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STAFF PAPER

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Project	Insurance Contracts
Paper topic	Separation of Components from an Insurance Contract – Summary of Tentative Decisions

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What is the purpose of this paper?

1. The purpose of this paper is to provide a summary of the boards' tentative decisions to date on separation[1] of non-insurance components from insurance contracts (e.g., unbundling) and to ask the boards to confirm the overall approach on separation of components. This paper also asks the boards to consider whether insurers should be permitted to separate components of an insurance contract when it is not required.

Summary of Staff Recommendation

2. The staff recommend that:

[1] The term 'separation' as used in this paper refers to both (a) unbundling (i.e., separation of a non-insurance component from the insurance component prior to measurement, therefore the insurance component would be measured under the insurance contract standard and the other component would be measured according to a different standard, such as the revenue recognition standard) and (b) the exclusion of a portion of the premium associated with the investment component from the statement of comprehensive income (which would occur subsequent to measurement of the bundled insurance contract under the insurance contract standard).

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a. if the boards accept the staff recommendation in agenda paper 2E/83E, the boards confirm the entire package of tentative decisions regarding separation from insurance contracts of embedded derivatives, noninsurance goods and services, and investment components.
b. insurers should be prohibited from applying revenue recognition or financial instrument standards to components of an insurance contract when unbundling is not required.

Objective of unbundling considered in tentative decisions to date

3. The primary benefits of unbundling are increased transparency and comparability. Unbundling based on the tentative decisions to date would lead an insurer to account for noninsurance and insurance components of a contract, regardless of form, in the same manner as another entity with separate, but otherwise identical, components if meaningful and reliably determinable for both components. Unbundling also enhances users' ability to compare the insurer's risk profile with the risk profile of other insurers and non-insurers. On the other hand, because of the interdependency of various components of an insurance contract and because insurers often do not manage or report on the different components separately, unbundling can be costly and subjective, and thus, may reduce the usefulness of the information produced.

Tentative decisions regarding separation of insurance and non-insurance components

4. The boards' decisions address unbundling of the following components:
    a. Embedded derivatives (paragraphs 6-10)
    b. Noninsurance goods and services (paragraphs 11-12)

c. Investment components (paragraphs 13-17)[2]

5. The following table summarizes these decisions, additional details of which are included in paragraphs 6 through 17:

[2] Paragraphs 16 and 17 include the staff recommendation included in Agenda Paper 2E/83E, which the boards have not previously deliberated or reached a tentative decision on.

	Embedded Derivatives	Noninsurance Goods and Services	Investment Components
Unbundling?	Yes, when the embedded derivative is not [IASB: closely related] [FASB: clearly and closely related] to the insurance component.	Yes, when the performance obligation to provide the goods or services is distinct. A performance obligation is distinct if: 1. The insurer regularly sells the good or service separately, or 2. The policyholder can benefit from the good or service either on its own or together with other resources that are readily available to the policyholder. However, a performance obligation is not distinct if: 1. The good or service is highly interrelated with the insurance component and transferring them to the policyholder requires the insurer also to provide a significant service of integrating the good or service into the combined insurance contract, and 2. The good or service is significantly modified or customized in order to fulfill the contract.	Yes, based on the staff recommendation in paper 2E/83E, when **both** the investment component and the insurance component are distinct. A component is distinct if: 1. The insurer or a third party regularly separately sells in the same market and jurisdiction contracts that are essentially equivalent to that component. However, an investment component or an insurance component is not distinct if: 1. The investment component is highly interrelated with the insurance component. An indicator that an investment component is highly interrelated with an insurance component is a lack of possibility for one of the components to lapse or mature without the other component also lapsing or maturing.
Other separation?	No	No	Yes, for contracts that are not unbundled, the exclusion of a portion of the premium and claims associated with the investment component from the statement of comprehensive income

Embedded Derivatives

6. During the 21 March 2011 joint board meeting, the boards affirmed the proposal in the IASB's Exposure Draft, *Insurance Contracts (ED),* and the FASB's Discussion Paper, *Preliminary Views on Insurance Contracts* (DP), that an insurer should account separately for embedded derivatives that are contained in a host insurance contract that is not closely related to the embedded derivative.
7. This would result in embedded derivatives that are currently separated (pursuant to existing US GAAP and IFRS guidance applicable to all contracts) continuing to be separated from insurance contracts.
8. The FASB DP referenced the existing embedded derivative bifurcation guidance in Topic 815. In addition to the specific Derivatives Implementation Guidance issues on point for insurance contracts, the guidance requires that:

