



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

October 3, 2008

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir

**Re: IAA comments on the IASB Expert Advisory Panel Draft Document:
Measuring and disclosing the fair value of financial instruments in markets
that are no longer active**

In response to the request for comments on the IASB Expert Advisory Panel draft document of September 16: *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*, I am pleased to transmit on behalf of the International Actuarial Association (IAA) our comments and recommendations.

These comments have been prepared by the Committee on Insurance Accounting of the IAA. If, upon reading these comments, you identify any points that you wish to pursue, please do not hesitate to contact the chairperson of that Committee, Sam Gutterman, or any of the other members of the Committee. The IAA will be pleased to develop these ideas further with you.

Yours sincerely,

Yves Guérard
Secretary General

[Attachment](#): IAA comments

**A Commentary on the
DRAFT DOCUMENT: MEASURING AND DISCLOSING
THE FAIR VALUE OF FINANCIAL INSTRUMENTS IN MARKETS THAT ARE NO LONGER ACTIVE
ISSUED BY THE INTERNATIONAL ACCOUNTING STANDARDS BOARD
EXPERT ADVISORY PANEL: SEPTEMBER 2008**

International Actuarial Association

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our sixty full member actuarial associations represent more than 95% of all actuaries practicing around the world and are listed in an Appendix to these comments. The IAA promotes high standards of actuarial professionalism across 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 on the areas of expertise of actuaries.

IAA Commentary

The IAA appreciates the opportunity to provide comments on this important document. These comments have been prepared by the Committee on Insurance Accounting. Our comments are written from the perspective of actuaries involved in financial reporting for insurers around the world, with an emphasis on measurement of insurance liabilities and of reinsurance assets, for which there is limited transfer markets; as a result we have had significant experience in this area. Statements in this letter reflect the collective experience of the actuaries who participated in the preparation of this comment letter, experience that we believe represents an accurate and fairly comprehensive view of the actuarial profession globally. The members of the committee are listed in an Appendix to these comments. It has been subject to the due process required for it to constitute a formal view of the IAA, and will be posted to the IAA’s web site.

The following paragraphs in this letter present our general comments regarding the document, followed by some specific comments on sections of the document.

General Comments

We believe that this document provides useful information and guidance for measuring and disclosing fair values. Particularly in the current market environment any further information and guidance of the measurement of fair values will be helpful.

Overall, we believe the document addresses the issues of measuring fair values in inactive markets quite well and as such it meets the objectives stated in the June press release.

1. It is important to note that some of the discussion included in the draft document (DD) not only relates to measurement of fair value in inactive markets, but is also relevant to the measurement of any fair value that is not (directly) observable, i.e., fair values that need to be modeled or, in SFAS 157 jargon, “use significant level 3 inputs”. For example, in the first line in the summary, the word “inactive” could be replaced by “all” -- the value of the document would be enhanced if it differentiates what distinguishes an

illiquid market from all level 3 inputs, or it describes better that it is just a special case, as applicable.

2. On pages 3 and 15 there is a discussion of adverse market sentiment and “illogical views of risk”, with specific reference to periods of market turmoil. We believe this is not an issue specific to inactive markets, but a discussion that also applies to any assessment of market behavior.

In addition, although this is specifically referred to in the context of today's markets, i.e., a general downward market, risk preferences of market participants can react in an excessive manner in both upward and downward markets. The internet bubble at the end of the previous decade and the significant increase in house prices are perfect examples of a situation where, in hindsight, it can be perceived that at some point risk was not adequately priced.

Further, regarding the reference to changes in market risk, we agree that this is an important issue, but at the same time it suggests that the market risk appetite has changed, but fails to include a discussion as to who will determine that and to what extent that it may occur at a particular instant.

In summary, we believe that a discussion on “illogical views of risk” is important in the context of this paper, and suggest that:

- a) this be addressed as a separate topic in the paper;
 - b) the lack of logic that might occur when markets go up be discussed; and
 - c) the issue of changes in market risk appetite be addressed.
3. The recent release by the SEC's Office of the Chief Accountant and the Staff of the FASB goes a long way towards clarifying the intent of FAS 157 and the measurement of fair value in illiquid markets. Overall, we support the comments in that release and believe this document should reflect them. However, we re-iterate our previous comment #2 regarding the need to include a discussion of fair values in over-exuberant markets as well.
 4. In general, fair value measurement refers to the price at which a transaction would take place **under normal business considerations** (as also referred to in the DD and in IAS 37, AG75). We believe the document would benefit from a discussion regarding what circumstances should be considered to be “normal business considerations”, as we believe this is a key element on how much reliance should be given to observed prices.
 5. When fair value estimates are involved, the document (in our view) correctly concludes that judgment is needed to meet the objectives of fair value measurement and compliance with accounting guidance. As stated on page 4 of the DD, this may imply that it is possible that separate entities will arrive at different estimates of the fair value of the same instrument at the same measurement date. As stated above, we agree, but we believe this conclusion is somewhat inconsistent with current standards and implementation guidance that seem to indicate there is only one such possible estimate.

