AMERICAN ACADEMY of ACTUARIES

September 21, 2001

Mr. Timothy Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O Box 5116
Norwalk, CT 068-5116

Dear Mr. Lucas:

Attached is the response by the American Academy of Actuaries to the Joint Working Group Draft Standard and Basis for Conclusions, Financial Instruments, and Similar Items.

The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries in the United States.

If you have any questions please do not hesitate to contact Meredith Watts at watts@actuary.org or (202) 223-8196. Thank you for the opportunity to contribute.

Best Regards,

Burton Jay

COMMENTS ON DRAFT STANDARD ON FINANCIAL INSTRUMENTS

I. Scope and Definitions

Q1. The Draft Standard would apply to all enterprises (see Draft Standard paragraph 1 and Basis for Conclusions paragraphs 2.1-2.12). Do you agree? If not, please specify which enterprises you believe should be excluded from the scope (and why), and the basis on which you would distinguish those enterprises that should apply the Draft Standard from those that need or should not.

<u>Academy Response –</u>

We agree that the standard on financial instruments should apply to all enterprises. However, we believe accounting standards for all financial instruments should be implemented at the same time.

Paragraph 1 points out that certain financial instruments are not covered under this Draft Standard. Specifically, it excludes:

(a) interests in subsidiaries, associates or joint ventures that are accounted for under other standards,
(b) employers' assets and liabilities under employee benefit plans,
(c) retirement benefit obligations of defined benefit plans, and
(d) rights and obligations with insurance risks, resulting from insurance contracts, with some exceptions.

Other financial instruments are also exempted.

We understand that others will address accounting standards for at least some of the above exempted financial instruments. We would like to emphasize the importance of uniform and consistent accounting standards for all financial instruments and for assets and liabilities similar to financial instruments that are held by a given enterprise. If a fair value accounting method is adopted for most financial instruments, the accounting for all other financial instruments and other instruments that are similar to financial instruments should be consistent with fair value concepts. We further believe that the new standards should not be implemented on a piecemeal basis. Consistent standards for all financial instruments should be defined and accepted before such standards are implemented for any financial instruments. Anything other than comprehensive adoption will result in financial statements that are misleading and may invite accounting arbitrage.

Q2. The definition of a financial instrument would differ somewhat from the present IASC definition (see Draft Standard paragraph 7 and Basis for Conclusions paragraphs 2.13 and 2.14). Do you agree with the definition in the Draft Standard? If not, what changes would you make, and why?

Academy Response –

We generally agree with the definition of a financial instrument in the draft standard, with the following exceptions.

In the definition of a financial instrument, the phrase "in exchange for no consideration other than release from the obligation" in paragraph 7(c) on page 20 does not seem appropriate.

One suggestion would be to change this part of the definition to read as follows:

> Includes: "a contractual obligation of one party to deliver a financial instrument to a second party and a corresponding contractual right of the second party to receive that financial instrument where the terms of the exchange are agreed to by both parties at the time they entered into the transaction.
>
> Note: A similar change would be needed to the language included in the definition of a loan asset on pp. 20-21. For example, this language might be changed to read as follows:
>
> A <u>loan asset</u> is a contractual right, that is not traded on an exchange or in dealer markets, to receive cash or other financial instruments of fixed or determinable amounts and timing, where the terms of the loan are agreed to by both parties at the time they entered into the transaction.

Paragraph 10, on page 21, excludes tax assets or liabilities from the definition of a financial instrument. We disagree with this exclusion. Once an obligation is clearly established as a requirement to make specific fixed payments on a certain schedule, it is a financial instrument and should be accounted for as such. Whether this obligation arose from a contractual agreement, tax obligation, government assessment or legal judgment should be irrelevant.

We recommend the addition of an item to the list in paragraph 7 to incorporate such obligations.

Q3. No Comment.

Q 4. The definition of an insurance contract used in the IASC Insurance Steering Committee's, Issues Paper: Insurance, November 1999, is used as the basis to exclude insurance contracts from the scope of the Draft Standard. However, financial guarantees and certain contracts that require payment based on the occurrence of uncertain future climatic, geological or other physical events would not be excluded (see Draft Standard paragraphs1(d), 17-19 and Basis for Conclusions paragraphs 2.23-2.30)? Do you agree with this approach and definition? If not, what approach and definition would you propose?

Academy Response –

We do not agree with the definition as stated because it is unclear whether retroactive insurance contracts satisfy this definition of insurance contracts. The proposed definition of an insurance contract in paragraph 17 can, in certain respects, be interpreted in more than one way. One interpretation, wherein the “future event” is constrained to the event triggering the insured’s liability, would exclude what are sometimes labeled "retroactive" insurance contracts, due to the phrase "future event" in the definition. On the other hand, if one may interpret the “future event” as the ultimate determination of amount of claim to be paid, then such contracts would be included within the definition. Clarification is needed as to which interpretation is intended. In our view, it would be inappropriate to exclude retroactive insurance contracts. This interpretation comes from a reading of paragraph 13, which focuses on the timing of the event that triggers coverage.

