CL 44

October 14, 2002

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

RE: Exposure Draft of Proposed Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement

Dear Sir David:

The International Accounting Subcommittee (the Committee) of the American Council of Life Insurers (ACLI) appreciates the opportunity to provide its comments to the International Accounting Standards Board (IASB) concerning the above referenced Exposure Draft (ED). The ACLI is the principal trade association of life insurance companies, representing 399 members that account for, in the aggregate, 75 percent of the assets of legal reserve life insurance companies in the United States.

The ACLI recognizes the importance of the two Standards on financial instruments and supports the objective of the IASB to improve the existing requirements. These Standards are especially important to the insurance industry because it's our understanding that insurance contracts not covered by the guidance currently under development by the IASB would mostly likely be accounted for under IAS 32 and IAS 39. Consequently, careful deliberation was given to the questions asked and in our response.

<u>IAS 32 - Financial Instruments: Disclosure and Presentation</u>

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 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:

We agree and support the recommendation that the classification of a financial instrument should be consistent with the substance of the contract terms. When the essence of the contract meets the definition of a liability, the instrument should be recognized as a liability.

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?

Response:

We agree that compound financial instruments should, first, be separated and measured into their asset and liability elements with any residual assigned to the equity element. While it's unlikely that the sum of the parts would exceed the total, the guidance should be clear that the equity element should not be less than zero.

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:

While the guidance is potentially more limiting than that in US GAAP EITF 00-19 (EITF), it is consistent with the general practice of the EITF. The proposed guidance presents a more concise and simple answer to a complex issue. The guidance proposed in IAS 32 would create an inconsistency with paragraph 8 of the EITF. The EITF would classify contracts requiring a net share settlement as equity, whereas the proposed IAS guidance would classify those as assets/liabilities. The difference that is being created should be re-evaluated in light of the IASB/FASB convergence effort.

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.)

Response:

While we have no objection to integrating the text in IAS 32 and 39, it may be prudent to keep the Standards separate unless the Board intends to resolve any and all differences. For example, in IAS 32, paragraph 2, notes that certain unrecognized financial instruments, e.g., loan commitments, are included but excluded in IAS 39.

In addition to our responses to the questions in IAS 32, we offer the following comments and recommendations regarding insurance contracts.

Definition of an Insurance Contract

The absence of a consistent definition of "insurance contract" (particularly within IAS 32 and the Draft SOP (DSOP) for the Insurance Contracts Project) is of the highest concern. We believe that the guidance contained in paragraph 43 of IAS 32 can be interpreted to require most permanent life insurance contracts to be included in the disclosure. Such an interpretation is most likely unintended, but nevertheless probable. The DSOP, in contrast, defines insurance contracts by focusing on insurance risk, which we believe is the more appropriate approach. Because the Board has indicated that it does not intend to reconsider the fundamental approach in IAS 32 and 39 at this time (paragraph 3 of the Introduction), it is essential that a definition of insurance contracts in IAS 32 be consistent with other existing or new Standards. It is our understanding that the Board intends to issue an exposure draft of Phase 1 of the Insurance Contracts Project by the end of the first quarter 2003 with the definition of insurance contracts being a high priority and part of the Phase 1 initiative. Therefore, we encourage the Board to consider excluding all insurance contracts from IAS 32 that meet the definition for insurance contracts. The definition for insurance contracts to be used in IAS 32 and IAS 39 should be that which is ultimately based on the guidance contained in the DSOP Principles 1.2 – 1.4.

Modification to IAS 32, Scope

Specifically, paragraph 1(c) of the Scope section should be modified to exclude insurance contracts without exception. The definition of insurance contracts for the DSOP noted above should be inserted into the Standard. In addition, the sentence stating that the Standard applies to embedded derivatives in insurance contracts should be deleted or modified to apply "local" accounting guidance pending the completion of the Insurance Contracts project. The DSOP states that embedded derivatives should not be separated from the host contract (Chapter 1, Principle 1.6), which differs from the guidance in the Scope section of IAS 32.

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:

We do not have a comment regarding this issue at this time.

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 do not agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets. We believe the continuing involvement as currently discussed in the Proposed Amendment to IAS 39 is far too restrictive in terms of criteria for derecognition. The Amendment does not consider any relative degree of continuing involvement as a basis for derecognition. Additionally, the proposed approach does not include any requirements for legal isolation of the transferred assets; i.e., that the transferred assets be put presumptively beyond the reach of the transferor and its creditors.

As an alternative, we believe the provisions of US. GAAP FAS 140 provide an adequate means of accounting for derecognition of financial assets. Paragraph 9 of FAS 140 provides the relevant guidance, as follows:

> "A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be 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:
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> a. 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 (paragraphs 27 and 28).
> b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking

advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29-34).

c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47-49) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call"

The following are several examples that involve continuing involvement, common in current practice, which qualify for sale accounting under FAS 140, but would be precluded from derecognition under IAS 39:

- ***Put options***. Although a put option held by the transferee provides the transferee with control over the right to put the asset back to the transferor and thus not defeating sale accounting under U.S. Standard FAS 140, the transferee's contractual ability to require the transferor to repurchase the asset may result in the transferor regaining control of the asset and, therefore, the transferred asset does not qualify for derecognition under the IAS 39 Exposure Draft to the extent of the amount of the asset that is subject to the put.

- ***Put options and call options that are deeply out of the money***. No exception to the derecognition principles is made for a deep out- of- the- money put option held by the transferee or, unlike in the U.S., a deep out- of- the- money call option or a fair value call option held by the transferor (that does not retain a financial interest) on transferred financial assets. Derecognition is precluded to the extent of the amounts subject to being reacquired because the transferor may regain control of the rights to the benefits of the cash flows of the transferred financial assets. The probability of the transferor exercising its option is not considered.

