ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION

July 21, 2004

Ms. Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom
(Email: CommentLetters@iasb.org.uk)

Dear Ms. Thompson:

Re: IAA comments on Exposure Draft of Proposed Amendments to IAS 39
Financial Instruments: Recognition and Measurement, The Fair Value Option

In response to the request for comments on the Exposure Draft of proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement, The Fair Value Option*, I am pleased to transmit on behalf of the International Actuarial Association (IAA) our comments and recommendations.

After comparing the proposed ED with its stated objectives, we do not believe that it should be adopted as it stands. Although we are pleased to see that the IASB is attempting to be responsive to one class of the stakeholders to financial reporting, in this case regulators, we do not believe that it would be advisable to adopt these restrictions to the current IAS 39 fair value option. In certain cases, the restrictions to the use of the fair value option would remove opportunities for certain financial institutions to better match the basis of their assets and their liabilities, which we believe to be a valuable feature of an entity's accounting policy and can help resolve some of the inconsistencies inherent in the mixed measurement model in IAS 39. An example would be an insurer that elects to use the current market interest rate option in measuring their insurance liabilities (paragraph 29 in IFRS 4) with the effect that insurance liabilities are adjusted with changes in the current level of interest rates only.

Nevertheless, we applaud the IASB for attempting to evaluate the fundamental problems inherent in IAS 39 and believe it important that they be dealt with in current and future projects. We hope that you find our attached comments of value.

These comments have been prepared by the Committee of Insurance Accounting of the IAA, the members of which are listed by name and association in the Appendix to this submission. The IAA member associations are also listed in the Appendix.

Yours sincerely,

Yves Guérard
Secretary General

Attachment: Comments

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IAA Comments on
the IASB's proposed Amendments to IAS 39*, the Fair Value Option*

THE INTERNATIONAL ACTUARIAL ASSOCIATION

The International Actuarial Association (the "IAA") represents the international actuarial profession. Our fifty Full Member actuarial associations represent more than 95% of all actuaries practicing around the world. The IAA promotes high standards of actuarial professionalism around the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within, or likely to have an impact upon, the areas of expertise of actuaries.

We are not a trade association and do not represent the interests of either clients or employers. As actuaries, we have developed significant experience and expertise in the assessment of the value of contingent cash flows. Using this experience, actuaries will, as a profession, continue to try to provide assistance to those involved in the enhancement of financial reporting standards to make them more useful to the users of financial statements.

The IAA appreciates this opportunity to provide input to the IASB with regards to its Exposure Draft on *The Fair Value Option*. We continue to commend the IASB for its efforts to develop a high quality and globally accepted set of international financial reporting standards.

These IAA comments regarding the IASB's Exposure Draft on *The Fair Value Option* has been prepared by the Insurance Accounting Committee of the IAA, the members of whom are listed by name and association in the Appendix to this brief. The Full Member associations of the IAA are also listed in the Appendix.

IAA COMMENTS

After comparing the proposed Exposure Draft (ED) with its stated objectives, we do not believe that it should be adopted as it stands. Although we are pleased to see that the IASB is attempting to be responsive to one class of the stakeholders to financial reporting, in this case regulators, we do not believe that it would be advisable to adopt these restrictions to the current IAS 39 fair value option. In certain cases, the restrictions to the use of the fair value option would remove opportunities for certain financial institutions to better match the basis of their assets and their liabilities, which we believe to be a valuable feature of an entity's accounting policy and can help resolve some of the inconsistencies inherent in the mixed measurement model in IAS 39. An example would be an insurer that elects to use the current market interest rate option in measuring their insurance liabilities (paragraph 29 in IFRS 4) with the effect that insurance liabilities are adjusted with changes in the current level of interest rates only.

The most significant reason put forth in BC9 to justify this ED that proposes to restrict the use of the IASB's current fair value option is that some believe that the fair value option might be used inappropriately. Although the IAA is also concerned that this could occur, we do not believe that the prescriptive rules included in this ED are likely to resolve these concerns and that the challenges associated with the use of the fair value option do not warrant the introduction of a new test. In fact, in certain cases, the adoption of this ED may limit the ability of financial institutions such as insurers from opportunities to measure their assets and corresponding liabilities on more consistent bases. We believe that such consistent measurement is appropriate in many cases. Its use could help certain entities to resolve some of the inconsistencies inherent in the mixed measurement model currently included in IAS 39.

