Institute of
CHARTERED ACCOUNTANTS
of New Zealand

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

Dear Sandra

RE: IASB Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement – The Fair Value Option*

The Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand (ICANZ) is pleased to submit its comments on the *IASB Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option* (IASB ED). The FRSB sought the views of New Zealand (NZ) constituents on the IASB ED. Five submissions were received and forwarded on to the IASB. One of these was from a New Zealand regulator, two from banks and two from entities in the public sector. Four out of the five respondents (including the regulator and the banks) were against the proposals in the Exposure Draft.

The FRSB also does not agree with the proposals in the Exposure Draft to restrict the application of the fair value option in IAS 39. The FRSB's reasons are set out in its responses to the IASB's Invitation to Comment.

If you have any queries, or require clarification of any matters in this submission, please contact me or Joanna Yeoh (Joanna.yeoh@icanz.co.nz).

Yours sincerely

Joanna Perry

Joanna Perry
Chair, Financial Reporting Standards Board

IASB Question 1

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

The FRSB does not agree with the proposals in the IASB ED. The FRSB continues to support the inclusion of the fair value option in its current form in IAS 39 (2003).

The proposals in the Exposure Draft introduce a new measurement criterion, "verifiability", which is not found either in IAS 39 or in other IFRSs that allow the measurement of assets at fair value where such changes in fair values are recognised in profit or loss (e.g. IAS 40). In relation to the conceptual framework, the FRSB views verifiability as one of the components of reliability. However, the proposals in the IASB ED will elevate verifiability above neutrality and representational faithfulness, being the other components of reliability.

The FRSB:

- notes that the IASB ED is not proposing to introduce the 'verifiability' criterion in other instances in IAS 39, where the financial asset is measured at fair value (e.g. where a financial asset is classified as available for sale or when an entity classifies an financial asset or financial liability as held for trading);
- notes that the introduction of 'verifiability' will increase further the number of "rules" in IAS 39. This is less than desirable as IAS 39 is already being perceived as rules based rather than principles based; and
- agrees with the alternative views as expressed by the three dissenting Board members as set out in pages 28-29 of the IASB ED.

The FRSB does not agree with the introduction of verifiability as proposed in the IASB ED. Instead, the FRSB recommends the inclusion of verifiability in the IASB Framework as part of the IASB's review of the conceptual framework.

The FRSB supports the fair value option in its current form without the verifiability condition in IAS 39 (2003) as it simplifies the application of IAS 39 by mitigating some anomalies that result from different measurement options in the Standard. In particular, designating financial instruments in this way:

(a) eliminates the need for hedge accounting for hedges of fair value exposures when there are natural offsets and thereby eliminates the related burden of designating, tracking, and analysing hedge effectiveness.

(b) eliminates the burden of separating embedded derivatives.

(c) eliminates problems arising from a mixed-measurement model where assets are measured at fair value and related liabilities are measured at amortised cost. In particular, it eliminates the artificial volatility in profit or loss and equity that results when matched positions of assets and liabilities are not measured consistently.

(d) de-emphasises interpretive issues around what constitutes trading.

These were the arguments for permitting the fair value option in the IASB Exposure Draft of proposed amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* issued in June 2002. The FRSB believes that these arguments are still valid and argues that including the condition that the fair value must be verifiable, if financial assets or liabilities are designated at fair value through profit and loss, will substantially limit the benefits of introducing the fair value option in the first place.

In the case of embedded derivatives, the FRSB notes that entities may choose to include embedded derivatives in a financial instrument, that meet the conditions of paragraph 10, to ensure that the financial instrument can be measured at fair value as a result of the proposals in the IASB ED.

IASB 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?

Insurance

The FRSB considers the loss of the fair value option will have adverse consequences for financial reporting by insurers in NZ. Under current NZ GAAP, life insurers' measure all assets at net market value and general insurers measure all assets integral to insurance activities at net market value. The adoption of IFRSs in NZ represents a step backwards for our insurers as IFRSs do not permit that all assets for life insurers' or assets backing insurance liabilities for general insurers be measured at fair value. The FRSB intends:

- to require all assets (including financial assets under IAS 39) backing insurance liabilities to be measured at fair value where it is permitted under IFRSs in the New Zealand Financial Reporting Standards for life and general insurers; and
- to require financial assets and financial liabilities under the scope of IAS 39 arising from the non-insurance contracts issued by life and general insurers to be measured at fair value.

Under the IAS 39 (2003) requirements, the application of the fair value option will not lead to a mismatch of the valuation of the assets and liabilities affected by similar economic factors, thus these assets and liabilities are not measured at different times, using different measurement models, or reported in different financial statements. This is because the fair value option would allow the value changes in asset and liabilities, measured at fair value, to be reported in the same place, the profit and loss. The proposals in the IASB ED to restrict the fair value option will lead to a mismatch in the valuation between the insurer's assets and liabilities and increasing the volatility in the profit or loss as a result of using a mixed measurement model.

