STAFF PAPER

19 March – 21 March 2012

REG FASB | IASB Meeting

| Project | Insurance Contracts | | |
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| Paper topic | Separation of Investment Components from Insurance Contracts – Background | | |



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## What is this paper about?

1. This is the first of a series of 3 papers in which we ask the boards to consider:
   (a) a principle to identify the investment components that should be separated from insurance contracts [See Paper 2G/81G],
   (b) how to determine the premium that is allocated to the investment component. That amount would not be presented as premium in the statement of comprehensive income [See Paper 2G/81G], and
   (c) how to measure and present the liability relating to the investment component in the statement of financial position [See Paper 2H/81H].

2. These papers do not address the allocation of any resulting total aggregate insurance component premiums to individual reporting periods, which the staff plan to address as part of a separate paper.

3. The purpose of this paper is to provide background information, including a description of the proposals in the exposure draft *Insurance Contracts* (ED) and Discussion Paper *Preliminary Views on Insurance contracts* (DP) (paragraph 6), a summary of respondents' feedback (paragraphs 7 - 15), the previous, relevant,

board decisions (paragraphs 16 - 23), and a discussion regarding various objectives of separating the investment components of an insurance contract (paragraphs 24 - 31).

4. The staff do not ask the boards any questions in this paper.

## Background

5. In this series of papers, the term ‘separation’ refers to two distinct approaches:

   (a) unbundling would separate investment from insurance component *prior* to measurement, therefore the insurance component would be measured under the insurance contract standard and the investment component would be measured according to different standard, such as the financial instruments standard),

   (b) disaggregation would occur *subsequent* to measurement of the (bundled) insurance contract under insurance standard with a separate presentation of both components (portion of the value allocated to the separated investment component and a portion allocated to the insurance component).

### *Proposals in the Exposure Draft/Discussion Paper*

6. Both the IASB ED and the FASB DP proposed to unbundle investment components from the insurance contract liability. The pertinent section of paragraph 8 of the IASB ED is reproduced in the FASB DP and below:

   > If a component is not closely related to the insurance coverage specified in the contract, an insurer shall…*unbundle* that component…The following are the most common examples of components that are not closely related to the insurance coverage:…an investment component reflecting an account balance that meets both the following conditions: (i) the account balance is credited with an explicit return…; and (ii) the

crediting rate is based on the investment performance of the underlying investments…

### *Respondents' feedback*

7. Feedback from constituents primarily indicates that the methodology put forth in the ED and the DP was unclear and that it would be very difficult to apply.

8. Some respondents to the ED and the DP believe that separating insurance components from investment components enhances a user's ability to compare the insurer's risk profile with the risk profile of other insurers and non-insurers.

9. Regarding investment components specifically, several respondents propose unbundling as a means of allowing entities to select cost-based measures for particular assets (when so permitted by IFRS and US GAAP) without triggering an accounting mismatch with the insurance liability.

10. Still others (mostly respondents from Australia) support the proposal to unbundle the investment components proposed for unbundling in the ED/DP because it would allow for a continuation of current unbundling practices that they believe work well.

11. Most respondents support separating investment components from insurance components but doubt that it can be done in practice in a manner where the benefits outweigh the costs.

12. Other respondents to the ED/DP believe that unbundling of investment components is not necessary. They argue 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.

13. Other respondents question the incremental value of the information that would result from unbundling only specified insurance contracts because, according to these respondents, 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.

14. Many respondents believe that unbundling would be costly for them because they do not manage or report on the different components separately for regulatory or financial reporting purposes. If unbundling were required, these insurers would need to:

    (a) Review the structure of their existing contracts to determine whether investment components should be unbundled, and

    (b) Design or modify their IT systems so that the individual components could be tracked and reported on separately, and

    (c) Develop a methodology for estimating what portion of each cash flow relates to what component for purposes of allocation.

15. Some of these respondents indicated that in their opinion, the costs of unbundling as it was presented in the ED would outweigh the benefits, but that they believe the information would be useful if it were able to be provided in a more efficient manner.

### *Previous Board Discussions*

16. The boards discussed the separation of investment components from the insurance contract liability at the joint board meeting on 4 May 2011. The boards tentatively decided that an insurer should unbundle explicit account balances that are credited with an explicit return that is based on the account balance. The boards also indicated that such an explicit account balance should be separated from an insurance contract using criteria based on the proposals in the revenue recognition project for identifying separate performance obligations.