The ED seems inconsistent with the overall thrust of the IASB, as illustrated in IFRS 4's requirements regarding a change in accounting policy. In IFRS 4, preparers are encouraged, or at least permitted, to change their accounting to a more realistic (read "current") basis. This ED seems to restrict such movement since the application of paragraph 9(b)(iii) of IAS 39 as proposed introduces the concept of "substantial offset" in the fair value of the related financial liabilities. It is not clear, that this phrase covers insurance liabilities measured under paragraph 24 of IFRS 4 in which only the effect of changes in current interest rates is captured in the change in liabilities. The purpose of paragraphs 24 and 45 of IFRS 4 is to allow the measurement of insurance liabilities and related assets on a more consistent basis. It is not at all clear that the objective of measuring insurance assets and liabilities on a more consistent basis meets the test of "substantial offset" in the fair value of the related financial liability in this ED.

The proposed rules to limit the fair value option's use appear overly complex, including the addition of a layer of validation through the new concept of "verifiability," with its additional criteria that have to be applied and in turn audited. The IAA notes that no such concept is contained in paragraph 24 of IFRS 4. The requirement to designate a financial asset or liability at inception and the prohibition of subsequent reclassification already impose sufficiently stringent conditions on its selection. These restrictions appear to add complexity to the preparation and auditing of fair value estimates included in financial statements that does not appear warranted. The IAA questions what this new "verifiability" criterion adds, considering the guidance provided in the last sentence of IAS 39.AG 76 (revised 2003) and IAS 39.AG 76A (proposed in "Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement Transition and Initial Recognition of Financial Assets and Financial Liabilities*").

However, we welcome the intention to move the guidance in IAS 39.AG76 to the body of the standard in IAS 39.48A. We further recommend, considering the increasing relevance of valuation techniques where fair value measurement is extended to items not traded in active markets, to include the entire guidance of IAS 39.76 and proposed IAS 39.76A in the body of the standard. That may improve the reliability of fair value measurements more than any limitation in the use of the fair value option.

Similar to other estimates made for financial reporting items, we believe that if a particular fair value cannot be calculated in a reliable manner, the preparer in conjunction with its auditor (in the latter's application of ISA 545, "*Auditing Fair Value Measurements and Disclosures*"), it should not use fair value in the first place. We do not believe that a new set of rules needs to be adopted to "protect" the preparer from excess volatility. In most cases that volatility is something that most preparers have demonstrated they are all too interested in avoiding in the first place. Thus it is not clear who this proposed ED is intended to protect,

As pointed out in the dissent to the ED (AV2 – AV7), this adds a second tier fair value measurement basis. We do not believe that the ED has sufficiently demonstrated the need to introduce such complexity and additional rules. It seems that it should be up to the preparer, confirmed by its auditor, to decide on whether the fair values used are measurable.

BC9 points out that supervisors of various financial institutions would prefer their regulated entities to adopt these rules to avoid volatility, when it is clear that these entities will typically do all within their power to do just that by themselves. Although we are pleased to see that the IASB is attempting to be responsive to one class of stakeholders to financial reporting, particularly since certain regulators have the current power to restrict the use of the choices given in the fair value option, we do not believe that it would be wise to adopt these restrictions to the current IAS 39 fair value option at this time. Nevertheless, we applaud the IASB for attempting to evaluate the

fundamental problems inherent in IAS 39 and believe it important that they be dealt with in current and future projects.

The third concern raised in BC9, that is the potential adverse effect of changes in an entity's own credit standing in measuring its financial liabilities, is certainly a significant issue, one that the IAA has pointed out in other contexts. However, the reasonable way of dealing with this concern is not to restrict the use of the fair value option, but rather to separately determine whether this characteristic that some attribute to fair value should apply to IAS 39 at all. If this issue is really a concern and constitutes a reason to restrict the use of fair values, a superior approach might be to eliminate this rule from all of IAS 39, not to restrict it to this one piece. We recommend that this issue should be addressed on its own merits in the upcoming reviews of the accounting for financial instruments and insurance contracts.

The ED does not make a convincing argument as to why the rules introduced here that would restrict the use of the fair value option are appropriate here, particularly in view of comparable fair value measurements included elsewhere in IFRSs, e.g., for complex derivatives. If a fair value measurement is unreasonable for one use, then it should be limited elsewhere.

The requirement or strong recommendation for disclosure of the amounts of financial instruments at fair value by designation might sufficiently address the major concerns raised.

If the IASB, nevertheless, proceeds with this proposal, we believe that it is clear that the use of the fair value option is permissible under IFRSs whenever it is required by local regulators or standard setters.

