitisation occurs, the insurer becomes obligated to make payments that will extend out potentially until the death of the policyholder. In general, contracts at this stage are accounted for as insurance contracts unless terms of the payout stipulate that the total cash outflows from the insurer will equal a known amount.

(c) Some respondents to the ED/DP, particularly U.S. insurers, indicated concern that they might have to account for deferred annuities in the

accumulation phase as insurance contracts based on the proposals for unbundling in the ED/DP. These respondents commented that, because the building block approach requires contracts to be assessed in their entirety, deferred annuities would no longer be broken apart based on whether or not annuitisation has occurred and insurance accounting would apply to the entire contract. For these respondents, unbundling guidance might determine as to whether or not their current practice should or should not continue.

(d) Some annuity contracts provide for a minimum payout and also pass on to the policyholder a portion of any excess earnings credited to their account. Following this feature, the insurer's liability could be interpreted to consist of both a fixed and variable component, which might introduce opportunities for insurers to structure such products to achieve a desired accounting result. Some might argue that the true nature of the liability is that of (a) a known liability for the account value (b) an insurance liability based on the annuitized amount that reflects mortality/morbidity for the estimated cash flows that will be paid out, and (c) a derivative instrument representing the variable cash flows that are dependent upon the insurer's investment performance. The Boards has tentatively decided to carry over the unbundling of embedded derivatives as currently required in IFRS and US GAAP, which leaves us with the account value and the insurance liability.

A3. However, some staff believes that unbundling for those contracts introduces complexity with little, if any, benefits.

(a) under the IFRS financial instruments requirements, the account balance (during the accumulation phase of the annuity) or the series of fixed cash

flows (when the annuity is in payout phase) is measured at fair value[5] at inception and subsequently measured at fair value or amortised cost;

(b) the insurer may be required to keep two systems to measure the non-insurance and insurance component; and

(c) transaction costs and other costs relating to the account balance will need to be determined so that these costs are not included in the building block measurement. Such requirements will introduce complexity.

A4. In our view, measuring the entire contract under the building block model provides better information than measuring the unbundled financial instrument at amortised cost and the non-insurance component under the building block model. This is because the economic mismatch is shown between the guaranteed return rate that is paid out and the market rate earned on the holding the investments.

A5. We believe that those supporting unbundling of annuities do so because the unbundled component with fixed contractual cash flows, and the assets held, could both be measured at amortised cost, so most insurance contracts could be unbundled in what would be, in our view, an artificial manner. Annuities and other insurance contracts can be unbundled in many ways to achieve a predetermined result and it would be arbitrary to determine where to draw the line in each case. 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.

[5] Fair value plus transaction costs if subsequently measured at amortised cost.

A6. Furthermore, we believe that that would be better to address the accounting mismatch concern in a more comprehensive manner and that unbundling will address only some of the accounting mismatch arising from those instruments.

Deferred annuities

A7. In regards to the concerns that the deferred annuities would be accounted for as an insurance contract under the ED/DP in the accumulation phase (discussed in paragraph A2(b)):

(a) In some cases, these contracts may not meet the definition of an insurance contract under the ED/DP during the accumulation phase, because the insurance risk is not significant. If so, those contracts will be accounted for as financial instruments. For example, if the option to annuitise is based on prevailing rates at the time the option is exercised, there is no insurance risk.

(b) However, sometimes there is insurance risk at inception when the insurer has guaranteed a minimum annuity rate. The contract transfers mortality risk at inception because the insurer may have to pay additional benefits for an individual contract if the annuitant elects to take the life-contingent annuity and services longer than expected. That insurance risk varies over the life of the contract depending on market performance versus guaranteed annuity rates, the value in the account balance and mortality rates. The insurer will have to judge whether the insurance risk is significant.

(c) If those contracts meet the definition of an insurance contract, then we believe that no 'special' requirements are needed (for eg unbundling). Treating the contract with all other insurance contracts provides comparable information across all long-term insurance contracts.