Examples of retroactive contracts include both a and b below:

> a) Reinsurance purchased by an insurer (or acquirer of an insurer) to protect against adverse development risk on existing claim liabilities. This is very common during acquisitions of property/casualty insurance companies, and it can result in the transfer of significant insurance risk.
>
> b) Insurance purchased by a formerly self-insured company that wishes to transfer its risk of future adverse development on existing claim liabilities. This is common for larger employers who used to retain their Workers Compensation or tort liability claim obligations, but who no longer want to deal with such risk on their balance sheet.

The pricing, analysis and economic risks associated with retroactive contracts are similar to those for prospective insurance contracts. The only significant difference is that events triggering a claim obligation have all occurred prior to the contract inception date. This difference is frequently not material to the level of insurance risk in the contract. In fact, many retroactive insurance contracts insure far higher levels of insurance risk than their prospective counterparts, due to a concentration of riskier, longer tail obligations in retroactive contracts.

We see no theoretical or philosophical reason why such "retroactive" contracts should be under a separate accounting standard from "prospective" contracts. The determining factor should be the existence of material insurance risk at contract inception, not the timing of the covered event. As such, we recommend that both retroactive and prospective insurance contracts be covered by the same accounting standard.

The definition of insurance should allow for reinsurance, for possible payment by cash or service, and for coverage of future insurance risk resulting from either past or future events. It should also allow for insurance contracts that essentially contain only timing risk (e.g., paid-up whole life insurance) or only amount risk (e.g., event coverage, such as for weather-related cancellation of an outdoor entertainment event).

Q5. No Comment.

Q6. The Draft Standard would require an enterprise, with certain exceptions, to separately account for sets of contractual rights and contractual obligations in a hybrid contract that, if they were separated, would fall within the scope of the Draft Standard (see Draft Standard paragraphs 4-6 and 25 and Basis for Conclusions paragraphs 2.48-2.52). Do you agree with this proposal? Is the definition of a hybrid contract clear and operational? If you disagree with either of these two questions, what alternative would you suggest?

Academy Response –

We disagree with the proposal to unbundle hybrid contracts if applied to insurance, and we suspect the unbundling concept may have limited value elsewhere.

We generally advise against the unbundling of contracts into financial instrument and non-financial instrument components. Such an exercise is inherently subjective, as many policy features generate synergistic benefits. Allocating the value of the total contract to individual features is frequently unreliable, and it is very dependent on the order and the method by which the separation is done.

We recommend instead that the rules for valuing both the financial instrument and non-financial instrument components be sufficiently similar such that separation is unnecessary.

For example, we believe that dual trigger insurance policies (e.g., insurance policies under which claim payments are a function of both insured losses and an external index or event) should be viewed as insurance policies and not hybrid contracts. (Note: The FASB Derivatives Implementation Group, or DIG, determined that such contracts were wholly under the insurance contract definition in their guidance on FAS 133.)

Similarly, an insurance contract that covers both past and future events (i.e., one with both retroactive and prospective features) should not be treated as a hybrid contract under this standard.

Our position in this regard was elaborated in our letter to Peter Clark, dated May 29, 2001, which is attached in Appendix A.

II. Recognition and Derecognition

Q7. The basic recognition principle is that an enterprise should recognize a financial asset or financial liability on its balance sheet when, and only when, it has contractual rights or contractual obligations under a financial instrument that result in an asset or liability (see Draft Standard paragraphs 31-34, Application Supplement paragraphs 214-220, and Basis

for Conclusions paragraphs 3.1-3.8). Do you agree? If not, why not? How would you amend the principle?

Academy Response –

We disagree with this principle, as stated. It is unclear how to interpret this principle relative to contingent (conditional) rights or obligations. We recommend rewording of the principle so that it discusses rights or obligations that "may result" in assets or liabilities.

The current wording would preclude consideration of constructive rights or obligations arising out of a contract, such as (in an insurance example) the constructive obligation to pay a dividend in the event of favorable experience. Constructive rights and obligations arising out of contracts should also be included.

We believe that the principle should be clarified to address the situation in which the obligation can be either a financial instrument or a service contract. Examples from the insurance field include warranty, repair or insurance contracts in which the obligation would be satisfied in either cash or repair of damaged property. In such cases, we believe that the cash equivalent should be reflected and thus the entire asset or liability would be treated as a financial asset or liability.

Q8. The Draft Standard would require that a transfer that does not have substance not affect the assets and liabilities recognized. It proposes that a transfer has substance only if either the transferee conducts substantial business, other than being a transferee of financial assets, with parties other than the transferor, or the components transferred have been isolated from the transferor (see Draft Standard paragraphs 35 and 36, Application Supplement paragraphs 222 and 223, and Basis for Conclusions paragraphs 3.72-3.80). Do you agree? If not, how would you propose to limit the potential for non-substantive transactions that might occur without such a test?

Academy Response –

Although we have no comment with respect to the transfer of an asset, we wonder why the transfer of financial liabilities was not addressed. If this is intentional, we suggest that the "Basis for Conclusions" section include the rationale.

Q9. No Comment.

Q10. No Comment.

Q11. No Comment.

