making progress . . . together

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

EXECUTIVE HEADQUARTERS

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

FEDERAL AND INTERNATIONAL RELATIONS

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

SECURITIES VALUATION OFFICE

48 Wall Street
6th Floor
New York NY
10005-2906
Voice 212-398-9000
Fax 212-382-4207

WORLD WIDE WEB

www.naic.org

October 22, 2004

CL 66

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

Dear Sir David and Members of the Board:

Thank you for the opportunity to comment on ED7 - *Financial Instruments: Disclosures*. On behalf of the International Accounting Standards Working Group (IASWG) of the National Association of Insurance Commissioners (NAIC), I am pleased to provide you comments in response to your Invitation to Comment.

Invitation to Comment

Our comments have been organized in a manner consistent with the questions outlined in the IASB's Invitation to Comment. With the release of this exposure draft, the IASWG notes that the IASB is again proposing revisions to IFRS 4: *Insurance Contracts*. The IASWG is concerned with continued revisions to IFRS 4 since its March 2004 adoption. Since companies are currently working to implement systems to address IFRS 4, the continuous changes cause resource and financial burdens to these companies as they strive to prepare for the upcoming year. Additionally, these immediate changes are viewed as unnecessary as the IASB has committed to complete phase II timely.

Question 1 – Disclosures relating to the significance of financial instruments to financial position and performance

The draft IFRS incorporates disclosures at present contained in IAS 32 *Financial Instruments: Disclosure and Presentation* so that all disclosures about financial instruments are located in one Standard. It also proposes to add the following disclosure requirements:

(a) financial assets and financial liabilities by classification (see paragraphs 10 and BC13).

(b) information about any allowance account (see paragraphs 17 and BC14).

(c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC16).

(d) fee income and expense (see paragraphs 21(d) and BC17).

Are these proposals appropriate? If not, why not? What alternative disclosures would you propose?

Response:

As the disclosure proposals included within question 1 appear to mirror the classifications established in IAS 39, the IASWG does not disagree with the proposed disclosure requirements for financial instruments.

Question 2 – Disclosure of the fair value of collateral and other credit enhancements

For an entity's exposure to credit risk, the draft IFRS proposes to require disclosure of the fair value of collateral pledged as security and other credit enhancements unless impracticable (see paragraphs 39, 40, BC27 and BC28).

Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

Response:

The IASWG does not suggest changes to the proposed credit risk disclosures for financial instruments. These disclosures are similar to what is required by U.S. GAAP and NAIC Statutory Accounting Principles (SAP) for financial instruments with off-balance-sheet risk. (Both the U.S. GAAP and NAIC SAP guidance exclude insurance contracts from the credit risk disclosures.)

Although the exposure draft is unclear, it is our interpretation that insurance contracts within IFRS 4, that are outside the scope of IAS 32, would not require the credit risk disclosures proposed within the exposure draft.

(*Although the exposure draft proposes consequential amendments to IFRS 4 to require similar disclosures for insurance contracts, paragraph 39(c) of the proposed amendments to IFRS 4 only requires disclosures involving interest rate risk and credit risk if the insurance contract was within the scope of the draft IFRS. Insurance contracts within IFRS 4, except those with embedded derivatives, are excluded from the scope of ED7. Furthermore, insurance contracts, except those that principally involve the transfer of financial risks are excluded from IAS 32 and IAS 39.)*

The NAIC has participated with the IAIS Enhanced Disclosure Subcommittee to establish draft standards regarding disclosure requirements. These requirements include disclosing information about exposure to credit risk. The standard requires insurers to disclose credit risk arising from all assets and off balance sheet exposures, including receivables due from reinsurers on settled claims. Per the IAIS Standard, the insurer should disclose its maximum credit risk exposure without taking into account the value of any collateral.

Question 3 – Disclosure of a sensitivity analysis

For an entity that has an exposure to market risk arising from financial instruments, the draft IFRS proposes to require disclosure of a sensitivity analysis (see paragraphs 43, 44 and BC36-BC39). Is the proposed disclosure of a sensitivity analysis practicable for all entities?

If not, why not and what, if any, alternative disclosures of market risk would you propose to meet the stated objective of enabling users to evaluate the nature and extent of market risk?

