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Sir David Tweedie, Chair  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH, United Kingdom

Mr. Robert H. Herz, Chair  
Financial Accounting Standards Board  
401 Merrit 7  
Norwalk, CT 06856-5116

Re: Insurance Contracts - Unbundling

Dear Sir David and Bob Herz:

The American Council of Life Insurers (ACLI)<sup>1</sup> is pleased to share with you our views regarding the issues related to unbundling insurance contracts, which was recently discussed at the October 2009 IASB meeting and noted at the joint IASB/FASB meeting. The IASB directed staff to develop the notion of interdependence among components of insurance contracts and bring the matter back to the Board for further deliberations at a subsequent meeting. We complement the Boards for recognizing the complexity of the issue and delaying a decision by requesting further study. Any decisions about unbundling are important to the overall measurement and presentation of insurance contract liabilities. Not only do we provide our views, but we also raise questions that we believe the Board should clarify and/or discuss before finalizing its decision about the measurement attribute for insurance contracts.

## Background

The October 2009 Staff Paper reference 4A and FASB memo reference 28A served as the basis for discussion on unbundling. The staff recommendation described in the paper argues that:

- (a) An insurer should unbundle a contract if its components are not interdependent;
- (b) The exposure draft should not state whether unbundling is prohibited or permitted in other cases.

Unbundling refers to accounting for the components of a contract as if they were separate contracts. An insurance contract may contain insurance, deposit (or financial) and service components. Staff noted that 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, or
- (b) Insurance premiums received are reported as revenue rather than as deposit receipts

The measurement models for the three relevant components (financial liabilities, insurance liabilities, performance obligations), described in the Paper, are:

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<sup>1</sup> The American Council of Life Insurers represents 340 member companies operating in the United States, of which 332 are legal reserve life insurance companies, and 8 are fraternal benefit societies. These member companies account for 93% of total life insurance company assets, 94% of the life insurance premiums, and 94% of annuity considerations in the United States.

(a) Insurance component (protection): the insurance measurements selected tentatively by the boards in this project, namely an updated IAS 37 approach for IASB and a current fulfillment value for FASB.

(b) Investment component: the measurement models for financial instruments.

(c) Service component: the model proposed in the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (the allocated transaction price model)

### **Accounting Principles-Measurement**

We believe that the building blocks approach, which has been described as foundational (principle) to the measurement of insurance contracts, should also serve as foundational for financial liabilities and performance obligations. That does not mean that the measurement must be identical for all contracts or obligations. For example, unearned premium reserve (UPR) has been tentatively decided as a proxy for measuring certain short-duration insurance contract liabilities. The Boards should articulate a common principle with additional guidance to supplement the principle to address unique features of the instrument being measured.

With respect to insurance contracts, the building blocks serve as the principle. Whether the Boards ultimately select the updated IAS 37 or current fulfillment approach for the measurement of insurance contract liabilities, the result will be that current estimates about the inputs to the measurement will be used. Consequently, we question the need to unbundle components of the contract. For example, there would be no need to unbundle an embedded derivative measured at fair value when the host contract is also measured at fair value or current value. As we have expressed in the past, the measurement of insurance contract liabilities needs to take into account all future cash flows including those cash flows associated with options and guarantees contained in the contract. Unbundling of interdependent cash flows, in our opinion, would result in arbitrary measurement decisions serving only to confuse and possibly mislead users of the financial statements.

Currently, stock analysts, regulators, rating agencies, and other financial statement users generally have an understanding of the current accounting model for traditional insurance and reinsurance. Unbundling of components within such contracts especially for financial reporting purposes would result in significant cost to develop and maintain the bundled and unbundled pieces, which in certain contracts may be an arbitrary allocation.

Views on the disadvantages of unbundling, especially when components of the contract are interdependent, were also expressed in response to the FASB's *"Invitation to Comment on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting"*, published in May 2006. The key concerns expressed in those responses by the insurance industry were:

a) Components of insurance contracts are closely interrelated and the value of the bundled product may differ from the sum of the individual values of the components.

(b) From a business perspective insurance contracts are designed, priced, managed and regulated as a package of benefits and the insurer cannot unilaterally terminate the agreement or sell parts of it. Any unbundling required solely for accounting would be artificial and often require significant and costly systems changes.

Having listened to the discussions about unbundling for some time, we believe the issue of unbundling may be about presentation and not measurement. The Boards' first priority should be to reach a decision about the measurement of insurance contract liabilities. Unbundling if necessary and the disaggregation of information about the liabilities whether on the face of the financial statements or in the notes should focus on the decision usefulness of the information.

