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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).

Summary of staff recommendations

2. The staff recommends that:
 - (a) an insurer should unbundle a component of an insurance contract if that component is not interdependent with other components of that contract;
 - (b) if components are interdependent, an insurer:
 - (i) should not unbundle those components of the contract for recognition and measurement, and
 - (ii) should not separate any deposit element from the remainder of the premium for presentation in the performance statement.

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.

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Structure of the paper

3. The rest of this paper is divided into the following sections:
 - (a) Background (paragraphs 5-7)
 - (b) Revenue recognition project (paragraphs 8-12)
 - (c) Compound financial instruments (paragraphs 13-17)
 - (d) Interdependency (paragraphs 18-21)
 - (e) How to unbundle contracts with interdependent components (paragraphs 22-24)
 - (f) When to unbundle (paragraphs 25-34)
 - (g) Permit or prohibit if unbundling is not required (paragraphs 35-36)
 - (h) Unbundling the deposit component for presentation (paragraphs 37-40)
4. It is beyond the purpose of this paper to discuss:
 - (a) bifurcation of embedded derivatives (agenda paper 7C (FASB Memorandum 32C) discusses this).
 - (b) whether an insurer should recognise items such as the pre-claims liability, the claims liability and future cash inflows separately or as part of a single net liability or asset. We will deal with this during a future meeting.
 - (c) if the investment component is regarded as funds under management, rather than as an asset and liability of the insurer, whether it will be reported off balance sheet. We will ask the boards to discuss that in January, particularly in the context of unit-linked contracts (known in the US as variable contracts).

Background

5. Unbundling, in this paper, refers to accounting for the components of a contract as if they were separate contracts. In other words, should components of contracts that are within the scope of other standards be accounted for in accordance with those standards or should they be accounted for under the proposed insurance model.

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[Agenda paper 7A (FASB Memorandum 32A) proposes a current measurement model based on a building block approach for insurance contracts.]

6. An insurance contract may contain insurance, deposit (or financial) and service components. The question of unbundling would arise if either:
 - (a) the measurement attribute for insurance liabilities differs from the measurement attribute used for financial liabilities, or for performance obligations arising under service contracts (recognition and measurement) (paragraphs 8-36), or
 - (b) insurance premiums received are reported as revenue rather than as deposit receipts (presentation) (paragraphs 37-40).
7. In its October meeting, the IASB discussed unbundling¹ [The FASB will discuss this paper in December]. During that meeting IASB members asked staff:
 - (a) to clarify how this notion relates to the notion of contract segmentation being discussed in the project on revenue recognition
 - (b) to consider whether this notion is similar to the notion that the fair value of a compound financial instrument may not equal the sum of the fair values of its components
 - (c) to develop a more detailed explanation of the notion of interdependence.

Revenue recognition project

8. Under the model proposed in the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (DP on revenue), an entity should allocate the transaction price, on a relative standalone selling price basis, to each performance obligation in the contract. When an entity satisfies a performance obligation, it should recognise revenue in the amount that was allocated to the performance obligation.

¹ October 2009, IASB agenda paper 4A.

9. In their October joint meeting, the boards tentatively decided that to implement that principle for contracts with many performance obligations, an entity should allocate the transaction price to segments of a contract rather than to individual performance obligations. A segment includes one or more performance obligations for which the entity has evidence of a market. When segmenting a contract, an entity should consider when the promised goods and services are transferred to the customer, the margins for those goods and services, and materiality.
10. The context for this discussion on segmentation was part of providing additional guidance for determining the *amount* of revenue an entity should recognise during the period from performing under the contract. Segmentation in the project on revenue recognition has the following consequences:
 - (a) Segmentation does not separate the contract into multiple contract positions; only the performance obligations in a contract position are separated into segments. The rights in the contract are measured as one bundle.
 - (b) Because only one contract position is identified, the same accounting model is used for all the segments, namely the proposed revenue recognition model.
 - (c) At inception, the same margin is allocated to all performance obligations within a segment.
 - (d) An entity recognises revenue when it satisfies each performance obligation.
11. The purpose of segmentation in the revenue recognition project was *not* to determine:
 - (a) *when* an entity should recognise revenue.
 - (b) whether an entity should account for particular rights and obligations arising under a contract:
 - (i) as part of a separate contract

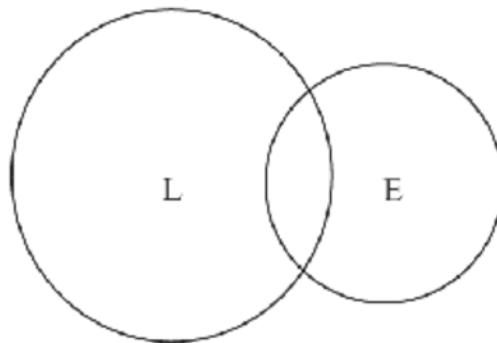
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- (ii) using an accounting model that differs from the model used for the rest of the contract.

