IASB/FASB Meeting
4 May 2011

IASB Agenda reference	**1E**
FASB Agenda reference	**66E**

Staff Paper

Project	**Insurance contracts**
Topic	**Unbundling investment components**

What is this paper about?

1. This paper considers when insurers should be required to separate (ie unbundle) an investment component from an insurance contract. More specifically, this paper considers:

   (a) What do we mean by an investment component?

   (b) What criteria should be considered for separating the investment component from an insurance contract?

   (c) Once separated, should the investment component be recognised and measured in accordance with the financial instrument requirements in IFRSs or US GAAP?

2. Agenda paper 1C/66C provides background information to support the discussion in this agenda paper, including the proposals in the IASB Exposure Draft (ED) *Insurance Contracts* and the FASB Discussion Paper *Preliminary Views on Insurance Contracts* and the feedback received on those proposals.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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Staff recommendation

3. We recommend that:

   (a) explicit account balances in insurance contracts that meet specified criteria should be unbundled. The specified criteria are adapted from those that are being developed for identifying separate performance obligations in the revenue recognition project (discussed in paragraphs 18-28);

   (b) if the account balance meets the specified criteria, that component should be accounted for in accordance with the relevant requirements for financial instruments in IFRS/US GAAP.

Staff analysis

What is the investment component?

4. As discussed in agenda paper 1C/66C, all long-term insurance contracts have a savings/deposit/investment feature and a protection for risk feature. Some insurance contracts have an explicit account balance, a larger number of contracts have a cash surrender value and most contracts have an implicit account balance.[1] Which of those should the boards consider separating? Appendix C of Agenda paper 1C/66C considers features of some life insurance contracts and potential investment components.

[1] Cash surrender value is a form of an implicit account balance. The cash surrender value may be different from the explicit account balance, mostly because of surrender charges, and potentially any policy loans. A policy loan is an amount that a policyholder can borrow at interest from the insurer, up to the cash surrender value. In the event of the policyholder's death while the loan is outstanding, any remaining balance (including accrued interest) is deducted from their death benefit. We intend to consider in a future meeting whether this and other contract riders should be unbundled from an insurance contract.

Explicit account balances

5. Explicit account balances are regularly communicated to the policyholder. For explicit account balances, the insurer credits an explicit return based on the value of the account balance. The insurer may have the ability to vary the fees and assessments that are charged. The policyholder may have to withdraw cash and pay for insurance coverage, depending on the contract terms.

6. We recommend that the boards should consider unbundling only explicit account balances, because it provides more useful information and is more pragmatic than also unbundling implicit account balances. We do not think that considering unbundling implicit account balances and in particular, cash surrender values is a viable option (discussed in paragraphs 7-14).

Implicit account balance

7. An implicit account balance can be derived by, for example, discounting an explicit maturity value and any returns at a rate not explicitly stated in the contract. For example, take the example of a 20-year life insurance contract that pays out CU10,000 on death, with annual fixed premiums of CU400. An implicit account balance could be derived by calculating the present value of CU10,000 from the period where death is expected to occur using a risk-free discount rate. This could be seen to represent the cost of choosing to 'invest' in an insurance contract instead of in a savings account. How would you measure the insurance component? Is there anything else to measure? We think that unbundling in this situation does not faithfully represent the insurance contract—the policyholder has entered into the contract to protect its beneficiaries from mortality risk and not because of the investment returns offered by the contract.

8. We think that performing an extensive search for an implicit account balance would be onerous for insurers.

Cash surrender value

9. Some consider cash surrender values to be an implicit account balance. In some life insurance contracts, policyholders accumulate a cash surrender value ('CSV') which is reported to the policyholder. This is the most common and simple form of an 'account balance' that is refundable. The CSV is the amount of cash that may be realised by the owner of a life insurance contract or annuity contract upon discontinuance and surrender of the contract before its maturity. On surrender, the policyholder forfeits rights to insurance coverage and to the benefits provided by the existing contract, such as not being required to be re-underwritten.

10. The cash surrender values is affected by the passage of time and surrender values in varying degrees depending on the facts and circumstances. In addition, sometimes the cash surrender value incentivises the policyholder to maintain the contract in force.

11. Some contracts offer policyholders the option of surrendering only a part of their contract. A partial surrender is a surrender of less than the full insurance coverage. While such transactions do not entirely relieve the insurer of its insurance risk, they do require a policyholder to reduce the amount of the death benefit. Even in a partial surrender, therefore, an insurer is relieved of at least a portion of the insurance risk associated with a contract.