17. At the May 2011 meeting, the boards also tentatively decided that an insurer would not unbundle implicit account balances. In addition, the IASB decided that an insurer should account for an unbundled explicit account balance in accordance with the relevant requirements for financial instruments in IFRSs, subject to future decisions on allocation. The FASB did not vote on this issue.

18. The boards then requested the staff to consider how these decisions would apply to typical types of contracts with account balances. The boards also indicated at this meeting they wished to consider further whether an explicit account balance exists only when the policyholder can withdraw the account balance without the loss of insurance coverage.

19. The boards discussed the separation of investment components from the insurance contract liability again at the joint board meeting on 16 November 2011. During that meeting, the boards discussed various advantages and disadvantages of *unbundling* the investment component compared to *disaggregating* the investment component for financial statement presentation purposes (see paragraph 5).

20. At this November 2011 meeting, the FASB also tentatively decided to separate explicit account balances from the insurance contract liability. The FASB indicated that explicit account balances are account balances within a contract that meet both of the following criteria:

    (a) The balance is an accumulation of the monetary amount of transactions between the policyholder and the insurer.

    (b) The balance is credited with an explicit return. A return is explicit if it is determined by applying either of the following to the balance:

        (i) A contractual formula in which the insurer may have the ability to reset the return rate during the life of the contract.

        (ii) An allocation determined directly by the performance of specified assets.

21. At this meeting, IASB members indicated their preference to measure explicit account balances as part of the insurance contract and to *disaggregate* them for presentation or disclosures. The IASB did not vote on the definition of explicit account balance.

22. The boards then requested the staff to consider the following items:

(a) Whether there are additional account balances that should be separated from the insurance contract liability.

(b) How income and expense items related to the explicit account balances should be recognised in the statement of comprehensive income.

(c) Whether to measure separated account balances:

(i) Using requirements other than those being developed in the insurance contracts project; or

(ii) As part of the insurance contract and to disaggregate those account balances for presentation or disclosure.

23. The staff have prepared these papers under the presumption that any investment components will be disaggregated rather than unbundled. Appendix B summarises the main reasons for and against each approach.

### *What is the objective of separating the investment component from the insurance contract?*

24. The staff believe it is important to focus on what specific objective(s) the boards want to achieve through the separation of investment components from the insurance contract liability. We believe that this is critical to the determination of which principles and guidelines should be followed in identifying investment components for separation and measurement. Possible objectives that have been identified include:

(a) As a means to determine total aggregate premiums recognized in the statement of comprehensive income;

(b) To improve statement of financial position comparability (i.e., investment components to comparable investment products, etc.); and

(c) To provide users with a liquidity measure (e.g. amounts payable on demand).

### *Objective (a): As a means to determine total aggregate premiums recognized in the statement of comprehensive income*

25. The boards have previously tentatively decided that insurers should show premium volume information on the statement of comprehensive income. Several board members had noted the importance of excluding cash inflows for investment components from this volume measure, especially if the premium is to be characterized as revenue. As discussed in previous meetings and communicated by preparers and others, there are challenges to reliably determining premium revenue on certain products (e.g., life insurance), including the significant judgment required to allocate premium to individual reporting periods. This series of papers do not address these allocation challenges. However, key to any allocation of premium is the determination of the total amount to be allocated. Separation of investment components from the premiums to be allocated to accounting periods might reasonably enable a preparer to exclude any consideration relating to the investment components from the amount of premiums recognized in the statement of comprehensive income.

26. Principles and guidelines to achieve Objective (a) would be designed to ensure the measurement of the premium for the remaining insurance component provides a meaningful representation of the consideration the insurer expects to be entitled to in exchange for satisfying its obligations associated with accepting insurance risk.

### *Objective (b): To improve statement of financial position comparability*

27. Improving the statement of financial position comparability is a second objective that has been identified for separating investment components from the remaining insurance contract liability. Separation of these components could better allow users to compare each component to other economically similar insurance contracts and financial instruments. More specifically, users would be able to more easily identify the obligations associated with the risk the insurer is subject to versus obligations that are backed by deposits.

