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## **Session 48SM**

### **FASB Update**

**Track:** Investment

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**Moderator:** PRAKASH A. SHIMPI

**Panelist:** WAYNE S. UPTON, JR.†

JUDY L. STRACHAN

**Recorder:** PRAKASH A. SHIMPI

*Summary: The Investment Section is sponsoring an FASB Update presentation.*

**Mr. Prakash A. Shimpi:** My name is Prakash Shimpi. The reason that I am up here is that as of a day-and-a-half ago, I was the chairperson of the Investment Section Council. I will introduce our new council by name, because not a lot of them are here, but our new chairperson, Judy Strachan is here.

We have a couple of things that we'd like to do. First is a very quick recap of the year in the Investment Section and then to pass the session over to Wayne Upton, who has agreed to talk about some things related to the FASB update.

In terms of the Investment Section, most of you, if you are here, are, I would expect, investment section members. If not, welcome anyway. We are one of the largest groups in the Society, which is tremendous because when I got involved with the SOA and the Investment Section many years ago, I was working in an investment bank. There were very few of us in the investment banking community that were active in the Society. Very few actuaries were actually active in the investment banks. Things have changed tremendously. I have since moved from the investment banking world to the reinsurance world, but I'm doing banking there as well.

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†Mr. Upton, not a member of the sponsoring organizations, is Project Manager of the Financial Accounting Standards Board in Norwalk, CT.

The great thing about the Investment Section is it started from a very small group, and has grown considerably over the last few years. That shows that there is recognition that a lot of what we are doing is related to the investment arena, if not directly in the investment arena. And it's recognition by the membership, which is very important, because if we can recognize it first, it helps to educate others to let them know that Society members are very credible participants in what's going on in the investment arena. Having said that, we don't have a lot to do with the stock market. We're primarily fixed income people. But if you are like me, I'm primarily in money markets right now. I seem to have had tremendous foresight in keeping my money in money markets. Unfortunately, it looks like I will also have tremendous hindsight when the market rallies in a few days or a few weeks, and I'll still have my money in money markets.

Over the last few years the Investment Section has been busy with promoting investment-related activities within the Society. That includes organizing a lot of the sessions that you see at the annual meetings and the spring meetings. We spend a considerable amount of our time sitting around the table or, more often, sitting around conference calls discussing possible topics. So as we go through the year and there are things that you think the membership should know about, we encourage you to let us know what those topics are, and we'll try and get them on to the programs.

In addition, a significant amount of the funds that you provide through dues supports research activities. I'll just read a selection of the research projects that we have recently sponsored. There is a monograph on pricing by Dave Babel. You might want to see that. There is a project on the 100-year term structure of interest rates. Only actuaries, you know, would think about looking that far ahead. There is the use of derivatives in the insurance industry project. There was a tremendous conference that was held in Atlanta. I'm not sure if any of you were able to attend that. But there was a survey, followed by a conference, and now followed by the papers from that being put into monograph. Actuarial aspects of foreign exchange risk is another project that's in process and also, the fair value of insurance liabilities. A conference, to discuss integrated approaches to risk management in the financial services industry is yet to be held. Alone, I think it a very valuable study. I call it the VAR conference. Because one of the things that it looks at is: What is the application of concepts like value-at-risk within the insurance industry?

That's just a flavor of some of the things that we're looking at. And we will continue with the new council, I'm sure, to do that, as well as hold the various seminars that we do from time to time. Let me also let you know that this year is the year for awarding the Reddington Prize. I'd like to invite you to submit papers by authors that you think have done good work by the end of this year. Then we

will decide who the winner is. So there's time to get your nominations in. Unfortunately, there isn't enough time to write the paper and get it published in order to get the prize. If you haven't already done it, it's kind of late for this year. You can direct your nominations to anybody on the council of the Society. Frank Sabatini is the coordinator.

We're a small council and we conduct an open election. We all sit around the table and say, "No, you." "No, you." Then we draw short straws, which is how I got this spot. I will introduce the new council to you. The chairperson is Judy Strachan, whom I mentioned earlier. Vice Chair is Joe Tan. Treasurer is Susan Watson. Susan was the Vice Chair this year, but she should have been up here as Chair. She did a tremendous amount of things—all the things that really happened, Susan took care of. All the things that we missed, were kind of my responsibility. It's a good sharing. Co-secretaries for this year will be Klau Shigley and Josephine Marks. The newsletter liaison is Pierre, who will liaison with the various editors, and let them know what's going on in the council and then get the information back into the newsletters. For research, there are various committees. Klau Shigley will coordinate for life, and for the financial area, Mark Leram. On continuing education, our representative is Steve Miller.

Given the amount of work there is for the annual meeting that we've had to do for this year, as well as previous years, we've decided it's a lot for one individual to carry on their own shoulder, so we have Joe Tan leading the effort, with Steve Ready and Mark Leram providing assistance. We know that the types of things that we try and do within the investment section are always subject to strange fates of the market. A few years ago, I was responsible for the investment sessions at the Chicago annual meeting. We had our fingers crossed because we wanted to go to one of the exchanges in Chicago, and there are all kinds of logistical things that happened. One thing that the Investment Section prides itself on is trying to find these day trips or afternoon trips and we're always subject to the interesting events that may occur externally. This time we have a trip to the Fed and a tour organized, but the key individual who is going to address and speak and so on, is now no longer employed there. The government moves fast when it needs to. So the trip is still on, but we're getting a backup person from them. These things happen. But we'd like to continue with those types of things at the annual meeting; it's very important to have people dedicated to not just the annual meeting, but also the spring meetings. This year our spring meeting representative is Steve Reddy, and I will encourage you, given the amount of work that we've all put in to thinking of interesting topics, to take that hardship trip to Hawaii in the spring. It's tough. You're going to have to talk to your bosses about that, and have them, you know, really understand the value of the things that you will be learning in Hawaii. And you know that once you see the program and the types of topics that the investment

section is promoting, there's no question they would like to join you too. Why are you going? I'll go instead!" You know your mission is being accomplished when you can persuade your boss to go instead of you.

