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Project **Insurance contracts**

Topic **Variable and unit-linked contracts – Separate accounts**

Purpose of this paper

1. This paper discusses the accounting for account-driven contracts generically referred to as *unit-linked* or *variable* insurance and annuity contracts. In particular, we address questions about whether the invested fund into which the premium is deposited represents an asset and corresponding liability of the insurance entity. The consolidations and derecognition teams are also addressing these contracts at the February and March joint Board meetings, and we believe that our recommendations are consistent with those of the derecognition team. The consolidations team has not developed their recommendations, but we have consulted with the team on which issues belong in which projects.

Questions addressed in this paper

2. The term *unit-linked* contract has become almost generic; we have seen the term used to describe any account-driven contract that is tied in some way to a portfolio of assets or index. In this paper, we will use the term to refer to a situation in which:

   (a) Account-driven contracts (refer to February paper 14A, FASB Memorandum 39A) are associated under the contract terms with an identified portfolio of

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assets (distinguished from contracts associated with a notional portfolio, as in index-linked contracts);

(b) All of the investment performance from that portfolio of assets is passed to the holders of the contracts, such that the shareholders and other policyholders neither benefit nor suffer from that investment performance, except to the extent of (c), and

(c) The contract may also include minimum guaranteed returns and death benefits.

3. That is a very broad definition of unit-linked contracts. Answering some of the questions that follow will demand that we look at particular contract features.

(a) Are the investments in the portfolio just described assets of the insurance company?

(b) Are there situations in which managed investment funds or similar vehicles that are associated with unit-linked contracts should be consolidated into the insurer's financial statements?

(c) There will be situations in which the answer to (a) is "yes," in those situations:

(i) Should the recognition and measurement be consistent with other account-driven contracts?

(ii) Are there particular accounting mismatches that the Boards should address?

(iii) Are there particular presentation issues?

Summary of staff recommendations

4. We recommend:

(a) That assets and related liabilities associated with unit linked contracts, including those defined as separate accounts should be reported as the insurer's assets and liabilities in the statement of financial position.

(b) That issues involving the consolidation of investment funds associated with unit-linked contracts (including separate account contracts) be addressed in the consolidations project rather than in the insurance contracts project.

(c) That unit-linked contracts be measured in the same manner as other account-driven contracts

(d) That if an insurer chooses to present the liability as a separate line item, the amount should include all of the insurer's obligations under the unit-linked contracts, rather than a balancing figure for the assets.

(e) Paragraph 31 describes three approaches to asset-liability measurement mismatches often raised by insurers in discussions of unit-linked contracts. The staff is divided on this point and does not have a single recommendation.

Definitions and guidance

7. We will try to use the following terms consistently through the remainder of this paper:

(a) Unit-linked contract – as described in paragraph 2;

(b) Units – as the way the insurer usually represents the contract holder's investments. "You have 16 units in the Cannon Street Portfolio."

(c) Separate account contract – as defined in US GAAP, a subset of unit-linked contracts;

(d) The portfolio – as the pool of assets associated by contract with the unit-linked contracts;

(e) Fund – as a managed fund, unit trust, mutual fund or similar investment company that may be part of the portfolio.

5. The terms *variable life* and *variable annuity* have more specific meanings than unit-linked contract, at least in US securities and insurance regulation. The Securities and Exchange Commission Registration Form for Insurance Company Separate

Accounts Registered as Unit Investment Trusts that Offer Variable Life Insurance Policies, offers this discussion:

> ***Variable Life Insurance***
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> Variable life insurance is similar to traditional life insurance, except that the cash value and/or death benefit vary based on the investment performance of the assets in which the premium payments are invested. Under a traditional life insurance policy, premium payments are allocated to an insurer's general account and invested, consistent with state law requirements, to enable the insurer to meet its death benefit and cash value guarantees. The investment return on assets in the general account has little or no direct effect on the cash value or the death benefit received.
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> Premium payments under a variable life policy, in contrast, are invested in an insurance company separate account, which generally is not subject to state law investment restrictions. A variable life policyholder typically is offered a variety of investment options (*e.g.*, equity, bond, and money market mutual funds). Death benefits and cash values are directly related to performance of the separate account, although typically there is a guaranteed minimum death benefit.
>
> Variable life insurance was introduced in the early 1970s. During the years from the end of World War II to the late 1960s, there was a significant decline in the share of savings dollars invested with life insurance companies. In an effort to counteract this trend, insurers began to offer a greater variety of products, including equity-based products such as variable life insurance. In recent years, variable life insurance has become an increasingly important segment of the insurance industry. By 2000, variable life insurance accounted for 51.3% of first year individual life insurance premiums, and 19.6% of total individual life insurance premiums. Since the early 1990s, assets in variable life products have grown substantially, from $4.8 billion in December 1991 to $42.8 billion in November 2001.
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> ***Current Forms for Variable Life Insurance Registration***
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> A separate account funding a variable life insurance policy most commonly is registered as a unit investment trust under the Investment Company Act. Separate accounts registered as unit investment trusts are divided into subaccounts , each of which invests in a different open-end management investment company, or mutual fund ("Portfolio Company").
>
> Both separate account unit investment trusts and the Portfolio Companies in which they invest are registered as investment companies under the Investment Company Act, and their securities are registered under the Securities Act. Investors in variable life insurance policies receive the prospectuses for both the separate account unit investment trust and the Portfolio Companies. Portfolio Companies, as mutual funds, use Form N-1A to register under the Investment Company Act and to register their shares under the Securities Act.7 Variable life separate accounts, as unit investment trusts, register under the Investment Company Act on Form N-8B-2 and register their securities under the Securities Act on Form S-6. [Footnote references omitted. Emphasis added.]

6. The FASB Codification section 944-80-25 includes the following guidance on *separate accounts* [Emphasis added.]*:*

944-80-25-1 **Separate account** assets and liabilities shall be included in the financial statements of the insurance entity that owns the assets and is contractually obligated to pay the liabilities.

944-80-25-2 The guidance in the following paragraph applies if the **separate account arrangement** meets all of the following conditions:

a. The separate account is recognized legally; that is, the separate account is established, approved, and regulated under special rules such as state insurance laws, federal securities laws, or similar foreign laws.

b. The separate account assets supporting the contract liabilities are insulated legally from the **general account** liabilities of the insurance entity; that is, the contract holder is not subject to insurer default risk to the extent of the assets held in the separate account.

c. The insurer must, as a result of contractual, statutory, or regulatory requirements, invest the contract holder's funds within the separate account as directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies.

d. All investment performance, net of contract fees and assessments, must as a result of contractual, statutory, or regulatory requirements be passed through to the individual contract holder. Contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling, as a ceiling would prohibit all investment performance from being passed through to the contract holder.

944-80-25-3 All of the following guidance applies if a separate account arrangement meets all of the conditions in the preceding paragraph:

a. The portion of separate account assets representing contract holder funds shall be reported in the insurance entity's financial statements as a summary total, with an equivalent summary total reported for related liabilities.

b. Any liabilities related to minimum guarantees and insurance benefit liabilities under the contracts in excess of the **fair value** of separate account assets representing contract holder funds shall be recognized as general account liabilities.

c. Contract fees and assessments shall be reported in accordance with paragraph 944-605-25-5.

944-80-25-4 All of the following guidance applies if a separate account arrangement does not meet all of the criteria in paragraph 944-80-25-2 through 25-3:

a. Assets representing contract holder funds under the arrangement shall be measured and presented the same as other general account assets as prescribed in this Topic.

b. Any related liability shall be accounted for as a general account liability.

c. Revenue and expenses related to such arrangements shall be recognized within the respective revenue and expense lines in the statement of operations.

8. FASB Codification section 810-10-17b (formerly FASB Interpretation 46R) excludes insurance company separate accounts from the scope of consolidation guidance. The FASB's Emerging Issues Task Force addressed questions about consolidation when the separate account holds a majority interest in an investment fund in Issue 09B and recommended that the scope exception apply in that situation as well.