Loan waived on death

A8. Some respondents referred to a single insurance contract that combines a plain-vanilla loan with are contractual feature that waives the unpaid balance on death. We understand that these contracts tend to be issued by banking groups and may be a consequence of combining two separate contracts with the same policyholder at the consolidated basis. Those respondents recommended that this contract should be unbundled into a loan (accounted for as a financial instrument at amortised cost or using the fair value option) and an insurance component for the waiver (accounted for as insurance). However, we believe that a plain-vanilla loan that is waived on death of the policyholder is economically similar to a hybrid financial asset, because the insurer has, in effect, taken on more exposure to the credit risk of the policyholder for a fee. Requiring separation and measurement of the plain-vanilla loan at amortised cost would be inconsistent with the IASB's decisions in finalising IFRS 9 that hybrid financial assets should be measured in their entirety at fair value through profit and loss. Measuring the plain-vanilla loan that is waived on death of the policyholder under the current measurement model of the building block approach is consistent with that approach.

Appendix B: Relevant tentative decisions on other topics in this project

A9. At their 14 March 2011 joint meeting, the boards discussed the discount rate for insurance contracts that contain participating features. The boards tentatively decided to:

(a) clarify that the objective of the discount rate used to measure participating insurance contracts should be consistent with the discount rate used to measure non-participating insurance contracts; and

(b) provide guidance that to the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the insurer should adjust those cash flows using a discount rate that reflects that dependency.

A10. The boards have yet to decide on the presentation alternatives for the statement of comprehensive income, including whether to recognise any changes in the insurance liability (or asset) in other comprehensive income. The analysis and recommendations on separation in this paper are based on the presentation proposals in the exposure draft—a summarised margin approach and with all changes in the insurance liability shown in profit and loss. If the boards decide on different proposals, we intend to consider whether further analysis and alternative recommendations are needed.

Appendix C: Product descriptions

A11. Some insurance contracts contain features which represent different contractual relationships between the insurer and the policyholder. For example, traditional life insurance contracts have terms that are fixed and guaranteed, eg the policyholder pays a fixed premium in return for a guaranteed death benefit. Other life insurance contracts have terms that might be varied by either the policyholder or the insurer. These may include the following:

Deposits	Policyholder may vary the amount and timing of premium payments, within limits set by the contract
Interest credited	Insurer credits the policyholder balance based on fixed or variable rates
Loads	Insurer assesses the policyholder for agent or broker compensation and to cover certain administrative costs
Fees (Mortality and expense charges, cost of insurance, etc…)	Insurer assesses the policyholder for certain fees, typically based on the policyholder account balance
Account value withdrawn at surrender	Policyholder may withdraw a portion of their account balance based on their discretion, potentially within limits set by the contract
Account value withdrawn on death	The full account value is paid to the policyholders beneficiary upon death

Unit-linked/variable contracts

A12. Some think that unit-linked (sometimes termed variable) contracts should be unbundled. Such contracts typically have most or all of the following features:

(a) The premium received from the policyholder is used to buy units in a fund, in some cases after the insurer has deducted a front-end fee or a bid-ask spread.

(b) The unit price at any time reflects the fair value of the assets held in the fund, possibly adjusted for a bid-ask spread.

(c) Charges are deducted from the fund (as a whole) for investment management, administrative and other expenses and tax.

(d) Other charges are often made to a policyholder's account for insurance coverage (eg a fee for mortality protection), and perhaps also for contract administration and as a means of recovering acquisition costs. These charges are typically determined as a monetary amount; with units cancelled to provide that amount (the number of units cancelled equals the monetary amount, divided by the unit price). In some cases, the charges are levied by issuing special subclasses of units that do not pass through all investment performance (eg where 'capital units' are used as a means of recovering acquisition costs).

(e) Depending on the structure and legal setup, the assets in the fund may or may not be insulated from the insurer's other activities.