   An **embedded derivative** shall be separated from the host contract and accounted for as a **derivative instrument** pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

   - The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
   - The **hybrid instrument** is not remeasured at **fair value** under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
   - A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic.
9. IFRS 9 *Financial Instruments* requires an entity to separate an embedded derivative from its host contract and account for it as a derivative under IFRS 9 if the embedded derivative meets all of the following criteria:

   (a) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host insurance contract (see paragraphs B4.3.5 and B4.3.8 of IFRS 9). The

economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host insurance contract if, for example, the embedded derivative and the host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately, ie without considering the host contract (see paragraph B4.3.8(h) of IFRS 9).

(b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative and be within the scope of IFRS 9 (eg the derivative itself does not meet the definition of an insurance contract).

(c) The contract is not measured at fair value with changes in fair value recognized in profit or loss.

10. As noted in Agenda Paper 12G/61G from March 2011, the staff plan to consider at a later date what, if any, implementation guidance should accompany the forthcoming FASB ED / IFRS. At that stage, we will consider whether the current implementation guidance on embedded derivatives in IFRS 4 should be amended and carried forward. That implementation guidance was developed to illustrate existing criteria in IFRS that specify when an embedded derivative is closely related to its host contract. The staff do not intend to revisit those criteria in this project[3].

Noninsurance Goods and Services

11. At the 27 February 2012 joint board meeting, the boards tentatively decided on the following criteria for unbundling goods and services:

    (a) An insurer shall identify whether any promises to provide goods or services in an insurance contract would be performance obligations as defined in the Exposure Draft, *Revenue from Contracts with Customers*.

[3] The implementation guidance for US GAAP is contained in Topic 815 rather than the insurance guidance and therefore does not need to be re-visited.

(b) A performance obligation is a promise in a contract with a policyholder to transfer a good or service to the policyholder. Performance obligations include promises that are implied by an insurer's customary business practices, published policies, or specific statements if those promises create a valid expectation by the policyholder that the insurer will transfer a good or service. Performance obligations do not include activities that an insurer must undertake to fulfill a contract unless the insurer transfers a good or service to a policyholder as those activities occur. For example, an insurer may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the policyholder as the services are performed. Hence, those promised setup activities are not a performance obligation.

(c) If a performance obligation to provide goods or services is distinct, an insurer shall apply the applicable IFRSs or U.S. GAAP in accounting for that performance obligation. Except as specified in the following sub-paragraph, a good or service is distinct if either of the following criteria is met:

(i) The insurer regularly sells the good or service separately.

(ii) The policyholder can benefit from the good or service either on its own or together with other resources that are readily available to the policyholder. Readily available resources are goods or services that are sold separately (by the insurer or another entity), or resources that the policyholder has already obtained (from the insurer or from other transactions or events).

(d) Notwithstanding the requirements in the previous sub-paragraph, a good or service in an insurance contract is not distinct and the insurer shall therefore account for the good or service together with the insurance component under the insurance contracts standard if both of the following criteria are met:

(i) The good or service is highly interrelated with the insurance component and transferring them to the policyholder requires the insurer also to provide a significant service of integrating the good or service into the combined insurance contract that the insurer has entered into with the policyholder.

(ii) The good or service is significantly modified or customized in order to fulfill the contract.

12. The staff provided examples of how the criteria for unbundling goods and services would be applied in the Agenda Paper 3D/79D for the February 2012 meeting. The staff will consider whether to include those examples in the application guidance.

Investment Components

13. During the 21 March 2012 joint board meeting, the boards tentatively decided that:

(a) An investment component in an insurance contract is an amount that the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs.

(b) In the statement of financial position, insurers should not be required to present investment components separately from the insurance contract. However 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; and

(ii) The amounts payable on demand.

