NAIC

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

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

EXECUTIVE HEADQUARTERS

2301 McGee Street
Suite 800
Kansas City MO
64108-2662
Voice 816-842-3600
Fax 816-783-8175

FEDERAL AND INTERNATIONAL RELATIONS

Hall of the States
444 North Capitol St NW
Suite 701
Washington DC
20001-1509
Voice 202-624-7790
Fax 202-624-8579

SECURITIES VALUATION OFFICE

1411 Broadway
9th Floor
New York NY
10018-3402
Voice 212-398-9000
Fax 212-382-4207

WORLD WIDE WEB

www.naic.org

Dear Sir David:

Thank you for the opportunity to comment on the Exposure Draft of the International Accounting Standards Board Financial Instruments Project (Exposure Draft). On behalf of the International Accounting Standards Working Group (IASWG) of the National Association of Insurance Commissioners (NAIC), I am pleased to provide you with comments on the International Accounting Standards (IAS) in response to your Invitation to Comment.

Formed in 1871, the NAIC is a voluntary organization of the chief insurance regulatory officials of the 50 states of the United States of America, the District of Columbia, American Somoa, Guam, Puerto Rico and the Virgin Islands. The mission of the NAIC is to assist state insurance regulators, individually and collectively, in serving the public interest and achieving the following fundamental insurance regulatory goals in a responsive, efficient and cost-effective manner, consistent with the wishes of its members:

1. Protect the public interest, promote competitive markets and facilitate the fair and equitable treatment of insurance consumers.
2. Promote the reliability, solvency and financial solidity of insurance institutions; and
3. Support and improve state regulation of insurance.

In fulfilling this mission, the NAIC has developed significant experience and expertise in the development of meaningful accounting principles for use in the financial statements of insurance enterprises. In 1998, the NAIC completed the base portion of the Codification of Statutory Accounting Principles project whose purpose was to produce a comprehensive guide to statutory accounting principles. This guide, called the *Accounting Practices & Procedures Manual* (NAIC SAP), which became effective January 1, 2001, is to be used by every insurance company in the United States in preparing financial statements for use by insurance regulators and is the result of over nine years of hard work and dedication by regulators and members of the U.S. Insurance Industry.

The fundamental concepts upon which these principles were promulgated are conservatism, consistency and recognition. These principles are materially different than the framework used by the International Accounting Standards Board (IASB). For this reason, the NAIC has taken a significant interest in the International Accounting Standards of the IASB. Additionally, the NAIC would note that our opinions and recommendations regarding this guidance might change as other subsequent projects are completed at the IASB.

The NAIC's interest in the IASB's Exposure Draft: International Accounting Standards, Financial Instruments Project, as with all standards developed by the IASB, is to assist the IASB in developing high quality standards to be used uniformly across all countries. The objective of the IASB Financial Instruments Project is to improve the existing requirements in IAS 32, Financial Instruments: Disclosure and Presentation and IAS 39, Financial Instruments: Recognition and Measurement. It is anticipated that the proposed amendments will reduce the complexity by clarifying and adding guidance, eliminate internal inconsistencies, and incorporate key elements of existing Standing Interpretations Committee (SIC) Interpretations and IAS 39 Implementation Guidance. For these reasons, the NAIC has reviewed and prepared comments on this Exposure Draft and is supportive of the IASB's objectives.

The NAIC has performed a comparative analysis of the International Accounting Standards contained in the Improvements Project to Generally Accepted Accounting Principles (GAAP) and the NAIC Statutory Accounting Principles (SAP). The NAIC performed this analysis with the understanding that the statutory principles underlying the financial statements prepared for regulatory use are sometimes different than those principles underlying financial statements prepared for general purposes. Based on this understanding, the NAIC comments provide some discussion of statutory accounting principles, but most importantly, they provide final recommendations based upon a general-purpose financial statement framework.

These comments have been prepared by the IASWG of the NAIC and are organized in a manner consistent with the questions outlined in the IASB's Invitation to Comment. As part of the NAIC's due process procedures, these comments have also been shared with interested parties to the IASWG, all of whom were given an opportunity to contribute to these comments.

IAS 32 - Financial Instruments: Disclosure and Presentation

Question 1 – Probabilities of different manners of settlement (paragraphs 19, 22 and 22A)

Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be reclassified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

Response:

The definition of a financial liability as provided in IAS 32, paragraph 20 agrees with the definition of a financial liability supported by GAAP and the NAIC SAP:

Financial liability - A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

We would concur that those financial instruments that are liabilities in substance should be reported as liabilities. We would also agree with the determinations of a financial liability as provided in IAS 32, paragraphs 22A-22D.

Question 2 – Separation of liability and equity elements (paragraphs 28 and 29)

Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?