28. Principles and guidelines to achieve Objective (b) would be designed to measure the insurance and investment components in manners consistent with the measurement of freestanding insurance and financial instruments with equivalent characteristics.

29. However, prior to determining what components should be separated, the insurer has already determined that the contract as a whole is an insurance contract. If the two components, insurance and financial instruments, are measured independently, the sum of the parts will most likely not equal the whole. This would also ignore the interdependencies between the insurance and financial instrument components. On the other hand, if the components are not measured independently (i.e., the sum of the parts is required to equal the whole) then the measurement of at least one of the two components will often not be comparable to economically similar financial instrument (thus leading to a question regarding what the measurement of the separate component means). Therefore it is more likely that unbundling rather than disaggregation would achieve this objective.

### *Objective (c): To provide users with a liquidity measure*

30. A third objective identified for separating investment and insurance components of an insurance contract is to provide users with a liquidity measure. For example, the balances separated from the remainder of the insurance contract might represent the amount payable to the policyholder on demand as of the statement of financial position date. Opponents of this as a primary objective note that, although this information might be useful to investors it might be better dealt with through footnote disclosure, in part because it avoids a balance sheet presentation of the remaining insurance contract that might not be a meaningful reflection of the insurance risk. Because many insurers aren't expecting much short term surrendering of insurance contracts, the financial statement prominence of this scenario might not reflect the contract economics very well.

*Conclusion*

31. Based on past board meeting deliberations, the staff have prepared this series of papers under the presumption that Objective (a), as a means to determine total aggregate premiums recognized in the statement of comprehensive income, is the boards' primary objective for separation of investment components from insurance contracts. This objective could be met by both: unbundling and disaggregation but the staff believe that unbundling would be less feasible for that purpose because of the higher cost of unbundling, the subjectivity involved in this method of separation and the interdependencies between the two components. Therefore this series of papers was prepared on the presumption that disaggregating rather than unbundling would be more feasible to achieve Objective 1.

## Appendix A: Arguments in favour and against disaggregation vs unbundling

| | Advantages | Disadvantages |
|---|---|---|
| Unbundle – separate from beginning and measure investment component and insurance component separately (using appropriate, different standards) | • Enhanced comparability for the insurance component and, possibly, the investment components | • Allocation of expenses that cover both insurance component and investment component could be complex, often subjective and require applying different standards to "each part" of the expenses<br>• Acquisition costs – potentially less expenses allowed to be capitalized; would need to record DAC for the investment component gross (as an asset); need to determine amortization pattern; allocation could be complex as paid on contract vs. components of the contract.<br>• Administrative expenses and asset management expenses – contract managed as one –the activities benefit the policyholder as well as the insurance company<br>• Allocation of income/revenue that cover both the insurance component and the investment component (premium (cost of insurance charges or mortality and expense fees), asset management fees, administrative fees) and may be treated differently depending on where it is allocated to<br>• Allows for product structuring given that the total liability for all insurance contracts measured using the building block approach would not be the same |
| Measure (bundled) insurance contract under insurance contracts standard and separately present investment component | • No allocation of expenses and income therefore minimizes subjectivity and complexity<br>• Measure certain options and guarantees not | • If part of the insurance contract liability relating to the investment component is separately presented in the statement of financial position, at least one of the two line items will often not be comparable to economically similar financial instruments (thus leading to a question regarding what the separate line items |

| | Advantages | Disadvantages |
| --- | --- | --- |
| | accounted for today, some of which are based on policyholder behaviour<br>• Sum of the parts would equal the whole<br>• Discourages product structuring given that the total liability for all insurance contracts measured using the building block approach would be the same | means)<br>– The aggregate contract liability will include expected fees (income) and expenses to be deducted from policyholder account balance unlike mutual fund that recognizes such expenses when they occur The discount rate used to measure the insurance contract liability and the rate that would be used for a standalone financial instrument liability differ<br>– Depending on how any allocation of income/revenue that cover both insurance component and investment component (M&E fees, asset management fees, administrative fees, acquisition costs) should occur, it could result differences between the liability and a comparable standalone financial instrument liability. If acquisition costs are significant and all of the acquisition costs are allocated to the insurance component, the insurance component could be an asset (counterintuitive to some) |