Consequently, we believe there is a need to update/revise current standards to reflect adequately the role of judgment and the possibility of having different estimates.

6. The discussion on broker quotes and pricing services seems somewhat confusing and circular. It seems to us that these services are used in cases where the entity's expertise is inadequate to value complex instruments itself. In such a case it is difficult to imagine how the same entity would be able to assess whether the quote provides a faithful representation of the fair value.

In fact, we believe that in such a case a question can be raised as to whether the entity has a thorough understanding of the instrument itself, an understanding that is needed in any case in which a broker quote is requested. Although the role of accounting standards does not enforce such a thorough understanding on the part of an entity, this then can become an audit issue, and points out the need in an area such as this that accounting and auditing standard-setters should work together to derive a reasonable and acceptable holistic approach.

7. We believe that the paper would benefit from inclusion of a discussion of how to assess the risk of illiquidity, a risk that we believe is a key element in the current market turmoil. The reference to looking at the bid-offer spread (page 17, second bullet) as a liquidity adjustment measure is not completely correct, since we believe that the bid-offer spread is not always due to liquidity; thus, an adjustment made on that basis may not necessarily be appropriate. More importantly, we believe that illiquidity is a risk that requires a separate discussion, particularly in the context of periods of market turmoil and in reference to prices "under normal business considerations".

Specific comments

Page 2 Summary 4th paragraph

The paragraph starts with "If a model is used to measure fair value, it is periodically calibrated...". We believe the calibration should be a requirement and thus suggest that "is" should be replaced by "should".

Page 3 Fundamental Value versus fair value, 1st paragraph

While we understand the suggestion, we believe the real issue is the assessment of "cash flows are not expected to decline over the life of the instrument". This would require judgment to identify that a specific market movement can be considered to be instantaneous in nature and not a reflection of a new trend that should be reflected. Such an assessment can easily be made in hindsight, but we believe that at the measurement date this may result in valuations that may not faithfully represent fair values. In fact, the assessment of a market decline may differ by entity causing, by definition, fair values and fair value estimates to differ.

Page 4 Active versus inactive markets, last sentence

In contrast to the last sentence that indicates that "a current transaction price for the same or similar instrument normally provides the best evidence of fair value", the first sentence of the next section describes a significant exception to this statement, and this exception is just one of

several examples where it does not provide the best evidence. Although we agree with the thought behind it, this sentence, taken out of context, may be misleading. It would benefit from a discussion, or list, of situations in which a current transaction price would not provide this evidence, particularly since this point has proven quite controversial in some cases.

Page 4 Forced transaction, last paragraph

The last sentence referring to an entity selling assets to meet regulatory requirements includes the phrase “the entity has a reasonable amount of time”. First, we believe that this statement may not be correct in cases where the entity is in serious financial difficulty. In such a case, the regulator may force a sale within a specific timeframe. Second, even in cases where the regulator allows a reasonable amount of time, the market will not necessarily allow it. We believe the experiences in the period September 12 to 16, 2008 shows that markets do not accept entities that are running out of capital to continue doing business. As a result, we suggest deleting the paragraph.

Page 4 Different estimate of fair value, 2nd paragraph last sentence

Reference is made to two entities using different inputs to their models. While the following paragraph explains this in more detail in reference to judgment and assumptions used, we suggest rephrasing it, since the wording may also indicate the use of different inputs from market observable data. As the latter to us seems inappropriate, we suggest a clarification to avoid misinterpretation.

Pages 4/5 Valuation adjustments

We believe that further discussion, or examples, of valuation adjustments applied for the purpose of reflecting differences in instruments or differences in markets would be a valuable addition to the paper.

Page 6 Terms of an instrument

We suggest that a bullet be added that refers to margin calls, as this has proven to be one of the main causes of illiquidity issues that some entities have recently experienced.

Page 7 last sentence

The last two sentences include the following wording: “Thus, entities evaluate the credit risk of the protection providers at each measurement date. If the protection is accounted for separately from the debt instrument, this assessment is necessary when measuring the fair value of the protection.” We suggest deleting the second of these sentences, as it seems to indicate that only in the case that the protection is separately accounted for is a re-assessment needed.

