

# IASB IAS 32-39 Roundtable Discussions Summary of Sessions on Insurance – 14 March 2003

## A. INTRODUCTION AND OVERVIEW

The notes below represent an observer's notes from the IASB roundtable discussions and do not represent official minutes of the IASB or views of Deloitte Touche Tohmatsu. Therefore, the information contained within should not be relied on.

The purpose of the IASB roundtable discussions is to provide the opportunity for the Board and constituents to meet and discuss issues raised in the comment letters on the IASB's exposure drafts on IAS 32, *Financial Instruments: Disclosure and Presentation*, and IAS 39, *Financial Instruments: Recognition and Measurement*. Such roundtable discussions are not decision-making meetings of the Board. Rather, they are intended to help increase the Board's understanding of various constituent views and, hopefully, lead to mutually acceptable solutions.

Moreover, by their nature, the roundtables provided an opportunity for the IASB's constituents primarily to air their concerns and disagreements with both the existing IAS 32 and IAS 39 and the amendments to those standards proposed by the Board. Because of the very limited time given to each participant, there was little presentation or discussion on areas of agreement. Therefore, the notes below are biased toward an enumeration of perceived problems without a counter-balance of supportive views.

There were nine sessions of roundtable discussions, each with a different group of constituents. This memorandum provides a summary of the last two sessions, which were dedicated to discussion of issues related to insurance companies. Rather than provide a summary of the two sessions separately, this memorandum first identifies the Board members and the outside participants that participated in each discussion. That is followed by a summary by topical area of the key discussion points from both sessions. The purpose of the summary is merely to capture the main issues and perspectives to provide a flavor for the discussion, rather than to provide a transcript or to ascribe views to any particular individual.

### Session 8

Board members present: Sir David Tweedie chaired the meeting, and Board members Tony Cope, Bob Garnett, Jim Leisenring, Warren McGregor, Tricia O'Malley, and Harry Schmid were seated at the table. Other IASB members observed from the audience.

Participants present: Frank Achtert, Mel Andersen, Jan Erik Back, Yutaka Chujo, Eva Groth, Doug Logan, Tim Harris, Florence Lustman, David Martin, Paul Mcrossan, Jacqui Stapley, Joseph Streppel, Peter Vipond.

### Session 9

Board members present: Tom Jones chaired the meeting, and Board members Mary Barth, Gilbert Gelard, Jim Leisenring, Warren McGregor, Tricia O'Malley, and John Smith were seated at the table. Other IASB members observed from the audience.

Participants present: Jacques le Douit, Esko Kivisarris, Nigel Masters, George Quinn, HansJurgen Saeglitz, Phillippe Trainat, Y van der Schaaf.

## HIGH-LEVEL OVERVIEW OF ISSUES IN SESSIONS 8 AND 9

In general, insurance companies were concerned about the interaction of the scopes of IAS 39 and the definition of an insurance contract in the first phase of the IASB's insurance project. In addition, they pushed for the Board to relax its provisions with respect to the held-to-maturity classification for insurance companies to permit them to have assets that were funding insurance liabilities to be accounted for as held to maturity, even though an unforeseen event might require them to sell the assets at some point in the future.

Other areas of concern included the bifurcation of derivatives embedded in insurance contracts and the application of the fair value hierarchy. In particular participants identified issues related to fair valuing all or one or more

elements of an insurance contract under IAS 39. No guidance currently exists on fair value measurement issues specifically related to insurance contracts because the Board intends to resolve those issues in phase two of its insurance project.

A good deal of time was spent with the IASB clarifying recent decisions on the IASB's insurance project, some of which was not relevant in terms of the amendments to IAS 32 and 39. For example, the Board's recently revised definition of an insurance contract was discussed in detail, and suggestions were made to the Board as to whether it was operational and how it could be clarified. While that discussion should ultimately lead to the Board's development of a crisper scope delineation, those contracts (or elements of contracts) that meet the definition of insurance would be excluded from IAS 39. Detailed content of those discussions has not been included in this summary.

## **B. SUMMARY OF ISSUES DISCUSSED**

The following sections provide a summary of the key issues discussed in each of the following areas (in order): scope, embedded derivatives, measurement, derivatives and hedging, derecognition, fair value option, debt-equity.

### **1. SCOPE ISSUES**

The discussion of scope was mostly about the Board's proposed definition of insurance contracts and whether constituents thought that definition was clear and robust enough to effectively draw the line between which contracts are in the scope of IAS 39 and which are outside the scope and therefore, will be covered by the insurance standard. The Board's proposed definition of an insurance contract is a contract under which one party (the insurer) accepts significant insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary.