I'm going to turn it over to Judy for a moment because she has some important things to say now, as the new chairperson.

**Ms. Judy L. Strachan:** I'm looking forward to being the chairperson. I think the Investment Section Council has had some of the more interesting projects over the years, and with your ideas and your help, I think we can continue to be a very active and interesting section. So with that said, I have a couple of things to present.

The first thing we have is this tray which lists all the chairs of the Investment Section Council since 1987 and, of course, it has Prakash Shimpi on the bottom.

This, of course, stays at the Society office, so we have this nice plaque. Your secretary told us we could not give you anything that had to sit on a shelf, that your office was covered with papers. This hangs on the wall and it reads, "To Prakash A. Shimpi, in appreciation of your dedicated leadership as Chairperson of the SOA Investment Section 1996-97."

**Mr. Shimpi:** That was very nice and I appreciate that very much. I would like now to turn the proceedings over to Wayne Upton. Wayne is Senior Project Manager at the FASB. He joined us in 1984. He's in charge of the present value project and also assigned to the fair value on Financial Instruments project, and he consults on all issues involving insurance. He's well known to the membership. He was formerly a partner at Clifton, Gunderson & Company in Denver, Colorado.

**Mr. Wayne S. Upton, Jr.:** The folks who put the account session together asked me to concentrate on the derivatives project. But I need to start out with a pro forma disclaimer, that while the board encourages the expression of views by members of the board and staff, that much of what you'll hear this morning are my personal opinions, rather than official positions of the FASB. Official positions of the FASB are reached only after extensive deliberation and due process, published, and so on.

That's a \$5 disclaimer. The 50 cent version is that if I insult anyone, it's a personal insult on my part, rather than an official insult from the FASB. Were we to insult you in an official capacity, we'd have to issue an exposure draft for a long time period, hold public hearings and, given our rate of progress, we'd take so long to do it, we'd forget why we were mad in the first place.

I do want to talk specifically about the derivatives in hedging project. In the next session, Peter Duran and I will be talking about fair value of financial instruments, which will really bring in both our concept statement on present value measurements, and the work that we're doing as a follow-up on the derivatives, looking at the fair value of financial instruments. I believe there is an international consensus that the only way to solve the long-term problems of accounting for financial assets/liabilities is to use fair values, but right now we're talking about derivatives in hedging. I have to say that we do sometimes feel like a little fellow in the fort, with folks shooting arrows at us on this project. You may have read some of the popular press, that we've been down here in Washington and attended a couple of Congressional Hearings, at which I have to admit we've received somewhat mixed messages. My favorite line was Senator Robert Graham (D-FL) in his concluding admonitions to our Chairman, encouraging him within one sentence to build consensus but to be true to his own conclusions. Unfortunately, in the job that we at the FASB do, those sometimes are conflicting objectives. To an extent, that tension is here in the derivatives and hedging project as well.

To understand what we're doing in derivatives and hedging, it's important first to look at the fundamental conclusions that the board has reached. These conclusions remain unchanged in large part from the exposure draft that we issued about a year ago. The first conclusion is that derivative financial instruments are assets/liabilities, which ought to be a pretty straightforward conclusion. As interest rates flop, depending on which side of the deal you're in, and where the market has gone, is either an asset or a liability is an option or futures contract, or any of the other building block instruments.

The second conclusion is that only assets/liabilities should be reported in the financial statement as assets/liabilities. Now that's a fairly fundamental conclusion. You think, what are the accountants talking about? Of course, only assets/liabilities should be reported in the statement. But when we get to talking about derivatives and hedge accounting, we find that existing practices for hedge accounting frequently result in a deferred gain, being reported as if it were a liability and shown in the financial statements in that section.

Now that's just nonsense. A deferred gain, especially a deferred realized gain, is not a liability; it's not owed to someone. You don't have to pay anybody for it. And it shouldn't be reported in the financial statements with liabilities.

Fair value is the most relevant measurement for all financial instruments, but with regard to derivative instruments and the board's conclusion, fair value is the only relevant measurement. If you think for a moment about a transaction like an interest-rate swap, what's its cost? What's the initial cost? Pretty close to zero.

Whatever you paid somebody in terms of a fee to set it up, but that di minimis, certainly, when an interest rate market moves 200 basis points. The fair value of any derivative financial instrument is always the most relevant measurement of that financial instrument and that is the board's conclusion.

Finally, special accounting, hedge accounting, should be allowed only to specific transactions that meet qualifying criteria. One of the reasons that this project was added to the board's agenda in the first place was the growing use of hedge accounting, for a whole variety of transactions that test the credibility of the notion of hedging and hedge accounting specifically.

Now before I move on, just a quick word for those of you who aren't familiar with what the accountants are talking about when we talk about hedge accounting. I think most of us are familiar with the old classical idea of a hedge. Typically what we do is we trot out the corn farmer with his bin of corn, and his desire to sell it at a price in the future. Hedge accounting becomes necessary when the accounting measurement of the hedging instrument is on one basis, say fair value, and the accounting measurement of the thing being hedged is on another basis, say historical cost. The consequence is being that the gain or loss on each emerges in different periods in the absence of some sort of special accounting convention that can put them back together again.