The FRSB notes with concern that the proposals in this exposure draft are inconsistent with IFRS 4 paragraph 45 which permits an insurer to reclassify some or all financial assets as 'at fair value through profit or loss. The reason being that the IASB "did not wish to create unnecessary barriers for those insurers that wish to move to a more consistent measurement basis that reflects fair values" (Paragraph BC145 Basis for Conclusions on IFRS 4 *Insurance Contracts)*.

The FRSB also has concerns with the practical implications of the "contractually linked" and "offsetting exposure" requirements proposed in the IASB ED. The FRSB notes that, in life insurance, the benefits under participating contracts and some investment account contracts are generally linked to the performance of an underlying pool of assets.[1] However, the relationship between these assets and liabilities may not be prescribed in the contracts. Under the proposals in the IASB ED, an insurer would be unable to use the fair value option where the relationship is not prescribed in the contracts for these linked assets and liabilities; thereby, creating artificial volatility in the profit and loss. The effect of the proposals in the IASB ED in respect of this scenario does not reduce the concern expressed in paragraph 3(b) of the IASB ED and instead increases the concern as the amendment to the fair value option will increase, rather than decrease, volatility in profit and loss caused by differing accounting treatments rather than economic factors.

Banks

In the case of banks, the proposed changes to the fair value option may mean that banks need to formally match certain assets, liabilities and derivatives, which will increase their compliance costs. The FRSB notes that NZ banks are unable to use the IAS 39 (2003) hedging requirements (including macro-hedging) for the majority of their asset and liabilities models/macro-hedges as these hedges do not meet conditions necessary to apply hedge accounting in IAS 39 (2003). Therefore, NZ banks are relying on the fair value option to allow them to neutralise the net impact on the profit and loss by measuring those financial assets and liabilities at fair value through the profit and loss that from a business perspective are managed within an economic fair value hedging relationship. The restrictions on the fair value option as proposed by the IASB ED will result in a mixed measurement model applied to the banks' financial assets and liabilities when in reality these are linked.

[1] As the IASB Insight states "The liability cash flows from those contracts are tied directly to the fair value of identified portfolios of assets. In effect, the contracts function much like a mutual fund or unit trust. By designating those liabilities and the linked assets as items at fair value through profit of loss, the insurer can eliminate this part of the mismatch problem. (April/May 2004)."

The "offsetting" criterion proposed in the IASB ED seems to be nearly as restrictive as the fair value hedging rules (and in some cases is more restrictive as at least the fair value hedge accounting model permits individual risks to be hedged). Banks in NZ understand that given the dealing model[2] and limit structure[3] that most NZ banks' use, NZ Banks are likely to fail the proposed "substantially offset" test. Moreover, repurchases of issued debt is generally insufficient to allow classification as "traded" items.

These above examples are from the Insurance and Banking industries', but the FRSB notes that these examples may be applicable to other industries.

Answers to Question 2(a)	Answers to Question 2(b)	Answers to Question 2(c)
	Loans and receivables	
Loans and receivables (specifically mortgage investment portfolios that may support insurance liabilities). Prohibited by requirement (b)(iv).	No. The market values would be estimated by looking at the interest rate spreads over government bonds at issue dates and applying these to the current yield curve (also constructed on a spread over govt).	Under NZ GAAP, an insurer currently measures these financial instruments at fair value. The proposals in the IASB ED lead to a mismatch between financial assets and the insurance liabilities they back. For example, a fixed interest loan which is not listed could match an insurance contract. Changes in interest rates may affect the value of the insurance contract but not the loan, which will be held at amortised cost.
	Annuities	
An annuity of certain life investment contracts. Prohibited by requirement (b)(iv).	No. The annuity would be valued using the current risk free yield curve.	This will be valued at amortised cost but it may be partially matched by listed fixed interest securities which are fair valued. An insurer currently measures these financial instruments at fair value. The proposals in the IASB ED lead to a mismatch between financial assets and the insurance liabilities they back.
	NZ Government Debt	
New Zealand Government's	Yes. This asset or	The potential benefits of adopting the fair

[2] Centralised treasury system used by most banks. Exposures of different business units within a bank are often transferred to a centralised treasury, which aggregates and/or offsets exposures within the bank. The aggregate risks of this system are then covered by external derivatives.

[3] As part of their management policies, banks typically set limits for their exposures to credit, market (currency, interest rate, equity and liquidity) and operational risk. For example, for interest rate risk, banks seek to match the repricing of assets and liabilities by changing the mix of assets and liabilities, buying and selling long term securities and through the use of derivatives such as interest rate swaps and forward rate agreements. Interest rate risk is managed centrally within the treasury using tools such as interest gap analysis and gap limits. Limits are set to ensure that interest earnings under different interest rate scenarios remain within certain percentages and that market values remain within a set percentage of capital.

