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Staff Paper

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Project **Insurance Contracts**

Topic **Follow-up on Unbundling-Part 3**

Purpose of this paper

1. In June, the boards discussed when to separate components of an insurance contract (unbundling) and requested that the staff perform additional research in developing the concepts behind a principle for when to separate components of insurance contracts. This paper discusses the proposed approach to unbundling to be included in the forthcoming exposure draft on insurance contracts.

Summary of staff recommendations

2. The staff recommends that the forthcoming exposure draft requires unbundling of following components of a contract that are not closely related to the insurance coverage specified in that contract:

   (a) policyholder account balances, that bear an explicitly credited return at a rate commensurate with the market rate for an investment that exposes the account balance to the same risks, supplemented with the guidance in paragraph 21, and

   (b) embedded derivatives that are separated under existing bifurcation guidance.

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(c) goods and services provided under the contract that are not closely related to the insurance coverage, supplemented with the clarification that the intention is not to create or require an exhaustive search for goods and services that are not closely related but to deal with situations where goods and services have been combined with the insurance coverage for reasons other than economic.

Structure of the memorandum

3. The rest of this paper is divided into the following sections:

   (a) Background (paragraphs 4-6)

   (b) Significant interdependence (paragraphs 7-8)

   (c) Variability in the overall cash flows (paragraphs 9-11)

   (d) Issues with defining a principle for unbundling (paragraphs 12-14)

   (e) An alternative approach (paragraphs 15-26)

   (f) Staff analysis and recommendation (paragraphs 27-30)

Background

4. At the June 23 2010 joint meeting, the boards discussed Agenda Paper 1C (FASB Memorandum No. 51C). In that paper, the staff proposed an unbundling principle based on an assessment of whether there is significant interdependence between components of an insurance contract. However, the boards questioned the clarity of the notion of significant interdependence.

5. Instead, the boards asked the staff to develop an unbundling principle that uses as a starting point whether a component can introduce variability in the overall cash flows

of the insurance contract for risks that are not considered part of the provision of insurance protection. The boards tentatively decided that, if development of an unbundling principle based on such a notion is not achievable, the forthcoming exposure draft will include an unbundling principle based on significant interdependence.

6. At earlier meetings, the boards decided the following on specific unbundling topics:

   (a) to unbundle policyholder account balances account-driven contracts (May 17 meeting)

   (b) to unbundle embedded derivatives using the unbundling principle that would be developed for, and applied to, all other components of an insurance contract (June 17 meeting).

Significant interdependence

7. At the May 2010 joint meeting, the boards discussed Agenda Paper 2E (FASB Memorandum No. 45E). In that paper, the staff recommended the following principle for when to unbundle an insurance contract:

   > **A component of an insurance contract should be unbundled if it functions independently from other components of that contract. A component functions independently if it is not significantly interdependent with other components of that contract.**

8. As mentioned earlier, the boards questioned the clarity of the notion of significant interdependence, involving issues such as:

   (a) what does interdependence mean? Does this relate to a pricing interdependency because components are priced as a package? Or should there also be interdependency between values of components as a result of cash flow scenarios

reacting to each other. [At previous meetings, staff explained that for a current measure like insurance only the latter notion would be relevant].

(b) when is interdependence significant enough? Arguably, many components of an insurance contract have some connection with other components of that contract. But in some cases, this connection would be trivial. In other cases, however, components are more intertwined. Where would the dividing line be that determines when interdependence becomes so significant that it makes unbundling a costly and burdensome exercise that does not provide useful information?

(c) what elements or components create significant interdependence? For example, is the presence of a surrender option alone sufficient to create significant interdependence?

Variability in the overall cash flows

9. At the June 23 meeting, the boards asked the staff to develop an unbundling principle that uses as a starting point whether a component can introduce variability in the overall cash flows of the insurance contract for risks that are not considered part of the provision of insurance protection. Board members suggested other factors that might be relevant, such as:

(a) the policyholder's ability to obtain some or all of the contract value through withdrawal or redemption; and

(b) the nature of the risks transferred by a component (eg whether those risks are primarily financial).

10. The staff considered the drafting of a principle based on variability in the overall cash flows; such a principle could the expressed in the following way:

> **A component of an insurance contract should be unbundled if that component causes variability in the amount or timing of the insurer's overall cash flows from the insurance contract and that variability results primarily from factors other than insurance risk.**

11. However, this drafting raises a need for further clarification on a number of issues:

    (a) what is variability? Does it refer to variability created by the contract, or variability transferred by the policyholder to the insurer? Only the first notion would include cash flow variability introduced into the contract by risks retained by the policyholder, eg participating features. Further, risks such as lapse risk and expense risk are not existing risks transferred from the policyholder, they are new risks created by the contract.

