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STAFF PAPER

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Project	**Insurance Contracts**		
Paper topic	Separation of Investment Components from Insurance Contracts – Statement of Financial Position Presentation		
CONTACT(S)	Christopher Irwin	cgirwin@fasb.org	+1 203 956 3468
	Andrea Silva	alsilva@fasb.org	+1 203 956 3445
	Jennifer Weiner	jmweiner@fasb.org	+1 203 956 5305
	Izabela Ruta	iruta@ifrs.org	+44 20 7246 6957
	Joanna Yeoh	jyeoh@ifrs.org	+44 20 7246 6481

What is this paper about?

1. This paper discusses whether the statement of financial position should disaggregate as a separate line item amounts relating to the investment component, and how such an investment component might be determined.

2. This paper is the third paper of a three paper series addressing separation of investment components from insurance contracts and should be considered together with papers 2F/81F and 2G/81G.

Summary of staff recommendation

3. The staff recommend that:

   (a) insurers should not be required to present in the statement of financial position investment components separately from the insurance contract,

(b) insurers should disclose both

   (i) the portion of the insurance contract liability that represents the aggregated portions of premiums received (and claims / benefits paid) that were excluded from the statement of comprehensive income pursuant to the recommendation in agenda paper 2G/81G and

   (ii) the amounts payable on demand.

Staff analysis

4. As noted in agenda paper 2F/81F, we have assumed for this series of papers that the boards have adopted a disaggregation approach rather than an unbundling approach to achieve the primary objective of determining the total aggregate premiums recognized in the statement of comprehensive income. This means that the insurance contract as a whole would be measured using the insurance contracts model, with a portion of the value allocated to the separated investment component and a portion allocated to the insurance component.

5. In paper 2G/81G we recommend that insurers should exclude from the statement of comprehensive income an amount of premium or other consideration received related to investment components. However, once it is determined which investment component should be separated from the insurance contract liability as a means to determine premium to recognize on the statement of comprehensive income, the questions remain as to whether the investment component should be presented separately from the insurance component in the statement of financial position.

6. In addressing this question the staff first reconsidered the primary objective of separating investment components from insurance contracts, which as stated in agenda paper 2F/81F, is presumed to be Objective (a) (ie, as a means to determine total aggregate premiums recognized in the statement of comprehensive income). Accordingly, the conclusion as to how to present the investment component on the statement of financial position does not affect the achievement of that

objective nor is it necessarily dependent on the conclusions reached related to the statement of comprehensive income.

7. The staff considered whether the investment component should be presented as a separate line item in the statement of financial position in a manner that maximizes cohesiveness with the statement of comprehensive income presentation. In other words, the staff considered whether the amount presented as a line item in the statement of financial position should reflect the aggregated portions of premiums received that were excluded from the statement of comprehensive income pursuant to the recommendation in agenda paper 2G/81G. Such separate presentation within the statement of financial position of the investment component and the insurance contract liability would be more easily reconcilable with the premium and claims and benefits performance measures included on the statement of comprehensive income. However, the staff believes that this would mean that at least one of the two line items on the balance sheet might often not be meaningful. As a result, there would be impaired comparability of both:

   (a) the investment component, which would often be presented in an amount that differs from the measurement of comparable freestanding financial instruments because (depending on the product) it would often not represent either the amount payable on demand (i.e., differentiating it from demand deposits), or the account balance (i.e., differentiating it from mutual funds).

   (b) the insurance components because those components would reflect cash flows that are not clearly unrelated to the investment component (e.g., related to guarantees, acquisition costs, and management fees).

8. Accordingly, the staff do not recommend that the boards' be guided by an objective of maximizing cohesiveness with the statement of comprehensive income presentation when deciding whether to present separately any investment components.