Response:

The IASWG does not necessarily disagree with the sensitivity analysis disclosures proposed within the exposure draft. As noted in previous comment letters, the IASWG agrees that certain sensitivity disclosures (e.g., sensitivity to liquidity in asset portfolios, commitments under contractual relationships) may be useful to financial statement readers. Similar disclosures of mismatch risk arising because assets and liabilities do not respond equally to economic events may be critical to assess management's performance, especially in a fair value accounting model. However, the IASWG has identified that the proposed disclosures include a level of detail and complexity that extend beyond what should be considered a reasonable disclosure. The proposed disclosures may be too extensive for an average reader and may actually inhibit the usefulness of the financial statements. The IASB should consider whether the difficulties caused by including these disclosures exceed the benefits received.

Question 4 – Capital disclosures

The draft IFRS proposes disclosure of information that enables users of an entity's financial statements to evaluate the nature and extent of its capital. This includes a proposed requirement to disclose qualitative information about the entity's objectives, policies and processes for managing capital; quantitative data about what the entity regards as capital; whether during the period it complied with any capital targets set by management and any externally imposed capital requirements; and if it has not complied, the consequences of such non-compliance (see paragraphs 46-48 and BC45-BC54).

Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?

Response:

The IASWG has identified a discrepancy between ED7 and the Basis for Conclusions. Paragraph 47a(i) of ED7 requires an entity subject to externally imposed capital requirements to disclose the nature of those requirements and how those requirements are incorporated into the management of capital. Paragraph BC53 of the Basis for Conclusions clearly indicates that the Board decided not to require disclosures of externally imposed capital requirements, but to only require disclosures about whether the entity complied with any externally issued capital requirements during the period and, if not, the consequences of non-compliance. It is requested that the IASB confirm the intention of the capital disclosure requirements.

The IASWG has concerns on the inclusion of externally imposed capital requirement disclosures as proposed within the exposure draft. Similar to arguments presented within the Basis for Conclusions, the IASWG believes that inclusion of externally imposed capital requirements, as indicated in paragraph 47(a)(ii), would cause users of the financial statements to inappropriately rely on the provided capital disclosures rather than consider all appropriate facets of the company's financials. The IASWG also believes that requiring the proposed capital disclosures would hinder regulators from imposing entity-specific capital requirements due to repercussions that could occur once the information was publicly available. Furthermore, the IASWG is greatly concerned with the disclosure of entity-specific capital requirements if such disclosures include regulator requests or company initiatives that are not driven in response to an established industry 'action level' but are requested to proactively address decreasing capital levels.

Within the NAIC Risk-Based Capital (RBC) regulatory requirements, 'action levels' have been established to address situations in which a company's RBC level decreases below a specific threshold. Confidentiality provisions of the NAIC RBC Model Acts for life and property and casualty insurers limit the disclosure of a company's explicit NAIC RBC ratio. As such, a requirement to disclose RBC levels, and actions requested of a company to address decreasing RBC levels, could be considered illegal in states that have adopted the NAIC Model Acts. The American Institute of Certified Public Accountants (AICPA) has considered requiring disclosure requirements of NAIC RBC, however, the AICPA Statement of Position 01-5 recognized the limitation of requiring these disclosures until the legal issues could be further considered. (Guidance from the NAIC RBC Model Act has been provided below.)

(The AICPA SOP 01-05 does include a disclosure requirement to indicate if the use of a 'prescribed' or 'permitted' practice results in significantly different risk-based capital than what would have been reported under NAIC SAP. Furthermore, the AICPA requires disclosures of the permitted practice and the related monetary effect on statutory surplus if the use of a permitted practice prevents the triggering of a regulatory event (i.e., action level). These requirements, however, still do not include disclosure of the explicit RBC ratio or other actions (i.e., company plans or regulator imposed requirements) to address decreases in capital.)