Specific ED Questions

Our responses to the specific questions raised in the ED are as follows:

Question 1: Do you agree with the proposal in this Exposure Draft? If not why not? What changes do you propose and why?

> ***IAA response: We disagree with the proposal in this Exposure Draft as written. The reasons stated above indicate that the establishment of a new, complex set of rules to restrict the use the fair value option does not seem consistent with the overall thrust of the IASB to produce more relevant financial information and limits the opportunities to better match the methods used to value assets and liabilities of many entities such as the current market interest rate adjustment in IFRS 4 . The IAA is unaware of the types of abuses of the use of the fair value option which this ED indicates that it is attempting to avoid.***

Question 2: Are you aware of any financial instruments to which entities are applying, or are intending to apply the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:

(a) please give details of the instrument(s) and why it(they) would not be eligible.

(b) is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?

(c) how would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

IAA response: Insurers could be limited in their possible application of the fair value option to such financial instruments as mortgages or private placement debt, private equities or GICs, as such assets are not often traded in a market and thus could be considered to be non-verifiable. We do not believe that entities should be restricted from estimating fair value for these asset classes, especially if the current market interest rate option is used in insurance liability measurement.

The IASB recently thoroughly discussed the advantages and disadvantages of introducing this option. We do not believe that the ED has made the case that the arguments underlying that decision have changed since then.

We note that this same verifiability concern could be raised with regard to complex derivatives that are not traded in an active observable market. We do not believe that the ED has made the case that there is any difference in principle between the issues that must be considered in measuring these complex derivatives and those that must be considered in measuring the financial assets and financial liabilities that are the subject of this ED.

One example of an asset that may not meet the verifiability requirement are pre-payable loans such as mortgages in Europe or GICs, neither of which are tradable in an active market. The majority of insurance liabilities would not meet the verifiability test, even though, while it is not likely that insurers would use such an option in most countries, it is required in some. Nevertheless, its restriction might inhibit the use the current market interest rate option on matching liabilities under new types of contracts.

Question 3: Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC9? If not, how would you further limit the use of the option and why?

IAA response: **As indicated above, we do not believe that the proposals adequately meet the objectives, or if they could potentially meet those objectives, they do so by introducing potentially complex rules that should not be necessary, as the preparer would typically not have selected the fair value option if it believed that it would add variability. This is particularly true when certain liabilities are already adjusted to reflect market conditions such as under the current market interest rate option in IFRS 4. In other cases, the concern is more appropriately raised for all those contracts subject to fair values throughout IFRS.**

There is no evidence to suggest that entities desire the volatility in their income statements, the principle concern raised in the ED any more than do regulators. A simpler approach would be for local regulators or standard setters to either require or prohibit the use of the fair value option, as appropriate in that jurisdiction. As we understand it, this approach is already available as IAS 39 now stands.

Question 4: Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or financial liability that contains one or more embedded derivatives whether or not paragraph 11 of IAS 39 requires the embedded derivative to be separated. The Board proposes this category

for the reasons set out in paragraphs BC6(a) and BC16-18 of the Basis for Conclusions on this Exposure Draft. However, the Board recognizes that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal.

> ***IAA response: The proposal in paragraph 9(b)(i) is appropriate. We would support the use of the fair value option to measure the entire financial instrument at fair value, rather than separately measuring any embedded derivatives. We do not believe that such separation adds value in comparison with the costs involved.***

Question 5: Paragraph 103A proposes that an entity that adopts early the December 2003 version of IAS 39 may change the financial assets and financial liabilities designated as at fair value through profit or loss from the beginning of the first period for which it adopts the amendments in this Exposure Draft. It also proposes that in the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:

(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.

(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognized in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognized.

However, in the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statement.

Finally this paragraph proposes that the entity shall disclose:

(a) for financial assets and financial liabilities newly designated as at fair value through profit or loss their fair value and the classification and carrying amount in the previous financial statements.

(b) for financial assets and financial liabilities no longer designated as at fair value through profit or loss their fair value and the classification and carrying amount in the current financial statement.

Are these proposed transitional requirements appropriate? If not, what changes do you propose and why? Specifically should all changes to the measurement basis of a financial asset or financial liability that result from adopting the amendments proposed in this Exposure draft be applied retrospectively by restating the comparative financial statements?

> ***IAA response: The IAA does not support the proposed transition requirements. Since the amendments to IAS 39 are to be applied retrospectively by restating the comparative financial statement, this proposal, if adopted, should be introduced in a consistent manner. The proposals introduce unnecessarily complex rules when there will be limited application.***

Question 6: Do you have any other comments on the proposals?