Whose assets and liabilities are they?

9. In this section, we focus on situations that satisfy the several conditions highlighted above and adopt the term *separate accounts*. That is, they are directed by the policyholder and legally isolated from the general assets and liabilities of the insurer, including in bankruptcy. We cannot identify a better definition with which to start our analysis of the question posed above. We understand that the unit-linked contracts sold in many jurisdictions do not meet the tests built into North American GAAP and regulation. The first-step question here is whether there is ***any*** situation in which the portfolio assets and related liability should be excluded from the insurer's balance sheet. If the answer to that question is "no" for the North American contracts, then we cannot identify any situation in which the answer would be "yes" for others.

10. If this project were not about insurance contracts there would be little argument that separate account contracts were something other than mutual funds or unit trusts. However, there is a complication. At least in the United States, the funds are owned by the insurance company. This is necessary to maintain the tax status of the contracts as insurance contracts or annuities – accumulation in the contract

balance is tax deferred. The policyholder owns units in the insurance company's separate accounts rather than units in the underlying fund. We understand that insurers may also invest in the underlying funds for the insurer's general account.

11. The solution in U.S. GAAP is to report separate account assets as a total, at fair value, below other assets in the statement of financial position, with a corresponding liability. (In Canada, the term is *segregated accounts*, and the amounts are presented below total assets and total liabilities and excluded from the footings. In effect, they are memorandum entries.) Guarantees, death benefits, and other items are reported in the insurance company's general accounts. Additions to the separate accounts are not reported as premium revenues.

12. The staff begins its analysis with the simplest form of agreement. The separate accounts are invested in funds managed by an independent fund manager. The insurer does not own any units in the fund for its own general accounts. One view would hold that the units in the fund, while held in the name of the insurer, are not assets of the insurer. Instead, the insurer acts as a pass-through entity and provides additional guarantees and benefits. Any guarantees and death benefits that form part of the contract between the insurer and the policyholder should be accounted for using the other guidance developed in the insurance project. Excluding the policyholders' investment in the separate accounts from the statement of financial position would constitute a change in practice for US constituents.

13. An alternative view would be that the guarantees and benefits would not exist without separate account contracts. The guarantees and benefits are necessary to gain the advantages of an insurance contract for the package of contract elements. The assertion that "shareholders bear no investment risk," is not completely accurate. There is not a one-to-one mapping between the value of a policyholder's units and the insurer's cash outflows, because the insurer guarantees a minimum return. In addition, the amount of net mortality coverage may depend on the value of the units. (For example, the contract pays a fixed death benefit of CU 1 million. If the contract value is CU 600,000, the net mortality benefit is CU 400,000.) Those who follow this view would maintain that even separate account contracts should be included as liabilities and the related portfolio as assets of the insurer.

They would reason that the various contract outcomes are so interdependent that it would be inappropriate to focus on a single contract element.

14. European constituents tell us that unit-linked contracts in their jurisdictions do not satisfy the conditions described for separate accounts. The reasons differ among jurisdictions, but seem to centre on (a) the legal isolation required by US GAAP and regulation and (b) the requirement that the portfolio have separate legal standing. Here the question becomes more difficult and very jurisdiction specific. For example, insurers in jurisdiction X might manage unit-linked contracts by channelling the payments from policyholders into managed funds. Insurers in jurisdiction Y might designate assets into what we might call "virtual" funds that have no separate legal standing. Insurers in jurisdiction Z might not be required to hold a matching portfolio.

15. In the staff's view, the balance of the argument supports the view that the portfolio of assets and related liabilities for separate account contracts should be included in the insurer's balance sheet. We acknowledge that the stringent conditions applied in the North American markets provide an unambiguous legal separation of contract elements. Without that framework, or something like it, we cannot find a basis for excluding the portfolio of assets and related liabilities associated with other unit-linked insurance contracts from the insurer's balance sheet.