Hedge accounting also arises when we have a hedging instrument, and we're hedging a future transaction that has yet to occur. So the gain or loss on the hedging instrument would emerge in the current period, but the future transaction is going to emerge in some future period. Thus, the need for a convention that accountants have come to call hedge accounting, in which we attempt to take those gains and losses and put them together with one another. The idea being, at least in the eyes of its proponents, to report something like economic reality. I say, "in the eyes of its proponents" because, quite frankly, there's a fair body of accounting thought that says there's no justification for hedge accounting at all, that in a proper market to market world, most of the hedge accounting problems would disappear. That was the view for example, taken by the steering committee of the International Accounting Standards Committee (IASC), in their attempt to come to grips with this problem. Either they were forward thinking or they were wrong. Time will tell. They've set that project aside, and right now in Paris, the IASC is considering a proposal by its staff to adopt all U.S. GAAP for financial instruments as the International Accounting Standard, including the derivatives and hedging project. Whether or not they will accept that proposal, I don't know, but that's the current state-of-the-art.

Finally, we get to the middle piece of the puzzle. We've said that we want these things at fair value, that we shouldn't report things like assets/liabilities that are not, in fact, assets/liabilities. We've discussed the idea of special accounting for qualifying transactions, specifically in the board's project on derivatives and hedging. The board has said that you can use hedge accounting to offset changes relative to fair value, in the case of an asset or liability held currently, or future cash flows, in the case of an anticipated transaction in an asset or liability in the future.

As I say, we issued the exposure draft about a year ago. In mid-August, the board issued what we call an Internet exposure. We put the board's most recent draft on our Web site, and opened it for comment for a period of 45 days. You may have seen in the popular press some reports on how voluminous this document is. Actually, the standard sections, the rules in the document, are 48 paragraphs long. The rules themselves are relatively short, even though they're long paragraphs and lots of sub-paragraphs, too. But what makes the document more than 200 pages long is all of the examples that have been added to help people to understand how the accounting works and how it might be applied to particular kinds of transactions.

I'd like to walk you through first the definitions, and then to say a little bit about how the accounting works, and what the general principles are. We could spend the best part of a day talking about all of the intricacies and we could trot up transactions and say, how does it work? Most of us would be lost well before the day was over. What I'd like to do is to talk about definitions, scope, and the fundamental principles that are in the document.

In the past, attempts to deal with derivative financial instruments have never really defined what a derivative is. That includes the FASBs existing as well. If you look at our disclosure standards for example, we say that they apply to options, swaps, futures, forwards, and similar instruments. We never actually define what we think a derivative is, and in the world of structured notes and such, it's become absolutely critical that we make that definition.

Our current definition requires that an instrument have two distinguishing characteristics. First, there has to be one or more underlyings. Here the FASB has really accomplished something. We've taken an adjective and made it into a noun. Usually, we think of underlying financial instrument or underlying asset or liability, but not us, we've taken that adjective and we've made it a noun! And you'll see it used as a noun throughout the document. We are, after all, accountants, not English majors, although the English majors who review our stuff, are absolutely gnashing their teeth. Second, that there has to be one or more notional amounts. A derivative, further, does not require that the holder either invest or receive the full

notional amount. Finally, it meets both of these conditions: the value changes occur because of direct reference to the underlying, and that it can be settled, or if it requires delivery, or settlement, or if it's on terms, not substantially different than that settlement would be.

I think you can see that most of the conventional things that we think of as derivative financial instruments—options, swaps, futures, forwards—easily meet these criteria. The difficulty comes, though, when you actually attempt to define derivative financial instrument. You find yourself quickly getting into what mythology calls “sticky bear” stories or “tar baby” stories, where you grab with this hand and you can't get loose, or you kick it and pretty soon you're stuck! That's the case here. We find very quickly that there are huge numbers of transactions that, taken on their own, would meet this criteria, including interestingly, any purchase order.

You've got a forward purchase contract at a fixed price in most situations. You have what could be construed as a derivative financial instrument. Nobody wants that. Nobody wants to change the face of accounting such that every purchase order is now the point at which we begin the accounting cycle.

And so the document as it stands right now includes several exclusions: regular securities trades, these are the typical two to three day settlement transactions which do not create a derivative instrument; normal purchases and sales, a great big spongy, marshmallow sort of an exclusion because it talks about normal purchases and sales to meet the normal needs and demands and so on and so forth of the entity. You say, well if the entity usually buys three months ahead or issues purchase orders three months ahead, if it moves to six months ahead, does that create a different situation? The answer is, I don't know. I think we'll have to leave it to practice to sort that particular problem out. Over time some consensus will come between companies and their auditors. However, even normal purchases and sales do not get out of the loop, if they are subject to an exchange traded futures contract. An exchange traded futures contract is, in this document, always a derivative instrument and always within the scope. Contingent consideration and business combinations is a fairly rare one. The one that is important for this group, most insurance contracts are excluded from the scope of the derivatives in hedging document. But watch out!

One of the real problems that developed in the exposure draft was the growth of insurance contracts that appeared to many to be structured and tailored specifically to escape derivatives and hedging. This is a common problem and one that I suppose is never going to be completely addressed. The minute you write an accounting rule to deal with one problem, some bright person runs out and



develops a product with a slightly different label on it, to get the same accounting result and the same economic result or, excuse me, to get the same economic result and a different accounting hedge.

And you can never completely escape that, I suppose. But we were concerned with the development of instruments that were financial instruments, that were derivatives in every sense of the word, except that at the top of the page, it said insurance contract. That was just an unacceptable situation. But what's scooped out is any traditional life insurance including universal life, traditional property/casualty insurance, most financial guarantees are excluded. In my estimation, variable life, in its plain vanilla state, is scooped out as well. Variable life with a guarantee floor includes an embedded derivative, and we'll talk about that in a minute. But what's left in, certainly an equity-indexed annuity product, is incorporated within the scope of this document as a product that includes an embedded derivative.

As I mentioned before, variable life, if it has a floor or an index feature, is going to be captured within the scope of the document as it stands now. Products that include foreign exchange exposures are likely to be captured in the scope and any of what have come to be called staple contracts are going to be captured. Those are the bundle of risks that are, in fact, different exposures incorporated into one contract by virtue of a staple gun. These are clearly going to be found to be contracts that include both an insurance element, and an embedded derivative.

