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Re: Summary of comments in the Round Table Discussion of Allianz Group (Dr. Frank Achtert), 14 March 2003, London

Ladies and Gentlemen,

thank you very much for your invitation to send further comments on the issues addressed in Friday's round table discussions. Please find enclosed our comments to your questions in the boxes with respect to the following issues:

The distinction between debt and equity, including derivatives on own shares (IAS 32, paragraphs 18-29G)

Principles underlying the ED's requirements

3 An instrument should be classified as equity if and only if it both:
- (a) contains no obligation to transfer cash or other assets; and
- (b) will be settled either by the entity unilaterally delivering a fixed number of its own equity instruments, or by the entity exchanging a fixed number of its own equity instruments for a fixed monetary amount of cash or other financial assets.

4 It follows from these two principles that:
- (a) an instrument whose terms require it to be settled in cash is a liability[1] even if the amount of cash to be paid or received is fully indexed to the price of the entity's own equity shares
- (b) an instrument for which the counterparty can require settlement in cash is a liability[1] even if the amount of cash to be paid or received is fully indexed to the price of the entity's own equity shares. This applies to all puttable instruments (ie instruments that give the holder the right to put the instrument back to the entity for cash), including those issued by mutual funds, unit trusts and similar institutions.

(c) a derivative under which the entity is obliged to pay out cash in exchange for receiving its own equity shares gives rise to a non-derivative liability—and hence a reclassification from equity to liabilities—for the present value of the cash it is obliged to pay out.

(d) an instrument that will be settled by the entity delivering shares whose value is equal to a fixed monetary amount[2], or where the number of shares to be delivered is indexed to something other than the price of the entity's own shares (eg the change in the price of gold) is a liability[1].

(e) A derivative under which the entity will receive a fixed amount of cash in return for delivering a fixed number of its own equity shares is equity.

5 Questions for participants: Do you agree with the principles set out in paragraph 3? If not what changes would you propose? Would those changes require an amendment to the definitions of equity and a liability given in paragraph 49 of the *Framework*? Should any other principles be added?

Derivatives on own shares

We do not agree on the guidance proposed on derivative transactions on own equity shares. ED IAS 32 sets forth different guidance on the treatment of derivatives on own shares depending on the type of derivative issued. This proposed guidance is overly complex and will result in confusion on the part of investors (details see ED 32 appendix B 27).

We propose that ED IAS 32 follows a model, in which the accounting for the derivative would be based on the potential methods of settlement, regardless of whether the derivative involves the receipt or delivery of shares (similar to US-GAAP EITF 00-19 with respect to derivatives on own shares), e.g.:

- exclusively physical settlement: equity
- issuer has the choice to settle in cash or physically: equity
- all other cases: derivative at fair value

Derecognition of financial assets (IAS 39. paragraphs 35-57)

Principles underlying the ED's requirements

10 A transfer of a financial asset should result in derecognition only to the extent that it results in the transferor having no continuing involvement with the asset.

11 Accordingly, where a transfer of a financial asset results in the transferor having no continuing involvement with a *portion* of the asset, that portion should be derecognised.

12 There should be no exceptions to this principle for particular transactions or circumstances.

13 Recognition and derecognition relate to assets and liabilities and not to the definition of the entity. Consolidation is a separate issue.

14 Questions for participants:

(a) Do you agree with these principles and if not what changes would you propose? Should any other principles be added?

(b) If you do not support a continuing involvement approach, what alternative approach would you support, and why? In particular:

(i) If you support a risks and rewards approach, how would you make it operational? In particular, how should different risks and rewards be aggregated or otherwise compared?

(ii) If you support a control approach, how would you make it operational? In particular, how should control be assessed when more than one party has rights and obligations relating to a financial asset and none of the parties has the ability to sell, pledge or otherwise control that asset?

(iii) Some respondents suggest using the approach set out in US GAAP. Do you support this suggestion and, if so, what particular aspects of US GAAP would you support incorporating into IAS 39?

(iv) Some respondents suggest that the Board should not change IAS 39 now, pending a fuller debate in its longer-term project on derecognition. Do you support this suggestion? Why/why not?

(v) If you support another approach, what is that approach and how would you make it operational?

(c) Under the approach you support, do you believe that a portion of a financial instrument can be transferred and derecognised or, alternatively, that a financial instrument can be transferred and hence derecognised only in its entirety?

We do not support the implementation of the proposed continuing involvement approach for derecognition of financial assets. In our view, the inconsistencies arising from the current model of the “control-concept with risk-and-rewards-elements” would be just replaced by another inconsistent and even more complex model.

The complexity and inconsistency is mirrored by the example of a sale of a financial asset with a retained call option (“failed sale”) given in Appendix B 18-22. The accounting results in a derecognition of the sold asset, a simultaneous recognition of a pledged security measured at the exercise price of the option and a borrowing liability measured at the option exercise less the time value of the call option. In addition to the prolongation of the balance sheet the company does not show the derivative.