NZD denominated debt and foreign-currency denominated debt. Prohibited by requirement (b)(iv).	liability is readily verifiable as they are actively traded by holders of debt.	value approach could include: o allowing entities to report all financial instruments on a consistent basis and thus avoid a mixed measurement approach. o allowing consistent treatment for all New Zealand government's domestic bonds across all the reporting entities that make up the Crown financial statements. o consistency with future plans for the internal management of New Zealand government's domestic bonds. o simplification of financial reporting systems if applied across all financial instruments.
Banking products		
Banking products, including certain loan receivables and deposits, which are often managed by a dealing room. Although some bank products such as wholesale funding do not in themselves meet the definition of held for trading (because they are not individually bought and sold for short-term profit), they are taken into consideration when reviewing the overall position in the trading book. As such, banks often consider them to be part of the trading book and currently report them at fair value. It is unclear how widely banks will be able to interpret the held for trading definition contained in paragraph 9(a) (ii) i.e. "a portfolio of identified financial instruments that are managed together".	No. Loans and deposits would be valued using discounted cash flows and therefore not meet the verifiability requirement.	The following are specific reasons explaining why banks are considering applying the fair value option in applying IAS 39 (2003): • There is an expectation that the impact of debt issue credit spreads will usually be relatively small and will be reported separately in any event. • Internal reporting of dealing room positions, for performance evaluation and risk assessment/compliance, tends to be on a fair value basis. Hence, using the fair value option for various wholesale liabilities would lead to a more consistent internal and external reporting regime. • Bank dealing rooms' are typically responsible for wholesale funding, managing liquidity and for external hedging. They normally manage these risk positions on a net/portfolio basis, utilising natural offsets where possible. Using fair value reporting for those "matching" liabilities better reflects this underlying risk management process. • To remove uncertainties around the interpretation of what constitutes "held for trading", and for the reasons below, we recommend that the use of fair value reporting for banks' funding not be restricted. Under the current fair value hedge accounting rules it is difficult and administratively burdensome to match and track an external hedge against underlying balance sheet items within the required 80% - 125% correlation range. It is possible banks may not adopt fair value hedge accounting because of the onerous systems requirements for banks, but will achieve the same accounting effect by

		adopting the fair value option: any net hedging ineffectiveness is correctly reported to the profit and loss under the fair value option. If, however, under the proposed amendment to the fair value option, an asset (or derivative hedge) is fair valued but the "matching" liability is not (or vice versa), then the profit and loss can be distorted and will not reflect economic reality.

IASB 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?

The FRSB agrees that the proposals contained in this IASB Exposure Draft address the concerns set out in paragraph BC9. However, the FRSB does not agree that the concerns expressed in paragraph BC9 are valid.

Arguments against the issue raised in paragraph 3(a)

In addition to the responses given in Question 1, the FRSB notes that the auditors will be scrutinising the valuation of these financial instruments to ensure that they have been appropriately valued. Moreover, the disclosures in IAS 32 (2003) allow the market to judge the appropriateness of the valuations of those instruments.

Arguments against the point raised in paragraph 3(b)

The FRSB notes that there is no way of knowing whether there will be an increase or decrease in volatility as a result of the use of the fair value option. The FRSB argues that if volatility is increased, this is simply a reflection of underlying economic volatility as a result of holding these financial instruments. The FRSB considers that artificial volatility will be introduced in cases of natural hedges and there will be an increase in volatility in profit and loss (e.g. for NZ insurers and banks) if the proposals in the Exposure Draft were to be adopted.

Arguments against the point raised in 3(c)

The FRSB considers that there is a relationship between creditworthiness and an entity's profit or loss. Put simply, a decline in an entity's creditworthiness will lead to a higher cost of borrowing and of capital thereby, affecting profit or loss. There is no reason why gains and losses from changes in an entity's creditworthiness shouldn't be recognised in profit and loss when gains and losses arising from changes in risk free rates are reported in the profit and loss.

Some of the "concerns" raised regarding the fair value option could be addressed if the profit and loss statement were to differentiate between transactions and remeasurements. We urge the IASB to give priority to the Reporting Comprehensive Income project given the potential benefits of adopting a comprehensive income approach.

The FRSB believes that the existing safeguards' in IAS 32 and 39 (2003) (for example. irrevocable designations, tainting rule and the required disclosures) are effective in ensuring that the fair value option is used appropriately.

IASB 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 IASB 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 IASB 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 FRSB agrees with this proposal subject to the comments made in response to question 1.

IASB Question 5

> Paragraph 103A proposes that an entity that adopted 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 at the beginning of the first period for which it adopts the amendments set out 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 assets 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?

The FRSB agrees with the proposals subject to the comments made earlier in response to question 1.

IASB Question 6

Do you have any other comments on the proposals?

The FRSB notes that the IMF will require countries to use fair values when reporting in accordance with its Government Financial Statistics (GFS) Framework. Adoption of the proposed changes in the IASB ED will increase the differences between IFRSs GFS, a situation not supported by the FRSB.