9. The staff next considered whether the boards might want to base the statement of financial statement presentation of investment components on guidelines and principles that are designed to achieve one of the secondary objectives identified in agenda paper 2F/81F. These two objectives, *to improve statement of financial position comparability* (Objective (b)) and *to provide users with a liquidity measure* (Objective (c)) are both inherently more statement of financial position oriented. The staff have considered whether there should be disaggregation of the investment component determined as follows:

   (a) on an amortized cost basis (Alternative (a)),

   (b) on a fair value basis (Alternative (b)),

   (c) in an amount equal to the account balance (Alternative (c)),

   (d) at the *current* amount payable on demand (Alternative (d)),

   (e) using the insurance contracts model (Alternative (e)), and

   (f) no required separation in the statement of financial position (Alternative (f)).

10. Each of the Alternatives (a) through (f) assume the contract meets the definition of an insurance contract and measures the whole contract using the insurance contract model. Any insurance component is defined as the residual after determining the investment component, ie as the difference between the overall contract measurement and the amounts described above for the investment component (for Alternatives (a) through (d)). Thus the aggregate for the insurance and investment components equals the measurement of an equivalent contract without the investment component separated. In addition, each of these alternatives will ensure the contract measurement reflects all of the estimated cash flows (e.g., those resulting from embedded options and guarantees not meeting the requirements to be bifurcated and measured separately) the boards have tentatively concluded should be included in the measurement of insurance contracts.

11. The staff notes that none of these alternatives would be cohesive with the statement of comprehensive income amount, however, as noted in paragraph 7, the staff rejected an objective of cohesiveness for determining which alternative to favour. Each alternative would require a separate determination of the carrying amount of the investment component, though we also note that some alternatives would use readily available information and thus may not be costly to produce.

12. The staff have summarized advantages and disadvantages of each of these alternatives in Appendix A.

13. Based on the advantages and disadvantages of each of the six alternatives included in the appendix, the staff believe that the most viable alternatives are:

    (a) Alternative (c), *separately presenting the investment component in an amount equal to the account balance* (because it is broadly consistent with current practice for some contracts);

    (b) Alternative (d), *separately presenting the investment component in an amount equal to the amount currently payable on demand* (because of its potential to achieve Objective (c)[1]);

    (c) Alternative (e), *presenting the investment component in an amount determined using the insurance contracts model* (because it uses the same basis to determine the two components); and

    (d) Alternative (f), *no required separation in the statement of financial position* (because of the disadvantages of each of the other alternatives).

14. The analysis below focuses on these alternatives. Although Alternatives (a) and (b) would provide some degree of financial statement comparability between the investment component and some financial instruments, they would not fully meet the objective of comparability because the insurance components would not be

[1] None of these alternatives fully address the statement of financial position comparability objective (Objective (b)) for contracts with an investment component. Because the entire (bundled) contract is measured based on the insurance contracts model, either the investment component will not be able to measured consistently with freestanding financial instruments or the insurance component will not be able to measured consistently with freestanding insurance contracts.

comparable. Furthermore, these alternatives do not provide a particularly meaningful liquidation measure. Thus alternatives (a) and (b) fail both objectives (b) and (c) described in paragraphs 8.

15. Alternative (c), *disaggregation of the investment component in an amount equal to the account balance*, is consistent with the way many insurers currently measure (but, as discussed in paragraph 21, not necessarily present) the investment component today under US GAAP for investment contracts[2] or universal life-type contracts[3]. If there is no *explicit* account balance, this alternative would require disaggregation of implicit account balances for contracts with investment components (as defined in agenda paper 2G/81G). However, that would then require insurers to gross up the cash surrender value of traditional insurance contracts with investment components to add back the implicit surrender charges, a process some observe would add complexity, yet not necessarily result in comparability because of the subjectivity in determining the implicit surrender charges. In addition, because the account balance is gross of surrender charges, Alternative (c) would not provide users a reliable liquidity measure (i.e., the investment component presented in the statement of financial position would overstate the amounts payable on demand).

16. Alternative (d), *separately presenting the investment component in an amount equal to the amount currently payable on demand*, would disaggregate the investment component in an amount based on the assumption that every policyholder will cancel their contract. Insurers have this information at the individual contract level for some insurance products. However, this differs from the assumption that would be used in measuring the contract as a whole, or in measuring the insurance component separately. Alternative (d) would eliminate

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[2] Long-duration contracts *issued by insurance enterprises* that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in US GAAP as investment contracts.