Q12. The Draft Standard also would require, in the case of a transfer that does not result in the transferee having the practical ability described in Q11, if the transferor is left with either (a) an obligation that could or will involve the repayment of consideration received or (b) a call option over a transferred component that the transferee does not have the practical ability to transfer to a third party, some or all of the transaction to be treated as a loan secured by the transferred component (see Draft Standard paragraphs 63-67, Application Supplement paragraphs 251-258, and Basis for Conclusions paragraphs 3.38-3.71 and 3.93-3.102).

(a) Do you agree? If not, why not? How would you amend the requirement? In particular, if you believe that some transfers involving financial assets are loans secured by the transferred asset, how would you differentiate between those transfers and transfers that are, in effect, sales of the transferred asset? If you do not believe that some transfers involving financial assets are loans secured by the transferred asset, or do not believe that some transfers are sales of the transferred asset, please explain your reasoning.

(b) The Draft Standard would require the liability to be recognized in such circumstances to be measured initially at the maximum amount that might need to be repaid under the obligation or the amount of the consideration received in respect of the transferred component over which the transferor has the call option. To the extent that the obligation and call option overlap, only the larger of the two liabilities would be recognized (see Draft Standard paragraph 64 and Basis for Conclusions paragraphs 3.93-3.98). Do you agree with this approach to determining the amount of the liability? If not, how would you change the approach?

(c) The Draft Standard would require, in the case of transfers that the Draft Standard would require the transferor to treat in part or entirely as loans secured on the transferred asset, the transferee not to adopt accounting that is the mirror-image of the transferor's (see Application Supplement paragraphs 238-241 and Basis for Conclusions paragraphs 3.64-3.68). Do you agree with this approach? If not, why not? How would you amend the Draft Standard?

<u>Academy Response -</u>

Paragraphs 49-58 and 62-63 basically describe the circumstances under which paragraphs 59-61 and 64-66 should be applied. The main concerns with this section relate to the treatments described in paragraphs 59-61 and 64-66.

The recognition criteria provided in paragraphs 64(a) and 64(b) appear to give measurement guidance, and such guidance does not appear to require reflection of the time value of money. If the intent is to refrain from including measurement guidance in this section, it can be accomplished by changing the words “recognize a liability for” to “recognize a liability, the value of which reflects”. If the intent is to include measurement guidance in this section, then the words “after reflecting the time value of money” should be added at the end of both paragraphs 64(a) and 64(b).

Paragraphs 50(b) and 61 deal with the treatment of options in cases where a financial instrument has been transferred but some option in the financial instrument has been retained. In such cases, we believe that the standard should recognize the full value of any option retained, separate from the derecognized financial instrument. For example, in the case of paragraph 50(b), we believe that retention of a clean-up call option does represent a residual interest in the original financial instrument to the extent that the clean-up call has any value. In the case of paragraph 61, we believe that any residual interest in a financial instrument that has been transferred should be measured based on the full value of any option retained as a residual interest -- not on the basis of whether it is “virtually certain” that the option “will be exercised” or “virtually certain” that the option “will not be exercised.”

Q13. No Comment.

III. Measurement

Q14. The Draft Standard would require an enterprise to measure all financial instruments at fair value when recognized initially and to re-measure them at fair value at each subsequent measurement date, with one exception (see Draft Standard paragraph 69, Application Supplement paragraphs 315-317, and Basis for Conclusions paragraphs 1.6-1.26). Do you agree? If not, what other approach would you suggest and why?

Academy Response-

We agree with the suggested approach conceptually, but we have two reservations.

First, for those financial instruments that are infrequently (if ever) traded, the fair value estimation process may be very involved – requiring non-trivial time and resources to estimate. In such circumstances, when there has been no obvious material change in the underlying data input or assumptions, a full fresh start valuation at each measurement date may not be justified. Where data is difficult to obtain, and the estimation result from that data uncertain, it may take time to differentiate noise in the data from true movement. When this happens, updating every quarter for these subjective and/or unstable inputs may add more noise than true information to the results.

A possible alternative approach in some situations may be to require updating the assumptions and other estimation parameters relating to general financial markets (e.g. yield curves and credit spreads) at each measurement date and to require reviewing all other assumptions and estimation parameters (i.e. those specific to the financial instruments in question) at least annually for possible update.. In this alternative approach, additional fresh start valuations would also be required whenever an event or circumstance occurs that would more-likely-than-not have a material impact on the fair value estimate and it is unlikely that the situation would reverse before the next annual fresh start valuation.

Second, we understand the logic behind making an exception for certain private equity investments, but we believe the private equity attributes which justify that exception also exist for certain other financial instruments. We would prefer to describe the exception in terms of the attributes, with private equity being given as one example that fits those attributes. Such an approach would be more transferable to insurance liabilities, when the standard for those liabilities is considered. See also Question 20.

Q15. The Draft Standard would require the fair value of a financial instrument to be an estimate of its market exit price determined by interactions between unrelated enterprises that have the objective of achieving the maximum benefit or minimum sacrifice from the transaction (see Draft Standard paragraphs 28, 70 and 71 and Basis for Conclusions paragraphs 4.1-4.10). The JWG also proposes that any expected costs that would be incurred to exit a financial instrument at that market exit price should not be taken into account in arriving at a fair value (see Draft Standard paragraphs 72 and 73 and Basic for Conclusions paragraph 4.11).