12. Some equate the cash surrender value to a certificate of deposit (CD), which, if cashed in early provides the investor with less than the full value of the CD.

13. As another simple example, take a 20-year life insurance contract that pays out CU10,000 on death with annual fixed premiums of CU400. The contract has a cash surrender value at the end of the 20 years of CU10,000. A present value of the cash surrender value at the end of the 20 years can be determined on inception. The residual, ie the insurance component, can be viewed as a written put option for CU10,000 contingent on death. How useful would it be to represent that insurance contract as the present value of the surrender value and the value of the written contingent put option under the building block model? Policyholders

typically enter into these contracts primarily for the insurance coverage. Unbundling the insurance contract in such a way would portray the investment risk of the contract as disproportionately larger than the insurance risk. We do not think that this is a faithful representation of the contract.

14. We do not recommend separating implicit account balances such as cash surrender values, because we think it would not faithfully represent the insurance contract and the process of identifying and measuring all implicit account balance would be onerous for insurers.

Question 1—unbundling investment components
Do the boards agree to consider unbundling only explicit account balances (as described in paragraph 5)?

15. The following section considers which explicit account balances should be unbundled and how those explicit account balances should be measured.

Criteria for unbundling explicit account balances

16. We believe that the boards have the following viable alternatives:

    (a) unbundle explicit account balances and account for those in accordance with the requirements for financial instruments in US GAAP and IFRSs (*'Alternative A'*).

    Under Alternative A, the boards could decide to unbundle:

    (i) account balances that meet criteria that have been adapted from those that are being developed in the revenue recognition project for identifying separate performance obligations (*'Alternative A(i)'*)

    (ii) explicit account balances that are credited with all the investment performance, after deducting fees, of a unit-linked, index-linked or market-based interest rate (*'Alternative A(ii)'*)

(iii) *all* explicit account balances (*'Alternative A(iii)'*); or

(b) unbundle all explicit account balances and measure them at face value ('*Alternative B*').

Staff recommendation

17. This section discusses the staff's recommended choice—Alternative A(i). Paragraphs 29-39 discusses the other alternatives: A(ii), A(iii) and B.

Alternative A(i)—criteria based on the revenue recognition model

18. In the revenue recognition project, the boards recently tentatively decided on criteria for identifying separate performance obligations. Those criteria were based on whether or not the separate performance obligations were integrated. For insurance contracts, the staff have interpreted this notion of integration as referring to whether the value of the account balance affects the insurer's insurance risk exposure.

19. The following table sets out how the criteria for identifying separate performance obligations in the revenue recognition project could be modified to identify and unbundle specified explicit account balances from insurance contracts.

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 under the building block model 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

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
	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)).
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.
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

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**
	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).

20. The appendix provides examples of the application of the above criteria to some insurance contracts. As illustrated in that appendix, these criteria would result in:

    (a) unbundling of insurance contracts such as unit-linked investments with basic life insurance cover, if the life cover is independent of the account balance. Reporting such contracts as a financial instrument and a separate insurance component more faithfully represents the risks under that contract, because the insurance risk is not affected by the financial risks of the account balance. In addition, it would be relatively straightforward to separate and to measure the insurance component under the building block model and to measure the account balance at fair value under the financial instruments requirements.

    (b) no unbundling for some unit-linked contracts that are integrated products. The insurance risk is affected directly by the investment performance of the account balance. In this case, the insurance and investment component are integrated.

21. We believe that the principles that have been developed, which are based on those used in the revenue recognition project for identifying separate performance obligations, appropriately result in separating accounting balances when they are not integrated and have distinct risks. On the other hand, if the insurance risk from the insurance component and the financial risks from the account balance are

unconnected, we think that it is more faithfully representative to separate those account balances.

22. This is similar to the requirement under financial instruments guidance where embedded derivatives are bifurcated if the economic characteristics and risks are closely related to the host instrument. If the insurance risk from the insurance component and the financial risks from the account balance are unconnected, we think it is more faithfully representative to require the separation of those account balances. However, as discussed in agenda paper 1C/66C, there are issues with using the 'closely related' criteria for insurance contracts and therefore, we do not recommend going forward using that criteria.

23. In addition:

    (a) the advantage of modifying the revenue recognition criteria is that, under those criteria, once a contract has been identified as providing an integrated product, the entity need not do any further analysis as to whether a distinct performance obligation exists.