[3] The term *universal life-type* contracts as used in this paper is based on the definition in ASC 944-20-15-11, long-duration insurance contracts with terms that are not fixed and guaranteed, and include contracts that provide either death or annuity benefits such as deferred annuity and equity-indexed life insurance contracts.

the subjectivity present for Alternative (c) referred to in the previous paragraph. However, it would differ from current practice in the following ways:

(a) It would require insurers to reduce the account values users are currently accustomed to seeing on the statement of financial position (i.e., the explicit account balances of investment contracts and universal life-type contracts would be presented net of surrender charges). That said, as discussed in paragraph 21, diversity exists today regarding presentation of these explicit account balances.

(b) It differs from the current measurement of traditional (formerly FAS 60[4]) insurance products with a cash surrender value, for which the liability for insurance contracts does not assume every policyholder will cancel their contract. Under the building block approach and under current US GAAP for traditional (formerly FAS 60) products, insurers estimate at the portfolio level the amount of surrender charges *expected* to be charged based on lapse assumptions (i.e., the probability weighted cash flows only reflect these fees for estimated lapses). Furthermore, under current US GAAP for investment contracts and universal life-type contracts, estimated surrender charges are only indirectly reflected in the financial statements as part of the estimated gross profits used for determining amortization of deferred acquisition costs.

17. It is the staff's understanding that it would be less complex and subjective to deduct the surrender charges from an explicit account balance (e.g., to arrive at the notion of cash surrender value required by Alternative (d)) than it would be to gross up a cash surrender value to arrive at the explicit account value proposed by Alternative (c).

18. Both Alternatives (c) and (d) will generally result in some differences in the amount allocated to the "residual insurance component" because of differences between the basis used to determine the amount of the investment component and

[4] Appendix A of agenda paper 2G/81G identifies a number of products that are currently accounted for under the codified guidance from FAS 60.

the basis used to measure the entire contract (i.e., the insurance contracts model). Such differences may include different discount rate or cash flow assumptions (e.g., related to the value of guarantees or amount of allocated acquisition costs, management fees, loads, and mortality/expense charges). These differences would impair the comparability of the insurance component to other insurance contracts that do not have an investment component, but that are nonetheless economically similar.

19. Alternative (e), *presenting the investment component in an amount determined using the insurance contracts model*, uses the same insurance contracts model basis to determine the amounts of both the investment and insurance components. Accordingly, it eliminates the issue described in the previous paragraph regarding the insurance component absorbing differences between the bases used to determine the amount of the investment component and the basis used to measure the entire contract. However, Alternative (e) is more complex and subjective than Alternatives (c) and (d) and is more onerous for insurers because it requires an allocation of cash flows to one of the two components. Some of those cash flows may relate to both components or are otherwise subjective due to their implicit nature (e.g., investment management services typically are not explicit and may be commingled with charges for administrative expenses and mortality and expense risks). Even if the cash flows are explicitly determinable, because both the policyholder and the insurer benefit from investment management services (e.g., the insurer uses the investments and the related results to pay out claims), it will not always be clear how much of the fees should be allocated to each component. Opponents to Alternative (e) believe the costs of the subjective process to allocate many cash flows outweigh any benefits of disaggregating this information as a separate line item. They observe that Alternative (e) would result in the determination of investment components at an amount other than that used for freestanding financial instruments and believe this would add complexity and be less intuitive to understand. This alternative might also require an allocation of the single and residual margins, which would be subjective (although an alternative to address this might be to present the total insurance contract margin

separately as a single amount without allocation amongst the components). Although, this alternative would provide a degree of financial statement comparability between the insurance component and insurance contracts without an investment component, it would not fully meet the objective of comparability because the investment components would not be comparable to freestanding financial instruments. Furthermore, this alternative does not meet the liquidity objective.