- **(a) Do you agree with the market exit price objective? If not, how would you amend it and why?**
- **(b) Do you agree with the proposed treatment of direct costs to sell or obtain relief from a financial instrument? If not, how would you amend it?**

<u>Academy Response -</u>

(a) We agree with the market exit price objective for those financial instruments for which such exit is a viable option. Where such an exit is not a viable option (e.g. where no active market exists), settlement value may be the best available indication of fair value.

(b) We disagree with the proposed treatment of direct costs to sell or obtain relief from a financial instrument, except in the case that these costs are not material. Ignoring these costs would overstate the value of financial assets and understate financial liabilities with regard to what could actually be realized by the holder. As such, a fair value estimate is mis-stated if it ignores these costs.

The proposed exclusion of such costs in paragraph 72 also is inconsistent with paragraph 96, which requires consideration of such costs in determining the most advantageous market.

We note that among the costs typically considered by the market in exit price valuations are various taxes, including income taxes resulting from the transaction. We believe that any income tax consequences of the transaction need to be considered in the fair value estimates in some manner, as these consequences can be a significant determinant of exit price. This is consistent with paragraph 116 (b), which states that factors the market participants would consider in prices should be considered in fair value estimates.

Q16. The Draft Standard would require an enterprise to measure a part of a hybrid contract that is to be separately accounted for as if it were a free-standing financial instrument, except if the enterprise determines that it cannot reliably identify and measure the separate sets of financial instrument rights and obligations in the hybrid contract. In the latter case the enterprise would account for the entire contract in the same manner as a financial instrument falling within the scope of the Draft Standard (see Draft Standard paragraphs 74-76 and Basis for Conclusions paragraphs 4.12-4.16). Do you agree with this proposal? If not, what alternative would you suggest?

Academy Response -

In general, we believe hybrid contracts should not be unbundled, as stated in our response to Question 6. To the extent that unbundling might be required, we agree with the proposal outlined in the latter case above

Q17. The Draft Standard sets out principles for estimating the fair value of financial instruments within a hierarchy. First, observable market exit prices for identical instruments are to be used if available. If such prices are not available, market exit prices for similar financial instruments are to be used with appropriate adjustment for differences. Finally, if the fair value of a financial instrument cannot be based on observable market prices, it should be estimated using a valuation technique that is consistent with accepted economic pricing methodologies (see Draft Standard paragraphs 77-86 and 104-117, Application Supplement paragraphs 320-327 and 344-369, and Basis for Conclusions paragraphs 4.17 and 4.36-4.47). Do you agree with this hierarchy? If not, how would you amend the proposals, and why?

Academy Response –

We agree with this hierarchy. However, the second sentence of paragraph 79 should be clarified in light of today's financial markets, involving 24-hour trading and multiple exchanges around the world dealing with the same financial instrument. For example, the last end-of-day closing price may be the one available on a thinly-traded exchange where transaction prices may not be indicative of the prices available if the transaction were made in a more active or "local" market. We suggest that the Standard should specify that, in relation to market exit prices for quoted instruments, the market of reference should be the market on which the instrument has its primary listing, since this will usually be the market in which the instrument is most actively traded.

Q18. The Draft Standard addresses a number of circumstances requiring special consideration in using observed market prices to determine fair value (see Draft Standard paragraphs 87-103, Application Supplement paragraphs 328-343, and Basis for Conclusions paragraphs 4.18-4.35.

- **(a) Do you agree with the Draft Standard's conclusions in these circumstances? Are there additional circumstances that should be addressed (please specify)?**

- **(b) Is the conclusion that value that is not directly attributable to a financial instrument should not enter into the determination of the fair value of a financial instrument (see Draft Standard paragraphs 92-94, Application Supplement paragraphs 331-339, and Basis for Conclusions paragraphs 4.18-4.32) appropriate and operational, in particular as it applies to demand deposit and credit card relationships? If not, why not?**

- (c) **Do you agree with the conclusion that, if an enterprise holds a large block of financial instruments and market exit prices are available only for individual instruments or small blocks, the available price should not be adjusted for the potential effect of selling the large block (see Draft Standard paragraphs 102 and 103 and Basis for Conclusions paragraphs 4.34 and 4.35)? If not, in what circumstances would you require adjustment, and how would you ensure consistency of the amount of the adjustments that would be made?**

Academy Response -

Regarding part (a) of question 18, we generally agree. However, we recommend clarification of the intent of paragraphs 100-101.

Paragraphs 100-101 (Effect of an Embedded Option on the Enterprise Holding the Option) read as follows:

100. If a financial instrument contains a contractual provision (an embedded option) that gives the enterprise the right to settle or require settlement at a price that is <u>more advantageous than the price in observed arm's-length transactions,</u> the enterprise should measure the instrument at that contractual settlement price (the exercise price of the embedded option) adjusted for the effect of any time period to the exercise date.

101. This requirement applies only to the enterprise that holds the option. The writer of the option would report the instrument at fair value based on observed transactions or, if necessary, at an estimate of that value determined by a valuation technique.

