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Project **Insurance Contracts**

Topic **Unbundling**

Purpose of this paper

1. An insurance contract may contain insurance, investment (or financial) and service components. This paper discusses whether an insurer should recognise and measure those components of a contract as if they were separate contracts (unbundling).
2. This paper discusses one approach to unbundling developed by some staff members and represents the views of those staff members (hereafter ‘the staff’). An alternative view developed by other staff members is described in agenda paper 14D (FASB Memorandum 39D).

Summary of staff recommendations

3. The staff recommends that an insurer should unbundle a component of an insurance contract if that component is not interdependent with other components of that contract. This would also apply to those components of insurance contracts that are embedded derivatives.
4. If components are interdependent, an insurer:
 - (a) should not be permitted to unbundle those components of the contract for recognition and measurement.

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

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

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

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- (b) should not separate any deposit element from the remainder of the premium for presentation in the performance statement.

Structure of the paper

- 5. The rest of this paper is divided into the following sections:
 - (a) Background (paragraphs 6-8)
 - (b) Why or why not unbundle (paragraphs 9-28)
 - (c) When to unbundle (paragraphs 29-38)
 - (d) Embedded derivatives (paragraphs 39-43)
 - (e) Unbundling for presentation (paragraphs 44-47)

Background

- 6. Two factors determine whether unbundling is relevant:
 - (a) whether a component of a contract would be in scope of another standard; and
 - (b) whether the measurement approach in that other standard differs from the measurement for insurance contracts.
- 7. At the January 5 joint meeting, the boards discussed how to approach unbundling. Some Board members wanted to look at the proposals for unbundling in the context of other steps of developing the overall model for insurance contracts. Board members also asked for clarity about the meaning of interdependency; we deal with this later in the paper. The following summary displays what those other steps might be and the order in which they might be assessed:
 - (a) definition and scope
 - (b) measurement model
 - (c) unbundling
 - (d) presentation model

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8. The last step, presentation for the performance statement, is arguably for a significant part influenced by the outcome of walking through the first three decision points, including unbundling. We discuss in this paper how a decision on unbundling for recognition and measurement would impact unbundling for presentation purposes. We discuss presentation of the performance statement in paper 14E (FASB Memorandum 39E).

Definition and scope

9. Definition and scope determines:
 - (a) which contracts qualify as insurance contracts.
 - (b) whether the scope of the standard on insurance contracts should exclude any insurance contracts.
10. Definition and scope would be the first natural step to take. We need to know what an insurance contract is and what is in scope before we can complete any further steps.
11. IFRS 4 *Insurance Contracts* defines an insurance contract as:

a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.
12. In the light of responses to the exposure draft that resulted in IFRS 4 *Insurance Contracts* and to the IASB's discussion paper *Preliminary Views in Insurance Contracts*, the staff concluded that the IASB's existing definition of insurance contracts was unlikely to require significant reworking and that the most productive time for the boards to review the definition and scope issues would be after the main discussions on recognition, measurement and presentation.
13. The staff intends to bring a paper on definition and scope to the joint meeting in March. This will also include a comparison of the definition and scope included in IFRS 4 with the guidance in current US GAAP. [The staff will introduce the topic of definition and scope to the FASB at an educational session prior to the March

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joint Board meeting.] Staff therefore does not intend to discuss definition and scope as part of this paper on unbundling.

14. The question of unbundling could be relevant for many insurance contracts within the existing scope of IFRS 4, including contracts that have an asset-accumulation element, for example whole-life contracts, traditional endowment contracts and account-driven life contracts (as described in agenda paper 14A (FASB Memorandum 39A)).

Measurement

15. The next step would be to establish the measurement approach for contracts that are in the scope of a future insurance standard.
16. Based on the boards' tentative decisions so far, the measurement approach for insurance contracts would be a hybrid of:
 - (a) a direct liability measurement, using current estimates of expected cash flows, time value of money and a risk adjustment; and
 - (b) an allocation to eliminate a day one gain (the residual margin).
17. We have identified three measurements that compete with the proposed insurance measurement.
18. One competing measurement is fair value, as applied to financial instruments. Both fair value and the proposed measurement for insurance contracts are current measures, but on the basis of tentative decisions to date might differ in the following areas:
 - (a) own credit risk (included in fair value, but not in the insurance contracts model).
 - (b) the deposit floor (not applied in the insurance contracts model and not applied in the proposed FASB model for financial liabilities, but applied by the IASB to financial liabilities).