12. The boards have not yet addressed in their project on revenue recognition whether (or when) a contract should be unbundled in the manner described in this paper, that is to say, split into separate components in order to apply the most relevant standard to each component. An example of a contract where unbundling might be relevant in the context of revenue recognition project is a financial instrument with fees, such as loan application fees. The revenue recognition project team intends to bring this issue to the boards during a future meeting, currently scheduled for January 2010.

Compound financial instruments

13. An illustration in the basis for conclusions on IFRS 7 *Financial Instruments: Disclosures* (paragraph 29) shows that the fair value of a compound financial instrument may not equal the sum of the fair values of its components.



14. The basis for conclusions on IFRS 7 (paragraphs 28-31) describes separation of the components of a compound instrument with multiple embedded derivative features, containing both a liability ('L') and an equity component ('E').
15. It explains that separating the two components will be (more) complicated if the separate components of a compound instrument are interdependent; in that case the sum of the separately determined values (the separate circle L plus the separate circle E) would not equal the sum of the compound instrument that contains both L

and E (the area covered by the combined circles, taking into account the overlap between the circles). In applying this to a compound instrument that includes an embedded derivative that would be classified as equity, paragraph 31 of IAS 32 *Financial Instruments: Presentation* requires that the liability component should be measured first and should include the joint value attributable to the interdependence. Consequently, the equity component is accounted for as the residual (with additional disclosure).

16. If an instrument has multiple embedded derivatives and none of those would be classified as equity, paragraph AG 29 of IAS 39 *Financial Instruments: Recognition and Measurement* explains that embedded derivatives that are not separated from the host contract under paragraph 11 of IAS 39² would generally be treated as a single compound derivative. Those embedded derivatives would be accounted for separately from each other only if they relate to different risk exposures and are readily separable and independent of each other.
17. Although the analysis in the basis for conclusions on IFRS 7 and the Application Guidance on IAS 39 apply to compound financial instruments with multiple embedded derivatives, staff believes that it is also a useful precedent for insurance contracts because:
 - (a) insurance contracts often contain multiple components, including embedded derivatives, and some or all of these components depend on each other
 - (b) these components may relate to the same risk exposure, and
 - (c) these components may not be readily separable.

Interdependency

18. In the basis for conclusions on IFRS 7 interdependency refers to the notion that the values of two components depend on each other. This, in effect, means that the cash

² Codification Topic 815-15 addresses the accounting for embedded derivatives under US GAAP. For purposes of the discussion in this paper, that guidance is not significantly different from IAS 39.

flows from one component affect the cash flows from another component and vice versa.

19. Examples of interdependence within insurance contracts are:

- (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 an additional death 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 only pay out 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).

20. In the above example, we looked at contracts that contain one or two interdependent components. In practice, insurance contracts may include a considerable number of those options in combination, for example the combination of a guaranteed minimum death benefit, a guaranteed minimum accumulation benefit at surrender or maturity, a surrender option and an option to make the policy paid-up (ie an option to cease paying premiums in exchange for lower benefits). Such embedded derivatives may be interrelated with each other and they may also cause interdependencies between, for example, the deposit component and the insurance component.
21. The interdependencies basically seem to reflect the same notion of interdependency that was explained in the context of the basis for conclusions on IFRS 7 (see paragraphs 13). That is, staff so far have not been able to identify anything that goes beyond it. However, the practical result of that interdependence may not always be the same because initial measurement under IAS 32 is fair value.

How to unbundle contracts with interdependent components

22. If one wants to unbundle a contract into components that are subject to interdependency (ie have overlapping values as illustrated in paragraph 13), two broad approaches are available:
- (a) measure one component and consider the other component as a residual, or
 - (b) split up the overlapping area between the two components.
23. In both cases, the outcome of measuring the parts would equal the total measurement of the whole contract.

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- (a) If one component is measured, that component would get measured in accordance with a selected measurement approach, but the other component would simply be a residual. Furthermore, the outcome for each of the components would differ based on the order of measurement (which one is measured and which one is the residual). (The DP on insurance contracts *Preliminary Views on Insurance Contracts* proposed unbundling of this kind in specified cases, with the deposit measured directly and the insurance component measured as a residual. Respondents generally argued that the resulting measurement would not be a faithful measurement of the insurance component. Indeed, in extreme cases, the residual might be measured as an asset when it is economically a liability, or vice versa.)
- (b) Splitting the overlapping area involves attributing its value (as shown by the illustration in paragraph 13) between the components. This would inevitably be arbitrary.

24. As a result, some might question the decision-usefulness of unbundling an instrument that contains interdependent components.

When to unbundle

25. Broadly, staff identified three approaches for determining if, or to what extent, an insurer should unbundle:

- (a) Do not require unbundling at all
- (b) Require unbundling in all cases
- (c) Require unbundling in some cases but not all, based on a specified trigger.

26. Some respondents to the DP on Insurance Contracts agreed with unbundling when it could be done in a way that is not arbitrary, for both conceptual and practical reasons. Others opposed unbundling in all cases.