Some financial instruments contain many embedded options, with some held by the writer of the instrument and some held by the owner of the instrument. It is not clear whether "the right to settle or require settlement" refers to settlement of each option individually or to settlement of the financial instrument as a whole. We believe the correct interpretation refers to settlement of the financial instrument as a whole.

In addition, some kinds of options that do not directly involve settlement of a financial instrument could be exercised in a way that would make immediate settlement a virtual certainty. An example is an option to change the interest rate paid on a savings account. Changing the interest rate paid to zero would likely lead to immediate settlement. Such options could be construed to be within the scope of these paragraphs, because their exercise would indirectly lead to settlement. We feel that such options should not be construed this way. Only options that give a direct right to settle or require settlement of the entire financial instrument should be given the special treatment described in paragraphs 100 and 101.

We are also concerned about the provision in paragraph 101 that limits the application of paragraph 100 to the "enterprise that *holds the option".* Our main concern here is that these paragraphs should not be interpreted in a manner that would require the issuer (or holder) of a financial instrument to unbundle the various embedded options in the financial instrument and account for each of these differently depending on whether the option is "held" by the issuer of the financial instrument or "held" by the owner of the financial instrument. <u>In our view it might be more appropriate to limit the application of paragraph 100 to the "enterprise that *holds the financial instrument in which such an option is embedded".*</u>

Regarding part (c) of Question 18, we generally agree, but note that there are circumstances in which the Draft Standard might inappropriately value a large block (e.g., the example given in Basis for Conclusions paragraphs 4.34 and 4.35). The presence of a controlling interest would seem to merit a premium. The Academy agrees that it is unlikely that an entity should value its holdings differently from observable market exit prices, but we believe that this should not be an absolute position. We suggest that the prohibition not be absolute. Instead, if an entity believes the fair value for its block is different from the observable market exit price, then it should disclose the rationale and the basis for revaluation from the observable market exit price.

Q19. No Comment.

Q20. The JWG believes that fair values are, generally, reliably determinable, at reasonable cost, for all financial instruments except certain investments in private equity instruments (see Draft Standard paragraphs 122-125 and Basis for Conclusions paragraphs 1.14-1.21 and 4.64-4.67). Do you agree? If not, why not? If you believe that other items are not capable of reliable fair valuation, what are they, what factors cause

their fair values not to be reliably determinable, and how should these items be measured?

Academy Response –

We disagree. We would prefer the exception to be described in terms of the attributes, with private equity being given as one example that fits those attributes.

Q21. No Comment.

Q22. No Comment.

IV. Balance Sheet Presentation

Q23. The Draft Standard would require that minimum categories of financial assets and financial liabilities be distinguished on the face of the balance sheet and in the notes to the financial statements (see Draft Standard paragraphs 131-135 and Basis for Conclusions paragraphs 5.1-5.5). Do you agree with the categories proposed? Are the categories clear and useful? If not, how would you amend them and why?

Academy Response –

We agree.

V. Income Statement Presentation

Q24. No Comment.

Q25. The Draft Standard would require an enterprise to separately disclose the income statement effects of certain changes in fair value (see Draft Standard paragraphs 137-152, Application Supplement paragraphs 382-390, and Basis for Conclusions paragraphs 6.30-6.84).

(a) Do you agree with the proposed disaggregation? If not, why not? What other basis of disaggregation would you propose to provide information about the components of changes in fair value of financial instruments?

(b) Do you believe that any other gains and losses arising on fair value measurement of financial assets and liabilities should be separately presented in the income statement or notes thereto? If so, which gains and losses, and why do you believe that they should be shown separately? On what basis should such gains and losses be distinguished?

Academy Response –

(a) We believe that the proposed disaggregation in the JWG draft is ambiguous and unworkable in its current form. The calculations needed to perform the disaggregations required by these paragraphs are order dependent and therefore subjective. Given a simultaneous change in credit standing, risk-free rates and credit risk spreads, the value assigned to each of these items is a function of which calculation is done first. Depending on the order in which the calculations are performed, significantly different disclosures can result. This raises the question of which calculation order should be required, if not raising doubt as to the value of any detailed disaggregation disclosures. (Note: This problem occurs with all the potential disaggregations suggested by the financial risk definitions found in paragraph 14, and it is not confined to the three items of disaggregation discussed above.)

As a result, we recommend that any requirement for disaggregating components of income be limited, with clear guidance on the order in which such calculations or allocations are to be performed. The more components for which disaggregation is required, the less meaningful the disclosures will be due to synergistic effects between components and the varied nature of these effects for various enterprises and financial instruments.

To the extent that disaggregation is required (such as in the case outlined in b. below), we suggest that the definitions of the various risks subject to disaggregation should be changed as proposed in Appendix B.

(b) If “own credit risk” is reflected in liability value, changes in value associated with *changes* in the credit-worthiness of the issuer should be excluded from “operating” earnings and reported in a footnote instead (or as a separate line item in non-operating earnings). For purposes of this provision, changes in value associated with *changes* in credit-worthiness of the issuer would be defined as noted in the attached Appendix B.