14. In addition, the IASB tentatively decided that insurers should exclude from the premium presented in the statement of comprehensive income the investment component as defined in paragraph 13(a) (the amounts that the insurer is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs) determined consistently with measurement of the overall insurance contract liability. The FASB did not vote on how to determine the amount excluded from the premium presented in the statement of comprehensive income and requested that the staff provide further information about possible interpretations of the wording.
15. Both boards directed the staff to consider whether any investment components (as defined) are sufficiently distinct from the insurance component that they should be recognized separately and measured applying the financial instrument standard, rather than the insurance contracts standard.
16. In Agenda Paper 2E/83E for this meeting, the staff recommend:
    a. If both the investment component and insurance component are distinct, an insurer shall unbundle the investment component and apply the applicable IFRSs or U.S. GAAP in accounting for the investment component.
    b. Except as specified in the following paragraph, a component is distinct if the insurer or a third party regularly separately sells contracts in the same market and jurisdiction that are essentially equivalent to that component.
    c. Notwithstanding the requirements in paragraph16 b, an investment component or an insurance component in an insurance contract is not distinct and the insurer shall therefore account for the investment component together with the insurance component under the insurance contracts standard if the investment component is highly interrelated with the insurance component. An indicator that an investment component is highly interrelated with an insurance component is a lack of possibility for one of the components to lapse or mature without the other component also lapsing or maturing.
17. Applying the staff recommendations, an insurer would need to take the following two steps for insurance contracts that contain an investment component:

a. If the investment component is distinct, unbundle that component and apply the financial instruments standard to it. (In some cases, the contract may also require the insurer to provide investment management services to the policyholder. The insurer would apply the criteria for goods and services to determine whether it should unbundle that service component.)

b. After unbundling the distinct investment component, if any, the insurer would then need to consider whether the remainder of the insurance contract obliges the insurer to pay any amounts to policyholders or their beneficiaries regardless of whether an insured event occurs. If so, the insurer should exclude those amounts from the premium presented in the statement of comprehensive income, in accordance with the IASB's tentative decision summarised in paragraph 14. The FASB has not yet reached a tentative conclusion as to what amount of the premiums would be excluded from the premium presented in the statement of comprehensive income.

Staff Analysis

Differences in Separation Approaches

18. As described above, the boards have tentatively decided on different criteria for separating different types of non-insurance components from insurance components. The staff believes that having different criteria is necessary for the guidance to be operational and to enhance consistency. This is in part because the different components of an insurance contract have different natures and because different accounting models are applicable to each type of comparable freestanding product. While there was one overarching principle in the IASB's ED and the FASB's DP (i.e., unbundle components that are not closely related to the insurance coverage specified in the contract), the proposals included specific examples on how to apply the principle to embedded derivatives, investment

components and goods and services. Feedback from respondents regarding the lack of clarity in the unbundling proposal indicated that further detail on unique separation principles is needed to consistently apply the guidance.

19. The different tentative decisions reached regarding separation of different non-insurance components mirror different accounting models that apply to different non-insurance products. Specifically, models in both IFRS and US GAAP apply different accounting for goods and services (i.e., the developing revenue recognition standard), derivatives, and other financial instruments. For example, the boards' tentative criteria for unbundling goods and services from an insurance contract are based on criteria used in the revenue recognition project, albeit tailored to reflect the nature of insurance contracts and to reflect the differences between the insurance contract and revenue recognition standards. Although such criteria might in theory be applied to unbundle embedded derivatives from insurance contracts, this would create inconsistency with existing guidance on unbundling embedded derivatives from non-insurance contracts, thus resulting in further specialized accounting.

20. The staff recommendation for unbundling investment components identified above in paragraph 16, uses criteria similar to those used for unbundling goods and services, albeit further tailored to recognize the nature of investment components (which are financial instruments). Accordingly, with the exception of the criteria for unbundling embedded derivatives which follow existing guidance applicable to all embedded derivatives, the remaining unbundling decisions are rooted in a comparable principle of separating components of a contract that are equivalent to freestanding products *if* such separation is reliably determinable (e.g., such as when the two components are sold separately by the insurer) and the resulting measurement is meaningful for *both* components (e.g., which might not be the case if the two components are not both distinct, for example if they are highly interrelated). As discussed in Agenda Papers 4F-D / 81 F-G for the 21 March 2012 joint board meeting there were a number of disadvantages to unbundling some investment components. However, the staff believe that for

those investment components that meet the recommended criteria for unbundling, the benefits of unbundling exceed the costs of unbundling.

