Institute of Actuaries of Australia

23 July 2004

Sandra Thompson
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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

By email: CommentLetters@iasb.org.uk

Dear Sandra

IASB ED Proposed Amendments to IAS 39 – The Fair Value Option

The Institute of Actuaries of Australia (Institute) has pleasure in enclosing its submission on The IASB's Exposure Draft of proposed amendments to IAS 39, entitled "The Fair Value Option". This submission represents the views of the actuarial profession in Australia.

As we have previously indicated, the Institute strongly supports the concept of adoption of common, high quality international financial reporting standards (IFRS). Throughout the development of the international standards, the Institute has worked with the Australian Accounting Standards Board (AASB), IASB and industry to find practical approaches to implementing IFRS that maintain the substantive strengths reflected in Australia's existing standards.

To ensure meaningful financial reporting, it is vital that assets and liabilities be measured consistently. Unfortunately, if the proposed changes to IAS 39 outlined in the ED are implemented it would, in our view, no longer be possible to implement a package of standards in Australia for life and general insurers that reasonably satisfy this fundamental principle. Ultimately, it would result in standards and financial reports that:

- Are significantly degraded and potentially produce misleading, artificially volatile results.
- Will not meet the needs of Australian regulators, who may well then require supplementary reporting from industry. Dual reporting would then re-emerge in life insurance, and any capacity to remove it for general insurance would be lost.

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We cannot, therefore, support the changes to IAS 39 in the form currently proposed.

We believe that it would be better for the IASB to maintain a high level, principles based position, permitting the widest possible use of fair value in IAS 39 (and in other IFRS). To address the concerns identified by the IASB, there is already scope within the measurement options established within IAS 39 for local regulators and standard setters to either mandate or prohibit the use of particular measurement options without imposing those constraints on other countries. This is the approach being adopted in Australia where the AASB has, to the extent possible, excluded non-fair value measurement for insurers.

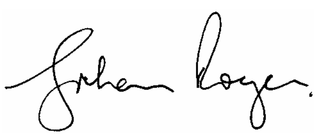
Such an approach would:

- retain a principles based focus for IFRS, consistent with the IASB's long term strategic direction;
- retain the means for those national regulators and standard setters that have concerns with certain measurement options (e.g. the fair value option for some assets or liabilities) to address their concerns, without the risk of adverse knock-on effects in other jurisdictions; and
- in the Australian context, provide proper support to the AASB in its efforts to ensure consistency of asset and liability measurement.

At the very least, the circumstances in which the fair value option is permitted should be expanded to unconditionally include the circumstance where a national regulator or standard setter may allow or require a financial asset or liability to be measured at fair value.

We hope that our comments will be of assistance to the IASB and we would be pleased to clarify or discuss further any aspect of these submissions as appropriate. In the first instance, please contact Catherine Beall, Chief Executive via email (catherine.beall@actuaries.asn.au) or ph: +61 2 9239 6106.

Yours sincerely



Graham Rogers
President

INSTITUTE OF ACTUARIES OF AUSTRALIA

SUBMISSION TO IASB ON ED PROPOSED AMENDMENTS TO IAS 39

– THE FAIR VALUE OPTION

1. Summary

This submission sets out the views of The Institute of Actuaries of Australia (Institute) on the IASB's Exposure Draft of proposed amendments to IAS 39 entitled "The Fair Value Option".

The Institute continues to support the development of a comprehensive set of high quality and meaningful international accounting standards. Indeed, representatives from the Institute have been working closely with the Australian Accounting Standards Board (AASB) to implement international accounting standards in a manner which maintains the integrity of financial reporting in Australia.

In that context we are as concerned as others to ensure that financial reports are free of meaningless volatility (ie, volatility that does not reflect the underlying nature or economics of the business – meaningful recognition of underlying volatility is to be encouraged) and that assets and liabilities are reliably and consistently measured for financial reporting purposes.

However, it is our firm belief that the constraints on the use and application of the "fair value option" as proposed in the ED cannot achieve that end. They will almost certainly have the opposite effect in a number of circumstances, particularly in the case of insurers. This is despite the efforts of the IASB to limit that possibility. In other words, it will generate in Australia a number of problems similar to those that it set out to ameliorate in Europe.

The reasons for this assessment are summarised in Section 3 of this submission.