The notion of embedded derivative is one that has frustrated, I think, everybody who's tried to come to grips with accounting for derivative products. It's frustrated mutual fund regulators. It's frustrated accountants. You read a mutual fund prospectus that says that we are not permitted to invest in leveraged products. Then you go back to the investment pages, and you find a note with an interest rate based on the prevailing interest rate on the Finnish National Bank multiplied by 13. Tell me again how they're not permitted to invest in leveraged products? Well, they're not permitted to invest in leveraged products, but they are permitted to invest in structured notes. Therein lies the rub, because clearly, the note piece of that transaction is fairly transparent, and the important piece is a leveraged bet on Finnish interest rates or whatever.

We do need to consider embedded derivatives. What the board has tried to do is to identify the circumstances in which you'd have to look for one of these things. The first question is, would it be a derivative within our definition, this feature or element of a contract? Would it be a derivative if you pulled it out and let it stand on its own? Would it otherwise meet the terms of the definition? If it is an embedded derivative, are its economic risks and characteristics not closely

associated with the underlying economics of the host contract? This has proved to be very tough in looking at the comment letters that we received on the exposure.

The concept is fairly straightforward. The application is proving difficult. The concept is that if I have, for example, a home mortgage, I have an embedded derivative. I've got a prepayment option. Is the ability to prepay my mortgage closely linked with the economic risks and characteristics of the host instruments? Yes, they are. As a consequence of that, I'm looking at my home mortgage, as if we were doing Wayne Upton's balance sheet here. Yes, there's an embedded derivative, but it's not one that I have to pull apart and account for separately. If I move over to something like an equity-indexed annuity product, I think we can see fairly clearly that the equity index, the index option that's inherent in that product, is not closely and clearly related to the underlying annuity notion.

Now, as I say, in theory, that sounded very good to us going in. In practice, it's proving fairly difficult, as we look at people's comment letters and people trying to apply the Internet reexposure. This is clearly one that the board is going to need to take another look at. If you do have an embedded derivative, in a host instrument, and it meets these tests, then the accounting is to suck that thing out of the instrument, and account for the two pieces separately. Continue to account for the host instrument on its own terms, take the embedded derivative out, and account for it as a derivative financial instrument.

**Mr. Steven P. Miller:** A callable bond issued by the investment grade, an investment grade corporation, is that a derivative? It is the call feature for one of the derivative instruments.

**Mr. Upton:** All I can give you is my sense of it. I will not attempt to give you a definitive answer. The question is: is a call feature an embedded derivative? I don't think so. The more important and tougher question is whether a conversion feature creates an embedded derivative under this document. My understanding is that it does not. Let me put to you a different example such as multiple attachment points in a reinsurance contract. Do those create an embedded derivative? I think the answer is "no" in most situations, that a multiple attachment point in a reinsurance contract would be, by and large, just a pricing feature. However, some of the industry loss warranty features that are more common in property/casualty reinsurance may very well create an embedded derivative.

**From the Floor:** In terms of the whole idea of the entire liability balance sheet, would the bonds of the corporation that they've issued be considered fair value? Would they have lost a lot of money yesterday when the bond market really went up?

**Mr. Upton:** Yes.

**From the Floor:** With or without the call options—this is basically not on the derivative side, but on your basic philosophy there—is there an event that happened that made corporations who are just going to be paying their coupons, lose money?

**Mr. Upton:** Well, under statement 115 which is the existing GAAP, all debt instruments, all debt securities, and all marketable equity securities are at fair value already. So, yes, in an event that significantly changed, if it were a quarter end for somebody, they'd have a significant financial event in their financial statements. No question about that.

**Mr. Shimpi:** A question on the emerging market, the combination of insurance and financial instruments and insurance products, and on the nonlife side. We've seen quite a bit on the life side with the examples you mentioned. But you mentioned staple contracts, and there is a growing market in, let's say, the insurance that covers your losses from property damage, from liability and from interest rate swings and foreign exchange, sort of balance sheet insurance.

**Mr. Upton:** Earnings per share insurance.

**Mr. Shimpi:** Right. I can understand if these are merely staple contracts, there is actually no relation between each of these, and you're simply putting them together. But what about a contract that gives you an aggregate cover across all losses? It says, "OK, you have five different sources of losses and we will cover you up to \$10 million irrespective of the source of that loss." Whether individually or in combination. So you can lose all \$10 million from foreign exchange or you could lose all \$10 million in a fire, or you could lose \$5 million in each. It's no longer cleanly separable. What happens then? How does this accounting statement take care of that?

**Mr. Upton:** Now you have mathematically a real pricing problem because there are some of those exposures that clearly meet the definition of a derivative—most particularly, they think the requirement still is that you pull the pieces apart. The minute you put three options in a bundle, as I'm sure many of you are aware, you will then introduce an ordering problem in the computation. If you have just two elements, a callable bond, it doesn't matter so much, but the minute you have three elements, it matters a lot which you value first. That is a little bit of a conundrum, but it doesn't escape the underlying problem. What you've done is (to) bury a derivative financial instrument in an insurance contract. There's a real need for accounting purposes to pull those pieces apart. If we don't, from an accounting standards setting, or a financial reporting problem, I think you can see where the

whole rush of the activity will be. You know, to the lower end of Wall Street, where the rocket scientists live, and will very quickly get a growth in insurance contracts that take up the problem. (But I understand the difficulty.)

**Mr. Shimpi:** Yes, it's tough to split that apart. How would you treat an option-type contract, which has a knock in feature? But that knock in feature is some hazard and the real example would be: I will pay you the loss on your investment related to some interest rates, as an interest rate cap, but that cap is only triggered if there is a hurricane of magnitude X? You may be chuckling here, but these are contracts that are now making their way in the marketplace.