We suggest to stay with the current approach until an improved consistent model is created that is easier to apply for the users of financial statements. The current approach is broadly field-tested and ”best practices” have developed. The only modification we propose is to either eliminate the criterion mentioned in current IAS 39.38 a (ii) “the asset is readily obtainable in the market” or provide practical guidance for interpretation. The current approach offers in our opinion a more realistic presentation of the economic situation as the artificial continuing involvement approach.

Specific issues raised in the comment letters

Derivatives and hedge accounting (IAS 39, paragraphs 69, 89A and 121-165)

Principles underlying the ED's requirements – derivatives

17 The following principles underlie the ED's requirements for derivatives:

(a) Derivative contracts create rights and obligations that meet the definition of assets and liabilities and, as a result, should be recognised.

(b) Fair value is the only relevant measurement basis for derivatives, because it is the only method that provides sufficient transparency in the financial statements. The cost of most derivatives is nil or immaterial. Hence if they were to be reported at cost, they would not be included in the balance sheet at all and their success (or otherwise) in reducing risk would not be visible. In addition, the value of derivatives often changes disproportionately in response to market movements (put another way, they are highly leveraged or carry a high level of risk). Fair value is the only measurement basis that can capture this leveraged nature of derivatives—information that is essential to communicate to investors the nature of the rights and obligations inherent in derivatives.

Principles underlying the ED's requirements – hedge accounting

18 Hedge accounting allows entities to depart selectively from the normal accounting treatment that would otherwise be applied to the items included in the hedging relationship. In particular, cash flow hedge accounting provides an exception by deferring the recognition in the income statement of derivative gains and losses, whereas fair value hedge accounting provides an exception by accelerating the recognition of gains and losses on the hedged item. Hence hedge accounting principles are needed to provide discipline over the use of hedge accounting. Without such principles, the exceptions noted above would permit a free choice over when to recognise gains and losses. These hedge accounting principles fall into two groups:

(a) those that underlie the ED's conditions for when a hedging relationship qualifies for hedge accounting (paragraph 19)

(b) those that underlie the ED's requirements for the accounting treatment of a qualifying hedging relationship (paragraph 20).

19 A hedging relationship should qualify for hedge accounting only when the hedging relationship is:

(a) clearly defined by designation and documentation;

(b) reliably measurable; and

(c) actually effective.

20 As regards the accounting treatment of a qualifying hedging relationship:

(a) to the extent that a hedging relationship is not effective, the ineffectiveness is recognised immediately in the income statement.

(b) to the extent that a hedging relationship is effective, the offsetting gains and losses on the hedging instrument and the hedged item are recognised in the income statement at the same time.
(c) only items that meet the definitions of assets and liabilities are recognised as such in the balance sheet.

21 Question for participants: Do you agree with these principles and if not what changes would you propose? Should any other principles be added? Are there any requirements in the ED that you believe are not necessary to meet the above principles and, if so, what are they?

In our opinion some modifications are necessary to the hedge accounting guidelines in order to better reflect economic reality in the accounts of a company:

Assessment of hedge effectiveness by assuming no ineffectiveness

We find it rather difficult to accept that even for micro-hedges with "plain vanilla interest rate swaps" a burdensome assessment of hedge effectiveness is still required in situations where the hedge relationship meets certain criteria which indicate a "perfect hedge". This assumption of no ineffectiveness (referred to by US-GAAP as "short-cut"-method) should be also accepted by IASB, providing similar prerequisites as mentioned in SFAS 133.68. It is important to underline that the purpose of applying this method is only to reduce the burden of the assessment of hedge effectiveness, and not to change the accounting for the hedge relationship. The permission of the assumption of no ineffectiveness would significantly improve working efficiency by facilitating the assessment of hedge effectiveness without any accounting impact. The benefits of this reduced burden would be most advantageous for the interest rate risk management conducted by banking entities.

I would like to emphasize that we recommend the adoption of the "short-cut"-method solely for micro-hedges and only when all terms and conditions of the hedging instrument and hedged item match as described in SFAS 133.68.

Grouping of similar assets and index-linked hedges

The requirements for the hedging of groups of similar assets or liabilities is too restrictive and does not reflect common investment policies. Specifically, the requirement of ED 39.132 that the change in FV attributable to the hedged risk of each individual asset or liability hedged in the group is expected to be approximately proportional to that of whole group prohibits the application of hedge accounting to hedges using index-linked derivative instruments.

For insurance companies, in particular, index hedging is a common practice. It is possible to demonstrate the effectiveness of an index-linked hedge (i.e. an equity index option) to an overall portfolio of investments. When such an acceptable level of effectiveness can be demonstrated, hedge accounting should be permitted even if each individual asset or liability in the portfolio does not share a proportional change in value.

The objective of our proposal is only to reduce the requirements for "similarity" among portfolios of assets or portfolios of liabilities.