## Unbundling

If the Boards conclude that guidance is needed about unbundling clearly stated objectives along with definition of terms is essential. In considering this issue, we believe the starting point should be a review of existing U.S. and international accounting literature. In U.S. GAAP, FASB Accounting Standards Codification (ASC) Master Glossary contains definitions that could meet this objective. The ASC defines integrated contract features, nonintegrated contract features and base contract as follows:

**Integrated contract feature-** A contract feature in which the benefits provided by the feature can be determined only in conjunction with the base contract.

**Nonintegrated contract feature-** A contract feature in which the benefits provided are not related or dependent on the provisions of the base contract.

**Base contract-** The type of contract specified in the policy form prior to the addition or election of riders or other contract features. For example, for an annuity with a guaranteed minimum income benefit (GMIB) rider, the annuity would be considered the base contract.

The terms integrated and nonintegrated are further described in ASC paragraph 944-30-35-30 and paragraph 944-30-35-31, which we find helpful to understand their meaning.

“For long-duration contracts, integrated contract features are those for which the benefits provided by the feature can be determined only in conjunction with the account value or other contract holder balances related to the base contract, and nonintegrated contract features are those for which the determination of benefits provided by the feature is not related to or dependent on the account value or other contract holder balances of the base contract. Underwriting and pricing for nonintegrated contract features typically are executed separately from other components of the contract, and it is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided.

For short-duration contracts, nonintegrated contract features are those that provide coverage that is underwritten and priced only for that incremental insurance coverage, and do not result in the explicit or implicit re-underwriting or repricing of other components of the contract. It is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided. Additional coverage provided by a nonintegrated contract feature would be considered nonintegrated even though the entire coverage provided by the short-duration contract may be subject to only one deductible or limit in the event of an insured loss. For short-duration contracts, integrated contract features are those where there is explicit or implicit re-underwriting or repricing of existing components of the base contract.”

Paragraph 10 of IFRS 4 contains guidance about unbundling of deposit components.

Some insurance contracts contain both an insurance component and a *deposit component*. In some cases, an insurer is required or permitted to *unbundle* those components:

- (a) unbundling is required if both the following conditions are met:
  - (i) the insurer can measure the deposit component (including any embedded surrender options) separately (ie without considering the insurance component).
  - (ii) the insurer's accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component.

- (b) unbundling is permitted, but not required, if the insurer can measure the deposit component separately as in (a)(i) but its accounting policies require it to recognise all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations.
- (c) unbundling is prohibited if an insurer cannot measure the deposit component separately as in (a)(i).

The guidance in 10.a., in our view, is an effort to identify measurement differences, either in the measurement attribute applied to the components or failure to include all expected cash flows in the measurement. Once the measurement attribute for insurance contracts is settled, this paragraph of IFRS 4 should be reviewed. We do not believe that the deposit component should be separated-unbundled or disaggregated, nor should this paragraph be retained as long as the measurement takes into account all cash flows of the contract.

### Illustration

An example is useful to understand the application of the term integrated. A policyholder who purchases a \$100,000 whole life contract paying an annual premium of \$1,000, has acquired a contract with a variety of features-death benefit, surrender for its cash value, maturity value (face amount of the contract at the end of its term), and extended coverage, to name a few. As long as the policyholder pays the annual premium, the insurer is obligated (stand ready obligation) to pay the beneficiary the death benefit of \$100,000 upon the death of the insured. If the insured lives to the end of the contract term, e.g., age 100, the insurer will pay the face amount of the contract-\$100,000 at that date. In other words, the insurer knows it will pay \$100,000 but doesn't know when the payment will be made.

Alternatively, the policyholder can surrender the contract for its cash value or elect to use the proceeds to purchase a life income. The contract typically details the surrender value at any point in the life of the contract. If the policyholder surrenders the contract, e.g., at the end of ten years for \$6,500, the policyholder forfeits the right to the death benefit. The surrender benefit and death benefit are integrated since their features are a function of the base contract. The measurement of the liability would take into account the probability of all scenarios and to unbundle the components adds complexity and cost with little value if any to the users.

### Recommendation

We believe the Boards' first priority should be to settle on the measurement attribute for insurance contracts. There should not be a requirement to separate components of the contract where the components are integrated since all cash flows are taken into account in the measurement. Secondly, the issue of unbundling is primarily about presentation and disaggregation. Clearly defined objectives and terms are needed that focuses on decision useful information. We request the Boards consider these responses in their discussions on unbundling. We welcome the opportunity to continue the discussion of these issues at your convenience.

Sincerely,



Cc: Peter Clark, IASB staff  
Hans van der Veen, IASB staff  
Jeffrey Cropsey, FASB staff  
Mark Trench, FASB staff