- ***Clean-up calls***. A clean-up call is a call option held by a servicer, which may be the transferor, to purchase remaining transferred financial assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Although this is the same definition as in FAS 140, a clean-up call held by a transferor precludes derecognition under the IASB proposal to the extent of the assets subject to the call.

- ***Conditional put options on defaulted assets***. A transferee may have the right to put defaulted assets back to the transferor. For a special purpose entity, the exercise of the put option may be automatic whereby, if and when a loan defaults, the special purpose entity is required to put the defaulted loan back to the transferor. Although the exercise of the put options is conditional upon the occurrence of default and is for the protection of the transferee, the options nonetheless provide a means by which the transferor regains control of the rights to the cash flows of the transferred asset and thereby preclude derecognition under the IAS proposal to the extent of the amount of the assets subject to the put.

- ***Subordinated retained interests and credit guarantees***. A transferor may agree to provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. Such agreements could result in the transferor in effect repurchasing the transferred asset if the debtor fails to make payments or the asset is impaired. Derecognition is precluded to the extent of the amount that the transferor could be required to pay. Alternatively, when a portion of a financial asset is transferred, the transferor may provide credit enhancement to the transferee by subordinating the residual interest retained to make good any credit losses in the portion of the underlying asset that was the subject of the transfer. The credit enhancement is similar to a written option because the retained beneficial interest is subject to downside risk from credit exposure and has limited upside potential. Derecognition is precluded under the IAS proposal to the extent of an amount that the transferor could lose related to the transferred assets.

- ***Total return swaps***. A transferor may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the transferor in exchange for a fixed payment or variable rate payment and any increases or declines in the market value of the underlying asset are absorbed by the transferor. Although a total return swap is a cash settled derivative, the transferor could potentially be required to compensate the transferee for a loss of the entire amount of the underlying principal in the event, no matter how remote, of a loss. Accordingly, derecognition is prohibited under the IAS proposal.

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?

<u>Response:</u>

We agree that pass-through arrangements as discussed above should not disqualify derecognition.

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?

<u>Response:</u>

We believe that an entity should be allowed to designate a financial instrument at initial recognition as "held for trading" and therefore recognize the unrealized gains or losses through the income statement. This classification would be consistent with financial instruments that reflect active and frequent buying and selling and/or the objective of generating profits for short-term price differences. However, we also believe that this designation should not be deemed irrevocable. There may be rare circumstances where the character of the financial instrument has changed as a result of a change in management's intent and/or ability for the financial instrument. We believe that a change in the classification would be appropriate in such cases.

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>

We believe that a hierarchal method should be developed to provide a framework for determining values when the techniques in the guidance cannot be applied. For example, in the event that the guidance cannot be applied to a specific liability, the company would value the liability at amortized cost. In the event that this is also not applicable, the liability would be valued on a held-to-maturity basis.

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>

We agree with this proposed guidance. However, this guidance would create an IAS/U.S. GAAP convergence issue with respect to individually significant investments that have been separately assessed for impairment and found not to be individually impaired. Specifically, the IAS requirement to include such assets in a group of assets with similar credit risk characteristics and collectively evaluate the group for impairment is not consistent with U.S. GAAP.

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 agree with this proposed guidance.

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 agree that hedges of unrecognized firm commitments should be considered fair-value hedges. Because the price or terms of the contract are fixed, a hedge of an unrecognized firm commitment is a hedge of the exposure to a change in fair value and not the variability of cash flows.

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:

We support the Board's decision to eliminate the basis adjustment approach in order to bring IAS 39 into line with U.S. GAAP FAS Statement 133 for this issue.

Question 10 – Prior derecognition transactions (paragraph 171B)

Do you agree that a financial asset that was derecognized under the previous derecognition 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 would support that the approach be prospective and applied only to investments that arise after the implementation of the requirement. Additionally, we do not agree that disclosure should be required for prior derecognition transactions. These transactions are historic events for which are disclosure is neither appropriate nor necessary.

Performance linked Insurance Contracts

It is unclear whether performance linked insurance contracts fall within the scope of IAS 39. Since guidance for performance-linked contracts is being considered as part of the Insurance Contracts Project, we request that all insurance contracts be excluded from the scope of this Standard.

Embedded Derivatives

The requirement to price a derivative embedded in an insurance contract separately from the contract in which it's contained could cause considerable technical difficulty and inconsistency. The methods for evaluating those options on a fair value basis are stochastic in nature and similar to the methodology required in the DSOP's. Since this methodology is an important innovation in the DSOP's, we urge that this requirement should not be implemented until the second stage of the Insurance project.

The requirement of paragraph 26 that if an embedded derivative cannot be unbundled from an insurance contract, the entire contract should be valued at fair value can cause two otherwise identical policies, one combined with a derivative and one not so combined, to be valued on different bases. This would cause an inconsistency within a company's financial statements.

Also, since the methodology for calculating the fair value of an insurance liability and, indeed, the general appropriateness of using a fair value approach for life insurance is not resolved, companies will have to develop their own interpretations of how to implement this requirement. This could cause inconsistency in treatment between companies as well. We therefore urge that insurance policies be exempted from the requirements of paragraph 26 and the subject be included in the final Insurance IFRS.

Modification to IAS 39 Scope

The Scope section of IAS 39, paragraph (d) should be modified to be consistent with any changes made to IAS 32 regarding insurance contracts. As noted above in our comments on IAS 32, we believe that "financial risk" should be replaced with the language consistent with the DSOP describing insurance risk.

We thank you for the opportunity to present our views on this important project and look forward to further discussions with the IASB and its staff.

Sincerely,

James F. Renz
Senior Accountant

Cc: Mr. Peter Clark