    (b) there is the added benefit that the unbundling of investment components would be consistent with the staff proposals in Agenda paper 1D/66D that the criteria that are being developed in the revenue recognition project for identifying separate performance obligations should be applied when determining whether goods and services components should be separated from insurance contracts. Those proposals would result in the unbundling from some unit-linked/variable insurance contracts of asset management services, where the performance of the assets affects insurance risk (as analysed in the examples in the Appendix to agenda paper 1D/66D).

24. We cannot see any compelling reason why similar principles that apply to the separation of performance obligations in revenue recognition and to the separation of goods and services from insurance contracts should not apply also to the separation of account balance components from insurance contracts. Having consistent requirements reduces complexity and may increase the understandability of the information produced. Our plan is to consider for a future meeting all the tentative decisions on unbundling made by the boards as a package to check for any inconsistencies.

25. Furthermore, we think that applying the principles that are being developed in the revenue recognition project results in intuitive and understandable results. While, theoretically, application of the principles may result in the unbundling of an explicit account balance but not of an asset management fee (or vice versa), we think that this is highly unlikely. The decision to separate asset management fees is dependent upon whether the risks arising from the assets interact with the insurance risks.

26. We think that any shortcomings or concerns about the separation requirements proposed in this paper would apply equally to the more general case in revenue recognition, and should therefore be considered more generally[2].

27. Furthermore, if the boards were to develop different criteria for the separation of account balance components from insurance contracts than for revenue recognition, we believe that there are further implications. In particular, would those alternative criteria be superior and whether those alternative criteria should also be extended to apply more generally.

28. A disadvantage of this alternative is that there is not a single treatment for all specific types of insurance contracts with an explicit account balance. For example, the account balance of some universal life contracts would be unbundled

[2] We understand that the revenue recognition team are working to clarify the boards' intent. We will consider whether further guidance may also be needed in the insurance requirements to clarify the application of those principles to insurance contracts.

depending on whether the value of the account balance affects insurance risk. We acknowledge this disadvantage, but, as stated in agenda paper 1C/66C, all the alternatives have flaws. We recommend this alternative because we think the pros outweigh the cons marginally more than is the case for the other alternatives discussed below.

Other alternatives

Alternative A—unbundle explicit account balances and account for them under the financial instruments guidance under US GAAP and IFRS

29. As noted in paragraph 16(a), under this alternative, the boards could decide to unbundle:

    (i) explicit account balances that meet criteria that have been adapted from those that are being developed in the revenue recognition project for identifying separate performance obligations;

    (ii) explicit account balances that are credited with all the investment performance, after deducting fees, of a unit-linked/variable, index-linked investment option or market-based interest rate; or

    (iii) *all* explicit account balances.

30. We have already discussed Alternative A(i) in paragraphs18-28.

31. Alternative A(ii) would unbundle explicit account balances from insurance contracts when all the investment performance is simply forwarded to the policyholder after deducting fees and charges. This alternative would improve comparability with similar contracts issued by other financial services providers that return the performance of the specified pool of assets in a fund, an index or market-based interest rates.

32. Under Alternative A(iii), an explicit account balance is unbundled regardless of the type of insurance contract. For example, some participating insurance

contracts have an explicit account balance and some do not. This alternative would require unbundling of those contracts that have an explicit account balance. The account balance would then be accounted for under the relevant requirements for financial instruments under US GAAP and IFRSs. The insurance component would consist of the obligation to provide the benefit on an insured event together with the participation feature.

33. We do not recommend Alternatives A(ii) and A(iii) because we believe that unbundling those account balances provides a less faithful representation when the value of those account balances affects the insurance risk because it presents the insurance component as unconnected to the value of the investment component. In addition, a disadvantage of Alternative A(iii) is that it separates based on form, ie the presence or absence of an explicit account balance, rather than on an underlying characteristic of the contract.

Alternative B—unbundling explicit account balances and measure them at face value

34. Some believe that the boards should consider unbundling an explicit account balance that is present in an insurance contract and measuring that unbundled component at face value. The account balance would be accounted for in the same way as a core deposit is measured and accounted for by a bank under US GAAP (this would therefore be consistent with Alternative A(iii) for US GAAP only). This alternative is consistent with current requirements in US GAAP on the separation of some life insurance contracts, in particular universal life contracts. However, under IFRSs, the measurement of the deposit liability may not be consistent with current guidance on financial instruments.

35. This alternative would only be operational if an explicit account balance is defined with the features discussed in paragraph 5.