- Many suggested that the Board needed to field-test the latest definition to ensure that it was effective. A number of participants suggested changes to the Board's definition that would help to clarify it. Some wanted to ensure convergence with U.S. GAAP.
- Participants stated that it was not clear how the term "significant" should be applied in practice. Many contracts contained various service and savings elements as well as insurance coverage. Did significant mean "predominant," should it be based on the maximum possible losses under the contract, or did the Board have something else in mind? Some participants thought that the IAS 39 scope exception should encompass any contract that contains any insurance risk. The Board noted that if the scope was drawn that way, then financial institutions or others could get around applying IAS 39 merely by introducing, for example, one dollar's worth of insurance benefit.
- Some thought the Board's objective was to maximize the contracts accounted for under IAS 39 as a way to essentially require the fair value measurement of insurance contracts that the Board anticipates to result from its phase two insurance project. The Board indicated its objective is to ensure that the definition scopes in to IAS 39 what truly is a financial instrument contract (such as an investment contract) and scopes out what the Board would like to provide separate guidance for in the insurance contract, while at the same time ensuring that the scope exception will not be abused.
- A key area of concern is that items that are considered to be in the scope of IAS 39 at this stage are not subsequently scoped out, for example, as a result of the conclusions reached in phase two of the insurance project. Changing back and forth would be problematic, especially since the impact of each change would be significant from a financial reporting standpoint and, therefore, confusing to financial statement users.

### **2. EMBEDDED DERIVATIVES**

- IAS 39 requires the separation of derivatives embedded in insurance contracts that are not closely related to the insurance contract. It was noted that embedded derivatives that themselves meet the definition of an insurance contract would be excluded from the guidance in IAS 39.
- Some suggested that if the Board extended the option to elect fair value accounting to include insurance contracts, that might overcome some of the issues related to separately valuing embedded derivatives because of IAS 39's exception from separation if the whole item is measured at fair value. However, participants indicated that it was not clear what qualified as "fair value" in terms of the exception in IAS 39—there is not enough

guidance on what is fair value for an insurance contract. For example, if actuarial valuation techniques are used to value insurance contracts, would that qualify as fair value accounting? Part of the problem is that the Board will not determine what is fair value for an insurance contract until phase two of the insurance project.

- Another issue is that actuarial calculations are used generally to estimate the value of the contract in its entirety, including the various derivatives that may be embedded in it. It was not clear what the effect of separating those derivatives would have on valuation of the host insurance contract, or whether that would be a meaningful valuation. For example if a contract had both a death benefit and a maturity benefit, which are looked at in combination in determining the price for the overall contract, valuing those two pieces separately would be difficult. Many believe that due to the interdependency of the valuations, these should be measured on a combined basis to be meaningful. In addition, there is a concern that the effect of separately accounting for the derivative is to “double count” its effects because the discount rate on the host contract will vary based on the proceeds allocated to it as a consequence of separately fair valuing the derivative.
- Further, different actuarial standards around the world may have different methodologies for valuing contracts, and options in insurance contracts would not necessarily be valued using an option-pricing model. Could any other valuation methodologies be used to meet IAS 39’s requirement for separately accounting for the option derivative at fair value?
- Another area of concern was transaction costs. Participants noted that the definition of transaction costs in terms of what costs are included in the initial measurement in IAS 39 was different from what is included under other IASB standards, such as IAS 16, *Property, Plant and Equipment*, IAS 18, *Revenue*, and IAS 40, *Investment Properties*. Some suggested that the accounting for transaction costs in the context of insurance contracts should converge with U.S. GAAP.
- It was also pointed out that because IAS 39 would only require certain embedded features to be separately accounted for (those that are not considered closely related to the host), significant options would not be valued. For example written options that are out of the money at inception that are closely related to the host would not be separately accounted for, however, those options pose significant risks to the insurer that might not otherwise be reflected in the accounting for the contract.

### **3. ISSUES RELATED TO MEASUREMENT AND DESIGNATION OF ASSETS AND LIABILITIES WITHIN CLASSES**

This discussion centered on issues arising with the measurement provisions of IAS 39 in the context of both phase one and phase two of the insurance project. Phase one will not address guidance related to fair valuing insurance liabilities, whose value is often determined by actuarial calculations and which generally are “funded” with financial assets that would be accounted for under IAS 39. Insurers want consistent accounting for the asset and liability positions.