We believe that changes in value due to *changes* in credit-worthiness should be reported in a footnote (rather than going through operating earnings) because an explanation of the nature of such changes will help to prevent users of the financial statements from misinterpreting the meaning of such a change in value. For example, assume a company experiences a downgrade in its credit standing and this leads to a decline in the value of its liabilities. To the extent that this decline in value reflects the diminished capacity of the company to meet its obligations, we feel that it is appropriate to emphasize this point so that such changes in value will not be incorrectly perceived as a reduction in the value of the obligations themselves.

Note: This provision is intended to apply only to liabilities issued by the reporting company. It is not intended to apply to assets held by the reporting company.

Q26. The draft Standard would require that interest revenue and interest expense be determined on the fair value basis, using the current yield to maturity basis, except that an enterprise may use the current market expectations basis if the chief operating decision maker relies primarily on

that basis for assessing the performance of its significant interest-bearing financial instruments and it is consistent with the enterprise's basis for managing interest rate risk (see Draft Standard paragraphs 139 and 140), Application Supplement paragraphs 382-390, and Basis for Conclusions paragraphs 6.46-6.77).

> **(b) Do you agree with the proposed method of determination? If not, how would you propose that interest revenue and interest expense be determined in a fair value model?**

<u>**Academy Response -**</u>

We generally agree. However, the current market expectations basis for determining interest revenue and interest expense reflects the time value of money more appropriately. We therefore recommend that this method of valuation should be accepted as the superior method in all cases.

We see a potential ambiguity in the wording of paragraph 139, possibly resulting in a perceived inconsistency between wording there versus wording in the Application Supplement paragraphs 386 and 387. Paragraph 139 uses the term "current" yield. In isolation, this might be interpreted as the yield at the reporting date. The Application Supplement uses the yield at the beginning of the reporting period instead of the reporting date. We agree with the general approach suggested by the Application Supplement as being more relevant and more practical than using the "current" yield at the reporting date. We also agree with the approach of performing this calculation separately for each reporting period, such that under quarterly reporting the annual investment income value would result from adding the four quarterly calculations, each with a potentially different beginning yield. We suggest that paragraph 139 be reworded so as to refer to the "current" yield at the beginning of each reporting period.

In addition, we would recommend a change to the language in Paragraph 30. This paragraph currently defines interest revenue (expense) as "the return to the lender (cost to borrower) for the temporary use of money. Within the context of measuring financial instruments at fair value, it is the market return (cost) on the fair value of an enterprise's interest-bearing financial assets (liabilities) for a reporting period. It includes (a) basic interest; (b) credit risk premium; (c) liquidity risk premium; and (d) any premium to the lender for bearing risks of adverse variability of expected cash flows apart from credit risk and liquidity risk."

We believe that use of the word "return" in this paragraph is confusing since it seems to imply that the definition is meant to include the part of market returns attributable to realized and unrealized gains on assets and liabilities. However, according to Paragraph 139 of the Draft Standard (pg. 55), the intent of this definition is to cover the yield on financial instruments only. The gains/losses that constitute the remainder of the returns on the financial instruments are covered separately under Paragraphs 141 and following.

VI. Hedges

Q27. The Draft Standard would not permit any special accounting for financial instruments entered into as part of risk management activities (see Draft Standard paragraph 153 and Basis for Conclusions paragraphs 7.1-7.22). Do you agree? If not, why not? How would you address the issues raised in paragraphs 7.1-7.22 of the Basis for Conclusions?

Academy Response –

We agree with the Draft Standard where the item hedged is also a financial instrument measured at fair value. However, not all financial instruments are included in the scope of the Draft Standard. If other financial instruments such as insurance contracts are not measured at fair value, then it may be appropriate to measure financial instruments used to hedge such contracts in a manner consistent with the item hedged (i.e., not at fair value).

We believe the same issue exists when the item being hedged is not a financial instrument. It is important that accounting for hedges be consistent with the accounting for the activities hedged against. Paragraphs 7.6 and 7.8 in the Basis for Conclusions discuss the JWG's preference to leave this issue to a future standard, when the accounting for the non-financial instrument being hedged is addressed. We disagree with this decision. This standard should address the accounting for financial instruments that are hedges of non-financial instruments to ensure that consistent accounting treatment of the hedging instrument and the item being hedged is achieved.

VII. Disclosure

Q28. The Draft Standard would require disclosure of an enterprise's significant financial risks and of the enterprise's financial risk management objectives and policies. Do you agree that this information is necessary to provide the context for understanding and evaluating information about the enterprise's actual financial risks and performance of its financial instruments? If not, how would you change these disclosures?

Academy Response -

The Academy agrees with the need for disclosures concerning the enterprise's significant risks and risk management policies. However, we urge caution be applied when determining the extent of such disclosures. Public disclosure of a risk to an entity could become a self-fulfilling prophecy. Some of the information and practices could well be proprietary and represent competitive advantages to the company.

Paragraph 397 of the Application Supplement refers to an example table that could be used in disclosure of interest rate and currency risks. The table classifies assets and liabilities by interest reset date and shows a "gap" equal to the difference between the amounts of assets and liabilities with similar reset dates. There are many types of liabilities that involve frequent reset of interest rates for which the “gap” analysis in that table would be very misleading. In general, we believe that the use of a “gap” table such as the one described in this section should not be part of the required disclosures.

Q29. No Comment.

Q30. No Comment.