(f) A unit-linked contract may provide both unit-linked benefits and other non-unit-linked benefits (eg life coverage).

(g) Insurers often provide some guarantees related to the investment performance of unit-linked benefits. There may or may not be an explicit separate fee for the guarantee.

Universal life insurance

A13. A universal life contract is a type of flexible permanent life insurance offering the low-cost protection of term life insurance as well as a savings element (like whole

life insurance)[6], which is invested to provide a cash value build-up. The death benefit, savings element and premiums can be reviewed and altered as a policyholder's circumstances change. In addition, unlike whole life insurance, universal life insurance allows the policyholder to use the interest from his or her accumulated savings to help pay premiums.

A14. Universal life insurance was created to provide more flexibility than whole life insurance by allowing policyholders to shift money between the insurance and savings components of the policy. Premiums, which are variable, are broken down by the insurer into insurance and savings, allowing the policyholder to make adjustments based on their individual circumstances. For example, if the savings portion is earning a low return, it can be used instead of external funds to pay the premiums. Unlike whole life insurance, universal life allows the cash value of investments to grow at a variable rate that is adjusted monthly.

[6] An insurance contract that remains in full force and effect for the life of the insured, with premium payments being made for the same period.

Appendix D: Comparison of FASB Measurement Methodologies in Insurance Contracts vs Accounting for Financial Instruments

Comparison of FASB Measurement Methodologies in Insurance Contracts vs. Accounting for Financial Instruments

Note: The purpose of this analysis is to show the similarities and/or differences between the measurement approaches for liabilities in the insurance contracts project as compared with those in the Accounting for Financial Instruments project.

Description	*Insurance Contracts*	*Accounting for Financial Instruments*
Measurement Attribute	Current fulfillment value (does not consider credit risk)	Amortized cost, except in specific circumstances where FV- Net Income is required.** FV- OCI has not been ruled out, however no situation has yet been contemplated where such treatment would be appropriate for a financial liability.
Remeasured	Every Reporting Period	Amortized Cost- Remeasured every period only in that the balance is rolled forward to reflect principal payments, accretion or amortization of discount or premium, foreign currency translation adjustments, and writeoffs. Fair value would have to be remeasured every reporting period, whether through net income or OCI.
Change Through	Profit and loss	Amortized Cost- Not applicable FV- NI- Profit and Loss FV- OCI- Other Comprehensive Income
Acquisition Costs	Include in liability measurement***	Include in liability measurement
Time Value	Discount using rate reflects that characteristics of the liability	Generally not applicable for core deposits are presumably equal to the amount deposited and can be withdrawn at any time. Other financial liabilities, generally shown at face value or discounted using a rate deemed appropriate.

*Information below does not contemplate continuation of fair value option. That option would be allowed in limited circumstances and would require measurement of financial liabilities at fair value, remeasured every reporting period.
**These assets would be required to be measured at FV- NI in specific situations (i.e. if business strategy is to trade such liabilities which would only be the case for short sales of securities in this case, or for all derivatives).
***Tentatively, FASB has decided to include costs associated with only successful selling efforts, while IASB makes no distinction between successful and unsuccessful.

Appendix E: IFRS 4 and SFAS 97 requirements on unbundling

IFRS 4

A15. 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.

A16. 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.

A17. The unbundled deposit component is then measured under IAS 39/IFRS 9.

SFAS 97

A18. In US GAAP, insurance contracts are currently accounted for under SFAS 60 unless they have characteristics of certain contract types as identified in SFAS 97. SFAS 97 requires that an insurer account for a contract in a manner similar to that applied to a deposit component, and it applies to the contracts as described below:

(a) Investment contracts: "Investment contracts issued by an insurance enterprise... do not incorporate significant insurance risk as that concept is contemplated in Statement 60 and shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterprise shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

(b) Limited-payment contracts: Limited-payment contracts subject the insurer to risks arising from policyholder mortality and morbidity over a period that extends beyond the period or periods in which premiums are collected. For those contracts, the liability for policy benefits shall be established in accordance with the provisions of Statement 60. The collection of premium does not, however, represent the completion of an earnings process. Any gross premium received in excess of the net premium shall be deferred and recognized in income in a constant relationship with insurance in force (when accounting for life insurance contracts) or with the amount of expected future benefit payments (when accounting for annuity contracts).