    (b) what does 'factors other than insurance risk mean? Should that be captured by using a more general notion like 'factors that are not closely related to the insurance coverage'? Or should it be made more specific by focussing on a particular area, presumably financial risk. Referring to financial risks would deal with the items that the boards seem most concerned about (account balances and embedded derivatives). However, financial risk would probably not cover other goods and services (eg fertiliser) that might be combined with insurance coverage.

    (c) what does primarily mean? Where is the line between variability that relates so much to risk other than insurance risk that unbundling is justified and variability that relates to a larger extent to the insurance component? This inevitably leads to issues about significance and materiality.

Issues with defining a principle for unbundling

12. Both principles described above have their issues. A common theme in those issues is how to express a notion that results in a balanced unbundling approach that:

(a) does not unbundle too few components, eg by leaving components together that have no or only little relationship.

(b) does not unbundle too many components, eg by trying to split components that belong too each other naturally.

(c) results in answers under (a) and (b) without ambiguity.

13. One way to deal with a potential lack of clarity is to provide additional guidance. Such guidance can clarify the underlying intent of the boards and it can assist in applying a principle to specific cases by providing factors for consideration and examples. But application guidance cannot solve any fundamental issues that might exist with a principle in the first place. Without a clear and robust underlying principle, application guidance runs the risk of, in the end, resulting in a list of rules.

14. The boards could decide to include an unbundling principle in the forthcoming exposure draft, supplemented with application guidance. However, for reasons mentioned above, the development of such a principle comes with a number of challenges. That is probably valid for any unbundling principle the boards would develop; we have so far not been able to identify a principle that would be without potential issues and controversy.

An alternative approach

15. There is an alternative to defining an unbundling principle:

(a) identify the components that seem to the most prominent candidates for unbundling (or, put otherwise, the components that the boards are most worried about if not unbundled).

(b) require the bifurcation of the components identified in (a) supported by a rationale for why those components should be unbundled, and provide any specific guidance that is necessary to implement the unbundling of those components.

16. This is a pragmatic approach that basically combines the thought process behind an unbundling principle with prescriptive guidance, but avoids the problems of actually having to define and implement a specific principle.

17. When looking back at the past meetings, staff noted two components that persistently came up as likely candidates for unbundling:

(a) policyholder account balances that bear an explicitly credited return at a rate commensurate with the market rate for an investment that exposes the account balance to the same risks (see also paragraph 21). Those account balances behave in a way similar to a stand-alone investment contract.

(b) embedded derivatives, particularly the ones that would be separated under existing bifurcation guidance and accounted for at fair value through profit or loss.

18. Under this pragmatic approach, the boards would simply require that those two components should be unbundled. When looking at the two unbundling principles mentioned in this paper, that outcome seems to be quite straight-forward for those components:

(a) A policyholder account balance defined as in paragraph 17(a) would not be (significantly) interdependent with other components. And the variability of that component would primarily relate to financial risks.

(b) An embedded derivative that is not closely related does not share the characteristics of the host insurance contract. Hence, embedded derivatives that are not closely related would be subject to variability that relates primarily to risks other than insurance risk. And if the derivative relates primarily to eg financial

risk, it could also be considered to be independent of the host insurance contract because the cash flows scenarios of both components would not react in a significant way to each other.

19. The underlying rationale for unbundling those policyholder account balances and embedded derivatives seems to be the fact that they are not closely related to the insurance coverage in the contract. Adding this rationale as an introduction to the requirements would help readers understand the boards' intention and would also provide a natural link with existing requirements for bifurcation.

20. To assist insurers in applying the requirements, the boards would also need to give guidance that specifies the features of the components that are to be unbundled in more detail. The next two paragraphs propose that guidance.

21. If the policyholder account balance bears an explicitly credited return at a rate commensurate with the market rate for an investment that exposes the account balance to the same risks, it represents an investment component with the following features:

    (a) the account balance is credited in an explicit way (ie not an implicit account balance, for example derived by discounting an explicit maturity value at a rate not explicitly stated in the contract).