Other issues

The fair value measurement option (IAS 39, paragraph 10)

40 The ED proposes that an entity be permitted to measure any financial asset or financial liability at fair value with changes in fair value reported in profit or loss, by designating it as held for trading at initial recognition (the 'fair value measurement option'). The objective of this option is to simplify the application of IAS 39, for example by

- removing the burden of separating an embedded derivative contained in a hybrid instrument,
- eliminating the need for hedge accounting for hedges of fair value exposures that are natural offsets, and
- enabling consistent measurement of matched asset and liability positions.

41 Some respondents agree with this proposal whereas others do not. Another suggestion is that the option should be retained, but be limited to certain financial instruments.

(a) Do you agree with the proposed fair value measurement option and why?
(b) Should the option be limited to certain financial instruments? If so, which ones and why?
(c) If the fair value measurement option were to be retained in the final standard, what items would you expect it to be used for?

Allianz is, in principle, in agreement with the proposed amendment of IAS 39.10. However, the objective of that provision – removing the burden of separating an embedded derivative which is not clearly and closely related to the host contract, enabling consistent measurement of matched asset and liability positions and reducing the need for hedge accounting – could only be reached if the choice in designation of a financial asset is not limited to the point in time of its initial recognition.

It is common practice that financial assets, e.g. AFS securities, are not hedged from the time that they are acquired, but are rather hedged from the point of time when risk management triggers require hedging. Therefore, if the company enters into a derivative contract weeks or months after a purchase of financial assets to reduce the exposures of dropping markets, and the re-designation of the AFS investment as "measured at fair value" is prohibited, the company must choose to either:

- apply the complex and cumbersome hedge accounting rules – if even possible (e.g. not for index derivatives) or
- accept a mismatch in the income statement even though the company is economically hedged.

The latter option, whose purpose is to reduce the need for hedge accounting by creating "natural" hedges, could only be reached by reclassifying financial assets after their initial recognition from e.g. held-to-maturity or available-for-sale to "measured at fair value".

Other issues

43 Are there any other major issues you would like to raise with the Board?

1. Insurance specific issues

Credit Insurance / Financial Guarantees

1. Some respondents have suggested that credit guarantees generally or, perhaps, credit insurance contracts written by insurance entities, should be excluded from the scope of IAS 39 and addressed in a standard on insurance contracts The Exposure Draft of Improvements to IAS 39 proposes that financial guarantee contracts be initially recognized and measured at fair value. Subsequently, the contracts would be measured in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets.*
   a. Are there characteristics of credit insurance contracts that distinguish them from similar guarantees written by other financial institutions?
   b. How would this suggestion affect your views on the definition of insurance contracts?

In general, credit insurance contracts are standard contracts typical of property insurance. However, there is no longer any discussion that a credit insurance contract meets the definition of an insurance contract as defined in the proposed DSOP „Insurance contract Phase I".

Therefore, this poses the question of why credit insurance contracts should be excluded from the scope of the „insurance contract Standard" – as proposed.

Moreover, it is important to note that credit insurance contracts are not contradictory to the term of „ financial guarantees". Consequently, an accurate classification of credit insurance contracts under the context of financial guarantees is an appropriate and practical approach.

Based on the same rationale as the one developed for weather derivatives (a-c), we propose to divide financial guarantees (including credit insurance) into 4 categories :

(a) contracts were a payment will occur if the failure of a debtor adversely affects the contract holder when payment is due,

(b) contracts where a payment will be made if a failure of a debtor occurs regardless of whether there is an adverse effect on the contract holder, although the contract holder does, in fact, use the contract to hedge some underlying exposure.

(c) contracts where a payment will be made if a failure of a debtor occurs regardless of whether there is an adverse effect on the contract holder and the contract holder does not in fact use the contract to hedge some underlying exposure.

(d) contracts, which provide for payments to be made in response to changes in a specified credit rating. which are derivatives.

As contracts that cover credit risks issued by credit insurance meet the above criteria (a), they do meet the definition of an insurance contract, as already acknowledge by the Staff. Including credit insurance contracts in the insurance standard will allow for more consistent guidance for related contracts and will ensure that their specific features (such as participating features, deductibles, acquisition costs, renewals and reinsurance) are addressed. Currently, neither IAS 37 nor IAS 39 addresses these issues.

In addition, the proposed approach to initially measure credit insurance contract at fair value according to IAS 39 and then subsequently measure them in accordance with IAS 37 is problematic. The application of two different standards would lead to confusion on the part of the users of financial statements.

The standard should give more guidance to distinguish guarantees and credit default swaps. While the generally accounting treatment of CDS measured at fair value is undisputable the classification of some CDS should be reconsidered. The standard requires both, failure to pay and exposure to a loss due to the debtor’s failure to pay. The economic substance of a CDS defined by some of the ISDA criteria is similar to the definition of a financial guarantee according to IAS 39. Therefore, we recommend to admit a financial guarantee accounting for those CDS which are defined by the ISDA criteria bankruptcy, failure to pay, obligation default, repudiation/moratorium, restructuring. Otherwise a standardised ISDA contract has to be enlarged by the “exposure to a loss due to the debtor’s failure to pay“ criteria which complicate the market closing.