(c) Universal life-type contracts are those with the any of the following features. Note that conventional forms of participating and nonguaranteed-premium contracts are excluded and should be accounted for under SFAS 60 and SFAS 120, respectively.

(i) "One or more of the amounts assessed by the insurer against the policyholder—including amounts assessed for mortality coverage, contract administration, initiation, or surrender—are not fixed and guaranteed by the terms of the contract.

(ii) Amounts that accrue to the benefit of the policyholder— including interest accrued to policyholder balances—are not fixed and guaranteed by the terms of the contract.

(iii) Premiums may be varied by the policyholder within contract limits and without consent of the insurer."

Appendix F: Measurement of Insurance Contract Liability (SFAS 60) vs. Deposit Component (SFAS 97)

A19. The purpose of this illustration is to highlight differences in the measurements required by SFAS 60, *Accounting and Reporting by Insurance Enterprises* and SFAS 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. Although required presentation is a major difference between the two standards, contracts are measured differently under each standard. Under SFAS 60, the entire liability and the related movements in the liability are attributed to the insurer and are therefore reflected in the financial statements. Under SFAS 97, the insurer shows the accumulated balances in the participants' accounts as deposits, while the only related movements that are attributable to the insurer are fees and expenses. The interest credited to the account balance offsets investment income, and is typically not shown in the statement of comprehensive income.

Statement of Comprehensive Income	
SFAS 60	SFAS 97
+ Premiums*	+ Mortality charges*
+ Investment income	+ Expense charges*
- Increase in reserves*	+ Surrender charges*
- Benefit claims incurred*	+ Amortization of deferred revenues*
- Policy maintenance expenses	+ Investment income
- Amortization of DAC	- Interest credited to account balances
	- Benefit claims incurred in excess of account balances
	- Policy maintenance expenses
	- Amortization of DAC
= Pre-tax income	= Pre-tax income

*The inclusion of this item differs from the measurement calculation under the other standard (i.e. SFAS 60 vs. SFAS 97).

Statement of Financial Position	
SFAS 60	SFAS 97
Reserves at beginning of year	Account value at beginning of year
- PV** of net premiums ***	+ Deposits (premiums received)
+ PV** of mortality and morbidity expenses	+ Interest credited
+ PV** of termination (lapses and surrenders)	- Loads
+ PV** of maintenance expenses	- Fees (mortality and expense charges, cost of insurance, etc.)
+ PV** of policyholder dividends	- Account value withdrawn at surrender or death
= Reserves at end of year	= Pre-tax income

**All assumptions are locked-in at the inception of the contract. Discount rate based on estimated pre-tax investment yields (net of related investment expenses) expected at the contract issue date, adjusted for adverse deviation (.25% to .50% is common).

***Net premiums are a portion of the premium to prevent gain at issue calculated as follows: PV gross premiums X (PV of benefits & maintenance expense / PV of gross premiums at issue.

Appendix G: Unbundling under current US GAAP for contracts issued by insurance entities

Applicability of Unbundling Guidance to Common Contracts issued by Insurance Entities under US GAAP