27. Not requiring unbundling at all would be problematic in terms of consistency:

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(a) in some cases, for example where there would be no difference between i) the contract as a whole and ii) the sum of components as if they were separate contracts, it seems quite natural to unbundle. In those cases, components are arguably separate contracts combined together and unbundling would avoid sharp accounting discontinuities by accounting for those components as if they were separate contracts. Furthermore, those components can probably be determined in a straightforward way; so the costs of unbundling would not exceed its benefits.

(b) not requiring unbundling at all could result in structuring (combining two or more components in one single contract for reasons other than economic).

28. On the other hand, requiring unbundling in all cases would not be feasible. In those cases, an insurer cannot identify evidence to decide what to allocate to each of the components (in other words; separating the components goes beyond requiring the insurer's judgment and becomes arbitrary). In such a case, unbundling would probably be costly and burdensome and, more importantly, not result in useful information :

(a) If one component is measured, that component would get measured in accordance with a selected measurement approach, but the other component would simply be a residual. Furthermore, the outcome for each of the components would differ based on the order of measurement (which one is measured and which one is the residual).

(b) Splitting the overlapping involves attributing the value of the overlapping area (as shown by the illustration in paragraph 13) to each of the instruments. For all relevant elements of that overlapping area, 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 should be allocated to each of the components.

29. The third option requires unbundling in some cases based on a trigger and combines the rationale behind the other two options; unbundle if it is likely that it can be done

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in a clear way, but not require it if it can only be done in a way that is unlikely to produce useful information and is probably costly.

30. What should the trigger be for determining when to unbundle? We identified the following options:
- (a) the components are not interdependent
 - (b) the components can be measured reliably
 - (c) the components are readily separable.
31. Interdependency seems to be a logical trigger because it best reflects the issues with values of two components depending on each other and also captures the notions of 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 staff therefore recommends to require unbundling of the components of a contract if they are not interdependent, ie the cash flows from one component do not affect the cash flows from any of the other components. The insurer should consider the circumstances to determine whether components are interdependent. Factors that might indicate (or help identify) interdependency are:
- (a) for some or all elements that need to be considered when separating the components, the insurer cannot identify what to allocate to each of the components; thus the allocation would require an arbitrary split.
 - (b) significant embedded derivatives.
33. Staff notes that these unbundling requirements should be applied 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

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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. However:

- (a) staff did not see a rationale why the reasoning in paragraph 27 would apply only to the contract as a whole, but not to individual components in a contract.
- (b) this could give rise to structuring.

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?

34. When the boards discuss unbundling in their project on Revenue Recognition at a future meeting, staff will determine whether the decisions the boards made on unbundling in that project have an impact on the insurance contracts project.

Permit or prohibit if unbundling is not required

35. If unbundling is not required based on the principle in paragraph 32, should it be
- (a) permitted, or
 - (b) prohibited?
36. Respondents have repeatedly emphasised that unbundling would be arbitrary, artificial and burdensome in most cases. This means in our view that insurers are unlikely to opt for unbundling if components are interdependent. Staff nevertheless believes that, in the case where unbundling would not be required, it should be prohibited because:
- (a) permitting unbundling in cases where it is not required (ie if components are interdependent) would be inconsistent with the reasoning that unbundling is not

decision-useful; it seems odd to permit something that would not be decision-useful.

(b) it could undermine comparability.

Question #2 for the boards

Do you agree with staff recommendation in paragraph 36 that, in cases where unbundling would not be required, it should be prohibited?

Unbundling the deposit component for presentation

37. The previous sections discussed unbundling for recognition and measurement; we argued that a component of a contract should be unbundled for those purposes only if it is not subject to interdependencies.
38. In addition, one has to consider whether the deposit component in a premium (if any) should be unbundled for presentation in the performance statement. Some existing models already use an unbundled model in the performance statement, for example *Financial Services – Insurance Topic (944)* of the FASB Accounting Standards Codification, contains such requirements for universal life contracts³ and some other participating and nonguaranteed-premium contracts. These requirements were introduced to US GAAP by SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*.
39. Could one unbundle the deposit component of a premium (ie treat that part of a premium as a deposit receipt rather than revenue) for presentation in the performance statement, even if unbundling is not applied for recognition and measurement?

³ Universal life contracts could be described as a type of permanent life insurance that allows the policyholder, after its initial payment, to pay premiums at any time, in virtually any amount, subject to a specified minimum and maximum. Universal life contracts explicitly unbundle the charges (fees) for mortality and other expenses from other contract elements. A universal life contract also permits the policyholder to reduce or increase the death benefit more easily than under a traditional whole life policy.

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40. Arguably, unbundling of 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. Therefore, staff recommends (a) not to require and (b) not to permit unbundling of the deposit component for presentation purposes if unbundling of that component is not required for recognition and measurement.

Question #3 for the boards

Do you agree with staff recommendation in paragraph 40 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?