**Mr. Upton:** I guess the only response I can give you is that this example is simple. You fair value it, because it's all financial instrument. There's no piece of it that's related to hurricane coverage, other than the trigger. Somebody was bright enough to price it.

**From the Floor:** You're not an accountant. They're not accountants.

**Mr. Upton:** I understand. But they were able to put a price on it, which means that at some point they thought it had a fair value. As a matter of fact, I suspect that for their own purposes, they reprice it daily for their value-at-risk and everything else. Now do the auditors and accountants get real queasy at the notion of introducing some of those computations into the financial statements? Yes. Especially when they realize that for some of these instruments, depending on which of four different pricing models you use, you may get three or four different fair values. Yes, all of those problems exist. The alternatives are worse. The alternatives are to keep them completely out of the financial statements, to ignore that they even exist, and then they'll just let them hit whenever they happen, which doesn't accomplish any notion of transparency.

Let's move ahead. Again, the broad outlines are the same, but the accounting has changed some from the exposure. The first point we've already talked about. All derivatives will be in the balance sheet at fair value, including the embedded derivatives that you've sucked out of the host instruments. By the way, the standard as it is written right now says that if you cannot readily separate the embedded derivative from the host instrument, then you roll the whole thing over into derivative accounting, rather than vice versa.

You can designate hedges of existing assets/liabilities, or forecasted transactions, and here there is a significant change which is of interest to this group. In the exposure draft, the board had said that insurance liabilities, especially for long duration or life liabilities, were not eligible to be hedged and could not be hedging

instruments. For reasons that I'll get to in a minute, the board has revisited that conclusion and said there's no good reason why you shouldn't be able to hedge individual risks within an insurance-type contract. The exclusion that would have prohibited, for example, hedging the interest rate risk in a universal life product has been removed. The entire balance sheet, both sides, is subject to hedge accounting. Excuse me, the entire balance sheet assets/liabilities. The equity section cannot be hedged. (And you'd be amazed, people try.)

For existing assets/liabilities, the change in the fair value of the derivative goes to the income statement. It's matched by the change in the fair value of the underlying—here's the big change from the exposure draft—attributable to the risk being hedged. The exposure draft would have said, "Take the gain or loss on the derivative, and the entire gain or loss on the underlying to the extent of the hedge, and put them both into the income statement."

What we ran into was the desire by many people to hedge only one of the underlying risks in an existing asset or liability. The easiest example is a foreign currency denominated bond. Someone may, for whatever reason, desire to hedge the interest rate risk in a Deutsche mark bond, but not the Deutsche mark exposure. Of course, what we could have is then the entire gain or loss on the derivative going to the income statement. Perhaps the entire gain or loss on the underlying, being worked this way, where the currency was going one direction and the underlying, the interest rate, was going the other, such that we didn't get that economic match up in the income statement that we were looking for. What the document says now is that you look for the change in the fair value attributable to the risk being hedged. You say, "Well how do I figure that out? How do I know what the gain or loss was, attributable to interest rates in this Deutsche mark bond?"

The answer to that is: it's a good question. However, in order to get to hedge accounting in the first place, you have to believe that your hedge effectively offsets the risk being hedged. If you can't tell me what the change in the fair value is attributable to that risk, I don't understand how you can assert that your hedge is effective. It's a little bit of a catch-22. If your hedge is effective, the way you know it's effective is by having some mechanism to track changes in the fair value of your hedging instrument and changes that arise from the risk being hedged.

I submit to you that if you don't have those mechanisms in place, the effectiveness is, in large part, a creature of your desires, not so much a creature of underlying economic reality. Or it may be but you don't know it. While this idea of looking at gain or loss attributable to the risk being hedged is a tough one, it is, in fact, the only way that you can test for effectiveness. It's the only way that you can know, on an ongoing basis, that the hedges you've put in place are in fact meeting the

objectives that you had for them. I'll talk in a minute here about this whole idea of effectiveness and the criteria for getting hedge accounting.

That takes care of the accounting on the existing asset or liability. What about the accounting for the transaction that has yet to occur? Here's where we get to the real accounting conundrum. You recall I said that only assets/liabilities ought to be reported in the balance sheet on the left and right hand side. We shouldn't have whatchamacallits running around and clouding up the picture. I've always found fascinating the notion that I have realized gain on a derivatives transaction. I go to my shareholders and say, "I'm worse off. I have more liabilities as a consequence of having a realized gain." I just can't get my little pea brain accountant's mind around that notion. The difficulty is, that we, as accountants, and even those of us at the FASB, harbor this notion that the debits should equal the credits. I once heard Warren Buffet say that was the most useful notion in finance: Debits ought to equal credits. Then you say, "OK, bright boy. You don't want that gain to be a liability, but it is a credit." You have a limited number of places in the financial statements that you can put credits. You can put them in the liabilities. That won't meet our desire to keep the liability section pure. OK, put it in the income statement. No, remember I wanted to get that matching kind of thing, even as much as we in the FASB hate matching. I didn't want to get that notion of things hitting the income statement at the same time, so I can't put it there. Where am I going to put it? I'm going to put it in what accountants used to call dirty surplus. We call it comprehensive income. I'm going to put it in the southeast corner of the balance sheet, and I'm going to hold it there, sort of circling around like planes over O'Hare, until the matching event occurs. The objective is then to roll that gain or loss out of short line comprehensive income, so that it hits earnings in the same period as the underlying event.