Q31: Do you agree with the other disclosures proposed in Draft Standard paragraphs 164-178 and 183-189…… If not, how should the disclosures be amended…..

<u>Academy Response -</u>

We have some concerns with the disclosures proposed in paragraph 183.

183(a) requires that when a valuation technique is used in place of a market price, one should disclose the technique, including methodology and significant assumptions. For insurance enterprises, virtually all liabilities will be valued in this way, and a wide variety of techniques will be used. Also, many of the assumptions will be based on expected claims experience. This information may be proprietary. We believe the disclosure of valuation techniques and assumptions should be in summary format and should exclude proprietary information.

183(d) requires the identification of the factors taken into account in determining the effect of the enterprise’s own credit risk in the fair value of its financial liabilities. This assumes, of course, that own credit risk is to be reflected. There is no consensus that own credit risk should be reflected in estimating the fair value of one’s own financial liabilities.

183(e) requires the disclosure of a range of reasonably possible estimates for any amount that depends significantly on assumptions. (If insurance liabilities were ever included in the scope of this document, this required disclosure would apply to virtually all insurance liabilities.) While such disclosure is well intended, it may provide a misleading view of the riskiness of long-term assets and liabilities, for several reasons.

First, valuation of long-term financial instruments is very sensitive to the level of assumed interest rates. If one discloses the range of values that could result from changes in interest rates, one might see a very wide range for both assets and liabilities. However a good risk management program might result in a very narrow range for the net difference in value between the assets and liabilities.

Second, the proposed disclosure would apply to only financial instruments within the scope of this Draft Standard, and subject to fair value accounting. In many cases financial assets and/or liabilities are managed in relation to non-financial assets and/or liabilities, or in relation to financial instruments not covered by a fair value standard (e.g., possibly insurance liabilities). In such case, the required disclosure would address potential variability in only one portion of a related set of holdings. Sensitivity to key assumptions may be material for the financial instruments covered by this standard, but such sensitivity may be completely mitigated by the sensitivity of items excluded from the standard. We advise against piecemeal disclosures of items potentially covered by an enterprise-wide risk management process.

Third, a requirement to disclose "the most likely range of reasonably possible estimates" sets an impossible standard. The estimation problem with this requirement is determining the endpoints of the range. In many cases, the range of possible values is somewhat continuous, with gradually declining probabilities the farther the amount is from the mean, median or mode. In such a case, the term "most likely" requires an arbitrary decision – an arbitrary cut-off in the probability distribution. The amount of work required to produce a definitive quantitative range can be significantly greater, if not problematic, versus that involved in producing a qualitative range. Therefore, while producing "**a**" range of reasonably possible estimates is generally realistic, producing "**the**" range of "**most likely**" estimates results in a standard that is unrealistic if not impossible to meet in many cases.

VIII. Effective Date and Transition

Q32. The JWG proposes that about two years is a suitable period of time between issuance of a final standard and the effective date to balance preparation time with the need for standards (see Basis for Conclusions 9.1-9.4). Do you agree? Do you believe that certain enterprises need additional time to prepare for implementation? If so, please specify which enterprises and how they should be differentiated from those that apply a final standard initially. Also, please specify why these enterprises may need more time and the length of time that may be required.

<u>Academy Response –</u>

We disagree that two years is a suitable period to implement this standard. Although beyond the scope of this Draft Standard, we believe that accounting for insurance contracts should be considered for implementation simultaneously to minimize avoidable inconsistencies in financial statement presentations. However, such a major change will require more than two years of lead time.

Implementation of even the proposals in this Draft Standard will be difficult and time consuming in many cases. We recommend that the time allowed for implementation be based on the experience of similar past efforts, such as for FAS 133 in the U.S. A two-year timeframe before the effective date is very tight, in light of the inevitable large number of Q&As and required interpretations that will result from this process. The time needed will also depend on the final form of the new Standard. We note that implementation of a new Standard for prior accounting periods generally requires more effort and resources; thus, if a restatement is required, additional time should be allowed. If the time period for adoption is extended, early adoption could be permitted.

Q33. Some suggest that a comprehensive fair value model for financial instruments should be first introduced in supplemental financial statement as, presented in parallel with financial statements prepared in accordance with existing practice. Only after a period of time would such financial statements replace financial statements prepared in accordance with existing practices (see Basis for Conclusions paragraphs 9.5-9.7). Do you believe that supplemental financial statements should be introduced before replacing financial statements prepared in accordance with existing practices? If so, how would you overcome the disadvantages of such an approach, which are identified in Basis for Conclusions paragraph 9.6?

Academy Response –

We believe that completion of a second full set of financial statements as supplementary information during a transition period would place an unacceptable burden on preparers. However, we believe that it is possible to design a less burdensome presentation of fair value results that would provide valuable insight into the worth of fair value financial statements as well as time to address the substantial implementation issues we foresee.

Q34. No Comment.

Q35. What steps need to be taken to assist in implementing a comprehensive fair value model for financial instruments? Please comment on any significant legal or other obstacles to implementing a final standard based on this Draft Standard and how they might be best addressed.

Academy Response –

We believe that with adoption of a standard for a comprehensive introduction of fair values for financial instruments, it would be important to the financial services sector to adopt, at the same time, new standards for financial instrument liabilities, including those that were excluded from this standard. Otherwise, misleading financial reports may result in that sector.