(c) fair value adopts a market-participant focus, whereas the insurance contracts model places less emphasis on the perspective of market-participants.

(d) recognition of day-one gains (not applied in the proposed insurance model but could arise for financial liabilities).

19. Another competing measurement is amortised cost, as used for some financial instruments. Amortised cost uses current estimates of cash flows but locks in the effective interest rate at inception. In contrast, the insurance contracts model uses current estimates of cash flows and current discount rates.
20. The third competing measurement is the allocated transaction price proposed in the boards' project on revenue recognition. A fundamental difference is direct liability measurement (insurance contracts) versus allocation (revenue recognition). This may cause a significant difference in measurement outcome. Nevertheless, the proposed insurance model also includes an allocation element for the deferred day-one difference; that bridges the gap between a pure direct liability measurement and an allocation approach somewhat.

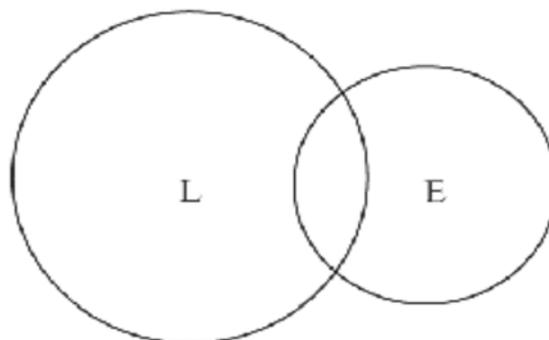
Why or why not unbundle

21. After considering definition and scope as well as measurement, it is likely that some components of an insurance contract would be (i) outside the scope of the standard on the insurance contracts if they were separate contracts and (ii) measured differently under another accounting standard. For those components, one has to determine whether and, if so, to what extent they should be unbundled.
22. Unbundling would achieve the result that:
- (a) an entity accounts in the same way for the investment component of an insurance contract as the issuer of a separate, but otherwise identical, financial instrument (eg one issued by a bank or a fund manager).
 - (b) sharp accounting discontinuities can be avoided between the accounting for a contract that transfers just enough insurance risk to be an insurance contract,

and the accounting for another contract that falls marginally on the other side of the line. This would reduce the pressure on the definition of insurance contract.

23. However, unbundling poses challenges. Often the components are interdependent and the value of the bundled product may differ from the sum of the individual values of the components. Interdependence, here, means that the cash flows from one component affect the cash flows from another component and vice versa. In agenda paper 14A (FASB Memorandum 39A) on account-driven contracts we explain this as the notion that the combination of elements in a contract does not behave the same as a synthetic combination of independent items.

24. The following diagram from the Basis for Conclusions on IFRS 7 *Financial Instruments: Disclosures* (paragraph BC29) portrays the notion of interdependence for a compound financial instrument:



25. Interdependencies result in an ‘overlap’ because the values of two components depend on each other. This, in effect, means that the cash flows from one component affect the cash flows from another component and vice versa. Such interdependencies are also present between components of an insurance contract, for example:

- (a) Surrender options. Often, cancelling the deposit component requires cancelling the insurance component as well. The value paid out on surrender (surrender value) is i) a repayment of the deposit component (if any) plus ii) the compensation for forfeiting the right to future insurance coverage less iii) surrender charges (if any). In principle, the deposit component does not

include the part of the surrender value needed to compensate the policyholder for forfeiting the right to future insurance coverage. However, it may not be straightforward to identify that part.

- (b) Guaranteed minimum death benefit and a surrender option. At maturity, the policyholder receives the account value (ie the policyholder's proportionate share of the fair value of the assets). If the policyholder dies before the end of the contract, the policyholder receives a guaranteed minimum or, if this is higher, the account value. The insurance component depends on the investment component: when the account value of a deposit component is low, it is more likely that this benefit will be payable and it is also more likely that that benefit will be higher (and vice versa). But the deposit component also depends on the insurance component: the higher the insurance benefit is, the higher the part of the surrender value for forfeiting the insurance coverage and the lower the part of the surrender value for the deposit component.
- (c) Participating features and lapse rates. Lapse rates depend on participating features: if an insurer pays lower dividends to policyholders, more policyholders are likely to cancel their contracts. But policyholder dividends also depend on lapse rates: the more lapses, arguably the lower future distributable surpluses may be available (but the more policyholder surpluses may be available for each remaining policyholder).
- (d) Dual trigger contract. The contract requires a payment that is contingent on i) an insured event and ii) a specified level of an index; the contingent payment is made only if both triggering events occur. The cash flows of the insurance component depend on the financial component; the insurance component will pay out only if the specified index is above the specified level, even if the insured event happened. However, the financial component also depends on the insurance component (ie whether the insured event happens or not).