(The AICPA SOP 01-05 acknowledges that the insurance laws and regulations of most states require insurance enterprises domiciled in those states to comply with the guidance provided in the NAIC Accounting Practices and Procedures Manual except as prescribed or permitted by state law. The AICPA SOP 01-05 defines 'prescribed' statutory accounting practices as practices incorporated directly or by reference in state laws, regulations and general administrative rules applicable to all insurance enterprises domiciled in a particular state. The AICPA SOP 01-05 defines 'permitted' statutory accounting practices as practices not prescribed by the domiciliary state, but allowed by the domiciliary state regulatory authority.)

Although the NAIC RBC requirements may be considered 'industry-wide capital requirements' and not required to be disclosed per paragraph BC50 of the Basis for Conclusions, there are situations in which financial analysts and regulators actively monitoring a company may require proactive actions to address decreases in capital. Disclosure of these items may cause concern to shareholders/policyholders and project a presumption of company distress even if the company had still been adequately capitalized.

We think the objective of the IASB would still be accomplished, and concerns regarding capital disclosures addressed, if paragraph 47a(ii) was deleted from the exposure draft. This paragraph currently requires disclosure of the nature of externally imposed capital requirements. As noted above, we do not agree with this disclosure and believe it may limit the regulators from proactively addressing concerns identified from varying capital amounts. Also, as indicated within the Basis of Conclusions, it does not appear to be the intention of the IASB to require disclosure of externally imposed capital requirements. Furthermore, we would request deletion of the disclosure requirements included within paragraphs 47(d) and 47(e) addressing externally imposed capital requirements.

<u>*Excerpt from the NAIC RBC Model Act regarding the establishment and limitations of the NAIC RBC calculation and levels:*</u>

It is the judgment of the legislature that the comparison of an insurer's Total Adjusted Capital to any of its RBC Levels is a regulatory tool which may indicate the need for possible corrective action with respect to the insurer, and is not intended as a means to rank insurers generally. Therefore, except as otherwise required under the provisions of this Act, the making, publishing, disseminating, circulating or placing before the public, or causing, directly or indirectly to be made, published, disseminated, circulated or placed before the public, in a newspaper, magazine or other publication, or in the form of a notice, circular, pamphlet, letter or poster, or over any radio or television station, or in any other way, an advertisement, announcement or statement containing an assertion, representation or statement with regard to the RBC Levels of any insurer, or of any component derived in the calculation, by any insurer, agent, broker or other person engaged in any manner in the insurance business would be misleading and is therefore prohibited;

Question 5 – Effective date and transition

The proposed effective date is for periods beginning on or after 1 January 2007 with earlier adoption encouraged (see paragraphs 49 and BC62-BC67). Entities adopting IFRSs and the draft IFRS for the first time before 1 January 2006 would be exempt from providing comparative disclosures for the draft IFRS in the first year of adoption (see Appendix B, paragraph B9).

Are the proposed effective date and transition requirements appropriate? If not, why not? What alternative would you propose?

Response:

The IASWG does not disagree with the January 1, 2007 effective date and transition requirements of this standard. The IASWG does disagree with the proposal to make consequential amendments to IFRS 4 so that it is fully consistent with the exposure draft. Please see the response to Question 7 for additional detail on this issue.

Question 6 – Location of disclosures of risks arising from financial instruments

The disclosure of risks arising from financial instruments proposed by the draft IFRS would be part of the financial statements prepared in accordance with International Financial Reporting Standards (see paragraph BC41). Some believe that disclosures about risks should not be part of financial statements prepared in accordance with IFRSs; rather they should be part of the information provided by management outside the financial statements.

Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?

Response:

The IASWG agrees that companies shall make disclosures about risks and uncertainties that exist at the date of the financial statements. Specifically, the NAIC SAP indicates that disclosures involving the nature of operations, use of estimates in the preparation of financial statements, and current vulnerability to certain concentrations should be disclosed.

However, the NAIC has noted that requiring disclosures of risks and uncertainties and reasonable possible changes in the relevant risk variables (i.e., interest rate fluctuations) within the financial statements may cause a significant burden for all reporting entities. Auditors must provide an opinion, taken as a whole, on the fairness of the financial statements. In providing this opinion, auditors must attest that the notes to the financial statements are also fairly stated. By requiring disclosures of risks and uncertainties and the impact of reasonable possible changes to risk variables within the financial statement notes, auditors will be required to test and verify these disclosures. Not only would these disclosure requirements cause concern for entities that will shoulder the cost of this additional assurance work, auditors may be concerned with additional liability repercussions if they endorse financial statements containing these types of disclosures. As such, disclosures of risks and uncertainties, the impact of risks in accordance with reasonable possible changes in relevant risk variables, other future assumptions and other sources of management uncertainty may be more appropriately discussed in the Management, Discussion and Analysis or in a similar section that accompanies, but is not considered part of, the financial statements. (Auditors are not required to attest to the information within an MD&A.)