To the extent financial statements based on this standard will be used by regulators to measure the solvency of financial institutions, transition time and preliminary results must be provided to regulators to recalibrate solvency measures based on other accounting standards. This need may be best met by an initial presentation of summarized financial results on the new basis.

Q36. No Comment.

APPENDIX A

AMERICAN ACADEMY OF ACTUARIES

May 29, 2001

Peter Clark
Senior Research Manager
IASB
166 Fleet Street
London EC4A 2DY
United Kingdom

Dear Peter,

The American Academy of Actuaries (Academy) Task Force on Fair Value is currently preparing its comment letter with respect to the report on Financial Instruments prepared by the Joint Working Group of National Standard Setters.

We understand that these comments are being received at the same time as the Insurance Steering Committee is winding up its work and is preparing a Draft Statement of Principles (DSOP) for review by the new International Accounting Standards Board (IASB). It is possible that the submitted DSOP will address these issues, but we thought it might be helpful to that process for the Steering Committee to understand a concern raised by the Academy Task Force in distinguishing certain products and assets between the Joint Working Group documents and the documents issued by the Insurance Steering Committee.

We are writing to you to describe an area of potential concern when the IASB addresses accounting for insurance products. We will express the same potential concern in our commentary on the Joint Working Group report even though insurance is explicitly excluded from its current deliberations.

Our potential concern has to do with potential hybrid instruments as expressed below. We are not clear as to whether this example is a hybrid instrument or not, but it raises a problem regardless.

Potential Hybrid Instrument question

We understand that insurance is currently excluded from the JWG draft (except for embedded options). Nevertheless, we have been trying to understand whether certain common forms of insurance (in the United States) would meet the definition of financial instruments, if they were not excluded from the scope. These forms of insurance promise a service or services, rather than a financial amount.

Consider the following.

> An insurance company (A) issues a medical insurance policy (B) to a policyholder (C). B commits A to secure necessary medical services for C, provided C pays the premiums

specified in B. Under B C must make a co- payment if he uses medical services. This co-payment is lower if C uses a chain of medical centers (D) with whom A has a contract.

When a person other than a policyholder of A uses D that person is charged for service by D according to a specified tariff. A's contract with D specifies that A will reimburse D for services provided to policyholders of A at 70% of the retail tariff in recognition of A's excellent payment history, and A's attempting to steer its policyholders to D.

Is this example intended to be a financial instrument? If so how is it to be valued? The commitment under B is obviously for service, not money. Further the value of that service has, in effect, a retail and a wholesale price.

Please contact Meredith Watts with the Academy when you are ready to discuss this hybrid question further at 202-223-8196 or watts@actuary.org.

Sincerely,

Burton Jay

APPENDIX B

Application of Approach described in Question 25

For purposes of excluding changes in value due to *changes* in credit-worthiness from operating income (as described in our response to question 25), *changes* in credit worthiness of the issuer would include all changes in value after issue from "credit risk", but not changes in value from "spread risk" (as defined below).

We recommend adding the following definition of Spread Risk to the "Definitions of Financial Risks" section:

> Spread Risk is the risk of changes in the fair value of cash flows of an asset or liability due to changes in market interest rates other than changes in the basic interest rate. For example, this might result from a widening of credit spreads on securities of a *given* credit worthiness due to changing market conditions.

The definition of Credit Risk should also be modified to clarify that this definition includes the risk of changes in the fair value of an asset or liability due to changes in creditworthiness or credit status of the security's issuer after issue (other than those associated with Spread Risk).

We also recommend changing the definition of Liquidity Risk to read as follows:

> Liquidity Risk is the risk of loss from sale of a financial instrument below fair market value that results from a need to raise cash in a shorter period of time than the period required to sell the financial instrument at its fair market value.

The following definition of Discontinuity Risk should also be added to the "Definitions of Financial Risks" section:

> Discontinuity Risk is the risk of loss arising from the inability to trade a financial instrument or modify a financial position due to the absence of any market for the instrument or position at a given point in time, such as during periods of trading suspension or when the markets are closed.

The list of financial risks in the first sentence of paragraph 16 on page 22 should then be changed to include "spread risk" and "discontinuity risk".

The following changes should also be made to the Draft Standard in order to be consistent with the proposed treatment of credit risk outlined above:

> Change paragraph 137(d) to read "net gain or loss resulting from changes in the credit risk premiums of interest-bearing financial liabilities where the net gain or loss from a change in creditworthiness (or credit risk) is shown

separately from the net gain or loss from a change in credit spreads on securities of a given credit quality (e.g. spread risk)."

Language should be added to the end of paragraph 138 that states "The cumulative gain or loss from changes in credit risk premiums should be split into "cumulative gains or losses from changes in creditworthiness (or credit risk)" and "cumulative gains and losses from changes in credit spreads on securities of a given credit quality (or spread risk)".

Paragraph 144(b) should be changed to read "changes in credit risk premiums of financial assets, distinguishing effects of changes in credit interest rate spreads for a given credit quality (spread risk) from the effects of changes in credit worthiness (credit risk); and"