Additional IAA comments:

(1) The IAA does not support another level of fair value hierarchy that would in effect be created through the use of the concept of "verifiability." In contrast, the IASB has recently introduced a demonstrably non-verifiable adjustment for insurance contract liability measurement through the current market interest rate adjustment. The proposed restriction when applied to financial assets of insurers might defeat the purpose of the approximate adjustment recently introduced in IFRS 4.

(2) IAS 39 already provides sufficient guidance for determining fair values and ISA 545 provides sufficient guidance for auditing these values. It does not make sense to impose more restrictive rules for financial instruments for which the fair value option is selected than for complex derivatives. Given that the original intent of the fair value option was to simplify the practical application of IAS 39, it does not make sense to introduce such complexity at this time.

(3) If supervisors are concerned that the fair value option will be misused, many of them have the power to restrict the selected entity's use of the fair value option. We suggest that concerned regulators pursue that approach rather than affecting standards that will affect all entities. Inclusion of the "supervisory" clause in paragraph 9 appears inconsistent with the primary objectives of IFRS.

(4) Insurers in certain countries, e.g., Australia and the U.K., will be required to carry most of their financial assets backing insurance liabilities using fair values to match the required treatment under local GAAP policy for insurance liabilities. The widespread availability of a fair value option would be appropriate to permit this treatment to continue.

(5) The sixth sentence of the proposed paragraph 48A of IAS 39 of the ED states: "The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs." Fair values determined by valuation techniques often refer not only to transaction prices, i.e., views of market participants regarding value, but also to other observable data not affected by views of market participants, such as observed execution probabilities of options and typical cost of certain transactions. Hence, in choosing input variables the most relevant sources of input need to be distinguished. In the case of bond prices, the time value of money as reflected in the observed actions of market participants is most relevant. But other input variables specific to the item to be valued or are assessed also need to be considered. In some cases, industry statistics might be available, e.g., lapse rates based on observations from similar contracts. Such inputs are contract- or portfolio-specific, rather than market-based. Sometimes, valuation techniques require input variables that refer to specific peculiarities of the entity obliged to execute the contract, especially in case of contractual obligations that cannot be traded, e.g. contracts with service components. In specific cases, the actual cost to the entity for such activities might be more relevant than transaction prices.

Along with other responders to this Invitation to Comment, the IAA appreciates the opportunity to express our views on this Exposure Draft and hope our comments add value to the deliberations.

Members of the IAA's Insurance Accounting Committee

Sam Gutterman	(Chair)
W. Paul McCrossan	(Vice-chair)
Francis Ruygt	(Vice-chair)
Clive Aaron	Institute of Actuaries of Australia
William Abbott	Institute of Actuaries
Yutaka Amino	Institute of Actuaries of Japan
Félix Arias Bergadà	Col.legi d'Actuaris de Catalunya
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Ralph Blanchard	Casualty Actuarial Society
Guy Castagnoli	Association Suisse des Actuaires
Paolo De Angelis	Istituto Italiano degli Attuari
Mark J. Freedman	Society of Actuaries
Mariano Gongora Roman	Instituto de Actuarios Españoles
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William C. Hines	American Academy of Actuaries
Antony John Jeffery	Society of Actuaries in Ireland
Ad A.M. Kok	Het Actuarieel Genootschap
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Kristine Lomanosvka	Latvijas Aktuaru Asociacija
W. Paul McCrossan	Canadian Institute of Actuaries/Institut Canadien des Actuaires
Richard O'Sullivan	Society of Actuaries in Ireland
Markku Paakkanen	Suomen Aktuaariyhdistys
Venkatarama Rajagopalan	Actuarial Society of India
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Robert E. Wilcox	Conference of Consulting Actuaries
Kevin Yah	Actuarial Society of the Republic of China
Jesús Zúñiga	Colegio Nacional de Actuarios A. C.

Full Member Associations of the IAA

Consejo Profesional de Ciencias Económicas de la Ciudad Autónoma de Buenos Aires (Argentina)
Institute of Actuaries of Australia (Australia)
Aktuarvereinigung Österreichs (AVÖ) (Austria)
Association Royale des Actuaires Belges (Belgique)
Instituto Brasileiro de Atuária (IBA) (Brazil)
Canadian Institute of Actuaries/Institut Canadien des Actuaires (Canada)
Cyprus Association of Actuaries (Cyprus)
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Singapore Actuarial Society (Singapore)
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