Staff Paper

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Project **Insurance Contracts**

Topic **Unit-linked follow-up issues**

Purpose of this paper

1. This paper addresses two follow-up issues for unit-linked contracts. Firstly, it discusses the accounting mismatches that arise from the measurement of the assets backing unit-linked contracts, basically by reusing the material that was presented in paper 14B (FASB Memorandum 39B) for the February joint meeting. Secondly, it deals with the presentation of assets, expenses and income arising from those contracts.

Summary of staff conclusion

2. Paragraph 19 describes three approaches to accounting mismatches related to unit-linked contracts. Staff is divided in its recommendations on which approach to select.

3. With respect to presentation of assets, income and expense, staff recommend that an insurer shall present:

   (a) the pool of assets underlying unit-linked contracts as a single line item, and not commingle them with the insurer's other assets; and

(b) income and expense from the pool of assets underlying unit-linked contracts as a single line item, presented on the face of the statement of comprehensive income or disclosed in the notes, and not commingle them with income or expense from the insurer's other assets.

Background

4. The discussion paper *Preliminary Views on Insurance Contracts* defined unit-linked contracts as contract for which some or all of the benefits are determined by reference to the price of units in an internal or external investment fund (ie a designated pool of assets held by the insurer or by a third party and operated in a manner similar to a mutual fund). Therefore these contracts can be described by reference to the following two characteristics:

   (a) a fund – that is the pool of assets that back each contract (sometimes also referred to as 'separate account' in the context of US GAAP); and

   (b) a unit – that is the smallest share of the fund attributable to each contract.

5. At their February joint meeting the boards discussed unit-linked contracts and tentatively decided that an insurer shall report assets and related liabilities associated with unit-linked contracts, including those defined as separate accounts, as the insurer's assets and liabilities in the statement of financial position. Also the boards tentatively agreed that any issues arising in connection with the consolidation of investment funds associated with unit-linked contracts would be addressed within the consolidation project.

6. In this paper, staff brings back two further topics related to unit-linked contracts that were identified in the papers for February joint meeting but not discussed then:

   (a) how to deal with measurement accounting mismatches between the liabilities between unit-linked contracts and assets backing those contract?

(b) presentation of assets, income and expenses arising from unit-linked contracts.

Accounting mismatches

7. Several issues arise 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 *Financial Instruments: Recognition and Measurement* does not require that a holder looks through a mutual fund or unit-trust to its component parts.

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

9. ***Insurer shares (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 shares are incorporated in the liability measurement because they affect the liability payoffs, but those shares are not an asset of the insurer and are therefore not recognised. The changes in the liability affect income without any corresponding effect from the own-shares asset.

10. However, this recognition issue related to own shares is not a new one. A similar issue arises under IAS 19 *Employee Benefits*, for example, where the employer's own shares, when transferable, are regarded as plan assets and the benefit obligation is measured net of the fair value of plan assets. Therefore the employer's own shares are not recognised as an asset, but in effect the measurement of the liability is reduced by the fair value of the employer's own shares. However, if the shares are not transferable, they do not form part of plan assets (and so would not reduce the reported pension liability) and would not be recognised as assets. A similar

treatment also exists under US GAAP where in the FASB Accounting Standards Codification™ (ASC) Glossary it is indicated that:

> Securities of the employer held by the plan are includable in plan assets provided they are transferable.

11. Also, the same issue arose in developing IAS 32 *Financial Instruments: Presentation* and IFRS 4 *Insurance Contracts*. The accounting 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.

12. ***View A.*** Some staff take the view that the accounting 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 fund and their carrying amount (ie zero).

13. The staff who hold this view observe that financial statement users nor neither insurers find the existing accounting mismatch acceptable. They believe that users would not be particularly disturbed by the approaches that would eliminate the accounting 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, in the treatment of indemnification assets in business combinations (see paragraphs 27 and 28 of IFRS 3 and ASC 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 an accounting mismatch in the statement of financial position and a recurring accounting mismatch in the statement of comprehensive income.

14. ***View B.*** The staff who hold view B could see an argument for allowing the company's own shares included in the fund 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. However, to the extent that the shares are part of a fund that can only be used to pay policyholder benefits generated by unit-linked contracts, proponents of view B regard them as resources in the same way the other fund assets are resources. They can be sold to pay death or surrender benefits or to pay the insurer for the policyholder's mortality and expense charges, and generally cannot be used for other purposes. In other words, their qualification as 'resources' and consequently their recognition as assets is conditional upon the linkage that by contract exists between the own shares and the liabilities they, together with other assets, back. Of course, a drawback of this approach would be the need to define explicitly when this contractual linkage between the liability under the contract and the own shares is sufficiently 'strong' to allow the insurer's own shares to qualify as resources.

15. In this respect, some may argue that the definition of unit-linked contracts in paragraph 4 which does not indicate any specific characteristics of the linkage between the benefits payable to the unit-linked contract holders and the assets underlying those contract, may be not a sufficient reference to identify whether in each case own shares qualify as resources and therefore can be recognised as assets.

16. ***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 shares from the measurement of the liability, nor for treating those shares as an asset, even if their only permissible use is to satisfy a contractual obligation.

17. ***Real estate.*** In some cases, the portfolio of assets associated with unit-linked contracts may include real estate, including owner-occupied real estate. Although owner-occupied real estate can be revalued under IAS 16, the resulting change in

carrying amount is recognised in revaluation surplus, not in profit or loss, and is never recycled.