We cannot, therefore, support the changes to IAS 39 in the form currently proposed. Nonetheless, we believe that there is a practical alternative to the proposals in the ED that would address the concerns of the IASB and other stakeholders without the adverse consequences of the current proposals. This is described in Section 2 of this submission.

Responses to the specific questions posed by the IASB are included in Section 4.

We appreciate the opportunity to make this submission and would be pleased to clarify or discuss further any aspects of this submission as appropriate.

2. Recommended alternative proposal

In the view of the Institute it would be better for the IASB to maintain a high level, principles based position permitting the widest possible use of the fair value option in IAS 39 (and in other IFRS). To address the concerns identified in paragraph BC9, a few paragraphs along the following lines should then be included, either in the IASB Framework or some other high level standard, instead of the ED proposals:

Consistent asset and liability measurement is essential for meaningful reporting and assessment of profit and loss, equity and capital sufficiency. Where reporting entities have a choice under IFRS as to the measurement approach that they apply to particular assets or liabilities, that choice should be exercised in a way that promotes consistent measurement between assets and liabilities. To ensure consistency of measurement in such circumstances national standard setters or regulators may choose to:

- mandate the use of a particular measurement approach from the options available under IFRS;
- prohibit the use of a particular measurement option that IFRS would otherwise allow to be chosen; or
- impose additional constraints (e.g. matching, verifiability, etc) on the use of a particular measurement option that IFRS allows.

Financial statements prepared in accordance with such national requirements comply with IFRS provided the measurement option used is one that IFRS permits for the asset or liability in the particular circumstances.

Such an approach would:

- Retain a principles based focus for IFRS, consistent with the IASB's long term strategic direction;
- Give those regulators that have concerns with certain measurement options a means to address their concerns without the risk of adverse knock-on effects in other jurisdictions; and
- In the Australian context, provide proper support to the AASB in its efforts to ensure consistency of measurement by mandating the use of the fair value option where it is available.

This would provide a "win-win" approach, unlike the current proposal where there will be significant losers in the process.

Alternatively, if the IASB intend to persist with a proposal along the current lines, then at the very least:

- Paragraph 9(b)(v) should be clarified to include any item that a national regulator or standard setter allows or requires to be designated as at fair value through profit or loss, and
- The second paragraph following 9(b)(v) (currently starting "Because designation…") should be amended to "Because designation as at fair value through profit or loss is at the entity's election **under (ii), (iii) and (iv)**, such…". It is illogical to "require" fair value measurement under (i) and (v) on the one hand and then disallow it on the grounds of verifiability and would have the potential to permit non-fair value measurement for non-traded derivatives etc which we assume is not intended.

3. Detailed Comments on the Exposure Draft

3.1 Local problems require local solutions

The problem that the IASB is seeking to address is not an international problem, but a national and industry specific problem. The problem therefore needs to be solved at the national and industry level.

Given the diversity of circumstances that still persists in different jurisdictions and different industries, it is evident that the use of fair value may be appropriate in one jurisdiction and yet potentially inappropriate in another. This is particularly the case in respect of insurance. In the absence of global standards that mandate a particular measurement approach across all countries and for all assets and liabilities within a particular industry, it is virtually impossible for the problem to be fully resolved at the international level. Plugging a gap in one jurisdiction must open up another gap somewhere else.

It needs to be remembered that what we are dealing with here is a measurement "option". The existing IAS 39 does not compel the use of fair value. Nor does it stipulate who has the authority to exercise the choice as to whether or not the option is utilised.

It is therefore reasonable for national regulators and standard setters to exercise some over-riding choices themselves, and to apply constraints on the use of particular measurement options to ensure that they are appropriate for the circumstances in their jurisdiction. Such an approach would be consistent with their responsibility to maintain financial stability within their jurisdiction.

As long as the measurement approach adopted is within the range of options permitted under IAS 39 (or any other IFRS) for the particular asset or liability and the particular circumstances, then financial reports will be compliant with IFRS.

This is the approach that the AASB has adopted in Australia for insurance business. In the Australian circumstances, the use of amortized cost methods for assets would be inappropriate and destabilising relative to our current value liability basis, and so fair value has been mandated wherever the option is available. IFRS compliance has not been compromised by this approach.

The IASB should, therefore, encourage other national regulators and standard setters to adopt a similar approach to the AASB and apply their own constraints to address their own concerns within the overall parameters of the options established by the IASB. In the Exposure Draft, the IASB already appears prepared to concede a role for regulators in ensuring the quality of measurement. It needs to also be prepared to concede, to either national regulators or standard setters, a role in applying the framework established by IFRS, in a manner that best achieves appropriate accounting outcomes, in the context of the national circumstances.