Let's say for example that I'm Hershey, to quote a company that's had a very profound interest in this project, and I hedged chocolate. According to Hershey's comment letter, they hedged lots of chocolate, and I guess you'd expect that. The objective, since their entering into futures contracts, is to have the gain or loss on the futures contract hitting that income at the same period as cost of goods sold, for the underlying chocolate. In fact, that's the principle that applies here. It is a little bit different from the exposure draft, but the idea is that the two of them roll—that the gain or loss on the derivative—rolls out of comprehensive income. In the case of a gain, debit comprehensive income credits the cost of goods sold, and hits the earnings statement at the same time, as the underlying transaction.

That's pretty easy to understand in the context of chocolate or interest rates. It does get to be a bookkeeping challenge when your anticipated transaction is the purchase of a machine. Because when does a machine hit the income statement?

Through depreciation? Under this accounting, you're going to have that chunk of gain or loss, sitting in comprehensive income and dribbling out as an offset to depreciation expense, over the life of that machine, a bookkeeping headache. It is not elegant solution to the problem. It's not the best of all possible worlds. It's the only way we can figure out to get around this problem of debits equal credits, and the desire to have these things roll out into earnings in the same period.

How do you qualify to get hedge accounting? We've talked about what a derivative is. We've talked about what hedge accounting is, and how it's going to work. You remember I said not everybody gets to play. The first, and I think the most difficult, criteria is formal documentation at the inception of the derivative contract that demonstrates what it was intended to hedge, and why management believes that it will be effective. Inherent in why management believes it will be effective has to be the mechanism for a continuing evaluation of effectiveness. That has to be documented at the inception of the instrument. One of the real difficulties with hedge accounting, quite frankly, has been that over time folks do tend to kind of make it up as they go along. The chief accountant to the SEC a few years ago observed that he was getting very tired of seeing nothing but gains on derivative transactions and losses on hedges. He suspected that economically in an efficient market, there ought to be about an even match of both. He suspected that people were harvesting the gains, and declaring the losses to embed hedges and roll them forward. He was Walter Rugland, now chairman or chief accountant of enforcement at the SEC. I have heard nothing that leads me to believe he's changed his mind on these things.

In any event, you have to document that you expected it to be highly effective. We do not define what highly effective means. We haven't put a correlation percentage on it or a way to evaluate effectiveness. Instead what we've said is that you've got to have one, and it's got to be consistent with the documented hedging strategy. So the onus is really on the company to make the assessment. There are some special rules for net written options that I won't get into here. The exposure draft would have said that you could not hedge with a written option at all, which makes sense. And so there are some special rules that do allow you to use written options in a hedging strategy.

That's how you qualify the derivative as a hedging. How do you qualify the hedged item? First, it has to be a specifically identified and recognized asset or liability. This is very much a ones-twos hedging document. As we'll see when I get to the end of it here, that's been one of the biggest complaints about it, that it does not really work very well in a macro hedging world. Folks who like to say, "I've got a macro hedge in place against all of my exposures," are probably not satisfied at all by this document, because it's a ones-twos approach.

My personal view is, the only way you can accommodate macro hedging is in a full marked-to-market balance sheet. We're not there yet. If you want to hear about how we're getting there, attend the next session.

So a hedged item is a single asset or liability. It can be a portfolio obviously. It's completely permissible to hedge a portfolio of mortgages, or the interest rate exposure in a block of universal life products. The notion is that it's an exposure to changes in fair value that could affect earnings. What are we talking about there? You cannot hedge the interest rate risk in a held-to-maturity security. Why? Changes in fair value don't affect earnings. If you think about it, that's sort of a common sense notion, but it's been fairly controversial. If you have investments that are still held-to-maturity—that's an ever-decreasing population, but there are some folks who still have a fair amount of their portfolio designated as held to maturity—then you've asserted in that designation that you don't care what happens to interest rates in the interim, because you won't sell based on interest rate movements.

How can you then say that you need to hedge interest rates? That's what we, as auditors, call incompatible assertion. It has to be an exposure to a change in fair value that will some day affect earnings. The easiest example is the held-to-maturity security. Two further things about that: you can hedge the credit risk in a held-to-maturity security. If you want to buy a credit derivative and hedge credit risk, you can do that. I believe that as a consequence of this document, one of the things that's incorporated is another amnesty for reclassifying held-to-maturities securities. If there's a need to reclassify in response to the change in the hedging guidance, that's an "Ollie Ollie oxen free". There's no tainting of the portfolio as a consequence of that reclassification.

What things can't be hedged? Anything that's already at market through earnings. You can't hedge the trading portfolio because it's already at marked to market and all the changes go through earnings. You can't hedge things that are on the equity method or a minority interest in a consolidated sub. You cannot hedge your own equity.

You can hedge things that change fair value or things with cash flows. You cannot hedge things that do not have one of those two attributes. Believe it or not, I've seen people try to hedge depreciation as a journal entry. You can't hedge journal entries. They have to be real economic events.

I mentioned held-to-maturity items. If you do have a nonfinancial item, that would be of relatively little interest, I suspect, to this group. The change in fair value is the change in fair value of the entire asset. If, for example, you're hedging crude oil,



you have to hedge crude oil. You can't go to your petroleum engineer and say, "How much of that crude oil is likely to wind up being gasoline? I only want to hedge the gasoline component of crude oil." We've left that piece of the engineering for another day.

Finally, if dealing with a financial instrument, the four risks that can be hedged are: interest rates, fair value, foreign currencies, and credit. Those are the only things that are eligible for hedge accounting. What are the major changes from the exposure draft? Let me stop before I do that, and do a little hand waving or hand wringing or whatever here for the FASB. In reading the basis for the conclusions to this document, I was struck by the number of situations in which the paragraph says, "The exposure draft said X, respondent said Y, and the board agreed and adopted Y." I don't recall in my 13 years at the FASB, any pronouncement that has seen as many changes to it in response to comments received from constituents. This document really does, in my mind, take the cake. It doesn't mean that it's not contentious. There are some folks who are real cross with us, and I'll talk about them as we wrap up.