26. Note that interdependence focuses on cross-relationship between values of components. This could involve all types of cash flows. This goes further than an insurer pricing items on a 'packaged' basis; combined pricing does not automatically result in cash flows of components reacting to each other.

27. The challenge would be how to deal with the overlap demonstrated in the diagram in paragraph 24 if one were to unbundle interdependent components, We identified two approaches:
- (a) measure one component and treat the other component as a residual. In this respect, the order of unbundling matters. If one decide to first measure component A, then component B would be the residual. The opposite would be true as well. A decision is needed about which component to measure and which component to treat as the residual. This exercise would become increasingly difficult if one would have to unbundle more than two components.
 - (b) split the components, including the overlap. The second option requires splitting all cash flows, including the common ground that components share. To achieve this, the insurer would have to identify an objective factor for deciding which part should be allocated to each of the components. The insurer would probably not be able to identify an objective factor for deciding which part of the ‘overlapping’ area should be allocated to each of the components.
28. As a result of these challenges, some question the usefulness of unbundling.

When to unbundle

29. To never require unbundling would go too far because in some cases, where there would be no difference between a) the measurement of the contract as a whole and b) the sum of the measurement of the components, it seems quite natural to unbundle. Furthermore, never requiring unbundling could result in structuring.
30. To require unbundling in every case will not work either, simply because there will always be some contracts that are too difficult to unbundle and for which the resulting information would not be useful.
31. Therefore the staff proposes that the insurer should unbundle on the basis of a trigger. In determining this trigger, we propose to look at interdependency. Interdependence is the key factor that creates ‘overlap’ of components in the first

place. And it also captures other likely notions that might act as the trigger, such as reliably measurable and readily separable:

- (a) If components are interdependent, it arguably will be difficult to measure them reliably without costs exceeding benefits.
- (b) If components are interdependent, it would be unlikely that they are readily separable.

32. The interdependence test would be applied:

- (a) in two directions, in other words one component depends on the other but the opposite needs to be true as well. Thus, if component A is dependent on component B, but component B is not dependent on component A, component B would be unbundled.
- (b) to the individual components of the contract. If there is interdependency between some components but not between others, those components that are not subject to interdependency should be unbundled. Another approach would have been to state that if some components of a contract are subject to interdependency but not all, none of the components of a contract should be unbundled.

33. How to unbundle is not an issue under the interdependence principle; if components are not interdependent and need to be unbundled, the insurer should be able to determine an objective factor for separating the cash flows without any arbitrariness.

34. The boards have already confirmed tentatively that, if unbundling would be required, it should not be permitted for reasons of (i) logic (it does not seem useful to permit something that is not considered to be useful) and (ii) comparability.

35. The staff expect that in many cases interdependency will exist between the components of insurance contracts. But some components would be separated because they would not interrelate with other components, for example:

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- (a) components that are combined in one single contract for reasons other than economic. An example would be goods and services included in the contract that are unrelated to the insurance coverage, for example fertiliser and cars.
- (b) an account-driven contract which pays, in addition to the account value, a fixed death benefit (say CU 100,000) but includes no other features or options. For this contract, the insurance component does not depend on the account value of the contract. Because the insurance component gives a fixed amount at risk, the account value does not depend on insurance component either.

36. A particular type of contract that, at least intuitively, puts pressure on unbundling is described in agenda paper 14A (FASB Memorandum 39A) as account-driven contracts. This includes universal life contracts and unit-linked contracts. Some see such contracts as mainly investment products with some insurance coverage attached that would be likely candidates for unbundling.

37. Staff acknowledges that in some, or perhaps a only a few, cases a unbundling principle based on interdependence would result in unbundling account-driven contracts (see the example in paragraph 35(b)). But in many cases account-driven contracts include all sorts of features that create interdependencies, such as surrender options, and guarantees. In this respect, we believe that account-driven contracts are no different than other types of insurance contracts, This is in line with the observation in agenda paper 14A (FASB Memorandum 39A) that ‘the combination of elements in the [account-driven] contract do not behave the same as a synthetic combination of independent items’. We therefore believe that the unbundling principle based on interdependence should be applied to account-driven contracts like it would be applied to other types of insurance contracts.