- Under IAS 39, fair value of financial assets is required unless the item is classified as held-to-maturity or is an originated loan or receivable. Thus, one way to match asset and liability positions would be for the Board to extend the option to fair value contracts to include the ability to designate insurance contracts. The difficulty with that is that there is no consensus on what is included in the determination of fair value for insurance contracts—that is the main issue to be addressed in phase two of the insurance project.
- A second way to match the asset and liability positions is to classify assets in the held-to-maturity category. However, IAS 39 requires that the entity must have the positive intent and ability to hold the item to maturity and provides for penalties if an item classified therein is not held to maturity. Those conditions may be difficult to meet since (1) insurance liabilities often contain a surrender value option, which, if exercised may require that assets be liquidated (2) risk management policies may dictate that asset positions be liquidated under certain conditions, such as in circumstances when concentrations of risk develop. Thus, until phase two of the insurance project is completed, insurance companies would like the Board to provide a way for them to match the accounting for assets and insurance liabilities.
- Some participants stated that the option to, at inception, irrevocably designate a financial instrument to be measured at fair value with changes in value recognized in the profit and loss was an important improvement to IAS 39 and should be kept. It was suggested that the Board allow entities to designate instruments irrevocably to fair value at any time, rather than just at inception. The view was expressed that from the insurance industry’s perspective, the option to designate liabilities to fair value was really a compulsion, since fair valuing both sides of the balance sheet was the only way to produce reasonable income statement positions.
- Some participants expressed concern about the interaction of the asset designation required to be made upon adoption of IAS 39 (trading, available for sale, or held to maturity) and the subsequent developments on the Board’s insurance project. The concern centered on making such a designation in the context of the Board’s

decisions on phase one of the insurance project only to find that they would have made a different decision based on the outcome of phase two. In particular they would like more flexibility in reclassification of items between held-to-maturity and fair value. They suggested that the Board reconsider limitations on the ability to redesignate items and possibly allow redesignation whenever there is a major change in the accounting for liabilities.

- A number of participants proposed that the Board add a new classification for assets or to provide insurance companies for a special exception that would allow assets to be accounted for at amortized cost (i.e., as held-to-maturity) even if they may need to be liquidated in the future due to unforeseen events. They also noted that the category for originated loans in IAS 39 is essentially a category that benefits mostly the banking industry. A similar category that primarily pertained to insurance companies could be developed.
- Another area of concern with fair value measurement was loss recognition. For insurance liabilities, sometimes the assumptions underlying estimates of cash flows change, and cash flow projections and discount rates are modified accordingly. However, under a fair value approach it appeared that the discount rate must be fixed at inception.

#### **4. DERIVATIVES AND HEDGING**

##### ***Hedging***

- General agreement was expressed with the Board's principles that derivatives should be at fair value and that ineffectiveness should be recognized in earnings.
- The Board should introduce a form of the short-cut method to ease the application of IAS 39 hedging documentation requirements. In addition, the Board should provide for some sort of macro-hedging, since insurers often hedge on a "book to book" basis.
- Some believe that the requirement for items to be similar to be grouped for hedging purposes was too restrictive. For example, an entity is prohibited under IGC 132-1 from designating a derivative to hedge a portfolio of available-for-sale securities even if the value of the derivative is based on an index whose changes in value exactly matches the changes in fair value of the portfolio.

##### ***Credit derivatives (including financial guarantees)***

- Concern was expressed that certain insurance products related to credit events might be inappropriately within the scope of IAS 39. For example, some participants believe that credit insurance meets the definition of an insurance contract and therefore, should be outside the scope. However, they did not see much difference between that product and a financial guarantee or a weather derivative.
- The Board indicated that it was difficult to tell the difference between what insurance companies view as credit insurance and what financial companies and others view as credit derivatives. The IASB staff added that in its consideration of this issue, the Board was unable to identify characteristics of insurance credit guarantees that distinguish them sufficiently from financial instruments to justify different accounting treatment.
- Some participants noted that to the extent that the pricing of credit insurance and other types of credit product differed, that implied that there is a substantive difference in the contracts. Some participants suggested that credit insurance contracts be scoped out of IAS 39 altogether. Others suggested that the scope exception should be based on the type of entity issuing the product and the primary business purpose for offering the product.
- A Board member noted that not all credit guarantees would be accounted for at fair value. That is, certain financial guarantees are under IAS 39 for initial recognition an measurement, but area accounted for under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, for subsequent measurement. Participants noted that this posed difficulties because the recognition and measurement criteria in the two standards differed.
- Some indicated that in order to ensure that there is consistent accounting between credit insurance and similar financial instruments, the accounting guidance should be in one standard, not split between a standard on financial instruments and one on insurance.
- It was noted that the Board should consider convergence with U.S. GAAP on this issue.

#### **5. DERECOGNITION**

- Participants suggested that the Board keep IAS 39 as is for the short-term but work to develop a robust approach over the longer term.

## **6. DEBT-EQUITY**

- Those constituents that expressed a view on the Board's debt-equity proposals disagreed with the approach in the exposure draft, indicating that it was rules-based and complex. Two alternative approaches were put forth for the Board's consideration. One is that the Board should adopt an approach like that in EITF 00-19 under which equity versus derivative or nonderivative liability accounting is determined based on whether the issuer has control over whether it can settle in its own equity. Another approach was that all equity-based derivatives should be marked to market through earnings until the exercise or expiration date.
- Another area of concern was the accounting for participating contracts, which contain both an insurance element and a profit participation element, which may be seen as having both liability and equity characteristics. It was noted that national and cultural differences existed in what qualified as a participating contract, and it would be helpful for the Board to develop guidance to identify the critical elements that distinguish those contracts from other contracts.