20. Proponents of Alternative (f), *no separation of the investment component in the statement of financial position*, note that all the other alternatives present difficulties and argue that:

    (a) the amount of subjectivity and the possible arbitrary nature of allocation of some cash flows are reason enough to not present the components as separate line items in the statement of financial position.

    (b) separate presentation of the two components would result in at least one of the line items on the statement of financial position having little meaning.

    (c) all the other alternatives inappropriately suggest a degree of comparability that doesn't exist, because the components would not be measured on the same basis as, for example, comparable freestanding financial instruments or insurance contracts.

21. Moreover, proponents of Alternative (f) note that there hasn't been an overwhelming demand from users for separate measurement (or at least not for further separation beyond what exists today). Under current US GAAP reporting while there is consistent presentation for contracts that are directly linked to a segregated asset portfolio (e.g., segregated funds or separate accounts), there is diversity in practice regarding other contracts that have explicit account balances. Some insurers present the aggregate liability for policyholder benefits associated with universal life-type contracts within an individual statement of financial position line item, which includes both the account value and insurance components (e.g., any amounts that have been assessed against the account value

but relate to the insurer's obligation to provide future insurance coverage), whereas others include the universal life account value in a separate line item (e.g., together with account balances on non-separate account / non-unit linked investment-type contracts).

22. Proponents of Alternative (f) believe that, instead, comparability is provided by measuring the whole insurance contract, including investment components using the insurance contracts model and that the objective of providing a liquidity measure could be addressed by using the footnotes to provide a more transparent communication of the account balance, the amounts payable on demand, and any other information deemed relevant regarding the investment component (together with the methodology that is used to distinguish between investment and insurance components for purposes of determining the total aggregate insurance component premiums).

Staff recommendation

23. The staff recommend that insurers should not be required to present in the statement of financial position investment components separately from the insurance contract (i.e., Alternative (f)), but instead should disclose[5] both the portion of the insurance contract liability that represents the aggregated portions of premiums received (and claims / benefits paid) that were excluded from the statement of comprehensive income pursuant to the recommendation in agenda paper 2G/81G and the amounts payable on demand for the following reasons:

    (a) The staff believe that any split of the components on the statement of financial position might be misleading or difficult to understand due to the lack of comparability of at least one of the components to similar types of contracts (because either the insurance component will absorb differences between the measurement basis for the whole contract and whatever other basis is used for the investment component, or the

[5] Additional disclosure requirements will be the subject of a future agenda paper.

investment component will not be measured consistently with comparable financial instruments). Consequently the staff recommend that there should not be a line item on the statement of financial position, if that line item does not provide a meaningful representation of a liability (ie, cannot be calculated as a free-standing liability).

(b) The staff believes that footnote disclosure would be a better tool for communicating any relevant information regarding the components of the liability (e.g., the account value or amounts payable on demand). Footnote disclosure rather than separate line item presentation on the statement of financial position avoids the concerns noted in sub-paragraph (a). In recommending disclosures, the staff believes:

(i) that the costs related to the subjective process of any allocation of cash flows (e.g., investment management costs, etc.) required under Alternative (e) outweigh the associated benefits.

(ii) The disclosure of the amounts payable on demand provides information about liquidity.

(iii) Disclosure of the portion of the insurance contract liability that represents the aggregated portions of premiums received (and claims / benefits paid) that were excluded from the statement of comprehensive income pursuant to the recommendation in agenda paper 2G/81G serves to better explain the relationship between the premium amounts recognized in the statement of comprehensive income and the insurance contract liability.

Question 1 – SFP presentation of investment component

Do the boards agree that insurers should:

(a) not be required to present in the statement of financial position investment components separately from the insurance contract [Alternative (f)],

(b) disclose both:

(i) the portion of the insurance contract liability that represents the aggregated portions of premiums received (and claims / benefits paid) that were excluded from the statement of comprehensive income pursuant to the recommendation in agenda paper 2G/81G and

(ii) the amounts payable on demand?

