

# **The LIAJ's Comments on the Exposure Draft Hedge Accounting**

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**The Life Insurance Association of Japan (LIAJ)**

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## **1. General opinions on the Exposure Draft**

1. With our greatest respect to the continuing efforts of the International Accounting Standards Board (IASB) for financial instrument project, the Life Insurance Association of Japan (LIAJ) would like to extend our gratitude to the Board for providing us with the opportunity to submit our comments on the exposure draft, *Hedge Accountings* (hereinafter referred to as 'the exposure draft'), published in December 2010.
2. The LIAJ is a trade association comprised of all 47 life insurance companies operating in Japan. Its aim is to promote the sound development of the life insurance industry and maintain its reliability in Japan. We would like to respectfully request that the Board carefully consider the comments submitted from the sole representative body of the life insurance industry in Japan, which holds the second largest life insurance market in the world.

### **1.1 Proposals for improvement to appropriately represent the life insurance business**

3. We think that the amendments to accounting standards for financial instruments that account for a large part of the life insurers' assets and the activities of Insurance Contract project on measuring insurance liability that accounts for a large part of the life insurers' liabilities, would have a great impact on the practice of life insurers. Therefore, we believe that all the phases of IFRS 9, including the proposals in this exposure draft need to be considered consistently with the Insurance Contract project.
4. The nature of life insurance business is to underwrite risks over a long period and requires insurers to firmly fulfil obligations to policyholders, instead of gaining profits through changes in fair value of financial assets and liabilities they hold. We think life insurers need to appropriately represent the nature of their business to users of the financial statements, and we are concerned that recognising in profit or loss 'unrealised gains and losses', such as changes in fair value of equity instruments held for a long period, would cause misunderstanding among users. Therefore, even if the financial assets and insurance liabilities are presented at fair value in the statement of financial position, we believe that changes in fair value should not be recognised in profit or loss before realisation, but they should be recognised when realised in a way that ensures the consistency between the accounting for financial instruments and the accounting for insurance contract.

(Proposals for improvement of IFRS 9)

5. Accounting standards for financial assets that account for a large part of the assets of life insurers were issued as IFRS 9 *Financial Instruments* in November 2009. Under IFRS 9, although an entity is allowed to make irrevocable election to present in other comprehensive income (OCI) subsequent changes in the fair value of an investment in an equity instrument that is not held for trading, the amounts presented in OCI shall not be subsequently recognised in profit or loss (i.e. recycling). We are concerned that without recycling the nature of profit or loss would be changed. Accordingly, we would like to suggest that IFRS 9 be amended as follows in

order to appropriately represent the nature of life insurance business:

- For equity instrument that is not held for trading, if an entity recognised subsequent changes in the fair value of the instrument in OCI, the entity shall be allowed to recognise the amounts presented in OCI in profit or loss when realised.
  - For financial instrument that is not an equity instrument and is not held for trading, it shall also be broadly allowed to recognise subsequent changes in the fair value of the instrument in OCI and then recognise the amounts in OCI in profit or loss when realised.
6. The US Financial Accounting Standards Board (FASB) published an exposure draft that generally required the measurement of financial asset at fair value. But in response to the feedback received from constituents, the FASB tentatively decided to change the proposal to categorise financial assets into three categories (i.e. Fair Value-Net Income (FV-NI), Fair Value-Other Comprehensive Income (FV-OCI) and Amortised Cost) according to an entity's business strategy, and reaffirmed its decision to recognise any realised gains and losses from sales of financial assets classified as FV-OCI in net income when such gains or losses are realised from sales or settlements. We hope that the IASB will consider the dialogue with constituents and the discussion at the FASB in order to develop high quality standards for financial instruments.

(Proposals for valuation of insurance contract liability)

7. In order to appropriately represent the nature of insurance business, 'to underwrite risks over a long period and to firmly fulfil obligations to policyholders', an entity should recognise subsequent changes in the fair value of the insurance liability in OCI and then recognise the amounts presented in OCI in profit or loss when realised, in a way that is consistent with the proposals for improvement we mentioned above. We believe that it would be useful for the users of financial statements to distinguish the comprehensive income which represents all gains and losses including unrealised gains and losses clearly from the profit or loss which represents the proper performance of an entity excluding unrealised gains and losses, and to disclose the two different measures.