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

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

    (a) Add the three items discussed above to the list of items that qualify for the application of the fair value option, in the interest of eliminating accounting mismatches. In addition, it would be necessary to specify that holdings of the insurer's own shares would qualify for recognition as an asset if the shares back unit-linked contracts,

    (b) Adjust the measurement of the liability, or

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

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

Question 1 for the boards
Paragraph 19 identifies three approaches that the boards might take to eliminate asset-liability accounting mismatches in the accounting for unit-linked contracts. (a) Expand the list of items that currently qualify for the application of the fair value option to encompass the topics identified. In addition, specify that holdings of the insurer's own shares would qualify for recognition as an asset if the shares back unit-linked contracts (b) Reduce the measurement of the liability for these contracts by the amount of the excess of the fair value of the contractually linked assets over their carrying amount.

> (c) Do not address these accounting mismatches in this project.
>
> Which do you support?

Presentation issues

21. The presentation for the liability side is driven by decisions the boards made so far, including their approach to unbundling. This broadly means that:

    (a) policyholder account balances of unit-linked contracts are presented as a financial liability;

    (b) any embedded derivatives that are bifurcated are reported as derivatives accounted for at fair value through profit or loss.

    (c) all remaining components will be presented as part of the insurance liabilities.

22. Agenda paper 3A (FASB Memorandum 52A) discusses unbundling in more detail.

23. The following additional issues regarding the presentation of items related to unit-linked contracts need to be addressed:

    (a) assets backing those contracts; and

    (b) income and expense arising from these contracts.

Assets backing unit-linked contracts

24. In paragraph 4 we presented the main characteristics of a unit-linked contract. The units associated with each contract, together with other contract terms (eg, in some cases, a minimum guaranteed amount), define the pay-off attributable to each contract holder. The assets that the insurer holds in the underlying fund are pooled together in a specific portfolio. In the US, as well as in some other jurisdictions, assets associated with unit-linked contracts and belonging to contract holders are

insulated (by legal requirements) from an insurer's assets in order to protect them from the risk of default by the insurer.

25. Many insurers have adopted presentation approaches that separate assets in portfolios associated with unit-linked contracts from other investments. The assets may be labelled as '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.

26. These assets are resources that, by contract, fund a specified group of insurance contracts, the unit-linked contracts. All of the investment performance from the specified pool 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 minimum guaranteed returns and death benefits). This differs from other, more 'traditional', types of insurance contracts, for which actual investment returns do not determine the benefits paid to policyholders.

27. Because of the contractual link between the actual return on a specific group of assets and the crediting of the liability, presenting the assets backing unit-linked contracts separately from the insurer's other assets would provide useful information; they do not expose the insurer to the same risks as other assets that are not contractually linked in that way.

28. This separate presentation is also provided under US GAAP for the assets included in a 'separate account', which is described in the ASC Glossary as:

> An investment account established and maintained by an insurance entity under relevant state insurance law to which funds have been allocated for certain contracts of the insurance entity or similar accounts used for foreign originated products.

29. Specific conditions in ASC Topic 944-80-25-2 further define a separate account:

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.

30. If those conditions are met, according to ASC Topic 944-80-25-3, an insurer shall present the contract holders' portion of the assets in the separate account in the insurance entity's financial statements as a summary total, with an equivalent summary total reported for the related liability.

31. At present, the IFRS literature does not specifically address the treatment of unit-linked contracts and the presentation in the statement of financial position of the related assets, and in the statement of comprehensive income of the income and expense arising from those assets and the related contracts.

32. However, the definition of unit-linked contracts provided in the Discussion Paper *Preliminary Views on Insurance Contracts* and repeated in paragraph 4, refers to contracts for which some or all of the benefits are determined by reference to the price of units in an internal or external investment fund (ie a designated pool of assets held by the insurer or by a third party and operated in a manner similar to a mutual fund). The staff believe that definition is sufficiently broad to include those contracts that at present under US GAAP rely on a separate account. It also has the

benefit of describing the basic aspects of these contracts in a way that is not determined by any country-specific regulatory or legal requirements.

33. Staff conclude that the forthcoming exposure draft on insurance contracts should require, for the presentation of contracts that meet the definition indicated in the paragraph above, that an insurer:

    (a) present the assets held in the pool of assets related to unit-linked contracts (this would include the separate accounts under US GAAP) as a separate line item

    (b) use the line items it uses for all other assets it owns to present any interest the insurer holds in the underlying fund for its own account (ie the general account).

34. Therefore staff recommend that an insurer shall present the pool of assets underlying unit-linked contracts, as defined in paragraph 32, as a single line item, and not commingle them with the insurer's other assets

Question 2 for the boards
Do the boards agree with the staff recommendation in paragraph 34?

Income and expense

35. It would be consistent with the recommendation in paragraph 34 to present income and expense arising from the pool of assets underlying unit linked contracts separately and not commingle them with income or expense from other contracts.

36. Staff believe that a presentation that aims at appropriately reflecting the nature of unit-linked contracts should portray the insurer's performance in holding (and managing) the assets in the interest of unit-linked contract holders. Staff therefore think that an insurer should separately show the income and expense arising from the pool of assets underlying unit-linked contracts in order to appropriately reflects the nature of these contracts. This approach would make available for users of

financial statements information regarding the insurer's performance on unit-linked contracts.

37. Therefore staff recommend that an insurer shall present income and expense from the pool of assets underlying unit-linked contracts as a single line item, presented on the face of the statement of comprehensive income or disclosed in the notes, and not commingle them with income or expense from the insurer's other assets.

Question 3 for the boards
Do the boards agree with the staff recommendation in paragraph 37?