The first big change is this notion of looking at the change in the fair value attributable to the risk that's being hedged, rather than looking at all of the change in the fair value of the instrument. That does create some mechanical problems. It creates, as we talked about before, some interesting valuation problems. Those are going to be difficult. The alternative, the easy answer, was to stick with the exposure draft and say, we'll just use the fair value of the underlying instrument. That can create some discontinuities, and many—most—people said, "We'd rather have it complicated and get the answer that we're looking for, than have it simple and get the wrong answer." We refer to that at the FASB as good complexity. Complexity that gets you the answer you want is typically good complexity. We've talked about the notion that the timing of the reversal will be in comprehensive income. In the exposure draft, things would have rolled out of comprehensive income on the maturity of the hedging instrument. For example, if you used a 90-day futures contract that has chocolate purchases, the gain or loss rolled out at maturity of the futures contract regardless of when the chocolate hit cost of goods sold. We've said, you hold that in comprehensive income, and roll them out into earnings simultaneously.

The exposure draft would not have permitted rollover hedging strategies. You can buy one futures contract for 90 days, and at the end of 90 days, that gain or loss hedged earnings. If you replace it with another one, you'll do it with the other one and so on and so forth. People said, "That's silly. If we want to hedge an exposure 18 months out, why can't we buy these little chunks of it along the way and just roll them over?" The board acceded to that, subject to that effectiveness notion. The

idea is that you have to be constantly, no less than quarterly, assessing and demonstrating that your hedge is still effective. As long as you can keep doing that, and as long as the rollover is consistent with your strategy, you can use a rollover hedging strategy.

The final big change from the exposure draft is the notion of embedded derivatives that we talked about before. Those are new to this document. They were not addressed in depth in the exposure draft, but it became obvious during the exposure period that it was absolutely critical to do so.

What are people still mad at? I guarantee, as Justin Wilson would have said, that there are some people who are still mad; most of them in this town. First, at the notion of derivatives at fair value, people, especially in the banking industry, and to a large extent, in the insurance industry as well, who just don't want to move to fair value. They don't want the derivatives at fair value, and certainly not at fair value in the balance sheet.

Second, and of a special interest, I suppose, to this group, as well as to the bankers, this does create volatility and equity for hedges of anticipated transactions. A hedge of an existing asset or liability, to the extent that it's effective, should create no particular problem at all. Of course, none of them are perfectly effective. There will be, I suppose, some increased volatility in earnings, but frankly our expectation is that they'll be rather small. The real problem for this group, and I think it is a serious problem in terms of how you explain your results, is that the hedge of future transactions does create volatility in equity. That's where comprehensive income sits, down there in the southeast corner of the balance sheet. This will curtail flexibility, given that the accounting standard for derivatives has been, for all intents and purposes, "Do whatever you please and whatever you can convince your auditors of." This will curtail flexibility, as is inherent in having a rule. The desire, obviously, is to make things more predictable, more understandable, and to communicate the results better. But as a consequence, it does curtail flexibility—specifically if it's not consistent with a macro hedging strategy.

There are things you can do within the document, we believe, to accommodate much of what people try to accomplish in macro hedging. But, strictly speaking, this document does not accommodate the macro hedging strategy. Some people, as we heard in the question earlier are concerned by their ability to calculate fair value. That's a legitimate concern. It has to be balanced against the assertion of effectiveness. If you believe you're effective, you must have some way of understanding why. Nobody has been able to demonstrate, at least to my satisfaction, or to the board's, how you can demonstrate effectiveness if you can't measure fair value of both the hedging item and the risk being hedged.

Finally, people are disturbed at the notion that hedging is not allowed for held-to-maturity instruments. I've not heard about it in the insurance industry, it has been a popular practice. They use hedging to get an available-for-sale income statement, and a held-to-maturity balance sheet. Let me turn it over for questions and reactions. We've kind of touched the surface here.

**Mr. Miller:** So if I am allowed to hedge my single premium deferred annuity (SPDA) liabilities, then I get to value my SPDA liabilities that have—the portion that's being hedged, on a fair value basis? Would I be able to explain to my auditor how I came up with the number? How then is that going to affect the amortization of deferred acquisition costs?

**Mr. Upton:** Good question. I wish I had an answer. I was trying to figure it out last night, as a matter of fact, in relation to the fair value process. We haven't addressed it specifically. Let me give you two ideas that we ought to follow up on. The document says that the recognition of interest income continues to be on what we might characterize as a historical cost basis. That's important for people who want to show a line called interest income. We might, on the one hand, continue to amortize deferred acquisition cost (DAC) on that basis. The other would be to say that I'm going to reflect the fair value change and that of DAC, much the way I do under statement 115 in the SEC rules now, hedging only that net exposure. That may run you afoul of the notion I stated earlier, that you can't hedge depreciation. The short answer is, I don't know for sure. That's a question that we're aware of, and unless somebody has come up with a bright idea in the last two days, we haven't answered it. I think my inclination would be to say that you continue to report DAC amortization on the historical cost basis.

**Mr. Leslie Strassberg:** I have a question about the timetable. My understanding is that the reexposure draft came out at the end of August, and comment letters were due about two weeks ago. You're currently looking at them. Originally we were supposed to come up with the final statement by the end of this calendar year, effective for 1999 financial statements. Can you give us your personal opinion on the likelihood of an actual statement being issued by the end of this year, as well as on any possible or probable changes to the reexposure draft, given the comment letters you've received in the last few weeks?