16. We recognise that this view conflicts with some of the analysis in the derecognition paper. We would agree with that analysis, absent the guarantees and insurance elements of these contracts. We also agree with the team's observation that "There are a wide range of these products with varying terms and conditions." Indeed, that is part of what pushes us toward our conclusion. We are confronted with a wide variety of jurisdiction-specific arrangements, both as to the contracts and the rules governing the assets. The unifying characteristic is that they all possess enough insurance features to be within the scope of this project.

Question 1 for the boards
The staff recommends that assets and related liabilities associated with unit linked contracts, including those defined as separate accounts should be reported as the insurer's assets and liabilities in the statement of financial position. Do you agree?

Consolidation questions

17. The next level of complexity would be a situation in which the insurer acts as investment manager and may own units for its general account. Now the questions focus on whether the fund should be consolidated in the insurer's financial statements. Were it not for the scope exclusion already noted, we can envision situations in which separate accounts would constitute variable interest entities under US GAAP. We cannot envision any reason why guidance developed in the consolidations project would be different for funds supporting unit-linked contracts than for managed funds generally. We recommend that guidance developed in that project should apply equally to insurance company separate accounts.

Question 2 for the boards
The staff recommends that issues involving the consolidation of investment funds associated with unit-linked contracts (including separate account contracts) be addressed in the consolidations project rather than in the insurance contracts project. Do you agree?

Measurement issues

Liability measurement model

18. Does the nature of unit-linked contracts suggest that the boards should use a different measurement model than for other account-driven contracts? In the staff's view, no, but it is easy to make more out of the question than is necessary.

19. The building-block approach does not ignore the role of the account balance in measuring the total contract liability. In the case of unit-linked contracts, the first assumption in the approach would be, "Assume that the amount of the policyholder's account balance is always equal to the fair value of the units. Make all other assumptions consistent with that first assumption." As discussed in the paper on other account-driven contracts, we view an insurance contract as the nexus of several interdependent elements. For example, an insurer could probably value the minimum return guarantee found in many unit-linked contracts as if it was a stand-alone derivative. However, the same conditions that would trigger the guarantee are the ones that influence contract terminations. The number of contract terminations in turn affects the amounts charged against contracts for mortality and administration and sometimes the net cost of mortality benefits.

20. We understand that some staff members may be developing an alternative view.

Question 3 for the boards
The staff recommends that unit-linked contracts be measured in the same manner as other account-driven contracts. Do you agree?

Some problems in asset measurement

21. Insurers have raised several issues in asset measurement for portfolios associated with unit-linked contracts. In the staff's view, these problems do not arise if the portfolio is composed of independently-managed funds that are not consolidated. IAS 39 does not require that a holder look through a mutual fund or unit-trust to its

component parts. The problems occur when funds are consolidated or when the portfolio is an internally managed virtual fund.

22. ***Insurer stock.*** Most portfolios of assets associated with unit-linked contracts have defined investment philosophies. Suppose the investment philosophy is to hold the companies that comprise the S&P, FRSE, and DAX indices, and that the insurer is a component of one of those indices. Changes in the fair value of insurer's stock are incorporated in the liability measurement because they affect the liability payoffs, but that stock is not an asset of the insurer. The changes in the liability affect income without any corresponding affect from the own-stock asset.

23. This is not a new issue. We recall it in discussions of IAS 32 and IFRS 4. It is also a conundrum. The mismatch is self evident, but the solution is not. The problem is especially acute in small capital markets, because of the limited range of available investments.

24. ***View A.*** Some staff take the view that the mismatch should be addressed by reducing the amount of the insurance contract liability by the difference between the fair value of the insurer's shares included in the portfolio and the carrying amount (ie zero) of those shares.

25. The staff who hold this view observe that neither insurers nor financial statement users find the existing mismatch acceptable. They believe that users would not be particularly disturbed by the approaches that would eliminate the mismatch and are more concerned by the mismatch itself, which creates a distraction that does not make it any easier for users to assess the amounts, timing and uncertainty of future cash flows and inevitably leads entities to explain that these amounts have no economic meaning. They also note that there is a precedent for a similar precedent in the treatment of indemnification assets in business combinations (see paragraphs 27 and 28 of IFRS 3 and FASB Accounting Standards Codification™ Topic 805-20-25-27, 805-20-25-28, 805-20-30-18 and 805-20-30-19). The observers question why a straightforward commercial relationship, with no motive of structuring beyond a balanced investment philosophy, should result in a permanent mismatch in the statement of financial position and a recurring mismatch in the statement of profit or loss.