This is not to say that regulators should have the power to overrule the IASB and insist on measurement bases being applied, where they should not. Rather, to address the concerns that have given rise to these amendments, the ability for national regulators and standard setters to constrain choice within the options available under IAS 39 should be acknowledged.

This is the basis for our recommended solution in Section 2.

3.2 Verifiability of Fair Value measurement

We entirely agree that appropriate steps should be taken to ensure that the value of an asset or liability recognised in financial statements should be relevant and reliable and not subject to manipulation. However, the value of particular assets or liabilities should not be subject to a stronger or weaker test of reliability depending on the measurement basis chosen. All assets and liabilities should be subject to the same basic reliability requirements.

In that context there is a clear inconsistency in the exemption from the verifiability requirement granted to Available for Sale assets and assets Held for Trading. There is nothing in the particular classifications that makes the fair value measurement of these assets more inherently reliable than the fair value measurement of other assets to which the fair value through profit or loss option is applied. If verifiability is not given primacy for Available for Sale or Held for Trading assets, then it should not be required for other assets or liabilities where the same underlying fair value measurement is used.

Furthermore, if regulators already have the power to ensure that valuations are appropriate, then an additional verifiability requirement within the accounting standards would appear to be unnecessary.

More generally, the fair value of any asset or liability is ultimately subject to some judgement. Alignment with recent market data may give support for that judgement – and the deeper and more informed the market is, the more reliable that support will be. But care is needed, before accepting such market data as the primary evidence that a particular measurement is suitable.

The existence of a quoted market price simply means that the opinion of two parties was sufficiently aligned in the recent past for a transaction to occur. Similarly, a quoted bid price is merely the opinion of an unknown person with no indication of the analysis on which their opinion is based. In markets with limited trade, such values may be manipulated and therefore unreliable.

Furthermore, verification of a liability or asset value by reference to pricing or pricing techniques may not necessarily be appropriate, particularly if the entity is, at a micro level, a price setter rather than a price taker. Such is likely to be the case for many financial liabilities.

That is not to say that it is not important to align valuation fundamentals with prevailing market parameters. Certainly, the availability of some independent endorsement of a valuation may be appropriate. However, ultimately, a formal evaluation of an asset or liability with documented methods and assumptions may be more reliable and subject to easier verification than market derived values.

In this context it is worth noting that Australia has, since 1996, effectively had universal application of the equivalent of fair value for all non-insurance (or reinsurance) assets of life insurers and general insurers (which encompasses a very diverse range of asset types). In that time, verifiability of the fair value of asset values has not been a significant issue in the success, failure or reporting of insurers.

It is the relevance of the measurement basis and the reliability of the overall financial result which should be paramount. Replacing a fair but unverifiable measurement with a verifiable but misleading value is not consistent with this principle. If there is some uncertainty over the reliability of a particular measure then the correct response is to disclose that uncertainty.

Ultimately, the relevance and integrity of a company's financial statements requires that the basis of measurement be chosen to ensure consistency between the measurement of assets and liabilities. The fact that a value, determined in accordance with a particular measurement basis, does not satisfy a strict definition of "verifiable" should not override this fundamental requirement. Strict application of the verifiability requirements detracts from relevance and risks imposing inconsistency of measurement and hence meaningless volatility in financial statements.

3.3 Consistency of measurement of assets and liabilities

Paragraph BC2 notes that the fair value option was originally introduced to avoid inconsistencies and anomalies that can arise under a mixed measurement model. This was possible, not so much because of its inherent measurement qualities, but because of its universal application. Only by having at least one measurement basis that can be universally applied is it possible to maximise the possibility of consistent measurement bases being used for both assets and liabilities in a particular circumstance.

If there are global circumstances where application of the fair value option is clearly never appropriate, then a specifically targeted prohibition, within a framework where fair value is otherwise generally available, would be reasonable. However, removing the universal application of the fair value option and defining only those situations where fair value clearly is appropriate appears to defeat the very purpose for which the fair value option was originally introduced. It must inevitably lead to circumstances where a common measurement basis cannot be achieved for assets backing a particular liability, or for liabilities that may be backed by a particular asset.