Appendix A: Determining the investment component presented in the statement of financial position

Alternative	Determination of Separated Investment Component	Advantages of Alternative	Disadvantages of Alternative
(a)	On an amortized cost basis	• Measured similar to a demand deposit	• Insurance component would be remaining amount after separating investment component (therefore it would not meet the *comparability* objective) • It would not meet *liquidity* objective • Value of options and guarantees that relate to the investment component are measured as part of the remaining insurance liability
(b)	On a fair value basis	• Value of options and guarantees that relate to the investment component are measured as part of the investment component	• Insurance component would be remaining amount after separating investment component (therefore it would not meet the *comparability* objective) • It would not meet *liquidity* objective • The investment component would not be equal to other economically similar financial instruments that are not measured at fair value (not equal to the amount due upon demand and not

Alternative	Determination of Separated Investment Component	Advantages of Alternative	Disadvantages of Alternative
			equal to the expected cash flows)
(c)	Determined as at account value	• Measurement is consistent with other economically similar financial instruments (i.e., mutual funds) • Minimizes system modifications (and therefore costs) for some products for which account value is tracked today • For contracts without an explicit account value, the determination of the implicit account value would be complex (i.e., due to grossing up the cash surrender value to add back the implicit surrender charges)	• Insurance component would be remaining amount after separating investment component (therefore it would not meet the *comparability* objective) • It would not meet *liquidity* objective • Measurement is inconsistent with other economically similar financial instruments (i.e., demand deposits, which are generally measured net of surrender charges) • Value of options and guarantees that relate to the investment component is measured as part of the remaining insurance liability (i.e., their value is not reflected in the account value)
(d)	Determined at amount payable on demand (e.g., cash surrender	• Measurement is consistent with some economically similar financial instruments (i.e., demand deposits) • Limited subjectivity as cash surrender values are explicit or	• Insurance component would be remaining amount after separating investment component (therefore it would not meet the *comparability* objective) • Measurement is inconsistent with other

Alternative	Determination of Separated Investment Component	Advantages of Alternative	Disadvantages of Alternative
	value and account values net of surrender charges)	should be relatively easily determinable • Measurement is easy to understand • Addresses liquidity objective of separating investment components from the insurance contract liability (i.e., Objective (c))	economically similar financial instruments (i.e., mutual funds, which are measured gross of surrender charges) • Value of some options and guarantees that relate to the investment component is measured as part of the remaining insurance liability (i.e., their value is not reflected in the account value) • Measurement of the investment component implicitly assumes all policyholders lapse immediately. This is inconsistent with the measurement of the contract as a whole, which is based on probability of lapse. Any result of this inconsistency will be allocated to the insurance component. • Other than as a liquidity measure, perhaps limited informational value in investment component measurement (i.e., the probability of all policyholders lapsing immediately after the statement of financial position date will almost

Alternative	Determination of Separated Investment Component	Advantages of Alternative	Disadvantages of Alternative
			always be extremely remote) • Some argue that a better liquidity measure would be a more reasonably possible worst case scenario
(e)	Determined in accordance with the insurance contracts model	• Eliminates the insurance component absorbing differences between the bases used to determine the amount of the investment component and the basis used to measure the entire contract	• The investment component would likely not be comparable to 'freestanding' financial instruments • Question regarding what the separate component means – not equivalent to the measurement of a mutual fund, etc. • Required allocation of expenses and income introduces significant subjectivity and complexity Cost/benefit of separating components measured the same way should be considered • Measurement of the investment component may not be the same as the value of the explicit account balance, which may be less intuitive to many users.

Alternative	Determination of Separated Investment Component	Advantages of Alternative	Disadvantages of Alternative
(f)	No separation	• No allocation of expenses and income therefore minimizes subjectivity and complexity • Separate measurement of the deposit is viewed by some as inconsistent with the notion of the building block approach (i.e., total cash flows in fulfilling all aspects of the contract) – the policyholder generally cannot surrender one component of the contract without surrendering the entire contract and many insurers do not manage the components separately	• Users won't easily be able to separate the amount of the insurance liability that is "on deposit" or "contractually due" (e.g., not accounted for consistent with other economically similar financial instruments) from the amount that is subject to insurance risk.