#	Contract Type	Potentially Separable Component	Unbundle Account	Explanation	Today's Accounting
1	Term life	None	N/A	There is no savings or investment component in a term life contract.	Nothing unbundled
2	Whole life	Cash Surrender Value	No	There is no savings or investment component in a whole life contract, but holders do accumulate a cash surrender value ("CSV"). The CSV is fully susceptible to insurance risk, as there is no distinction between funds used to fund the death benefit and participants' account balances . The CSV is a communication to the holder of how much of their account balance they're entitled to in the event they wish to surrender the contract early, thereby foregoing their right to any insurance coverage. Generally, there are significant fees and/or penalties charged to the holder in the event that he/she surrenders the contract.	Nothing unbundled
3	Fixed annuity	Cash Surrender Value	No	Refer to explanation above for whole life contract. Insurance risk is established on the date that the contract is annuitized. The holder receives a stated rate of return each year, and the death benefit is known at inception. Although CSV accumulates, funds are not separated from the insurers' general asset pools. As in whole life contracts, insurers seek to discourage surrender by charging significant fees and/or penalties to process such transactions. The accounting for annuities differs depending on the specific type of contract and whether it is in the accumulation or payout phase, as outlined below:	Refer to below for details. Varies by contract type.
		Account balance	No	Immediate annuity contracts*:* one-time premium paid at inception to guarantee a stream of future payments. There is no CSV in this type of contract because there is no accumulation phase; rather the insurer is obligated to make payments starting at inception because annuitisation takes place on that date. Insurance risk is present in that the terms of these contracts often specify that payment will extend out for the longer of a specified period or the policyholder's remaining life. If the amount of the payout is known at inception (i.e. amount is not dependent upon the duration of the policyholder's life), then the contract is accounted for as an investment contract.	Generally, nothing unbundled. When payment is for a known amount, accounted for as investment contract.

Applicability of Unbundling Guidance to Common Contracts issued by Insurance Entities under US GAAP

#	Contract Type	Potentially Separable Component	Unbundle Account	Explanation	Today's Accounting
				Deferred Annuity Contracts: premiums are generally paid by the policyholder over a specified period ("accumulation phase"), after which the insurer is obligated to pay to the holder a stream of payments as specified in the contract ("payout phase").	Refer to below for details. Varies based on stage of contract.
		Account Balance and/or Cash Surrender Value	No	*Accumulation phase*: period during which the policyholder makes premium payments that will entitle him/her to stream of payments. Once all premiums have been paid, the contract is annuitized and the payout phase begins. During the accumulation phase, the policyholder accumulates a CSV and is generally credited with interest income at a guaranteed minimum rate. Insurance risk is not present during this phase because the policyholder is entitled only to their CSV, without regard to any sort of mortality element.	Contract accounted for as an investment contract.
		None	N/A	*Payout Phase:* period subsequent to annuitisation when the policyholder is being paid by the insurer per the terms of the contract. During this phase the insurer is subject to insurance risk, as the contract often specifies that the payout term will extend out to the longer of a specified period or the policyholder's remaining life. There is no CSV during this phase; rather the policyholder at this point is entitled to the stream of payments specified in the contract. In some circumstances, the payout is specified to be a fixed dollar amount or number of payments. In that circumstance, the contract is void of insurance risk, and is accounted for as an investment contract. Contracts with these payment terms are far less common than those that contain an element of insurance risk, as identified above.	Generally, nothing unbundled. When payment is for a known amount, accounted for as investment contract.

Applicability of Unbundling Guidance to Common Contracts issued by Insurance Entities under US GAAP

#	Contract Type	Potentially Separable Component	Unbundle Account	Explanation	Today's Accounting
4	Equity-indexed annuity	Cash Surrender Value & Embedded Derivative	No	This type of contract acts in much the same way as a fixed annuity, however investment returns are tied to a specific index as indicated in the contract (e.g. S&P 500, FTSE, etc...). In this type of contract, the account balance is tied to an index only during the accumulation phase (as described above). During this phase, the contract is accounted for as an investment contract. During the payout phase, the accounting is the same as that identified above for a fixed annuity in the payout phase.	Contract accounted for as an investment contract during accumulation phase. During payout phase, accounted for as insurance contract with nothing unbundled. When payment is for a known amount, accounted for as investment contract.
5	Universal life	Account Balance	Yes	Pure insurance protection, related expenses, and mortality elements are separately and specifically defined. That is, each stands on its own and is largely unaffected by the actions of the insurer. In a universal life contract, the holder has considerable flexibility in determining the timing and amount of premium payments, so long as the balance in the account is sufficient to cover costs associated with provision of the death benefit and other administrative expenses. The account balance generally earns a guaranteed rate of return. Should the insurer earn a return higher than the guaranteed rate, it can allocate the excess to participants or retain the excess at its discretion.	Account balance unbundled and accounted for as financial instrument.