Under the Exposure Draft, if an asset or liability does not satisfy the conditions of the amended paragraph 9 then fair value may not be used, even if it is necessary to achieve relevance and consistency.

Despite all the best intentions of the IASB to accommodate legitimate uses of the fair value option, it will be virtually impossible to develop a form of words, short of allowing universal application, which addresses all the potential circumstances across all countries and all industries where the fair value option needs to be used, to ensure relevance and consistency of measurement.

This again points towards the alternative solution described in Section 2.

3.4 Own creditworthiness

The problem of own creditworthiness is frequently raised as an inherent evil of fair value measurement. Own creditworthiness is a difficult issue. However, rejecting legitimate fair value measurement of assets and liabilities because of concern over the impact of own creditworthiness on liability values is excessive and unnecessary.

To the extent that the problem exists it would be better addressed directly by other means. For example, allowance for reduction in own creditworthiness in the measurement of liabilities should be restricted to circumstances where the entity can freely and legitimately trade in the liability instrument itself and issue new instruments at its current rating, and so take appropriate advantage of its current own creditworthiness.

Indirectly addressing the problem, by constraining general use of the fair value option, must inevitably have other adverse consequences, and is not an appropriate solution.

3.5 Specific categories of assets that can be classified as at fair value through P&L

Individually, it is appropriate to permit fair value measurement through profit and loss for each of the categories of assets and liabilities listed in paragraph 9(b). However, as noted earlier, the 9(b) list can never be a complete list, which adequately covers all legitimate circumstances.

However, assuming that this prescriptive approach prevails, there are areas where the particular categories are overly restrictive.

1. Category (ii) requires liability cash flows to be "contractually linked" to "specified" assets. Use of these terms does not adequately reflect the way in which many contracts operate, and as a result, the category may not capture the full extent of circumstances that it is appropriate to include. For example, linkage is more commonly to a pool of assets, the composition of which may change from time to time. Also, for practical purposes, the linkage may not be perfect at all times (e.g. from time to time a proxy value, such as a market index, may be used to derive unit prices between formal asset valuations).

   Furthermore, the category only covers the liability side of such "contractual linkages". There may be liabilities that are already fair valued, but where not all the assets can be fair valued. The category needs to cover all assets and all liabilities in such circumstances.

   Finally, the concession requires both the assets and the liabilities to be literally fair valued. Thus circumstances (such as may arise with some linked life insurance business) where liabilities are measured on a market consistent basis, but not literally at fair value, will be excluded.

2. Category (iii) requires the movement in the fair value of the asset or liability to "substantially offset" the movement in the fair value of another asset or liability. It is not clear to what extent this test must apply. For example, annuity products would often be prudently matched to corporate debt assets. Changes in interest rates therefore produce movements in the value of the assets and liabilities that effectively offset each other. However, the offset is not perfect:

   - The assets may not exactly replicate the liability, so that a change in interest rates may still produce a profit or a loss.
   - The term of the liability may extend beyond the longest available debt assets.
   - Changes affecting the value of the liabilities, such as future expense assumptions, may not result in any offsetting change in the value of the assets.
   - Similarly, changes in the value of the assets, such as a re-rating or default, may not result in an offsetting movement in the value of the liabilities.

   Furthermore, while it may be prudent to adopt a matched asset strategy, entities may be free to mismatch if they so choose. It would still be preferable for the assets and liabilities to be consistently measured in such circumstances, with the impact of the mismatch appropriately reflected in profit or loss. However, this might not be possible if the assets cannot be fair valued because of the absence of a "substantial offset".

   Finally, as with category (ii), the concession only applies if both assets and liabilities are literally fair valued. Again, there may be circumstances (such as may arise with lifetime annuities and investment account products) where liabilities that are measured on a market consistent basis, but not necessarily at fair value, are excluded.

3. According to paragraph BC15, category (iv) is intended to cover some of the remaining gaps arising under categories (ii) and (iii) in respect of life insurers and unit trusts. However, the solution (of allowing the fair value option to be used in respect of any financial asset other than a loan or receivable) still does not fully work.

   Firstly, loans and receivables may include legitimate fixed interest assets, albeit that they are unlisted, that are appropriately included in a portfolio of assets backing particular liabilities. The explicit exclusion of such assets under (iv) could therefore result in different parts of the one asset portfolio being measured on different bases.

   A similar inconsistency could also arise where an asset portfolio is in some way geared, or where capital is provided by way of subordinated debt. Again, the debt liability, not being a financial asset, and not falling under any of the other categories, would not be fair valued, even though other assets and capital items are.