26. ***View B.*** The staff who hold this could see an argument for allowing the company's own shares included in the portfolio to be reported as assets and measuring them in the same manner as other assets in the portfolio. The general rationale for reporting treasury shares in equity is that they fail the definition of assets because they are not "resources" as contemplated in the IASB definition. To the extent that the shares are part of a portfolio associated with unit-linked contracts, they are resources in the same way the other portfolio assets are resources. They can be sold to pay policyholders who die or surrender or to pay the insurer for the policyholder's mortality and expense charges. An obvious problem with this approach would be limiting it to a small number of situations. The definition of unit-linked contracts in paragraph 2 may not be enough.

27. ***View C.*** Other staff take the view that the accounting result is an unavoidable consequence of linking the payoff from a liability to the value of the entity's own shares. Those same staff do not see an argument for excluding the value of the insurer's own stock from the measurement of the liability.

28. ***Real estate.*** In some cases, the portfolio of assets associated with unit-linked contracts may include real estate, including owner-occupied real estate. While owner-occupied real estate can be revalued under IAS 16, the change in value is reported in IAS 16's revaluation surplus and is never recycled.

29. ***Associates.*** In some cases, the portfolio of assets associated with the unit-linked contracts may include investments in associates. The asset is then measured on the equity method, while the liability payoffs are based on fair value of the associate's shares.

30. Each of these asset measurement problems is a consequence first, of the accounting for things other than insurance contracts and second, of the desire for a presentation solution that segregates the portfolio of assets associated with unit-linked contracts and a related measure of liabilities from other insurer assets and liabilities. We will discuss the presentation issue in the next section of this paper.

31. The staff sees three possible answers to these and any other mismatches that might arise in the context of unit-linked contracts.

(a) Expand the fair value option to include the three items discussed above, in the interest of eliminating mismatches. This assumes that the boards accept View B described above to address the insurer stock issue,

(b) Adjust the measurement of the liability, or

(c) Do nothing, on the basis that each of the three topics raises more fundamental questions.

32. The staff are divided on which approach the boards should take.

Question 4 for the boards
Paragraph 31 identifies three approaches that the boards might take to eliminate asset-liability measurement mismatches in the accounting for unit-linked contracts. a. Expand the existing fair value options to encompass the topics identified. b. Reduce the measurement of the liability for these contracts by the amount of the excess of the fair value of the linked assets over their carrying amount. c. Do not address these mismatches in this project. Which do you support?

Presentation

33. Many insurers have adopted presentation approaches that separate assets in portfolios associated with unit-life contracts from other investments. The assets may be labeled with ‘investments for the account of policyholders,’ ‘investments for risk of policyholders,’ or similar captions. The amounts are presented in the same section of the balance sheet as other investments. Some insurers present a similar amount in liabilities, while others do not.

34. The staff believe that IFRS and US GAAP should not prohibit this kind of separation in the assets of the insurer. On the liability presentation, notwithstanding other conclusions that the boards might reach in discussing the presentation paper, we note that (1) measuring all of the liability's elements using the building block approach, (2) presenting part of the liability as a balancing item equal to the portfolio of assets, and (3) presenting the remainder with other liabilities, has little information content. The important information is a comparison between the amount of the portfolio assets and the *total* obligation under the unit-linked contracts. Today, the difference between the portfolio of assets and the total liability is not always transparent. We recommend that any separate presentation of the liability should be of the total amount, rather than the account balance.

Question 5 for the boards

The staff believe that IFRS and US GAAP should not prohibit an insurer to present the portfolio of assets associated with unit-linked contracts as a separate line item in the statement of financial position. If an insurer chooses to present the liability as a separate line item, the amount should include all of the insurer's obligations under the unit-linked contracts, rather than a balancing figure for the assets.

Do you agree?