## **1.2 Introduction of simplified practice for hedge accounting**

8. Although many life insurers have the needs to use derivatives as part of their risk management activities, we have concerns that the rigorous requirement in the hedge accounting under current IAS 39 would prevent insurers from reflecting the outcome of their hedging activities in the financial statements (creating unnecessary volatility in the statements) and thus from facilitating risk management that utilises derivatives.
9. As stated in the exposure draft, the objective of hedge accounting is 'to represent in the financial statements the effect of an entity's risk management activities'; thus, we expect it to be an accounting that could facilitate risk management using derivatives. However, there is a concern that hedge accounting would be difficult for an entity to apply because unnecessarily rigorous hedge accounting requirements are included in the exposure draft. Therefore, as stated in our

comment in paragraph 10 and 11 below, we would like to suggest the IASB to allow an entity to adopt simplified practices for hedge accounting so that risk management using derivatives could be facilitated.

(Where the critical terms of the hedged item and the hedging instrument are closely aligned)

10. Typical examples of entity's risk management activities where the critical terms of the hedged item and the hedging instrument are closely aligned include using derivative for the purpose of changing floating rate into fixed rate and for swapping the cash flows on the basis of the foreign currency into the cash flows on the basis of the Japanese yen. Judging from the objective of risk management to transform cash flows of the hedged item and manage them together, we think it would be preferable for an accounting practice to allow the entity to present hedged item and hedging instrument together.

(Where an entity purposefully underhedging in risk management)

11. If, for risk management purpose, an entity does not rigorously match the hedged item and hedging instrument thereby they are underhedged, it would not be particularly necessary for the entity to recognise profit or loss if it recalculates the part of hedged item that exceeds the hedging instrument using an original approach. Because the requirement to minimise the hedge ineffectiveness by rebalancing required in the exposure draft might pose a difficult and unnecessary practical burden on the entity, we would like to propose the flexible treatment for underhedging to address such problems.

### **1.3 Request for future deliberation on portfolio hedge**

12. Insurers have great interest in portfolio hedge. However as the exposure draft does not include the discussion on portfolio hedge, we can not evaluate the issue at this point. We believe that retrospective redeliberation on portfolio hedge accounting would be essential if the proposals in this exposure draft lead to any restrictions on the future discussion on portfolio hedge.

## **2. Responses to the questions**

### **2.1 Question 1(Objective of hedge accounting)**

*Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?*

[We do not agree with the proposed objective.]

13. The exposure draft states that the objective of hedge accounting is 'to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss.' However, we do not agree with the eligibility of hedge accounting to limit only those instruments '...that could affect profit or loss', as we think, in the entity's risk management activities, there would be a great needs to hedge the subsequent changes in the fair value of not only 'profit or loss' but also 'equity', for example, those equity instruments designated as FV-OCI. Accordingly, we believe

that the objective of hedge accounting should be to allow entity to present in the financial statements its risk management activities that manage changes in 'equity' as well as 'profit or loss', and thus, we respectfully request the IASB to delete the sentence in the exposure draft; 'Hedge accounting shall not be applied to investments in equity instruments designated as at fair value through other comprehensive income.'