    (b) the crediting rate for the account balance is determined by the investment performance of the underlying investments, namely a specified pool of investments for variable and unit-linked, a notional pool of investments for index-linked or a general account pool of investments for universal life. The crediting rate shall be commensurate with the market rate of those underlying investments and does not reflect any effects of cross-subsidy between the investment component and other components of the contract.

(c) all charges and fees assessed against the account balance, as well as cross-subsidy effects included in the crediting rate, belong to either the insurance component or another component, but are not part of the investment component.

22. If the investment component is defined that way, it acts independently of the insurance component. The investment component functions solely as a funding mechanism for other components of the contract; all the charges and fees are considered to belong to the insurance component. In that way, the investment component (policyholder account balance) exists independently from the insurance component and behaves like a stand-alone investment contract without being affected by cross-subsidy effects.

23. For embedded derivatives, the boards could simply refer to existing bifurcation guidance.[1] We did not find a need to modify or supplement existing bifurcation guidance on embedded derivatives as part of the insurance contracts project.

Are there more components that should be unbundled?

24. Staff concluded that by unbundling policyholder account balances and embedded derivatives that are not closely related, a major part of the 'unbundling universe' that might worry the boards is covered. The question then arises whether there are more components that should be identified for unbundling. But for other components the staff believe it is likely that the additional cost of unbundling would exceed the benefits.

25. For example, account balances of traditional life contracts (eg whole life, traditional participating contracts) are often implicit and arguably function more as an integral part of the insurance coverage. Another example that frequently came up during

[1] Note that the existing bifurcation guidance for embedded derivatives under IFRSs uses the notion of significant interdependence in the context of explaining whether derivatives embedded in insurance are closely related to the host (see paragraph AG33(h) of IAS 39 Financial Instruments: *Recognition and Measurement*).

meetings is a surrender option. Surrendering an insurance contract generally leads to cancellation of the entire contract (that would include any embedded derivatives and account balances). Therefore, a surrender option usually relates to various components of the contract and it may be difficult and burdensome to separate the effects of the surrender option. As a result, there seems to be little benefit in accounting for a surrender option separately. In fact, accounting for a surrender option separately would be inconsistent with the boards' decision to 'look through' those options by included future cash flows into the measurement of an existing contract on an expected value basis.

26. A final question is whether there should be a 'stop gap' that deals with situations where goods and services have been combined with the insurance coverage for reasons other than economic, for example the sale of fertiliser as part of the insurance contract. To deal with such arrangements, the boards could specify that goods and services that do not relate to the existing insurance coverage should be unbundled. This approach would be consistent with the boards' proposed treatment of **options** to buy goods and services that are unrelated to the existing insurance coverage; the insurer should account for those options as stand-alone instruments.

Staff analysis and recommendation

27. The boards can in our view choose between the following:

    (a) develop a principle that acts a filter to identify when unbundling should occur, presumably supplemented with guidance on applying that principle in specific cases. The boards could adopt a principle based on:

        (i) significant interdependence (see paragraph 7).

        (ii) variability in overall cash flows of the contract (see paragraph 10).

(b) limit unbundling to the particular components that the boards identified as the most relevant and prominent unbundling cases, namely policyholder account balances as defined in paragraph 17(a) and embedded derivatives that are separated under existing bifurcation guidance.

28. Staff sees the conceptual merit of (a) developing a principle. A principle would provide a framework for dealing with unbundling in a consistent and coherent way.

29. However, this paper describes a number of issues that make developing an unbundling principle very challenging. Staff observes that (b) limiting unbundling to identified components also deals with the most compelling unbundling cases. But under that approach there is no need to develop a principle that, because of all the challenges, may be difficult to develop and result in unintended consequences.

30. Accordingly, staff recommends to adopt (b) requiring unbundling, articulated in the following way: An insurer shall unbundle the following components of a contract that are not closely related to the insurance coverage specified in that contract:

(a) policyholder account balances, that bear an explicitly credited return at a rate commensurate with the market rate for an investment that exposes the account balance to the same risks, supplemented with the guidance in paragraph 21, and

(b) embedded derivatives that are separated under existing bifurcation guidance.

(c) goods and services provided under the contract that are not closely related to the insurance coverage, supplemented with the clarification that the intention is not to create or require an exhaustive search for goods and services that are not closely related but to deal with situations where goods and services have been combined with the insurance coverage for reasons other than economic.

Question for the boards
Do you agree with the staff recommendation in paragraph 30? If not, which unbundling principle would you adopt? (a) significant interdependence (see paragraph 7) (b) variability in overall cash flows of the contract (see paragraph 10)