Question 7 – Consequential amendments to IFRS 4 (paragraph B10 of Appendix B)

Paragraph B10 of Appendix B proposes amendments to the risk disclosures in IFRS 4 Insurance Contracts to make them consistent with the requirements proposed in the draft IFRS. The requirements in IFRS 4 were based on disclosure requirements in IAS 32 that would be amended by the draft IFRS. The Board's reasons for proposing these amendments are set out in paragraphs BC57-BC61.

Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS? If not, why not and what amendments would you make pending the outcome of phase II of the Board's Insurance project?

Response:

The IASWG is concerned with thoroughly applying to insurance contract liabilities (particularly claim liabilities) those disclosure requirements designed for exchange traded financial instruments with cash flows well defined by contract language. Not all insurance contract liabilities may be conducive to such disclosures, yet the proposed language does not allow for exceptions. For example, claim liabilities resulting from a heterogeneous mix of tort liability coverages may not be amenable to such disclosures, yet the proposed language would require the creation and disclosure of sensitivity analyses anyway. (Note that the current IFRS 4 language only requires discussion of sensitivity, which can range from qualitative discussion to full sensitivity analysis where appropriate.) We believe the issues associated with insurance liabilities are complex, and are best handled in a focused manner and should be addressed during the phase II discussion.

In addition, the IASWG disagrees with the proposed amendment to make changes to the disclosure requirements of IFRS 4 so that is fully consistent with ED7 (the new Financial Instruments Disclosures IFRS). Given that progress towards phase II of the Insurance Contracts Project has begun, and that the IASB has committed to complete phase II as soon as possible, we would request for the IASB to limit the amount of changes to IFRS 4. The IASWG requests for the IASB to address desired disclosure revisions within phase II. We would support the alternative suggestion included in the Basis for Conclusions to make only minimum essential changes to IFRS 4 in response to ED7 and conduct a fuller review of the disclosures in IFRS 4 as part of phase II of the insurance project.

As noted within Appendix B of the ED7, the changes to other standards in accordance with the exposure draft shall be applied for annual periods beginning on or after Jan. 1, 2007. With this implementation date, insurers will be required to make significant system changes twice within two years (IFRS 4 in 2005 and ED7 in 2007), and a third time, as soon as phase II is released. In order for insurers to limit the amount of changes they face within a short period of time, insurers will be forced to implement ED7 early. Although the IASB may believe this to be an acceptable solution, it is not reasonable to expect insurers to include disclosures within their 2005 financial statements if the standard governing those disclosure requirements will not be finalized until 2005. (Even if this was feasible, insurers have already begun to make changes in accordance with IFRS 4.)

Although we understand the IASB's desire to have IFRS 4 comply with ED7, we are concerned that the IASB has not fully considered the time and impact these system changes will have on financial statement preparers. Furthermore, it will be confusing to users as comparability to prior years and other insurers will be hindered due to changes in the presentation and disclosure of the financial statements. By accepting the alternative solution presented in BC58(i) of the Basis of Conclusions, both users and preparers would benefit.

Lastly, when IFRS 4 was deliberated, it was communicated that the standard would be adopted no later than March 2004 to allow insurers ample implementation time to comply with the Jan. 1, 2005 effective date. During this time, a 'cooling off' period was considered to prevent insurers from having to address additional revisions until phase II of the Insurance Contracts Project was completed. Since the release of IFRS 4, the IASB has released at least three exposure drafts that could impact the treatment of insurance contracts (credit insurance, fair value option, ED7). This continued release of exposure drafts impacting the accounting and reporting of insurance contracts is a concern to the industry. In addition to the burden of addressing the elements of the exposure drafts, the industry has become concerned that phase II of the Insurance Contracts Project is not a focus of the IASB. If the IASB was determined to complete a phase II standard timely, the industry questions whether there would be a need for these interim revisions.