Page 9 Similar instruments, third bullet

This bullet refers to financing at a rate that is not a market rate. We agree that in some cases an adjustment may be needed, but we believe that, before deciding on an adjustment, an investigation of the reason for the financier to charge a lower rate than the market rate would be appropriate. There may be a reasonable reason for such to occur.

Page 9 Indices, 2nd paragraph

This paragraph seems to indicate that portfolio prices may differ from a single unit price. While we agree that is often the case, this statement is inconsistent with the discussions and current guidance on “unit of account” in IASB standards. We suggest that this be discussed in the context of current accounting guidance or suggest that changes be considered in the guidance.

Pages 10/11 Broker quotes

In addition to our general comments on broker quotes and pricing services above, we offer the following:

- 1st paragraph; we do not understand the reference to “not a binding offer (unless the broker is a market maker)”. We believe any non binding offer can serve as an indication, although not definitive evidence, of what a price might be, even when the market maker provides it.
- In the third paragraph, we do not believe that all entities that do not have the expertise to value complex instruments themselves will necessarily be able to perform an assessment of whether a value can be construed to be a representationally faithful assessment, although in certain cases there are other means as indicated to help to make such an assessment.
- We believe the assessment of proprietary models needs more discussion. It is difficult to believe how the same entity that does not have sufficient expertise to value a complex instrument would be able to assess the reasonableness of such a model based on assumptions and inputs used in such a model.

Page 11 Pricing services

In addition to general comments on broker quotes and pricing service made above, we note that the insurance industry has experience with models developed by others to provide relevant measurement information. An example is the models that are used to provide information on catastrophic events. Experience shows that the outcomes of the models can differ significantly by vendor and that even entities with a lot of expertise in modeling this type of event are not able to assess the differences in these models.

We agree that back-testing of models generally can be very important, but we also note that in some cases it is not possible to conduct such testing in a reliable manner. Also, back-testing in many cases can provide a false sense of correctness, since it is not so much the past history that will define the next market turmoil as it is a completely different set of occurrences.

Therefore we suggest further discussion on the assessment of models used provided for by others is needed.

Page 15 Calibration

In this section, a model is calibrated by testing its ability to reproduce prices for similar assets that have observable markets. It would be helpful if a discussion was included here of the acceptability or reliability of model results when there are no similar instruments for which pricing information is available.

Page 15 Calibration, example, 2nd paragraph

The second paragraph of the example seems to refer to the use of historic volatility as an indication of future volatility. We believe that such is often not appropriate, since future volatility relates better to the implied volatility rather than observed volatility. We suggest amending the wording to capture this distinction.

Page 16 Measuring the underlying components of an instrument, 3rd paragraph

This paragraph refers to the alternative to measure the fair value of collateral by considering the economic characteristics of the collateral. We believe the fair value of the collateral should always reflect the economic characteristics of the collateral and not only in the case of alternative measurement. We suggest the reference to the economic characteristics be placed at the beginning of this section.

Page 18 Summary, 2nd paragraph

In the second line, we believe that what is meant is that "although it is not the purpose of the disclosure to provide sufficient information independently to validate a fair value estimate or calculate an alternative fair value".

Page 28 Disclosure of valuation techniques

We agree with the general discussion of disclosure of valuation techniques, but although dealt with in the example, the general text does not contain anything in particular with any special considerations of an illiquid market. If there are any, it would be useful to reference it. In addition, a bullet could be added to discuss the choice of a relevant market and conditions of the market selected that are relevant to the valuation technique chosen.

Page 34 The effect of reasonably possible alternative assumptions

In addition to the disclosure of a reasonably possible alternative assumption if it would change the fair value significantly, it is also appropriate to indicate whether an alternative set of assumptions does not change the fair value significantly even though many users would normally think that it would. For example, a change in the prepayment speed or aggregate credit quality for a particular portfolio of mortgages would ordinarily be assumed by a user to make a significant difference in its fair value; however, if due to the characteristics of the mortgages it does not, then it would be useful to disclose this fact.

Page 35 Disclosure of changes in own credit risk

If the own-credit (non-performance or credit characteristics of the instrument) risk requirement of the fair value of financial instruments is applied to the measurement of liabilities, we suggest that its amount and the effect of changes in this risk factor be disclosed where practical.

In addition, we note that the DD should be edited thoroughly, e.g., on page 11, first line after 'Pricing Services', it should be 'broker quotes' rather than 'brokers' and on page 13, second full paragraph, second to last line, "entities" should be "instruments" or "instruments of entities".

Appendix A

Members of the IAA Insurance Accounting Committee

Sam Gutterman	Chairperson
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Full Member Associations of the IAA

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Bulgarian Actuarial Society (Bulgaria)
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Actuarial Institute of Chinese Taipei (Chinese Taipei)
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