38. We note that some staff members may be developing an alternative view, particularly focussing on account-driven contracts.

Question #1 for the boards

Do you agree that unbundling of a component of a contract for recognition and measurement should be required if that component is not interdependent with other components of the contract?

If not, what approach should the exposure draft adopt for unbundling for recognition and measurement and why?

Question #2 for the boards

Do you agree with staff recommendation that, in cases where unbundling would not be required, it should be prohibited?

Embedded derivatives

39. At their extra joint meeting in January, the boards also discussed embedded derivatives. The boards questioned how the issue of bifurcating embedded derivatives would fit in with the proposed application for unbundling.

40. We identified three approaches for dealing with embedded derivatives:

- (a) Do not bifurcate embedded derivatives and measure them all under the proposed insurance contracts model.
- (b) Apply an unbundling trigger based on existing guidance for bifurcation.
- (c) Apply an unbundling trigger based on interdependency, the same trigger proposed for all other components.

41. Arguably many embedded derivatives would be interdependent; the value of embedded derivatives such as cancellation options and interest guarantees depends on other components but also affect other components. One form of embedded derivative that would not be interdependent is an option to buy goods and services unrelated to the insurance coverage.

42. Some might argue that existing guidance should be used for bifurcating embedded derivatives for the following reasons:

- (a) embedded derivatives that would be separated under existing guidance would be measured at fair value. Fair value is the only appropriate measure for all derivatives and all derivatives should be measured using a consistent measurement attribute.
- (b) significant pressure will be placed on the definition of an **insurance contract** and entities will have an incentive to meet the definition to avoid accounting for derivatives at fair value.
- (c) the guidance for bifurcation is already present in current practice. No new guidance would have to be developed; accounting for embedded derivatives would simply be a continuation of existing practice.

43. However, if the boards affirm (IASB: reaffirm) the unbundling approach proposed this paper, the staff propose that the boards also apply that approach for bifurcation of embedded derivatives for the following reasons:

- (a) bifurcation of embedded derivatives is one form of unbundling. Applying the same principle would result in one consistent unbundling principle for all components of the contract and all the existing guidance, for example the detailed guidance in the implementation guidance in IFRS 4, would become redundant;
- (b) some might prefer using existing bifurcation guidance for embedded derivatives. But arguably the notion of interdependence will differ from existing bifurcation guidance to some extent. If there would be some difference, it arguably is not worth putting effort in trying to resolve those differences because the outcome of the proposed measurement for insurance

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contracts would be close enough to fair value.¹ The proposed insurance measurement achieves the main benefits that fair value measurement achieves; eliminating the remaining differences would not provide users with significant additional benefits.

Question #3 for the boards

Do you agree with the staff recommendation that, if the boards affirm the unbundling approach proposed this paper, an insurer should apply the notion of interdependence for bifurcation of derivatives embedded in insurance contracts?

Unbundling for presentation

44. The previous sections deal with unbundling for recognition and measurement. Another, but related, question is whether to unbundle for presentation in the statement of comprehensive income. This means that the insurer would:
- (a) separate the premium into parts that belong to the separate components of the contract, and
 - (b) treat those parts of the premium as they would have been treated under the accounting model for those separate contracts
45. The most important issue would be how to deal with a deposit element in the premium.
46. Arguably, unbundling a deposit component would always have some connection with measurement. If unbundling a deposit component for measurement is not required because it not considered useful, it is likely that separating the premium into a deposit element and a fee element for presentation purposes would not be useful either.

¹ Paragraphs 7-10 of agenda paper 7C (FASB Memorandum 32C) issued for the December joint meeting discuss the differences between a fair value measurement and the measurement proposed for insurance contracts.

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47. Therefore, staff recommends (i) not to require and (ii) not to permit unbundling of the deposit component for presentation purposes if unbundling of that component is not required for recognition and measurement.

Question #4 for the boards

Do you agree with staff recommendation that the boards should prohibit an insurer from unbundling the deposit component for presentation in the performance statement if unbundling of that component is not required for recognition and measurement?

If not, what approach should the exposure draft take to unbundling a deposit component for presentation purposes and why?