<u>Response:</u>

We have no comment on the new guidance that addresses the allocation of equity and liability elements for compound instruments. Although statutory accounting does not separate the liability and equity components of a financial instrument, our framework requires that embedded derivatives be included within the host contract. As such, we do support the proposed guidance for embedded derivatives to be included (not separated) within the liability component of the instrument.

Question 3 – Classification of derivatives that relate to an entity's own shares (paragraphs 29C-29G)

Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?

Response:

In accordance with our special-purpose framework, we have no comment over the specific requirements to classify a derivative contract as an equity instrument. In considering this question on a general-purpose financial statement approach, we would request the Board to adopt guidance similar to GAAP as described in ETIF 00-19.

We agree with the IAS definition of a financial liability as a contract that imposes a contractual obligation on an entity to deliver cash or another financial instrument or to exchange other financial instruments on potentially unfavorable terms. The use of this definition appears to be consistent with the determination of a derivative liability included within IAS 32, paragraphs 29D-29G.

Question 4 – Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard

Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalizing the revised Standards.)

<u>Response:</u>

It would be considered beneficial if IAS 32 and IAS 39 were combined into one comprehensive standard for financial instruments.

IAS 39 - Financial Instruments: Recognition and Measurement

Question 1 – Scope: loan commitments (paragraph 1(i))

Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

Response:

Loan commitments, as indicated in IAS 39 Paragraph 1(i) would not be considered applicable for the insurance industry. As such, the IASWG has no comment on this question.

Question 2 – Derecognition: continuing involvement approach (paragraphs 35-57)

Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

Response:

We have adopted the GAAP 'financial components approach' for the determination of asset derecognition. This approach is not consistent with the IAS 'continuing involvement approach'. Under the GAAP/SAP approach, transferred assets should not be derecognized and accounted for as a sale unless the transferor has surrendered control of the assets and consideration other than beneficial interests in the transferred assets is received in exchange. We would request the IASB to consider the FAS 140 guidance as a basis for the derecognition of assets:

A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

- *The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.*
- *Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right, to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right, to pledge or exchange those interests; and*
- *The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (ii) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.*

If these conditions are not met, the transaction should not be recorded as a sale, but should be recorded as a financing arrangement with the transferee.

The ‘financial components approach’ is also used for servicing assets and liabilities. Under this approach, servicing rights become an asset or liability only when contractually separated from the underlying assets or with a separate purchase or assumption of the servicing. If distinct servicing rights exist and are retained by the reporting entity, then the reporting entity shall recognize a servicing asset or liability. When servicing fees received exceed the cost of servicing the asset, the asset is not permitted to be reported on the balance sheet. When the cost of servicing the asset exceeds any servicing fees received, a liability and a corresponding loss should be recorded. Servicing assets and liabilities should be amortized into income over the servicing income or loss period.

Question 3 – Derecognition: pass-through arrangements (paragraph 41)

Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the exposure draft?

Response:

Although the guidance provided in IAS 39 is supportive of the SAP requirements for Special Purpose Entity (SPE) pass-through arrangements, we cannot support the proposed guidance unless the requirements to be an SPE are clearly defined. We would request the IASB to consider the GAAP/SAP guidance which distinctly defines the requirements of a qualifying SPE:

- *It is a trust, corporation, or other legal vehicle whose activities are permanently limited to the legal documents establishing the special-purpose entity to:*

  i. *Holding title to transferred financial assets;*
  ii. *Issuing beneficial interests;*
  iii. *Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interest, and otherwise servicing the assets held;*
  iv. *Distributing proceeds to the holders of its beneficial interest*

- *It has a standing at law distinct from the transferor (i.e., assets are isolated from the transferor, beyond the reach of the transferor, creditors, even in bankruptcy or other receivership.*

Question 4 – Measurement: fair value designation (paragraph 10)

Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognized in profit or loss?

Response:

As the NAIC SAP guidelines relate to the special-purpose characteristics of insurance companies, we adhere to a different approach to measuring financial instruments than GAAP and the recommended IAS guidelines. Our approach, which focuses on conservatism and the ability of companies to meet policyholder expectations, does not support valuing financial instruments, other than at initial recognition, at fair value. The measurement of financial instruments under statutory accounting primarily depends on market value or an amortized cost method. As we understand that this is a regulatory approach and is unable to be included as an international standard, we would like to comment on the proposed IAS guidance on the basis of a general-purpose financial statement approach.

