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Member of the Board of Management

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
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23 July 2004

Comment letter by Allianz Group on the Exposure Draft (ED) of amendments to IAS 39: The Fair Value Option

Dear Sir David,

Ladies and Gentlemen,

The Allianz Group appreciates the opportunity to comment on the ED of amendments to IAS 39: the Fair Value Option. In our comments on the ED of proposed amendments to IAS 32 and IAS 39 in 2002, we welcomed the introduction of the fair value option permitting a simpler application of IAS 39 particularly in those situations in which the mixed measurement model could result in reported volatility on positions that are economically matched. Therefore, we do not agree with the proposed limitations to the fair value option in the present ED and recommend to revert to the version of IAS 39 issued 17 December 2003. Furthermore, we regard the proposed restrictions to the fair value option as contravening the Board's intention to mitigate the asset liability mismatch for insurance companies by permitting in IFRS 4 to discount designated insurance liabilities at market interest rates. More specifically, we regard the following limitations as very problematic:

- The proposal to empower prudential supervisors to oversee the determination of the fair value of a financial asset or a financial liability by a company. The application and interpretation of fair value measurement by different national regulators cannot work and will cause difficulties in particular for international

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financial services groups without further harmonisation of supervisory law. Moreover, it would decrease comparability of financial statements for users.

- The interaction of the limitation to the fair value option with IFRS 4 and its impact on the mismatch issue. The Board intended to mitigate the asset liability mismatch, by permitting to discount insurance liabilities at market interest rates. In order to use this option in IFRS 4 insurers need to fair value assets held to back insurance liabilities at fair value through profit and loss. However, the introduction of the substantially offset criterion might impair the ability to create an asset liability match for insurance companies, as the insurance liabilities that are measured using discounting at market interest rates are not measured at "fair value". Furthermore, different durations of the assets and liabilities might lead to non-compliance with the substantially offset criterion. If the fair value option will be limited as proposed in the ED, consequential amendments are necessary in IFRS 4 that would allow to account for the discounted insurance liabilities through the OCI.

- The intention of the IASB to create a stable platform for 2005 is seriously flawed with the present exposure draft. The late changes to IAS 39 impair the implementation process for companies of IAS/IFRS becoming applicable 1 January 2005, given that the amendments to IAS 39 will not be finalised before 4th quarter 2004.

We outline below our responses to the questions raised by the IASB in the invitation to comment.

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

The Allianz Group does not agree with the proposals in the Exposure Draft to limit the application of the fair value option. From our perspective, the December 2003 version of IAS 39 permitted a simpler application of IAS 39, in particular in situations in which the mixed measurement model could result in reported volatility on positions that are economically matched. Therefore its application allowed the results of the business to be presented more consistently with the way it is managed and its risk management practices. Contrary to the ECB and other regulator's point of view, it is our view that an unlimited fair value option is necessary to reduce accounting volatility arising from the mixed measurement model. More specifically, we disagree with the following proposals:

- Substantially offset

The ED allows the use of the fair value option when the "exposure to changes in the fair value of the financial asset or financial liability (or portfolio of....) is substantially offset by the changes in the fair value of another financial asset or financial liability (or portfolio of...), including a derivative....". No further guidance is provided to explain how this rule should be applied in practice. We do not know whether 'substantially offset'

- will create even stronger requirements than the existing qualification for hedge accounting that is based on a prospective effectiveness within a range of 80-125 per cent;
- requires an offset across all risk factors present in a portfolio of financial assets and liabilities;
- is to be proven throughout a reporting period or for the reporting date only.

Against the background that the Board intended to simplify the application of IAS 39 on matched positions reflecting the risk management adequately, we regard this criterion as ill-defined, in particular with respect to its interaction with IFRS 4, where the Board intended to mitigate the insurers' accounting mismatch problem by allowing insurers to discount designated insurance liabilities with a current market interest rate. If interpreted too strictly, the 'substantially offset' criterion, might increase the mismatch problems for insurers.

- Verifiable

The ED allows that a financial asset or financial liability may be designated at fair value through profit and loss only if its fair value is verifiable. The Board concluded that the fair value is to be regarded as verifiable only if the variability in the range of reasonable fair value estimates is low. This criterion is met if several independent and knowledgeable observers were to estimate the fair value of a particular instrument in accordance with IAS 39, and would all arrive at approximately the same amount. The

Board considers the verifiability criterion a stricter test than the "reliably measured" criterion contained in para 46 (c) and 47 (a) of IAS 39.