36. Under this alternative:

    (a) *all* insurance contracts with explicit account balances would be unbundled.

    (b) the account balance would be reported as a deposit liability, as follows

(i) Premiums received from the policyholder would be added to the deposit liability and would not be reported as revenues.

(ii) All other charges against the account balance, no matter how they were characterised, would be included in the expected cash flows in the building block model for the insurance components.

(iii) Credits by the insurer to the account balance would be reported as interest expense in the profit and loss statement.

(iv) The deposit liability would be accounted for at face value.

The following table illustrates this approach.

Expected present value of the cash flows included in the insurance liability:	**Face value of the account balance**
+ PV of death benefits	Account value at beginning of year
+ PV of other fulfilment costs and acquisition costs	+ Deposits (premiums received)
+ PV of policyholder dividends	+ Interest credited
- PV of all fees/charges	- Fees and charges (mortality and expense charges, cost of insurance, etc.) - Amounts withdrawn from account
It would not include: 1) Future premiums 2) Interest charges	= Account value at the end of the year (reported in the statement of financial position as a deposit liability)

37. This alternative would not unbundle individual charges against the policyholder's account, eg asset management services. Proponents of this approach argue that the charges for services sometimes subsidise other contract flows that are included in the insurance contracts model. If so, unbundling a charge based on market rates would distort the remaining measurement of the insurance liability. For the same reason, the insurer would include all specified acquisition costs for the bundled contract in the expected cash flows of the building block model.

38. Those who support Alternative B argue that unbundling the explicit account balance is a pragmatic way of separating investment components from insurance contracts because they think that:

    (a) It is simple and objective. Insurers need not go through an analysis of every product to prove that they should or should not unbundle. The contract either has an explicit account balance or it does not.

    (b) It avoids the arguments about cross-subsidies between different charges (including surrender charges) against the customer account by including them all in the insurance model.

    (c) It requires only small changes to current accounting systems. At most, an insurer might have to integrate the policyholder accounting system with the financial reporting system.

    (d) A similar model has worked well in US GAAP for over 20 years. This suggestion is a simplified version of current guidance in US GAAP for universal life contracts.[3]

    (e) It provides the best available measurement of the investment element of a long-duration contract. There is no non-arbitrary way of achieving this.

39. However, we think the same shortcomings are likely to apply as for unbundling to different standards —lack of comparability between insurance contracts, and complexity. We do not recommend this alternative because:

    (a) It places form over economic substance. The criterion for unbundling is the presence of an explicit account balance, rather than an underlying characteristic of the contract.

    (b) Under IFRSs, this alternative does not achieve the objective of unbundling, which is to treat a separated financial instrument component consistently with other financial instruments. We question the

[3] The complexity in Statement 97 came from the scheme for amortising deferred acquisition costs, not from using the policyholder account as the liability measurement.

information value of separating explicit account balances without requiring those account balances to be treated in the same way as other financial instruments

Question 2—unbundling explicit account balances based on criteria that are being developed in revenue recognition
Do the boards agree that explicit account balances in insurance contracts should be separated from an insurance contract in accordance with criteria based on those used for identifying separate performance obligations that are being developed in the revenue recognition project (in paragraphs 18-21)?

Question 3—measuring the unbundled account balances
Do the boards agree that, once separated, those explicit account balances should be recognised and measured in accordance with relevant requirements for financial instruments in IFRSs/US GAAP?

Further discussions

40. The IASB's ED indicates that 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 to another component, rather than as part of the investment component.

41. On the basis of the boards' tentative decisions at this meeting, the staff will discuss at a future meeting the allocation of charges and fees to the various components.

42. In addition, further guidance may be needed on the treatment of products with more than one balance. The starting point for the guidance could be the questions that were commonly received during outreach, field tests and comment letters.

Appendix: Separating explicit account balances from insurance contracts based on the criteria being developed in separating performance obligations

Examples	**Applying the developed criteria based on those being developed for identifying separate performance obligations in the revenue recognition project**
Example 1 A unit-linked/variable 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. 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 mixture of bonds and equity	*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?* 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 policyholder's investment return is

Examples	Applying the developed criteria based on those being developed for identifying separate performance obligations in the revenue recognition project
investments. (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[4] 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.	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.

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

Examples	**Applying the developed criteria based on those being developed for identifying separate performance obligations in the revenue recognition project**
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. On death, the insurer is on risk for the difference between CU100,000 and the value of the invested units, if the value of the units is below CU100,000.	*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.