Question 8 – Implementation Guidance

The draft Implementation Guidance accompanying the draft IFRS suggests possible ways to apply the risk disclosure requirements in paragraphs 32-45 (see paragraphs BC19, BC20 and BC42-BC44).

Is the Implementation Guidance sufficient? If not, what additional guidance would you propose?

Response:

The IASWG does not have any proposed revisions to the Implementation Guidance.

Question 9 – Differences from the Exposure Draft of Proposed Statement of Financial Accounting Standards Fair Value Measurements published by the US Financial Accounting Standards Board (FASB).

The FASB's Proposed Statement of Financial Accounting Standards Fair Value Measurements, which is open for public comment at the same time as this Exposure Draft, proposes guidance on how to measure fair value that would apply broadly to financial and non-financial assets and liabilities that are measured at fair value in accordance with other FASB pronouncements. That Exposure Draft proposes disclosure of information about the use of fair value in measuring assets and liabilities as follows:

(a) For assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities)

- (i) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities,
- (ii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and
- (iii) the effect of the remeasurements on earnings for the period (unrealized gains or losses) relating to those assets and liabilities still held at the reporting date.

(b) For assets and liabilities that are remeasured at fair value on a non-recurring (or periodic) basis during the period (for example, impaired assets), a description of

- (i) the reason for remeasurements,
- (ii) the fair value amounts,
- (iii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and
- (iv) the effect of the remeasurements on earnings for the period relating to those assets and liabilities still held at the reporting date.

Disclosures similar to (a)(ii) above are proposed in paragraph 31 of the draft IFRS (and are currently required by paragraph 92 of IAS 32) and disclosures similar to (a)(iii) are proposed in paragraph 21(a).

Do you agree that the requirements in the draft IFRS provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft? If not, why not, and what changes to the draft IFRS would you propose?

Response:

The IASWG agrees that the suggested disclosures included within the exposure draft provide adequate disclosure of fair value in accordance with the current proposed guidance of the FASB. However, the IASWG is aware that this guidance is still being debated, and recent actions have suggested that changes to the overall scope of the FASB exposure draft may be considered. This issue may need to be readdressed once the FASB standard has been finalized.

Question 10 – Other comments

Do you have any other comments on the draft IFRS, Implementation Guidance and Illustrative Examples?

Response:

As previously noted, the IASWG is concerned with the recent trend of the IASB to continue to make changes to IFRS 4. Insurers are undergoing significant system changes to apply IFRS 4 for 2005. These continuing changes cause resource and financial burdens to the companies as they strive to prepare for the upcoming year. Additionally, these immediate changes are viewed as unnecessary as the IASB has committed to complete phase II timely.

We appreciate the opportunity to comment on the proposed revisions to ED7 - *Financial Instruments: Disclosures*. Should you have any questions, please contact me at (501) 371-2667, or Julie Gann (NAIC Financial Examination Manager) at (816) 783-8125.

Sincerely,

Mel Anderson
Chair, NAIC International Accounting Standards Working Group

Background and NAIC Process

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

In fulfilling this mission, the NAIC has developed significant experience and expertise in the development of meaningful accounting principles for use in the financial statements of insurance enterprises. The NAIC has the responsibility to establish and interpret statutory accounting principles. The codification of statutory accounting principles by the NAIC produced a comprehensive guide for use by insurance departments, insurers, and auditors.

The fundamental concepts upon which these principles were promulgated are conservatism, consistency and recognition. While these principles are not identical to the framework used by the IASB, which govern general-purpose financial statements, the NAIC has developed expertise with general-purpose financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). The NAIC reviews all U.S. GAAP pronouncements to determine their relevance for statutory accounting purposes.

These comments have been prepared by the IASWG of the NAIC. As part of the NAIC's due process procedures, these comments have also been shared with interested parties to the IASWG, all of whom were given an opportunity to contribute to the IASWG's deliberations of these issues. However, the IASWG does not wish to imply that these comments are shared by all of the IASWG interested parties.