Applicability of Unbundling Guidance to Common Contracts issued by Insurance Entities under US GAAP

#	Contract Type	Potentially Separable Component	Unbundle Account	Explanation	Today's Accounting
6	Variable universal life	Account Balance and/or Separate Account*	Yes	This type of contract is substantially similar to a universal life contract, with the added feature that the participant takes on all investment risk in that they allocate their account balance to different investments with the aim of attaining a higher rate of return than they would by simply collecting a guaranteed interest rate from the insurer.	Account balance unbundled and accounted for as financial instrument.
7	Variable life	Separate Account*	Yes	In this type of contract, investment risk is passed entirely to the holder of the contract, as he/she chooses how to allocate funds in the account. Cash values are not guaranteed, and the holder is responsible for making up any shortfall in the balance of the account or he/she risks having the death benefit reduced or the policy lapse. The death benefit generally cannot fall below a contractually specified amount, however it, along with allocations to the savings element and the amount of premiums, can be reviewed and altered as a policyholder's circumstances change. In addition, unlike whole life insurance, universal life insurance allows the policyholder to use the interest from his or her accumulated savings to help pay premiums.	Account balance unbundled and accounted for as financial instrument.
8	Variable annuity	Separate Account*	Yes	This type of contract is similar to a variable life contract, except that instead of providing for a specific method of payout policyholders make withdrawals at their discretion. Consequently, this type of contract does not ever annuitize; rather, it is always in the accumulation phase meaning the account balance is accounted for under financial instrument guidance.	Account balance unbundled and accounted for as financial instrument.
8(a)	Variable annuity with GMxB* rider	Separate Account* & Embedded Derivative	Yes	The account balance in a variable annuity with GMxB rider is likely to be unbundled for the reasons described above. Further unbundling may be required if it's determined that the GMxB rider constitutes an embedded derivative, which is the case for GMAB and GMWBs (see below for definitions).	Account balance unbundled and accounted for as financial instrument. GMABs and GMWBs are unbundled and

Applicability of Unbundling Guidance to Common Contracts issued by Insurance Entities under US GAAP

#	Contract Type	Potentially Separable Component	Unbundle Account	Explanation	Today's Accounting
					accounted for as embedded derivatives.
9	Guaranteed investment contracts		Yes	Insurance risk is entirely absent in an investment contract. There is no mortality/morbidity component. Rather, the risk taken on by the insurer is purely investment-related.	Contract accounted for as an investment contract.

*****A separate account is an account that is legally restricted and is held separate and apart from the insurers' general asset pool.

**A GMxB rider is an added feature to a contract that guarantees any of a number of benefits to the holder. Some GMxB riders are unbundled as embedded derivatives. The four common GMxB riders are as follows:

GMDB: Guaranteed Minimum Death Benefit (Guarantees the account value will not go below a specific amount. This rider is not unbundled.)

GMIB: Guaranteed Minimum Income Benefit (Guarantees a minimum payment stream at annuitisation. This rider is not unbundled by the direct writer under US GAAP because it is not net settled, however it generally would be unbundled by a reinsurer as an embedded derivative)

GMAB: Guaranteed Minimum Accumulation Benefit (Guarantees that a minimum balance will be accumulated by a specified date. This rider is unbundled as an embedded derivative.)

GMWB: Guaranteed Minimum Withdrawal Benefit (Guarantees that a specific amount will be available for withdrawal over a specific period. This rider is unbundled as an embedded derivative.)