14. As we commented on the exposure draft *Financial Instrument : Classification and Measurement*, we believe that IASB should allow the recycling of subsequent changes in equity instruments designated as FV-OCI. If the recycling is allowed, such profit or loss on sale that would arise from changes in price would affect the profit or loss. Thus, we think this would meet the objective of hedge accounting: 'to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss' proposed in the exposure draft.
15. Many insurers in Japan usually invest in equity instruments to back insurance liabilities to underwrite risks over a long period. If insurers apply IFRS 9 to equity instruments, they might have to be widely designated as FV-OCI. According to the proposal in the exposure draft, hedge accounting shall not be applied to equity instruments designated as FV-OCI, if an insurer entered into a transaction to hedge the changes in the fair value of those instruments, that would result in the inappropriate presentation of the insurer's risk management activities in the financial statement. This is because while the insurer recognised the changes in the fair value of equity instruments designated as hedged item in 'OCI', the insurer recognised the changes in the fair value of the hedging instruments in 'profit or loss.' If the recycling of subsequent changes in equity instruments designated as FV-OCI is allowed, the profit or loss on sale would affect the profit or loss and thus enable the entity to apply hedge accounting for those instrument within the framework proposed in the exposure draft. This would meet the objective of hedge accounting: 'to represent in the financial statements the effect of an entity's risk management activities'. As stated above, we would like to urge the IASB to allow an entity to adopt the recycling of subsequent changes in equity instruments designated as FV-OCI, enabling the entity to apply hedge accounting for those instruments.

## 2.2 Question 5(Designation of a layer component of the nominal amount)

- (a) *Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?*
- (b) *Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?*

[(a) We agree with the proposal.]

16. With the prediction that there may be a level of uncertainty surrounding the hedged item, the needs to hedge a layer component of a contract that includes a prepayment option would be high

in the entity's risk management activities.

[(b) We do not agree with the proposal.]

17. It is expected in the future that fair value hedge would be applied comprehensively to insurance contract portfolio that includes a prepayment option as a hedged item. We think that retrospective redeliberation on portfolio hedge accounting would be essential if the proposals in this exposure draft that a layer component of a contract which includes a prepayment option is not eligible as a hedged item in a fair value hedge lead to any restrictions on the future discussion on portfolio hedge.

## **2.3 Question 6(Hedge effectiveness requirements to qualify for hedge accounting)**

*Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?*

[We do not agree with the proposal.]

18. The exposure draft states that the objective of the hedge effectiveness assessment is 'to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness.' However, we think that the objective needs to be further clarified as we have a concern that, in practice, an entity could be required to ensure a higher degree of linkage between the hedging instruments and the hedged items than it would be required in its risk management activities. Therefore, we propose to add at least such words that 'reasonably estimated' in the proposed requirement.

## **2.4 Question 7(Rebalancing of a hedging relationship)**

- (a) *Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?*
- (b) *Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?*

[We do not agree with the proposal.]

19. In an entity's risk management activities, there are many cases that an entity does not rigorously minimise hedge ineffectiveness when, for example, the entity takes a flexible approach such as underhedging to manage risk without matching the hedged items and the hedging instruments. However, since the exposure draft states that one of the hedge effectiveness requirements is to 'minimise expected hedge ineffectiveness', the entity would be required to rebalance the hedging

relationship if the relationship no longer meets the objective of the hedge effectiveness assessment.

20. Requiring an entity that has not minimised hedge ineffectiveness in their risk management to rigorously rebalance the hedging relationship in hedge accounting would further separate the entity's risk management activities from the accounting practice. Therefore, if the entity does not rigorously minimise hedge ineffectiveness (for example, when it is underhedging in its risk management), we believe that the IASB should not require the rigorous rebalancing of a hedging relationship in hedge accounting.

## **2.5 Question 16(Effective date and transition)**

*Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?*

[We do not agree with the proposed requirements.]

21. We think it is not even feasible for the proposals in the exposure draft to be based on the expectation that the Financial Instrument project will be completed in June 2011, given the fact that the deliberation on the application of hedge accounting to open portfolio has not yet started and there is an uncertainty surrounding the final decision on the phase of impairment in IFRS 9.
22. It is impossible for an entity to apply the new IFRS in January 2013, even if the financial instrument project is to be completed by the end of 2011 as about three years will be needed for system and practical preparation. We are particularly concerned, from the standpoint of preparers of financial statements, that the IASB has not presented any proposals on hedge accounting applied to open portfolio. Therefore, we can not fully start considering specific application of the new IFRS and preparing system development and others as we can not capture the entire aspects of hedge accounting in this exposure draft.