   In any case, the concession is still potentially undermined by the verifiability requirement which overrides it.

4. Reference is made in (v) to other standards. The scope of this concession is not clear. In particular, if national standards such as those issued by the AASB in respect of life insurance and general insurance constitute “another Standard” then many of the problems created by these proposals might be overcome. Alternatively, if paragraph 45 of IFRS 4 can be interpreted as allowing these constraints to be overridden then, again, the problems might be averted. However, neither of these possibilities are ones that we would want to rely on unless confirmed by the IASB.

3.6 Effective date and transition

It is unclear how implementation of the changes to IAS 39 from 1 January 2005 will fit with adoption in Australia from 1 January 2006. Mandatory adoption in Australia from 1 January 2005 is clearly not possible given:

- The problems identified with the proposals themselves, which will need to be resolved or addressed in some way,
- The flow on effect of the changes to other Australian standards, and
- The inadequate time for implementation between finalisation of the changes in late 2004 and their adoption on 1 January 2005.

There is also the added complication that, if the changes are adopted internationally on 1 January 2005 then, during 2005, Australian businesses will not technically comply with international standards. If the IASB were to defer adoption until 1 January 2006, with early adoption permitted if required to achieve acceptance within the European Union, then the timing difficulties for Australia would be overcome, albeit that the fundamental problems with the ED remain.

4. Responses to specific questions posed by IASB

> **Question 1**
>
> Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

No.

The proposals do not achieve their stated purpose, as we have outlined in Section 3 above.

See Section 2 for a proposed alternative.

> **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?

Yes.

Particular financial instruments affected include:

- Loans and receivables issued by the entity (i.e. non-quoted fixed interest assets) that are held to back certain products not covered by paragraphs 9(b)(ii) and 9(b)(iii). These are excluded under paragraph 9(b)(iv). Their fair value would be verifiable in accordance with paragraph 48B(ii).
- Non-insurance debt liabilities of insurers (e.g. subordinated debt). In the context where most other assets and liabilities of Australian insurers will be measured on a market consistent basis for both prudential and financial reporting purposes, it is appropriate that subordinated debt liabilities be similarly measured at fair value. However, they are excluded by not falling into any of the categories in paragraph 9(b).
- Unlisted equity assets supporting policy liabilities that are not subsidiaries, associates or joint ventures and where the value cannot be verified by reference to quoted prices or where there is a degree of subjectivity in the value.
- Financial instrument components of certain investment contracts (for example, term certain annuities). If the benefits are neither contractually linked to specific assets nor is there "substantial offsetting" of movements in the fair value of assets and

liabilities, then they will not satisfy paragraphs 9(b)(ii) or 9(b)(iii). As financial liabilities they do not satisfy paragraph 9(b)(iv) either.

The ability to apply fair value measurement to such instruments is not an issue of simplifying the application of IAS 39. Rather it is a fundamental issue of producing relevant and meaningful financial statements with consistent measurement of assets and liabilities.

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?

Limiting the use of the fair value cannot, fundamentally, address the concerns set out in paragraph BC9. See section 3 above. In summary:

- Concerns about the reliability of measurement should be addressed directly, not by imposing additional verifiability constraints on some assets or liabilities that do not apply to others. If the value of an asset or liability is inherently uncertain, no measurement technique can remove that uncertainty. The reliability of the overall financial result should not be sacrificed simply to achieve a semblance of certainty as to the value of a particular asset or liability.

- Consistent measurement of assets and liabilities ultimately requires universal application of the fair value option, not limitations on its use.

- The proposed limitations do not in any way address the concerns regarding own creditworthiness.

The proposed limitations are already more restrictive than is appropriate. They should not be extended any further.

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-BC18 of the Basis for Conclusions on this Exposure Draft. However, the Board recognises 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.

Is the proposal in paragraph 9(b)(i) appropriate? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?

The fair value option should be available as widely as possible.

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 recognised 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 recognised.

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 statements.

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 statements.

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?

These transitional arrangements appear appropriate in the circumstances.

Question 6

Do you have any other comments on the proposals?

Refer to Section 3.1 above. The IASB are seeking to solve a local problem by imposing global rules that create problems elsewhere. This is not appropriate. Rather the global framework should provide scope for national regulators and standard setters to address local problems, as recommended in Section 2.