21. As discussed during the 21 March 2012 joint board meetings and in Agenda Papers 4F-D / 81 F-G for that meeting, the boards also tentatively decided to exclude an amount of premium associated with the remaining (i.e., not unbundled) investment components (as defined) from the statement of comprehensive income. The recommendation behind this tentative decision was developed as a means to determine meaningful premiums amounts (for the insurer's exposure to risk for the insured event) to be recognized in the statement of comprehensive income, which was identified as the primary objective for separating investment components from insurance contracts[4].

22. In the Agenda Papers for each of the topics noted above, the staff considered whether common criteria could be applied but determined that, due to the differing nature of goods and services, derivatives, and other investment components, and the interaction of these components with the different insurance contracts that contain these components, using common criteria would mean that the objectives of unbundling could not be met. For example, it was unclear how the 'closely related' principle for separating embedded derivatives would be applied to goods and services that are sometimes provided alongside insurance coverage.

23. In summary, the staff think that the unique characteristics of each of the contractual components validate the need for different separation criteria.

[4] The staff analysis and recommendations included in Agenda Paper 2E/83E to unbundle some investment components were based on a secondary objective of statement of financial position comparability and not intended to supersede the March tentative decisions.

Question 1 – Reconfirmation of tentative decisions on separation of noninsurance components of insurance contracts
Do the boards confirm the entire package of tentative decisions regarding separation from insurance contracts of embedded derivatives, noninsurance goods and services, and investment components?

Further Separation

24. In the IASB's ED and FASB's DP, the boards proposed that unbundling would be prohibited when it is not required. The FASB's DP stated that allowing further unbundling when not required would undermine comparability and likely would not provide more decision-useful information. Similarly, the IASB's ED Basis for Conclusions described the IASB's reasons for proposing to prohibit unbundling when it is not required. Although some argued that some insurers might find it easier to account for some components embedded in insurance contracts using the relevant guidance for similar stand-alone contracts, the IASB concluded that permitting unbundling when it is not required (1) would be inconsistent with the reasoning for not requiring it in the first place, which was that when the components are not distinct (are inter-related) unbundling would result in information that is not a faithful representation of each component, and so is not decision-useful; it does not seem rational to permit something that would not be decision-useful; and (2) could also undermine comparability.
25. Here we ask the boards to consider whether to permit or prohibit separation when it is not required by the standard. The staff believes the biggest concern in deciding to permit or prohibit further separation is maintaining comparability. The standard should require similar accounting for similar contracts by all entities except where the measurement of one or more components would not be meaningful or where the costs outweigh the benefits.
26. Some argue that insurers are not likely to opt for more separation than required. Separating and measuring an additional component and the related cash flows

would cause an insurer to incur additional costs. However, some insurers may find it easier to account for some components included in an insurance contract, which are not required to be separated, using the relevant guidance for similar stand-alone contracts. In addition, some insurers may decide that the benefits of achieving a different accounting result (e.g., amortized cost for specific components of an insurance contract which would result in a locked-in discount rate) would outweigh the costs that would be incurred.

27. Some insurers have also noted they would like to continue their current practice of unbundling. For example, IFRS 4 permits unbundling if certain criteria are met (ie that the insurer must be able to measure the unbundled component separately[5]). An option would allow an insurer to choose to separate insurance contracts if it thinks that doing so produces better information.

28. We are sympathetic to the concerns received that the current practice of unbundling should not be interrupted in some limited cases. However, the primary benefits of unbundling are increased transparency and comparability of the various components. The staff believes that further unbundling (unbundling not required by the guidance) should be prohibited to preserve comparability. Therefore, the staff recommend that the boards reaffirm the proposal in ED/DP to prohibit any unbundling when it is not required (and thus disallowing the use of financial instrument or revenue recognition guidance in place of the insurance contract standard).

29. Neither US GAAP or IFRS prohibits entities from presenting additional line items. Moreover, IAS 1 requires entities to provide additional line items, headings and subtotals in the statement of financial position/comprehensive income when relevant to an understanding of the entity's financial position/performance. The proposed prohibition on unbundling when it is not required would not prevent insurers from presenting additional line items.

[5] 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, IFRS 4 permits (but does not require) unbundling. (This criterion in IFRS 4 is no longer applicable because the building block approach will require the insurer to recognise and measure all of the obligations and rights arising from the deposit component.)

Question 2 – Further unbundling
Do the boards agree that insurers should be prohibited from applying revenue recognition or financial instrument standards to components of an insurance contract when unbundling is not required?