We are concerned that the introduction of a second threshold will result in an undesirable dual standard for fair value measurement of financial instruments. Since IAS 39 requires financial instruments classified as trading instruments or available for sale assets to be measured at fair value without the need to satisfy the verifiability criterion, the impression arises that the fair value of the two categories might be less reliable than the fair value of items designated at fair value under the fair value option.

As we cannot see a qualitative difference between realiably measured and verifiable, we do not see the need for introducing another threshold for fair value determination. Furthermore, IAS 39 already contains considerable guidance on the determination of fair values of non-marketable financial instruments.

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 this 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 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?

- **Assets backing insurance liabilities:** We are concerned that a limitation of the fair value option would restrict the application of the asset liability match for insurance companies. The limitations to the fair value option contravene the option in IFRS 4 to discount insurance liabilities at market interest rates, which has been introduced in order to mitigate accounting mismatches. In particular, we suggest to delete the substantially offset criterion.

- **Loans and receivables:** Criterion (iv) of paragraph 9(b) proposes that the item shall be a financial asset other than one that meets the definition of loans and receivables. Insurance companies may back insurance liabilities with investments in assets that meet the definition of loans and receivables, which are not eligible for being designated as at fair value under the new proposals.

- **Amortising loans:** Financial institutions often originate loans that are not being repaid in full at maturity but are being amortised over their term. In order to fulfil the substantially offset criterion an entity would have to enter into an amortising swap to lay off the interest rate exposure. Financial institutions often hedge their loan portfolios on a macro basis with other non-amortising financial instruments. These entities would not be eligible for hedge accounting nor would they qualify for designating the loans as at fair value, because the loans do not contain embedded derivatives and the requirement to demonstrate a substantial offset on an ex ante basis may be difficult in practice.

- **Instruments hedged on a portfolio basis for which a substantial offset cannot be demonstrated at inception:** Financial institutions often sell several products to the same customer. For instance, a bank may have originated a ten-year Euro loan at a fixed rate, written a financial guarantee, entered in a loan commitment, and originated a two-year Dollar loan with a floating interest rate. The risks inherent in this portfolio are generally offset using a central treasury function. Since there is no direct link between the instruments that are contained in the baskets and the offsetting derivative and non-derivative financial instruments, a substantial offset cannot be demonstrated.

- **Credit spread:** Although we acknowledge that a credit spread is generally available at the time the liability is entered into, it might be burdensome, in many cases virtually impossible to track the changes in fair value that relate to changes in the credit spread (both entity- and industry-specific and, narrowing and widening of spreads). Given that the Board intends to apply an even stricter notion to the criterion of verifiability in relation to reliability, we are concerned that a huge number of financial instruments which otherwise would have passed the five conditions of draft IAS 39.9 would not qualify for use of the fair value option under the verifiability criterion.

Question 3

Do the proposals in the 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?

As explained above, we disagree with the limitations to the fair value option as proposed in this exposure draft. In our view the December 2003 version of IAS 39 is appropriate.

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 proposal to retain the fair value option for hybrid instruments does not create a difference to the December 2003 version of IAS 39. The issue was brought forward by the Board in the Basis for Conclusions as one of the driving factors, which led to the introduction of the fair value option. We favour retaining the option in full without limitations to certain hybrid instruments. This would also allow entities to implicitly fair value the embedded derivative in cases where IAS 39 prohibits separation of the embedded from the host contract.

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 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.*
- *(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 a financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?

As we have stated above, we do not favour a limitation of the fair value option, hence there would be no need for introducing additional transitional requirements.

Question 6

Do you have any other comments on the proposals?

We propose to facilitate the first time adoption of the fair value option for existing financial instruments either if the entity is unable to apply the fair value option at the beginning of 2005 to existing transactions due to operational and system constraints or if the hedging strategy is determined only after the inception of a financial instrument. This would allow entities to benefit from the fair value option.

Yours sincerely,

Helmut Perlet

Dr. Helmut Perlet

Member of the Board of Management of Allianz AG
and Chief Financial Officer