While commenting on this proposed guidance for the purposes of a general-purpose financial statement, we are unable to support the proposed IAS guidelines that would permit the irrevocable designation at initial recognition of an instrument at fair value. Although, the IAS indicates that the "designation of a financial instrument as held for trading is not precluded simply because the entity does not intend to sell or repurchase in the near term", we believe that this classification is only for those instruments that reflect active and frequent buying and selling and/or an objective of generating profits on short-term differences in price. Those instruments that do not meet this category should be classified as available-for-sale or held-to-maturity depending on the anticipation of use. For those instruments classified as available-for-sale, a fair value valuation method would be appropriate, but those securities that are being held-to-maturity would generally be more properly valued under the amortized cost method. Even though instances in which transfers occur from instruments classified as 'trading' to the 'held-to-maturity' or 'available-for-sale' classifications are considered rare, the company should be instructed to properly allocate and value these instruments as appropriate without the benefit of an irrevocable designation.

Question 5 – Fair value measurement considerations (paragraphs 95-100D)

Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95-100D of the exposure draft? Additional guidance is included in paragraphs A32-A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

<u>Response:</u>

For those instances in which fair value is utilized to value a financial instrument, the NAIC SAP guidance mirrors the guidance provided in IAS 39, paragraphs 95-100D. However, to reiterate the response of question 4, under statutory accounting there are only limited opportunities in which fair value will be used for the measurement of financial instruments.

Question 6 – Collective evaluation of impairment (paragraphs 112 and 113A-113D)

Do you agree that a loan asset or other financial asset measured at amortized cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?

<u>Response:</u>

NAIC SAP does not endorse the use of a collective evaluation of impairment in the manner suggested by IAS 39. In addition to completing an individual asset impairment evaluation, our special-purpose framework prohibits assets that will not be available for current or future policyholder obligations to be reported on the balance sheet. This process, although not considered to be a collective evaluation of impairment as promulgated by IAS 39, does require a stricter-standard for the reporting of assets. As our approach embraces a conservative reporting standard for asset recognition and reporting, we would not object to this stricter standard as recommended by the IAS.

Question 7 – Impairment of investments in available-for-sale financial assets (paragraphs 117-119)

Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?

Response:

We endorse the proposed IAS guidance preventing the reversal of impairment losses. In accordance with statutory accounting, once impaired assets are identified, the original cost basis is written down to fair value and the amount of the write down is accounted for as a realized loss. This new cost basis cannot be subsequently changed for recoveries in fair value. Additional, other than temporary, declines in the fair value of the asset are considered to be realized losses and require restating the cost basis accordingly.

Question 8 – Hedges of firm commitments (paragraphs 137 and 140)

Do you agree that a hedge of an unrecognized firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

Response:

We have adopted the guidance included in FAS 133, which indicates that qualifying fair value hedges must be identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. This guidance does support the proposed revision in IAS 39 to classify unrecognized firm commitments as fair value hedges and not cash flow hedges.

Question 9 – 'Basis Adjustments' (paragraph 160)

Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognized directly in equity should remain in equity and be released from equity consistently with the reporting of gains and losses on the hedged asset or liability?

Response:

Although NAIC SAP does not particularly address this issue, we would support the proposed IAS guidance in a general-purpose financial statement as it is analogous with the FAS 133 guidance.

Question 10 – Prior derecognition transactions (paragraph 171B)

Do you agree that a financial asset that was derecognized under the previous derecongition requirements in IAS 39 should be recognized as a financial asset on transition to the revised Standard if the asset would not have been derecognized under the revised derecognition requirements (i.e., that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognized had the new requirements been applied?

Response:

We have no comment on this question.

Additional Comments:

In addition to responding to the questions requested by the IASB, we would like to convey the following as additional comments to IAS 32 and IAS 39:

Insurance Contracts Definition

We have noted that the IASB is inconsistent with the application of the definition of an insurance contract (particularly in IAS 32 and IAS 37). This causes concern as each existing definition produces a slightly different result. We would request the Board to determine a definition of insurance contracts, which could be consistently applied over the international standards, that focuses on insurance risk (similar to the Draft SOP for the Insurance Contracts Project) and not financial risk.

Insurance Contracts Application

We have noted that the IASB is currently not limiting the scope of IAS 32 and IAS 39 to exclude insurance contracts. This causes concern with regards to performance linked insurance contracts, financial guarantees (i.e., credit insurance), and derivatives embedded in insurance contracts that may fall within the current scope of these international standards. As the IASB is currently working on an Insurance Contracts Standard, we would request that these areas, as well as other areas pertaining to insurance contracts, be excluded from IAS 32 and IAS 39. We would prefer all guidance pertaining to insurance contracts to be included within the new Insurance Contracts Standard.

We appreciate the opportunity to comment on this IASB initiative. Should you have any questions, please contact me at 501-371-2667, or Julie Gann (NAIC Staff) at 816-783-8125.

Sincerely,

Mel Anderson
NAIC IASWG Chair