**Mr. Upton:** Those are two questions. One, the timetable, two the changes. The timetable is unchanged. It is the board's expectation that we will issue a final standard by the end of this year, and that the effective date will be as mentioned. As a result of the comment letters, we're still in the process of analyzing changes. We've identified a couple of areas that may need attention. The one that I'm familiar with most is this embedded derivative notion, and whether or not the

clearly and closely related criterion in that test is really operational, or whether we need to do something different. That seems to be the toughest one of the bunch. I'm sure we'll make other changes; we always do. But it's the board's expectation that we'll have a final standard by year end. One of the reasons why the board is so interested in reaching that target is, if you look ahead to all of the other things that are going on. If we don't make that target, we may, in fact, have to roll back two or even three years. If we don't make that January 1, 1999, deadline, then we've got a standard that would conceivably take effect January 1, 2000, and who knows what we're going to run into with the year 2000? Then people would be saying, you have to put it off till 2001, or maybe 2002, or three, or four, or five, whatever. So, we really are on a critical path model right now, and it's not just eagerness to be through, although everybody who has been involved with it would like it to be done. But there is a recognition that we are conceivably in this box, and we need to get out.

**Mr. Douglas W. Andrews:** I'm interested in the concept of comprehensive income on a purchase or sale of a company. What adjustment has to be made for that comprehensive income item if any?

**Mr. Upton:** The question is: On a purchase or sale of a company, what happens to comprehensive income? Now you're going to get me back into advanced accounting 101. It depends on whether it's accounted for in a purchase method or a pooling of interest. On a pooling of interest, I believe it would clearly survive. On a purchase, that's an interesting question. I haven't thought about it. In a purchase, we revalue all of the assets/liabilities of the acquired company to fair value, so you would think that comprehensive income of the acquired company would disappear in the purchase business combination. In a pooling of interest, I suppose it would survive, because everything comes over its original basis. Nobody does purchase business combinations anymore, at least these days.

**Mr. Jeffrey E. Johnson:** In the accounting standards that you see coming down the road, what provisions are allowed to repair a transaction? Let's say you have a derivative associated with an asset or a liability. If it's an asset, it defaults or prepays, and you anticipate revenue in unwinding this swap, replacing the asset.

**Mr. Upton:** That's an interesting question. When you said repair a transaction, I thought you were going to get to a failure of effectiveness. But what you really have is a failure of the underlying—default, in one case. I believe that the expectations believe the same rule would apply, as a failure of effectiveness. You stop the deferral accounting at the point that it is no longer effective. You don't reverse the deferred amount. You continue to run that out as you would have expected to. In the case of a hedge accounting of an existing asset or liability, as long as it's

effective, you're reporting gain or loss from the asset and gain or loss from the derivative in earnings. As soon as it ceases to be effective, you continue to report gain or loss from the derivative in earnings, but you quit on the underlie. Now if the underlying either prepays or defaults, your hedging relation is broken. There's no reason why you can't keep the derivative and put in place a new instrument to hedge against it and redesignate. It becomes a new hedge going forward. It's really not a notion of replacing the old one, or trying to fix it.

The other problem that happens, and it happens I would expect more frequently in a hedge of an anticipated transaction, is this notion when you reach the conclusion that the hedge is no longer effective. The standard says, as it is written right now, when you reach the conclusion that the hedge is no longer effective, you cease to defer in the comprehensive income. But you roll what's in comprehensive income out into earnings, in the period that you would have expected to roll it out, had the hedge continued to be effective. So you cease to defer, but you don't have to reverse all of the effect of that accounting, because it was effective, arguably, up to that point.

The final word, then, on this international question and two final issues: international and fair value. Obviously, the key for going forward—at least obviously in my mind and in the mind of accountants and standard setters around the world—is the need ultimately to move toward a fair value balance sheet. Is this need one to move toward fair value? That is not an uncomplicated problem, as you are no doubt aware. But that is the move for going forward, and it has been made more important or more urgent by actions of the IASC. As you know, this is an international group, attempting to form a body of standards that would allow multinational companies to register their securities, without reconciliation, in several different countries. As I mentioned earlier, the proposal that they're evaluating this week in Paris, is a proposal to adopt U.S. GAAP as International GAAP for financial instruments, because it's there and nobody else has got one.

However, that assumes with it a commitment, especially by the countries that are members of what's called the G4, the U.S., Great Britain, Canada, and Australia, to work with the IASC and to move expeditiously toward fair value-based financial statements for financial assets/liabilities. Inherent in the definition of a financial liability is an insurance liability. It's inescapable that, in looking at fair values, we're going to have to spend a lot of time looking there.

**Mr. Shimpi:** I think this is a very clear exposition on a topic that is of very much interest to this group. It's interesting to reflect that 15 years ago, or thereabouts, this whole area didn't exist, and now we have the entire FASB, a lot of the Society, and a lot of the lawyers, busy with this. If nothing else, there's an employment

opportunity here. The definition of the underlying, I think, is a very interesting one. Just to think about life insurance, and I know you've excluded insurance, but if you think about the underlying being life, the probability of death is, ultimately, one, in a cumulative fashion. The only thing that remains is the timing of the cash flows, and that's an investment risk. By setting a lot of these rules, we're really having the accounting framework dictate, in a manner, the investment strategy that the life insurance business will ultimately follow. We already see it happening with the difference between the holdings and the fixed income versus equities. There are some interesting consequences for this that need to be looked at. I think clearly, as you said, in the case of the evolution of the financial services, one can say that insurance is a derivative. It works on the net present value (NPV) zero-pricing principle and the underlying is whatever your exposure is. There are lots of reasons to call it a derivative. Of course, the options that one trades in the capital markets, those are clearly insurance on some risk, so there's a convergence there. I like rules that clarify what one does across all these things, because they tell you what you can't do, but more importantly, they identify things that you can do. That's always an opportunity. I think why this was important and why we really thank and appreciate your joining us today, is that in the derivatives world, the economics of the deals are easy to figure out. The details are the real devils, in figuring out whether you can do something and whether the issues like taxes and accounting and so on, make the economics work or not.